May 17, 2004

Directors' Report on the State of the Company's Affairs for the period ended March 31, 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 (hereinafter collectively referred to as "the Group") for the three-month period ended March 31, 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 on the assumption that the reader can also refer to the Directors' Report for the year ended December 31, 2003.

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 up to December 31, 2003 are presented in NIS of December 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. On March 31, 2004, the Company's general license was thoroughly and extensively amended. According to the notice of the Ministry of Communications to the Ministerial Committee for Privatization, the amended license is intended to adapt the general license to the competitive environment in which the Company operates, but it is the opinion of the Company that certain provisions in the license restrict the company's operations and are expected to impede its ability to compete.

B. An offer for sale and an offering to the public under a prospectus is scheduled for publication at the end of May 2004. The final details of the offering to the public have not yet been agreed, and in any case might yet undergo changes – see Note 1D to the financial statements. The debentures offered to the public in the offering have been rated by two companies as AA and Aa1 debentures.

C. On April 22, 2004, regulations took effect which determine processes and conditions for receipt of a general license for providing international telecommunications 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 domestic operator, a cellular operator or a material operator in a segment of operations of international transmission service. Bezeq International estimates, in view of the restrictions in the regulations, that companies that provide Internet access services will be the first to enter the international telecommunications market, but others may join them. Expansion of the competition will bring with it a further drop in the prices of international calls without the volume of traffic increasing by any meaningful amount. Bezeq International and the Company estimate that the competition will have an adverse effect on both their revenues.

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

E. In February 2004 the Board of Directors of the Company resolved to exercise the option to acquire Pelephone and the Company has applied for the required approvals. Upon exercise of the option, the Company will be the sole owner of Pelephone – see Note 4A to the financial statements.

F. To mark the twentieth anniversary of its establishment, the Company launched a campaign of donations during 2004 to various institutions. The amount of the monthly donation will be the higher of 5% of the Company's revenues from calls on the 20th of each month of the campaign, or NIS 200,000. The campaign will last for 12 months, starting on February 20, 2004. During the reporting period of these financial statements the Company's campaign donations amounted to NIS 457 thousand. During the reporting period Pelephone made donations of NIS 500 thousand and also contributed its infrastructure for the "Good Day" campaign of the "Israeli Spirit" not-for-profit association.

2. Details concerning exposure to and management of market risks

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

B. The report on linkage bases and positions in derivatives as at March 31, 2004, does not differ significantly from that reported as at December 31, 2003.

C. The Group's surplus monetary liabilities over monetary assets denominated in or linked to foreign currency as at March 31, 2004, amounted to approximately NIS 3 billion. As a result of forward currency transactions as at March 31, 2004, the net balance of foreign currency liabilities not hedged by such forward transactions, amounted to approximately NIS 318 million.

The Group's surplus monetary liabilities over monetary assets that are linked to the CPI as at March 31, 2004, amounted to approximately NIS 1.2 billion.

3. Financial Position

A. The Group's assets as at March 31, 2004, amounted to approximately NIS 15.9 billion, compared with NIS 15.8 billion on March 31, 2003. Of these, approximately NIS 8.5 billion (approximately 53.4%) are fixed assets, compared with approximately NIS 9.6 billion (60.8%) on March 31, 2003.

The decrease in total assets derived mainly from the decrease in the net book value of the fixed assets as a result of the difference between the depreciation expense and the investments made during the reporting period. The decrease was mainly offset by an increase in the balance of cash and cash equivalents and in short-term investments.

B. The Group's shareholders' equity as at March 31, 2004, amounted to approximately NIS 7.01 billion, representing approximately 44.2% of the total balance sheet, compared with approximately NIS 6.47 billion on March 31, 2003, which represented approximately 40.9% of the total balance sheet. The increase in shareholder' equity derived mainly from an issuance of shares in accordance with an agreement with the State to raise capital for the Company. The increase was offset by the net loss of the Group, which was carried forward from the preceding period.

C. Total Group debt to financial institutions and debenture holders as at March 31, 2004, amounted to approximately NIS 5.2 billion, compared with approximately NIS 5.87 billion at March 31, 2003.

D. Group balances in cash and short-term investments as at March 31, 2004, amounted to approximately NIS 3.18 billion, compared with appoximately NIS 2.05 billion on March 31, 2003.

4. Results of Operations

A. Principal results

Net earnings for the first three months of 2004 amounted to approximately NIS 168 million, compared with net earnings of approximately NIS 68 million in the corresponding period in the prior year.

Earnings per share in the first three months of 2004 were NIS 0.064 per NIS 1 par value, compared with earnings of NIS 0.028 per share in the corresponding period in the prior year.

B. Revenues

Group revenues in the first three months of 2004 amounted to approximately NIS 2.01 billion, compared with approximately NIS 1.98 billion in the corresponding period in the prior year.

The increase in the Group's revenues derived principally from an increase in the revenues of Pelephone, Bezeq International and BezeqCall. Conversely, 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. The decrease in revenues from domestic fixed-line communications was due to the decrease in the call and dial-up Internet traffic, and the lower tariffs introduced in September 2003.

Conversely, the Company's revenues from fixed fees increased with the ongoing trend of increased revenues from ADSL lines and the rise in the fixed fee that took effect in September 2003.

C. Operating and general expenses

The Group's operating and general expenses in the first three months of 2004 amounted to approximately NIS 1.09 billion, compared with approximately NIS 1.12 billion in the corresponding period in the prior year.

There was no significant change to most of the operating and general expenses of the Group. The Company's payroll expenses decreased to a certain extent as a result of employee retirement under the early retirement plan. In addition, building maintenance expenses decreased following an agreement with the Broadcasting Authority whereby the Company will be reimbursed retroactively for its municipal tax expenses.

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. Furthermore, an additional decrease was recorded due to the change in the estimated useful lives of the assets – see Note 5A to the financial statements.

E. Royalty payments to the Government of Israel

The Group's royalties expenses in the first three months of 2004 amounted to approximately NIS 47 million, compared with approximately NIS 60 million in the corresponding period in the prior year. The source of the decrease was the decrease in the percentage of royalties due on the revenues of the Group from 4% to 3.5% commencing on January 1, 2004.

F. Operating income

The Group's operating income in the first three months of 2004 amounted to approximately NIS 399 million, compared with approximately NIS 255 million in the corresponding period in the prior year, an increase of approximately NIS 145 (Hebrew not quite right) million. The increase in operating income derived from the changes described above in the revenues and expense items. These changes led to the transition from loss to operating profit at Pelephone compared with the corresponding quarter and an increase in the operating income of the Company.

G. Financing expenses

The Group's net financing expenses in the first three months of 2004 amounted to approximately NIS 31 million, compared with approximately NIS 32 million in the corresponding period in the prior year. Commencing in 2004, the financing expenses disclosed in the financial statements are the nominal financing expenses rather than the inflationary portion of the expenses recorded in prior years, this being due to the transition to financial reporting based on nominal financial data. Accordingly, there is no basis for comparison of the results. The financing expenses in the quarter were influenced mainly by an increase in the financing income of the Company from its monetary assets and from a decrease in the financing expenses from the total financial debt of the Group. The effect of changes in foreign currency exchange rates was eliminated to a large extent by hedging transactions.

H. Company equity in losses of affiliates

The Company’s equity in losses of affiliates decreased compared to the corresponding period in the prior year, from approximately NIS 69 million in the first quarter of 2003 to approximately NIS 65 million in the first quarter of 2004. Most of the decrease derived from the decrease in the Company's equity in the losses of DBS due to the improvement in that company's results, even though the Company's holding in DBS increased as compared with the corresponding quarter in the prior year.

5. Liquidity and sources of financing

Consolidated cash flows generated by operating activities in the first three months of 2004 amounted to approximately NIS 758 million, compared with approximately NIS 731 million in the corresponding period in the prior year. The increase in consolidated operating cash flows was due to an increase in the operating cash flows of Pelephone and Bezeq International. The increase was offset by a decrease in the cash flows of the Company and BezeqCall.

Cash flows generated by operating activities are the principal source of financing the Group's investments, these being applied during the reporting period, *inter alia*, to the investment of approximately NIS 397 million in the development of communications infrastructures, approximately NIS 47 million in investee companies and approximately NIS 16 million in long-term deposits and investments. During the quarter, the Group repaid approximately NIS 724 million of debt, of which approximately NIS 133 million was on account of long-term loans, approximately NIS 516 million on account of debentures, and approximately NIS 75 million on account of short-term credit. Conversely, the Group raised new debt in a total amount of approximately NIS 387 million by an offering of debentures and receipt of new long-term loans.

The average monthly short-term credit during the period was approximately NIS 107 million. The average monthly long-term liabilities during the period were approximately NIS 5,254 million.

Working capital as at March 31, 2004, was positive and amounted to approximately NIS 1,490 million, compared with positive working capital of approximately NIS 362 million at March 31, 2003. The increase in the Group's working capital derived mainly from an increase in cash balances and short-term investments of the Group.

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

Adv. Miriam (Miki) Mazar Chairperson of the Board	Amnon Dick President & CEO