August 29, 1999

Directors' Report on the State of the Company's Affairs for the Six Months ended June 30, 1999

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, 1999 (hereinafter: "the Report"). The Report was prepared in accordance with the Securities Regulations (Periodic and immediate reports), 5730-1970 and the Securities Regulations (Rules for reporting on preparations for solving the Y2K bug problem) (Temporary Order), 5759-1998.

The 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, 1998.

The financial data in the Report are presented in adjusted shekels of June 1999.

1. The Business Environment

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

a. In February 1999, as part of the Arrangements Law, the cancellation of Section 50 of the Telecommunications Law, 5742-1982 was approved. Section 50 granted the Company exclusivity in providing national telecommunications services in a nationwide network of telephones under the general license. The law stipulates that the cancellation is effective on June 1, 1999; however, the activities of the new operators in the domestic fixed telecommunications field will become possible only from the date on which they are granted a general license by the Ministry of Communications. As of the date of the Report, no such license has been granted and the provision of nationwide fixed telecommunications services by new competitors has not yet commenced. Immediately prior to approval of the Report, the Company received two Government resolutions dated August 22, 1999, concerning the acceleration and increase of competition in the domestic telecommunications field during 1999 and in the personal mobile telecommunications (PCS) field during the year 2000.

   As a result of the opening of the domestic telecommunications services to full competition, an adverse material effect in the Company's business results is expected which cannot be estimated at this time.

b. The Ministry of Communications notified the Company that the Ministers of Communications and Finance resolved to adopt the recommendations of the committee for the determination of the Company's tariffs, with certain amendments, and on March 22, 1999 the Ministry of Communications sent a revised notice superseding a notice dated March 1. Subsequently, on March 22, 1999 the Knesset Finance Committee approved the Telecommunications Regulations (Payments for the telecommunications services listed in the addendum to the law), 5759-1999, and the Telecommunications Regulations (Method of calculation of payments for telecommunications services and their linkage to the CPI), 5759-1999.

   the financial statements.

   Pursuant to the regulations, on April 1, 1999 the Company's tariffs were reduced by an average of approximately 8%. This has led to a material decrease in the Company's business results in the three months ended June 30, 1999.

c. As part of the plan for efficiency and restructuring of the Company, the employee retirement plan is continuing. Approximately 1,527 employees have retired between January 1998 and June 30, 1999. The results of the organizational change continue to be reflected in the Company's salary costs during this period, and are expected to be further reflected during the second half of 1999 in a more complete manner.

Following adoption of the recommendations of the committee for the determination of the Company's tariffs by the Ministers of Finance and Communications, the Board of Directors directed the Company's Management on March 4, 1999 to present to the Board, within 90 days, a proposed plan for the preparation of the Company for the future, in light of the adoption of t
of such a plan will also require changes in the organizational structure of the Company, where one of its goals will be a further reduction in the Company's workforce by means of a new retirement plan.

The Company is currently working on preparing a plan based on a material change in its organizational and operational concept, in a format similar to the change already made in several similar companies in the telecommunications field upon their transition to operating in a competitive environment. Preparation of such plan is a complex process which is likely to continue for another several months, and as of the date of the Report the Company does not yet have a firm estimate of its possible cost.

In light of the above, and due to the need to prepare a preliminary estimate of the extent of the Company's preparation costs, Management has formulated a plan based on a number of changes which it believes can be implemented as part of its existing organizational and operational framework. This plan indicates a need for the retirement of approximately 530 employees, for which the Company has recorded a provision in its financial statements of approximately NIS 273 million, representing the estimated cost of this retirement plan.

It is the Company's intention, if possible and if found viable, to implement the new plan, while the plan for which the provision was created constitutes at this stage only an alternative option in case implementation of the new plan will be impossible or will be postponed for a significant period of time. As mentioned, the cost of the new plan cannot be estimated at this stage, and is likely to be materially different from the cost of the plan for which the provision was made.

d. Pursuant to an amendment to the license of the International Telecommunications Operators dated January 17, 1999, these Operators will be permitted to connect their subscribers by direct trunk, subject to fulfilling their obligation to pay the Company access fees for the traffic minutes in the direct trunk lines. In an additional amendment to the license of the International Operators and in an amendment to the Company's license, both dated May 11, 1999, the method of allocation of subscribers to the International Operators was stipulated. According to the amendment, beginning July 1, 1999, subscribers who have not selected a particular International Operator will be randomly allocated in an equal division among the International Operators. With regard to legal proceedings taken following the amendment and their possible implications, see Note 1(B)(2) to the financial statements. Implementation of

Internat

e. On November 15, 1998, the holder of the "Bezeq" portfolio in the Histadrut announced a collective labor dispute concerning the intention of the Government to cancel Section 50 of the Telecommunications Law, 5742-1982 and to open up domestic telecommunications to competition, as well as its intention to adopt the recommendations of the committee for the

demands that the Company negotiate a special collective labor agreement which will define the terms of dismissal for those employees likely to be dismissed as a result of the aforesaid and which will establish certain guarantees to ensure the rights of dismissed workers and of those remaining in the Company. The workers' representative is also demanding that a new financial stability arrangement be negotiated with the State to ensure the above.

On March 3, 1999, a new announcement was sent by the Histadrut, stating that in view of the Government's announcement of its decision to implement the recommendations of the committee for the determination of the Company's tariffs, the employees are renewing the

and recommended that the parties hold a meeting with the authorized Government entity in order to attempt to resolve the dispute. Following meetings among representatives of both management and employees, and the Ministers of Communications and Finance, the Minister of Communications issued a letter on March 22, 1999 concerning the Company's tariffs, which contains changes in the rates of the efficiency factor compared with the rates which were determined in the committee's recommendations. No agreement has yet been formulated with regard to the terms of dismissal and the ensuring of the rights of dismissed workers.

f. On May 12, 1999, the General Meeting of the Company's Shareholders resolved to approve t proposed by the State, some of which are effective immediately and others which will take effect upon reduction of the State's holding in the Company to 50% or less. The principal changes which took immediate effect relate to a change in the method of appointment of directors to that of election at the General Meeting by a 60% majority of the votes of the shareholders who are present and vote (excluding abstentions). Prior to this amendment, the right to appoint a director existed for a holding of 7% of the share capital of the Company. Among the other changes in the Bylaws which will take effect upon reduction of the State's holding to 50% or less, are provisions which will continue to require the Company to obtain Government approval for certain material resolutions, and to apply conditions of qualification to the directors, Chairman of the Board and the CEO, and methods of their appointment in accordance with the Government Companies Law. The result of the said provisions is that the Government will continue to control the Company even after a reduction in the State's holding to 50% or less as long as the State holds 10% or more of the Company's share capital, unless another entity controls the Company, pursuant to approval in accordance with the Telecommunications Order.

The resolution of the General Meeting regarding the changes to the Bylaws as described above was adopted as a result of decisions of the Ministerial Committee for Privatization on August 4, 1998 and January 31, 1999 as part of the Company's public offering proceedings which were supposed to result in a reduction of the State's holding in the Company to not less than 40% of the Company's share capital. In April 1999 the Company submitted a draft prospectus to the Securities Authority for an offering of Company securities to the public. The issue proceedings were suspended, following a decision of the Attorney General on May 13, 1999, whereby the offering cannot be implemented prior to clarification of the dispute between the Israel Lands Authority and the Company concerning the Company's rights in some of the real estate assets transferred to it as part of a 1984 asset transfer agreement. (Regarding the continuation of the privatization of the Company, see Note 1B to the financial statements; regarding the dispute with the Israel Lands Authority, see Note 4B to the financial statements.)

g. In October 1998, a third cellular operator commenced partial provision of services. The entry of this operator, and the fact that it uses a different telecommunication technology (GSM), increased competition in the telecommunications market in general, and in cellular communications in particular. The entry of additional cellular operators, pursuant to the Government decision of August 22, 1999, is also expected to intensify competition in this field (see clause a. above). In the fourth quarter of 1998, Pelephone Communications Ltd. ("Pelephone") commenced commercial operation of infrastructure which operates with CDMA digital technology. The operation of this system led to a decrease in Pelephone's operating profit in the fourth quarter of 1998 and substantially more so in the first half of 1999. The

implementation of commercial operation and expansion of the CDMA system are expected to cause a further decrease in the profitability of Pelephone in 1999.

An additional factor damaging Pelephone's profitability in the first half of 1999 was the perpetration of fraudulent acts by "cloning" of subscribers' numbers in the analog network. This factor had a material adverse effect on Pelephone's results in the second quarter of the year. Pelephone took steps to minimize and prevent this phenomenon, and its management expects a significant decrease in the scope of the phenomenon and its effect on earnings in subsequent report periods.

h. In January 1999, D.B.S. Satellite Services (1998) Ltd. ("DBS"), in which the Company is expected to hold approximately 30% of the issued and paid-up share capital, received a license for satellite television broadcasts in consideration of NIS 30 million and the presentation of a guarantee in the amount of NIS 30 million. DBS foresees considerable losses and negative cash flow from activities in the first years of operation. Pursuant to a revised business plan, further investments by the company in DBS are subject to the approval of its Board of Directors and of the Government.

i. On May 12, 1999, the Board of Directors of the Co
recommendations, which were based on the report of a firm of outside consultants, to change the depreciation policies and the depreciation rates of the Company's assets. For details of this decision, see Note 4(A) to the financial statements.

j. As part of the implementation of the Company's strategic plan, including the intention to expand the Company's Internet and broadband communications operations, the Company entered into two transactions in July 1999. In the first transaction, the Company is supposed to purchase, in consideration of approximately $1.6 million, 28% (26% at full dilution) of the share capital of Infogate Online Ltd. ("Infogate"), with an option to increase its holdings up to 45%. Infogate focuses mainly on the development and provision of data processing services using the ASP concept, whereby computers are linked in a broadband network to a central server from which they receive various services. In the second transaction, the Company received two option warrants: one enabling it to purchase 26% of the issued and paid up share capital of Walla! Communications Ltd. ("Walla") in consideration of NIS 24.6 million, and another enabling it to purchase additional shares of Walla which will constitute, together with the options underlying the first option, 50% of Walla's share capital, for additional consideration of NIS 51.8 million. Walla provides Internet services, mainly the operation of a portal to the Internet, and builds, develops and hosts Internet sites. Exercise of the options is contingent upon the formulation of a shareholders agreement which is subject to the approval of the Company's Board of Directors. Both transactions are subject to the approvals of the competent authorities. The Ministry of Communications has notified the Company that it finds the transactions acceptable.

k. In August 1999 the CEO of the Company gave notice of his decision to terminate his term of employment. The CEO will continue to function in his capacity for a period to be agreed upon with the Company, during which the Company will act to appoint a replacement.

2. Financial Position

a. The Group's assets as at June 30, 1999 amount to approximately NIS 17.36 billion, of which NIS 13.15 billion (approximately 75.8%) are fixed assets.

b. The Group's shareholders' equity as at June 30, 1999 amounted to approximately NIS 7.42 billion, which comprises 42.8% of the total balance sheet, compared with approximately NIS 6.71 billion at June 30, 1998 which comprised approximately 36.9% of the total balance sheet at such date. The increase during the period resulted primarily from the increase in unrestricted retained earnings and from the exercise of option warrants and convertible securities.

c. Total Group debt to financial institutions and to holders of its debentures as at June 30, 1999 amounted to approximately NIS 7.30 billion, compared with approximately NIS 8.23 billion at June 30, 1998.

The decline in the amount of financial debt resulted from a positive cash flow from current operations, of which only part was used for investment activities.

d. The balances of the Group's cash and short-term investments as at June 30, 1999 amounted to approximately NIS 1.22 billion, compared with approximately NIS 1.09 billion at June 30, 1998.

e. The Group's surplus of monetary liabilities in US dollars in excess of dollar-linked monetary assets as at June 30, 1999 amounted to approximately NIS 3.2 billion.

During the Report period, the Company carried out forward exchange contracts to reduce its exposure, and intends to continue with this policy in the future.

As at June 30, 1999, the net balance of dollar liabilities which were not hedged by such forward contracts amounted to approximately NIS 299 million.

f. Th -linked liabilities in excess of linked monetary assets as at June 30, 1999 amounted to approximately NIS 4.0 billion. This exposure is partially covered by a mechanism for adjusting tariffs, which takes into account price increases in the economy (see Note 1B to the financial statements).

3. Results of Operations

a. Principal results

Net earnings for the first half of 1999 amounted to approximately NIS 41.9 million, compared with net earnings of approximately NIS 362.4 in the corresponding period last year.

After removing the effect of the provision made during the first quarter of 1999 for costs of financing the restructuring plan in the amount of NIS 273.4 million (before tax), as compared with income of NIS 82.7 million (before tax) in the corresponding period last year, net earnings for the first half of 1999 amounted to approximately NIS 217 million, compared with approximately NIS 309 million in the corresponding period last year.

The decline in the Group's profitability was caused by the deterioration in the business results of the principal companies in the Group, particularly in the second quarter of 1999. The deterioration was the result of the tariff reductions as noted in the description of the nvironment above. However, due to the improvement in business results in the first quarter, the Company's business results for the first half of the year were not inferior to those of the first half of 1998.

On the other hand, the ongoing deterioration in the results of Pelephone Communications Ltd. and Bezeq International Ltd. led to deterioration in the consolidated Group's business results as a whole.

Earnings per share for the first half of 1999 amounted to NIS 0.06 per NIS 1 par value share, compared with earnings of NIS 0.48 per share in the corresponding period last year.

b. Revenues

Group revenues for the first half of 1999 amounted to approximately NIS 4,428.1 million, compared with approximately NIS 4,572.1 million in the corresponding period last year, a decrease of approximately NIS 144.0 million. The overall decline in revenues is primarily the result of the reduction in the Company's tariffs by an average of 8% as of April 1, 1999, which was reflected in a decline in revenues from domestic calls, interconnect fees from international operators and access fees from cellular operators, tempered by an increase in revenues from the fixed usage fees. The decline in the revenues of Bezeq International was primarily the result of lower prices and international settlement fees, and the decline in

equipment sales.

c. <u>Costs and expenses</u>

The Group's operating and general expenses for the first half of 1999 amounted to approximately NIS 2,404.1 million, compared with approximately NIS 2,452.0 million in the corresponding period last year, a decrease of approximately NIS 47.9 million. The decrease in operating and general expenses resulted from a decline of approximately NIS 166.8 million in salaries expense, owing mainly to the considerable decline in the workforce as a result of the early retirement plan; as a result of assignment, in 1998, of the value of a benefit to employees in respect of an offering and sale of shares by the State; and as a result of a reduction in the employee bonus provision. An additional factor was the decline of approximately NIS 99.6 million in expenses for international communications, which arose from a change in activity and in settlement fees with international communications operators. Most of this decline was offset by an increase in general expenses resulting primarily from -time write-off of NIS 15 million for the cost of the purchase of Internet access operations by Bezeq International at the end of 1998, and from the costs involved in adapting information systems to the Year 2000.

Depreciation expense increased during the first half of 1999 compared with the corresponding period by approximately NIS 98 million, primarily as a result of a change in depreciation rates of the Company's assets. (See Note 4A to the financial statements.)

d. <u>Operating income</u>

The Group's operating income for the first half of 1999 amounted to approximately NIS 539.9 million, compared with approximately NIS 712.0 million in the corresponding period last year, a decrease of approximately NIS 172.1 million. The decrease in operating income resulted from the changes described above, principally originating with the deterioration in the business operations of Pelephone and Bezeq International.

e. <u>Financing expenses</u>

The Group's financing expenses for the first half of 1999 amounted to approximately NIS 186.4 million, compared with approximately NIS 218.0 million in the corresponding period last year, a decrease of NIS 31.6 million.

There was a decrease in interest payments during the Report period owing to the significant decrease in the Group's total interest-bearing debt, and an increase in the Group's income from investments in shekel deposits. In contrast, the Group's net finance expense during the Report period increased due to hedging transactions against dollar-denominated liabilities, whereby the expense therefrom exceeded the profit generated by the increase in the shekel against the dollar, as a result of the material differential arising between the interest premium included in hedging transaction costing and the change in the Consumer Price Index.

f. <u>Other income (expense)</u>

In the first half of 1999, a provision of NIS 273.4 million was included for the restructuring plan, whereas the first half of 1998 included a reduction of a provision of approximately NIS 82.7 million (see Note 6 to the financial statements).

4. Liquidity and Sources of Financing

Consolidated cash flows generated by operating activities during the first half of 1999 amounted to approximately NIS 1,088.2 million, compared with approximately NIS 1,367.9 million in the corresponding period last year. The decrease in cash flows resulted primarily from a decline in profits, an increase in inventory and a decline in current liabilities and trade payables. The decrease was partially offset by a decline in trade receivables and in payments for early retirement, as compared with the corresponding half last year. Cash flows generated by operating activities are the Group's principal source of financing, and are earmarked primarily for financing investments in developing telecommunications infrastructures, amounting to approximately NIS 740.6 million. Most of the remaining cash flow was used during the report period to reduce the Group's financial debt - in the first half of 1999 long-term loans of approximately NIS 557.2 million were repaid, as well as NIS 132.8 million of debentures and NIS 463.7 million of a debenture issued to the State, for a total of approximately NIS 1,153.7 million. On the other hand, the Group received long-term loans

in a total amount of approximately NIS 460.8 million, issued debentures for approximately NIS 257.8 million, and received short-term bank credit of approximately NIS 108.1 million, so that approximately NIS 826.7 million was raised in total.

Working capital as at June 30, 1999 was negative and amounted to approximately NIS 1,313 million, compared with approximately NIS 1,823 million at June 30, 1998. The improvement in the Group's working capital is material, and resulted primarily from a decrease in current liabilities, principally due to a decrease in the liability for employee severance benefits as a result of implementation of the restructuring plan and the decrease in trade payables and other current liabilities. The negative working capital does not restrict the Group in its operating activities, since the revenue collection cycle from customers is short.

5. Comparison of the Results of the Second Quarter of 1999 with those of the Second Quarter Last Year

Revenues in the second quarter of 1999 declined by approximately NIS 149.6 million compared with the corresponding quarter last year, a decline of approximately 6.6%. Operating and general expenses increased compared with the corresponding quarter last year by approximately NIS 38.0 million (approximately 3.2%) as a result of the increased operating expense of the Group's investee companies.

Depreciation expenses in the second quarter of 1999 increased by approximately NIS 44.5 million, an increase of approximately 7.2%.

The decrease in revenues combined with the rise in costs and expenses caused a decline in operating income for the quarter in the amount of NIS 219.7 million compared with the corresponding quarter last year - which resulted primarily from the decline in operating income of the Group's principal companies.

Financing expenses in the second quarter of 1999 decreased by approximately NIS 36.4 million compared with the corresponding quarter last year.

The behavior of the revenue and expense items and the causes for the changes therein are as explained in the half-year results.

the corresponding quarter last year reveals similar results to those described in the analysis of the half-yearly results.

The changes described above in the Statement of Operations items led to net earnings of approximately NIS 71.4 million in the second quarter of 1999, compared with approximately NIS 223.0 million in the corresponding quarter last year, a decline of NIS 151.6 million. Removing the reduction in the provision for restructuring recorded in the second quarter of last year yields a decline of NIS 133.3 million.

6. Effect of External Factors

a. On June 30, 1998, the Company's General License was amended to stipulate an arrangement forbidding the Company from appointing one of its employees as a director of a subsidiary if, within his capacity, he may have access to "commercial information" (as defined in the amendment to the license) concerning the licensed companies competing with that subsidiary, where the use of such information by the relevant subsidiary may harm the competition between them. The amendment also suspended, for one year, the provision limiting the Company in the appointment of both the Chairman of the Board of a subsidiary and the majority of the directors of the subsidiary appointed to represent the Company from

of Communications requesting cancellation of the above restriction or, alternatively, extension of the suspension for an additional period. On May 6, 1999, the Company's general license was amended to extend the suspended period until June 30, 2000.

On the same date, a further amendment was inserted in the Company's General License, concerning compliance with, inter alia, the provisions for providing telecommunications services to the Security Forces: installation of facilities, telecommunications activities

including access to a facility, and compliance with the directives of the General Security Services or the Israeli Police regarding the security classification of Company officers exposed to classified information for reasons of State security or the public peace. Under the amendment, payment to the Company will be determined by mutual consent, based on reasonable expenses and taking into account the current cost for the service, if any. In the absence of consent, the payment will be determined by an appointee of the Attorney General, with the consent of the parties to the extent possible. This amendment to the Company's license was preceded by a proposed law to replace Section 13 of the Telecommunications Law, which passed its first reading in the Knesset on April 14, 1999 and whose main points are similar to the above amendment to the Company's General License. On February 4, 1999, the Company undertook to act as provided in this proposed law.

b. Regarding additional amendments to the General License of the Company and relevant legislation, see the " Business Environment" section above.

7. Details of Preparation Plans for Solving the Y2K (Year 2000) Issue

See attached appendix in accordance with Regulation 2 of the Securities Regulations (Rules for reporting on preparations for solving the Y2K bug issue) (Temporary Order), 5759-1998.

We thank the manage

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Israel Tapoohi	Ami Erel
Chairman of the Board	CEO

August 29, 1999

Pursuant to Regulation 2 of the Securities Regulations (Rules for reporting on preparations for solving the Y2K bug problem) (Temporary Order), 5759-1998, below are details of the Company's preparations for solving the Y2K (Year 2000) problem*

1. **Details of preparation plans for solving the Y2K problem**

   a. No change.

   b. No change.

   c.+ d. Operation of the Group's computer systems and computer-integrated systems is carried out by the Group, except for the salaries systems of the Company and of a subsidiary, which are operated by outside suppliers. The companies have maintained contact with these suppliers to ascertain their readiness for the year 2000.

   e. No change.

   f. No change.

   g. Not relevant.

   h. No change.

2. Cost of preparation for solving the Y2K problem

Below are details of the investments in preparation for solving the Y2K problem, by fiscal year:

Fiscal year	Have costs or budgets been earmarked	Activities included in planned costs	Amounts, in NIS millions
1998	Yes	Advisory services, systems conversion and adaptation	38
1999	Yes	Advisory services, systems conversion and adaptation, acceleration of investments, integration tests and preparation of emergency plans	221
2000	No (at this stage)	---	---

In addition to the above, other indirect costs exist relating primarily to staff engaged in conversion work.

As at the report date, the Company does not expect to exceed the planned investment budget.

3. Human resources involved in the preparation

No change.

* This report relates to the Company and its consolidated companies, each of which is making independent preparations for solving the Y2K problem.

4. Outside professional assistance

No change.

5. Progress assessment

a. Method of assessing progress of preparation

(1) No change.

(2) No change.

(3) The internal audit units of the Group's companies are also monitoring the progress of the preparation, as are outside consultants appointed by some of the Group's companies.

On August 10, 1999, the Office of the State Comptroller published a report on the Company's preparations for the Y2K computer problem. The report referred to a number of shortcomings which the Company is acting to correct.

b. No change.

6. Timetable

No change.

7. Plan in the event of systems failure

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brought about by the Y2K bug problem. These plans relate, inter alia, to the possibility of uninterrupted provision of vital services to the Company's customers, the activities of the companies on the transition date to the year 2000, and plans in the event of non-provision of vital services to the Company by other suppliers (such as electricity, fuel, etc.). Such plans have not yet been finalized. Failure in one of the main operating systems of the Company is liable to prevent it from continuing to provide services.

The Company has set up a central body to formulate emergency plans, and has run a first drill to evaluate its readiness and preparations made for the transition dates. The emergency plans currently being prepared cannot prevent disruptions which might befall the Company owing to the interruption of operation of one or more of the Company's main systems.

8. Third party systems

No change.

9. Additional information

Note 7B to the financial statements contains additional reference on this subject.

The Group cannot guarantee that all aspects of the Y2K issue affecting the Group, including and in particular those which relate to its readiness for the Year 2000 of its customers, suppliers and other outside entities, including infrastructure providers, whose activities affect the Company, will be fully solved. Failure to complete the conversion on time and in a suitable manner is liable to cause disruptions in the operation of the information and telecommunications systems of the Group, damage to its current operations and damage to essential systems - to the point of halting its operations, loss of revenues and even monetary claims against it.