April 9, 2000

Directors' Report on the State of the Company's Affairs for the Year Ended December 31, 1999

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, 1999 (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 1999.

1. The Company and its Business Environment

a) The Company, together with its wholly-owned and partly-owned subsidiaries, is the main provider of telecommunications services in Israel. The Group performs and provides a wide range of telecommunications activities and services, including domestic and international telephone services, cellular services, installation, maintenance and development of infrastructure, providing telecommunications services to other telecommunications service providers, data communications, leased lines, satellite services, transmission of radio and television broadcasts to the public, supply and maintenance of equipment, and services at the customer's premises.

b) The field of telecommunications in which the Group operates is subject to change, both technologically and in the business structure of the sector. In recent years this sector has been characterized by growing competition where, in accordance with government policies, the areas of activity which were engaged in exclusively by the Group have been or are about to be opened up to competition.

c) The Group and its activities are subject to close government supervision by various government authorities, whose policy has changed and continues to change materially from time to time. This government supervision is reflected, *inter alia*, in all of the following:

(1) The setting and revision of most of the Company's tariffs are done in accordance with the provisions of the Telecommunications Law, 5752-1992 (hereinafter: "the Telecommunications Law") and the regulations promulgated thereunder (see Note 1B to the financial statements). Furthermore, the Company's tariffs are subject to regulation under the Law for Price Regulation of Goods and Services, 5756-1996.

(2) Mandatory royalties are paid to the State in respect of most of the Group's revenues. (See also Note 1C to the financial statements.)

(3) Since the Government of Israel has a controlling interest in the Company, the Company is subject to the Government Companies Law, 5735-1975 and other laws.

(4) The activities of the Company are subject to a general license granted to it, requiring it, inter alia, to operate only in areas defined therein, and to obtain the approval of the Minister of Communications to engage in any area which is not defined in its general license. This license also permits the Company to operate in certain sectors which have been opened to competition, but only through subsidiaries in which the Company's control and ability to influence their businesses are limited under provisions by virtue of the general license.

(5) The Company was declared a monopoly in certain areas of its activities, and is therefore subject also to regulations 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 its subsidiary Pelephone Communications Ltd. entail the use of wireless frequencies, and as such are subject to

the Wireless Telegraph Ordinance (New Version), 5732-1972. The Wireless Telegraph Regulations determine the fees for use of the wireless frequency.

This governmental regulation restricts the Group's freedom of activity as a business entity, its ability to compete successfully in those of its markets being opened to increasing competition, its ability to deal effectively with the changes occurring in the telecommunications sector and its ability to take full advantage of new business opportunities.

d) During and immediately following the period of this Directors' Report, several events and changes occurred in the state of the Group's affairs and its business environment, the most noteworthy of which are described below:

(1) In February 1999, as part of the Arrangements Law, the Law for Cancellation of Section 50 of the Telecommunications Law, 5742-1982 was approved. Section 50 granted the Company exclusivity in providing national telecommunications services in a nationwide network of telephones under the general license. The cancellation took effect on June 1, 1999; however, the activities of the new operators in the domestic fixed telecommunications field will become possible only from the date on which they are granted a general license by the Ministry of Communications. As at the date of this report, no such license has been granted and the provision of nationwide fixed telecommunications services by new competitors has not yet commenced. On August 22, 1999, the government adopted two resolutions concerning acceleration and increase of competition in the domestic telecommunications field during 1999 and in the personal mobile communications field (PCS) during the year 2000. In addition, as part of the steps taken to expedite competition, the Ministry of Communications intends to publish tenders for granting licenses for LMDS broadband wireless access. In January 2000, as part of the Arrangements in the State Economy Law, a number of amendments were inserted in the Telecommunications Law, which were necessary, in the opinion of the Ministry of Communications, in the run-up to opening the communications market to full competition.

The anticipated opening of domestic communications services to full competition, in addition to the growing competition in the cellular communications field and in the international telecommunications field, are expected to have a materially adverse effect on the Company's business results which cannot be estimated at this stage.

2) The Ministry of Communications notified the Company that the Ministers of Communications and Finance had resolved to adopt the recommendations of the committee for the determination of the Company's tariffs, with certain amendments. On March 22, 1999 the Ministry of Communications sent a revised notice which superseded a notice dated March 1. Subsequently, on March 22, 1999, the Knesset Finance Committee approved the Telecommunications Regulations (Payments for the telecommunications services listed in the addendum to the law), 5759-1999, and the Telecommunications Regulations (Method of calculation of payments for telecommunications services and the linkage thereof), 5759-1999.

Pursuant to the regulations, on April 1, 1999 the Company's tariffs were reduced by an average of approximately 8%. This has led to a material decrease in the Company's business results. Pursuant to the decision of the Finance and Economics Committee of the Knesset on March 13, 2000, the Company's tariffs will be additionally reduced by another approximate average of 2.43% effective from May 1, 2000, and a change will be made in the method of charging for calls. The main thrust of this change is from charging by meter pulses to charging by time.

3) As part of the plan for efficiency and restructuring of the Company, the employee retirement plan is continuing. The number of employees who have retired as part of this plan is higher than the Company forecasted during the plan's preparation, and is approximately 2,050 employees rather than 1,800. The financial statements include a provision of NIS 110 million for the adjustment of the expected cost of the updated retirement data.

The results of the organizational change continue to be reflected in the Company's salary costs during the period.

Following the adoption of the recommendations of the committee for the determination of the Company's tariffs (see Note 1B) by the Ministers of Finance and Communications, the Board of Directors directed the Company's Management to formulate an appropriate plan for the Company.

The Company presented its plan to the Board of Directors in March 2000. The plan, based on a material change in the Company's organizational and functional concept, is in a formula resembling the changes already made in several other similar companies around the world as they switched to operation in a competitive environment. The Board of Directors of the Company requested further clarification from the Company before approving the plan, which validated the preliminary estimate made by the Company in 1999 with regard to the number of employees who would need to retire - between 500 and 600. The Company included in the report a provision of approximately NIS 288 million, which is the estimated cost of the retirement plan according to an agreement valid until June 30, 2000. The Company has approached the Companies Authority for its consent to extend the agreement to March 31, 2001.

4) Pursuant to an amendment to the license of international telecommunications operators from January 17, 1999, these operators will be permitted to connect their subscribers by direct trunk, subject to fulfilling their obligation to pay the Company access fees for the traffic minutes in the direct trunk lines.

On September 26, 1999, the High Court of Justice ruled, with the agreement of the parties involved, on the manner of allocating subscribers to the international operators, and in accordance with this ruling, amendments were added to the licenses of the international operators and to the Company's general license. (See Note 1E(2) to the financial statements.)

The aforementioned allocation process may have a material effect on the Company's subsidiary, Bezeq International Ltd. ("Bezeq International").

Bezeq International ended 1999 with an operating loss, and as a result of costs which it incurred due to the allocation process, ended the year with a material net loss. The Company, based on the assessment of Bezeq International, estimates that following changes in Bezeq International's business environment since the start of the competition, there are likely to be changes in the field of international telecommunications including, inter alia, tariffs, market share and traffic ratio, which may result in a material decrease in the Group's financial results.

During the year 2002, the international call market will be opened to full competition and this is likely to change the business environment in which Bezeq International operates, and to have a material adverse effect on the results of its activities.

5) On March 3, 1999 a new announcement was sent by the Histadrut, stating that in view of the Government's announcement of its decision to implement the recommendations of the committee for the determination of the Company's tariffs, the employees are renewing the labor dispute from November 1998. On the recommendation of the Regional Labor Court, meetings were held between representatives of Management, the workers and the Ministers of Communications and Finance, following which the Minister of Communications issued a letter on March 22, 1999 concerning the Company's tariffs, which contained changes in the rates of the efficiency factor compared with the rates which were determined in the committee's recommendations. In December 1999 the workers announced their intention to take organizational steps against the Ministry of Communication's intention to grant a license to Israel Railways to provide communications services via an optical fiber in its possession (the workers considered this to be a step in opening up the market to full competition before their rights had been regulated). The workers started partial work disruptions, whereupon the Company demanded that they cease immediately and return to normal work. The workers' demand of the Government is that before privatization and opening of the

communications market to full competition, an agreement be signed concerning workers' retirement, and that securities be given by the State for fulfillment of obligations towards the workers.

The State instructed Management as to the principles of the negotiations with the workers in relation to wage arrangements and involuntary retirement arrangements after privatization. There is a gap between these instructions and the demands of the workers, and Management has opened negotiations with the workers on their demands. Following a worsening of the sanctions by the workers, the Company applied to the Work Tribunal on March 16, 2000, requesting that the Tribunal issue an injunction against the sanctions. As the request was being filed, the parties reached an agreement whereby the hearing of the request would be postponed until after a meeting of the workers with the Ministers of Finance and Communications, and that the sanctions would not be intensified at this stage.

6) On May 12, 1999 the General Meeting of the Company's Shareholders resolved to approve changes in the Company's Bylaws in the format proposed by the State, some of which are effective immediately and some of which will take effect upon reduction of the State's holding in the Company to 50% or less. The principal changes which took immediate effect relate to a change in the method of appointment of directors to that of election at the General Meeting by a 60% majority of the votes of the shareholders who are present and vote (excluding abstentions). Prior to this amendment, the right to appoint a director existed for a holding of 7% of the share capital of the Company. Among the other changes in the Bylaws which will take effect upon reduction of the State's holding to 50% or less, are provisions which will continue to require the Company to obtain Government approval for certain material resolutions, and to apply conditions of qualification to the Directors, Chairman of the Board and the CEO, and methods of their appointment in accordance with the Government Companies Law. The result of the said provisions is that the Government will continue to control the Company even after a reduction in the State's holding to 50% or less, as long as the State holds 10% or more of the Company's share capital, unless another entity controls the Company, pursuant to approval in accordance with the Telecommunications Order. Regarding the decision of the Ministerial Committee for Privatization concerning the possible sale of the Company's control core, see Note 1F to the financial statements.

The resolution of the General Meeting regarding the changes to the Bylaws as described above, was adopted as a result of the decisions of the Ministerial Committee for Privatization on August 4, 1998 and January 31, 1999, as part of the Company's public offering proceedings which were supposed to result in a reduction of the State's holding in the Company to not less than 40% of the Company's share capital. In April 1999, the Company submitted a draft prospectus to the Securities Authority, for an offering of Company securities to the public. The issue proceedings were suspended, following a decision of the Attorney General on May 13, 1999, whereby the offering cannot be implemented prior to clarification of the dispute between the Israel Lands Administration and the Company concerning the Company's rights in some of the real estate assets transferred to it as part of a 1984 asset transfer agreement. (Regarding the dispute with the Israel Lands Administration, see Note 9B to the financial statements.)

On October 20, 1999 the Ministerial Committee for Privatization decided to impose upon the Government Companies Authority, in coordination with the relevant government ministries, the submission to them of a proposed resolution for the privatization of all the State's holdings in the Company, together with a document setting out the considerations in determining the percentage of control core which would be sold (see Note 1F to the financial statements).

7) In October 1998, a third cellular operator commenced partial provision of services. The entry of this operator, and the fact that it uses a different telecommunication technology (GSM), increased competition in the telecommunications market in general, and in cellular communications in particular. The entry of additional cellular operators pursuant to the Government decision of August 22, 1999 is also expected to

intensify competition in this field (see paragraph (1) above). In the fourth quarter of 1998, Pelephone Communications Ltd. ("Pelephone") commenced commercial operation of infrastructure which operates with CDMA digital technology. The operation of this system led to a decrease in Pelephone's operating profit in the fourth quarter of 1998 and substantially more so in 1999. The growing competition in this sector, the effects on increasing costs, the erosion of Pelephone's tariffs, the future effect of amortization of capitalized costs in respect of the subscriber acquisitions as described in Note 2M to the financial statements, as well as the continuation of implementing commercial operation and expansion of the CDMA system, are expected to continue to adversely affect Pelephone's profitability. The Ministry of Communications is considering changing the method of calculation of incoming call tariffs which, if implemented, is liable to have a materially adverse effect on the future results of Pelephone's operations.

An additional factor which caused material damage to Pelephone's profitability in 1999 was the perpetration of fraudulent acts by "cloning" subscribers' numbers in the analog network. Pelephone took steps to minimize and prevent this phenomenon. Following implementation of most of these steps during the third quarter of the year, a significant decrease was attained in the scope of the phenomenon and its effect on earnings.

Due to the cumulative effect of all the factors described above, Pelephone ended 1999 with a considerably smaller profit than in previous years.

8) In January 1999, D.B.S. Satellite Services (1999) Ltd. ("DBS"), in which the Company has a right to hold approximately 30% of the issued and paid-up share capital, received a license for satellite television broadcasts in consideration of NIS 30 million and the presentation of a guarantee in the amount of NIS 30 million. DBS foresees considerable losses and negative cash flow from activities in the first years of operation. At the end of October 1999, DBS notified the Company that as a result of changes in DBS's regulatory environment, DBS is reevaluating its strategy and consequently also its business plan. The commencement of provision of services by DBS is being delayed, among other reasons, due to the failure to regulate regulatory issues whose application has a material influence on its business plan, and due to delays in submitting bank financing arrangements. It is noted that the Company's exposure resulting from its investment in DBS was limited by the Ministerial Committee for Privatization and any increase in that exposure is contingent upon its approval.

9) On May 12, 1999, the Board of Directors of the Company resolved to adopt Management's recommendations, which were based on the report of a firm of outside consultants, to change the depreciation policies and the depreciation rates of the Company's assets. For details of the expected effect of this decision, see Note 9D to the financial statements.

10) As part of the implementation of the Company's strategic plan and its preparations for competition and a decrease in its revenues from "traditional" areas of communications, the Company's plans for the year 2000 include starting to provide ADSL broadband technology and e-commerce services, the operation of call center services, and investment in venture capital funds, inter alia in the field of communications.
As part of this policy, the Company entered into the following transactions in the second half of 1999:

(I) The purchase of 28.6% (26% at full dilution) of the share capital of Infogate Online Ltd. ("Infogate") in consideration of approximately $1.6 million. Infogate focuses mainly on the development and provision of data processing services using the ASP concept, whereby computers are linked in a broadband network to a central server from which they receive various services.

(II) Receipt of two option warrants for the purchase of a total of 9% of the shares of A.R.M.T. Multimedia Communications Ltd. whose business is providing broadband multimedia solutions. Exercise of the options requires government approval.

11) In 1999, Bezeq International started to provide Internet services, and on December 30, 1999 exercised an option to purchase 26% of the issued capital of Walla! Communications Ltd. ("Walla"), for consideration of approximately NIS 24.6 million. Walla provides Internet services - mainly by the operation of a portal to the Internet and the construction, development and hosting of Internet sites.

l) In August 1999, Pelephone purchased 51% of the rights of ownership and control of Safe Car Communication Ltd. The company's main activity focuses on vehicle locating and identification.

m) In August 1999, the Company's CEO gave notice of his decision to end his term of office. The new CEO took office in November 1999.

2. Details on exposure to market risks and their management

Market risk is not managed from a consolidated viewpoint. Rather, the Company and the consolidated companies each manages market risks for itself. Below is a description of the risks and their management in the Company:

a. Risk management in the Company is the responsibility of the Chief Financial Officer, Mr. Oren Lieder.

b. 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 securities. The market risks are described below:

Interest rates - The Company's foreign currency loans bear variable interest rates at LIBOR plus a margin. The Company is exposed to changes in the LIBOR rate, which can affect the financing expenses that the Company must meet and its cash flows. On the other hand, the fact that the interest is variable means that the fair value of these loans is similar to their book value.

The Company's loans and bonds that are CPI-linked usually bear a fixed interest, and therefore a change in the interest rate will affect their fair value but not their book value. The Company has invested in negotiable bonds, which are presented in the Company's books at their market value. This market value is influenced by changes in the interest rate in the economy.

The Company does not hedge the exposures described above by means of futures transactions on the interest rates, but takes the aforementioned effects into account in its considerations when deciding on the type of loan to take.

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

The Company also has book exposure stemming from the percentage of the change in the exchange rate of the shekel compared with the percentage of the change in the CPI during the reporting period. This exposure generates exposure or appreciation of the Company's dollar-linked liabilities that could, in turn, materially affect its real financing expenses.

In order to minimize this exposure, the Board of Directors of the Company decided that the Company should limit itself to exposure of not more than 150 million dollars. This is achieved by futures contracts with banking corporations - see Note 21B to the financial statements for details. In applying this policy of minimization of exposure, all of the Company's exposures as at December 31, 1999 were hedged. It is noted that some of these hedging transactions incorporate a high inherent nominal interest that, in a period of low inflation, means high real interest. In contrast, the Company receives a parallel nominal interest on its shekel deposits, thereby partly neutralizing the high cost of the real interest.

Inflation - The rate of inflation has a material effect on the operating income and expenses of the Company during the year. The Company's tariff updating mechanism that is set out in the regulations, enables tariffs to be updated once a year or when the rate of inflation reaches 8.5%. Thus, the annual inflation rate and its distribution over the year can have a significant influence on the erosion of the Company's tariffs. Company expenses are also affected by inflation, when unlinked expenses such as wages are eroded during the year and in contract, purchasing costs, which are partially linked, do not change in real terms. The Company is unable to influence its exposure to this risk.

The Company's loans are linked to the "known" CPI. The accounting measurement is according to the "actual" CPI. Differences between the "known" and "actual" CPI cause appreciation or erosion of loans in terms of accounting measurement. In periods of high inflation this difference had a material effect on the accounting measurement of the Company's financing expenses due to the significant amount of its CPI-linked liabilities. The Company cannot hedge this risk.

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

Prices of raw materials and equipment - The Company's cash flow from operations is used in part for investment in equipment. The prices of the equipment are influenced by the indices to which the prices are linked, including industry indices, exchange rates and world prices. The Company does not hedge this exposure.

Prices of securities - The Company invests part of its balances in securities. The Board of Directors decides upon the composition and amount of the portfolio. With the aim of preventing volatility in yields on the portfolio, the Board of Directors determined investment principles whereby no investments will be made in shares - only in interest bearing bonds, shekel deposits and foreign currency instruments (dollar basket only). The types of bonds and their proportional part in the investment portfolio were also determined according to criteria based on linkage basis, redemption dates and a division between government and non-government bonds. In addition, a ceiling was set for the various types of investment.

Note 30 to the financial statements contains detailed financial information about the main market risks and the means adopted by the Company so as to influence its exposure to those risks. Note 31 to the financial statements contains information about the linkage terms of the Company's balances. The Company has no costs in making hedging transactions since they are forward transactions. Nevertheless, as a result of the hedging transactions, the Company has incurred additional interest costs. Furthermore, the financing expenses of the Company were affected by real rate differences in periods when foreign currency liabilities were not fully protected. Influenced by these factors, financing expenses increased by approximately NIS 73 million.

The persons responsible for risk management in the subsidiaries are the financial managers. These companies are exposed to market risks that are similar to those to which the Company is exposed. Pelephone has started hedging its exposure in respect of a rise in exchange rates on its liabilities for the equipment it purchases. However, most of the exposure is not covered by hedging transactions.

3. Financial Position

a. The Group's assets as at December 31, 1999 amount to approximately NIS 16.81 billion, compared with approximately NIS 18.23 billion at the end of 1998. Of these, approximately NIS 12.66 billion (approximately 75.3%) are fixed assets, compared with NIS 13.91 billion at the end of 1998.

The decrease in total assets is derived from the decrease in the net book value of the fixed assets as a result of the differential between depreciation expenses and the investment made in the reporting period, as well as a decrease in the Group's cash balances and short term investments.

b. The Group's shareholders' equity as at December 31, 1999 amounted to approximately NIS 7.26 billion, which comprise 43.2% of the total balance sheet, compared with approximately NIS 7.36 billion on December 31, 1998 which comprised approximately 40.4% of the total balance sheet. The decrease stemmed primarily from the payment of a dividend.

c. Total Group debt to financial institutions and to the holders of its debentures as at December 31, 1999 amounted to approximately NIS 6.51 billion, compared with approximately NIS 7.96 billion on December 31, 1998. Data on the debt at December 31, 1999 do not include convertible debentures in the amount of NIS 233.7 million which will probably be converted. The decline in the amount of financial debt resulted from a positive cash flow from current operations, of which only part was used for investing activities.

d. The balances of the Group's cash and short-term investments as at December 31, 1999 amounted to approximately NIS 965 million, compared with approximately NIS 1,318 million at December 31, 1998.

e. The Group's surplus of monetary liabilities in US dollars in excess of dollar-linked monetary assets as at December 31, 1999, amounted to approximately NIS 3.2 billion. This exposure has an adverse effect on the Group's profitability, due to the costs entailed in its protection. During the reporting period, the Company carried out forward exchange contracts to reduce its exposure, and it intends to continue with this policy.

   As at December 31, 1999, the net balance of dollar liabilities which were not hedged by such forward contracts amounted to approximately NIS 290 million.

f. The Group's surplus of CPI-linked liabilities in excess of linked monetary assets as at December 31, 1999 amounted to approximately NIS 3.1 billion. This exposure is partly covered by a mechanism for updating tariffs, which takes into account price increases in the economy (see Note 1B to the financial statements).

4. Results of Operations

Comparison of results of 1999 with the results of 1998

a. Principal results
   Net earnings for 1999 amounted to approximately NIS 7 million, compared with net earnings of approximately NIS 764 million in 1998. The material decrease in earnings was caused mainly by an increase of approximately NIS 601 million (before tax) in “other expenses, net.” In 1999, this item includes provisions for financing the costs of the restructuring plan as well as expenses for depreciation of the investment in the billing system. In 1998 the provisions for financing the restructuring plan were reduced, and provisions were made for other wage-related issues.

   After removing the effect of the other expense items in the two periods, net earnings in 1999 amounted to approximately NIS 364 million, compared with approximately NIS 737 million in 1998. In addition, a decrease of 39.2% in operating earnings also affected the decline in earnings. The decrease in operating earnings was caused by a deterioration in the business results of the principal companies in the Group which started in the second quarter of 1999 mainly as a result of intensification of the competition as described in the section "The Business Environment". The deterioration in the Company's business derived from increased depreciation expenses as a result of a change in the depreciation policy and of the tariff reductions, despite the decrease in salary expenses achieved as a result of implementing the employee retirement plan.

   Earnings per share in 1999 amounted to NIS 0.02 per NIS 1 par value share, compared with earnings of NIS 1.00 per share in 1998.

b. Revenues

Group revenues for 1999 amounted to approximately NIS 9.14 billion, compared with approximately NIS 9.51 billion in 1998, a decrease of approximately 3.9%. The decline in revenues is primarily the result of the reduction in the Company's tariffs by an average of 8% as of April 1, 1999, which was reflected in a decline 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. The decline in the revenues of Bezeq International was primarily the result of lower prices and international settlement fees.

c. Costs and expenses

The Group's operating and general expenses for 1999 amounted to approximately NIS 5.11 billion, compared with approximately NIS 4.99 billion last year, an increase of approximately 2.5%. The increase in operating and general expenses resulted from an increase in the marketing expenses of Bezeq International and the operating expenses of Pelephone, as well as the costs involved in adaptation of the Company's information systems to the year 2000. The increase was moderated by a decrease of approximately NIS 208 million (approximately 11.1%) in salary expenses, mainly due to the restructuring plan, the 1998 assignment of the value of a benefit to employees in respect of an offering and sale of shares by the State, and a decrease in the employee bonus provision. The decrease was tempered by an increase in the salary expenses of Bezeq International and Pelephone.

An additional factor which moderated the increase in expenses was the decrease in expenses for international communications, which arose from a change in activity and in settlement fees with international communications operators.

Depreciation expense increased in 1999 compared with 1998 by approximately NIS 212 million (an increase of about 8.4%), primarily as a result of a change in the Company's depreciation rates.

Payments of royalties to the State of Israel decreased in 1999 by approximately NIS 53 million (a decrease of about 15%), due mainly to the reduction of tariffs, which in turn caused a decrease in revenues subject to royalties.

d. Operating income

The Group's operating income for 1999 amounted to approximately NIS 1,010 million, compared with approximately NIS 1,662 million in 1998, a decrease of approximately 39.2%. The decrease in operating income resulted from the changes described above in operating and general income and expenses.

e. Financing expenses

The Group's financing expenses for 1999 amounted to approximately NIS 360 million, compared with approximately NIS 46 million in 1998, a decrease of about 21%.

There was a decrease in interest payments during the Report period, owing to the significant decrease in the Group's total interest-bearing debt and an increase in the Group's income from investments in shekel deposits. In contrast, the Group's net finance expense during the report period increased due to hedging transactions against dollar-denominated liabilities as a result of the material differential created between the interest premium included in hedging transaction costing and the change in the Consumer Price Index. In addition, there was also a decrease in income due to the erosion of the Group's liabilities linked to the Consumer Price Index, as a result of the differentials between the "known index" for a particular month and "actual index" as compared to these differentials for last year.

f. Other income (expense)

In 1999, other expenses in the amount of approximately NIS 558 million was recorded under this item compared with income of approximately NIS 43 million in 1998. The main cause for the increase in the expense is the provisions for the Company's restructuring plan. Last year the provision was reduced by some NIS 202 million, compared with an increased provision of NIS 389 million in 1999. In addition, an expense for depreciation of an investment and compensation to a supplier in respect of the billing system were also included this year as well as the costs of allocation of subscribers at Bezeq International.

In 1998 other expenses included a provision for claims of Company employees in respect of salary and pension components and a provision for unused sick leave in respect of employees under the age of 55.

g. Quarterly data - consolidated statements - in NIS millions

	1999					1998
	Total	Q4	Q3	Q2	Q1	Q4
Revenues	9,143	2,338	2,279	2,175	2,351	2,365
Costs and expenses	8,133	2,082	2,074	2,002	1,975	1,888
Operating income	1,010	256	205	173	376	477
Financing expenses	360	93	77	60	130	181
Other expenses (income)	558	175	106	-	277	45
Equity in earnings (losses) of associated companies	(22)	(15)	(4)	(2)	(1)	4
Net earnings (losses)	7	(46)	10	73	(30)	154
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The quarterly data include reclassification

5. Liquidity and sources of financing

Consolidated cash flows generated by operating activities in 1999 amounted to approximately NIS 2,375 million, compared with approximately NIS 3,019 million in 1998. The decrease in cash flows from operating activities resulted primarily from a decline in profits, an increase in inventory and current liabilities and a decrease in trade payables. The decrease was partially offset by a decline in trade receivables, an increase in trade payables and a decrease in payments for early retirement, as compared with last year, and by the fact that a material part of the decrease in net earnings stems from an increase in depreciation expenses and a provision for depreciation of fixed assets. Cash flows generated by operating activities are the Group's principal source of financing, and are earmarked mainly for financing investments in developing telecommunications infrastructures (amounting to approximately NIS 1,418 million) and for investments in investee companies and other assets. Most of the remaining cash flow was used during the report period to reduce the Group's financial debt - in 1999, long-term loans of approximately NIS 1,106 million were repaid, as well as NIS 207 million of debentures and NIS 939 million of a debenture issued to the State, for a total of approximately NIS 2,252 million. On the other hand, the Group received a long-term loans in a total amount of approximately NIS 721 million, issued debentures for approximately NIS 263 million, and received short-term bank credit of approximately NIS 271 million, so that approximately NIS 1,255 million were raised in total.

The monthly average of short-term credit for the period was approximately NIS 117 million. The monthly average of long-term liabilities for the period was approximately NIS 7.2 billion.

The Group recycles some of its payments in respect of past debts and uses its cash flow surpluses for the gradual reduction of the debt load. Due to the restrictions on a single borrower in the Israeli market, the Company is required to borrow considerable sums from foreign sources.

Working capital as at December 31, 1999 was negative and amounted to approximately NIS 1,575 million, which is unchanged from last year. The negative working capital does not restrict the Group in its operating activities, since the cycle of collection of revenues from customers is short.

6. Effect of external factors

a. On June 30, 1998, the Company's general license was amended to stipulate an arrangement forbidding the Company from appointing one of its employees as a director of a subsidiary, if within his capacity he may have access to "commercial information" (as defined in the amendment to the license) concerning the licensed companies competing with that subsidiary, where the use of such information by the relevant subsidiary may harm the competition between them. The amendment also suspended, for one year, the provision limiting the Company in the appointment of both the Chairman of the Board of a subsidiary and the majority of the directors of the subsidiary appointed to represent the Company from amongst the Company's directors or its employees. The Company approached the Ministry of Communications and requested cancellation of the above restriction or, alternatively, extension of the suspension for an additional period.

On May 6, 1999 the Company's general license was amended to extend the suspension period until June 30, 2000. On the same date, a further amendment was inserted in the Company's general license concerning, inter alia, compliance with the provisions for providing telecommunications services to the Security Forces: installation of facilities, telecommunications activities including access to a facility, and compliance with the directives of the General Security Services or the Israeli Police regarding the security classification of Company officers exposed to classified information for reasons of State security or the public peace. Under the amendment, payment to the Company will be determined by mutual consent, based on reasonable expenses and taking into account the current cost for the service, if any. In the absence of consent - the payment will be determined by an appointee of the Attorney General, with the consent of the parties to the extent possible. On October 18, 1999 the Knesset approved an amendment to Section 13 of the Telecommunications Law whose principal points are similar to the above amendment to the Company's License.

b. Regarding additional amendments to the general license of the Company and relevant legislation, see the "Business Environment" section above.

c. A petition of Globecall to the High Court of Justice applied for injunctions concerning the determination of ownership of network termination points infrastructures, the Company's (alleged) duty to transfer these infrastructures to others, and the determination of prices to be paid to the Company for the transfer of these infrastructures. In September 1999 a hearing was held at which the parties agreed, with the approval of the High Court of Justice, to appoint a finance expert who would determine the price for the transfer of infrastructures from Bezeq to customers. The parties reached agreement on the identity of the expert and are now negotiating the text of an agreed letter of appointment. At this stage, the interim injunction given in the petition, which prevents the transfer of the network termination point infrastructures, is still in force.

7. **Details of preparation plans for solving the Y2K (Year 2000) issue** - See attached appendix in accordance with Regulation 2 of the Securities Regulations (Rules for reporting on preparation for solving Y2K bug problems) (Temporary Order), 5759-1999.

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

Israel Tapoohi Chairman of the Board	Ilan Biran CEO

April 9, 2000

Pursuant to Regulation 2 of the Securities Regulations (Rules for reporting on preparations for solving Y2K bug problem) (Temporary Order), 5759-1998, below are details of the Company's preparations for solving the Y2K (Year 2000) problem[(1)] [(2)]

1. **Details of preparation plans for solving the Y2K problem**

a. No change.

b. The Group has identified the critical systems.

c.+d. Operation of the Group's computer systems and computer-integrated systems is carried out by the Group, except for the salaries system of the Company which is operated by an outside supplier and that of a subsidiary which is based on software acquired from an external supplier. The companies have maintained contact with these suppliers to ascertain their readiness for the year 2000.

e.+f. No change.

g. Not relevant.

h. No change.

2. **Cost of preparation for solving the Y2K problem**

Below are details of the investments in preparation for solving the Y2K problem, by fiscal year:

Fiscal year	Have costs or budgets been earmarked	Activities included in planned costs	Amounts, in NIS millions
1998	Yes	Advisory services, systems conversion and adaptation	38
1999	Yes	Advisory services, systems conversion and adaptation, acceleration of investments, integration tests and preparation of emergency plans	207
2000	No (at this stage)	---	---

In addition to the above, other indirect costs exist relating primarily to staff engaged in conversion work.

As at the report date, the Company does not expect to exceed the planned investment budget.

3. **Human resources involved in the preparation**

In a change from earlier reports, the Company's steering committee is headed by the CEO, Mr. Ilan Biran, who replaced Mr. Ami Erel.

(1) This report refers to the Company and its subsidiaries, each of which is making independent preparations for solving the Y2K problem.

(2) The changes described in this report are as compared with the Directors Report of December 31, 1998.

4. **Outside professional assistance**
The Group's companies have hired outside professional assistance - for each company the kind of help it required - including: problem evaluation, performing system repairs, systems replacement, internal control, training, supplier evaluation, testing communication systems for third parties, project management, preparation and implementation of compliance tests and performance of adaptation verification.

5. **Progress assessment**
   a. Method of assessing progress of preparation
      (1) No change.

      (2) No change.

      (3) The internal audit units of the Group's companies are also monitoring the progress of the preparation, as are the outside consultants appointed by some of the Group's companies. On August 10, 1999 the Office of the State Comptroller published a report on the Company's preparations for the Y2K computer problem. The report referred to a number of shortcomings that the Company is acting to correct.

   b. No change.

6. **Timetable**
In most cases, the Company and its subsidiaries are each adhering to the timetables they have set for themselves for solving the Y2K bug problem.

7. **Plan in the event of systems failure**
The Group's companies have completed plans for the event of systems failure brought about by the Y2K bug problem. These plans relate to the possibility of uninterrupted provision of vital services to the Company's customers, the activities of the companies on the transition date to the year 2000, and plans in the event of non-provision of vital services to the Company by other suppliers (such as electricity, fuel, etc.). Failure in one of the main operating systems of the Company is liable to prevent it from continuing to provide services.

The Company has set up a central body to formulate the emergency plans.

8. **Third party systems**
No change.

9. **Additional information**
As at the date of signing this report, the companies of the Group have passed the transition dates to the year 2000 without any special malfunctions caused by that transition, as far as they are aware. However, the Group's companies cannot guarantee that all aspects of the Y2K problem which affect them, including and in particular those which relate to the readiness for the Year 2000 of their customers, suppliers and other outside entities, including infrastructure suppliers, whose activities affect the companies, have been fully solved.