August 27, 2002

Directors' Report on the State of the Company's Affairs for the six-month period ended June 30, 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 six-month period ended June 30, 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 form, and was 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 June 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 the following:

a As a result of the cancellation of Section 50 of the Telecommunications Law, 5742-1982, effective as of June 1, 1999, which had granted the Company exclusivity in providing fixed-line 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 .

. During the reporting period, the Ministry of Communications awarded national 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. The application by the cable companies for permission to merge was approved, under certain conditions, by the Anti-Trust Authority and by all relevant regulatory bodies. The Company filed an appeal against the Anti-Trust Authority's approval of the merger as long as the strict rules of structural separation which apply to the Company remain in effect, or alternatively, that similar rules of structural separation are imposed on the cable companies.

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, and the Company submitted its reservations regarding those recommendations (see Note 1(B)(4) to the financial statements).

b. According to the principles formulated by the above-mentioned committee the opening of fixed-line domestic communications services to full competition, *inter alia,* in addition to the intensifying competition in the cellular and international communications sectors, are expected to continue to have a materially 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 and 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., see Note 4(A) to the financial statements.

2. Details concerning exposure to and management of market risks

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

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 on this matter and the authorization for the implementation of 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 June 30, 2002 is not very significantly different to that reported for December 31, 2001, except for the fact that during the report period, the Company purchased and granted options, as described in Note 7(B) to the financial statements.

d. The Group's surplus monetary liabilities over monetary assets denominated in or linked to foreign currency as at June 30, 2002, amounted to approximately NIS 2.22 billion. As a result of forward currency transactions as at that date, all net foreign currency liabilities were hedged by forward transactions, however, the Company has positions in currency derivatives (see Note 7(B) to the financial statements – Options granted), which could, if the dollar continues to gain in 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 June 30, 2002 amounted to approximately NIS 1.68 billion. The Company has a balance of forward CPI contracts that reduce the exposure to increases in the CPI during the year.

3. Financial Position

a. The Group's assets as at June 30, 2002 amounted to approximately NIS 18 billion, compared with NIS 18.4 billion as at June 30, 2001. Of these, approximately NIS 10.3 billion (approximately 57.2%) was fixed assets, compared with approximately NIS 11.7 billion (63.7%) as at June 30, 2001.

The decrease in total assets 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 reporting period. This decrease was offset mainly by an increase in current asset balances and long-term investments and receivables.

b. The Group's shareholders' equity as at June 30, 2002 amounted to approximately NIS 7.8 billion, representing approximately 43.5% of the total balance sheet, compared with approximately NIS 7.7 billion as at June 30, 2001, which represented approximately 41.7% of the total balance sheet.

c. Total Group debt to financial institutions and debenture holders as at June 30, 2002 amounted to approximately NIS 6.4 billion, compared with approximately NIS 7 billion as at June 30, 2001.

d. Group balances in cash and short-term investments as at June 30, 2002 amounted to approximately NIS 2,064 million, compared with NIS 1,603 million as at June 30, 2001.

4. Results of Operations

a. Principal results

Net earnings for the first half of 2002 amounted to approximately NIS 198 million, compared with net earnings of approximately NIS 167 million in the corresponding period in the prior year.

Earnings per share in the first half of 2002 were NIS 0.082 per NIS 1 par value, compared with NIS 0.069 per share in the corresponding period in the prior year.

b. Revenues

Group revenues in the first half of 2002 amounted to approximately NIS 4.11 billion, compared with approximately NIS 4.35 billion in the corresponding period in the prior year. The decrease in revenues principally derives from the decrease in revenues from domestic fixed-line communications, international communications and fixed fees. Revenues from domestic fixed-line communications decreased as a result of the tariff erosion due to accelerated inflation during the period, and as a result of a reduction in call traffic. Revenues from international communications decreased due to cancellation of the access fees that the Company received in the past from the international communications operators. Revenues from fixed fees decreased compared with the corresponding period in the prior year as a result of tariff erosion. The decrease in the Group's revenues was partially offset by an increase in the revenues of Pelephone Communications Ltd. ("Pelephone").

c. Operating and general expenses

The Group's operating and general expenses in the first half of 2002 amounted to approximately NIS 2.28 billion, compared with approximately NIS 2.37 billion in the corresponding period in the prior year.

The decrease in the operating and general expenses of the Group derived mainly from increased cellular expenses of the Company during the corresponding period in the prior year, due to the consequences of the agreement relating to the transfer of air-time payments signed at that time with Pelephone. Additionally, expenses also decreased as a result of improved efficiency in the Company – mainly relating to sub-contractor and building maintenance expenses and a decrease in the expenses of Bezeq International. The decrease in expenses was partially offset by an increase in the expenses of Pelephone, which was mainly caused by a change in Pelephone's method of acquiring new subscribers.

d. Depreciation

The Group's depreciation expenses are decreasing 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 also decreased as a result of a change in the estimated period of useful life of communications equipment, as described in Note 5 to the financial statements.

e. Royalty payments to the Government of Israel

The ongoing decrease in the rate of royalty payments due on the revenues of Bezeq International and Pelephone has led to a decrease in the Group's obligation in respect of royalties.

f. Operating income

The Group's operating income in the first half of 2002 amounted to approximately NIS 546 million, compared with approximately NIS 455 million in the corresponding period in the prior year, an increase of approximately NIS 91 million. The increase in operating income results from the changes described above in the revenues and expenses items, and from lower depreciation charges and royalties due to the Government of Israel. These changes led to improved operating income at Bezeq International, to a 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 the first half of 2002 amounted to approximately NIS 72 million, compared with approximately NIS 55 million in the corresponding period in the prior year. The increase is derived from the fact that in the corresponding period in the prior year the Company had interest income from income tax (approximately NIS 80 million) and a decrease in the yield on the Company's liquid investments due to accelerated inflation. The increase was largely offset by an inverse effect of the accelerated inflation in reducing the financing expenses on the unlinked liabilities of the Group's companies, and by the decrease in the financing expenses as a result of a decrease in the Group's financial liabilities. The effects of changes in currency exchange rates were eliminated to a large extent as a result of hedging transactions.

h. Company equity in losses of affiliates

The Company's equity in losses of affiliates increased compared to the corresponding period in the prior year, mainly due to profit derived from the sale of an indirect ownership interest in a Hungarian company that was recorded in the corresponding period.

5. Liquidity and sources of financing

Consolidated cash flows generated by operating activities in the first half of 2002 amounted to approximately NIS 1,343 million, compared with approximately NIS 1,615 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. 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 550 million in the development of communications infrastructures, approximately NIS 224 million in investee companies and approximately NIS 118 million in long-term deposits and investments. During the first half of 2002, the Group repaid approximately NIS 644 million of debt, of which approximately NIS 244 million was on account of long-term loans, approximately NIS 178 million on account of debentures and approximately NIS 222 million on account of short-term credit. Conversely, the Group raised new debt in a total amount of approximately NIS 303 million, of which approximately NIS 195 million derived from new long-term loans and approximately NIS 109 million from issuances of debentures.

The average monthly short-term credit during the period was approximately NIS 253 million. The average monthly long-term liabilities during the period were approximately NIS 6,154 million.

Working capital as at June 30, 2002 was positive and amounted to approximately NIS 927 million, compared with negative working capital of approximately NIS 692 million as at June 30, 2001. The improvement in the Group's working capital derived mainly from an increase in cash balances, short-term investments and trade receivables of the Group, as well as a decrease in current liabilities to banks.

6. Comparison of the results of the second quarter of 2002 with those of the corresponding period in the prior year

Revenues in the second quarter of 2002 decreased by approximately NIS 100 million compared with the corresponding quarter in the prior year, a decrease of approximately 4.6%. Operating and general expenses decreased by approximately NIS 97 million, approximately 7.9%, compared with the corresponding period in the prior year.

Operating income in the quarter increased by approximately NIS 97 million.

Financing expenses in the second quarter of 2002 increased by approximately NIS 28 million compared with the corresponding period in the prior year.

The movement in the revenue and expense items and the reasons for the differences between the quarters are similar to the explanations in the half-year results.

The changes described above in the statement of operations items led to net earnings of approximately NIS 86 million in the second quarter of 2002, compared with net earnings of approximately NIS 90 million in the corresponding period in the prior year.

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

Ido Dissentshik Chairman of the Board	Ilan Biran CEO