August 15, 2000

Directors' Report on the State of the Company's Affairs
for the Six Months ended June 30, 2000

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 months ended June 30, 2000 (hereinafter: "the Directors' Report"). The Report was prepared in accordance with the Securities Regulations (Periodic and immediate reports), 5730-1970 and the Securities Regulations (Rules for reporting on preparations for solving the Y2K problem) (Temporary Order), 5759-1998.

The Directors' Report contains a review of its subject matter, in condensed form, and has been prepared assuming that the reader also has access to the Directors' Report of December 31, 1999.

The financial data in the Directors' Report are presented in adjusted shekels of June 2000.

1. The Business Environment

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

a) In February 1999, as part of the Arrangements Law, Section 50 of the Telecommunications Law, 5742-1982 was canceled. Section 50 granted the Company exclusivity in providing fixed national telecommunications services in a nationwide telephone network under the general license. The cancellation took effect on June 1, 1999, although 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. In May 2000, the Ministry of Communications sent a draft of new regulations to the Knesset Economics Committee, for its information, which are designed to regulate the proceedings and conditions for receipt of general licenses for the provision of nationwide fixed domestic telecommunications services. Concurrently, the text of the draft was conveyed for the comments of the Ministry of Justice. Approval of the regulations will enable the commencement of awarding of licenses to new operators to start and the beginning of competition in domestic communications. On the decision of the Attorney General in the matter of awarding licenses to the cable broadcasting franchisees and the memorandum of the proposed law for amendment of the Telecommunications Law which was submitted by the Ministry of Communications in the wake of the Attorney General's decision as aforesaid - see Note 1B to the financial statements.

   The anticipated opening of fixed domestic communications services to competition, in addition to the growing competition in cellular and international communications sectors, is expected to have a materially adverse effect on the Company's business results which cannot be estimated at this stage. Furthermore, the passing of the said amendment is likely to have a material effect on the communications market in a way which the Company is unable to evaluate.

b) Pursuant to the decision of the Knesset Finance and Economics Committee of March 13, 2000, the Company's tariffs were lowered, effective May 1, 2000, by an average of approximately 2.43%, and a change was made in the method of charging for calls, principally by changing from charging by meter pulses to charging by duration (subject to a minimum tariff per call). In addition, a number of tariff baskets were offered, mainly for Internet users, which entail lower tariffs.

c) In March 2000, the Company's management presented a plan to the Board of Directors which is based on a material change in its organizational and functional concept, in a pattern similar to the change already made in a number of other similar companies in the field of communications, as part of the transition to operating in a competitive environment. The Board of Directors approved the plan after receiving clarification from the Company's management. It is estimated that the retirement of some 500 to 600 employees is needed for implementation of the plan. The estimated cost of the plan will be approximately NIS 293 million, an amount which was included in the financial statements for 1999. Up to June 30, 2000, 248 employees had retired under this plan. Pursuant to an agreement which was validated as a decision by the Labor Court, the term of the agreement has been extended until March 31, 2001.

d) Bezeq International ended the first half of 2000 with an operating loss and a net loss in a material amount, as a result, inter alia, of the costs it bore due to the allocation process, a decrease in tariffs, and a rise in related expenses to the Internet sector. The Company, based on the assessment of Bezeq International, estimates that following changes in Bezeq International's business environment since the start of competition, there are likely to be additional changes in the field of international communications, inter alia, in tariffs, market share and traffic ratio. As a result, there may be a material adverse effect on the Group's financial results.

e) The representatives of the Company's workers demanded from the Government that before privatizing the Company and opening the communications market to full competition, an agreement will be signed concerning the retirement of employees, and that guarantees will be given by the State for fulfillment of obligations towards the employees.

The State directed the Company's management in respect of the principles of negotiation with the workers relating to pay arrangements and non-voluntary retirement after the privatization. There is a difference between these directives and the demands of the workers, and the parties are working to bridge that gap.

On May 11, 2000 the workers started sanctions and work disruptions against the background of the labor dispute which they announced in February 2000. The issue in dispute is the workers' above demands. On May 21, 2000 the Company, the workers, the Histadrut and the State reached an agreement which was validated as a decision by the Labor Court. The main points of the agreement are that intensive negotiations will take place in an attempt to end the dispute, representatives from the Ministry of Finance and the Companies Authority will join those negotiations and the workers will return to normal work until the next session. On June 22, 2000 an additional session was held, which extended he term of the agreement until the next session, which is scheduled for September 14, 2000.

f) On October 20, 1999, the Ministerial Committee for Privatization decided to impose upon the Government Companies Authority, in coordination with the pertinent government ministries, the submission to that Committee of a proposed resolution for the privatization of all of the State's holdings in the Company, together with a document setting out the considerations in determining the percentage of significant control to be sold. In response to the proposed resolution which was submitted to the Company, the Board of Directors conveyed its position in accordance with the Government Companies Law. Just prior to the publication of these financial statements, the Company was informed of the intention to convene the Ministerial Committee for Privatization in the next few days, concerning approval of the proposed resolution for the privatization of the Company.

g) The intensifying competition in the cellular communications market and its effects on the increase in costs and on tariff erosion at Pelephone, as well as the effect of depreciation of the capitalized costs of subscriber acquisition, caused a decrease in the operating income of Pelephone in the reported period. Ongoing investments in expansion of the CDMA system also increased Pelephone's finance expenses. Due to the cumulative effects of the above factors, Pelephone ended the first half of 2000 with a net loss.

The Ministry of Communications is considering making changes in the method of calculating the tariff for incoming calls, which, if carried out, are likely to have a materially adverse effect of the future operating results of Pelephone.

h) DBS Satellite Services (1998) Ltd. (hereinafter: "DBS") started to provide satellite broadcasting services in July 2000. In so doing, DBS accumulated losses in the period prior to starting to provide services, in which the Company's equity as at June 30, 2000 amounts to approximately NIS 61 million, of which approximately NIS 36 million were incurred during the reported period.

i) The Company and the Ministry of Communications are discussing the provision by the Company of broadband communications services using ADSL technology.

The Ministry has presented the Company with new requirements as a condition for giving its consent to approval of the final version of the service portfolio which the Company finds unacceptable. The Company is acting in a way which will enable it to start providing the service as soon as possible.

The service is currently being provided on a trial basis. At the same time, the Company is investing in the requisite infrastructure in preparation for providing the service to the general public, and is therefore entering into agreements with vendors for the supply of equipment at material cost.

Concerning the announcement by the Anti-Trust Commissioner according to which a suspicion apparently exits that in connection with its arrangements in preparation for providing ADSL services, the Company is taking part in activities which may represent violations of the directions of Anti-Trust Law, see Note 6A(5).

j) As part of the implementation of its strategic plan and preparation for the imminent competition, the Company has exercised options to purchase some 6.25% of the share capital of Accent Technologies Ltd. (formerly A.R.M.T. Communications Multimedia Ltd.), which provides broadband multimedia solutions; increased its holding in the Goldnet partnership (Bezeq Gold) to approximately 49% (subject to final approval by the Ministry of Communications for the change in the ownership structure of Goldnet); started investing in the field of call center services, and made investments in venture capital funds which invest, inter alia, in the communications sector.

k) In July 2000, the Knesset enacted the Employment of Workers by Personnel Contractors (Amendment) Law, 5760-2000. The law stipulates, inter alia, that workers of personnel contractors who are effectively employed by an employer for a period exceeding nine consecutive months, will be considered in effect as workers of the employer. A material number of workers of personnel contractors are employed by the Group's companies. The Company is unable to estimate, at this stage, what effect the above law might have on the Group.

l) On June 30, 1999, an amendment was made to the general license of the Company, stipulating an arrangement which forbids the Company to appoint one of its employees as a director on its behalf of a subsidiary, if, in that capacity, he might have access to "commercial information" (as defined in the amendment to the license) about licensees who are in competition with that subsidiary, the use of which by the subsidiary is liable to harm the competition between them. In addition, in the said amendment the provision which limits the Company in the appointment of both the Chairman of the Board of the subsidiary and the majority of the directors of the subsidiary who are appointed on behalf of the Company from among the Company's directors or from among its employees was frozen for one year. The Company approached the Ministry of Communications, requesting cancellation of the above restriction or, alternatively, to extend the freeze for an additional period. The freeze was recently extended until June 30, 2001.

m) On July 6, 2000 the Board of Directors of the Company elected Board member Mr. Ido Dissentshik as Chairman of the Board. The appointment was approved by the Committee for Examining Appointments in the Public Sector, and is contingent upon the final written approval of the relevant Ministers.

2. Details concerning exposure to and management of market risks

Further to that described in the Directors' Report for 1999, as a result of hedging transactions against market risks relating to exposure to changes in the exchange rate, the Company incurred additional interest expenses during the reported period. In addition, finance expenses were influenced by real exchange rate differentials in periods when the protection of surplus foreign currency liabilities was not comprehensive. Due to these factors, the Company's finance expenses increased in the reported period by approximately NIS 19 million.

3. Financial Position

a. The Group's assets as at June 30, 2000 amount to approximately NIS 15.94 billion, compared with approximately NIS 17.76 billion as at June 30, 1999. Of these, approximately NIS 12.12 billion (approximately 76.0%) are fixed assets, compared with approximately NIS 13.43 billion (approximately 75.6%) as at June 30, 1999. The decrease in total assets derived mainly from the decrease in the depreciated cost of the fixed assets caused by the differential between depreciation expenses and the investment made in the reported period and the decrease in the cash balances and short-term investments of the Group.

b. The Group's shareholders' equity as at June 30, 2000 amounted to approximately NIS 7.66 billion, which comprise approximately 48.1% of the total balance sheet, compared with approximately NIS 7.58 billion on June 30, 1999, which comprised approximately 42.7% of the total balance sheet.

c. Total Group debt to financial institutions, to the holders of its debentures and to others as at June 30, 2000 amounted to approximately NIS 6.08 billion, compared with approximately NIS 7.45 billion on June 30, 1999. The data relating to debt as at June 30, 2000 do not include convertible debentures in the approximate amount of NIS 81 million, the conversion of which is probable.

   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.

   In August 2000 the Company completed an issue of debentures which will be listed on the Luxembourg stock exchange - see Note 7 to the financial statements.

d. The balances of the Group's cash and short-term investments as at June 30, 2000 amounted to approximately NIS 690 million, compared with approximately NIS 1.25 billion at June 30, 1999.

e. The Group's surplus of monetary liabilities over monetary assets in foreign currency or linked thereto as at June 30, 2000 amounted to approximately NIS 3.4 billion.

   This exposure adversely affects the Group's profitability due to the costs involved in hedging it. During the reported period, the Company carried out forward exchange contracts to reduce its exposure, and it intends to continue with this policy.

   As at June 30, 2000, the net balance of foreign currency liabilities which are not hedged by such forward contracts, amounted to approximately NIS 256 million.

f. The Group’s surplus of CPI-linked liabilities in excess of linked monetary assets as at June 30, 2000 amounted to approximately NIS 2.2 billion. This exposure is partly covered by a mechanism for updating tariffs which takes into account price increases in the economy.

4. Results of Operations

a. Principal results

Net earnings for the first half of 2000 amounted to approximately NIS 203 million, compared with net earnings of approximately NIS 46 million in the corresponding period last year.

The difference between the results was caused mainly by a decrease of approximately NIS 365 million (before tax) in the other income/expenses item. In the first half of 1999 this item included an expense of approximately NIS 278 million (before tax) for the change of organizational structure. In the first half of 2000, income of approximately NIS 87 million (before tax) was recorded within this item, mainly from earnings from calling in the guarantee of a billing software vendor and from recording a debt in connection with the Company's investment in India. Removing the effects of the other expenses / income items in both periods would bring the net earnings for the first half of 2000 to approximately NIS 147 million, compared with approximately NIS 224 million in the corresponding period last year.

The decline in operating income by approximately NIS 21 million compared with corresponding period last year was caused by the deterioration in the business results of the Company's investee companies, mainly as a result of intensification of competition as noted in the description of the business environment above.

Earnings per share for the first half of 2000 amounted to NIS 0.256 per NIS 1 par value share, compared with NIS 0.062 per share in the corresponding period last year.

b. Revenues

Group revenues for the first half of 2000 amounted to approximately NIS 4.26 billion, compared with approximately NIS 4.54 billion in the corresponding period last year, a decrease of approximately 6.3%. 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. In addition, as of January 1, 2000, the access fees paid to the Company by the international operators were lowered, and starting on May 1, 2000 the Company's tariffs were lowered by an average 2.43% and tariff baskets were offered which would have the effect of a further reduction. Due to changes in the Company's accounting arrangements with the cellular communications companies, since March 2000 the Company's revenues do not include revenues for airtime. The decrease in the revenues of Bezeq International was primarily the result of lower prices and international settlement fees. The decrease in revenues was mitigated by an increase in the revenues of Pelephone.

c. Operating and general expenses

The Group's operating and general expenses for the first half of 2000 amounted to approximately NIS 2.22 billion, compared with approximately NIS 2.48 billion in the corresponding period last year. The decrease in total expenses resulted mainly from the change in the Company's settlement arrangements with the cellular communication companies starting in March 2000, following which the Company's expenses do not include airtime, as well as from a decline in expenses for sub-contractors, building maintenance and general expenses. The decrease in these items was offset by an increase in expenses for salaries, materials and spare parts, largely resulting from an increase in these items at Pelephone.

d. Operating income

The Group's operating income for the first half of 2000 amounted to approximately NIS 523 million, compared with approximately NIS 544 million in the corresponding period last year, a decrease of approximately NIS 21 million. The decrease in operating income resulted from the changes described above in income and operating and general expenses items, deriving from the decrease in operating income of the Company's investee companies which offset the increase in the operating income of the Company.

e. Financing expenses

The Group's financing expenses for the first half of 2000 amounted to approximately NIS 166 million, compared with approximately NIS 190 million in the corresponding period last year. There was a decrease in interest payments during the reported period, owing to the significant decrease in the Group's total interest-bearing debt, which was partially offset by an increase in the financing expenses of the Company's investee companies. In addition, the net expenses, incurred by the Group decreased in the reported period as a result of the hedging transactions against its dollar-denominated liabilities. This expense exceeded the income generated by the Group from appreciation of the shekel against the dollar in the two reported periods, due to the differential generated between the interest premium included in the pricing of hedging transactions and the change in the CPI. Conversely, there was a decrease in Group interest income from investments as a result of a decrease in the Group's total investments.

f. Other income (expense)

In the first half of 2000, income of approximately NIS 87 million (before tax) was recorded in this item, which consisted mainly of approximately NIS 84 million income from calling in the guarantee of a billing software vendor and approximately NIS 23 million income in respect of a debt in connection with the Company's investment in India. This item also included the costs which Bezeq International bore in connection with allocation of subscribers. The above income is compared with the first half of 1999, in which this item included an expense of approximately NIS 278 million in respect of the restructuring plan.

5. Liquidity and sources of financing

Consolidated cash flows generated by operating activities during the first half of 2000 amounted to approximately NIS 1,558 million, compared with approximately NIS 1,122 million in the corresponding period last year. The increase in cash flows from current operations resulted primarily from an increase in net earnings compared with the earnings in the corresponding period, from an increase in expenses not involving cash flows (mainly deferred taxes), and from changes in the current assets and liabilities items. The increase was partially offset due to payment of the Company's obligations in connection with the restructuring plan. The cash flow generated by operating activities is the principal source of the Group's financing, and is earmarked mainly for financing investments in developing telecommunications infrastructures, amounting to approximately NIS 992 million. Most of the remaining cash flow was used during the reported period to reduce the Group's financial debt and for payment of a dividend. The above included repayment of approximately NIS 641 million in long-term loans, approximately NIS 145 million in debentures and approximately NIS 473 million of government bonds - a total of approximately NIS 1,259 million during the first half of 2000. Conversely, the Group received long-term loans in a total amount of approximately NIS 660 million and short-term bank credit of approximately NIS 208 million, so that approximately NIS 868 million was raised in total.

The monthly average of short-term credit for the period was approximately NIS 487 million. The monthly average of long-term liabilities for the period was approximately NIS 5.9 billion.

The Group recycles part of the payments for past debts and uses its surplus cash flow for the gradual reduction of its debt burden. Due to limitations on a single borrower in the local market, the Company is required to borrow considerable sums from foreign sources.

Working capital as at June 30, 2000 was negative and amounted to approximately NIS 917 million, compared with NIS 1,341 as at June 30, 1999. The improvement in the Group's working capital is material, and derived from a decrease in current liabilities, mainly as a result of full repayment of the debenture which was issued to the Government of Israel. 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. Comparison of results of the second quarter of 2000 with the results of the corresponding period last year

Earnings in the second quarter of 2000 decreased by approximately NIS 190 million compared with the corresponding quarter last year, a decrease of approximately 8.7%. Operating and general expenses decreased compared with the corresponding quarter last year by approximately NIS 279 million.

Operating income in the quarter increased by approximately NIS 94 million, since the decrease in operating and general expenses was greater than the decrease in the Group's income between the quarters.

Financing expenses in the second quarter of 2000 decreased by approximately NIS 26 million compared with the corresponding quarter last year.

The behavior of the income and expense items and the causes of the differences between the quarters are similar to the explanations for the half-yearly results.

7. Details of preparation plans for solving the Year 2000 issue. See attached appendix in accordance with Regulation 2 of the Securities Regulations (Rules for reporting on preparation for solving the Y2K problem) (Temporary Order), 5759-1998.

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

Ido Dissentshik Member of the Board	Ilan Biran CEO

August 15, 2000

Pursuant to Regulation 2 of the Securities Regulations (Rules for reporting on preparations for solving the Y2K problem) (Temporary Order), 5759-1998, below are details of the Company's preparations for solving the Year 2000 problem: (1) (2) (3)

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 that detailed in the table 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

As a change from previous 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 made 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.

(3) This report is presented in accordance with the Securities Regulations mentioned above, which require continued reporting on this matter until the end of the fiscal year 2000.

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 modification, 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 also monitored the progress of the preparation, as did 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 which the Company acted to correct.

b. No change.

6. Adherence to timetable

In most cases, the Company and its subsidiaries adhered to the timetables they set for themselves for solving the Y2K problem.

7. Plan in the event of systems failure

The Group's companies completed preparation of plans for an event of systems failure brought about by the Y2K 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 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 Group's companies made the transition to the year 2000 without noteworthy malfunctions deriving from the transition, as far as they know. Nevertheless, the companies of the Group 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 its customers, suppliers and other outside entities, including infrastructure suppliers, whose activities affect the companies, have been fully solved.