November 4, 2004

Directors' Report on the State of the Company's Affairs for the period ended September 30, 2004

We respectfully present the Directors' Report on the state of affairs of "Bezeq" – The Israel Telecommunication Corp. Limited (hereinafter: "the Company") and the consolidated Group companies (the Company and the consolidated companies hereinafter collectively referred to as "the Group"), for the nine-month period ended September 30, 2004 (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 assuming that the Directors' Report as at December 31, 2003, is available to the reader.

The financial data relating to the period from January 1, 2004, are presented in reported amounts as defined in Note 2D to the financial statements. Data for the period ended December 31, 2003 are presented in NIS of December 2003.

1. Business Environment

During the period of the Directors' Report and the immediate period subsequent to the date of the report , a number of events and changes occurred with respect to the state of the Group's affairs and business environment, the most noteworthy of which are the following:

A. On March 31, 2004, the Company's general license was thoroughly and extensively amended. According to a notice from the Ministry of Communications to the Ministerial Committee on Privatization, the amended license was intended to adapt the general license to the competitive environment in which the Company operates, but in the Company's opinion, certain provisions of the license restrict the Company's operations and impede its ability to compete.

B. An offer for sale and an offering to the public under a prospectus were published on May 24, 2004 – for details of the offer for sale and the offering to the public, and their results, see Note 1E to the financial statements. The proceeds of the offering are to be applied – as may be decided upon by the Company from time to time, in accordance with its needs, including the replacement of loans detailed in the prospectus. As of the date of approval of the financial statements, there has been no requirement to replace the loans as aforesaid.

On July 19, 2004, the Ministerial Committee on Privatization resolved to amend the resolution to privatize the Company so that the State's holdings in the Company will be privatized by way of private sale of 30% of the Company's share capital, and options for the purchase of an additional 10.66% of the Company's share capital. On October 28, 2004, the date set for filing applications by those interested in participating in the sale proceeding, eight such applications had been received. In accordance with the procedure for the sale of the State's holdings, dated August 27, 2004, the State, applying its exclusive discretion and subsequent to screening the applicants and checking the questionnaires and any other material submitted, will soon select those participants who will be invited to participate in the sale proceeding.

C. On April 22, 2004, regulations took effect which determine processes and conditions for receipt of a general license for the provision of international telecommunication services. The regulations stipulate, *inter alia*, that a license will not be granted to a corporation in which an interested party is an international operator, or to a corporation which is a national domestic operator, a cellular operator or to a significant operator in a sector of operations of an international transmission service. The Ministry of Communications subsequently granted a license to several companies, one of which commenced operations in August 2004. For an assessment of the effects of the aforementioned licenses– see Note 1C(4) to the financial statements.

D. On July 5, 2004, regulations were published relating to processes and conditions for receiving a specific general license to provide domestic fixed-line communications services with no universal service obligation, and the Ministry of Communications published a policy for approval of a marketing trial for providing telecommunications services for consideration – see Note 1C(5) to the financial statements.

E. With respect to the temporary provision relating to interconnection fees between the Company's network and the domestic operator's network, see Note 1D to the financial statements.

F. On July 29, 2004, a notice was received from the Deputy Prime Minister and Minister of Communications regarding a change in the interconnection fees to the cellular network which stated that a significant reduction in such tariffs was being considered (see Note 1C(6) to the financial statements). In the Company's estimation, if and when these changes are implemented, they will cause significant damage to Pelephone's revenues, and as a result, will have a materially adverse effect on the Company's financial statements.

G. The Group companies are obliged to pay royalties to the State of Israel. The rate of the royalties in 2003 was 4%, and as of 2004, decreased to 3.5% of the revenues defined in the regulations as being subject to royalties.

H. On July 23, 2004, as declared and approved by the New Histadrut, notice of strike was given by the Professional Union Department of the General Federation of Workers ("the New Histadrut") due to various matters in dispute between Company Management and employee representatives. The date set for the strike was August 15, 2004 onwards. The employees took various organizational actions and the Company applied to the Regional Labour Court. On October 17, 2004, the parties notified the Labour Court of a continuance of several weeks for intensive negotiations, during which no unilateral action would be taken by either of the parties. The dispute revolved mainly around the intention of the management to dismiss certain employees and the implementation of the retirement agreement as it concerns the filling of positions that fall vacant. As of the date of the financial statements, there has been no progress in the negotiations and the disagreements between the management and the employee representatives have not been resolved.

I. On August 26, 2004, the Company exercised the option to purchase the remaining 50% of the shares of Pelephone. Due to the exercise of the option, Pelephone is now wholly owned by the Company, and from that date its financial statements are fully consolidated with those of the Company – see Notes 4A and 2H(2) to the financial statements.

J. With respect to the Company's investment in D.B.S. Satellite Services (1998) Ltd. ("DBS"), including the resolution of the Board of Directors of the Company approving an additional investment and increase in the Company's holdings in DBS, as well as the Company's application for approvals from the relevant authorities and the position of the Minister of Communications on the matter, see Note 4B to the financial statements. Since June 21, 2004, the financial statements of DBS are fully consolidated with those of the Company – see Note 2H(1) to the financial statements.

K. To mark the twentieth anniversary of its establishment, the Company launched a campaign of donations to various institutions during 2004. The amount of the monthly donation is the greater of 5% of Bezeq's call time revenue on the 20th day of each month of the campaign or NIS 200,000. The campaign is to last for 12 months commencing on February 20, 2004. During the period of account, the Company donated NIS 1,898,000 as part of this campaign.
In the "Community Summer" project organized by the Company, 16 – 18 year old children of Company employees were employed in medical institutions and community centers. The cost of the project to the Company was approximately NIS 846,000.
Pelephone donated NIS 500,000 during the period of account in addition to allowing the use of part of its infrastructure for the "Good Day" campaign of the "Israeli Spirit" non-profit association.

2. Details concerning market risk exposure management

A. Further to that described in the Directors' Report for the year 2003, as a result of hedging transactions against market risks associated with exposure to exchange rate fluctuations, the Group sustained no material financing expenses and generated no substantial financing income during the period of account.

B. The report on positions on derivatives as at September 30, 2004, does not differ significantly from the report as at December 31, 2003.

C. The report on linkage bases as at September 30, 2004, differs from the report as at December 31, 2003 due to raising the debt of the Company and due to the first-time consolidation of DBS and Pelephone, as follows:

The Group's surplus monetary liabilities over monetary assets denominated in or linked to foreign currency as at September 30, 2004, amounted to approximately NIS 3.3 billion. As a result of forward currency transactions as at September 30, 2004. the net balance of foreign currency liabilities not hedged by such forward transactions amounts to approximately NIS 619 million.

The Group's surplus monetary liabilities over monetary assets linked to the consumer price index as at September 30, 2004, amounted to approximately NIS 3.6 billion. This was influenced by the offering of index-linked debentures of the Company to institutional investors and to the public, and by the first-time full consolidation of DBS and Pelephone.

3. Financial position

For the first time, the financial statements of the Company include the full consolidation of DBS and Pelephone. Below are details of the changes this and other factors have caused.

A. The Group's assets as at September 30, 2004, amount to approximately NIS 20 billion, compared with approximately NIS 15.4 billion on September 30, 2003. Of these, approximately NIS 10.72 billion (approximately 53.6%) are fixed assets, compared with approximately NIS 9.1 billion (approximately 59.2%) on September 30, 2003. NIS 3.3 billion of the increase in total assets derives from the first-time consolidation.
The increase was offset by a decrease in the depreciated cost of the fixed assets in the Company as a result of the gap between the depreciation expense and the investment made during the period of account.

B. The Group's shareholders' equity as at September 30, 2004, amounted to approximately NIS 7.4 billion, comprising approximately 36.8% of the total balance sheet, compared with approximately NIS 6.51 billion as at September 30, 2003, which comprised approximately 42.2% of the total balance sheet. The increase in shareholders' equity derives from the issuance of shares in accordance with an agreement with the State to raise capital for the Company, and from the net earnings of the Group accumulated from the end of the corresponding reporting period.

C. Total Group debt to financial institutions and debenture holders as at September 30, 2004, amounted to approximately NIS 8.3 billion, compared with approximately NIS 5.56 billion on September 30, 2003. Of the increase, approximately NIS 2.36 billion is derived from first-time consolidation and the remainder from an offering of debentures to institutional investors and the public.

D. Group balances in cash and short term investments amounted to approximately NIS 2.57 billion as at September 30, 2004, compared with approximately NIS 2.26 billion on September 30, 2003. This increase derives from the cash flow from operating activities, an allotment of Company shares in 2003, and from the private issue of debentures to institutional investors and an offering of debentures to institutional investors and the public. The increase was partially offset by exercise of the option to acquire Pelephone,

4. Results of Operations

A. Principal Results

Net earnings for the first nine months of 2004 amounted to approximately NIS 517 million compared to net earnings of approximately NIS 2 million for the corresponding period in the prior year. The source of the increase in earnings was the increase in the Group's operating profit, the reduction of a provision recorded in the corresponding period in connection with employees' claims, a decrease in the Company's share in DBS's losses due to an improvement in its operating results, and the improvement in the results of Pelephone together with the increase in the Company's holdings in that company.

Earnings per share for the first nine months of 2004 amounted to NIS 0.198 per NIS 1 par value, compared with earnings of NIS 0.001 per share in the corresponding period in the prior year.

The results of DBS's operations are included under the equity method until July 1, 2004, when the Company first consolidated its operations.

The results of Pelephone's operations are included by the proportional consolidation method until August 26, 2004, and from that date are fully consolidated.

B. Revenues

Group revenues for the first nine months of 2004 amounted to approximately NIS 6.49 billion compared to approximately NIS 6.01 billion for the corresponding period in the prior year. The source of the increase in revenues is the first-time consolidations described in Section A above.

A change occurred in the mix of the Group's revenues during the period of account as compared with the same period in the prior year: the revenues of Pelephone, Bezeq International and BezeqCall increased, while the total revenues of the Company decreased. Most of the decrease in the Company's revenues resulted from a decrease in revenues from domestic fixed-line communications and cellular communications. Revenues from domestic fixed-line communications decreased as a result of the decline in call traffic and dial-up Internet connections and from a reduction of tariffs in September 2003 and June 2004. Conversely, the Company's revenues from fixed fees increased as a result of the continued rising trend in revenues from ADSL lines and the increase of fixed fee tariffs commencing in September 2003. In addition, revenues from installations and the sale of equipment also increased.

C. General and operating expenses

The Group's general and operating expenses for the first nine months of 2004 amounted to approximately NIS 3.73 billion compared with approximately NIS 3.36 billion in the corresponding period in the prior year. The source of the increase is mainly the first-time consolidations.

The mix of the Group's expenses also changed in the period of account, as compared with the same period last year: the expenses of Pelephone, Bezeq International and BezeqCall rose while the total expenses of the Company decreased. Most of the decrease in the Company's expenses is attributable to the decrease in salary expenses due to the retirement of employees under the early retirement plan. A decrease was also recorded in the building maintenance expenses following an agreement whereby the Company will receive retroactive reimbursement for municipal tax expenses. The decrease was partially offset by a rise in expenses for materials.

D. Depreciation

The Group's depreciation expenses decreased as a result of the completion of the depreciation charge on some of the Company's fixed assets and a decrease in investments in new assets. Furthermore, an additional decrease was recorded due to the change in the estimated useful lives of some of the assets – see Note 5A to the financial statements. This decrease in depreciation was offset by NIS 90 million due to the first-time consolidations described in Section A above.

E. Royalties to the Government of Israel

The Group's royalties expense for the first nine months of 2004 amounted to approximately NIS 156 million compared with approximately NIS 183 million in the corresponding period in the prior year. The source of the decrease is the reduction in the percentage of royalties payable on the Group's revenues, from 4% to 3.5%, effective January 1, 2004. The decrease was partially offset by additional royalties of approximately NIS 11 million, the source of which is the first-time consolidations referred to in A above.

F. Operating income

The Group's operating income during the first nine months of 2004 amounted to approximately NIS 1,108 million, compared with approximately NIS 836 million in the corresponding period in the prior year, an increase of approximately NIS 272 million. The increase in operating income derives from the changes described above under the revenue and expense items. The increase was partially offset by the first-time consolidation of DBS.

G. Financing expenses

The Group's net financing expenses for the first nine months of 2004 amounted to approximately NIS 137 million compared with approximately NIS 130 million in the corresponding period in the prior year. Commencing in 2004, financing expenses included in the financial statements reflect the nominal financing expenses, rather than the inflation-adjusted financing expenses recorded in the past, due to the transition to nominal financial reporting. Accordingly, there is no basis for comparison of the results. Approximately NIS 22 million of the financing expenses are attributable to the first-time consolidations referred to in A above. Conversely, the financing expenses of Pelephone and Bezeq International decreased. Financing expenses during the period were influenced mainly by changes in the consumer price index and by Dollar and Euro exchange rate fluctuations. The effect of foreign currency exchange rate fluctuations was neutralized, mainly, as a result of hedging transactions and financing income from financial assets.

H. Tax Expense

The Group's tax expense for the first nine months of 2004 amounted to approximately NIS 433 million compared with approximately NIS 175 million in the corresponding period last year. Following the amendments to the Income Tax Ordinance coming into effect including, *inter alia*, the gradual reduction in corporate tax rates from 36% to 30%, the Group reduced its tax asset and placed it at the rate expected to apply when that asset is realized. As a result, an additional tax expense was recorded in the sum of approximately NIS 78 million.

I. Other expenses (income)

Other expenses (income) of the Group in the first nine months of 2004 amounted to income of approximately NIS 109 million, compared with an expense of approximately NIS 266 million in the corresponding period in the prior year.

Most of the expense last year was the provision for the reduction in value of assets and investments and the recording of a provision in connection with employees' claims. The income recorded in the period of account derived from a reduction of the provision for employees' claims recorded last year (see Note 11 to the financial statements).

J. Group's equity in losses of affiliates

The Group's equity in losses of affiliates decreased compared with the corresponding period in the prior year from approximately NIS 264 million in the first nine months of 2003 to approximately NIS 131 million in the first nine months of 2004. Most of the decrease derived from the decrease in the Company's equity in the losses of DBS in the first half of the year. With the full consolidation of DBS close to the end of the first half, the results of its operations are presented in the financial statements in this third quarter on a consolidated basis (rather than on the equity basis).

5. Liquidity and sources of financing

Consolidated cash flows generated by operating activities in the first nine months of 2004 amounted to approximately NIS 2,027 million compared with approximately NIS 1,977 million in the corresponding period in the prior year. The increase in consolidated cash flows from operating activities was due to an increase in the operating cash flows of the principal Group companies.

Cash flows generated by operating activities are the principal source of financing for the Group's investments, which during the period of account included, *inter alia*, approximately NIS 997 million in the development of communications infrastructure and approximately

NIS 356 million in investee companies. During the quarter, the Group repaid approximately NIS 3,006 million in debts, of which approximately NIS 2,313 million was on account of long term loans, approximately NIS 573 million on account of debentures, and approximately NIS 120 million on account of short-term credit.

The Group raised new debt in a total amount of approximately NIS 1,616 million by an offering of debentures (of which NIS 850 million was by way of a stock exchange offering) and receipt of new long-term loans.

The average monthly short-term credit during the period was approximately NIS 479 million. The average monthly long-term liabilities for the period was approximately NIS 5,873 million.

Working capital as at September 30, 2004, was negative and amounted to approximately NIS 1.31 billion, compared with positive working capital of NIS 540 million on September 30, 2003. The transition to negative working capital is due to the first-time consolidations.

6. <u>Comparison of the results of the third quarter of 2004 with the results of the corresponding quarter in the prior year</u>

Revenues during the third quarter of 2004 increased by approximately NIS 394 million compared with the corresponding quarter in the prior year – an increase of approximately 19%. Approximately NIS 463 million of third quarter revenues derived from first-time consolidations. Eliminating this additional revenue, revenues in the third quarter decreased by approximately NIS 69 million compared with the corresponding quarter in the prior year.

General and operating expenses increased compared with the corresponding quarter last year by approximately NIS 353 million – an increase of approximately 30.4%. Approximately NIS 358 million of the operating and general expenses in the third quarter derived from the first-time consolidations. Eliminating this additional expense, expenses for the quarter decreased by approximately NIS 5 million compared with the corresponding quarter in the prior year.

Operating income during the quarter rose by approximately NIS 41 million compared with the corresponding quarter in the prior year. Approximately NIS 5 million of the increase derived from the first-time consolidations.

Financing expenses during the third quarter of 2004 increased by approximately NIS 22 million compared with the corresponding quarter in the prior year. The source of the increase is the first-time consolidations.

The behavior of the various revenue and expense items and the causes of the differences between the quarters, are similar to the explanations set out in the results for the period.

The changes described above in the profit and loss statements brought about net earnings of approximately NIS 243 million in the third quarter, compared with a net loss of approximately NIS 85 million in the corresponding quarter of the prior year. This represents an increase of approximately NIS 328 million.

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

Adv. Miriam (Miki) Mazar **Chairperson of the Board**	**Amnon Dick** **President & C.E.O.**