November 11, 2003

Directors' Report on the State of the Company's Affairs for the period ended September 30, 2003

We respectfully 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 nine-month period ended September 30, 2003 (hereinafter: "the Directors' Report"). The Report was prepared in accordance with the Securities Regulations (Periodic and immediate reports), 5730-1970.

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, 2002.

The financial data in the Directors' Report are presented in adjusted shekels of September 2003.

1. Business Environment

During the period of the Directors' Report and the period immediately subsequent thereto, a number of events and changes took place in the state of the Group's affairs and business environment, the most noteworthy of which are the following:

A. In March 2003 the Committee for Regulating the Tariffs of the Company presented a report containing its recommendations. In July 2003 the ministers decided to adopt the recommendations with certain amendments, and on August 5, 2003 the Knesset Finance Committee approved the recommendations with certain amendments. The changes in tariffs, which took effect on September 1, 2003, and the update mechanism, appear in Note 1(b)(1) to the financial statements. The Company believes that the decrease in its tariffs is expected to have a materially adverse effect on its business results.

B. On May 15, 2003, a settlement agreement was signed between the Company and the Government of Israel on behalf of the State of Israel and the Israel Lands Administration, regulating the dispute between them regarding the rights of the Company in various real estate properties which were transferred to the Company when it commenced operations in 1984 under an asset transfer agreement signed between the Company and the State. For a description of the principal terms of the agreement, see Note 5 to the financial statements. The settlement agreement will take effect once authorized by the court. The Company's Management does not expect the agreement to have a material effect on the financial statements of the Company.

C. In May 2003 the Knesset enacted the Law for the Recovery of the Israeli Economy (Legislative amendments for achievement of the budgetary goals and the economic policy for the fiscal years 2003 and 2004), 5763-2003. The law includes, *inter alia*, amendments to the Communications Law (Telecommunications and broadcasts), 5742-1982 and to the Government Companies Law, 5735-1975, which could have a materially adverse effect on the activities of the Group. Among the amendments, and further to the recommendations of the committee appointed by the Minister of Communications to make detailed recommendations for the rules and policy of opening domestic fixed-line communications to competition in Israel, was an amendment regarding the grant of licenses to new domestic operators without imposing a universal services obligation, commencing in September 2004. The Ministry of Communications subsequently published a draft of the Communications Regulations concerning the conditions for receipt of licenses to provide domestic fixed-line telecommunications services. The Company submitted its position and remarks to the Ministry. In addition, the above mentioned law includes provisions relating to a reduction in public sector wages and an amendment to the Supervision of Insurance Business Law relating to old pension funds which are operating at a deficit. For the possible effects of this amendment on the Company's liabilities with respect to its early retirement program – see Note 6 to the financial statements.

D. On August 27, 2003 the Ministerial Committee for Privatization resolved to amend its resolution of August 27, 2000 (as amended several times after that date) in the matter of the privatization of the Company.

According to the above amendment – the State's holdings in the Company will be privatized by way of a private sale of 30% – 40% of the share capital of the Company (assuming full dilution), as will be determined by the Ministerial Committee for Privatization (instead of a sale of at least 50.01% of the shares of the Company as was determined in the original decision of the Ministerial Committee for Privatization). The sale will be accompanied by a raising of capital for the Company and the sale/s of the additional holdings (except for 1.01% of the issued share capital of the Company), by way of an offering/s to the public and/or during stock exchange trading and/or by means of a private placement of bundles of shares, alone or combined with raising capital for the Company, as the Government Companies Authority will decide together with the Accountant General at the Ministry of Finance. Following the amended decision to privatize the Company, the Company received a draft of the amendment to its general license which is intended to adapt the license, according to the notice of the Ministry of Communications, to the competitive environment in which the Company operates. The Company is currently involved in a hearing process on this matter and has submitted its remarks to the Ministry of Communications. In the opinion of the Company, the draft license does not meet the needs of the Company in the competitive environment in which it operates.

In addition, the Government Companies Authority submitted to the Company for its remarks, a draft of new articles of association for the Company, adapted to the provisions of the Companies Law, which includes cancellation and/or modification of some of the limiting conditions in the Company's Articles which are expected to take effect after the Company becomes a mixed company. After several amendments were inserted into the draft Articles, the Board of Directors of the Company decided to call a General Meeting to approve the new Articles, and authorised the Company Secretary to set its date. The Company also received the text of an amendment to the Telecommunications Order that includes adaptation of certain amendments which were made in the Communications Law.

E. On August 17, 2003, Mr. Amnon Dick took up his post as CEO of the Company.

The term of office of Adv. Miriam (Miki) Mazar as Chairperson of the Board of Directors of the Company, which was initially approved until June 30, 2003, was extended until the end of her term of office as a director of the Company.

2. <u>Details concerning exposure to and management of market risks</u>

<u>The officer responsible for managing market risk in the Company</u>

A. The Company officer responsible for managing market risk is its Chief Financial Officer, Mr. Ron Eilon. For details of his education and experience, see the periodic report Regulation 26A in for 2002.

B. Further to that described in the Directors' Report for the year 2002 and as a result of hedging transactions against market risks associated with exposure to fluctuations in exchange rates, the Group experienced no material interest expenses and generated no material interest income during the period of account, despite the material changes which occurred in the exchange rates of foreign currencies during the period.

C. The report on linkage bases and positions in derivatives as at September 30, 2003 does not differ significantly from that reported as at December 31, 2002.

D. The Group’s surplus monetary liabilities over monetary assets denominated in or linked to foreign currency as at September 30, 2003, amounted to approximately NIS 2.65 billion. As a result of forward currency transactions, as at September 30, 2003 there is no net balance of foreign currency liabilities not hedged by such forward transactions.

The Group’s surplus monetary liabilities over monetary assets that are linked to the CPI as at September 30, 2003, amounted to approximately NIS 0.87 billion.

3. Financial Position

A. The Group's assets as at September 30, 2003 amounted to approximately NIS 15.5 billion, compared with approximately NIS 17.03 billion on September 30, 2002. Of these, approximately NIS 9.18 billion (approximately 59.2%) were fixed assets, compared with approximately NIS 9.95 billion (approximately 58.4%) on September 30, 2002.

The decrease in total assets derived mainly from a decrease in investments and long-term debt and from a decrease in the depreciated cost of the fixed assets as a result of the difference between depreciation expenses and the investment made in the report period.

B. The Group's shareholders' equity as at September 30, 2003 amounted to approximately NIS 6.5 billion, representing approximately 42.2% of the total balance sheet, compared with approximately NIS 7.4 billion on September 30, 2002, which represented approximately 43.4% of the total balance sheet. The reduction in shareholder' equity was mainly due to the Group's net loss in 2002 and the distribution of a dividend in the report period. The decrease in shareholders' equity was partially offset by an issuance of shares made during the report period.

C. Total Group debt to financial institutions and debenture holders as at September 30, 2003 amounted to approximately NIS 5.6 billion, compared with approximately NIS 6.2 billion on September 30, 2002.

D. Group balances in cash and short-term investments as at September 30, 2003 amounted to approximately NIS 2.27 billion, compared with NIS 1.9 billion on September 30, 2002.

4. Results of Operations

A. Principal results

Net earnings for the first nine months of 2003 amounted to approximately NIS 1.8 million, compared with a net loss of approximately NIS 142.3 million in the corresponding period last year. The difference between the results was due mainly to a decrease in operating income and to the other expenses/income item in which an expense of NIS 382 million (before tax) was recorded in the corresponding period last year in connection with the Company's investment in convertible debentures of Pelephone Holding L.L.C.

Earnings per share in the first nine months of 2003 were NIS 0.001 per NIS 1 par value, compared with earnings of NIS 0.059 per share in the corresponding period last year.

B. Revenues

Group revenues in the first nine months of 2003 amounted to approximately NIS 6.04 billion, compared with approximately NIS 6.1 billion in the corresponding period last year. The decrease in revenues derives principally from the decrease in revenues from domestic fixed-line and cellular telephone communications.

Revenues from domestic fixed-line communications decreased as a result of decreased outputs and tariff erosion. Company revenues from cellular telephone communications decreased due to the decrease in interconnect fees, transmission revenues, royalties and collection fees. The decrease in the Group's revenues was moderated by an increase in the

Company's revenues from ADSL lines, an increase in revenues from Pelephone, Bezeq International and BezeqCall Communications, as well as by the first-time consolidation of the Goldnet Communications Services partnership.

C. Operating and general expenses

The Group's operating and general expenses in the first nine months of 2003 amounted to approximately NIS 3.37 billion, compared with approximately NIS 3.39 billion during the corresponding period in the prior year.

The operating and general expenses of the Group were influenced mainly by a decrease in expenses for building maintenance and international communications, which were offset mainly by an increase in cellular telephone and motor vehicles expenses. An increase in salaries charged to investments in fixed assets as described in Note 12 to the financial statements, further reduced the operating expenses.

D. Depreciation

The Group's depreciation expenses are decreasing as a result of the cessation of the depreciation charge on the Company's fixed assets and a decrease in investments in new assets.

E. Royalties to the Government of Israel

The Group's royalty expenses in the first nine months of 2003 amounted to approximately NIS 184 million, compared with approximately NIS 187 million during the corresponding period in the prior year. The source of the decrease is the decrease in the royalty percentage due on the revenues of Pelephone and the decrease in the Company's revenues.

F. Operating income

The Group's operating income in the first nine months of 2003 amounted to approximately NIS 857 million, compared with approximately NIS 810 million during the corresponding period in the prior year, an increase of approximately NIS 47 million. The increase in operating income results from the changes described above in the revenues and expenses items. These changes led to a transition to operating income at Pelephone and to improvement in the operating income of the Company.

G. Financing expenses

The Group's net financing expenses in the first nine months of 2003 amounted to approximately NIS 131 million, compared with approximately NIS 152 million during the corresponding period in the prior year. The increase is derived mainly from a decrease in the financing expenses of the Company due to the decrease in its monetary debt and an increase in revenues from the Company's financial investments. Most of this decrease was offset by the sharp increase in the financing expenses of Pelephone and Bezeq International.

H. Other expenses (income), net

The expenses in the first nine months of 2003 amounted to approximately NIS 321 million, of which approximately NIS 195 million are a provision in respect of a claim filed by employees in the matter of recognition of certain payments as wage components applicable to pension calculations – see Note 7.A.(14) to the financial statements, approximately NIS 52 million are a provision in respect of the Company's investments in Adanet for Business Group Ltd. – see Note 4(c) to the financial statements, and approximately NIS 36 million are a provision for impairment of the fixed asset used in the Inmarsat venture in the Company – see note 5(c). During the corresponding period in the prior year, a provision of NIS 382 million for impairment was included in connection with the Company's investment in debentures convertible to shares of Pelephone Holding L.L.C.

I. <u>Company equity in losses of affiliates</u>

The Company's equity in losses of affiliates decreased compared to the corresponding period in the prior year, due to the decrease in the Company's equity in the loses of D.B.S. Satellite Services and an improvement in the financial expenses of Pelephone.

5. Liquidity and sources of financing

Consolidated cash flows generated by operating activities in the first nine months of 2003 amounted to approximately NIS 1,985 million, compared with approximately NIS 1,829 million in the corresponding period in the prior year. The increase in consolidated cash flows was due mainly to an increase in the operating cash flows of Pelephone.

Cash flows generated by operating activities are the principal source of financing the Group's investments, and these were applied during the report period, *inter alia*, for the investment of approximately NIS 1,167 million in the development of communications infrastructures, approximately NIS 158 million in investee companies and approximately NIS 170 million in short-term deposits and investments. During the quarter, the Group repaid approximately NIS 927 million of debt, of which approximately NIS 415 million was on account of long-term loans, approximately NIS 180 million on account of debentures, and approximately NIS 332 million on account of short-term credit. In addition, the Company paid a dividend of approximately NIS 186 million. Conversely, the Group raised new debt in a total amount of approximately NIS 418 million in new long-term loans and approximately NIS 101 million in consideration of an issuance of shares.

The average monthly short-term credit during the period was approximately NIS 326 million. The average monthly long-term liabilities during the period were approximately NIS 5,285 million.

Working capital as at September 30, 2003 was positive and amounted to approximately NIS 542 million, compared with positive working capital of approximately NIS 819 million on September 30, 2002. The decrease in the Group's working capital derived mainly from an increase in the balance of current maturities of debentures and long-term loans and an increase in other current liabilities, which was offset mainly by a decrease in short-term credit, a decrease in short-term severance benefit liabilities and an increase in cash balances and short-term investments.

6. Comparison of the results of the third quarter of 2003 with those of the corresponding period in the prior year

Revenues in the third quarter of 2003 increased by approximately NIS 32 million compared with the corresponding quarter in the prior year, an increase of approximately 1.6%. Operating and general expenses were similar to those in the corresponding period in the prior year.

Operating income in the quarter increased by approximately NIS 53 million compared with the corresponding quarter in the prior year.

Financing expenses in the third quarter of 2003 decreased by approximately NIS 35 million compared with the corresponding period in the prior year.

The movement in the revenue and expense items and the reasons for the differences between the quarters are similar to the explanations for the changes in the results for the first nine months of 2003.

Other expenses, net in the third quarter of 2003 included, as noted, a provision of approximately NIS 195 in respect of claims of employees in the matter of recognition of certain payments as wage components applicable to pension calculations – see Note 7.A(14) to the financial statements, as well as a provision of approximately NIS 36 million in respect of impairment of the fixed assets used in the Inmarsat venture in the Company, and a provision of approximately NIS 22 million in respect of the Company's investments in Adanet Business Group Ltd., compared with the corresponding period in the prior year, in which an expense of NIS 382 million was recorded in connection with the Company's investment in convertible debentures.

The changes described above in the statement of operations items led to a net loss of approximately NIS 85 million in the third quarter, compared with a net loss of approximately NIS 338 million in the corresponding period in the prior year.

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

Adv. Miriam (Miki) Mazar	**Amnon Dick**
Chairperson of the Board	**CEO**