August 14, 2006

Directors' Report on the State of the Company's Affairs for the three months ended June 30, 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 June 30, 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 June 30, 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 June 30, 2006, amounted to approximately NIS 19.17 billion, compared with NIS 20.52 billion on June 30, 2005. Of these, approximately NIS 9.30 billion (approximately 48%) are fixed assets, compared with approximately NIS 10.33 billion (approximately 50%) on June 30, 2005.

The reduction stemmed mainly from the fixed-line domestic communications segment. In this segment, there was a decrease in total assets compared with the previous year, in the sum of approximately NIS 1.0 billion, mainly due to 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. In addition, there was a decrease in long-term investments and materials and spare parts.

In the cellular segment, assets decreased by approximately NIS 5.4 billion as at June 30, 2006, to a sum of approximately NIS 5.2 billion as at June 30, 2006. This reduction stemmed mainly from steps taken by Pelephone to reduce the inventory balance, 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. The reduction was offset by an increase in cash balances and short-term investments.

In the international communications and internet services segment there was a decrease in total assets compared with June 30, 2005, due to a decrease in cash balances and the net investment in fixed assets.

In the multi-channel television segment total assets decreased compared with June 30, 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 trade receivables balance.

B. Shareholders' equity as at June 30, 2006 amounted to approximately NIS 7.17 billion, comprising approximately 37% of the total balance sheet, compared with approximately NIS 7.77 billion on June 30, 2005, which comprised approximately 38% of the total balance sheet. The decrease in shareholders' equity derived from the distribution of a dividend of NIS 1.2 billion during the reporting period. The decrease was moderated by the net earnings of the Group.

Shareholders' equity as at June 30, 2005 was retroactively adjusted by restatement following recording of the Company's undertaking to its retirees (see Note 2D to the Financial Statements).

C. Total Group debt to financial institutions and debenture holders as at June 30, 2006 amounted to approximately NIS 8.50 billion, compared with approximately NIS 8.77 billion on June 30, 2005. The decrease derived mainly from a decrease in liabilities in the cellular segment and in the domestic fixed-line communications segment. The decrease was partially offset as a result of an 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(A), including DBS management's estimation, based on its updated forecasts 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 June 30, 2006 amounted to approximately NIS 3.73 billion compared with approximately NIS 3.62 billion on June 30, 2005. The source of the increase is the cash flow from current operations in the principal segments of the Group's business less the dividend distributed in the reporting period in the amount of NIS 1.2 billion.

2. Results of Operations

A. Principal results

Net earnings for the first half of 2006 amounted to approximately NIS 456 million, compared with net earnings of approximately NIS 444 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's other income (expenses), net item. Earnings after financing expenses amounted to approximately NIS 661 million compared to NIS 538 million in the corresponding period.

Below are details of the changes in the results of the segments this year as compared with the same period last year.

	For the six-month period ended June 30	
	2006 NIS millions	2005 NIS millions
Segment	**Income (loss)**	**Income (loss)**
Fixed-line domestic communications	495	455
Cellular	294	254
International communications and internet services	69	43
Multi-channel television	(17)	(50)
Others	6	1

Earnings per share in the first half of 2006 amounted to NIS 0.175 per NIS 1 par value share, compared with earnings of NIS 0.170 per share in the corresponding period in the prior year.

B. Revenues

Group revenues in the first half of 2006 amounted to approximately NIS 5.65 billion, compared with approximately NIS 5.50 billion in the corresponding period.

Revenues from fixed-line domestic communications decreased from approximately NIS 2.36 billion in the first half of 2005 to approximately NIS 2.33 billion in the first half of 2006 (a decrease of approximately 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 2.21 billion in the first half of 2005 to approximately NIS 2.19 billion in the reporting period, resulting from a decrease in revenues from the sale of terminal equipment. Conversely, revenues from Pelephone services increased due to an increase in 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 403 million in the first half of 2005 to approximately NIS 502 million in the reporting period. 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.

Revenues from the multi-channel television segment increased from approximately NIS 585 million in the first half of 2005, to approximately NIS 670 million in the reporting period, 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 half of 2006 amounted to approximately NIS 3.6 billion, compared with approximately NIS 3.5 billion in the corresponding period.

In the fixed-line domestic communications segment, general and operating expenses increased from approximately NIS 1,129 million in the first half of 2005, to approximately NIS 1,169 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 (mainly advertising) and in expenses for services and maintenance by sub-contractors.

In the cellular segment, general and operating expenses decreased from approximately NIS 1,655 million in the first half of 2005, to approximately NIS 1,548 million in the reporting period, mainly due to lower costs of terminal equipment in parallel with a decrease in revenues from the sale of terminal equipment, a decrease in the cost of spare parts and handsets, and a reduction in expenses for doubtful debts.

In the international communications and internet services segment, general and operating expenses increased from approximately NIS 307 million in the first half of 2005, to approximately NIS 389 million in the reporting period. The increase derived mainly from the increase in expenses for foreign administrations 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, advertising and marketing expenses, and customer recruitment.

The general and operating expenses of the multi-channel television segment increased from approximately NIS 476 million in the first half of 2005, to approximately NIS 516 million in the reporting period, as a result of an increase in content expenses and lease fees for satellite segments in parallel with an increase in revenues.

D. <u>Depreciation</u>

The Group’s depreciation expenses decreased from approximately NIS 1,161 million in the first half of 2005, to approximately NIS 1,144 million in the reporting period, due to the cessation of depreciation of fully depreciated fixed assets and a lower level of 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 due to the accelerated depreciation expenses of sites designated for dismantling as well as an increase in the multi-channel television segment.

E. Royalties to the Government of Israel

The Group's royalties expense amounted to approximately NIS 89 million, compared with approximately NIS 130 million in the corresponding period, mainly due to a decrease in the provision for royalties in the fixed-line domestic communications segment resulting from an agreement with the Ministry of Communications to end the past dispute up to and including 2002 (see Note 6A(6) to the financial statements) as well as a deduction of the payment for interconnect fees.

F. Operating income

The Group's operating income in the first half of 2006 amounted to approximately NIS 847 million, compared with approximately NIS 703 million in the corresponding period, an increase of approximately NIS 144 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 fixed line domestic communications segment, the cellular segment and international and internet services segment, and to improved operating results in the multi-channel television segment.

G. Financing expenses

The Group's net financing expenses in the first half of 2006 amounted to approximately NIS 186 million, compared with approximately NIS 165 million in the corresponding period, an increase of approximately NIS 21 million.

In the domestic fixed line communications segment, financing expenses increased due to an increase in the Consumer Price Index and a decrease in income from the capital market. This increase was offset by the cancellation of a provision resulting from an agreement with the Ministry of Communications to end the past dispute (see Note 6 (A) (6) to the financial statements).

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

In the cellular segment, financing expenses increased due to the rise in the percentage increase of the Consumer Price Index and a decrease in the Dollar exchange rate.

H. Other income

Other income, net in the first half of 2006 amounted to approximately NIS 31 million compared with income of approximately NIS 153 million in the corresponding quarter.

The income in the corresponding period derived mainly from capital gains of approximately NIS 104 million and a reduction in the provision for early retirement, in the sum of NIS 83 million (due to transition to an insurance company), which was partially offset by an expense of approximately NIS 47 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, standard amortization of goodwill was terminated.

I. Group's equity in earnings (losses) of affiliates

The Group's equity in earnings of affiliates in the first half of 2006 amounted to approximately NIS 2 million, compared with a loss of approximately NIS 11 million in the corresponding period.

3. Liquidity and sources of financing

Consolidated cash flows generated by operating activities in the first half of 2006 amounted to approximately NIS 1,439 million, compared with approximately NIS 1,270 million in the corresponding period, an increase of approximately NIS 169 million. The source of the increase in cash flow is mainly due to an increase in expenses and a decrease in revenues not involving cash flows as well as a decrease in asset items and an increase in liability items. The changes above were mainly in the cellular segment.

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 628 million of which, *inter alia*, approximately NIS 532 million was in the development of communications infrastructures and approximately NIS 76 million was in short-term investments. In the corresponding period, net cash flows used for investments amounted to NIS 1,092 million.

During the reporting period, the Group repaid approximately NIS 570 million of debt, of which approximately NIS 391 million was on account of long-term loans and approximately NIS 179 million on account of debentures. In the reporting period the Group raised new debt in a total amount of approximately NIS 56 million by receipt of short-term bank credit. The net amount of debt repaid during the reporting period amounted to NIS 514 million, compared with the raising of new debt in the amount of NIS 484 million during the corresponding period. In the fixed line domestic communications segment, a dividend in the amount of NIS 1,200 million was distributed on April 16, 2006 (see Note 1.C (6) to the financial statements).

The average monthly short-term credit during the first half of 2006 was approximately NIS 126 million. The average of monthly long-term liabilities in the first half of 2006 was approximately NIS 8,490 million.

Working capital as at June 30, 2006, was positive and amounted to approximately NIS 1,720 million, compared to positive working capital on June 30, 2005 of NIS 1,976 million. The decrease was due to a reduction in working capital in the fixed-line domestic communications segment, multi-channel television segment, and the international communications and internet segment, which was moderated by an increase in working capital in the cellular segment.

4. Comparison of results of Second Quarter 2006 with results of corresponding period last year

	For the period of three months ending June 30	
Segment	**2006** **NIS Millions** **Income (loss)**	**2005** **NIS Millions** **Income (loss)**
Fixed-line domestic communications	255	206
Cellular	155	133
International communications and internet services	36	22
Multi-channel television	(3)	(25)
Other	3	1

Revenues in the second quarter of 2006 increased by NIS 99 million as compared with the corresponding quarter last year.

General and operating expenses increased by NIS 39 million as compared with the corresponding quarter.

Other income, net decreased by approximately NIS 43 million as compared to the corresponding quarter – see Note 10 to the financial statements.

The quarterly results were influenced by the reduction in the provision for royalties and the decrease in financing expenses – see Note 6 (A) (6) to the financial statements.

The behavior of revenue and expense items and the causes of the differences between the quarters are similar to the explanations in the half-year results. The changes described above in the profit and loss items brought about a net profit of approximately NIS 230 million in the second quarter, compared with a net profit of approximately NIS 164 million in the corresponding quarter last year.

5. 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 held "Exposure to Modern Communications" workshops, in cooperation with the Ministry of Education, for junior high school students.

In the reporting period, Bezeq donated approximately NIS 248,000 to community institutions and organizations, the main ones being set out below:
In a project entitled "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.
Under a joint decision between management and the employee organization, Passover *Haggadot* were distributed to employees, which contained drawings by autistic children. The cost of the *Haggadot*, at approximately NIS 73,000, was donated to the Association for Children at High Risk.

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 37,000 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 donations amounted to approximately NIS 250,000.

The Company is taking part in the general efforts to assist those affected by the hostilities in the North. In this framework, it is acting for the sake of the welfare of residents in the confrontation areas by, *inter alia*, installing telephones and internet access in shelters.

6. 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 connected to such exposure significantly decreased.

B. The report of positions in derivatives as at June 30, 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 June 30, 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 June 30, 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 June 30, 2006, amounted to approximately NIS 119 million.

Surplus monetary liabilities over monetary assets linked to the CPI as at June 30, 2006 amounted to approximately NIS 3.9 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 period.

In the main segments of the Group, exposure to the Index is reduced since the computation of tax expenses is calculated based on real earnings.

7. Miscellaneous

Peer review

The Company has expressed its agreement 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.

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

Dov Weissglas Chairman of the Board	Yacov Gelbard President & CEO