March 6, 2003

Directors' Report on the State of the Company's Affairs for the year ended December 31, 2002

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 together are hereinafter referred to as "the Group") for the year ended December 31, 2002 (hereinafter: "the Directors' Report"). The Report was prepared in accordance with the Securities Regulations (Periodic and Immediate Reports), 5730 - 1970.

The financial data in the Directors' Report are presented in adjusted shekels of December 2002.

1. The Corporation and its Business Environment

A. The Company, together with its wholly or partially owned subsidiaries, is the principal provider of telecommunications services in Israel. The Group operates and provides a wide range of telecommunications activities and services, including domestic and international telephone services, cellular telephone services, satellite television services, the laying, maintenance and development of infrastructure, telecommunications services for other telecommunications providers, internet services, data communications, leasing of lines, satellite services, the distribution of radio and television services to the public, provision and maintenance of equipment and services on customer premises.

B. The field of telecommunications in which the Group operates is subject to technological changes as well as changes to the business structure of the sector. It is a field which in recent years has been subject to intensifying competition and areas which were once in the exclusive domain of the Group have been or are about to be opened to competition in accordance with Government policy.

C. The Group and its activities are subject to close governmental supervision, which is carried out by authorities and other official entities whose policy has changed and continues to change considerably from time to time. This governmental supervision is reflected, *inter alia*, in each of the following ways:

(1) Most of the Company's tariffs are set and updated in accordance with the provisions of the Telecommunications Law (Telecommunications and Broadcasts), 5742 - 1982 (hereinafter: "the Telecommunications Law") and the regulations promulgated under that Law (see Note 1B to the financial statements).

In addition, some of the Company's tariffs are subject to supervision and regulation in accordance with the provisions of the Supervision of Prices of Products and Services Law, 5756 - 1996.

(2) The Group is obligated to pay royalties to the State in respect of most of its revenues (see also Note 1C to the financial statements).

(3) Since the Company is a government company, it must operate in accordance with the provisions of the Government Companies Law, 5735 - 1975, and other laws.

(4) The Company's activities are subject to the provisions of a general license awarded to it by virtue of the Telecommunications Law. In some sectors the Company was authorized to operate through subsidiaries in which its control is limited.

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

(6) Some of the activities of the Company and its subsidiary Pelephone Communications Ltd. (hereinafter: "Pelephone") involve the use of wireless frequency, and as such, are subject to the Wireless Telegraph Ordinance (New Version), 5732 - 1972. The Wireless Telegraph Regulations determine the fees to be paid for the use of a wireless frequency.

The governmental supervision restricts the freedom of action of the Group as a business entity, its ability to compete successfully in the markets which are being opened to increased competition in which it operates, its ability to cope effectively with the changes occurring in the field of telecommunications and to exploit new business opportunities.

D. During the period of the Directors' Report and 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 the following:

1. As a result of the cancellation of Section 50 of the Telecommunications Law, effective as of June 1, 1999, which had granted the Company, in the past, exclusivity in providing fixed-line domestic telecommunications services in a nationwide telephone network, the Ministry of Communications embarked upon a series of actions designed to enable additional operators to provide domestic telecommunication services, as follows:

   a. As described in Note 1E(3) to the financial statements, in July 2001 the Telecommunications Law was amended so as to enable, inter alia, the Ministry of Communications to grant the cable companies licenses to provide domestic fixed-line communications on the cable infrastructure.

   b. In March 2002 the Ministry of Communications granted domestic operator licenses to the cable companies. At this stage, the license has been granted for the provision of broadband internet services via the cable infrastructure and to provide data communication and transmission services, with certain restrictions. The application by the cable companies to merge was approved, under certain conditions, by the Anti-Trust Authority and by all relevant regulatory bodies. The matter is pending as part of an appeal filed by D.B.S. Satellite Services (1998) Ltd. in the Anti-Trust Tribunal.

   c. A committee appointed by the Minister of Communications to make detailed recommendations regarding rules and policy on the opening of competition in the fixed-line communications market in Israel presented its recommendations to the Minister in August 2002. The Minister of Communications adopted the recommendations, with certain modifications (see Note 1E(3) to the financial statements).

      Following adoption of the committee's recommendations, the Ministry of Communications announced that it had broadened the special licenses of Cellcom and Med-1 so as to permit them to provide data communication and high-speed transmission services to business customers. Concurrently, the general licenses of the domestic communications operators of the cable companies were broadened to permit them to provide data communication, digital transmission and optical transmission services.

2. The opening of domestic communications services to full competition, inter alia, in accordance with the principles formulated by the aforementioned committee appointed by the Minister of Communications, in addition to the intensifying competition in the cellular and international communications sectors, are expected to continue and have a materially adverse effect on the Company's business results, the extent of which cannot be estimated. In order to cope with the anticipated changes, the Company is preparing, *inter alia*, a plan for changing its organizational structure. The plan has not yet been completed and has not yet been approved by the relevant bodies in the Company.

3. The accelerated growth in cellular telephone services, which occurred as the additional operators began operations, has turned this service into a direct competitor of the fixed line telephony and data transmission services provided by the Company. As a result, it has led to stagnation in growth and even to a decrease in the volume of fixed-line telephony services provided by the Company.

   Following the directives of the Ministry of Communications to the cellular companies to disconnect direct connections that bypass the Company's network, one cellular company filed an appeal in the Supreme Court, demanding that the directive be revoked, in response to which the Supreme Court issued an interlocutory order preserving the status quo. As a result of the order, instructions were issued by the Ministry of Communications to all the cellular companies not to make any additional direct connections. The Supreme Court subsequently issued an interim order, granting the respondents, including the Company, 60 days to respond.

4. Bezeq International Ltd. (hereinafter: "Bezeq International") ended 2002 with an operating profit as compared with a loss in the prior year. The significant improvement in the results of operations was achieved by reducing operating expenses and general and administrative expenses even though there was a reduction in revenues due to the effective price reduction which resulted from competition in the internet broadband operations.

   The Minister of Communications has decided to grant a general license for international telecommunications services to additional applicants, commencing on January 1, 2004. This change is expected to have an adverse effect on the financial results of Bezeq International, *inter alia,* in tariffs, market share and traffic ratio.

5. The increase in the revenues of Pelephone led to a significant decrease in its loss from ordinary activities. The loss for the year also decreased significantly due to the write-down of assets which would no longer be used by Pelephone in providing its services that was made in the prior year.

6. D.B.S. Satellite Services (1998) Ltd. (hereinafter: "DBS") commenced the provision of satellite services in July 2000. In so doing, it has accumulated losses of which the Company's share as at December 31, 2002, reached NIS 762 million, of which approximately NIS 290 million relate to the reporting year. DBS has suffered considerable losses and negative cash flows from its operating activities. During the year of account, DBS losses decreased compared with the prior year, mainly due to the increase in its revenues and the decrease in its sales and marketing, administrative and financing expenses. For details about the Company's increased exposure and holdings in DBS, see Note 8E to the financial statements.

7. During the year of account , the Company expanded its broadband internet services in ADSL technology and significantly increased the number of subscribers to the service.

8. Due to past Government decisions and the regulations of the Government Companies Authority, the Company and its government company subsidiaries are forbidden to make donations. The Company's request to the Government Companies Authority to consider allowing the Company, out of business considerations, to make donations as part of its policy of "commitment to the society and the community in Israel", was rejected. In view of this restriction, the Company acts for the community by involvement in social institutions and organizations such as the education system in distressed areas and on the line of confrontation .

9. The privatization of the Company, which should have been completed some time ago, has yet to be completed (see Note 1F to the financial statements).

10. On January 1, 2003, Adv. Miriam (Miki) Mazar took office as Chairperson of the Board of Directors of the Company – at this stage until June 30, 2003.

2. Details concerning exposure to and management of market risks

The Company and the consolidated companies each manage their market risks individually and not on a consolidated perspective. Following is a description of the risks and the management thereof by the Company:

Responsibility for the management of the Company's market risks

During the reporting year the person responsible for the management of the Company's market risks was the outgoing Chief Financial Officer, Mr. Oren Lieder. For details of his education and experience, see the Periodic Report for 2001, under Regulation 26A.

Description of market risks and the Company's risk management policy

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

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 is an accounting exposure and 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 thereby eliminating this possible economic exposure.

Loans and debentures of the Company that are linked to the Consumer Price Index ("CPI") usually bear fixed interest and therefore a change in the interest rate will affect the fair value rather than the book value. This feature also exists with respect to the euro-denominated debentures that the Company issued on an overseas stock exchange.

The Company has invested in quoted bonds that are recorded in its books at their market value. This market value is influenced by changes in the interest rates in the economy.
The Company has invested in quoted bonds defined as a "permanent investment" and therefore their presentation is not affected by market value or by changes in the interest rate in the economy.

As of the date of this Report the Company does not hedge against the aforementioned exposures. It is not inconceivable, however, that hedging will be carried out in future market circumstances. Additionally, the Company also takes into account such aforementioned influences when considering the types of loans it takes.

Exchange rates – Of itself, a change in the shekel exchange rate constitutes economic exposure in that it can affect the Company's future profit and cash flows, mainly 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 as compared with the rate of change in the CPI in the reporting period. Such exposure generates a decrease or an increase in the value of currency-linked liabilities, which could, in turn, have a significant 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 positions so that the balance of the unhedged exposure would not exceed 150 million dollars. The reduction to the exposure during the reporting period was accomplished by means of forward currency transactions with banking corporations. In minimizing exposure in accordance with the policy, the unhedged balance as at December 31, 2002 amounted to NIS 329 million.

We note that inherent in some of the Company's hedging transactions is nominal shekel interest that constitutes, in a period of low inflation, a high real interest rate. Conversely, the Company receives a parallel nominal interest on its shekel deposits thereby partially neutralizing that interest risk.

The Company had no material costs in performing hedging transactions against exchange rates since they were made as forward transactions. The financial statements include finance interest of NIS 298.7 million from these hedging transactions.

Inflation – 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 by the same rate as inflation (less a fixed efficiency factor) once a year or when the rate of accumulated 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. On the other hand, the influence of the rate of inflation on the Company's real expenses is reduced, since some of these expenses have direct or indirect linkage mechanisms. In addition, the Company invests a considerable part of its cash balances in unlinked shekel deposits and mutual funds, which are exposed to changes in their real yield due to changes in the rate of inflation.

In recent years, the low rate of inflation in Israel greatly reduced the financial significance of this risk, but the accelerated inflation in the year of account has made it more significant regarding its accounting and economic effect . In applying its policy of minimizing exposure, the Company made hedging transactions against the CPI. The financial statements include interest income of NIS 33.1 million from these transactions.

The Company's loans are linked to the "known index", while accounting indexation is made according to the "actual index". Differentials in the rise in the known index compared with the actual index create an increase or reduction in value of loans in accounting index terms. In a period of high inflation this differential had a material effect on the accounting 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.

Prices of raw materials and equipment – The cash flow from 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 global prices. The Company is not protected against this exposure.

Prices of securities – The Company invests some of its financial balances in securities. The composition and amount of the securities portfolio are determined by the Board of Directors of the Company. 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 include shares invested in the TASE 100. The types of bonds, their proportional part in the portfolio and a separation between government and non-government bonds were also determined according to criteria based on linkage and redemption date. Additionally, a ceiling was also determined for the various types of investment.

Supervision and implementation of the market risk management policy

Following the amendment to the Securities Regulations (Periodic and Immediate Reports) on the subject of exposure to market risks and its management, a sub-committee of the Finance Committee of the Company Board of Directors was established whose role was to discuss the market risk management policy of the Company in accordance with the amendment, and make its recommendations to the Finance Committee and the Board of Directors. On May 14, 2002, the Board of Directors approved the recommendations of the sub-committee. The resolution defines the Company's policy on the matter and authority for implementation. A quarterly reporting format that is designed to oversee the relevant activities of the Company's management on the matter was subsequently approved by the sub-committee and the Board of Directors

Description of the risks and their management in the consolidated companies and in a proportionally consolidated company

The persons responsible for market risk management in the principal consolidated companies are the Chief Financial Officers of those companies and in a proportionally -consolidated company - the Treasurer of the company. The consolidated companies carry out hedging transactions in accordance with and under the supervision of their boards of directors. The proportionally-consolidated company hedges part of its exposure in respect of its infrastructure purchases.

Report on linkage bases

Note 30 to the financial statements includes information regarding the linkage terms of monetary balances of the Company and the Group as at December 31, 2002.

Positions in derivatives as at December 31, 2002 (consolidated)
(Amounts are in NIS thousands)

Dollar / NIS								
	Nominal Value				**Fair Value - asset (liability)**			
	Up to one year		More than one year		Up to one year		More than one year	
	Long	Short	Long	Short	Long	Short	Long	Short
Forward transactions								
Hedging recognized for accounting	286,936	85,266			1,650	100		
Hedging not recognized for accounting	71,055				(1,914)			
Transactions at predetermined interest rates								
Hedging recognized for accounting	632,390		241,587		(2,913)		1,240	
Call option								
Hedging recognized for accounting	39,080				242			
Hedging not recognized for accounting	23,685				912			

Euro / NIS								
	Nominal Value				**Fair Value - asset (liability)**			
	Up to one year		More than one year		Up to one year		More than one year	
	Long	Short	Long	Short	Long	Short	Long	Short
Forward transactions								
Hedging recognized for accounting	323,024				34,560			
Transactions at predetermined interest rates								
Hedging recognized for accounting	891,720		248,480		120,798		43,703	

CPI / NIS								
	Nominal Value				**Fair Value - asset (liability)**			
	Up to one year		More than one year		Up to one year		More than one year	
	Long	Short	Long	Short	Long	Short	Long	Short
Forward transactions								
Hedging recognized for accounting	25,000				1,370			
Call option								
Hedging not recognized for accounting		20,000						

3. Financial Position

a. The Group's assets as at December 31, 2002, amounted to approximately NIS 16.5 billion, compared with NIS 18.3 billion at December 31, 2001. Of these, approximately NIS 10.0 billion (approximately 60.3%) are fixed assets compared with approximately NIS 10.9 billion (59.7%) at December 31, 2001.

The decrease in total assets derived mainly from the decrease in the depreciated cost of the fixed assets resulting from the difference between the depreciation expense and the investment made in the reporting period; from the decrease in investments and long-term debts, mainly due to writing down investments in convertible debentures in Pelephone Holdings L.L.C., as described in Note 8D to the financial statements and from a decrease in the balance of cash and cash equivalents. The decrease was partially offset by an increase in short –term investments.

b. The Group's shareholders' equity as at December 31, 2002, amounted to approximately NIS 6.72 billion, representing approximately 40.6% of the total balance sheet compared with approximately NIS 7.65 billion at December 31, 2001, which represented approximately 41.8% of the total balance sheet. The decrease in shareholder' equity was due to the net loss of the Group.

c. Total Group debt to financial institutions and debenture holders as at December 31, 2002, amounted to approximately NIS 6.2 billion compared with approximately NIS 6.6 billion at December 31, 2001.

d. Group balances in cash and short-term investments as at December 31, 2002, amounted to approximately NIS 2.17 billion compared with NIS 1.86 billion at December 31, 2001.

e. Surplus monetary liabilities over assets denominated in or linked to foreign currency as at December 31, 2002, amounted to approximately NIS 3.01 billion in the Group. During the reporting period the Group entered into forward currency transactions to reduce the exposure deriving from the surplus. (See Section 2 above for details about market risks and their management.)

f. Surplus liabilities linked to the CPI over linked assets as at December 31, 2002, amounted to approximately NIS 0.96 billion in the Group. The Company has a balance of future linked transactions that reduces its operational exposure to a rise in the CPI during the year.

4. Results of Operations

Comparison of results for 2002 with results for 2001

a. Principal results

The net loss for 2002 amounted to approximately NIS 930 million compared with net earnings of approximately NIS 129 million in corresponding period in the prior year. The difference in the results derives mainly from the Other expenses/income item where an expense of NIS 1,243 million (before tax) was recorded. The aforementioned was mainly a provision for a write-down in connection with investments in convertible debentures of Pelephone Holdings L.L.C., as described in Note 8D to the financial statements. Eliminating the effect of the write-down, the net earnings for 2002 would have been approximately NIS 267 million. The effects of accelerated inflation during the year of account, mainly due to the real erosion of Company tariffs, had a significant effect on the financial results.

Loss per share in 2002 was NIS 0.386 per NIS 1 par value compared with earnings of NIS 0.053 per share in the corresponding period in the prior year.

b. Revenues

Group revenues in 2002 amounted to approximately NIS 8.23 billion, compared with approximately NIS 8.68 billion in the corresponding period in the prior year . The decrease in revenues derives principally from the decrease in revenues from domestic fixed-line communications, international communications, cellular communications and fixed fees.

Revenues from domestic fixed-line communications decreased as a result of erosion of real tariffs due to accelerated inflation during the period and as a result of a decrease in call traffic. Revenues from international communications decreased due to cancellation of the access fees that the Company had received in the past from the international communications operators. Revenues from cellular communications decreased due to the decrease in interconnect fees and the repayment of bad debts in respect of airtime to the cellular companies. Revenues from fixed fees decreased compared with the prior year as a result of erosion tariff erosion. The decrease in the Group's revenues was partially offset by an increase in the revenues of Pelephone.

c. Operating and general expenses

The Group's operating and general expenses in 2002 amounted to approximately NIS 4.62 billion compared with approximately NIS 4.76 billion in the corresponding period in the prior year.

The decrease in the operating and general expenses of the Group derives mainly from efforts to improve efficiency in the Company – mainly relating to wages, general and sub-contractor expenses and a decrease in the expenses of Bezeq International. The decrease in expenses was offset mainly by an increase in the expenses of Pelephone mainly arising from a change in Pelephone's method of recording the expenses of new customer acquisition so as to grant immediate recognition of the costs of acquiring those customers.

d. Depreciation

The Group's depreciation expenses decreased as a result of the cessation of the depreciation charge of the Company's fixed assets and a decrease in investments in new assets. In addition, depreciation expenses decreased as a result of a change in the estimated period of useful life of telecommunications equipment as described in Note 9 to the financial statements.

e. Royalty payments to the Government of Israel

The Group's royalty expenses in 2002 amounted to approximately NIS 255 millioncompared with approximately NIS 288 million in the corresponding period in the prior year. The source of the decrease is the decrease in the percentage of royalties on the revenues of Bezeq International and Pelephone and the decrease in the revenues of the Company.

f. Operating income

The Group's operating income in 2002 amounted to approximately NIS 1,037 million compared with approximately NIS 870 million in the corresponding period in the prior year, an increase of approximately NIS 167 million. The increase in operating income results from the changes described above in the revenues and expenses items, from lower depreciation charges and royalties due to the Government of Israel. These changes led to an operating profit at Bezeq International as compared with a loss in 2001; to a considerable decrease in the operating loss of Pelephone and to a decrease in the operating income of the Company.

g. Financing expenses

The Group's financing expenses in 2002 amounted to approximately NIS 168 million, compared with approximately NIS 153 million in the corresponding period in the prior year when the Company included approximately NIS 84 million in interest income from income tax. Eliminating this income, the financing expenses of the Group decreased. The decrease in expenses derived from the reduction of the Group's financial debt and as a result of accelerated inflation which caused erosion of unlinked liabilities. Conversely, accelerated inflation decreased the Company's yield on its liquid investments. The effects of changes in currency exchange rates were eliminated to a large extent as a result of hedging transactions.

h. Other expenses, net

As described in Note 8D to the financial statements, in the reporting period a provision was made for a write-down of NIS 1,233 million in connection with the Company's investment in convertible debentures of Pelephone Holdings L.L.C., of Shamrock Holdings of California Inc.

i. Company equity in losses of affiliates

The Company’s equity in the losses of affiliates increased compared with the corresponding period in the prior year due to the increase in the Company's equity in the losses of DBS Satellite Services and due to profit deriving from the realization of the Company's indirect holding in Hungary which was recorded in 2001.

j. Quarterly data – Consolidated statements (in NIS millions)

	2 0 0 2					2001
	Total	Q4	Q3	Q2	Q1	Q4
Revenues	8,235	2,027	2,087	2,056	2,065	2,164
Costs and expenses	7,198	1,812	1,811	1,786	1,789	1,984
Operating income	1,037	215	276	270	276	180
Financing expenses	168	14	82	27	45	48
Other expenses (income)	1,243	852	397	(4)	(2)	106
Company's equity in earnings (losses) of investee companies	(347)	(106)	(116)	(74)	(53)	(92)
Net (loss) earnings	(930)	(786)	(343)	86	113	(46)

5. Liquidity and sources of financing

Consolidated cash flows generated by operating activities in 2002 amounted to approximately NIS 2,815 million compared with approximately NIS 3,425 million in the corresponding period in the prior year . The decrease in consolidated cash flows was due to a decrease in the operating cash flows of the Company, resulting principally from a decrease in revenues and an increase in payments in respect of early retirement, as well as a decrease in the operating cash flows of Pelephone as a result of the change in its method of recording the expenses of customer acquisitions. The decrease was partially offset by an increase in the operating cash flows of Bezeq International.

Cash flows generated by operating activities are the principal source of financing the Group's investments, and these were applied during the reporting period, inter alia, for the investment of approximately NIS 1,380 million in the development of telecommunications infrastructure, approximately

NIS 366 million in investee companies and approximately NIS 222 million in long-term deposits and investments. During 2002 the Group repaid approximately NIS 1,068 million of debt, of which approximately NIS 842 million was on account of long-term loans and approximately NIS 226 million on account of debentures. Conversely, the Group raised new debt in a total amount of approximately NIS 397 million, of which approximately NIS 211 million was in new long-term loans, approximately NIS 109 million in issuances of debentures and approximately NIS 77 million in short-term credit.

The average monthly short-term credit during the period was approximately NIS 341 million. The average monthly long-term liabilities during the period were approximately NIS 6,046 million.

Working capital as at December 31, 2002, was positive and amounted to approximately NIS 839 million compared with positive working capital of approximately NIS 250 million at December 31, 2001. The improvement in the Group's working capital derived mainly from an increase in the short-term investments of the Group.

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

Adv. Miriam (Miki) Mazar Chairperson of the Board of Directors	Ilan Biran CEO