May 3, 2005

Directors' Report on the State of the Company's Affairs for the period ended March 31, 2005

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 are hereinafter collectively referred to as "the Group") for the three-month period ended March 31, 2005 (hereinafter: "the Directors' Report").

The Directors' Report contains a review of its subject matter, in condensed form, and was prepared on the assumption that the reader can also refer to the Directors' Report for the year ended December 31, 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 in the Report Period and which were not included in the corresponding period last 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 March 31, 2005 amounted to approximately NIS 20.36 billion, compared with NIS 15.86 billion as at March 31, 2004. Of these, approximately NIS 10.50 billion (approximately 52%) are fixed assets, compared with approximately NIS 8.50 billion (approximately 54%) on March 31, 2004. NIS 3.27 billion of the increase in total assets originates from first-time consolidation.

In the fixed-line domestic communications segment there was a decrease in the net book value of the fixed assets resulting from the difference between depreciation expenses and the investment made in the Report Period. There was also 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 trade receivables and inventory, which contributed to the increase in total assets.

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

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

B. The Group's shareholders' equity as at March 31, 2005 amounted to approximately NIS 7.75 billion, comprising approximately 38% of the total balance sheet, compared with approximately NIS 7.01 billion on March 31, 2004, which comprised approximately 44% of the total balance sheet. The increase in shareholder' equity derived from the Group’s net earnings accumulated since the end of the corresponding period last year.

C. Total Group debt to financial institutions and debenture holders as at March 31, 2005 amounted to approximately NIS 8.54 billion, compared with approximately NIS 5.21 billion on March 31, 2004. Approximately NIS 2.5 billion of the increase derives from the first-time consolidation and the remainder from the receipt of loans and an offering of debentures to the public and institutional investors by the Company and Pelephone.

D. Group balances in cash and short-term investments as at March 31, 2005 amounted to approximately NIS 3.13 billion compared with approximately NIS 3.18 billion on March 31, 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 the cash flow 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 three-month period ended March 31, 2005, amounted to approximately NIS 280 million, compared with net earnings of approximately NIS 168 million in the corresponding period of the prior year. The difference in the results derives mainly from the Other income (expenses) item, where an expense of approximately NIS 30 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 88 million (before tax) were recorded, mainly a capital gain of about NIS 104 million. In addition, the reported period includes a cumulative effect as at the beginning of the year of the change in the accounting method relating to recognition of a deferred tax asset of NIS 25 million (see Note 2B to the financial statements).
The increase in net earnings was offset by a decrease in operating income and a rise in the financing expenses of the Group.

Below are details of the changes in the results of the segments in comparison with the previous year (not including other revenues/expenses, net).

	For the three-month period ended March 31	
Segment	**2005 NIS millions**	**2004 NIS millions**
Fixed-line domestic communications	249	296
Cellular(1)	121	67
International communications and internet services	21	34
Multi-channel television(2)	(26)	–
Others	–	2

Earnings per share in the first three months of 2005 amounted to NIS 0.107 per NIS 1 par value, compared with earnings of NIS 0.064 per share in the corresponding period in the prior year.

B. Revenues

Group revenues in the first three months of 2005 amounted to approximately NIS 2.77 billion, compared with approximately NIS 2.01 billion in the corresponding period in the prior

(1) First-time full consolidation.
(2) First-time consolidation.

year. The increase of approximately NIS 811 million 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 1.27 billion in the first three months of 2004 to approximately NIS 1.2 billion in the reported period (a decrease of approximately 5.5%). Most of the decrease in the segment's revenues derives from tariff reductions in June 2004, 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 535 million in the first three months of 2004 to approximately NIS 1.11 billion in the reported period, mainly as a result of the effect of the first-time full consolidation implemented during 2004. In addition, the segment's revenues increased as a result of the increase in the number of customers by about 48 thousand in the quarter, the increase in revenues from sales of handsets to customers and from the sale of repair service packages. Amendment to 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 in 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 198 million in the first three months of 2004 to approximately NIS 199 million in the reported period. The segment's revenues increased mainly as a result of the increase in internet revenues which derived from the growth in the number of ADSL customers, the sale of internet access service capacity, growth in international call routing traffic and an increase in data service revenues. The growth was offset mainly by a decrease in traffic and in outgoing call tariffs, and a decrease in internet access service tariffs.

Revenues of approximately NIS 289 million from the multi-channel television segment were included in the Group's revenues for the first three months of 2005, with the first-time consolidation of DBS during 2004. There has been an increase in revenues in this segment compared with the corresponding period as a result of the increase of about 12.7 thousand subscribers in the quarter and in average revenue per subscriber.

C. General and Operating Expenses

The Group’s general and operating expenses in the first three months of 2005 amounted to approximately NIS 1.76 billion, compared with approximately NIS 1.09 billion in the corresponding period of the prior year. Approximately NIS 622 million derives from first-time consolidation.

In the fixed-line domestic communications segment, general and operating expenses increased from approximately NIS 554 million in the first three months of 2004 to approximately NIS 562 million in the reported period (an increase of about 1%). Most of the increase is attributable to the rise in building maintenance expenses as a result of an agreement in which the Company received a refund of municipal taxes in the corresponding period in the prior year.

In the cellular segment the increase in expenses from approximately NIS 401 million in the first three months of 2004 to approximately NIS 839 in the reported period, arises mainly from the first-time full consolidation. In addition, expenses in the segment increased compared with the corresponding period mainly due to the increase in revenues and in the costs of subscriber acquisition, which derives 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 expenses from approximately NIS 132 million in the first three months of 2004 to approximately NIS 152 million in the reported period, as a result of the increase in expenses for foreign managers deriving mainly from a significant increase in traffic routed from one foreign operator to another foreign operator.

General and operating expenses of approximately NIS 235 million from the multi-channel television segment were included in the Group's expenses for the first three months of 2005, due to the first-time consolidation of DBS during 2004.

D. Depreciation

The Group's depreciation expenses increased from approximately NIS 472 in the first three months of 2004 to approximately NIS 578 million in the current period, as a result of first-time consolidation in respect of which depreciation expenses increased by about NIS 135 million. Eliminating this increase, depreciation expenses decreased as a result of the full depreciation of 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 66 million, compared with approximately NIS 47 million in 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 amounted to approximately NIS 366 million, compared with approximately NIS 399 million in the corresponding period in the prior year, a decrease of approximately NIS 33 million. The decrease in operating income derives from the changes in the results of the segments described above in the revenues and expenses sections. These changes led to a fall in the profitability of the Group's main segments of operation (except for the multi-channel television segment). The decrease in the Group's operating income was partially decreased due to the first-time consolidation of DBS, as described above.

G. Financing expenses

The Group's net financing expenses amounted to approximately NIS 55 million, compared with approximately NIS 31 million in the corresponding period in the prior year. The source of approximately NIS 41 million of the expenses is the first-time consolidation.
These finance expenses are influenced by changes in interest rates, exchange rates and the Index.
In the fixed-line domestic communication segment, financing expenses decreased compared with the prior year due to changes in the CPI and in the exchange rates of the dollar and the euro. The effect of the changes in the foreign currency and shekel rates was largely neutralized by carrying out hedging transactions and investment in financial assets.
In the cellular segment, financing expenses were lowered, *inter alia*, by recycling loans at lower interest rates and as a result of the negative inflation in the quarter.

H. Other income (expenses)

Income amounting to approximately NIS 88 million was recorded in the Group's Other income (expenses) item, compared with an expense of approximately NIS 30 million in the corresponding period of 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 reported period derived mainly from capital gains of approximately NIS 104 million. This income was partially offset by amortization of goodwill in respect of companies consolidated for the first time in the financial statements (see Note 10 the financial statements).

I. Group’s equity in losses of affiliates

The Group’s equity in losses of affiliates decreased compared with corresponding period in the prior year, from approximately NIS 65 million in 2003 to approximately NIS 3 million in the reported period. Most of the decrease derived from the change of DBS into a consolidated company towards the end of the first half of the prior 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 (or other alternative financing), including loans from the Company, in accordance with the DBS's work plan.

3. Liquidity and sources of financing

Consolidated cash flows generated by operating activities amounted to approximately NIS 628 million, compared with approximately NIS 758 million in the corresponding period in the prior year. Eliminating an increase of approximately NIS 83 deriving from first-time consolidation, cash flows from operating activities decreased by approximately NIS 213 million. In the fixed-line domestic communications and cellular segments this was mainly as a result of 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 reported period included, *inter alia*, approximately NIS 476 million in the development of communications infrastructure and approximately NIS 275 million in short-term investments.

During the period the Group repaid approximately NIS 683 million in debts, of which approximately NIS 592 million was on account of long-term loans and approximately NIS 91 million on account of debentures. The Group raised new debt in a total amount of approximately NIS 940 million by an offering of debentures, receipt of new long-term loans and receipt of short-term bank credit.

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 8,333 million.

Working capital as at March 31, 2005 is positive and amounted to approximately NIS 1,254 million, compared with positive working capital of approximately NIS 1,490 million on March 31, 2004. The decrease derives mainly from the first-time consolidation, which reduced working capital by approximately NIS 398 million, mainly from the multi-channel television segment, and from a reduction of approximately NIS 395 million in the working capital of the fixed-line domestic communications segment. Conversely, working capital increased in the cellular segment, mainly as a result of raising long-term debt and the repayment of short-term loans.

4. Group involvement in the community and donations

In the reported period 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.
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 thousand. In the reported period the Company donated NIS 231 thousand, and overall throughout the campaign, a total of NIS 2,792 thousand.

5. Details concerning market risk exposure and management thereof

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

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

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

Surplus monetary liabilities over monetary assets denominated in or linked to a foreign currency as at March 31, 2005 amounted to approximately NIS 3 billion in the Group. As a result of forward currency transactions, the net balance of foreign currency liabilities not hedged as aforesaid as at March 31, 2005 amounts to approximately NIS 131 million.
Surplus monetary liabilities over monetary assets linked to the CPI as at March 31, 2005 amount to approximately NIS 3.8 billion in the Group.

6. 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 need to replace such loans (except for a loan of NIS 5 million which was repaid by the Company before its due date).

7. 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 Vice President for Management Resources was appointed compliance officer for the implementation of the provisions of the code of ethics.

b. 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.

Dalit Braun **Member of the Board** **(Chairperson of the approval meeting)**	**Amnon Dick** **CEO**