August 8, 2003

Directors' Report on the State of the Company's Affairs for the period ended June 30, 2003

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 (hereinafter collectively referred to as "the Group") for the six month period ended June 30, 2003 (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, 2002.

The financial data in the Directors' Report are presented in adjusted shekels of June 2003.

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. In March 2003 the Committee for Regulating the Tariffs of the Company presented a report containing its recommendations. In July 2003 the Ministers decided to adopt the recommendations with some amendments and on August 5, 2003 the Knesset Finance Committee approved the recommendations with certain amendments. The changes in tariffs, which will take effect on September 1, 2003, and the update mechanism, appear in Note 1(b)(1) to the financial statements. The Company believes that the decrease in its tariffs is expected to have a materially adverse effect on its business results.

B. On May 15, 2003, a settlement agreement was signed between the Company and the Government of Israel on behalf of the State of Israel and the Israel Lands Administration, regulating the dispute between them in the matter of the rights of the Company in various real estate properties which were transferred to the Company when it commenced operations in 1984 under an asset transfer agreement signed between the Company and the State. For a description of the principal terms of the agreement see Note 5 to the financial statements. The settlement agreement will take effect upon receipt of the approvals mentioned in Note 5. The Company's Management does not expect the agreement to have a material effect on the financial statements of the Company.

C. In May 2003 the Knesset enacted the Law for the Recovery of Israel's Economy (Legislative Amendments for Achievement of the Budgetary Goals and the Economic Policy for the Fiscal Years 2003 and 2004), 5763 - 2003. The law includes, *inter alia*, amendments to the Communications Law (Telecommunications and Broadcasts), 5742 - 1982 and to the Government Companies Law, 5735 - 1975, which could have a materially adverse effect on the activities of the Group. Among the amendments, and further to the recommendations of the committee appointed by the Minister of Communications to make detailed recommendations for the rules and policy of opening domestic fixed-line communications to competition in Israel, the Knesset Economics Committee approved the grant of licenses to new domestic operators without imposing a universal services obligation, commencing in September 2004. In addition, the law includes provisions relating to a reduction in the public sector wages and an amendment to the Supervision of Business Insurance Law relating to the old pension funds which are operating at a deficit. For the possible effects of this amendment on the Company's liabilities with respect to its early retirement program – see Note 6 to the financial statements.

D. On July 29, 2003, a letter was sent to the Company by the head of the Department for Privatization at the Government Companies' Authority, regarding the amendment of the resolution of the Ministerial Committee for Privatization dated August 27, 2000, which concerned the privatization of the Company. Enclosed with the letter was the proposal for the amendment of the aforementioned resolution which the Government Companies' Authority plans to put forward for the approval of the Ministerial Committee for Privatization. The proposal is for the State's holdings in Bezeq to be privatized by way of a private placement of 30-40% of the share capital of the Company in a single sale (rather than 50.01% as in the original decision), where that sale will be accompanied by the raising of capital for the Company and the sale of the additional holdings (except for 1.01% of the issued share capital of the Company) by way of a public offering or during trading on the stock exchange or by means of a private sale of bundles of shares, alone or combined with the raising of capital for the Company, as the Government Companies' Authority will decide together with the Accountant General at the Ministry of Finance.

   The Company was requested to submit to the Government Companies Authority the position of the Board of Directors of the Company pursuant to Section 59B(c) of the Government Companies Law, 5735 - 1975, and is currently preparing to do so.

E. On July 30, 2003, the Company issued to the State the remainder of its unissued share capital for a consideration of NIS 101,261,807, as part of a framework agreement signed between the Company and the State with regard to the raising of capital and financing the costs of employee retirement. For a detailed description, see Note 1(b)(4) and Note 8 to the financial statements.

F. The term of office of Adv. Miriam (Miki) Mazar as Chairperson of the Board of Directors of the Company, which was initially approved until June 30, 2003, was extended until the end of her term of office as a director of the Company.

   On July 13, 2003, the Board of Directors approved the appointment of Mr. Amnon Dick as CEO of the Company. Mr. Dick will take up his new post after the appointment is approved by the Prime Minister and the Minister of Finance.

2. <u>Details concerning exposure to and management of market risks</u>

<u>The officer responsible for managing market risk in the Company</u>

A. The Company officer responsible for managing market risk is the Chief Financial Officer Mr. Ron Eilon. For details of his education and experience, see the periodic report Regulation 26A for 2002.

B. Further to that described in the Directors' Report for the year 2002 and as a result of hedging transactions against market risks associated with exposure to fluctuations in exchange rates, the Group experienced no material interest expenses and generated no material interest income during the period of account , despite the material changes which occurred in the exchange rates of foreign currencies during the period.

C. The report on linkage bases and positions in derivatives as at June 30, 2003 does not differ significantly from that reported for December 31, 2002.

D. The Group's surplus monetary liabilities over monetary assets denominated in or linked to foreign currency as at June 30, 2003, amounted to approximately NIS 2.9 billion. As a result of forward currency transactions, the net balance of foreign currency liabilities not hedged by such forward transactions, amounted to approximately NIS 36 million as at June 30, 2003.

   The Group's surplus monetary liabilities over monetary assets that are linked to the CPI as at June 30, 2003, amounted to approximately NIS 0.78 billion.

3. Financial Position

A. The Group's assets as at June 30, 2003 amounted to approximately NIS 15.9 billion, compared with NIS 17.94 billion on June 30, 2002. Of these, approximately NIS 9.58 billion (approximately 60.3%) are fixed assets, compared with approximately NIS 10.3 billion (57.2%) on June 30, 2002.

The decrease in total assets derived mainly from a decrease in investments and long-term debt and from a decrease in the depreciated cost of the fixed assets as a result of the difference between depreciation expenses and the investment made in the report period.

B. The Group's shareholders' equity as at June 30, 2003, amounted to approximately NIS 6.6 billion, representing approximately 41.4% of the total balance sheet, compared with approximately NIS 7.8 billion on June 30, 2002, which represented approximately 43.5% of the total balance sheet. The reduction in shareholders' equity was mainly due to the Group's net loss in 2002 and the distribution of a dividend during the reporting period.

C. Total Group debt to financial institutions and debenture holders as at June 30, 2003, amounted to approximately NIS 5.7 billion, compared with approximately NIS 6.35 billion on June 30, 2002.

D. Group balances in cash and short-term investments as at June 30, 2003, amounted to approximately NIS 2.26 billion, compared with approximately NIS 2.06 billion on June 30, 2002.

4. Results of Operations

A. Principal results

Net earnings for the first half of 2003 amounted to approximately NIS 88 million, compared with net earnings of approximately NIS 198 million during the corresponding period in the prior year.

Earnings per share in the first half of 2003 were NIS 0.036 per NIS 1 par value, compared with earnings of NIS 0.082 per share in the corresponding period in the prior year.

B. Revenues

Group revenues in the first half of 2003 amounted to approximately NIS 3.99 billion, compared with approximately NIS 4.1 billion in the corresponding period in the prior year. The decrease in revenues derives principally from the decrease in revenues from domestic fixed-line and cellular telephone communications. The decrease was moderated by the rise in revenues from fixed fees.

Revenues from domestic fixed-line communications decreased as a result of decreased outputs and the erosion of tariffs. Company revenues from cellular telephone communications decreased due to the decrease in interconnect fees, transmission revenues and collection fees and a decrease in the revenues of Pelephone. The decrease in the Group's revenues was moderated by an increase in the Company's revenues from ADSL lines.

C. Operating and general expenses

The Group's operating and general expenses in the first half of 2003 amounted to approximately NIS 2.23 billion, compared with approximately NIS 2.27 billion during the corresponding period in the prior year.

The operating and general expenses of the Group were influenced mainly by a decrease in general expenses, salary costs and building maintenance expenses, which were offset mainly by an increase in cellular telephone, international communications and motor vehicles expenses.

D. Depreciation

The Group's depreciation expenses are decreasing as a result of the cessation of the depreciation charge on the Company's fixed assets and a decrease in investments in new assets.

E. Royalties to the Government of Israel

The Group's royalty expenses in the first half of 2003 amounted to approximately NIS 123 million, compared with approximately NIS 132 million during the corresponding period in the prior year. The source of the decrease is the decrease in the royalty percentages due on the revenues of Pelephone and the decrease in the Company's revenues.

F. Operating income

The Group's operating income in the first half of 2003 amounted to approximately NIS 538 million, compared with approximately NIS 544 million during the corresponding period in the prior year, a reduction of approximately NIS 6 million. The decrease in operating income results from the changes in the revenues and expenses items described above. These changes led to a decrease in the operating loss of Pelephone, to an increase in the operating income of Bezeq International and a decrease in the operating income of the Company.

G. Financing expenses

The Group's net financing expenses in the first half of 2003 amounted to approximately NIS 85 million, compared with approximately NIS 72 million in the corresponding period in the prior year. The increase is derived mainly from a rise in the financing expenses of Pelephone and Bezeq International. The increase was offset mainly by a decrease in the financing expenses of the Company due to the decrease in its total monetary debt and an increase in revenues from the Company’s financial investments.

H. Other expenses (income), net

The expenses in the first half of 2003 amounted to approximately NIS 40 million, of which approximately NIS 31 million are a provision in respect of the Company's investments in Adanet for Business Group Ltd. – see Note 4(c) to the financial statements.

I. Company equity in losses of affiliates

The Company’s equity in losses of affiliates increased compared to the corresponding period in the prior year, due to the increase in the Company's equity in the losses of D.B.S. Satellite Services.

5. Liquidity and sources of financing

Consolidated cash flows generated by operating activities in the first half of 2003 amounted to approximately NIS 1,491 million, compared with approximately NIS 1,310 million in the corresponding period in the prior year. The increase in consolidated cash flows was due to an increase in the operating cash flows of the Company and of Pelephone.

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 731 million in the development of communications infrastructures, approximately NIS 117 million in investee companies and approximately NIS 167 million in short-term deposits and investments. During the quarter, the Group repaid approximately NIS 502 million of debt, of which approximately NIS 289 million was on account of long-term loans, approximately NIS 154 million on account of debentures, and approximately NIS 59 million on account of short-term credit. In addition, the Company paid a dividend of approximately NIS 188 million. Conversely, the Group raised new debt in a total amount of approximately NIS 203 million in new long-term loans.

The average monthly short-term credit during the period was approximately NIS 458 million. The average monthly long-term liabilities during the period were approximately NIS 5,365 million.

Working capital as at June 30, 2003, was positive and amounted to approximately NIS 142 million, compared with positive working capital of approximately NIS 927 million as at June 30, 2002. The decrease in the Group's working capital derived mainly from an increase in current maturities of debentures, an increase in short-term credit and an increase in short-term employee severance benefits.

6. Comparison of the results of the second quarter of 2003 with those of the corresponding period in the prior year

Revenues in the second quarter of 2003 decreased by approximately NIS 62 million compared with the corresponding quarter in the prior year, a decrease of approximately 3%. Operating and general expenses, compared with the corresponding quarter in the prior year decreased by approximately NIS 35 million, a reduction of approximately 3.1%

Operating income in the quarter increased by approximately NIS 11 million.

Financing expenses in the second quarter of 2003 increased by approximately NIS 26 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 relating to the half-year results.

As stated in Note 4C to the financial statements, a provision of approximately NIS 31 million was recorded in the second quarter for the Company's investment in Adanet for Business Ltd.

The changes described above in the Statement of Operations items led to net earnings of approximately NIS 19 million in the second quarter, compared with net earnings of approximately NIS 86 million in the corresponding period in the prior year, a decrease of approximately NIS 66 million.

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

Adv. Miriam (Miki) Mazar Chairperson of the Board	Ilan Biran CEO