March 15, 2001

Directors' Report on the State of the Company's Affairs
for the Year ended December 31, 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 year ended December 31, 2000 (hereinafter: "the Directors' Report"). The Report was prepared in accordance with the Securities Regulations (Periodic and immediate reports), 5730-1970.

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

1. The Corporation and its Business Environment

A. The Company, together with its wholly or partially owned subsidiaries, is the main supplier of communications services in Israel. The Group executes and provides a wide range of telecommunications activities and services, including domestic and international telephone services, mobile radio-telephone (cellular) services, satellite television services, laying, maintenance and development of infrastructures, communications services to other communications providers, Internet and data communications services, line leasing, satellite services, distribution of radio and television services to the public, supply and maintenance of equipment and services on customer premises.

B. The field of communications in which the Group operates is subject to changes of a technological nature and with regard to the business structure of the sector. It is also a field in which competition has intensified in recent years, as a result of the Government's policy of opening up areas that were once exclusive to the Group, to competition.

C. The Group and its activities are subject to close governmental supervision by government-appointed authorities whose policies have changed and continue to change significantly from time to time. This supervision is reflected, *inter alia*, in each of the following:

(1) Determination and revision of most of the Company's tariffs are effected in accordance with the provisions of the Telecommunications Law, 5742-1982 (hereinafter: "the Telecommunications Law") and the regulations promulgated thereby (see Note 1B to the financial statements).

In addition, some Company tariffs are supervised and arranged in accordance with the provisions of the Supervision of Prices of Products and Services Law, 5756-1996.

(2) A duty to pay royalties to the State is imposed on most of the Group's revenues (see also Note 1C to the financial statements).

(3) As a government company, the Company is subject to the Government Companies Law, 5735-1975 and other laws.

(4) The Company's activities are subject to the provisions of a General License that was granted to it under the Telecommunications Law. This license enables the Company to operate only through subsidiaries, in which the Company's control is limited.

(5) The Company was declared a monopoly in certain areas of its activities, and is therefore subject to supervision and restrictions under the Anti-Trust Law, 5748-1988 (see also Note 1D to the financial statements).

(6) Some of the activities of the Company and of the subsidiary Pelephone Communications Ltd. involve the use of wireless frequencies, and are therefore subject to the Wireless Telegraph Ordinance (New Version), 5732-1972. The Wireless

Telegraph Regulations stipulate the fees to be paid for the use of the wireless frequency.

The governmental supervision restricts the freedom of action of the Group as a business entity, its ability to compete successfully in markets which are opening up to increasing competition, its ability to deal with the changes being made in the field of communications and to exploit new business opportunities.

D. In the period of the Directors' Report and in 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 these:

1. Further to cancellation of Section 50 of the Telecommunications Law, 5742-1982, which took effect on June 1, 1999, which had granted the Company exclusivity in providing fixed national telecommunications services in a nationwide telephone network, the Ministry of Communications commenced a series of actions designed to enable domestic communications services to be provided by additional operators, as follows:

   a. In December 1999, the Ministry of Communications granted a special license to Israel Railways for providing communications services by the optical fibers it owns. The license has not yet been utilized, in light of a request for the decision of the Attorney General on the matter.

   b. 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 (LMDS). A draft was attached to the tender documents, describing the main points of the terms of the general license that will be granted to the winners of the tender. It is possible that the principles in the above draft will form the basis of a new license that will replace the Company's present license.

   c. At the beginning of February 2001, the Ministry of Communications granted a license for operating domestic fixed-line communications to an additional company.

   The granting of licenses for providing domestic fixed-line communications services by means of the cable infrastructure, is delayed due to legislative actions as described in Note 1(B)(1) (d) to the financial statements.

2. The anticipated opening of fixed-line domestic communications services to full competition and the award of licenses for fixed-line domestic communication services, 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.

3. 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 time (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 (see also Note 1(b) to the financial statements).

4. Bezeq International ended 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 plan, decrease in tariffs, rise in expenses in international operations, and the increase in communications expenses related to Internet access.

   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. The Internet access field is also characterized by high marketing expenses and a trend of eroding tariffs, which is expected to continue, Furthermore, starting in 2002, additional companies will be able to receive licenses for providing international telecommunications services. As a result, there may be a material decrease in the Company's financial results.

5. 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 sale which would be accompanied by raising capital for the Company. The sale 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 sale process would end, if possible, within 9 - 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 capital had not been raised for the Company. (See also Note 9 to the financial statements.)

6. 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 should be signed concerning the retirement of employees, and that securities should be given by the State for fulfillment of obligations towards the employees.

   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 in effect until December 31, 2006, 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. (See also Note 17 to the financial statements.)

7. 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. The Company was granted the measure of flexibility it requested with regard to wages, the regulations governing the obligation to publish a tender were amended to exempt the Company with respect to commitments of up to NIS 2.5 million, and certain reliefs were allowed with regard to share purchase transactions and the establishment of companies.

8. 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. Ongoing investments in expansion of the CDMA system also increased Pelephone's finance expenses. Due to the cumulative effects of the above factors, Pelephone ended the year with a net loss.

9. In September 2000 the Ministry of Communications promulgated regulations (effective from 2 October 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.

10. Concerning the exercise of a right of first refusal to purchase an additional 50% of the share capital of Pelephone, see Note 8 to the financial statements.

11. DBS Satellite Services (1998) Ltd. (hereinafter: "DBS") started to provide satellite broadcasting services in July 2000. In so doing, DBS accumulated losses in which the Company's equity as at December 31, 2000 amounts to approximately NIS 188 million, of which approximately NIS 163 million were incurred during the Report Period. DBS expects to incur considerable loses and a negative cash flow from current operations in the first years of its operation. On increased exposure and holdings in DBS, see Note 8(h) to the financial statements.

12. Following discussions between the Company and the Ministry of Communications concerning the provision by the Company of broadband communications services using ADSL technology, in November 2000 the Ministry approved the service file subject to the conditions set out in the approval. The Company started to provide the service and is working to expand it.

13. As part of the implementation of its strategic plan and preparation for the imminent competition, the Company has exercised options to purchase approximately 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%, invested in venture capital funds that invest, *inter alia*, in communications, and established a company to operate in the field of call center outsourcing. In addition, Bezeq International increased its holdings in Walla! Communications Ltd. to 38.5% of the share capital, and Pelephone Communications Ltd. holds 51% of the share capital of GoNext Ltd., which is establishing a mobile internet portal.

14. In July 2000, the Knesset enacted the law for Employment of Workers by Personnel Contractors (Amended), 5760-2000. The law stipulates, *inter alia*, that workers of personnel contractors, who are actually 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 material number of workers of personnel contractors. After the balance sheet date, the Company took on most of those workers as its employees, on terms that were set out in a special collective agreement.

2. Details concerning exposure to and management of market risks

The Company and each of the consolidated companies manages its own market exposure, each according to its own approach. The risks and their management at the Company:

1. The person responsible for risk management in the Company is the Chief Financial Officer, Mr. Oren Leider.

2. The Company is exposed to market risks as a result of changes in interest rates, exchange rates, inflation, the prices of raw materials and equipment, and the prices of the securities.

Hereunder is a detailed description of the market risks:

Interest rate – Most of the Company's loans are in foreign currency bearing variable interest at LIBOR plus a margin. The Company is exposed to changes in the LIBOR rate. This exposure can affect the finance expenses borne by the Company, as well as its cash flows. On the other hand, the fact that the interest rate is variable makes the fair value of these loans similar to their book value.

Loans and the Company's CPI-linked debentures usually bear fixed interest, and therefore any change in the interest rate will affect their fair value rather than their book value. This characteristic also exists with regard to the euro-denominated debentures that the Company issued on an overseas stock exchange.

The Company invested in negotiable bonds that are stated in its books at their market value. This market value is influenced by changes in the interest rates in the economy.

The Company does not hedge against the above exposures by means of futures transactions on the interest rates, but takes into account such influences when considering the types of loans it takes.

Exchange rates – A change in the shekel exchange rate constitutes, of itself, financial exposure, in that it can affect future cash flows, particularly the repayment of currency-linked obligations and payments for the currency-linked purchase of equipment and raw materials.

The Company also has accounting exposure deriving from the rate of change in the shekel exchange rates compared with the rate of change in the CPI in the Report Period. Such exposure generates erosion or an increase in the value of dollar-linked liabilities, which could, in turn, have a considerable effect on the Company's real finance expenses.

In order to minimize this exposure, the Board of Directors decided that the Company should take hedging actions so that the balance of the unhedged exposure would not exceed 150 million dollars. This is being accomplished by means of futures currency transactions with banking corporations – for details, see Note 21B to the financial statements. As part of the policy for minimizing exposure, all of the Company's exposure as at December 31 was hedged, except for the sum of NIS 331 million. We note that inherent in some of the Company's hedging transactions is a high nominal interest that constitutes, in a period of low inflation, high real interest. In contrast, the Company receives a parallel nominal interest on its shekel deposits, thereby neutralizing the cost of the high real interest.

<u>Inflation</u> – The rate of inflation affects the operating income and expenses of the Company during the year. The Company's tariff updating mechanism as set out in the Regulations, allows tariffs to be updated once a year or when the rate of inflation reaches 8.5%. As a result, the annual rate of inflation and its spread over the year can have a material influence on the erosion of the Company's tariffs. Company expenses are also affected by the rate of inflation when unlinked expenses such as wages are eroded during the year while purchase costs, some of which are linked, do not change in real terms. The decrease in the rate of inflation reduces this risk considerably.

The Company's loans are linked to the "known index", while accounting measurement is according to the "actual index". Differentials in the rise in the known index compared with the actual index create an increase in value or erosion of loans in book terms. In a period of high inflation, this differential had a material effect on book measurement of the Company's finance expenses, since a considerable part of the Company's liability is linked to the CPI. The Company cannot protect itself against this exposure.

The Company invests its cash balances in unlinked shekel deposits and mutual funds. These deposits are exposed to changes in the rates of inflation, which affects their real yield.

<u>Prices of raw materials and equipment</u> – The cash flow from the Company's operations is used partially for investment in equipment. The prices of equipment are affected by the indices to which they are linked, including sectoral indices, exchange rates and world prices. The Company does not protect this exposure.

<u>Prices of securities</u> – The Company invests some of its financial surpluses in securities. The Board of Directors of the Company determines the composition and amount of the securities portfolio. With the aim of preventing fluctuations in the portfolio's yield, the Board of Directors laid down investment principles whereby most of the investment will be in bonds, shekel deposits and interest-bearing foreign currency instruments (dollar and basket only), while the share component will not exceed 15% of the investment portfolio and will be TASE 100 shares. The types of bonds and their proportional part in the portfolio was also determined, according to criteria based on linkage, redemption date and a division between government and non-government bonds. A ceiling was also set for the various types of investment.

Note 30 to the financial statements includes detailed financial information about the principal market risks and the steps taken by the Company to influence its exposure to them. Note 31 to the financial statements includes information about the linkage terms of the Company's financial surpluses.

The Company has no expenses in the hedging transactions it makes, as they are forward transactions. However, as a result of making those transactions, additional interest costs are incurred. The Company's finance expenses were also influenced by real exchange rate differentials in periods when its foreign currency liabilities were not fully protected. All these factors led to an increase of NIS 57 million in finance expenses.

The persons responsible for risk management in the consolidated companies are the finance managers. These companies are exposed to market risks that are similar to those to which the Company is exposed. Pelephone protects itself against exposure to increases in exchange rates for the equipment it purchases, but most exposures are not covered by such transactions.

3. Financial Position

a. The Group's assets as at December 31, 2000 amounted to approximately NIS 16.97 billion, which reflected no material change with assets at the end of 1999, which were NIS 16.82 billion. Of these, approximately NIS 11.6 billion (approximately 68.4%) were fixed assets, compared with approximately NIS 12.66 billion (75.3%) on December 31, 1999. The decrease in the depreciated cost of the fixed assets derived mainly from the difference between depreciation expenses and the investment made in the Report Period. The decrease in fixed assets, net, was offset by an increase in current assets, which derived mainly from an increase in the Group's cash balances and from an increase in investments in investee companies and in other assets (mainly deferred taxes).

b. The Group's shareholders' equity as at December 31, 2000 amounted to approximately NIS 6.89 billion, which comprised 40.6% of the total balance sheet, compared with approximately NIS 7.26 billion on December 31, 1999, which comprised approximately 43.2% of the balance sheet. The decrease in shareholders' equity derived from the net loss of the Group for the period.

c. Total Group debt to financial institutions and to the holders of its debentures as at December 31, 2000 amounted to approximately NIS 6.31 billion, compared with approximately NIS 6.51 billion on December 31, 1999.

d. The balances of the Group's cash and short-term investments as at December 31, 2000 amounted to approximately NIS 1,721 million, compared with approximately NIS 965 million on December 31, 1999.

e. The Group's surplus of monetary liabilities over monetary assets in or linked to foreign currency as at December 31, 2000 amounted to approximately NIS 2.75 billion. During the Report period, the Company made forward currency transactions to reduce exposure deriving from this surplus. As at December 31, 2000, net dollar liabilities that were not hedged by such forward transactions amounted to approximately NIS 348 million.

f. The Group's surplus of monetary liabilities over monetary assets linked to the CPI as at December 31, 2000 amounted to approximately NIS 2.16 billion (not including forward transactions.

4. Results of Operations

Comparison of the results for 2000 with those for 1999

a. Principal results

Net loss for the year 2000 amounted to approximately NIS 549 million, compared with net earnings of approximately NIS 8 million last year.

The difference between the results was caused mainly by an increase of approximately NIS 714 million (before tax) in the other expenses / income item. In 2000, this item included an expense of approximately NIS 1,273 million (before tax), mainly for the early retirement scheme, which amounted to approximately NIS 1,446 million. In 1999, this item also consisted mainly of an expense of NIS 398 million (before tax) for early retirement. Eliminating the effect of the other expenses / income items in the two periods, net earnings in 2000 would be approximately NIS 265 million, compared with NIS 366 million in 1999.

Loss per share in 2000 was NIS 0.226 per NIS 1 par value, compared with earnings of NIS 0.008 per share last year.

b. Revenues

Group revenues for 2000 amounted to approximately NIS 8.4 billion, compared with approximately NIS 9.15 billion last year, a decrease of approximately 8.2%, which was primarily the result of the change in the Company's settlement arrangements with the cellular communications companies, whereby starting from March 2000, the Company's revenues do not include revenues from airtime. The decrease also resulted from a reduction in the Company's tariffs by an average of 8% as of April 1, 1999, which was reflected in a decrease 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.

Most of the decrease in revenues as a result of the lower tariffs was offset by a rise in communications traffic in 2000, both in calls and in Internet traffic, and in the field of cellular communications.

c. Costs and expenses

The Group's operating and general expenses for 2000 amounted to approximately NIS 4.28 billion, compared with approximately NIS 5.13 billion last year, a decrease of approximately 16.5%. 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.

In addition, there was a decrease in expenses for almost all other expense items, particularly wages, sub-contractors, and general expenses. The decrease in these items was offset mainly by an increase in expenses for subscriber equipment at Pelephone and by a rise in expenses for wages at investee companies.

d. Operating income

The Group's operating income in 2000 amounted to approximately NIS 1,104 million, compared with approximately NIS 1,001 million last year, an increase of approximately 10.3%. The increase in operating income resulted from the changes described above in income and operating and general expenses items, which was partially offset by poorer business results in the Company's investee companies, mainly as a result of the intensifying competition described in the business environment section above.

e. Financing expenses

The Group's financing expenses in 2000 amounted to approximately NIS 343 million, compared with approximately NIS 360 million last year, a decrease of approximately 4.7%. There was a decrease in the Report Period in interest payments on CPI-linked liabilities, owing mainly to the repayment of the debenture to the Government. The expense for hedging transactions against foreign-currency liabilities in the Report Period exceeded the profit generated by appreciation of the shekel against the dollar, due to the differential generated between the interest premium included in the pricing of hedging transactions and the change in the CPI. The decrease in the Company's financing expenses was largely offset by the rise in these expenses at Pelephone and at Bezeq International.

f. Other income (expenses)

In the year 2000, an expense of approximately NIS 1,273 million (before tax) was recorded in this item, which consisted mainly of NIS 1,446 million expense for early retirement in the Company. Also recorded in this item were income of approximately NIS 99 million from compensation received from a billing software supplier, and income of approximately NIS

139 million from realization of 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 1999, in which this item included an expense of approximately NIS 558 million (before tax), consisting mainly of an expense of NIS 398 million for the costs of early retirement and an expense of NIS 127 million relating to the billing software supplier.

g. Quarterly date – Consolidated statements – In NIS millions

	2000					1999
	Total	Q4	Q3	Q2	Q1	Q4
Revenues	8,402	2,071	2,092	1,986	2,253	2,343
Costs and expenses	7,298	1,837	1,744	1,722	1,995	2,087
Operating income	1,104	234	348	264	258	256
Financing expenses	343	55	123	34	131	93
Other expenses (income)	1,273	(33)	1,393	3	(90)	175
Company's equity in earnings (losses) of investee companies	(195)	(77)	(69)	(23)	(26)	(15)
Net profit (loss)	(549)	44	(795)	108	94	(46)

The quarterly data include reclassifications. Data for 1999 include the restatement - see Note 2(s) to the financial statements.

5. Liquidity and sources of financing

Consolidated cash flows generated by operating activities in 2000 amounted to approximately NIS 3,265 million, compared with approximately NIS 2,386 million last year. The increase in cash flows from current operations resulted primarily from a decrease in payments for financing the retirement of employees and from changes in current assets and liabilities items. The increase was partially offset by payment of the Company's liabilities in connection with the early retirement scheme. The cash flow generated by operating activities is the principal source of the Group's financing, and was used for financing investments in developing telecommunications infrastructures, amounting to approximately NIS 1,726 million, for investment in investee companies and other assets, and for payment of a dividend of approximately NIS 303 million. In the year 2000, the Company repaid approximately NIS 1,823 million in long-term loans, NIS 226 million of debentures and approximately NIS 472 million of government bonds - a total of approximately NIS 2,521 million. Conversely, the Group received long-term loans in a total amount of approximately NIS 803 million, issued debentures of approximately NIS 1,094 million, and received short-term bank credit of approximately NIS 464 million, so that approximately NIS 2,361 million was raised in total. As a result of the aforesaid, the surplus of cash and cash equivalents of the Group as at December 31, 2000 amounted to approximately NIS 869 million.

The monthly average of short-term credit for the period was approximately NIS 556 million. The monthly average of long-term liabilities for the period was approximately NIS 5.9 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 December 31, 2000 was positive and amounted to approximately NIS 8 million, compared with negative working capital of NIS 1,575 on December 31, 1999. The improvement in the Group's working capital derives from an increase in current assets, mainly in cash balances, and from a decrease in current liabilities and as a result of a decrease in current maturities of long-term liabilities and payment of a dividend.

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

Ido Dissentshik Chairman of the Board	Ilan Biran CEO