August 2, 2005

Directors Report on the State of the Company's Affairs for the period ended June 30, 2005

We respectfully present the Directors' Report on the state of the affairs of "Bezeq" – The Israel Telecommunication Corp. Limited (hereinafter: the "Company") and the consolidated Group companies (the Company and the consolidated companies hereinafter collectively referred to as the "Group"), for the six-month period ending June 30, 2005 (hereinafter: "the Directors' Report").

The Directors' Report contains a review of its subject matter, in condensed form, and is prepared on the assumption that the reader can also refer to the Directors' Report for the year ended December 31, 2004.

The Group operates in four 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**

Below is information detailing the financial statements which were fully consolidated during the period of report and which were not included in the corresponding period in the prior year:

1. Pelephone Communications Ltd. – full consolidation since August 26, 2004 (until that date, 50% proportional consolidation).

2. D.B.S. Satellite Services (1998) Ltd. – full consolidation since June 21, 2004.

1. Financial Position

A. The Group's assets as at June 30, 2005, amounted to approximately NIS 20.52 billion, compared with NIS 18.6 billion as at June 30, 2004. Of these, approximately NIS 10.33 billion (approximately 50.4%) are fixed assets compared with approximately NIS 9.38 billion (approximately 50.4%) on June 30, 2004. NIS 1.63 billion of the increase in the total assets originates from first time full consolidation of Pelephone.

In the fixed-line domestic communications segment, there was a decrease in the net book value of fixed assets resulting from the difference between depreciation expenses and the investment made during the period of report. Additionally, there was a decrease in cash balances and short-term investments compared with the prior year.

In the cellular segment, there were additional investments in fixed assets and an increase in cash, cash equivalents and trade receivables which contributed to the increase in total assets. Conversely, there was a reduction in the deferred tax balances due to utilization of past losses for tax purposes.

In the international communications and internet services segment, there was an increase in total assets compared with the prior year, mainly due to an increase in cash and trade receivable balances. Conversely, net investments in fixed assets decreased in this segment compared with the prior year.

In the multi-channel television segment, total assets increased compared with the prior year, mainly due to a rise in content rights and in the customer credit balance.

B. The Group's shareholders' equity as at June 30, 2005, amounted to approximately NIS 7.91 billion, comprising approximately 39% of the total balance sheet, compared with approximately NIS 7.12 billion as at June 30, 2004, which comprised approximately 38% of the total balance sheet. The increase in shareholders' equity derived from the Group's net earnings accumulated since the end of the corresponding period in the prior period.

C. Total Group debt to financial institutions and debenture holders as at June 30, 2005, amounted to approximately NIS 8.77 billion, compared with approximately NIS 7.30 billion on June 30, 2004. Approximately NIS 1.18 billion of this increase derives from the first-time full consolidation of Pelephone.

D. Group balances in cash and short-term investments as at June 30, 2005, amounted to approximately NIS 3.62 billion, compared with approximately NIS 4.40 billion on June 30, 2004. The decrease derives mainly from exercise of the option to purchase the second half of the shares of Pelephone. The decrease was offset by cash flows from current operations in the main segments of the Group's business and also from an issuance of debentures and receipt of loans.

2. Results of Operations

A. Principal Results

Net earnings for the first six months of 2005 amounted to approximately NIS 444 million, compared with net earnings of approximately NIS 274 million for the corresponding period in the prior year. The difference in the results derives mainly from the other income (expenses) item, where an expense of approximately NIS 23 million (before tax) was recorded in the corresponding period mainly in connection with early retirement costs and in the reported period, revenues of approximately NIS 153 million (before tax) were recorded, mainly capital gains of about NIS 107 million and a reduction in early retirement costs of approximately NIS 83 million.

The increase in net earnings was offset by a decrease in operating income and an increase in the financing expenses of the Group.

Below are details of the changes in the results of the segments compared to the corresponding period (not including other income / expenses, net).

	For the six-month period ended June 30	
Segment	**2005 NIS millions**	**2004 NIS millions**
Fixed-line domestic communications	455	551
Cellular[1]	254	140
International communications and internet services	43	67
Multi-channel television[2]	(50)	-
Others	1	4

[1] First-time full consolidation.
[2] First-time consolidation.

Net earnings per share for the first six months of 2005 amounted to NIS 0.170 per NIS 1.00 par value compared with net earnings per share of NIS 0.105 per NIS 1 par value in the corresponding period in the prior year.

B. Revenues

Group revenues in the first six months of 2005 amounted to approximately NIS 5.50 billion compared with earnings of approximately NIS 4.02 billion in the corresponding period in the prior year. The increase of approximately NIS 1.62 billion derives from first-time consolidation. Eliminating the effects of the first-time consolidation, there was a decrease in the Group's revenues which derived from the fixed-line domestic communications segment.

Revenues from fixed-line domestic communications decreased from approximately NIS 2.52 billion in the first six months of 2004 to approximately NIS 2.36 billion in the period of report (a decrease of approximately 6.6%). Most of the decrease in the segment's revenue derived from a tariff reduction in June 2004 and June 2005, a decrease in call and internet dial-up traffic and a decrease in revenues from the sale of equipment to subscribers. The decrease in revenues was moderated by the ongoing growth in the number of customers who subscribe to high-speed internet service (ADSL) and by a settlement agreement with a controlling customer (see Note 7B to the financial statements). The auditors drew attention to the ongoing opening of the communications industry to competition and to expected tariff changes.

Revenues from the cellular telephone segment increased from approximately NIS 1.08 billion in the first six months of 2004 to approximately NIS 2.21 billion during the period of report, mainly as a result of the effect of the first-time consolidation implemented during 2004. In addition, the segment's revenues increased as a result of an increase of approximately 112,000 in the net number of customers during the first half of 2005, the increase in revenues from sales of terminal equipment to customers and from the sale of repair service packages. Amendment of the cellular network interconnect regulations and the reduction of interconnect tariffs commencing March 1 2005 slowed the upward trend in the segment's revenues. In partial compensation for the reduction of those tariffs, Pelephone increased the outgoing call tariff for some of its customers.

Revenues from the international communications and internet services segment increased from approximately NIS 401 million in the first six months of 2004 to approximately NIS 403 million during the period of report. The stability of revenues compared with revenues in the corresponding period derives from an increase in the number of ADSL customers, growth in international call routing traffic and growth in revenues from data services. The increase was offset mainly by a decrease in traffic and outgoing call tariffs, and a decrease in internet access service tariffs, due to increased competition in this segment resulting from the entry of additional carriers.

Revenues of approximately NIS 585 million from the multi-channel television segment were included in the Group's revenues for the first six months of 2005, due to the consolidation of DBS during the course of 2004. There has been an increase in revenues in this segment compared with the corresponding period as a result of the net increase of approximately 26,000 subscribers during the first half of 2005, and an increase in average revenue per subscriber.

C. General and Operating Expenses

The Group's general and operating expenses for the first six months of 2005 amounted to approximately NIS 3.51 billion compared with approximately NIS 2.22 billion during the corresponding period in the prior year. Approximately NIS 1.2 billion derives from first-time consolidation.

In the fixed-line domestic communications segment, general and operating expenses decreased from approximately NIS 1,140 million in the first half of 2004 to approximately NIS 1,129 million during the period of report. The decrease derives mainly from a reduction in the costs of material consumption, which was partly set off by an increase in the costs of building maintenance.

In the cellular segment, general and operating expenses increased from approximately NIS 804 million in the first six months of 2004 to approximately NIS 1,655 million during the period of report derived mainly from the first-time full consolidation. In addition, expenses in the segment increased compared with the corresponding period mainly due to increased revenues and subscriber acquisition costs which derive from winning the tender of the Accountant General at the Ministry of Finance.

In the international communications and internet services segment, there was an increase in general and operating expenses from approximately NIS 271 million in the first six months of 2004 to approximately NIS 307 million during the period of report, resulting from the increase in foreign managers expenses deriving mainly from a significant increase in traffic routed from one foreign operator to another foreign operator.

General and operating expenses of approximately NIS 476 million from the multi-channel television segment were included in the Group's expenses for the first six months of 2005 due to the consolidation of DBS during 2004.

D. Depreciation

The Group's depreciation expenses increased from approximately NIS 939 million in the first six months of 2004 to approximately NIS 1,161 million during the period of report, resulting from the first-time consolidation in respect of which depreciation expenses increased by approximately NIS 275 million. Eliminating this increase, depreciation expenses decreased as a result of fully depreciated fixed assets and a decrease in investments in new assets in the fixed-line domestic communications segment.

E. Royalties to the Government of Israel

The Group's royalties expense amounted to approximately NIS 130 million compared with NIS 96 million during the corresponding period in the prior year. The source of the increase is the first-time consolidation referred to above.

F. Operating Income

The Group's operating income in the first half of 2005 amounted to approximately NIS 703 million, compared with NIS 762 million during the corresponding period in the prior year, a decrease of approximately NIS 59 million. The decrease in operating income derives from the changes in the results of the revenues and expenses sections of the segments described above. These changes led to a reduction in the profitability of the Group's main segments of operation (except for the multi-channel television segment). The Group's operating income was partially reduced due to the first-time consolidation of DBS's financial results as described above.

G. Financing Expenses

The Group's net financing expenses for the first six months of 2005 amounted to approximately NIS 165 million compared with approximately NIS 69 million during the corresponding period in the prior year. The source of approximately NIS 108 million of the expenses is the first-time consolidation. Group finance expenses are influenced by changes in interest rates, exchange rates and the Index.

The effect of the changes in foreign currency and shekel rates on the Company's liabilities were largely neutralized by hedging transactions carried out, and investment in financial assets.

In the cellular segment, financing expenses were reduced, *inter alia*, by recycling loans at lower interest rates and as a result of lower rates of inflation than in the corresponding period in the prior year.

Financing expenses of approximately NIS 95 million from the multi-channel television segment, were included in the Group's expenses for the first six months of 2005 due to the consolidation of DBS during 2004.

H. Other Income (Expenses)

Income amounting to approximately NIS 153 million was recorded in the Group's Other Income (Expenses) item, compared with expenses of approximately NIS 23 million during the corresponding period in the prior year. Most of the expense in the corresponding period was an increase in the provision for early retirement. The income recorded in the period of report derives mainly from capital gains of approximately NIS 107 million and a reduction in the provision for early retirement in the sum of approximately NIS 83 million (due to transfer to an insurance company). The income was partially offset by amortization of goodwill in respect of companies consolidated for the first time in the financial statements (see Note 10 to the financial statements).

I. Group's equity in losses of affiliates

The Group's equity in losses of affiliates in the first half of 2005 amounted to approximately NIS 11 million compared with losses of approximately NIS 129 million recorded during the corresponding period in the prior year. Most of the decrease in the period of report derives from the transfer of DBS to a consolidated company towards the end of the first half of the previous year, and the results of its operations are presented in the financial statements on a consolidated basis, rather than by the equity method (see Note 4 to the financial statements).

The Company's auditors drew attention to the financial condition of DBS, and to the fact that its continued operation is contingent upon further receipt of loans from the shareholders, including loans from the Company as well as loans from other lenders, in accordance with DBS's work plan.

3. Liquidity and sources of financing

Consolidated cash flows generated by operating activities during the first half of 2005 amounted to approximately NIS 1,304 million, compared with approximately NIS 1,468 million during the corresponding period in the prior year. Eliminating an increase of approximately NIS 233 million deriving from first-time consolidation, cash flows from operating activities decreased by approximately NIS 397 million. In the fixed-line domestic communications and cellular segments, the reduction in cash flow was mainly due to changes in the assets and liabilities items. In addition, operating income in the fixed-line domestic communications segment also decreased, also contributing to the decrease in cash flows from operating activities.

Cash flows generated by operating activities are the principal source of financing of the Group's investments, which during the period of report included, *inter alia*, approximately NIS 984 million in the development of communications infrastructure and approximately NIS 190 million in short-term investments.

During the period, the Group repaid approximately NIS 1,173 in debts, of which approximately NIS 1,053 million was on account of long-term loans and approximately NIS 120 million was on account of debentures.

The Group raised new debt in a total amount of approximately NIS 1,656 million by an issuance of debentures and receipt of new long-term loans.

The average monthly short-term credit during the period was approximately NIS 96 million. The average monthly long-term liabilities for the period was approximately NIS 8,558 million.

Working capital as at June 30, 2005, is positive and amounted to approximately NIS 1,986 million, compared with positive working capital of approximately NIS 577 million on June 30, 2004. The increase derives mainly from an improvement in working capital in the multi-channel television segment, in the amount of approximately NIS 1,331, as a result of a raising of long-term debt and payment of short-term loans, and from improvement in the working capital of Pelephone and its first-time full consolidation which increased working capital by approximately NIS 572 million. Conversely, there was a reduction of approximately NIS 647 million in working capital in the fixed-line domestic communications segment.

4. Comparison of the results of the second quarter of 2005 with the results of the corresponding quarter last year

The following are details of the changes in the results of segments in comparison with the corresponding quarter.

	For the three-month period ended June 30	
Segment	**2005**	**2004**
	NIS Millions	**NIS Millions**
Domestic communications	206	255
Cellular	133	73
International communications	22	32
Multi-channel television	(25)	-
Sites	1	3

Revenue during the second quarter of 2005 increased by approximately NIS 715 million compared with the corresponding quarter in the prior year. An increase of approximately NIS 809 million derives from the effect of the first-time consolidation. Eliminating the effect of the first-time consolidation, there has been a reduction in the total revenues of the Group. General and operating expenses increased by approximately NIS 609 million compared with the corresponding quarter in the prior year. This increase is derived mainly from the first-time consolidation. Financing expenses during the second quarter of 2005 increased by approximately NIS 72 million compared with the corresponding quarter in the prior year. This increase is derived mainly from the first-time consolidation.

The behavior of the various income and expense items and the causes of the differences between the quarters are similar to the explanations set out in the half-yearly results. The changes described above in the statements of operations brought about a net profit of approximately NIS 164 million in the second quarter, compared with a net profit of approximately NIS 106 million in the corresponding quarter of the prior year.

5. Group involvement in the community and donations

During the period of the report, the Company was active in the community through its involvement in social institutions and organizations such as the education system in distressed areas and the confrontation line.
As part of the campaign launched by the Company to mark the twentieth anniversary of its establishment, the Company made donations to various organizations during the 12 months commencing February 20, 2004. The amount of the monthly donation was the higher of 5% of its call revenues on the twentieth day of each month of its anniversary year, or NIS 200,000. During the period of report, the Company donated NIS 231,000 and overall throughout the campaign, a total of NIS 2,792,000.

6. Details concerning exposure to and management of market risks

A. Further to that described in the Directors' Report for 2004, as a result of hedging transactions against market risks relating to exposure in changes of exchange rates, the Group incurred no material financing expenses or income during the period of report.

B. The report of positions of derivatives as at June 30, 2005, is not significantly different from the report as at December 31, 2004.

C. The report on linkage bases as at June 30, 2005, is not significantly different from the report as at December 31, 2004.

Surplus monetary liabilities over monetary assets denominated in or linked to foreign currency as at June 30, 2005, amounted to approximately NIS 2.8 billion in the Group. As a result of forward currency transactions, the net balance of foreign currency liabilities not hedged as aforesaid as at June 30, 2005, amounts to approximately NIS 409 million.

Surplus monetary liabilities over monetary assets linked to the CPI as at June 30, 2005, amount to approximately NIS 4.3 billion in the Group.

7. Utilization of proceeds from securities

An offer for sale and an issuance to the public pursuant to a prospectus was published on May 24, 2004. The application of proceeds from the offering will be decided by the Company from time to time, in accordance with its requirements, including, taking into account the necessity of replacing loans by early repayment. As at the date of approval of the financial statements there has been no requirement to replace such loans (except for a loan in the amount NIS 5 million which was repaid by the Company before its due date).

8. Miscellaneous

a. Adoption of a code of ethics

On April 20, 2005, the Board of Directors of the Company adopted a code of ethics formulated by the Company for business conduct. The code of ethics sets out principles and rules of behavior for guiding the activities of Company officers, managers and employees. The Acting Vice President of Human Resources was appointed compliance officer for the implementation of the provisions of the code of ethics.

b. **Peer Review**

On July 20, 2005, a directive was published by the Securities Authority requiring disclosure regarding the provision of consent for the performance of a “peer review”, the purpose of which, as set out in the directive, is to commence the process of monitoring the performance of accountancy firms. The directive raises questions, including legal issues mainly as to the confidentiality of the material transferred to accountants, and the damage that might be caused to the Company as a result of disclosure of such information. In light of this, the Company, together with its legal counsel, is looking into the matter, including methods of solving the problem of confidentiality, and shall provide its recommendations for the discussion and approval of the Board.

c. **Sale of the Controlling Share**

On May 10, 2005, a notice was received from the Government Companies Authority to the effect that Ap. Sab. Ar. Holdings Ltd. had been chosen as the “preferred bidder” in the process of sale of the controlling share of the Company. Upon completion of the transaction and grant of consent and of the control of the Company to the preferred bidder in accordance with the Communications Law and the Telecommunications Order, the Company is expected to be released from certain limitations imposed upon it as a company controlled by the State of Israel, including cancellation and/or change of part of the provisions of its Articles of Association, which are similar to several provisions of the Government Companies Law, 5735-1975.

d. **Directors with Accounting and Financial Skills**

Current serving directors with accounting and financial skills are: Yigal Cohen Orgad (external director) and Hava Shechter.

e. **Chairman of the Board**

Commencing March 7, 2005, the Company has no acting Chairman. In accordance with the Company's Articles of Association, a chairman is appointed for each meeting of the Board of Directors.

Hava Shechter	**Amnon Dick**
(Chairperson of the approval meeting)	**CEO**