28 August, 2001

Directors' Report on the State of the Company's Affairs
for the Six Months ended June 30, 2001

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, 2001 (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 has been prepared assuming that the reader also has access to the Directors' Report of December 31, 2000.

The financial data in the Directors' Report are presented in adjusted shekels of June 2001.

1. The Business Environment

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

1. Following the cancellation of Section 50 of the Telecommunications Law, 5742-1982, effective from 1 June, 1999, which had granted the Company exclusivity in providing fixed national telecommunications services in a nationwide telephone network, the Ministry of Communications embarked upon a series of actions designed to enable additional operators to provide domestic communication services, as follows:

    a. In December 1999, the Ministry of Communications granted a special license to Israel Railways for providing communications services by the optical fibers it owns. In July 2001, Israel Railways published a tender for lease of the its infrastructure for providing telecommunications services.

    b. In October 2000, the Ministry of Communications published tenders for the provision of domestic communication services by means of a wireless access network to the homes of subscribers (LMDS). A draft was attached to the tender documents, describing the main points of the terms of the general license that will be granted to the winners of the tenders.

    c. At the beginning of February 2001 the Ministry of Communications granted a license for operating domestic fixed-line communications services to another company.

    d. As explained in Note 1(b)(6) to the financial statements, in July 2001 the Telecommunications Law was amended, which enables the Ministry of Communications to grant the cable companies licenses for providing domestic fixed-line telecommunications services on the cable infrastructure.

2. The imminent opening of domestic communications services to full competition and awarding licenses to provide domestic fixed-line services as above, in addition to the growing competition in cellular and international communications sectors, is expected to have a material adverse effect on the Company's business results which cannot be estimated at this stage.

3. Pursuant to the decisions of the Knesset Finance and Economics Committees, the Company's tariffs were lowered, effective March 1, 2001, as described in Note 1(b)(2) to the financial statements.

4. At its meeting on August 27, 2000, the Ministerial Committee for Privatization resolved to sell the State's holdings in the Company by way of a private sale that would be accompanied by raising capital for the Company. The sale will include shares comprising at least 50.1% of the Company's share capital. The Government Companies Authority was authorized to carry out the actions required for the implementation of the resolution, including actions listed in the resolution. It was further decided that if possible, the sale process would end within 9 - 12 months from the date of the resolution. The Knesset Finance Committee approved the method of privatization as provided in the resolution of the Ministerial Committee on September 6, 2000. On June 11, 2001 the Ministerial Committee for Privatization amended its resolution from August 27,2000 with regard to selection of the buyer of the State's holdings in the Company, so that a financial investor (in addition to a strategic investor) would be permitted to participate in the tender. On June 17, 2001, the Ministerial Committee for Privatization decided that the announcement of the sale of the States holdings in the Company would be made only after completion of amendment of the Company's by-laws, the Company's license and the Telecommunications Order to make them compatible with the privatization resolution, and also decided to grant flexibility to the buyer of the core control so that it would be able, on the stipulated terms, to reduce its holdings from 50.01% to 40.02%. In August 2001 the Company received a draft of the Telecommunications Order. The draft includes amendments to the order which are the result of the decision of the Ministerial Committee for Privatization, as well as other amendments, the meaning of some of which is restriction of the Company's operating arena, while other amendments restrict potential buyers of the Company's shares in everything relating to the duties of disclosure imposed upon them. The Company has submitted its comments and reservations about these amendments.

   The General Meeting of the Company which convened on April 30, 2001 resolved to approve an increase of the registered capital of the Company by 130 million ordinary shares, and to amend Article 64 of the Company's By-laws, in order to enable capital to be raised for the Company in accordance with the privatization resolution. On June 11, 2001, the Ministerial Committee for Privatization approved the increase of the Company's registered capital. The General meeting which convened on August 29, 2001 approved, inter alia, additional amendments relating to security matters in the Company's By-laws, pursuant to the privatization decision of June 17, 2001.

5. Concerning exercise of a right of first refusal to purchase an additional 50% of the share capital of Pelephone, see Note 4(a) to the financial statements.

6. Concerning the Company's investment in D.B.S. Satellite Services (1998) Ltd. and the financing agreement signed with banking corporations, see Note 4(c) to the financial statements.

7. In January 2001, the subsidiary Bezeq International Ltd. entered into an agreement of principles for the establishment of a joint venture for laying and operating a seabed optical fiber system in the eastern Mediterranean basin, as part of the Tycom Global Network ("TGN"), for a total cost of $390 million. The investment of Bezeq International in the project will be about 20%, with an option to increase its share, on certain terms, to 33% of the joint venture. The Board of Directors of the Company approved an outlay of up to $78 million by the Company for financing the project. The parties are negotiating prior to signing a detailed agreement.

8. In May 2001 the Company signed an agreement in which it undertook to invest the sum of $20 million in a venture capital fund. The objective of the fund is to make investments in start-up telecommunications companies. The Company invested three million dollars during the report period.

2. Details concerning exposure to and management of market risks

Further to that described in the Directors' Report for the year 2000, as a result of hedging transactions against market risks associated with exposure to changes in exchange rates, the Company sustained no material increases in financing income or expenses, despite the material changes in the exchange rates of foreign currencies in the report period.

3. Financial Position

a. The Group's assets as at June 30, 2001 amount to approximately NIS 17,26 billion, compared with NIS 16.05 billion on June 30, 2000. Of these, approximately NIS 11.0 billion (approximately 63.7%) are fixed assets, compared with approximately NIS 12.2 billion (76.0%) at June 30, 2000. The increase in total assets derived mainly from an increase in the cash balances and long-term investments of the Group an increase which was partially offset by the decrease in the depreciated cost of the fixed assets as a result of the differential between depreciation expenses and the investment made in the report period.

b. The Group's shareholders' equity as at June 30, 2002 amounted to approximately NIS 7.2 billion, which comprise 41.7% of the total balance sheet, compared with approximately NIS 7.7 billion on June 30, 2000, which comprised approximately 48.1% of the total balance sheet.

c. Total Group debt to financial institutions and to the holders of its debentures as at June 30, 2001 amounted to approximately NIS 6.6 billion, compared with approximately NIS 6.1 billion on June 30, 2000. The increased debt was generated as a result of the Company's investment in dollar-linked convertible debentures (in connection with the Pelephone transaction described in Note 4(a) to the financial statements), and the increase in the Company's cash balances.

d. The balances of the Group's cash and short-term investments as at June 30, 2001 amounted to approximately NIS 1,503 million, compared with approximately NIS 694 million at June 30, 2000.

e. The Group's surplus of monetary liabilities over monetary assets in foreign currency or linked thereto as at June 30, 2002 amounted to approximately NIS 2.39 billion. During the report period, the Company made forward currency transactions to reduce the exposure, and the Company intends to continue pursuing this policy.

   As a result of the forward currency transactions and investment in dollar-linked convertible debentures (in connection with the Pelephone transaction), the Company's surplus of foreign currency assets over liabilities as at June 20, 2001 amounted to approximately NIS 299 million.

f. The Group’s surplus of CPI-linked liabilities in excess of linked monetary assets as at June 30, 2001 amounted to approximately NIS 1.81 billion. This exposure is partly covered by a mechanism for updating tariffs, which takes into account price rises in the economy. In addition, the Company made hedging transactions that limit the exposure to rises in the CPI.

4. Results of Operations

a. Principal results

   Net earnings for the first half of 2001 amounted to approximately NIS 156 million, compared with net earnings of approximately NIS 204 million in the corresponding period last year.

   The difference between the results was caused mainly by a decrease in the Company's operating income, an increase in the operating loss of Pelephone, and a decrease of approximately NIS 65 million in the other income item. These influences were partially offset by a decrease in the Company's financing expenses

   Earnings per share for the first half of 2001 amounted to NIS 0.065 per NIS 1 par value share, compared with NIS 0.086 per share in the corresponding period last year.

b. Revenues

   Group revenues for the first half of 2001 amounted to approximately NIS 4.08 billion, compared with approximately NIS 4.29 billion in the corresponding period last year. Revenues in the corresponding period last year include Company revenues from airtime for two months, whereas in the report period, no airtime is included because of the change in the

Company's method of settlement arrangements with the cellular communication companies. Eliminating the airtime component, revenues in the corresponding period last year would have been only approximately NIS 4.05 billion.

Revenues from domestic fixed-line communications traffic decreased as a result of tariff reductions in May 2000 and March 2001, and as a result of a decrease in call traffic, the effects of which were offset to some extent by the increase in Internet access traffic. Revenues from international calls decreased due to a 30% reduction in access fees and a decrease in the revenues of Bezeq International. Revenues from installations and sales of equipment decreased due to various discount campaigns. The decrease in the Group's income was offset mainly by a rise in revenues from fixed usage fees and by revenues from cellular calls which are not airtime.

c. Operating and general expenses

The Group's operating and general expenses for the first half of 2001 amounted to approximately NIS 2.22 billion, compared with approximately NIS 2.24 billion in the corresponding period last year.

Expenses are affected, on the one hand, by 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; on the other hand, the implications of the agreement with Pelephone as described in Note 1(b)(3) to the financial statements, increased the Company's expenses. In addition, the operating expenses of Pelephone increased, as did salary expenses and general expenses, while sub-contractor expenses decreased. Most of the increase in salary expenses and the decrease in sub-contractor expenses derived from the absorption of employees from temporary employment agencies as employees of the company.

d. Royalties to the Government of Israel

The decrease in royalties rate as described in Note 1(b)(5) to the financial statements, led to a decrease in the loyalties obligation of the Group, mainly at Pelephone, which in the past had paid royalties at 8% of its revenues.

e. Operating income

The Group's operating income for the first half of 2001 amounted to approximately NIS 426 million, compared with approximately NIS 527 million in the corresponding period last year, a decrease of approximately NIS 101 million. The decrease in operating income results from the changes described above in the operating income and the operating and general expenses items, and from a decrease in depreciation and royalties to the Government of Israel. The decrease in operating income was recorded at the Company and at Pelephone.

f. Financing expenses

The Group's financing expenses for the first half of 2001 amounted to approximately NIS 51 million, compared with approximately NIS 167 million in the corresponding period last year. The decrease derives from the decrease in net interest expenses as a result of the decrease in net financial liabilities, as well as from interest income from income tax (approximately NIS 73 million) as a result of the assessment arrangement for preceding years. The effects of changes in foreign currency exchange rates were neutralized mainly by hedging transactions.

g. The Company's share in the losses of affiliates

The increase in the Company's share in the losses of affiliates was due to the increase in the Company's share in the losses of D.B.S. Satellite Services (1998) Ltd., and the increase in the losses of Walla Communications Ltd. The increase was offset mainly by the Company's share in the profits deriving from the disposal of an indirect holding of the Company in Hungary – see also Notes 4(b), 4(c) and 4(d) to the financial statements.

h. Other income (expenses)

In the first half of 2002, this item includes a capital gain from the sale of part of the Company's holdings in a satellite communications association and the sale of other assets for approximately NIS 19 million. In the first half of 2000, other income included approximately NIS 88 million (before tax), which consisted mainly of about NIS 85 million income from calling in the bond 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.

5. Liquidity and sources of financing

Consolidated cash flows generated by operating activities during the first half of 2001 amounted to approximately NIS 1,515 million, compared with approximately NIS 1,570 million in the corresponding period last year. The decrease in cash flows from current operations resulted primarily from a decrease in net earnings compared with the earnings in the corresponding period, from a decrease in expenses not involved in cash flows, and from changes in the current assets and liabilities items. The decrease was partially offset by a decrease in payments for financing employee retirement. The cash flow generated by operating activities is the principal source of the Group's investments, and was used during the report period, inter alia, for the investment of about NIS 715 million in the development of telecommunications infrastructures, approximately NIS 257 million in investee companies, and about NIS 1,107 million in convertible debentures in connection with the Pelephone transaction (see Note 4(a) to the financial statements). Investments which were not financed by cash flow from current operations were financed by a reduction in the cash balances of the Group and by increasing its monetary liabilities, by which the Group repaid, in the first half of the year, NIS 386 million of debts, of which NIS 196 million in long-term loans, NIS 134 million on account of debentures and NIS 56 million in short-term credit. In contrast, the Group raised a new loan of NIS 664 million, of which about NIS 155 million in new long -term loans and NIS 509 million in an issue of debentures. The total of these transactions was reflected in an increase in the Group's total debt to banks and debenture-holders, where this exceptional increase, after years of steady reduction, derived from the exceptional investment arising from the Pelephone transaction in the report period.

The average monthly short-term credit in the period was approximately NIS 852 million, and the average monthly long-term liabilities in the period were approximately NIS 5,799 million.

Working capital as at June 30, 2001 was negative and amounted to approximately NIS 633 million, compared with NIS 925 in the corresponding period in 2000. The improvement in the Group's working capital derived from an increase in the Group's cash surpluses. 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 in 2000

Revenues in the second quarter of 2001 increased by approximately NIS 7 million compared with the corresponding period last year, an increase of about 0.4%. Operating and general expenses increased compared with the second quarter last year by approximately NIS 170 million, an increase of about 17.2%.

Operating income in the quarter decreased by approximately NIS 106 million.

Financing expenses in the second quarter of 2000 decreased by approximately NIS 36 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 those explained for the half-yearly results.

The changes described above in the items of the statement of income resulted in net earnings of approximately NIS 84 million in the second quarter of 2001, compared with net earnings of approximately NIS 109 million in the corresponding period last year, a decrease of about NIS 25 million.

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

Ido Dissentshik Chairman of the Board	Ilan Biran CEO