November 23, 2000

Directors' Report on the State of the Company's Affairs for the Nine Months ended September 30, 2000

We are pleased to 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 months ended September 30, 2000 (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 has been prepared assuming that the reader also has access to the Directors' Report of December 31, 1999.

The financial data in the Directors' Report are presented in adjusted shekels of September 2000.

1. The Business Environment

During the period of the Directors' Report and immediately following the date of the report, several events and changes occurred in the Group's affairs and its business environment, the most noteworthy of which are described below:

a) In February 1999, as part of the Arrangements Law, Section 50 of the Telecommunications Law, 5742-1982 was canceled. Section 50 granted the Company exclusivity in providing fixed national telecommunications services in a nationwide telephone network under the general license. The cancellation took effect on June 1, 1999, although the activities of the new operators in the domestic fixed telecommunications field will become possible only from the date on which the Ministry of Communications grants them a general license.

In October 2000 the Ministry of Communications published tenders for the provision of domestic communication services by means of a wireless access network to the homes of subscribers. The granting of licenses for providing fixed domestic communication services by means of the cable infrastructure is being delayed due to a dispute between the various Government entities, as explained in Note 1(b)(1)(d) to the financial statements.

The anticipated opening of fixed domestic communications services to competition and the granting of licenses for fixed domestic communication services by means of the cable infrastructure, in addition to the growing competition in cellular and international communications sectors, is expected to have a materially adverse effect on the Company's business results which cannot be estimated at this stage.

b) Pursuant to the decision of the Knesset Finance and Economics Committee of March 13, 2000, the Company's tariffs were lowered, effective May 1, 2000, by an average of approximately 2.43%, and a change was made in the method of charging for calls, principally by changing from charging by meter pulses to charging by duration (subject to a minimum tariff per call). In addition, a number of tariff baskets were offered, mainly for Internet users, which entail considerably lower tariffs.

c) Bezeq International ended the first nine months of 2000 with an operating loss and a net loss in a material amount, inter alia, as a result of the costs it bore due to the allocation process, the decrease in tariffs, and the rise in expenses relating to the Internet sector.

In October 2000 the report of the Ministry of Communications was received, expressing doubt as to the reliability of one of the main files conveyed to the Ministry in the allocation process. Bezeq International submitted its preliminary reservations about the report, and intends to submit its detailed comments in the near future. One of the competing operators approached the Ministry of Communications, demanding that it instruct that the dial code "00" be blocked to all telephone lines that were in the aforementioned file.

The Company, based on the assessment of Bezeq International, estimates that following changes in Bezeq International's business environment since the start of competition, there are likely to be additional changes in the field of international communications, inter alia, in tariffs, market share and traffic ratio. Furthermore, in 2002 licenses are supposed to be granted to additional companies for providing international telecommunications services. As a result, there may be a material adverse effect on the Group's financial results.

d) The representatives of the Company's workers demanded from the Government that before privatizing the Company and opening the communications market to full competition, an agreement will be signed concerning the retirement of employees, and that guarantees will be given by the State for fulfillment of obligations towards the employees.

As described in Note 5 to the financial statements, on September 4, 2000 a special collective agreement was signed for early retirement of another 1,770 workers. An additional special collective agreement was signed, extending the labor agreements currently in effect until December 31, 2006, and in which the workers' representatives undertook not to present further demands in connection with the privatization process and the opening of the communications market to competition.

e) At its meeting on August 27, 2000, the Ministerial Committee for Privatization decided to sell the State's holdings in the Company by way of a private placement which would be accompanied, in the initial stage, by raising capital for the Company. The placement will include shares comprising at least 50.1% of the Company's share capital. The Companies Authority was authorized to carry out the actions required for implementation of the decision, including actions listed in the decision. It was further decided that the placement process would end, if possible, within 9 to 12 months from the date of the decision. The Knesset Finance Committee approved the above decision of the Ministerial Committee on September 6, 2000. (As at the date of this Report, the conditions set by the Government decision for raising capital for the Company, have not yet been met.)

In its discussions with State representatives, the Company demanded a number of reliefs that would enable it to cope more effectively and with greater equality in the market in which it operates. These reliefs related principally to three areas - the Requirement to Publish Tenders Law, reliefs and greater flexibility on the subject of wages, and reliefs relating to the approval of certain transactions of the Company as a government company. At this stage, the Company has been granted the measure of flexibility it requested with regard to wages.

f) The intensifying competition in the cellular communications market and its effects on the increase in costs and on tariff erosion at Pelephone, as well as the effect of depreciation of the capitalized costs of subscriber acquisition, caused an operating loss at Pelephone in the reported period. In addition, ongoing investments in expansion of the CDMA system increased Pelephone's finance expenses. Due to the cumulative effects of the above factors, Pelephone ended the period with a net loss.

In September 2000 the Ministry of Communications promulgated regulations (effective from 1.10.2000), in connection with incoming call tariffs in the cellular network. Under the new regulations, incoming call tariffs will be gradually reduced between October 2000 and January 2003. The management of Pelephone estimates that the new regulation is liable to have a material effect on the future profitability of Pelephone. Pelephone has petitioned the Supreme Court for cancellation of the regulation.

Concerning the intention of the Company to exercise its right of first refusal to purchase an additional 50% of the share capital of Pelephone, see Note 4 to the financial statements.

g) DBS Satellite Services (1998) Ltd. (hereinafter: "DBS") started to provide satellite broadcasting services in the third quarter of 2000. In so doing, DBS accumulated losses in which the Company's equity as at September 30, 2000 amounts to approximately NIS 117 million, of which approximately NIS 92 million were incurred during the reported period. Following notification by a shareholder who holds 15% of the share capital of DBS of her intention to sell her shares to a third party, the Company announced that it wishes to exercise a right of first refusal to buy a proportional part of those shares. Concurrently, the Company applied for the relevant regulatory approvals.

h) Following discussions between the Company and the Ministry of Communications concerning the provision by the Company of broadband communications services using ADSL technology, on November 6, 2000, the Ministry approved the service portfolio subject to the conditions set out in the approval. The Company is continuing its preparations for providing the service to the general public, and has entered into agreements with suppliers for purchase of equipment, at considerable cost.

i) As part of the implementation of its strategic plan and preparation for the imminent competition, the Company has exercised options to purchase some 6.25% of the share capital of Accent Technologies Ltd. (formerly A.R.M.T. Communications Multimedia Ltd.), which provides broadband multimedia solutions; increased its holding in the Goldnet partnership (Bezeq Gold) to 49% (subject to final approval of the Ministry of Communications for the change in the ownership structure of Goldnet); started investing in the field of call center services which, pursuant to the decision of the Ministry of Communications and Government approval, will be provided through a specially established subsidiary, and has made investments in venture capital funds which invest, inter alia, in the communications sector. In addition, Bezeq International has increased its holdings in Walla! Communications Ltd. to 38.5% of the share capital.

j) In July 2000, the Knesset enacted the Employment of Workers by Personnel Contractors (Amendment) Law, 5760-2000. The law stipulates, inter alia, that workers of personnel contractors who are actively employed by an employer for a period exceeding nine consecutive months, will be considered to be actual employees of the employer. The Group's companies employ a significant number of workers of personnel contractors, and the Company is making preparations to absorb some of them as its employees. The Company is unable to estimate, at this stage, what effect the above law might have on the Group.

k) On June 30, 1999, an amendment was made to the general license of the Company, stipulating an arrangement which forbids the Company to appoint one of its employees as a director on its behalf in a subsidiary, if in that capacity he might have access to "commercial information" (as defined in the amendment to the license) about licensees who are in competition with that subsidiary, the use of which by the subsidiary is liable to harm the competition between them. In addition, in the said amendment, the provision which limits the Company in the appointment of both the Chairman of the Board of the subsidiary and the majority of the directors in the subsidiary who are appointed on behalf of the Company from among the Company's directors or from among its employees, was frozen for one year. The Company approached the Ministry of Communications, requesting cancellation of the above restriction or, alternatively, extension of the freeze for an additional period. The freeze was recently extended until June 30, 2001.

A draft of the main terms of the general license designed for the winners of the tender, was added to the documents of the tender for providing domestic communication services by means of a wireless access network, published by the Ministry of Communications in October 2000. It is possible that the principles laid down in this draft will in the future constitute the basis for a new license that will replace the present license of the Company. The Company has submitted its reservations on the draft license to the Ministry of Communications.

l) On July 6, 2000 the Board of Directors of the Company elected Board member Mr. Ido Dissentshik as Chairman of the Board. The Committee for Examining Appointments in the Public Sector approved the appointment.

2. Details concerning exposure to and management of market risks

Further to that described in the Directors' Report for 1999, as a result of hedging transactions against market risks relating to exposure to changes in the exchange rate, the Company incurred additional interest expenses during the reported period. In addition, finance expenses were influenced by real exchange rate differentials in periods when the protection of surplus foreign currency liabilities was not comprehensive. Due to these factors, the Company's finance expenses increased in the reported period by approximately NIS 58 million.

3. Financial Position

a. The Group's assets as at September 30, 2000 amount to approximately NIS 17.17 billion, compared with NIS 17.53 billion as at September 30, 1999. Of these, approximately NIS 11.85 billion (approximately 68.9%) are fixed assets, compared with approximately NIS 12.94 billion (73.8%) at September 30, 1999. The decrease in total assets derived mainly from the decrease in the depreciated cost of the fixed assets caused by the differential between depreciation expenses and the investment made in the reported period.

b. The Group's shareholders' equity as at September 30, 2000 amounted to approximately NIS 6.81 billion, which comprise 39.6% of the total balance sheet, compared with approximately NIS 7.24 billion on September 30, 1999, which comprised approximately 41.3% of the total balance sheet. The decrease in shareholders' equity derived from the net loss for the period, which was partially offset by the conversion of convertible debentures to capital.

c. Total Group debt to financial institutions, to the holders of its debentures and to others as at September 30, 2000 amounted to approximately NIS 6.71 billion, compared with approximately NIS 7.16 billion on September 30, 1999. The data relating to debt as at September 30, 2000 do not include convertible debentures in the approximate amount of NIS 72 million, the conversion of which is probable.

d. The balances of the Group's cash and short-term investments as at September 30, 2000 amounted to approximately NIS 1.7 billion, compared with approximately NIS 1.33 billion at September 30, 1999.

e. The Group's surplus of monetary liabilities over monetary assets in foreign currency or linked thereto as at September 30, 2000 amounted to approximately NIS 2.2 billion.

This exposure adversely affects the Group's profitability due to the costs involved in hedging it. During the reported period, the Company carried out forward exchange contracts to reduce its exposure, and it intends to continue with this policy.

As at September 30, 2000, the net balance of foreign currency liabilities that are not hedged by such forward contracts amounted to approximately NIS 792 million.

f. The Group’s surplus of CPI-linked liabilities in excess of linked monetary assets as at September 30, 2000 amounted to approximately NIS 3.5 billion. This exposure is partly covered by a mechanism for updating tariffs, which takes into account price increases in the economy.

4. Results of Operations

a. Principal results

Net loss for the first nine months of 2000 amounted to approximately NIS 590 million, compared with net earnings of approximately NIS 54 million in the corresponding period last year.

The difference between the results was caused mainly by an increase of approximately NIS 918 million (before tax) in the other expenses / income item. In the first nine months of 2000 this item included an expense of approximately NIS 1,299 million (before tax), mainly for the change of organizational structure - approximately NIS 1,437 million, whereas in the first nine months of 1999 this item included mainly an expense of NIS 381 million (before tax) for the change in organizational structure. Removing the effect of the other expenses / income items in both periods, the net earnings for the first nine months of 2000 would be approximately NIS 241 million, compared with NIS 298 million in the corresponding period last year.

The increase of approximately NIS 123 million in operating income compared with the corresponding period last year, reflects an increase in the operating income of the Company, which was offset by deterioration in the business results of the Company's investee companies, mainly as a result of the intensification of competition as noted above in the description of the business environment.

Loss per share for the first nine months of 2000 amounted to NIS 0.729 per NIS 1 par value share, compared with earnings of NIS 0.074 per share in the corresponding period last year.

b. Revenues

Group revenues for the first nine months of 2000 amounted to approximately NIS 6.3 billion, compared with approximately NIS 6.77 billion in the corresponding period last year, a decrease of approximately 7%. The decline in revenues was primarily the result of the reduction in the Company's tariffs by an average of 8% as of April 1, 1999, which was reflected in a decline in revenues from domestic calls, interconnect fees from international operators and access fees from cellular operators, tempered by an increase in revenues from the fixed usage fees. In addition, as of January 1, 2000, the access fees paid to the Company by the international operators were lowered, and starting on May 1, 2000 the Company's tariffs were lowered by an average 2.43% and the tariff baskets which were offered included a further reduction. The decrease in revenues as a result of the lower tariffs was moderated by a rise in communications traffic in 2000, both in calls and in Internet traffic, and by the negative inflation in the period. Due to changes in the Company's settlement arrangements with the cellular communications companies, since March 2000 the Company's revenues do not include revenues for airtime. The decrease in the revenues of Bezeq International was primarily the result of lower prices and international settlement fees. The decrease in revenues was also moderated by a rise in the revenues of Pelephone.

c. Operating and general expenses

The Group's operating and general expenses for the first nine months of 2000 amounted to approximately NIS 3.18 billion, compared with approximately NIS 3.77 billion in the corresponding period last year. The decrease in total expenses resulted mainly from the change in the Company's settlement arrangements with the cellular communication companies starting in March 2000, following which the Company's expenses do not include airtime, as well as from a decline in expenses for sub-contractors, building maintenance general and wage expenses. The decrease in these items was offset by an increase in expenses for materials and spare parts at Pelephone.

d. Operating income

The Group's operating income for the first nine months of 2000 amounted to approximately NIS 865 million, compared with approximately NIS 742 million in the corresponding period last year, an increase of approximately NIS 123 million. The increase in operating income resulted from the changes described above in income and operating and general expenses items, which were partially offset by the decrease in the operating income of the Company's investee companies.

e. Financing expenses

The Group's financing expenses for the first nine months of 2000 amounted to approximately NIS 287 million, compared with approximately NIS 266 million in the corresponding period last year. There was a decrease in interest payments on CPI-linked liabilities, owing mainly to the repayment of the debenture to the Government. This decrease was offset by the increase in the finance expenses of the investee companies of the Company. The expense for hedging transactions against foreign-currency liabilities was greater than the group's profit from the increased appreciation of the shekel against the dollar in the reported period due to the differential generated between the interest premium included in the pricing of hedging transactions and the change in the CPI. In addition, the changes in the "known" index and the "actual" index influenced the Company's CPI-linked liabilities, and interest income from investments decreased as a result of the decline in the total investments of the Group.

f. Other income (expenses)

In the first nine months of 2000, an expense of approximately NIS 1,299 million (before tax) was recorded in this item, which consisted mainly of NIS 1,437 million expense for changing the organizational structure of the Company. Also recorded in this item were income of approximately NIS 99 million of compensation received from a billing software supplier, and income of approximately NIS 67 million relating to the Company's investment in India. This item also included the costs that Bezeq International bore in connection with allocation of subscribers. The above are compared with the first nine months of 1999, in which this item included an expense of approximately NIS 381 million (before tax) in respect of the restructuring plan.

5. Liquidity and sources of financing

Consolidated cash flows generated by operating activities during the first nine months of 2000 amounted to approximately NIS 2,405 million, compared with approximately NIS 1,928 million in the corresponding period last year. The increase in cash flows from current operations resulted primarily from an increase in expenses not involving cash flows, mainly a rise in net liabilities (after tax) due to the organizational restructuring. The increase was partially offset due to payment of the Company's obligations in connection with the restructuring plan.

The cash flow generated by operating activities is the principal source of the Group's financing, and is earmarked mainly for financing investments in developing telecommunications infrastructures, amounting to approximately NIS 1,558 million. Most of the remaining cash flow was used during the reported period to reduce the Group's financial debt and for payment of a dividend. The above included repayment during the period of approximately NIS 1,221 million in long-term loans, approximately NIS 209 million in debentures and approximately NIS 4693 million of government bonds - a total of approximately NIS 1,899 million. Conversely, the Group received long-term loans in a total amount of approximately NIS 699 million, issued debentures of approximately NIS 1,089 million, and received short-term bank credit of approximately NIS 414 million, so that approximately NIS 2,202 million was raised in total.
The monthly average of short-term credit for the period was approximately NIS 554 million. The monthly average of long-term liabilities for the period was approximately NIS 5.71 billion.

The Group recycles part of the payments for past debts and uses its surplus cash flow for the gradual reduction of its debt burden. Due to limitations on a single borrower in the local market, the Company is required to borrow considerable sums from foreign sources.

Working capital as at September 30, 2000 was negative and amounted to approximately NIS 249 million, compared with NIS 1,628 million as at September 30, 1999. The improvement in the Group's working capital is material and derived from a decrease in current liabilities, mainly as a result of full repayment of the debenture that was issued to the Government of Israel and payment of a dividend. The negative working capital does not restrict the Group in its operating activities, since the cycle of collection of revenues from customers is short.

6. Comparison of results of the third quarter of 2000 with the results of the corresponding period last year

Earnings in the third quarter of 2000 decreased by approximately NIS 186 million compared with the corresponding quarter last year, a decrease of about 8.2%. Operating and general expenses decreased compared to the third quarter last year by approximately NIS 323 million, a decrease of 24.6%.

Operating income in the third quarter increased by approximately NIS 144 million compared with the corresponding quarter in 1999, since the decrease in operating and general expenses was greater than the decrease in the Group's income between the quarters.

Finance expenses in the third quarter of 2000 increased by approximately NIS 45 million compared with the corresponding quarter last year.

In the other income / expenses item, an expense of approximately NIS 1,386 million (before tax) was recorded, compared with NIS 106 million (before tax) in the corresponding quarter last year. Most of the difference derived from an increase in the expense for the Company's restructuring plan in the third quarter of 2000.

The behavior of the income and expense items and the causes of the differences between the quarters are similar to those explained for the periodic results.

The changes described above in the items of the statement of income led to a net loss of approximately NIS 791 million in the third quarter of 2000, compared with net earnings of approximately NIS 8.4 million in the corresponding quarter last year.

The difference between the results was caused mainly by the change in the other expenses / income items, as shown above. Removing the effects of the other expenses / income items in the two periods, net earnings in the third quarter of 2000 would have been approximately NIS 96 million, compared with NIS 76 million in the corresponding quarter last year.

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

Ido Dissentshik Chairman of the Board	Ilan Biran CEO