May 23, 2006

Directors' Report on the State of the Company's Affairs for the three months ended March 31, 2006

We respectfully present the Directors' Report on the state of affairs of "Bezeq" - The Israel Telecommunication Corp. Limited ("the Company") and the consolidated Group companies (the Company and the consolidated companies are hereinafter collectively referred to as "the Group") for the three-month period ended March 31, 2006 ("the Directors' Report").

The Directors' Report contains a review of its subject matter, in condensed form, and was prepared on the assumption that the reader can also refer to the Directors' Report for the year ended December 31, 2005.

The Group operates in four principal areas which are reported as business segments in the Company's consolidated reports, as follows:

1) **Fixed-line domestic communications**

2) **Cellular**

3) **International communications and internet services**

4) **Multi-channel television**

The Company has other areas of operation which are not material to the operations of the Group, and these are included in the financial statements as at March 31, 2006 of the Company as the "Others' business segment, which consists mainly of network end point services, customer center services and content services for the business segment.

1. Financial Position

A. The Group's assets as at March 31, 2006, amounted to approximately NIS 20.52 billion, compared with NIS 20.36 billion on March 31, 2005. Of these, approximately NIS 9.61 billion (approximately 47%) are fixed assets, compared with approximately NIS 10.50 billion (approximately 52%) on March 31, 2005.

In the fixed-line domestic communications segment there was a decrease in the net book value of the fixed assets resulting from the difference between depreciation expenses and the investment made in the reporting period. Conversely, cash balances and short-term investments increased compared with March 31, 2005.

In the cellular segment, cash balances, short-term investments and trade receivables increased. The increase was partially offset by a decrease in the inventory balance following the efficiency measures implemented by Pelephone, a decrease in the deferred tax balance due to utilization of past losses for tax purposes, and additionally a decrease in the net book value of the fixed assets.

In the international communications and internet services segment there was a decrease in total assets compared with March 31, 2005, due to a decrease in the cash balances and the net investment in fixed assets.

In the multi-channel television segment total assets decreased compared with March 31, 2005, which derived mainly from a decrease in the net investment in fixed assets. The decrease was offset by an increase in the broadcasting rights and the customer credit balance.

B. The shareholders' equity of the Group as at March 31, 2006 amounted to approximately NIS 7.08 billion, comprising approximately 35% of the total balance sheet, compared with approximately NIS 7.75 billion on March 31, 2005, which comprised approximately 38% of the total balance sheet. The decrease in shareholder' equity derived from the declaration of a dividend of NIS 1.2 billion during the reporting period. The decrease was moderated by the net earnings of the Group.

C. Total Group debt to financial institutions and debenture holders as at March 31, 2006 amounted to approximately NIS 8.73 billion, compared with approximately NIS 8.54 billion on March 31, 2005. The increase derived mainly from the increase in liabilities in the multi-channel television segment.

The Company's auditors drew attention to the financial condition of DBS, as mentioned in note 4, including DBS management's belief, based on its 2006 budget and on its business plan, that the prospects are good for arranging the financial resources it will need in the coming year.

D. Group balances in cash and short-term investments as at March 31, 2006 amounted to approximately NIS 4.73 billion compared with approximately NIS 3.13 billion on March 31, 2005. The source of the increase is the cash flow from current operations in the principal segments of the Group's business.

2. Results of Operations

A. Principal results

Net earnings for the first quarter of 2006 amounted to approximately NIS 226 million, compared with net earnings of approximately NIS 280 million in the corresponding period in 2005. The difference in the results derived mainly from changes in operating income of the Group companies, an increase in financing expenses and a decrease in the Company income (expenses) item. Earnings after financing expenses amounted to approximately NIS 329 million compared to NIS 311 million in the corresponding period.

Below are details of the changes in the results of the segments this year compared with the first quarter of 2005.

	For the three-month period ended March 31	
Segment	**2006 NIS millions**	**2005 NIS millions**
Fixed-line domestic communications	240	249
Cellular	139	121
International communications and internet services	33	21
Multi-channel television	(14)	(24)
Others	3	(1)

Earnings per share in the first quarter of 2006 amounted to NIS 0.087 per NIS 1 par value, compared with earnings of NIS 0.107 per share in the corresponding period in the prior year.

B. Revenues

Group revenues in the first quarter of 2006 amounted to approximately NIS 2.82 billion, compared with approximately NIS 2.77 billion in the corresponding period.

Revenues from fixed-line domestic communications decreased from approximately NIS 1.20 billion in the corresponding quarter to approximately NIS 1.17 billion in the first quarter of 2006 (a decrease of approximately 2.1%). Most of the decrease in the segment's revenues derived from tariff reductions in June 2005, a decrease in call traffic and in development work. The decrease in revenues was moderated by the ongoing growth in the number of customers who subscribe to high-speed internet service (ADSL). In their review letter, the auditors drew attention to the ongoing opening of the communications industry to competition and to tariff changes.

Revenues from the cellular telephone segment decreased from approximately NIS 1.11 billion in the corresponding quarter to approximately NIS 1.09 billion in the first quarter of 2006, resulting from a decrease in revenues from the sale of terminal equipment due smaller quantities of handsets sold. Conversely, revenues from Pelephone services and terminal equipment services increased due to an increase in the number of customers but was offset by a decrease in interconnect tariffs payable to other communications operators..

Revenues from the international communications and internet services segment increased from approximately NIS 199 million in the corresponding quarter to approximately NIS 245 million in the first quarter of 2006. The increase was due mainly to an increase in all areas and in global operation, except for a decrease in revenues from outgoing calls as traffic continues to decline and tariffs are eroded due to the expansion of competition since the corresponding quarter.

Revenues from the multi-channel television segment increased from approximately NIS 289 million in the corresponding quarter, to approximately NIS 332 million in the first quarter of 2006, as a result of the increase in the number of subscribers and in average revenue per customer.

C. <u>General and Operating Expenses</u>

The Group's general and operating expenses in the first quarter of 2006 amounted to approximately NIS 1.78 billion, compared with approximately NIS 1.76 billion in the corresponding period.

In the fixed-line domestic communications segment, general and operating expenses increased from approximately NIS 562 million in the corresponding quarter, to approximately NIS 577 million in the reporting period. Most of the increase is attributable to the increase in salary and vehicle maintenance expenses, and were moderated mainly by a decrease in general expenses and in expenses for materials and spare parts.

In the cellular segment, general and operating expenses decreased from approximately NIS 839 million in the corresponding quarter, to approximately NIS 779 in the reporting period, mainly due to lower costs of terminal equipment in parallel with a decrease in revenues from terminal equipment, as well as a one-time expense of NIS 30 million recorded in the corresponding quarter in respect of a transaction with the Accountant General in the amount of NIS 30 million.

In the international communications and internet services segment, general and operating expenses increased from approximately NIS 152 million in the corresponding quarter, to approximately NIS 190 million in the reporting period. The increase derived mainly from the increase in expenses for foreign managers deriving from a significant increase in traffic routed from one foreign operator to another foreign operator, with a corresponding increase in revenues from that service, and also from an increase in expenses attributed to internet customers and in advertising and marketing expenses.

The general and operating expenses of the multi-channel television segment increased from approximately NIS 235 million in the corresponding quarter, to approximately NIS 262 million in the reporting period, as a result of an increase in content expenses and lease fees for satellite segments.

D. <u>Depreciation</u>

The Group's depreciation expenses decreased from approximately NIS 578 in the corresponding quarter, to approximately NIS 572 million in the reporting period, resulting from a decrease in those expenses due to the cessation of depreciation of fixed assets and a smaller investment in new assets in the fixed-line domestic communications segment and in the international communications and internet services segment. Most of the decrease was offset by an increase in depreciation expenses in the cellular segment and in the multi-channel television segment..

E. <u>Royalties to the Government of Israel</u>

The Group's royalties expense in the first quarter of 2006 amounted to approximately NIS 63 million, compared with approximately NIS 66 million in the corresponding quarter,, resulting from a decrease in the royalties expense in the fixed-line domestic communications segment due to the deduction of the payment for interconnect fees.

F. <u>Operating income</u>

The Group's operating income in the first quarter of 2006 amounted to approximately NIS 401 million, compared with approximately NIS 366 million in the corresponding quarter, an increase of approximately NIS 35 million. The increase in operating income derives from the changes in the results of the segments described above in the revenue and expense items. These changes led to an increase in the profitability of the cellular segment and international and internet services segment, to improved operating results in the multi-channel television segment and to lower profitability in the fixed-line domestic communications segment.

G. <u>Financing expenses</u>

The Group's net financing expenses in the first quarter of 2006 amounted to approximately NIS 72 million, compared with approximately NIS 55 million in the corresponding quarter an increase of approximately NIS 17 million. The increase derived from an increase in the financing expenses of the multi-channel television segment and the fixed-line domestic communications segment.

Financing expenses were influenced by the overall increase in the Group's debt and by changes in exchange rates and the Consumer Price Index. The increase was partially offset by revenues from the capital market in respect of investments in marketable securities and revenues from deposits.

In the fixed-line domestic communications segment, financing expenses increased due to the rise in the euro exchange rate and in the percentage increase of the Index. The effect of the changes in the foreign currency and shekel rates on liabilities in this segment was partially offset by hedging transactions and investment in financial assets.

In the multi-channel television segment, financing expenses increased as a result of the increase in the Index and an increase in total loans.

H. <u>Other income</u>

Income in the first quarter of 2006 amounting to approximately NIS 9 million was recorded in the Group's Other income, net item, compared with an income of approximately NIS 88 million in the corresponding quarter.
The income in the corresponding quarter derived mainly from capital gains of approximately NIS 104 million, which was partially offset by an expense of approximately NIS 23 million in amortization of goodwill in respect of companies then consolidated for the first time in the financial statements (see Note 10 to the financial statements). Following publication of Accounting Standard 20 (Amended), effective from the current reporting period, the method of amortization of goodwill was terminated.

I. <u>Group's equity in earnings (losses) of affiliates</u>

The Group's equity in earnings of affiliates in the first quarter of 2006 amounted to approximately NIS 1 million, compared with approximately NIS 3 million in the corresponding quarter.

3. Liquidity and sources of financing

Consolidated cash flows generated by operating activities in the first quarter of 2006 amounted to approximately NIS 748 million, compared with approximately NIS 592 million in the corresponding quarter, an increase of approximately NIS 156 million. The source of the increase in cash flow is adjustments in revenues and expenses not involving cash flow, and was partially offset by a decrease in the earnings of the Group.

In the cellular segment, cash flows generated by operating activities increased compared with the corresponding quarter, due mainly to an increase in earnings and a decrease in the balance of trade receivables.

Cash flows generated by operating activities are the principal source of financing of the Group's investments, which during the reporting period amounted to NIS 349 million of which, *inter alia*, approximately NIS 306 million was in the development of communications infrastructures and approximately NIS 31 million was in short-term investments. In the corresponding period, net cash flows used for investments amounted to NIS 758 million.

During the reporting period, the Group repaid approximately NIS 313 million of debt, of which approximately NIS 164 million was on account of long-term loans and approximately NIS 149 million on account of debentures. In the reporting period the Group raised new debt in a total amount of approximately NIS 46 million by receipt of short-term bank credit. The net amount of debt repaid during the reporting period amounted to NIS 267 million, compared with the raising of new debt in the amount of NIS 259 million during the corresponding period.

The average monthly short-term credit during the first quarter of 2006 was approximately NIS 98 million. The average monthly long-term liabilities in the first quarter of 2006 was approximately NIS 8,726 million.

Working capital as at March 31, 2006, was positive and amounted to approximately NIS 1,247 million, similar to the working capital on March 31, 2005 which amounted to NIS 1,254 million. In the fixed-line domestic communications segment, improved working capital was offset by a decrease in the working capital of the other main companies in the Group.

4. Group involvement in the community and donations

The Group involves itself in community institutions and social organizations such as the education system in distressed areas and border areas, and additionally, employees volunteer is various community activities.

For example, about 500 Group employees hold "Exposure to Modern Communications" workshops for junior high school students, in a program launched in 2005 in cooperation with the Ministry of Education.

In another project, "Children and Parents Learn Computers and Internet", which has been in operation for about five years, Company employees tutor parents and children from disadvantaged groups on various aspects of computers and the internet. The cost of the project, in addition to the volunteer employees' time, is approximately NIS 250 thousand per year.

Pelephone does not have a binding policy on donations, and its management discusses each case on its merits. In the reporting period, Pelephone donated approximately NIS 15,000 to various causes.

Bezeq International is involved in ongoing activities for disadvantaged populations in Petach Tikva, the "adoption" of soldiers without families in Israel and the adoption of a fighting battalion, and also participates in environmental and educational projects. In the reporting period, Bezeq International expenses amounted to approximately NIS 120 thousand.

5. Details concerning market risk exposure and management thereof

A. Further to the description in the Directors' Report for 2005, as a result of hedging transactions against market risks relating to exposure to changes in exchange rates, the Group's financing expenses significantly decreased in the accounting period.

B. The report of positions in derivatives as at March 31, 2006, is not significantly different from the report as at December 31, 2005 (see note 6 to the financial statements).

C. The report on linkage bases as at March 31, 2006, is not significantly different from the report as at December 31, 2005.

Surplus monetary liabilities over monetary assets denominated in or linked to a foreign currency as at March 31, 2006, amounted to approximately NIS 2.5 billion in the Group. As a result of forward currency transactions, the net balance of foreign currency liabilities not hedged as aforesaid as at March 31, 2006, amounted to approximately NIS 155 million.

Surplus monetary liabilities over monetary assets linked to the CPI as at March 31, 2006 amounted to approximately NIS 4.2 billion in the Group. Due to this surplus, the Group incurred exceptional financing expenses resulting from the exceptional rise in the Consumer Price Index in the quarter.

In the main segments of the Group, the protection in place reduces exposure to the Index deriving from the computation of tax expenses on real earnings.

6. Miscellaneous

a. Peer review

The Company has agreed to transfer the material required for a sampling relating to a peer review, following the directive of the Securities Authority published on July 20, 2005. This consent is subject to the maintaining of the confidentiality of the data transferred, as well as guaranteeing prevention of conflict of interests of the reviewers.

b. Post balance sheet date events

On May 14, 2006, the Company received a partnership notice from the Eurofund 2000 venture capital fund, regarding a distribution from which the Company expects to receive an immediate payment of $5.7 million and to record a capital gain (before tax) of approximately NIS 25 million (see Note 11 to the financial statements).

We thank the managers and employees of the Group companies, and our shareholders.

Menachem Inbar Member of the Board (Chairman of the approval meeting)	Yacov Gelbard President & CEO