August 19, 2004

Directors' Report on the State of the Company's Affairs for the period ended June 30, 2004

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 (the Company and the consolidated companies hereinafter collectively referred to as the "Group"), for the six-month period ending June 30, 2004 (hereinafter: the "Directors' Report"). The Report was prepared in accordance with the Securities Regulations (Periodical and Immediate Reports), 5730-1970.

The Directors' Report contains a review of its subject matter, in condensed form, and was prepared assuming that the December 31, 2003 Directors' Report is available to the reader.

The financial data relating to the period from January 1, 2004 are presented in reported amounts as defined in Note 2D to the financial statements. Data for the period ending December 31, 2003 are presented in NIS as of December 2003.

1. Business Environment

During the period of the Directors' Report and the period subsequent thereto, a number of events and changes occurred with respect to the state of the Group's affairs and business environment, the most noteworthy of which are the following:

A. On March 31, 2004, the Company's general license was thoroughly and extensively amended. According to a notice from the Ministry of Communications to the Ministerial Committee on Privatization, the amended license was intended to adapt the general license to the competitive environment in which the Company operates, but in the Company's opinion, certain provisions of the license restrict the Company's operations and are expected to impede its ability to compete.

B. An offer for sale and an offering to the public under a prospectus was published on May 24, 2004 – for details of the offer for sale and the offering to the public, and the results thereof, see Note 1E to the financial statements. Designation of the proceeds of the offering – as may be decided upon by the Company from time to time, in accordance with its needs, including the replacement of loans detailed in the prospectus. As of the date of approval of the financial statements, no need has arisen to replace the loans as aforesaid.

On July 19, 2004, the Ministerial Committee on Privatization resolved to amend the resolution to privatize the Company such that the State's holdings in the Company be privatized by way of private sale of 30% of the Company's share capital, and options for the purchase of an additional 10.66% of the Company's share capital.

C. On April 22, 2004, regulations took effect which determine processes and conditions for receipt of a general license for the provision of international telecommunications services. The regulations stipulate, *inter alia*, that a license will not be granted to a corporation in which an interested party is an international operator, or to a corporation which is a domestic operator, a cellular operator or to a significant operator in a segment of operations of international transmission service. Bezeq International estimates that expansion of competition will cause a further drop in the prices of international calls without any significant increase in the volume of traffic. Bezeq International and the Company estimate that the competition will have an adverse effect on both their revenues – see Note 1C(4) to the financial statements.

D. On July 5, 2004, regulations were published relating to processes and conditions for receiving a special general license to provide domestic fixed-line communications services with no universal service obligation – see Note 1C(5) to the financial statements.

E. With respect to the temporary provision relating to interconnection fees between the Company's network and the domestic operator's network, see Note 1D to the financial statements.

F. On July 29, 2004, a notice was received from the Deputy Prime Minister and the Minister of Communications regarding a change in the interconnection fees to the cellular network which stated that a significant reduction in such tariffs was being considered (see Note 1C(6) to the financial statements). In the Company's estimation, if and when these changes are implemented, they will cause significant harm to Pelephone's revenues, and as a result, will cause a material adverse effect on the Company's financial statements.

G. The Group companies are obliged to pay royalties to the State of Israel. The rate of royalties in 2003 was 4%, and as of 2004, decreased to 3.5% of revenues defined in the regulations as being subject to royalties.

H. On July 28, 2004, notice of strike was given by the Professional Union Department of the General Trade Union, as declared and approved by the New General Trade Union, due to various matters in dispute between Company management and employee representatives. The date set down for the strike was August 15, 2004 and onwards. As of the date of approval of the financial statements, the employees did not institute a strike action, however, they took actions to disrupt management work. In a hearing at the Regional Labor Court, the parties reached a settlement by which they undertook to enter into accelerated negotiations to resolve the matters in dispute.

I. In February 2004, the Board of Directors of the Company resolved to exercise the option to acquire the balance of 50% of the shares in Pelephone. On August 12, 2004, an agreement to amend the option agreement was signed, prescribing, *inter alia*, exercise of the option at an agreed price of USD 60 million, and distribution of a dividend in the amount of US$ 8.3 million by Pelephone to its shareholders prior to exercise of the option. Exercise of the option is subject to the approvals of the Ministerial Committee on Privatization and the Minister of Communications, which have been received, and to the approval of the Commissioner for Restrictive Trade Practices, which has not yet been received. Upon exercise of the option, Pelephone shall become a wholly owned subsidiary of the Company – see Note 4A to the financial statements.

J. With respect to the Company's investment in DBS, including the resolution of the Board of Directors of the Company approving an additional investment and increase in the Company's holdings in DBS, as well as the Company's application for approvals from the relevant authorities, see Note 4B to the financial statements. Since June 21, 2004, the financial statements of DBS are fully consolidated with those of the Company – see Note 2H to the financial statements.

K. To mark the twentieth anniversary of its establishment, the Company launched a campaign of donations to various institutions during 2004. The amount of the monthly donation is the greater of 5% of Bezeq's call time revenue on the 20th day of each month of the campaign or NIS 200,000. The campaign is to last for 12 months commencing on February 20, 2004. During the Report period, the Company donated NIS 1,180,000 as part of the campaign. Pelephone donated NIS 500,000 during the Report period as well as use of part of its infrastructure for the "Good Day" campaign of the "Israeli Spirit" non-profit association.

2. Details concerning exposure to and management of market risks

A. Further to that described in the Directors' Report for the year 2003, as a result of hedging transactions against market risks associated with exposure to exchange rate fluctuations, the Group sustained no material financing expenses and generated no substantial financing income during the period of account.

B. The report on linkage bases and positions on derivatives as at June 30, 2004 does not differ significantly from the report as at December 31, 2003.

C. The Group's surplus monetary liabilities over monetary assets denominated in or linked to foreign currency as at June 30, 2004 amounted to approximately NIS 3 billion. As a result of forward currency transactions, as at June 30, 2004 the net balance of foreign currency liabilities not hedged by such forward transactions amounted to approximately NIS 239 million.

The Group's surplus monetary liabilities over monetary assets linked to the consumer price index as at June 30, 2004 amounted to approximately NIS 2.9 billion.

3. Financial position

A. The Group's assets as at June 30, 2004 amounted to approximately NIS 18.6 billion, compared with NIS 15.7 billion as at June 30, 2003. Of these, approximately NIS 9.4 billion (approximately 50.4%) are fixed assets, compared with approximately NIS 9.5 billion (approximately 60.3%) at June 30, 2003. The increase in total assets stemmed mainly from an increase in cash and short term investments as a result of a private issue of debentures to institutional investors and of an issue of debentures to the public under the prospectus of May 24, 2004. The Group's assets also increased as a result of the consolidation of DBS Satellite Services (1998) Ltd. for the first time.

The increase was offset by the reduction in the net book value of fixed assets as a result of the disparity between depreciation expense and investments made during the Report period.

B. The Group's shareholders' equity as at June 30, 2004 amounted to approximately NIS 7.12 billion, comprising approximately 38.3% of the total balance sheet, compared with approximately NIS 6.49 billion as at June 30, 2003, which comprised approximately 41.4% of the total balance sheet. The increase in shareholders' equity stemmed from an issue of shares in accordance with an agreement with the State to raise capital for the Company. The increase was offset by the Group's net loss, which was carried forward from the end of the corresponding report period.

C. Total Group debt to financial institutions and debenture holders as at June 30, 2004 amounted to approximately NIS 7.3 billion, compared with approximately NIS 5.62 billion as at June 30, 2003. The main reason for the increase in the Group's debt stemmed from the first-time consolidation of DBS Satellite Services (1998) Ltd. and from the issue of debentures to institutional investors and to the public.

D. Group balances in cash and short term investments amounted to approximately NIS 4.4 billion as at June 30, 2004, compared with approximately NIS 2.23 billion at June 30, 2003. This increase derives from the issue of the Company's shares in 2003, and from the private issue of debentures to institutional investors and the issue of debentures to the public.

4. Results of Operations

A. Principal Results

Net earnings for the first six months of 2004 amounted to approximately NIS 274 million compared to net earnings of approximately NIS 87 million for the corresponding period last year. The source of the increase in earnings was the increase in the Group's operating profit and the decrease in the Company's share of DBS's losses, due to an improvement in its operating results.

Earnings per share for the first six months of 2004 amounted to NIS 0.105 per NIS 1 par value compared with earnings of NIS 0.036 per share during the corresponding period last year.

The results of DBS's operations were consolidated using the equity method due to its consolidation for the first time in close proximity to the end of the Report period.

B. Revenues

Group revenues for the first six months of 2004 amounted to approximately NIS 4.02 billion compared to approximately NIS 3.93 billion during the corresponding period last year.

The increase in the Group's revenues stemmed mainly from an increase in the revenues of Pelephone, Bezeq International and BezeqCall. Conversely, the total revenues of the Company decreased. Most of the decrease in the Company's revenues resulted from a decrease in revenues from domestic fixed-line communications and cellular communications. Revenues from domestic fixed-line communications decreased as a result of the decline in call traffic and dial-up Internet connections and from a reduction of tariffs in September 2003 and June 2004. Conversely, the Company's revenues from fixed fees increased as a result of the continued rising trend in revenues from ADSL lines and the increase of fixed fee tariffs commencing in September 2003.

C. General and operating expenses

The Group's general and operating expenses for the first six months of 2004 amounted to approximately NIS 2.22 billion compared with approximately NIS 2.20 billion during the corresponding period last year.

These results were mainly influenced by an increase in marketing expenses, cellular expenses and expenses for international communications which were partly offset by the decrease in the Company's salary expenses as a result of retirement of employees as part of an early retirement plan. Similarly, a decline in building maintenance expenses was recorded following an agreement under which the Company is to receive a retroactive refund of municipal taxes.

D. Depreciation

The Group's depreciation expenses decreased as a result of the completion of the depreciation charge on the Company's fixed assets and a decrease in investments in new assets. Furthermore, an additional decrease was recorded due to the change in the estimated useful lives of the assets – see Note 5A to the financial statements.

E. Royalties to the Government of Israel

The Group's royalties expense for the first six months of 2004 amounted to approximately NIS 96 million compared with approximately NIS 121 million during the corresponding period last year. The source of the decrease was the reduction in the rate of royalties due on the Group's revenues, from 4% to 3.5%, effective January 1, 2004.

F. Operating income

The Group's operating income during the first six months of 2004 amounted to approximately NIS 762 million, compared with approximately NIS 530 million in the corresponding period last year, an increase of approximately NIS 232 million. The increase in operating income stems from the changes described above under the revenue and expense items.

These changes led to the transition from loss to operating income at Pelephone, and to an increase in operating income for all of the other companies in the Group.

G. Financing expenses

The Group's net financing expenses for the first six months of 2004 amounted to approximately NIS 69 million compared with approximately NIS 84 million during the corresponding period last year. Commencing in 2004, financing expenses included in the financial statements reflect the nominal financing expenses, rather than the inflationary adjusted financing expenses recorded in the past, due to the transition to nominal financial reporting. Accordingly, there is no basis for comparison of the results. The financing expenses during the period were influenced mainly by an increase in the consumer price index and by Dollar and Euro exchange rate fluctuations. The effect of foreign currency exchange rate fluctuations was neutralized, mainly, as a result of hedging transactions and financing income from financial assets.

H. Tax Expense

The Group's tax expense for the first six months of 2004 amounted to approximately NIS 267 million compared with approximately NIS 165 million during the corresponding period last year. Following the amendments to the Income Tax Ordinance coming into effect including, *inter alia*, the gradual reduction in corporate tax rates from 36% to 30%, the Group reduced its tax asset and placed it at the rate expected to apply upon realization of the tax asset. As a result, an additional tax expense was recorded in the sum of approximately NIS 78 million.

I. Group's equity in losses of affiliates

The Group's equity in losses of affiliates decreased compared with the corresponding period last year from approximately NIS 193 million in the first six months of 2003 to approximately NIS 129 million in the first six months of 2004. Most of the reduction stemmed from the decrease in the Company's equity in the losses of DBS as a result of an increase in its revenue.

5. Liquidity and sources of financing

Consolidated cash flows generated by operating activities in the first six months of 2004 amounted to approximately NIS 1,468 million compared with approximately NIS 1,410 million during the corresponding period last year. The increase in consolidated cash flows from operating activities was due to an increase in the operating cash flows of Pelephone and Bezeq International. The increase was offset by a decrease in the operating cash flows of the Company and BezeqCall.

Cash flows generated by operating activities were the principal source of financing for the Group's investments made during the Report period including, *inter alia*, the investment of approximately NIS 678 million in the development of communications infrastructure, approximately NIS 108 million in investee companies and approximately NIS 28 million in long term deposits and investments. During the quarter, the Group repaid approximately NIS 1,012 million in debts, of which approximately NIS 371 million was on account of long term loans, approximately NIS 544 million on account of debentures, and approximately NIS 97 million on account of short-term credit. The Group raised new debt in a total amount of approximately NIS 1,459 million by an offering of debentures (of which NIS 850 million was by way of a stock exchange offering) and receipt of new long-term loans.

The average monthly short-term credit during the period was approximately NIS 130 million. The average monthly long-term liabilities for the period was approximately NIS 5,547 million.

Working capital as at June 30, 2004 was positive and amounted to approximately NIS 577 million, compared with positive working capital of NIS 140 million at June 30, 2003. The increase in the Group's working capital stemmed mainly from an increase in the Group's cash balances and short-term investments. This increase was offset by an increase in the Group's current liabilities as a result of the first-time consolidation of DBS Satellite Services (1998) Ltd.

6. Comparison of the results of the second quarter of 2004 with the results of the corresponding quarter last year

Revenue during the second quarter of 2004 increased by approximately NIS 55 million compared with the corresponding quarter last year – an increase of approximately 2.8%. General and operating expenses increased compared with the corresponding quarter last year by approximately NIS 49 million, an increase of approximately 4.5%.

The operating income during the quarter rose by approximately NIS 87 million compared with the corresponding quarter last year.

Financing expenses during the second quarter of 2004 decreased by approximately NIS 14 million compared with the corresponding quarter last year.

The behavior of the various revenue and expense items, and the causes of the differences between the quarters, are similar to the explanations set out in the half-year results.

The changes described above in the profit and loss statements brought about net earnings of approximately NIS 106 million in the second quarter, compared with net earnings of NIS 19 million in the corresponding quarter of last year. This represents an increase of approximately NIS 87 million.

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

Adv. Miriam (Miki) Mazar **Chairperson of the Board**	**Amnon Dick** **President & C.E.O.**