May 28, 2002

# Directors' Report on the State of the Company's Affairs for the three-month period ended March 31, 2002

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 period ended March 31, 2002 (hereinafter: "the Directors' Report"). The Report was prepared in accordance with the Securities Regulations (Periodic and immediate reports), 5730-1970.

The Directors' Report contains a review of its subject matter, in condensed from, and has been prepared on the assumption that the reader can also refer to the Directors' Report for the year ended December 31, 2001.

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

## 1. Business Environment

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 these:

a. Following the cancellation of Section 50 of the Telecommunications Law, effective from June 1, 1999, which had granted the Company exclusivity in providing fixed national 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:

During the report period, the Ministry of Communications awarded licenses to the cable companies to provide domestic fixed-line telecommunications services. At this stage, the license is valid for providing broadband Internet services via the cable infrastructure. The application of the cable companies to merge was approved by the Anti-Trust Authority and by all relevant regulatory bodies, under certain conditions. In addition, the Minister of Communications appointed a committee to make detailed recommendations for rules and policies regarding the opening of competition in the fixed-line telecommunications market in Israel.

b. The opening of fixed-line domestic telecommunications services to full competition and the award of licenses for domestic fixed-line telecommunications services, in addition to the intensifying competition in the cellular and international telecommunications sectors, are expected to continue to have a material adverse effect on the Company's business results, the extent of which cannot yet be estimated.

c. Pursuant to the decisions of the Knesset Finance and Economics Committee, the Company's tariffs were changed, effective May 14, 2002, as described in Note 1(B)(3) to the financial statements. In March 2002 a committee was appointed to examine and revise the Company's tariffs and make recommendations for a new tariff arrangement, to bring the arrangement in line with the changing environment of the telecommunications industry.

d. For details about the Company's investment in D.B.S. Satellite Services (1998) Ltd. and the financing agreement signed with the banks, see Note 4(A) to the financial statements.

## 2. Details concerning exposure to and management of market risks

a. As described in the Directors' Report for 2001, as a result of hedging transactions against market risks associated with exposure to fluctuation of exchange rates, the Group sustained no material financing income or expenses despite the material changes in the exchange rates of foreign currencies during the period.

b. On May 14, 2002, the Board of Directors approved its sub-committee for market risks' recommendations regarding the Company's market risk management policy. The resolution defines the Company's policy and its authorization to implement such policy. The policy covers currency exchange rates risks, increases in the CPI, interest, and risks in prices of raw and other materials. The policy decided upon is not significantly different from that appearing in the Directors Report for the year ended December 31, 2001.

c. The report on linkage bases and positions in derivatives as at March 31, 2002 is not significantly different from that reported for December 31, 2001.

d. The Group's surplus monetary liabilities over monetary assets in foreign currency or linked thereto as at March 31, 2002, amounted to approximately NIS 2.1 billion. As a result of forward currency transactions as at that date, no net foreign currency liabilities were unhedged by forward transactions, and the Company has positions in currency derivatives (see Note 7(B) to the financial statements – Options written), which could, if the dollar continues to gain strength against the shekel, generate a material surplus of foreign currency liabilities for the Company. The Group's surplus liabilities over assets that are linked to the CPI as at March 31, 2002 amounted to approximately NIS 1.9 billion. The Company entered into hedging transactions that limit the exposure to rises in the CPI during the year.

## 3. Financial Position

a. The Group's assets as at March 31, 2002 amounted to approximately NIS 17.30 billion, compared with NIS 17.98 billion on March 31, 2001. Of these, approximately NIS 10.18 billion (approximately 58.8%) are fixed assets, compared with approximately NIS 11.63 billion (64.7%) on March 31, 2001.

   The decrease in total assets is derived mainly from the decrease in the net book value of fixed assets as a result of the difference between depreciation expenses and the investment made in the Report Period. This decrease was offset mainly by the increase in long-term investments and an increase in cash balances, short-term investments and trade receivables.

b. The Group's shareholders' equity as at March 31, 2002 amounted to approximately NIS 7.46 billion, comprising approximately 43.1% of the total balance sheet, compared with approximately NIS 7.3 billion on March 31, 2001, which comprised approximately 40.6% of the balance sheet.

c. Total Group debt to financial institutions and to the holders of its debentures as at March 31, 2002 amounted to approximately NIS 6.23 billion, compared with approximately NIS 7.07 billion on March 31, 2001.

d. The balances of the Group's cash and short-term investments as at March 31, 2002 amounted to approximately NIS 1,975 million, compared with NIS 1,384 million on March 31, 2001.

## 4. Results of Operations

### a. Principal results

Net earnings for the first three months of 2002 amounted to approximately NIS 108 million, compared with a net earnings of approximately NIS 74 million in the same period last year.

Earnings per share in the first three months of 2002 were NIS 0.045 per NIS 1 par value, compared with NIS 0.03 per share in the same period last year.

### b. Revenues

Group revenues in the first three months of 2002 amounted to approximately NIS 1.99 billion, compared with approximately NIS 2.12 billion in the same period last year, a decrease of approximately 6.3%.

The decrease in revenues stems mainly from the decrease in the Company's revenues from fixed-line communications, international communications and fixed fees. Revenues from fixed-line traffic in Israel decreased as a result of the lower tariffs that took effect on March 1, 2001, erosion of tariffs due to accelerated inflation during the period, and a decrease in call traffic. Revenues from international communications decreased due to cancellation of the access fees which the Company received in the past from the international communications operators.

### c. Operating and general expenses

The Group's operating and general expenses in the first three months of 2002 amounted to approximately NIS 1.098 billion, compared with approximately NIS 1.091 billion in the same period last year, an insignificant change.

The stability in the operating expenses of the Group is a result of stability in the expenses of the Company, while the decrease in expenses at Bezeq International was offset by an increase in expenses at Pelephone.

### d. Depreciation

The Group's depreciation expenses are decreasing as a result of the end of depreciation of the Company's fixed assets and a decrease in investments in new assets. Depreciation expenses also decreased as a result of a change in the period of useful life of communications equipment, as described in Note 5 to the financial statements.

### e. Royalties to the Government of Israel

The ongoing decrease in the rate of royalties on the revenues of Bezeq International and Pelephone has led to a decrease of approximately 23% in the royalties obligation of the Group.

### f. Operating income

The Group's operating income in the first three months of 2002 amounted to approximately NIS 266 million, compared with approximately NIS 272 million in the same period last year, a decrease of approximately NIS 6 million. The decrease in operating income results from the decrease in the Company's revenues, most of which was offset by the lower depreciation expenses and royalties to the Government of Israel. The decrease in operating income at the Company amounted to approximately NIS 52 million, while Bezeq International posted an increase of approximately NIS 41 million in operating income.

g. Financing expenses

The Group's financing expenses in the first three months of 2002 amounted to approximately NIS 43 million, compared with approximately NIS 54 million in the same period last year. The decrease is derived from a decrease in the interest expenses of Pelephone and Bezeq International as a result of accelerated devaluation and inflation. The financing expenses of the Company increased due to a decrease in the yield on the Company's liquid investments as a result of the accelerated inflation. The decrease in yield on investments offset the decrease in financing expenses as a result of a decrease in the Company's financial liabilities. The effects of the changes in foreign currency exchange rates on the financing expenses of the Company, were neutralized to a large extent by hedging transactions.

## 5. Liquidity and sources of financing

Consolidated cash flows generated by operating activities in the first three months of 2002 amounted to approximately NIS 648 million, compared with approximately NIS 861 million in the same period last year. The decrease in consolidated cash flow derives from a decrease in the cash flow of the Company, mainly as a result of the decrease in revenues and also as a result of an increase in payments in respect of early retirement. Cash flow generated by operating activities is the principal source for financing the Group's investments, and was used during the Report Period, *inter alia*, for the investment of approximately NIS 294 million in the development of telecommunications infrastructures, approximately NIS 86 million in investee companies and approximately NIS 14 million in deposits and long-term investments. In the first three months of 2002, the Group repaid approximately NIS 427 million of debts, of which approximately NIS 107 million on account of long-term loans, approximately NIS 121 million of debentures and approximately NIS 199 million of short-term credit. Conversely, the Group raised new debt in a total amount of approximately NIS 267 million, of which approximately NIS 162 million in new long-term loans and approximately NIS 105 million in issues of debentures.

The average monthly short-term credit for the period was approximately NIS 278 million. The average monthly long-term liabilities in the period were approximately NIS 5,984 million.

Working capital as at March 31, 2002 was positive and amounted to approximately NIS 835 million, compared with negative working capital of approximately NIS 1.06 billion on March 31, 2001. The improvement in the Group's working capital derived mainly from an increase in cash balances, trade receivables and short-term investments of the Group, as well as a decrease in current liabilities to banks.

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

Ido Dissentshik
Chairman of the Board

Ilan Biran
CEO