November 26, 2002

Directors' Report on the State of the Company's Affairs for the nine-month period ended September 30, 2002

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 nine-month period ended September 30, 2002 (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, 2001.

The financial data in the Directors' Report are presented in adjusted shekels of September 2002.

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:

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

. During the report period, the Ministry of Communications awarded national operator licenses to the cable companies. At this stage, the license has been granted for the provision of broadband Internet services via the cable infrastructure. The application by the cable companies for permission to merge was approved, under certain conditions, by the Anti-Trust Authority and by all relevant regulatory bodies. The matter is pending in the Anti-Trust Tribunal, as part of an appeal filed by D.B.S. Satellite Services (1998) Ltd.

   A committee appointed by the Minister of Communications to make detailed recommendations regarding rules and policy on the opening of competition in the fixed-line telecommunications market in Israel, presented its recommendations to the Minister in August 2002. The Minister adopted the recommendations, with certain modifications (see Note 1(B)(4) to the financial statements).

   Following adoption of the committee's recommendations, the Minister of Communications announced that he had broadened the special licenses of Cellcom and Med-1 so as to permit them to provide data communication and high-speed transmission services to business customers. Concurrently, the cable companies' general licenses to provide domestic communication services were broadened to permit them to provide data communication, digital transmission and optical transmission services. The Company has petitioned the Supreme Court against the decision of the Minister to adopt the recommendations of the committee on this matter.

2. The opening of fixed-line domestic communications services to full competition, *inter alia,* in accordance with the principles formulated by the above-mentioned committee, in addition to the intensifying competition in the 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.

3. Pursuant to the decisions of the Knesset Finance and Economics Committee, the Company's tariffs were changed, effective May 14, 2002, as described in Note 1(B)(3) to the financial statements. In March 2002 a committee was appointed to examine and revise the Company's tariffs and make recommendations for a new tariff arrangement for the Company, and to bring the arrangement in line with the changing environment of the telecommunications industry.

4. For details about the Company's investment in D.B.S. Satellite Services (1998) Ltd., see Note 4(A) to the financial statements.

5. Regarding the privatization of the Company, following the Government Companies Authority's directive to the Company to open a data room for those participating in the privatization process, on November 15, 2002 the Company completed its preparations for opening such a room. However, as at the date of this report, no review of documents has commenced in the data room. Furthermore, to the best of the Company's knowledge, some of the groups that had expressed interest in participating in the privatization process have given notice of their withdrawal.

6. On November 17, 2002, Ido Dissentshik ended his term of office as Chairman of the Board of the Company.

2. Details concerning exposure to and management of market risks

1. Further to that described in the Directors' Report for the year 2001 and as a result of hedging transactions against market risks associated with exposure to fluctuations in exchange rates, the Group sustained no material financing expenses and generated no material financing income, despite the material changes which occurred in the exchange rates of foreign currencies during the period.

2. On May 14, 2002, the Board of Directors approved the recommendations of the sub-committee for market risks (a sub-committee of its Finance Committee) regarding the Company's market risk management policy. The resolution defines the Company's policy on this matter, and the authorization for the implementation of the policy. The policy covers currency exchange rate risks, rises in the CPI, interest, and risks in prices of raw and other materials. The policy decided upon is not significantly different from that appearing in the Directors' Report for the year ended December 31, 2001.

3. The report on linkage bases and positions in derivatives as at September 30, 2002 does not differ very significantly from that reported for December 31, 2001, except for the fact that during the report period, the Company purchased and granted options, as described in Note 7(B) to the financial statements.

4. The Group's surplus monetary liabilities over monetary assets denominated in or linked to foreign currency as at September 30, 2002, amounted to approximately NIS 2.3 billion (including NIS 848 million of debentures convertible to shares of Pelephone Holdings LLC – see Note 4C to the financial statements). As a result of forward currency transactions, as at that date the net balance of foreign currency liabilities not hedged by such forward transactions amounts to approximately NIS 245 million. However, the Company has positions in currency derivatives (see Note 7(B) to the financial statements – Options granted), which could, if the dollar continues to gain in strength against the shekel, generate a material surplus of foreign currency liabilities for the Company.

   The Group's surplus monetary liabilities over monetary assets that are linked to the CPI as at September 30, 2002, amounted to approximately NIS 1.2 billion. The Company has a balance of forward CPI contracts that reduce the exposure to a rise in the CPI during the year.

3. Financial Position

a. The Group's assets as at September 30, 2002 amount to approximately NIS 17.4 billion, compared with NIS 18.2 billion as at September 30, 2001. Of these, approximately NIS 10.1 billion (approximately 58.0%) are fixed assets, compared with approximately NIS 11.4 billion (approximately 62.6%) as at September 30, 2001.

   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 depreciation expenses and the investment made in the report period. This decrease was offset mainly by an increase in current asset balances.

b. The Group's shareholders' equity as at September 30, 2002 amounted to approximately NIS 7.5 billion, representing approximately 43.1% of the total balance sheet, compared with approximately NIS 7.7 billion as at September 30, 2001, which represented approximately 42.5% of the total balance sheet. The decrease in shareholder' equity was caused by the loss in the report period.

c. Total Group debt to financial institutions and debenture holders as at September 30, 2002 amounted to approximately NIS 6.3 billion, compared with approximately NIS 6.8 billion as at September 30, 2001.

d. Group balances in cash and short-term investments as at September 30, 2002 amounted to approximately NIS 1.9 billion, compared with NIS 1.5 billion as at September 30, 2001.

4. Results of Operations

a. Principal results

   Net loss for the first nine months of 2002 amounted to approximately NIS 145 million, compared with net earnings of approximately NIS 175 million in the corresponding period in the prior year. The difference in the results derives mainly from the Other expenses/income item, where an expense of NIS 390 million (before tax) was recorded in the report period. Eliminating the effect of this write-down, the net earnings for the first nine months of 2002 would be approximately NIS 209 million.

   Loss per share in the first nine months of 2002 were NIS 0.060 per NIS 1 par value, compared with earnings of NIS 0.073 per share in the corresponding period in the prior year.

b. Revenues

   Group revenues in the first nine months of 2002 amounted to approximately NIS 6.24 billion, compared with approximately NIS 6.55 billion in the corresponding period in the prior year. The decrease in revenues derives principally from the decrease in revenues from domestic fixed-line communications, international communications and fixed fees.

   Revenues from domestic fixed-line communications decreased as a result of real tariff erosion due to accelerated inflation during the period, and as a result of a decrease in call traffic. Revenues from international communications decreased due to cancellation of the access fees that the Company received in the past from the international communications operators. Revenues from fixed fees decreased compared with the corresponding period in the prior year as a result of tariff erosion. The decrease in the Group's revenues was partially offset by an increase in the revenues of Pelephone Communications Ltd. ("Pelephone").

c. Operating and general expenses

The Group's operating and general expenses in the first nine months of 2002 amounted to approximately NIS 3.47 billion, compared with approximately NIS 3.57 billion in the corresponding period in the prior year.

The decrease in the operating and general expenses of the Group derives mainly from the high cellular expenses of the Company during the corresponding period in the prior year, due to the consequences of the agreement relating to the transfer of air-time payments signed at that time with Pelephone. Additionally, expenses also decreased as a result of improved efficiency in the Company – mainly relating to sub-contractor and building maintenance expenses, and a decrease in the expenses of Bezeq International. The decrease in expenses was offset mainly by an increase in the expenses of Pelephone, which was mainly caused by a change in Pelephone's method of customer acquisition so as to grant immediate recognition of the costs of acquiring those customers.

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. In addition, depreciation expenses decreased as a result of a change in the estimated period of useful life of communications equipment, as described in Note 5 to the financial statements.

e. Royalty payments to the Government of Israel

The Group's royalties expenses in the first nine months of 2002 amounted to approximately NIS 190.7 million, compared with approximately NIS 213.8 million in the corresponding period in the prior year. The source of the decrease is the decrease in the percentage of royalties on the revenues of Bezeq International and Pelephone, and the decrease in the revenues of the Company.

f. Operating income

The Group's operating income in the first nine months of 2002 amounted to approximately NIS 826 million, compared with approximately NIS 694 million in the corresponding period in the prior year, an increase of approximately NIS 132 million. The increase in operating income results from the changes described above in the revenues and expenses items, from lower depreciation charges and from royalties due to the Government of Israel. These changes led to improved operating income at Bezeq International, to a decrease in the operating loss of Pelephone, and to a decrease in the operating income of the Company and a decrease in its revenues.

g. Financing expenses

The Group's financing expenses in the first nine months of 2002 amounted to approximately NIS 155 million, compared with approximately NIS 106 million in the corresponding period in the prior year. The increase is derived from the fact that in the corresponding period in the prior year the Company had interest income from income tax of approximately NIS 80 million, and a decrease in the yield on the Company's liquid investments due to accelerated inflation. The increase was largely offset by an inverse effect of the accelerated inflation in reducing the financing expenses on the unlinked liabilities of the Group's companies, and by the decrease in the financing expenses as a result of a decrease in the Group's financial liabilities. The effects of changes in currency exchange rates were eliminated to a large extent as a result of hedging transactions.

h. Other expenses, net

As described in Note 4C to the financial statements, a provision was made in the report period for a decrease in value of NIS 390 million in connection with the Company's investment in debentures convertible to shares in Pelephone Holdings LLC.

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 profit derived from the sale of an indirect ownership interest in a Hungarian company that was recorded in the corresponding period, and due to an increase in the Company's equity in the losses of D.B.S. Satellite Services (1998) Ltd.

5. Liquidity and sources of financing

Consolidated cash flows generated by operating activities in the first nine months of 2002 amounted to approximately NIS 1,896 million, compared with approximately NIS 2.530 million in the corresponding period in the prior year. The decrease in consolidated cash flows was due to a decrease in the operating cash flows of the Company, resulting principally from a decrease in revenues and an increase in payments in respect of early retirement, as well as a decrease in the operating cash flows of Pelephone as a result of the change in its customer acquisition method. The decrease was partially offset by an increase in the operating cash flows of Bezeq International. 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 925 million in the development of communications infrastructures, approximately NIS 305 million in investee companies and approximately NIS 182 million in long-term deposits and investments. During the first nine months of 2002, the Group repaid approximately NIS 812 million of debt, of which approximately NIS 559 million was on account of long-term loans, approximately NIS 205 million on account of debentures, and approximately NIS 48 million on account of short-term credit. Conversely, the Group raised new debt in a total amount of approximately NIS 307 million, of which approximately NIS 198 million derives from new long-term loans and approximately NIS 109 million from issuances of debentures.

The average monthly short-term credit during the period was approximately NIS 301 million. The average monthly long-term liabilities during the period were approximately NIS 6,169 million.

Working capital as at September 30, 2002 was positive and amounted to approximately NIS 832 million, compared with positive working capital of approximately NIS 249 million on September 30, 2001. The improvement in the Group's working capital derived mainly from an increase in short-term investments and trade receivables of the Group.

6. Comparison of the results of the third quarter of 2002 with those of the corresponding period in the prior year

Revenues in the third quarter of 2002 decreased by approximately NIS 72 million compared with the corresponding quarter in the prior year, a decrease of approximately 3.3%. Operating and general expenses decreased by approximately NIS 8 million, approximately 1%, compared with the corresponding period in the prior year.

Operating income in the quarter increased by approximately NIS 40.5 million.

Financing expenses in the third quarter of 2002 increased by approximately NIS 32.1 million compared with the corresponding period in the prior year.

As described in Section 4h above, a write-down of NIS 390 million was recorded in connection with the Company's investment in convertible debentures. As a result of the write-down, the Company ended the quarter with a loss of approximately NIS 345 million, compared with earnings of approximately NIS 8 million in the corresponding period in the prior year. Eliminating the effects of the write-down, net earnings for the quarter were approximately NIS 9 million.

The movement in the revenue and expense items and the reasons for the differences between the quarters, are similar to the explanations for the changes in the results for the first nine months of 2002 compared with the corresponding period in the prior year.

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

Avi Barak	Ilan Biran
Member of the Board of Directors	CEO