# Bezeq - The Israel Telecommunication Corp. Ltd.

# Board of Directors' Report on the State of the Company's Affairs for the Period Ended March 31, 2015

bezeq

We hereby present the Board of Directors’ report on the state of affairs of “Bezeq” - The Israel Telecommunication Corporation Ltd. (“the Company”) and the consolidated Group companies (the Company and the consolidated companies, jointly - “the Group”), for the three months ended March 31, 2015 (“Quarter”).

The Board of Directors’ report includes a condensed review of its subject-matter, and was prepared assuming the Board of Directors' report of December 31, 2014 is also available to the reader.

On March 23, 2015, the Company assumed control of D.B.S. Satellite Services (1998) Ltd. ("DBS"). As of that date, DBS is consolidated in the Company's statements. Thus, the statement of financial position as of March 31, 2015 includes DBS's assets and liabilities. Due to the merger's proximity to the financial statements' date, the results of DBS's operations did not materially affect the Group's income statement for the three months ended March 31, 2015. These effects were included under the 'Share in the losses of investees accounted for under the equity method" item.

For more information, see Note 4.2 to the financial statements.

In its financial statements, the Group reports on four main operating segments:

1. **Domestic Fixed-Line Communications**
2. **Cellular Communications**
3. **International Communications, Internet and NEP Services**
4. **Multi-Channel Television**

It is noted that the Company’s financial statements also include an "Others" segment, which comprises mainly online content and commerce services (through "Walla") and contracted call center services (through “Bezeq Online”). The “Others” segment is immaterial at the Group level.

| | **1-3.2015** | **1-3.2014** | **Increase (decrease)** | |
|---|---|---|---|---|
| | **NIS millions** | **NIS millions** | **NIS millions** | **%** |
| Profit | **463** | 457 | 6 | 1.3 |
| EBITDA<br>(operating profit before depreciation and amortization) | **953** | 1,002 | (49) | (4.9) |

Profit in the present quarter, as compared to the same quarter last year, was mainly affected by lower revenues from Cellular Communications operations, which were entirely offset, mainly by a decrease in this segment's operating expenses, as well as by improvement in the Company's share in the results of DBS's operations.

## 1. The Board of Directors' explanations on the state of the Company's affairs, the results of its operations, equity, cash flows, and additional matters

### 1.1 Financial position

| | March 31, 2015 | March 31, 2014 | Increase (decrease) | | Explanation |
|---|---|---|---|---|---|
| | NIS millions | NIS millions | NIS millions | % | |
| Cash and current investments | **3,709** | 2,394 | 1,315 | 54.9 | This increase was mainly due to current investments in the Domestic Fixed-Line Communications segment, and by the first-time consolidation of NIS 299 million in cash from the Multi-Channel Television segment. |
| Current and non-current trade and other receivables | **3,102** | 3,410 | (308) | (9.0) | This decrease was mainly attributable to a decrease in trade receivables in the Cellular Communications segment, as a result of a decrease in revenues from handsets sold in 36 installments, and a decrease in revenues from services. The decrease was partially offset by the first-time consolidation of NIS 184 million in trade and other receivables from the Multi-Channel Television segment. |
| Other current assets | **102** | 150 | (48) | (32.0) | The decrease was mainly attributable to a reduction in held-for-sale assets in the Domestic Fixed-Line Communications segment. |
| Broadcasting rights | **460** | - | 460 | - | The balance was due to the first-time consolidation of broadcasting rights from the Multi-Channel Television segment. |
| Property, plant and equipment | **6,956** | 6,008 | 948 | 15.8 | The increase was mainly due to the first-time consolidation of NIS 801 million in property, plant and equipment from the Multi-Channel Television segment. |
| Goodwill and intangible assets | **4,503** | 2,039 | 2,464 | 120.8 | The increase was due to the first-time consolidation of DBS, mainly comprising goodwill, customer relations and brand value - for a total amount of NIS 2,722 million (see Note 4.2.4 to the financial statements). This increase was partially offset, mainly by the de-consolidation of Corel-Tell Ltd. in the second quarter of 2014. |
| Investments in investees as per the equity method | **29** | 1,032 | (1,003) | (97.2) | The decrease was due to the reversal of DBS's investment, presented as per the equity method. |
| Other non-current assets | **359** | 370 | (11) | (3.0) | |
| Total assets | **19,220** | 15,403 | 3,817 | 24.8 | |
| Debt to financial institutions and debenture holders | **11,912** | 9,717 | 2,195 | 22.6 | The increase was mainly due to the first-time consolidation of NIS 1,947 million in debt balances from the Multi-Channel Television segment (including recognition of surplus acquisition costs). The increase was also due to debentures issued and loans received in 2014 in the Domestic Fixed-Line Communications segment, partially offset by the repayment of debentures and loans in the Domestic Fixed-Line Communications and Cellular Communications segments. |

## 1.1 Financial Position (contd.)

| | March 31, 2015 | March 31, 2014 | Increase (decrease) | | Explanation |
|---|---|---|---|---|---|
| | NIS millions | NIS millions | NIS millions | % | |
| Liability towards Eurocom D.B.S. Ltd. | **781** | - | 781 | - | A commitment to pay the cash consideration and the contingent consideration for acquiring all of Eurocom D.B.S.'s holdings (see Notes 4.2.1 and 4.2.2). |
| Trade and other payables | **2,027** | 1,442 | 585 | 40.6 | The increase was mainly due to the first-time consolidation of NIS 632 million in trade and other payables from the Multi-Channel Television segment. |
| Dividends payable | **-** | 802 | (802) | (100) | Difference in timing of a semi-annual dividend's approval by the general meeting. |
| Other liabilities | **1,576** | 1,350 | 226 | 16.7 | The increase was mainly attributable to the Domestic Fixed-Line Communications Segment, due to derivatives and current tax liabilities. |
| Total liabilities | **16,296** | 13,311 | 2,985 | 22.4 | |
| Total equity | **2,924** | 2,092 | 832 | 39.8 | This increase in equity was mainly due to a change in the timing of a semi-annual dividend's approval by the general meeting.<br>Equity comprises 15.2% of the balance sheet total, as compared to 13.6% of the balance sheet total on December 31, 2014. |

## 1.2 Results of operations

### 1.2.1 Highlights

| | 1-3.2015 | 1-3.2014 | Increase (decrease) | | |
|---|---|---|---|---|---|
| | NIS millions | NIS millions | NIS millions | % | Explanation |
| Revenues | **2,174** | 2,311 | (137) | (5.9) | The decrease was due to lower revenues in the Cellular Communications segment, partially offset by an increase in revenues in the International Communications, Internet and NEP Services segment and the Domestic Fixed-Line Communications segment. |
| Depreciation and amortization expenses | **317** | 314 | 3 | 1.0 | |
| Salary expenses | **439** | 448 | (9) | (2.0) | The decrease was mainly attributable to downsizing in the Cellular Communications segment. |
| General and operating expenses | **799** | 869 | (70) | (8.1) | The decrease was mainly attributable to lower expenses in the Cellular Communications segment, partially offset by increased expenses in the International Communications, Internet and NEP Services segment. |
| Other operating income, net | **17** | 8 | 9 | 112.5 | |
| Operating profit | **636** | 688 | (52) | (7.6) | |
| Finance expenses, net | **37** | 42 | (5) | (11.9) | |
| Share in losses (earnings) of investees | **(16)** | 19 | (35) | - | The difference was due to improved results in the Multichannel Television segment. |
| Income tax | **152** | 170 | (18) | (10.6) | The decrease was due to lower profits before income tax in the Cellular Communications segment. |
| Profit for the period | **463** | 457 | 6 | 1.3 | |

1.2.2 Operating segments

**A Revenue and operating profit data, presented by the Group's operating segments:**

| | 1-3.2015 | | 1-3.2014 | |
|---|---|---|---|---|
| | **NIS millions** | **% of total revenues** | **NIS millions** | **% of total revenues** |
| **Revenues by operating segment** | | | | |
| Domestic Fixed-Line Communications | **1,113** | **51.2** | 1,077 | 46.6 |
| Cellular Communications | **727** | **33.4** | 917 | 39.7 |
| International Communications, Internet and NEP Services | **393** | **18.1** | 355 | 15.4 |
| Multi-Channel Television | **440** | **20.2** | 424 | 18.3 |
| Other and offsets* | **(499)** | **(22.9)** | (462) | (20.0) |
| Total | **2,174** | **100** | 2,311 | 100 |

| | 1-3.2015 | | 1-3.2014 | |
|---|---|---|---|---|
| | **NIS millions** | **% of segment revenues** | **NIS millions** | **% of segment revenues** |
| **Operating profit by segment** | | | | |
| Domestic Fixed-Line Communications | **547** | **49.1** | 504 | 46.8 |
| Cellular Communications | **32** | **4.4** | 126 | 13.7 |
| International Communications, Internet and NEP Services | **61** | **15.5** | 58 | 16.3 |
| Multi-Channel Television | **59** | **13.4** | 73 | 17.2 |
| Other and offsets* | **(63)** | **-** | (73) | - |
| Consolidated operating profit/ % of Group revenues | **636** | **29.3** | 688 | 29.8 |

(*) Offsets are mainly attributable to the Multi-Channel Television segment, included in the reporting period as an associate company.

1.2.2. Operating segments

### B Domestic Fixed-Line Communications Segment

| | 1-3.2015 | 1-3.2014 | Increase (decrease) | | |
|---|---|---|---|---|---|
| | NIS millions | NIS millions | NIS millions | % | Explanation |
| Fixed-line telephony | **403** | 426 | (23) | (5.4) | The decrease was mainly due to a reduction in ARPU. |
| Internet - infrastructure | **383** | 332 | 51 | 15.4 | The increase was mostly attributable to growth in the number of internet subscribers and higher average revenues per user. |
| Transmission, data communications and others | **327** | 319 | 8 | 2.5 | |
| Total revenues | **1,113** | 1,077 | 36 | 3.3 | |
| Depreciation and amortization | **176** | 168 | 8 | 4.8 | |
| Labor costs | **227** | 223 | 4 | 1.8 | |
| General and operating expenses | **180** | 190 | (10) | (5.3) | The decrease was mainly due to a reduction in building maintenance costs and call completion fees to telecom operators. |
| Other operating income, net | **17** | 8 | 9 | 112.5 | This increase was due to NIS 12 million in gains from assuming control of DBS. |
| Operating profit | **547** | 504 | 43 | 8.5 | |
| Finance expenses, net | **54** | 56 | (2) | (3.6) | |
| Income tax | **126** | 116 | 10 | 8.6 | |
| Segment profit | **367** | 332 | 35 | 10.5 | |

1.2.2 Operating segments

**C Cellular Communications segment**

| | 1-3.2015 | 1-3.2014 | Increase (decrease) | | |
|---|---|---|---|---|---|
| | NIS millions | NIS millions | NIS millions | % | Explanation |
| Services | **499** | 637 | (138) | (21.7) | The decrease was due to a NIS 52 million reduction in hosting services revenues, following termination of the contract with HOT Mobile in December 2014. The decrease was further due to a reduction in the number of subscribers, lower rates due to increased market competition, and migration of existing customers to cheaper bundles at current market prices, both of which lowered ARPU. |
| Terminal equipment sales | **228** | 280 | (52) | (18.6) | The decrease was mainly due to lower sales volumes. |
| Total revenues | **727** | 917 | (190) | (20.7) | |
| Depreciation and amortization | **104** | 106 | (2) | (1.9) | |
| Labor costs | **96** | 109 | (13) | (11.9) | The decrease was mainly attributable to downsizing due to streamlining efforts. |
| General and operating expenses | **495** | 576 | (81) | (14.1) | The decrease was mainly due to lower terminal equipment sales costs, following a decrease in the number of units sold, which was partially offset by an increase in costs following a change in the sales mix. There was also a decrease in advertising expenses. |
| Operating profit | **32** | 126 | (94) | (74.6) | |
| Finance income, net | **14** | 18 | (4) | (22.2) | The decrease in income was mainly due to a decrease in credit income from installment-based terminal equipment sales, and an increase in currency difference expenses following an increase in the USD exchange rate. These were partially offset by a decrease in interest expenses, due to a reduction in the average debt balance. |
| Income tax | **10** | 36 | (26) | (72.2) | The decrease was attributable to the reduction in income before taxes. |
| Segment profit | **36** | 108 | (72) | (66.7) | |

### 1.2.2 Operating segments

### D International Communications, Internet and NEP Services

| | 1-3.2015 | 1-3.2014 | Increase (decrease) | | |
|---|---|---|---|---|---|
| | NIS millions | NIS millions | NIS millions | % | Explanation |
| Revenues | **393** | 355 | 38 | 10.7 | The increase was attributable to greater revenues from enterprise communication solutions (ICT), higher internet revenues due to growth in the number of subscribers, higher revenues from call transfers between global communication carriers, and an increase in revenues from data communication services. The increase was partially offset by a reduction in revenues from outgoing calls, mainly due to ongoing competition with cellular operators. |
| Depreciation and amortization | **32** | 32 | - | - | |
| Labor costs | **77** | 75 | 2 | 2.7 | This increase was mainly attributable to an increase in the number of employees providing outsourced services in ICT operations. |
| General and operating expenses | **223** | 190 | 33 | 17.4 | The increase was due to an increase in ICT equipment costs, internet services, call transfers between global communication carriers, and data communication services, corresponding with the above revenues. |
| Operating profit | **61** | 58 | 3 | 5.2 | |
| Finance expenses, net | **1** | 2 | (1) | (50.0) | |
| Share in the earnings of associates | **-** | 1 | (1) | (100.0) | |
| Tax expenses | **16** | 15 | 1 | 6.7 | |
| Segment profit | **44** | 42 | 2 | 4.8 | |

1.2.2 Operating segments

### E Multi-Channel Television

| | 1-3.2015 | 1-3.2014 | Increase (decrease) | | |
|---|---|---|---|---|---|
| | NIS millions | NIS millions | NIS millions | % | Explanation |
| Revenues | **440** | 424 | 16 | 3.8 | This increase was mainly attributable to an increase in the average number of subscribers. |
| Depreciation and amortization | **76** | 70 | 6 | 8.6 | |
| Labor costs | **69** | 62 | 7 | 11.3 | |
| General and operating expenses | **236** | 219 | 17 | 7.8 | This increase was mainly due to an increase in utilized broadcasting rights, and content costs. |
| Operating profit | **59** | 73 | (14) | (19.2) | |
| Finance expenses (income), net | **(1)** | 18 | (19) | (105.6) | This decrease was mainly due to linkage differences on debentures due to a greater drop in the CPI in the present Quarter, as compared to the same quarter last year. |
| Finance expenses for shareholder loans, net | **63** | 89 | (26) | (29.2) | The decrease was mainly due to linkage differences. |
| Segment loss | **(3)** | (34) | 31 | (91.2) | |

## 1.3 Cash flow

| | 1-3.2015 NIS millions | 1-3.2014 NIS millions | Change NIS millions | % | Explanation |
|---|---|---|---|---|---|
| Net cash from operating activities | **961** | 1,043 | (82) | (7.9) | The decrease in net cash from operating activities was mainly due to the Domestic Fixed-Line Communications segment, as a result of changes in the segment's working capital structure. |
| Net cash used in investing activities | **(378)** | (497) | 119 | (23.9) | The decrease in net cash used in investing activities was due to NIS 299 million in cash balances recognized after assuming control of DBS. This decrease was partially offset, mainly by a net increase in the purchase of held-for-trade financial assets, and acquisition of property, plant and equipment in the Domestic Fixed-Line Communications segment. |
| Net cash used in financing activities | **(75)** | (107) | 32 | (29.9) | The decrease in net cash used in financing activities was mainly due to a decrease in debenture repayments in the Cellular Communications segment. |
| Increase in cash | **508** | 439 | 69 | 15.7 | |

<u>Average volume in the reporting period</u> (excluding DBS, which was consolidated for the first time):

Long-term liabilities (including current maturities) to financial institutions and debenture holders: NIS 10,026 million.

Supplier credit: NIS 648 million.

Short-term credit to customers: NIS 2,171 million.  Long-term credit to customers: NIS 525 million.

As of March 31, 2015, the Group had a working capital surplus of NIS 684 million, as compared to a working capital surplus of NIS 1,059 million on March 31, 2014. This decrease was due to a working capital deficit in the Multi-Channel Television segment, consolidated for the first time in the end of the present Quarter.

## 2. Market Risk - Exposure and Management

**2.1** Fair value sensitivity analysis data as of March 31, 2015 do not differ materially from sensitivity analysis data as of December 31, 2014, except for the effect of DBS's consolidation, which increased the Group's exposure to CPI changes by NIS 2 billion; exposure to changes in the real NIS-based interest rate - by NIS 2 billion; exposure to changes in the USD exchange rate - by NIS 1 billion; and exposure to changes in the USD-based interest rate - by NIS 0.8 billion.

**2.2** The linkage bases report as of March 31, 2015 does not differ materially from the report as of December 31, 2014, except for a NIS 1.9 billion increase in CPI-linked liabilities, mainly due to DBS's consolidation.

## 3. Aspects of Corporate Governance

### Disclosure concerning the financial statements' approval process

### 3.1 Committee

The Company's Financial Statements Review Committee is a separate committee which does not serve as the Audit Committee. The Committee comprises 4 members, as follows: Yitzhak Idelman, chairman (external director); Mordechai Keret (external director); Tali Simone (external director); and Dr. Yehoshua Rosenzweig (independent director). All Committee members have accounting and financial expertise. All Committee members have submitted a statement prior to their appointment. For more information concerning the directors serving on the Committee, see Chapter D of the Company's Periodic Report for 2014.

### 3.2 Financial statements approval process

A. The Financial Statements Review Committee discussed and finalized its recommendations to the Company's Board of Directors in its meetings of May 10, 2015, and May 17, 2015.

   The Committee's meeting on May 10, 2015, was attended by all Committee members and by the Deputy CEO and CFO, Mr. Dudu Mizrahi; Company Comptroller, Mr. Danny Oz; the Internal Auditor, Mr. Lior Segal; the Legal Counsel, Mr. Amir Nachlieli; Mr. Rami Nomkin - director; the external auditors; and other Company officers. In addition to the above persons, the Committee's meeting of May 17, 2015 was also attended by Company Secretary, Mrs. Linor Yochelman.

B. The Committee reviewed, inter alia, the assessments and estimates made in connection with the financial statements; internal controls over financial reporting; full and proper disclosure in the financial statements; and the accounting policies adopted on material matters.

C. The Committee submitted its recommendations to the Company's Board of Directors in writing on May 17, 2015.

   The Board of Directors discussed the Financial Statements Review Committee's recommendations and the financial statements on May 20, 2015.

D. The Company's Board of Directors believes that the Financial Statements Review Committee's recommendations were submitted a reasonable time (three days) prior to the Board meeting, taking into account the scope and complexity of these recommendations.

E. The Company's Board of Directors adopted the Financial Statements Review Committee's recommendations and resolved to approve the Company's financial statements for the first quarter of 2015.

# 4. Disclosure Concerning the Company's Financial Reporting

## 4.1 Disclosure of material valuations

The following table discloses a material valuation pursuant to Regulation 8B to the Securities Regulations (Periodic and Immediate Reports), 1970. The valuation is attached to the financial statements.

4.1.1 Valuation of Bezeq's investment in DBS:

| | |
|---|---|
| **Subject of valuation** | Value of Bezeq's investment in D.B.S. Satellite Services (1998) Ltd., in shares, share options, and various shareholder loans. The valuation was made as part of a Company transaction leading to Bezeq assuming control of DBS's shares. |
| **Date of valuation** | March 23, 2015; the valuation was signed May 19, 2015. |
| **Value prior to the valuation** | The carrying amount of the Company's investment in DBS - NIS 1,064 million. |
| **Value set in the valuation** | NIS 1,076 million - value of Bezeq's investment in DBS. |
| **Assessor's identity and profile** | Fahn Kanne Consulting Ltd. The valuation was made by a team headed by Mr. Shlomi Bartov, CPA, partner and CEO of Fahn Kanne Consulting. Mr. Bartov has extensive experience in consulting and supporting some of the largest companies in Israel.<br>Fahn Kanne Consulting is a subsidiary of Fahn Kanne & Co., a part of the Grant Thornton International Ltd. (GTIL) network, the special advisory services branch of the global Grant Thornton network specializing in spearheading international transactions, valuation and transaction consulting, global IPOs, executive consultancy and project financing.<br>The assessor has no dependence on the Company. |
| **Valuation model** | The valuation was conducted using the income approach, using the discounted cash flows (DCF) method. Value was assigned to share capital and shareholder debt based on the repayment order of the new shareholder loans and the extent of the shareholder's investments. |
| **Assumptions used in the valuation** | Discount rate - 8.5% (post-tax).<br>Permanent growth rate - 1%.<br>Scrap value of total value set in valuation - 80%. |

4.1.2 Purchase Price Allocation (PPA) Valuation:

| | |
|---|---|
| **Subject of valuation** | PPA upon assuming control of D.B.S. Satellite Services (1998) Ltd., by exercising the option to purchase 8.6% of the company's shares. |
| **Date of valuation** | March 23, 2015; the valuation was signed May 19, 2015. |
| **Value prior to the valuation** | N/A |
| **Value set in the valuation** | Brand value (before assigning deferred taxes) - NIS 347 million. Customer relations value (before assigning deferred taxes) - NIS 790 million. Goodwill (100%) (residual value) - NIS 841 million. |

| | |
|---|---|
| **Assessor's identity and profile** | See above table - Section 4.1.1. |
| **Valuation model** | Fair value of customer relations was appraised using the income approach, using the multi-period excess earnings method.<br>Fair value for the brand was appraised using the relief from royalties approach. |
| **Assumptions used in the valuation** | Customer relations - Discount rate - 8.5% (post-tax).<br>Brand - Discount rate - 9.5% (post-tax). |

**4.2** Due to the material nature of legal actions brought against the Group, which cannot yet be assessed or for which the Group cannot yet estimate its exposure, the auditors drew attention to these actions in their opinion concerning the financial statements.

### 4.3 Material events subsequent to the financial statements' date

For information on material events subsequent to the financial statements' date, see Note 13 to the financial statements.

## 5. Details of debt certificate series

Debentures (Series 5-8) are rated Aa2 Stable by Midroog Ltd. ("Midroog") and ilAA/Stable by Standard & Poor's Maalot Ltd. ("Maalot").

For current and historical ratings data for the debentures, see the Company's immediate report (amended) of April 21, 2015 (ref. no. 2015-01-004083) and its immediate report of August 13, 2014 (ref. no. 2015-01-133185) (Maalot), and its immediate reports of December 28, 2014 (ref. no. 2014-01-232224) and March 5, 2015 (ref. no. 2015-01-045085) (Midroog). The rating reports are included in this Board of Directors' Report by way of reference.

## 6. Miscellaneous

For information concerning the liabilities balances of the reporting corporation and those companies consolidated in its financial statements as of March 31, 2015, see the Company's reporting form on the MAGNA system, dated May 21, 2015.

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

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|---|---|
| Shaul Elovitch | Stella Handler |
| Chairman of the Board | CEO |

Signed: May 20, 2015