# Chapter B of the Periodic Report

## Directors' Report on the State of the Company's Affairs
## For the quarter ended March 31, 2008

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 collectively referred to as "the Group"), for the three-month period ended March 31, 2008 (hereinafter: "the Directors' Report").

The Group operates in four main areas which are reported as business segments in the Company's consolidated reports as follows:

1. **Domestic fixed-line communications**
2. **Cellular**
3. **International communications, internet services and NEP**
4. **Multi-channel television**

The Group has an additional area of operations which is not material to the Group's operations, and which has been included in the financial statements of March 31, 2008 as another business sector, which mainly includes customer call center services and investment in a venture capital fund.

The net earnings in the reporting period amounted to NIS 385 million, the same as the net earnings in the corresponding period in 2007. The net earnings remained the same due to similar results of operations in all the segments. In the domestic fixed-line communications segment and the internet communications, internet services and NEP segment, there was a decrease in income and a decrease in expenses, respectively, and in the cellular and multi-channel television segments there was an increase in income and an increase in expenses, respectively. See below for further details.

## 1. Financial position

A. The financial statements are prepared in accordance with International Financial Reporting Standards (IFRS).

B. The Group's assets on March 31, 2008 amounted to NIS 15.18 billion, compared to NIS 15.69 billion on March 31, 2007. Of these, NIS 5.98 billion (39%) are property, plant and equipment, compared to NIS 6.33 billion (40%) on March 31, 2007.

The decrease is due to the domestic fixed-line communications segment. There was a decline in total assets in this segment, not including investment in subsidiary companies, compared to the corresponding period last year, in the amount of NIS 1,019 million, mainly due to the sale of financial assets held for trading which was used for distribution of a dividend. In addition, there was a decrease in the depreciated cost of property, plant and equipment resulting from the difference between depreciation expenses and the investment made in the reporting period. The decrease in total assets was offset by an increase in the customer balance mainly due to the late issue of bills to customers and the transition from billing in advance of fixed user fees for telephone lines to retroactive billing.

In the cellular segment, assets increased from NIS 4.1 billion on March 31, 2007 to NIS 4.42 billion on March 31, 2008. The increase was mainly due to an increase in the cash balances. In addition there was an increase in the customer balances mainly due to the termination of credit card payments. On the other hand, there was a reduction in the tax asset due to the sale of an asset recorded in the past for losses, and a decrease in the depreciated cost of property plant and equipment.

In the international communications, internet and NEP services segment, there was an increase in total assets compared to March 31, 2007, mainly due to the increase in the customer balance and advance expenses for users rights in capacities that were offset by a reduction in the cash balances used for early payment of loans and tax advance payments.

In the multi-channel television segment, there was an increase in total assets compared to March 31, 2007, which was mainly due to an increase in broadcasting rights and an increase in the net investment balance in property, plant and equipment.

C. The shareholders' equity of the Company on March 31, 2008 amounted to NIS 4.95 billion, representing 33% of the total balance sheet, compared to NIS 4.35 billion on December 31, 2007, which represented 28% of the total balance sheet. The increase in shareholders' equity was mainly due to the Group's net profit which was partially offset by dividends paid in the amount of NIS 760 million in 2007.

D. Total Group debt on March 31, 2008 amounted to NIS 6.93 billion, compared to NIS 7.83 billion on March 31, 2007. Group debt to financial institutions and debenture holders on March 31, 2008 amounted to NIS 6.54 billion, compared to NIS 7.25 billion on March 31, 2007. The decrease is mainly due to payment of Eurobonds and debentures in the domestic fixed line communications segment in the amount of NIS 1.96 billion and payment of loans and debentures in the cellular segment. In addition, there was early payment of loans in the international communications, internet services and NEP segment.

The decrease was offset mainly by the sale of debentures to institutions in the domestic fixed-line communications segment in the amount of NIS 1.2 billion and issue of debentures in the multi-channel television segment in July 2007 in the amount of NIS 614 million.

The Company's auditors have highlighted in the financial statements the financial position of DBS. As stated in Note 6, as of March 31, 2008 DBS is in compliance with the financial criteria established for it, after the banks adjusted the stipulations on March 5, 2008 to comply with the budget of DBS. The continuation of the operations of DBS is also conditional on compliance with conditions set for 2008 and/or further relief to be received during the year. The management of DBS believes that the financial resources available to it will be sufficient for its operating needs in the coming period based on the forecasted cash flow approved by the board of directors of DBS.

E. The Group's cash and other current investment balances on March 31, 2008 amounted to NIS 1.6 billion compared to NIS 1.88 billion on March 31, 2007. The decrease is mainly due to a decrease in the cash balance and the sale of commercially held securities in the domestic fixed-line communications segment, which were used to pay a dividend. In the international communications, internet services and NEP segment, there was a decrease in the cash flow that was used for early payment of loans and advanced tax payments.

The decrease was partially offset by an increase in cash balances in the cellular segment and the positive cash flow from current operations in the principal segments of the Group's operations.

## 2. Results of operations

A. Principal results

Net earnings attributable to the shareholders of the Company for the first quarter of 2008 amounted to NIS 398 million, compared to net earnings of NIS 399 million in the corresponding quarter last year.

Below are details of the changes in the results of the segments compared to the corresponding quarter last year.

| Segment | March 31, 2008 Operating profit NIS millions | March 31, 2007 Operating profit NIS millions |
|---|---|---|
| Domestic fixed-line communications | 368 | 369 |
| Cellular | 214 | 213 |
| International communications, internet services and NEP | 55 | 51 |
| Multi-channel television | 27 | 24 |
| Total | 664 | 657 |

Basic and diluted earnings per share in the first quarter of 2008 and in the corresponding quarter last year amounted to NIS 0.15 per NIS 1.00 par value.

B. Revenue

Group revenue in the first quarter of 2008 amounted to NIS 3.1 billion compared to NIS 3.09 billion in the corresponding quarter last year.

Revenues from domestic fixed-line communications decreased from NIS 1.44 billion in the corresponding quarter last year to NIS 1.41 billion in the reporting quarter (a decrease of 2%). The decrease in the segment's revenues is due to a decrease in interconnect fees to the cellular networks (with a parallel decrease in expenses). An additional decrease is due to a decrease in the number of lines (mainly due to number portability), a reduction in call traffic and a decrease in tariffs in June 2007. The decrease in revenues was moderated mainly by ongoing growth in revenues from high-speed internet service (ADSL) and by an increase in income from data communication services. The Company's auditors continue to highlight the growing competition in the communication sector and the impact of regulation.

Revenues from the cellular segment increased from NIS 1.15 billion in the corresponding quarter last year to NIS 1.17 billion in the reporting quarter. The increase is mainly due to an increase in content revenue and an increase in the number of subscribers, which was partially offset by a decrease in average revenue per subscriber. There was also an increase in revenue from sale of terminal equipment, due to an increase in the number of handsets sold and upgraded.

Revenue in the international communications, internet and NEP services segment amounted to NIS 314 million in the reporting quarter, compared to NIS 323 million in the corresponding quarter last year. In this segment there was a decrease in operations relating to transfer of calls between communication operators around the world. In contrast, there was an increase in revenue from internet broadband service and outgoing calls.

Revenue in the multi-channel television segment increased from NIS 354 million in the corresponding quarter last year to NIS 381 million in the reporting quarter, due to an increase in the number of subscribers and an increase in the average revenue per customer.

C. Depreciation and amortization

The Group's depreciation and amortization expenses decreased from NIS 441 million in the corresponding quarter last year to NIS 429 million in the reporting quarter, mainly due to a decrease in the depreciation expenses in the domestic fixed-line communication segment resulting from full depreciation of property plant and equipment and a decrease in investments in new assets. The decrease was partially offset by an increase in depreciation expenses in the cellular segment as a result of the accelerated depreciation of the 1 X network due to the establishment of a UMTS network.

D. Salaries

The Group's salary expenses increased from NIS 575 million in the corresponding quarter last year to NIS 616 million in the reporting quarter. The increase in salary is due to the expansion of the workforce in preparation for number portability in the cellular segment. The decrease in expenses due to early retirement of employees in the domestic fixed-line communications sector was offset by salary increases in this segment and in the other segments in the Group.

E. General and operating expenses

The Group’s operating and general expenses in the reporting quarter amounted to NIS 1.37 billion, compared to NIS 1.42 billion in the corresponding quarter last year.

In the domestic fixed-line communications segment, operating and general expenses decreased from NIS 533 million in the corresponding quarter last year to NIS 486 million in the reporting quarter. The decrease is mainly due to a reduction in interconnect fees to cellular operators, service and maintenance by subcontractors, building maintenance, and royalty expenses, which were partially offset by an increase in materials and spare parts expenses and by general expenses.

In the cellular segment, general and operating expenses decreased from NIS 668 million in the corresponding quarter last year to NIS 660 million in the reporting quarter. The decrease is mainly due to a decrease in prices of terminal equipment and advertising expenses which was partially offset by an increase resulting from an increase in content expenses and connectivity as well as an increase in revenues.

In the international communications, internet services and NEP segment there was a decrease in general and operating expenses from NIS 189 million in the corresponding quarter last year to NIS 174 million in the reporting quarter. The decrease is mainly due to a reduction in operations relating to call transfers between communication operators around the world alongside a decrease in revenues.

In the multi-channel television segment, general and operating expenses increased from NIS 219 million in the corresponding quarter last year to NIS 239 million in the reporting quarter, due to an increase in content consumption in view of broadcasts of original productions and general expenses.

F. Other operating expenses (income), net

The Group’s other net operating expenses originated mainly from the domestic fixed-line communications segment. These expenses amounted to NIS 21 million in the reporting quarter, compared to income of NIS 7 million in the corresponding quarter last year. This was mainly due to an increase in expenses recorded for provision for severance pay in early retirement and an absence of capital gain.

G. Operating income

The Group's operating income in the reporting quarter amounted to NIS 664 million, compared to NIS 657 million in the corresponding quarter last year, an increase of NIS 7 million. The increase in operating income is due to the changes in the results of the segments described above in the revenue and expenses sections.

H. Financing expenses - net

The Group’s net financing expenses in the reporting quarter amounted to NIS 100 million compared to NIS 58 million in the corresponding quarter last year, an increase of NIS 42 million.

The Group's debt to financial institutions and debenture holders is mainly linked to the CPI and the financing expenses are affected by fluctuations in the Index. In the reporting period there was a rise in the Index, to which the debt balance is linked, compared to the corresponding quarter last year and revaluation of liabilities led to an increase in the Group's financing expenses.

In the domestic fixed line communications segment, there was an increase in net financing expenses compared to the corresponding period. This is mainly due to a decrease in revenues in the capital market and realization of deposits and securities and a decrease in their return. In this segment there is an increase in expenses due to revaluation of CPI-linked liabilities, which was mainly offset by hedging transactions.

In the cellular segment, there was an increase in net financing expenses, mainly due to the reduction in liabilities and the decrease in the dollar exchange rate which was partially offset by the increase in expenses for revaluating CPI-linked liabilities as a result of a rise in the index.

In the multi-channel television segment, net financing expenses in the reporting quarter amounted to NIS 92 million compared to NIS 72 million in the corresponding quarter last year. The increase in the CPI led to an increase in financing expenses due to the revaluation of CPI-linked liabilities and an increase in the Company’s financial debt.

I. Income tax

The Group's tax expenses in the reporting quarter amounted to NIS 180 million, representing approximately 32% of profit before taxes, compared to NIS 214 million in the corresponding quarter last year, representing 36% of pre-tax profit. Most of the decrease in the tax expenses from profit before income taxes is due to a reduction in the tax rate and the cancellation of Income Tax (Taxation Under Conditions of Inflation) Law.

## 3. Liquidity and sources of financing

Consolidated cash flows generated by operating activities in the reporting quarter amounted to NIS 637 million, compared to NIS 865 million in the corresponding quarter last year, a decrease of NIS 228 million. The decrease in cash flows generated by operating activities is mainly due to an increase in the customer balances, due to the abovementioned reasons, and a decrease in suppliers due to the decrease in the volume of purchases in the cellular segment and international communications, internet services and NEP segment and payments for early retirement.

Cash flows generated by operating activities are one of the sources of financing of the Group's investments, which during the reporting quarter included, inter alia, NIS 307 million invested in the development of communications infrastructures, compared to investments amounting to NIS 177 million in the corresponding quarter last year.

In the reporting period, the Group repaid net debts and paid interest of NIS 313 million, of which NIS 229 million was on account of debentures, NIS 40 million in loans, NIS 56 million in interest payments and NIS 12 million for short-term credit received, compared to payment of net debt and interest payments in the amount of NIS 258 million in the corresponding quarter last year.

In the reporting quarter, cash dividends were not paid compared to NIS 2.1 billion paid in the corresponding quarter last year.

The monthly average short-term credit balance from banks in the reporting quarter amounted to NIS 87 million. The monthly average of long-term liabilities to financial institutions and debenture holders in the reporting quarter amounted to NIS 6,658 million.

The working capital on March 31, 2008 was positive, and amounted to NIS 573 million, compared to negative operating capital on March 31, 2007 which amounted to NIS 2.59 billion, an improvement of NIS 3.2 billion. The increase in the working capital is due to an increase in working capital in all the segments in which the Group operates.

In the domestic fixed-line communications segment there was a decrease of NIS 1.2 billion in the working capital deficit compared to the corresponding quarter of last year. The decrease in deficit is mainly due to a decrease in current liabilities, which is mainly due to repayment of debentures (Eurobonds), a decrease in current provisions related to benefits for employees as well as an increase in customer balance. On the other hand, there was a decrease in investments in commercially held financial assets.

In the multi-channel television segment there was a decrease in deficit mainly due to the classification of bank loans as long-term loans, in view of the compliance with the terms of the financing agreement with the banks.

## 4. Group involvement in the community and donations

The Group is active in the community through contributions to recognized non-profit organizations that channel funds to education, welfare and other causes, and through development of direct volunteering of employees in the community. In the reporting quarter, the Company started to work with "Matan - Your Way to Give", a non-profit organization that helps donors implement their philanthropic vision. In addition, the Company has become a member of Ma'ale – Business for Social Responsibility, a non-profit membership organization that advocates corporate values. The Group is active in the community through its involvement in social institutions and organizations, such as the education system in underprivileged areas and the confrontation line. In addition, Group employees volunteer in additional and diverse community involvement activities.

During the reporting period the Group donated NIS 214,000. The principal recipients are listed below:

A. In the project "Youth Employment at Bezeq", which has been ongoing for some 14 years, the Company's employees voluntarily mentor underprivileged youth employed at Bezeq with the aim of integrating them into normative life. In addition, Bezeq continues to support the "Dialogue in the Dark" project at the Children's Museum in Holon, and many other activities.

B. Bezeq International is involved in ongoing operations on behalf of underprivileged communities in Petach Tikva, it adopted "lone" soldiers and a combat division and participated in projects for children with special needs.

## 5. Exposure to and management of market risks

A. Further to the description in the Directors' Report of 2007, hedging transactions against market risks connected to exposure to fluctuations in the exchange rate and the CPI significantly reduced this exposure.

B. The derivative positions report on March 31, 2008 is not significantly different from the report on December 31, 2007.

C. The sensitivity analyses for the fair value and the effect of the change in the market prices on the fair value of on- or off-balance sheet contractual agreements on March 31, 2008, are not substantially different from the December 31, 2007 statement. However, the total fair value of net liabilities that are sensitive to fluctuations in the dollar-shekel exchange rate on December 31, 2007 should amount to NIS 1,148 million. The sensitivity to changes in the dollar interest rate should amount to NIS 622 million, due to the adjusted measuring of communications to space sections, which should amount to NIS 611 million instead of NIS 343 million.

D. The linkage basis report on March 31, 2008 is not substantially different from the report on December 31, 2007.

The surplus financial liabilities on financial assets in or linked to foreign currency on March 31, 2008 amounted to NIS 93 million in the Group. Future currency transactions on March 31, 2008 amounted to NIS 335 million. The purpose of the transactions is also to hedge against off balance-sheet liabilities in or linked to foreign currency.

The surplus liabilities on CPI-linked financial assets on March 31, 2008 amounted to NIS 6,027 million in the Group. As a result of hedging transactions, on March 31, 2008 the net CPI-linked liabilities, which are not defined by forward transactions, amounted to NIS 3,577 million.

## 6. Critical accounting estimates

The preparation of the financial statements according to international accounting principles requires the management to make estimates and assessments that influence the reported values of assets and liabilities, income and expenses, and disclosure relating to contingent assets and liabilities. Management bases its estimates and assessments on past experience and on additional factors, value appraisals and opinions which it believes are relevant, taking into account the circumstances. The actual results can differ from those assessments based on various assumptions and conditions. Information on the principal matters of uncertainty in critical assessments and judgments in the application of the accounting policy is provided in the annual financial statements. We believe that these assessments and estimates are critical because every change in them and in the assumptions has the potential to materially affect the financial statements.

## 7. Opinion of process for approving the Company's financial statements

The Board of Directors is responsible for oversight. The Board of Directors appointed a balance sheet committee with the tasks and composition described in the Directors’ Report of 2007.

The financial statements were discussed at the balance sheet committee and submitted to the Board of Directors for approval. The following officers attended the board discussion: board members – Shlomo Rodav, Eyal Yaniv, Menachem Inbar, Michael Grabiner, Ran Gottfried, Yoav Rubenstein, Elon Shalev, Kihara R. Kiarie, David Gilboa, Rami Nomkin, Yitzhak Edelman and Yehuda Porat. In addition, the following officers attended: Avi Gabbay – CEO, Alan Gelman – Deputy CEO and CFO, and Bosmat Chelouche – legal consultant. Representatives of Somekh Chaikin also participated in the discussion.

## 8. Miscellaneous

Events subsequent to the date of the financial statements

A. On January 31, 2008 the general meeting of the Company approved a stock options plan for managers and senior employees in the Company and/or in affiliates. Consequently, 45,700,000 options were allotted. On April 17, 2008 the Board of Directors resolved to allocate an additional separate 9,000,000 options to the Chairman of the Board, in accordance with the plan described in Note 9 to the financial statements.

B. On March 10, 2008 the Company's Board of Directors resolved to recommend, at the general shareholders' meeting, the distribution of a cash dividend to shareholders in the total amount of NIS 679 million (representing NIS 0.26 per share). On April 3, 2008 the General Meeting approved payment of the dividend, which was paid on April 28, 2008.

C. On April 17, 2008 the Company's Board of Directors resolved to partially adopt the recommendations of the committee to examine a corporate governance code (Goshen Committee) as described in the Company's immediate report issued on April 18, 2008.

D. On April 17, 2008 the Company's Board of Directors resolved to approve the employment terms of the Chairman of the Board as described in Note 8 to the financial statements. After examining the separate components of the compensation package and the compensation as a whole, the Board of Directors is of the opinion that the compensation package is appropriate and reasonable under the circumstances, and is in line with the nature of the position, the challenges facing the chairman and the expectations of the board of directors. Comparison with peer companies indicate that the compensation package is within the upper range of compensation packages in the peer companies.

E. On March 31, 2008 the net dollar-linked contractual liabilities (including off-balance sheet liabilities) amounted to NIS 1,028 million. In the period between March 31, 2008 and the date of approval of the financial statements, the dollar exchange rate decreased by 5.4%. The Company estimates that the amount of the exposure does not necessitate deviation from the way the Company currently manages exposure to the dollar.

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

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| **Shlomo Rodav**<br>**Chairman of the Board of Directors** | **Avi Gabbay**<br>**CEO** |