March 18, 2004

Directors' Report on the State of the Company's Affairs for the year ended December 31, 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 (the Company and the consolidated companies together are hereinafter referred to as "the Group") for the year ended December 31, 2003 (hereinafter: "the Directors' Report"). The Report was prepared in accordance with the Securities Regulations (Periodic and immediate reports), 5730-1970.

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

1. The Corporation and its Business Environment

A. The Company, together with its wholly or partially owned subsidiaries, is the principal provider of communications services in Israel. The Group operates and provides a wide range of telecommunications activities and services, including domestic fixed-line and international telephone services, cellular telephone services, multi-channel satellite television services, call center services, the laying, maintenance and development of infrastructures, telecommunications services for other telecommunications providers, Internet services, data communications, satellite services, the distribution of radio and television services to the public, and provision and maintenance of equipment and services on customer premises.

B. The field of telecommunications in which the Group operates is subject to technological changes as well as changes to the business structure of the sector. It is a field which in recent years has been subject to intensifying competition in areas which were once the exclusive domain of the Group, and have now been or are about to be opened to competition in accordance with government policy.

C. The Group and its activities are subject to strict government supervision, which is carried out by authorities and other official entities whose policy has changed and continues to change considerably from time to time. This supervision is reflected, *inter alia*, in each of the following:

(1) Most of the Company's tariffs are set and updated in accordance with the provisions of the Telecommunications Law (Telecommunications and broadcasts), 5742-1982 (hereinafter: "the Telecommunications Law") and the regulations promulgated by virtue of that Law (see Note 1B to the financial statements).

In addition, some of the Company's tariffs are subject to supervision in accordance with the provisions of the Supervision of Prices of Products and Services Law, 5756-1996.

(2) The Group is obligated to pay royalties to the State in respect of most of its revenues (see Note 1C to the financial statements).

(3) Towards the end of the Report year, the State reduced its holding in the Company to less than 50%, thereby turning the Company into a "mixed company". Nevertheless, certain provisions of the Government Companies Law, 5735-1975, pertinent to mixed companies, continue to apply to the company, as well as some provisions which are similar to those of that law, by virtue of the Company's articles of association.

(4) The Company's activities are subject to the provisions of a general license awarded to it by virtue of the Telecommunications Law. In some sectors the Company was authorized to operate through subsidiaries in which its control is limited.

(5) In certain areas of its activity, the Company was declared a monopoly, and is therefore subject to supervision and restrictions described in the Anti-Trust Law, 5748-1988 (see also Note 1D to the financial statements).

(6) Some of the activities of the Company and its subsidiary Pelephone Communications Ltd. involve the use of wireless frequency, and as such, are subject to the Wireless Telegraph Ordinance (New Version), 5732-1972. The Wireless Telegraph Regulations determine the fees to be paid for the use of a wireless frequency.

The governmental supervision restricts the freedom of action of the Group as a business entity, its ability to compete in markets which are being opened to increased competition in which it operates, its ability to cope with the changes occurring in the field of telecommunications and to exploit new business opportunities.

D. 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:

1. As a result of the cancellation of Section 50 of the Telecommunications Law, effective as of June 1, 1999, which had granted the Company, in the past, exclusivity in providing fixed-line domestic telecommunications services in a nationwide telephone network, the Ministry of Communications continued actions for enabling additional operators to provide domestic telecommunication services. For example, special licenses were grated to certain operators to provide transmission and data communication services, and a general license for providing fixed-line domestic communications services was granted to a partnership of the three cable companies. In May 2003, as part of the Law for the Recovery of the Israeli Economy (Legislative amendments for attainment of budgetary targets and the economic policy for fiscal years 2003 and 2004), 5763-2003, determined that starting from September 2004, specific general licenses would be granted to new fixed-line domestic telecommunication operators without imposing a universal services obligation.

2. The opening of domestic fixed-line communications services to full competition, in addition to the ongoing and intensifying competition in cellular and international communications sectors, are expected to continue to have a materially adverse effect on the Company's business results, the extent of which cannot be estimated. In order to cope with the anticipated changes, an efficiency plan was negotiated between the Company's Management and the workers' union. Subsequently, on March 18, 2004, an amendment was signed to the collective early retirement agreement of 1997, whereby certain amendments to that agreement were agreed. See Note 16 to the financial statements.

3. According to media reports, Partner Communications Ltd. signed a memorandum of understandings prescribing the principles for the purchase of up to 40% of the shares of the Matav Cable company. The transaction, which is subject to various permits and approvals, highlights the trend towards the creation of groups that will provide a basket of telecommunications services. The closing of the transaction is expected to influence the telecommunications market as a whole and the business of the Group in particular.

4. In March 2003 the committee for regulation of the Company's tariffs presented a report that includes its recommendations. In July 2003 the Ministers decided to adopt the recommendations with certain amendments, and on August 5, 2003 the Knesset Finance Committee approved the recommendations of the committee with certain amendments. Note 1(b)(1) to the financial statements describes the changes in the tariffs that took effect on September 1, 2003, and the mechanism for their periodic updating. The Company believes, based on its projections, that the lowering of tariffs and the updating mechanism will have a materially adverse effect on its business results.

5. 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 Israel Lands Administration,

settling the dispute between them in relation to the Company's rights in various properties which were transferred to the Company under an asset transfer agreement between the Company and the State when it commenced operations in 1984. For a description of the main points of the agreement, see Note 9(c) to the financial statements. The agreement took effect after March 10, 2004, when it was validated as a decision by the court. In the opinion of the Company's Management, the agreement has no material implications for the financial statements.

6. In May 2003, the Knesset enacted a law for the recovery of the Israeli economy. This law includes, among other things, provisions relating to wage cuts in the public sector that still apply to the Company (but not to its subsidiaries) as a mixed company, as well as an amendment to the Supervision of Insurance Business Law that relates to the old deficit-laden pension funds. For the effects of this law on the commitments of the Company due to the early retirement plan, see Note 16 to the financial statements.

7. On August 27, 2003 the Ministerial Committee for Privatization decided on an amendment to its decision of August 27, 2000 (as amended several times thereafter), in the matter of the privatization of the Company.

   Under that amendment, the State's holdings in the Company would be privatized by way of a private sale of 30% – 40% of the Company's share capital (assuming full dilution), in a manner to be determined by the Ministerial Committee for Privatization (rather than sale of at least 50.01% of the Company's shares, as in the Ministerial Committee's original decision). The sale would be accompanied by a raising of capital for the Company and sale/s of the additional holdings (except for 1.01% of the Company's issued share capital), by way of an offering/s to the public and/or during stock exchange trading and/or by means of a private placement of bundles of shares, alone or together with raising capital for the Company, as the Government Companies Authority would decide together with the Accountant General at the Ministry of Finance. Subsequently, shares held by the State were sold through financial institutions and the Company allotted the State shares against them. As a result, the percentage of the State's holdings in the Company decreased on November 18, 2003 to approximated 49.1%, thereby changing the Company's status from "government company" to "mixed company". The proceeds from the allotment of the shares by the Company to the State, were designated by the Company for financing the costs of employee retirement.

   Immediately after approval of the amendment of the privatization decision, the Company was instructed by the Government Companies Authority to prepare for a prospectus. The Company is now preparing that prospectus, which is expected to be published on the basis of the Company's financial statements as at December 31, 2003.

8. Following amendment of the decision regarding the privatization of the Company, a draft amendment of the Company's general license was submitted to the Company, intended to adapt the license, according to the Ministry of Communications' notice, to the competitive environment in which the Company operates.

   The Company submitted its position and remarks to the Ministry of Communications, and the matter is currently in a hearing process. In the opinion of the Company's Management, certain provisions in the draft of the new general license, if not amended, are expected to limit the Company's activities and hinder its ability to compete.

   In addition, the Government approved an amendment to the Telecommunications Order that corresponds, *inter alia*, to the amendment to the privatization decision and amendments made to the Telecommunications Law (the amendment will also be approved by a joint economics, foreign affairs and security committee of the Knesset).

   New articles for the Company, adapted to the provisions of the Companies law, 5759-1999, which include cancellation and/or modification of some of the restricting provisions in the existing articles, which took effect when the Company became a mixed company, were removed from the agenda of the general meeting of the shareholders of the Company. To the best of the Company's knowledge, the State, through the Government Companies Authority, intends to raise again the subject of amendment of the articles at the general meeting of the shareholders.

9. The accelerated growth in cellular telephone services which occurred as the additional operators began operations, has turned this service into a direct competitor of the fixed line telephony and transmission services provided by the Company. As a result, it has led to a decrease in the volume of fixed-line telephony and transmission services provided by the Company.

10. In the Report year, the Company expanded ADSL technology broadband Internet services, and as at December 31, 2003, the number of subscribers of the service had increased to approximately 428 thousand subscribers.

11. D.B.S. Satellite Services (1998) Ltd. (hereinafter: "DBS") commenced the provision of satellite services in July 2000. DBS is in fierce competition in the field of with corporations licensed to provide cable television services (hereinafter: "the Cable Companies"), that operate nationwide in a format of temporary merger arrangements. A license received in November 2003 by a corporation held by the Cable Companies to provide fixed-line domestic telecommunications services, in addition to the access services to the Internet and data communication services and transmission which they already provide, is liable to make it difficult for DBS to compete with them. Moreover, DBS has already accumulated losses in which the Company's share, as at December 31, 2003, was approximately NIS 1,051 million, of which NIS 286 million relate to the Report year.

12. In the account year, DBS's operating losses decreased considerably compared with the prior year, mainly due to the increase in its revenues and the decrease in operating and administrative expenses. Financing expenses increased considerably due to the increase in its financial debt, which bears high real interest. For increase of the exposure and holdings in DBS, see Note 8(e) to the financial statements.

13. Pelephone Communications Ltd. (hereinafter: "Pelephone") operates in a saturated market in which four companies operate. The competition between them is reflected, *inter alia*, by a constant lowering of tariffs and large-scale churn between the companies. The cellular market in Israel, and indeed worldwide, is characterized by heavy capital investment in the deployment of infrastructures and subscriber equipment. The frequent technological changes in both infrastructures and user equipment, together with the intense battle for market share, impose a heavy burden on the companies operating in the market, who are compelled to update their infrastructure technology from time to time or to incur high costs in the market penetration of new handsets.

    Despite this, Pelephone succeeded in considerably increasing its revenues and reducing its operating expenses in the account year, and as a result, recorded an operating profit of approximately of approximately NIS 193 million and a net profit of approximately NIS 25 million, compared with a loss from operations of NIS 143 million and a net loss of NIS 155 million in the prior year.

    On February 26, 2004, the Board of Directors of the Company resolved to approve exercise of an option to purchase 50% of the shares of Pelephone. Exercise of the option will increase the Company's holding in Pelephone to 100% (see Note 8(d)(4) to the financial statements).

14. Bezeq International Ltd. (hereinafter: "Bezeq International") ended 2003 with a smaller operating profit than in the prior year. The decrease in operating profit derives from an increase in its operating expenses. As a result of an increase in financing expenses and provisions for impairment and disposal of assets, Bezeq International ended 2003 with a net loss of approximately NIS 71 million, compared with a net profit of approximately NIS 75 million in 2002.

The Minister of Communications decided to allow the grant of a general license for international communications services to additional operators, and the designated date for broadening the competition was January 1, 2004. Draft regulations for the conditions and proceedings for receipt of a general license for international communications were submitted to the existing operators. The grant of licenses to additional applicants is liable to lead to further lowering of international call prices and is expected to have an adverse effect on the financial results of Bezeq International.

15. Due to past Government decisions and the directives of the Government Companies Authority, the Company and its government company subsidiaries were prevented from making donations. Accordingly, the Company acted for the community in the Report year by involving itself in social institutions and organizations such as the education system in distressed areas and on the line of confrontation. Upon becoming a mixed company, the above restriction no longer applies to the Company and its subsidiaries, and they may now make donations out of business considerations. To mark the 20th anniversary of its establishment, the Company launched a campaign for making donations to the community during 2004. The Company has not yet formulated a policy for donations. Pelephone, which was not a government company then or now, donated NIS 308,000 to various associations.

16. On August 17, 2003, Mr. Amnon Dick took over as CEO of the Company, and the tenure of Adv. Miriam (Miki) Mazar as Chairperson of the Board of the Company, which was initially approved until June 30, 2003, was extended to the end of her term as a director in the Company.

2. Directors with accounting and financial expertise

A. The Board of Directors of the Company determined that the appropriate minimum number of directors who have accounting and financial expertise is two. In the opinion of the Board of Directors, that number will enable it to fulfill the duties imposed upon it by law and the documents of association, including review of the financial condition of the Company and preparing and approving the financial statements, while taking into consideration the nature, activities and business of the Company.

B. Serving directors who have the skills referred to above:

1. Yoram Aridor

B.A. in the humanities, minors: economics and political science, Law degree, and licensed to practice law.
Former Minister of Finance and Minister of Communications in Israel, and member of the Knesset Finance Committee, 1983-1988.
Served as a director in Maalot Israeli Securities Rating Co. Ltd., 1994-2000.
Chairman of the Herut Executive Committee, 1979-1987.

2. Avi Barak

B.A in economics. Serves as a director in various companies.
Chairman of the Finance Committee of the Board of Directors since 2001.
CEO of Yissum, the research and development company of the Hebrew University of Jerusalem.

3. Shoshana Weinshal

LL.B. and licensed to practice law.
Between 1956 and 1991, served in various positions at Bank Leumi Israel Ltd., including General Counsel, and managed the Underwriting and Issuances department at the bank. In her last position at Bank Leumi, she headed the Business Division and was a member of the bank's management board. From 1991 to the present, she has served as a director in public companies such as El Al Israel Airlines Ltd., Israel Fuel

Co. Ltd. , Dan Hotels Ltd., Rafael Weapons Development Ltd., and Mercantile Discount Bank Ltd. – where she is currently Chairperson of the Loans Committee.

At the Company, she is Chairperson of the Audit Committee and a member of the Finance Committee of the Board of Directors.

4. Yigal Cohen-Orgad (outside director)

B.A. in economics and education, studied for M.A. in economics and business administration (Finance track).
Former Minister of Finance of Israel.
Deputy Chairman of the Board of Bank Leumi Israel Ltd., 1989-1993.

5. Shilo Lifschutz

Qualified CPA, and M.B.A. from the Hebrew University of Jerusalem.
Economist at the Bank of Israel, 1988-1993.
Various positions at United Mizrahi Bank Ltd, 1994-2000, including manager of the Asset and Liability department.
Vice President at the Institute for Forward Contract and Options Ltd., 2000-2001.
Lecturer in accounting and finance courses, 2000-2002, and in 2001 Director of Research Budget Control, at the Hebrew University of Jerusalem.

At the Company, member of the Finance Committee of the Board of Directors and chairman of the sub-finance committee for market risk management.

6. Hava Shechter

B.A. in economics, MBA – major in finance and accounting.
Member of the board of Gachelet. Owner of H. Shechter & Co. Investment House Ltd. – a company specializing in financial solutions, issuances, mergers and acquisitions.
Started her career in the Issuances department of Israel Discount Bank Ltd., and managed the Analysis department of the Investments segment at Bank Leumi Israel Ltd..
Formerly a partner in Zmicha Investment House Ltd., and head of its Integrated Financial Services segment.
Lecturer at an investment banking course for M.A. students.

At the Company, currently Chairperson of the Issuance/Privatization Committee of the Board of Directors of the Company, and member of the Finance Committee.

3. Details concerning exposure to and management of market risks

The Company and the consolidated companies each manage their market risks individually, and not from a consolidated perspective. Following is a description of the risks and their management at the Company.

<u>Responsibility for the Company's market risks</u>

The person responsible for management of the Company's market risks is the Chief Financial Officer, Mr. Ron Eilon. For details of his education and experience, see the Periodic Report under Regulation 26A.

<u>Description of market risks and the Company's risk management policy</u>

The Company is exposed to market risks as a result of changes in interest rates, exchange rates, inflation, the prices of raw materials and equipment and the prices of securities.

Interest rate – Most of the Company's loans are in foreign currency bearing variable interest at LIBOR plus a margin. The Company is exposed to changes in the LIBOR rate. This is an accounting exposure and can affect the finance expenses borne by the Company as well as its cash flows. On the other hand, the fact that the interest rate is variable makes the fair value of these loans similar to their book value, thereby eliminating this possible economic exposure.

Loans and debentures of the Company that are linked to the Consumer Price Index ("CPI") usually bear fixed interest and therefore a change in the interest rate will affect the fair value rather than the book value. This feature also exists with respect to the euro-denominated debentures that the Company issued on an overseas stock exchange.

The Company has invested in quoted bonds that are recorded in its books at their market value. This market value is influenced by changes in the interest rates in the economy.
The Company has invested in quoted bonds defined as a "permanent investment", and therefore their presentation is not affected by market value or by changes in the interest rate in the economy.

As of the date of this Report, the Company does not hedge against the aforementioned exposures. It is not inconceivable, however, that hedging will be carried out in future market circumstances. Additionally, the Company takes into account such influences when considering the types of loans it takes and in the management of its investments portfolio.

Exchange rates – Of itself, a change in the shekel exchange rate constitutes economic exposure in that it can affect the Company's future profit and cash flows, mainly the repayment of currency-linked obligations and payments for the currency-linked purchase of equipment and raw materials.

The Company also has accounting exposure deriving from the rate of change in the shekel exchange rates as compared with the rate of change in the CPI in the reporting period. Such exposure generates a decrease or an increase in the value of currency-linked liabilities, which could, in turn, have a significant effect on the Company's real finance expenses.

In order to minimize this exposure, the Board of Directors decided that the Company should partially or fully hedge the accounting exposure deriving from all the balances recorded in the balance sheet. In the event of partial hedging, the unhedged exposure would not exceed `150 million dollars, of which not more than the equivalent of 50 million dollars would relate to currencies other than the U.S. dollar. In addition, the Company would be able to implement additional hedging transactions from time to time against exposure to expected transactions during one year of operation, of a total volume not exceeding the equivalent of 100 million dollars – of which not more than the equivalent of 30 million dollars would relate to currencies other than the U.S. dollar. The reduction of exposure during the reporting period was accomplished by means of forward contracts of currencies hedged against shekels or against CPI-linked shekels. The time frame of the forward contracts is equal to or shorter than the time frame of the hedged exposure. In minimizing exposure in accordance with the company’s policy, as at December 31, 2003 there was no unhedged balance of foreign currency at the Company. We note that inherent in some of the Company's hedging transactions is a nominal shekel interest that constitutes, in a period of low inflation, high real interest. Conversely, the Company receives a parallel nominal interest on its shekel deposits, thereby partially neutralizing that interest risk. With the transition in 2004 to accounting reporting and indexation on the basis of nominal shekels, the Company has increased the volume of these transactions.

The Company had no material costs in performing hedging transactions against exchange rates, since they were made as forward transactions. The financial statements include financing income of approximately NIS 21 million from these hedging transactions.

Inflation – The rate of inflation affects the operating income and expenses of the Company during the year. The Company's tariff updating mechanism as set out in the Regulations, allows tariffs to be updated by the same rate as inflation (less a fixed efficiency factor) once a year. As a result, the annual rate of inflation and its spread over the year can have a material influence on the erosion of the Company's tariffs and on its revenues.
On the other hand, the influence of the rate of inflation on the Company's real expenses is reduced, since some of these expenses have direct or indirect linkage mechanisms. In addition, the Company invests a considerable part of its cash balances in unlinked shekel deposits and

mutual funds, and these deposits are exposed to changes in their real yield due to a change in the rate of inflation.

The low rate of inflation prevailing in Israel in recent years has considerably reduced the financial significance of this risk.

The Company's loans are linked to the "known index", while accounting indexation is made according to the "actual index". Differentials in the rise in the known index compared with the actual index create an appreciation or erosion in the value of loans in accounting index terms. In a period of high inflation, this differential had a material effect on the accounting measurement of the Company's finance expenses, since a considerable part of the Company's liabilities are linked to the CPI.

The transition to accounting measurement and reporting on the basis of nominal shekels is expected to commence in 2004. This transition will increase the Company's exposure in respect of its CPI-linked surplus liabilities, and in positive inflation will increase its financing expenses.
In minimizing exposure in accordance with the policy, the Company has made hedging transactions against the CPI so as to reduce this risk.

<u>Prices of raw materials and equipment</u> – The cash flow from the Company's operations is used partially for investment in equipment. The prices of equipment are affected by the indices to which they are linked, including sectoral indices, exchange rates and global prices. The Company is not protected against this exposure.

<u>Prices of securities</u> – The Company invests some of its financial balances in securities. The composition and amount of the securities portfolio are determined by the Board of Directors of the Company. With the aim of preventing fluctuations in the portfolio's yield, the Board of Directors laid down investment principles whereby most of the investment will be in bonds, shekel deposits and interest-bearing foreign currency instruments (dollar and basket only), while the share component will not exceed 15% of the investment portfolio and will include shares invested in the TASE 100. The types of bonds and their proportional part in the portfolio were determined according to criteria based on linkage, redemption date, and the separation between government and non-government bonds. Additionally, a ceiling was determined for the various types of investments.

<u>Supervision and implementation of market risk management policy</u>

Following the amendment to the Securities Regulations (Periodic and immediate reports) on the subject of exposure to market risks and its management, a sub-committee of the Finance Committee of the Company's Board of Directors was established with a mandate to discuss the market risk management policy of the Company in accordance with the amendment and make its recommendations to the Finance Committee and the Board of Directors. A reporting format that is designed to oversee the relevant activities of the Company's Management on the matter was subsequently approved by the sub-committee and the Board of Directors. The committee receives and discusses a monthly report on the exposure situation. The Company appointed an outside consultant who reviewed the exposures and who assists the Company in its management of all aspects of market risks.

<u>Description of the risks and their management in the consolidated companies and in a proportionally-consolidated company</u>

The persons responsible for market risks management in the principal consolidated companies are the Chief Financial Officers of those companies, and in a proportionally-consolidated company – the Treasurer of the company. The consolidated companies carry out hedging transactions in accordance with and under the supervision of their boards of directors. The proportionally-consolidated company hedges its investments in long-term projects being carried out under contacts with milestones. Invoices or orders in respect of purchases of subscriber equipment are partially hedged.

<u>Report on linkage bases</u>

Note 29 to the financial statements includes information about the linkage terms of the monetary balances of the Company and of the Group as at December 31, 2003.

Positions in derivatives as at December 31, 2003 (consolidated)
(Amounts are in NIS thousands)

	Dollar / NIS							
	Nominal Value				**Fair Value - asset (liability)**			
	Up to one year		More than one year		Up to one year		More than one year	
	Long	Short	Long	Short	Long	Short	Long	Short
Forward transactions								
Hedging recognized for accounting	532,381		87,580		(9,420)		(1,517)	
Call options								
Hedging recognized for accounting	13,137				18			
Hedging not recognized for accounting	148,886				487			

	Dollar / CPI-linked NIS							
	Nominal Value				**Fair Value - asset (liability)**			
	Up to one year		More than one year		Up to one year		More than one year	
Currency exchange transactions at predetermined interest rates								
Hedging recognized for accounting	511,226		43,970		(55,989)		(5,347)	

	Euro / NIS							
	Nominal Value				**Fair Value - asset (liability)**			
	Up to one year		More than one year		Up to one year		More than one year	
	Long	Short	Long	Short	Long	Short	Long	Short
Forward transactions								
Hedging recognized for accounting	660,379		105,129		22,941		2,722	

	Euro / CPI-linked NIS							
	Nominal Value				**Fair Value - asset (liability)**			
	Up to one year		More than one year		Up to one year		More than one year	
Currency exchange transactions at predetermined interest rates								
Hedging recognized for accounting	669,505		138,328		87,079		21,949	

	CPI / NIS							
	Nominal Value				**Fair Value - asset (liability)**			
	Up to one year		More than one year		Up to one year		More than one year	
	Long	Short	Long	Short	Long	Short	Long	Short
Forward transactions								
Hedging recognized for accounting	334,000		110,000		(3,844)		(1,130)	

4. Financial Position

a. The Group's assets as at December 31, 2003 amounted to approximately NIS 16.1 billion, compared with NIS 16.2 billion at December 31, 2002. Of these, approximately NIS 8.7 billion (approximately 54%) are fixed assets, compared with approximately NIS 9.78 billion (60.3%) at December 31, 2002.

The decrease in total assets derived mainly from the decrease in the net book value of the fixed assets resulting from the difference between depreciation expense and the investment made in the reporting period, and from the provision and write-down of fixed assets of approximately NIS 327 million. The decrease was offset mainly by the increase in the cash balances of the Group due to receipt of the proceeds from an allotment of the Company's shares.

b. The Group's shareholders' equity as at December 31, 2003 amounted to approximately NIS 6.8 billion, representing approximately 42.5% of the total balance sheet, compared with approximately NIS 6.59 billion at December 31, 2002, which represented approximately 40.6% of the total balance sheet. The increase in shareholders' equity derived from an issuance of shares in accordance with the agreement with the State to raise capital for the Company. The increase was offset by the net loss of the Group and by the distribution of a dividend in the Report year.

c. Total Group debt to financial institutions and debenture holders as at December 31, 2003 amounted to approximately NIS 5.51 billion, compared with approximately NIS 6.03 billion at December 31, 2002.

d. Group balances in cash and short-term investments as at December 31, 2003 amounted to approximately NIS 3.29 billion, compared with NIS 2.13 billion at December 31, 2002.

5. Results of Operations

a. Principal results

The net loss for 2003 amounted to approximately NIS 438 million, compared with a net loss of approximately NIS 913 million in 2002. The difference in the results derives mainly from the Other expenses/income item, where an expense of NIS 1,209 million (before tax) was recorded in the prior year in connection with the Company's investment in debentures convertible to shares of Pelephone Holdings L.L.C.

Loss per share in 2003 was NIS 0.179 per NIS 1 par value, compared with a loss of NIS 0.379 per share in the prior year.

b. Revenues

Group revenues in 2003 amounted to approximately NIS 7.98 billion, compared with approximately NIS 8.06 billion in 2002. Most of the decrease in revenues derives from the decrease in revenues from domestic fixed-line communications and cellular communications.

Revenues from domestic fixed-line communications decreased as a result of a decrease in call traffic, dial-up Internet and price erosion.

Revenues from cellular telephones decreased due to the decrease in interconnect fees, transmission revenues and collection fees of the Company. The decrease was moderated as a result of the increase in revenues from fixed fees for ADSL lines and the increase in the revenues of Pelephone (mainly from sales of subscriber equipment) and BezeqCall Communications Ltd.

c. Operating and general expenses

The Group's operating and general expenses in 2003 amounted to approximately NIS 4.49 billion, compared with approximately NIS 4.53 billion in 2002.

There was little change in the operating and general expenses of the Group. A slight decrease was recorded in the wage expense of the Company as a result of implementation of the Company's early retirement plan. An increase in wages charged to investments in fixed assets as described in Note 22 to the financial statements, also contributed to the reduction in the Company's operating 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.

e. Royalty payments to the Government of Israel

The Group's royalties expenses in 2003 amounted to approximately NIS 243 million, compared with approximately NIS 250 million in 2002. The source of the decrease was the decrease in the percentage of royalties on the revenues of Pelephone.

f. Operating income

The Group's operating income in 2003 amounted to approximately NIS 1,093 million, compared with approximately NIS 1,017 million in 2002, an increase of approximately NIS 76 million. The increase in operating income results from the changes described above in the revenues and expenses items. These changes led to the transition from operating loss to operating profit at Pelephone and to a decrease in the operating income of the Company and of Bezeq International.

g. Financing expenses

The Group's net financing expenses in 2003 amounted to approximately NIS 158 million, compared with approximately NIS 165 million in 2002. The decrease in expenses derives mainly from the considerable decrease in the financing expenses of the Company due to reduction of its financial debt, and an increase in income from the financial investments in the Company. The decrease was largely offset by the sharp rise in the financing expenses of Pelephone and Bezeq International.

h. Other expenses (income), net

Other expenses in 2003 amounted to approximately NIS 983 million, of which about NIS 419 million was an increase in the provision for early retirement (see Note 16D to the financial statements) and approximately NIS 195 million was mainly a provision for employees' claims in the matter of recognition of certain wage components as part of the salary that determines pensions (see Note 19(a)(13) to the financial statements). In addition, expenses of approximately NIS 327 million were recorded in 2003 in respect of the disposal and impairment of fixed assets , of which approximately NIS 128 million at Bezeq International – see Note 9 to the financial statements.
In 2002, other expenses amounted to NIS 1,207 million, most of which was a provision for a decrease in value of debentures convertible to shares of Pelephone Holdings L.L.C.

i. Company equity in losses of affiliates

The Group’s equity in the losses of affiliates in 2003 decreased compared with 2002 from about NIS 354 million to about NIS 343 million. Most of the decrease derived from an improvement in the results of DBS which, combined with the change in the percentage of the holding reduced the Group's share in the loss.

j. Quarterly data* – Consolidated statements (in NIS millions)

	2003					2002
	Total	Q4[2]	Q3[1]	Q2	Q1	Q4
Revenues	7,981.3	1,967.6	2,079.1	1,956.2	1,978.4	1,985.3
Costs and expenses	6,887.9	1,710.4	1,773.1	1,680.7	1,723.7	1,774.6
Operating income	1,093.3	257.2	305.9	275.5	254.7	210.7
Financing expenses	157.5	27.5	46.1	52.1	31.8	14.0
Other expenses (income)	983.2	729.4	252.0	1.7	0.09	822.9
Company's equity in losses of investee companies	343.3	66.8	83.3	124.2	69.0	115.7
Net earnings (loss)	(437.8)	(439.6)	(84.8)	19.1	67.5	(771.1)

* Some quarterly data have been reclassified.

1. Other expenses, net, in the third quarter of 2003 included a provision of approximately NIS 195 million in respect of employees' claims in the matter of recognition of certain wage components as part of the regular wage for pension, and an expense of approximately NIS 59 million in respect of amortization of assets.
2. Other expenses, net in the fourth quarter of 2003 included an increase of approximately NIS 419 million in the provisions for early retirement, and approximately NIS 268 million in respect of the disposal and impairment of fixed assets.

6. Liquidity and sources of financing

Consolidated cash flows generated by operating activities in 2003 amounted to approximately NIS 2,692 million, compared with approximately NIS 2,830 million in 2002. The decrease in consolidated cash flows was due mainly to a decrease in the operating cash flows of the Company and of Bezeq International. The decrease was partially offset by an increase in the operating cash flows of Pelephone and BezeqCall Communications.

Cash flows generated by operating activities are the principal source of financing the Group's investments, and these were applied during the Report period, *inter alia*, for the investment of approximately NIS 1,414 million in the development of communications infrastructures, NIS 190 million in investee companies, NIS 107 million in short-term deposits and NIS 82 million in investments and long-term deposits, net.

During the year, the Group repaid approximately NIS 1,139 million of debt, of which approximately NIS 557 million was on account of long-term loans, NIS 208 million on account of debentures and NIS 374 million of short-term credit. In addition, the Company paid a dividend of approximately NIS 185 million. The cash flow from financing operations increased as a result of raising new debt of approximately NIS 493 million in long-term loans, and due to the proceeds of approximately NIS 878 million received from the issuance of shares.

The average monthly short-term credit during the period was approximately NIS 356 million. The average monthly long-term liabilities during the period were approximately NIS 5,349 million.

Working capital as at December 31, 2003 was positive and amounted to approximately NIS 1,111 million, compared with positive working capital of approximately NIS 823 million at December 31, 2002. The improvement in the Group's working capital derived mainly from an increase in cash and cash equivalent balances due to the proceeds received from the issuance of shares.

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

Adv. Miriam (Miki) Mazar
Chairperson of the Board of Directors

Amnon Dick
President & CEO