October 31, 2006

Directors' Report on the State of the Company's Affairs for the nine months ended September 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 nine-month period ended September 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 September 30, 2006 of the Company as the "Others" business segment, which consists mainly of network end point services and customer center services.

1. Financial Position

A. The Group's assets as at September 30, 2006, amounted to approximately NIS 18.54 billion, compared with NIS 20.65 billion on September 30, 2005. Of these, approximately NIS 8.96 billion (approximately 48%) are fixed assets, compared with approximately NIS 10.12 billion (approximately 49%) on September 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 amount of approximately NIS 1.1 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 cash balances, which has been moderated by an increase in short-term investments.

In the cellular segment, assets decreased from approximately NIS 5.6 billion as at September 30, 2005, to approximately NIS 4.9 billion as at September 30, 2006. This reduction stemmed mainly from utilizing deposits and short-term investments applied in distribution of a dividend and repayment of loans, and from a reduction in the depreciated cost of fixed assets. In addition, there was a decrease in the inventory balance as a result of a decrease in inventory costs and quantities, and a decrease in the deferred tax balance due to utilization of past losses for tax purposes.

In the international communications and internet services segment there was a decrease in total assets compared with September 30, 2005, mainly 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 September 30, 2005, which derived mainly from a decrease in the net investment in fixed assets. The decrease was moderated by an increase in the broadcasting rights and the trade receivables balance.

B. Shareholders' equity as at September 30, 2006, amounted to approximately NIS 7.41 billion, representing approximately 40% of the total balance sheet, compared with approximately NIS 7.87 billion on September 30, 2005, which represented 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 September 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 September 30, 2006 amounted to approximately NIS 7.60 billion, compared with approximately NIS 9.08 billion on September 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 alternative 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 September 30, 2006, amounted to approximately NIS 3.52 billion compared with approximately NIS 4.16 billion on September 30, 2005. The decrease derived from the dividend in the amount of NIS 1.2 billion distributed in the reporting period. In addition, in the cellular segment, deposits and investments in securities were utilized in order to repay loans. The decrease was set off due to cash flow from current operations in the principal sectors in which the Company operates.

2. Results of Operations

A. Principal results

Net earnings for the first nine months of 2006 amounted to approximately NIS 701 million, compared with net earnings of approximately NIS 547 million in the corresponding period in 2005. The increase in the net earnings derived mainly from an increase in operating income of the Group companies, set off by a decrease in other net revenues. Earnings after financing expenses amounted to approximately NIS 1,042 million compared to NIS 781 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 nine-month period ended September 30	
	2006	**2005**
	NIS millions	**NIS millions**
Segment	**Income (loss)**	**Income (loss)**
Fixed-line domestic communications	765	681
Cellular	458	384
International communications and internet services	102	69
Multi-channel television	(36)	(79)
Others	9	(2)

Earnings per share in the first nine months of 2006 amounted to NIS 0.269 per NIS 1 par value share, compared with earnings of NIS 0.210 per share in the corresponding period.

B. Revenues

Group revenues in the first nine months of 2006 amounted to approximately NIS 8.53 billion, compared with approximately NIS 8.34 billion in the corresponding period.

Revenues from fixed-line domestic communications decreased from approximately NIS 3.57 billion in the first nine months of 2005 to approximately NIS 3.51 billion in the first nine months of 2006 (a decrease of approximately 1.6%). Most of the decrease in the segment's revenues derived from tariff reductions in June 2005 and July 2006, 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 segment decreased from approximately NIS 3.35 billion in the first nine months of 2005 to approximately NIS 3.33 billion in the reporting period, resulting from a decrease in revenues from the sale of terminal equipment due to a decrease in the amount of handsets sold and updated, and a decrease in the prices of such handsets. Conversely, revenues from cellular services increased due to an increase in the number of customers and an increase in content revenues, less the effect of a decrease in interconnect tariffs.

Revenues from the international communications and internet services segment increased from approximately NIS 604 million in the first nine months of 2005 to approximately NIS 761 million in the reporting period. The increase was due mainly to an increase in all areas and an increase in the global operations, 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 896 million in the first nine months of 2005, to approximately NIS 1,009 million in the reporting period, as a result of the increase in the number of subscribers and in average revenue per customer.

C. General and Operating Expenses

The Group's general and operating expenses in the first nine months of 2006 amounted to approximately NIS 5.4 billion, compared with approximately NIS 5.3 billion in the corresponding period.

In the fixed-line domestic communications segment, general and operating expenses increased from approximately NIS 1,733 million in the first nine months of 2005, to approximately NIS 1,744 million in the reporting period. Most of the increase is attributable to the increase in salary and vehicle maintenance expenses, and were set off 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 2,506 million in the first nine months of 2005, to approximately NIS 2,368 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 laboratory repairs and a reduction in expenses for salaries, doubtful debts and distribution fees. The decrease was set off in part by an increase in the cost of call completion fees, content operation expenses and advertising and sales promotion costs.

In the international communications and internet services segment, general and operating expenses increased from approximately NIS 460 million in the first nine months of 2005, to approximately NIS 595 million in the reporting period. The increase derived mainly from the increase in global operations with a corresponding increase in revenues, and also from an increase in expenses attributed to internet customers, and customer recruitment expenses.

The general and operating expenses of the multi-channel television segment increased from approximately NIS 733 million in the first nine months of 2005, to approximately NIS 793 million in the reporting period, as a result of an increase in content expenses and lease fees for satellite segments.

D. Depreciation

The Group’s depreciation expenses decreased from approximately NIS 1,749 million in the first nine months of 2005, to approximately NIS 1,708 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. 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 126 million, compared with approximately NIS 195 million in the corresponding period, mainly due to a reduction in the rate of royalties by 0.5% as of January 1, 2006 (see Note 1C(1) to the financial statements), 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 7A(8) 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 nine months of 2006 amounted to approximately NIS 1,298 million, compared with approximately NIS 1,053 million in the corresponding period, an increase of approximately NIS 245 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 nine months of 2006 amounted to approximately NIS 257 million, compared with approximately NIS 272 million in the corresponding period, a decrease of approximately NIS 15 million.

The decrease originates in a reduction in financing costs in the mobile radio telephone sector, stemming from an erosion of CPI-linked loans and a reduction in the status of loans in the sector. The reduction was set off by an increase in financing costs in the multi-channel television sector.

In the domestic fixed line communications sector, financing expenses were similar to the corresponding period mainly due to a decrease in income from capital markets which was offset by cancellation of a provision relating to an agreement with the Ministry of Communications to end past disputes (see Note 7A(8) to the financial statements).

H. Other income

Other income, net in the first nine months of 2006 amounted to approximately NIS 54 million compared with income of approximately NIS 131 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 70 million in amortization of goodwill in respect of companies then consolidated for the first time in the financial statements (see Note 11 to the financial statements). Income in this period stemmed mainly from capital gains and a dividend received from a venture capital fund. Following publication of Accounting Standard 20 (Amended), effective from the current reporting period, standard amortization of goodwill was terminated.

3. Liquidity and sources of financing

Consolidated cash flows generated by operating activities in the first nine months of 2006 amounted to approximately NIS 2,304 million, compared with approximately NIS 1,802 million in the corresponding period, an increase of approximately NIS 502 million. The source of the increase in cash flow was mainly due to an increase in operating profit, revenues and expenses not involving cash flows and changes in asset and 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. During the reporting period cash flows from investing activities amounted to NIS 729 million compared with NIS 1,893 million in the corresponding period. The difference was mainly due to investments for the development of telecommunications infrastructures and short-term investments. In the Reporting Period, the Group invested approximately NIS 805 million for the development of telecommunications infrastructures and utilized approximately NIS 100 million of short-term investments, as compared with approximately NIS 1,331 million and NIS 717 million respectively, in the corresponding period.

During the reporting period, the Group repaid approximately NIS 1,410 million of debt, of which approximately NIS 1,175 million was on account of long-term loans and approximately NIS 236 million on account of debentures. In the reporting period the Group raised new debt in a total amount of approximately NIS 65 million by receipt of short-term bank credit. The net amount of debt repaid during the reporting period amounted to NIS 1,345 million, compared with the raising of new debt in the amount of NIS 725 million during the corresponding period. On April 16, 2006 a dividend in the amount of NIS 1,200 million was distributed (see Note 1.C (7) to the financial statements).

The average monthly short-term credit during the first nine months of 2006 was approximately NIS 131 million. The average of monthly long-term liabilities in the first half of 2006 was approximately NIS 8,154 million.

Working capital as at September 30, 2006, was positive and amounted to approximately NIS 655 million, compared to positive working capital on September 30, 2005 of NIS 1,774 million. The decrease was due to a reduction in working capital of all of the principal companies in the Group. The decrease stems mainly from the domestic fixed-line communications sector, due to an increase in current maturities of debentures and a decrease in cash and cash equivalents due to the dividend distribution.

4. Comparison of results of Third Quarter 2006 with results of corresponding quarter

	For the period of three months ending September 30	
Segment	**2006 NIS Millions Income (loss)**	**2005 NIS Millions Income (loss)**
Fixed-line domestic communications	270	225
Cellular	164	130
International communications and internet services	33	26
Multi-channel television	(18)	(29)
Other	3	(2)

Revenues in the third quarter of 2006 increased by approximately NIS 43 million as compared with the corresponding quarter.

General and operating expenses decreased by approximately NIS 5 million as compared with the corresponding quarter.

Royalty expenses decreased by approximately NIS 29 million as compared with the corresponding quarter, mainly due to a reduction in the rate of royalties (see Note 1C(1) to the financial statements).

In the corresponding quarter, tax expense of approximately NIS 45 million was recorded due to the change in tax rates and their effect on the Group’s deferred tax asset. This increased the effective tax rate on the Group’s earnings in the corresponding quarter as compared with the reporting period.

Other income, net increased by approximately NIS 45 million as compared to the corresponding quarter – see Note 11 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 results of the period. The changes described above in the profit and loss items brought about a net profit of approximately NIS 245 million in the third quarter, compared with a net profit of approximately NIS 103 million in the corresponding quarter.

5. <u>Group involvement in the community and donations</u>

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.

During the course of hostilities in the north of the country, the companies in the Group volunteered for a variety of activities for residents of the north, including, *inter alia*, connecting bomb shelters to the internet and to satellite television, free calls, renovation of bomb shelters and equipping them and providing service under fire to civilians and soldiers. In addition, employees made donations and distributed food, games and gifts to residents.

In the reporting period, Bezeq donated approximately NIS 1.4 million 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.

In the “Summer for the Community” project, implemented by the Company for the third year running, children of employees, aged 16-18, worked over the summer in medical institutions and community centers. The cost to the Company of this project was approximately NIS 1 million.

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 121,000 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 375,000.

6. Details concerning market risk exposure and management thereof

The person responsible for management of market risks at the Company from August 28, 2006 is the Acting CFO, Mr. Shay Ben-Yakar, who is also serving as Head of the Finance & Investments Department since 2004. For three years (2001-2004) he served as the CEO of DS Mutual Funds Management in DS Investment Management. Mr. Ben-Yakar has an MBA in finance.

A. Further to the description in the Directors' Report for 2005, hedging transactions against market risks relating to exposure to changes in exchange rates substantially reduced such exposure.

B. The report of positions in derivatives as at September 30, 2006, is not significantly different from the report as at December 31, 2005 (see Note 7B to the financial statements).

C. The report on linkage bases as at September 30, 2006, is not significantly different from the report as at December 31, 2005.

Surplus liabilities over monetary assets denominated in or linked to a foreign currency as at September 30, 2006, amounted to approximately NIS 1.9 billion in the Group. As a result of forward currency transactions, the net balance of foreign currency liabilities not hedged as aforesaid as at September 30, 2006, amounted to approximately NIS 90 million.

Surplus liabilities over monetary assets linked to the CPI as at September 30, 2006 amounted to approximately NIS 3.6 billion in the Group.

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	**Yacov Gelbard**
Chairman of the Board	**President & CEO**