November 27, 2001

Directors' Report on the State of the Company's Affairs
for the Nine Months ended September 30, 2001

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 nine months ended September 30, 2001 (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 has been prepared assuming that the reader also has access to the Directors' Report of December 31, 2000.

The financial data in the Directors' Report are presented in adjusted shekels of September 2001.

1. The Business Environment

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

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

    a. In December 1999, the Ministry of Communications granted a special license to Israel Railways for providing communications services by the optical fibers it owns. In July 2001, Israel Railways published a tender for lease of its infrastructure for providing telecommunication services. The tender proceedings are suspended, at this stage, following a petition filed by the Company to the Supreme Court of Justice.

    b. In October 2000, the Ministry of Communications published tenders for the provision of domestic communication services by means of a wireless access network to the homes of subscribers (LMDS). A draft was attached to the tender documents, describing the main points of the terms of the general license that will be granted to the winners of the tenders.

    c. At the beginning of February 2001 the Ministry of Communications granted a license for operating domestic fixed-line communications services to another company. To the best of the Company's knowledge, that company recently announced that its has cut back on its operations and is reconsidering its steps in this field.

    d. As explained in Note 1(b)(6) to the financial statements, in July 2001 the Telecommunications Law was amended in a manner that enables the Ministry of Communications to grant the cable companies licenses for providing domestic fixed-line telecommunication services via the cable infrastructure.

    e. The Ministry of Communications has enabled several entities to start operation in the field of transmission services.

2. The imminent opening of domestic communications services to full competition and the awarding of licenses to provide domestic fixed-line services as above, in addition to the growing competition in the cellular and international communications sectors, is expected to have a materially adverse effect on the Company's business results the scope of which cannot be estimated at this stage.

3. Pursuant to the decisions of the Knesset Finance and Economics Committees, the Company's tariffs were lowered, effective March 1, 2001, as described in Note 1(b)(2) to the financial statements.

4. At its meeting on August 27, 2000, the Ministerial Committee for Privatization resolved to sell the State's holdings in the Company by way of a private sale that would be accompanied by raising capital for the Company. The sale will include shares comprising at least 50.01% of the Company's share capital. The Ministerial Committee for Privatization later adopted a number of resolutions intended to advance the implementation of the above decision, and the Company's license, its Articles of Association and the Telecommunications Order were amended. On November 13, 2001, the Government of Israel published a notice stating that it was considering the sale of holdings, comprising 50.01% of the share capital of the Company, by way of a private sale. According to the notice, anyone wishing to purchase the State's holdings may apply to the Government of Israel through the Companies Authority. The procedure for the sale of the State's holdings will be distributed through the Companies Authority. Those wishing to participate in the sale proceedings are required to submit their applications, in accordance with the procedure, by February 13, 2002.

   The General Meeting which convened on April 30, 2001 resolved to approve an increase of the registered capital of the Company by 130 million ordinary shares, and to amend Article 64 of the Company's Articles of Association, in order to enable capital to be raised for the Company in accordance with the privatization resolution. On June 11, 2001, the Ministerial Committee for Privatization approved the increase of the Company's registered capital.

5. Concerning the option to purchase an additional 50% of the share capital of Pelephone, see Note 4(a) to the financial statements.

6. Concerning the Company's investment in D.B.S. Satellite Services (1998) Ltd. and the financing agreement signed with banking corporations, see Note 4(c) to the financial statements.

7. In January 2001, the subsidiary Bezeq International Ltd. entered into a memorandum of understanding for the establishment of a joint venture for laying and operating a seabed optical fiber system in the eastern Mediterranean basin, as part of the Tycom Global Network ("TGN"), for a total cost of $390 million. The parties were negotiating with the aim of reaching a detailed agreement, but the negotiations were recently terminated. Bezeq International is examining possible alternatives in this field.

8. In May 2001 the Company signed an agreement in which it undertook to invest the sum of $20 million in a venture capital fund. The objective of the fund is to make investments in start-up telecommunications companies. The Company invested three million dollars during the report period.

9. During the report period, the Company invested $9.5 million in Xpert Integrated Systems Ltd. ("Xpert"), in consideration for 15.6% of the fully diluted capital of that company. In addition, the Company also received options that will enable it to increase its holdings to 21.5%. Xpert is an Israeli company engaged mainly in the building and integration of IP networks.

2. Details Concerning Market Risk Exposure and Management

Further to that described in the Directors' Report for the year 2000, as a result of hedging transactions against market risks associated with exposure to fluctuation of exchange rates, the Group sustained no material financing income or expenses, despite the material changes in the exchange rates of foreign currencies in the report period.

3. Financial Position

One. The Group's assets as at September 30, 2001 amount to approximately NIS 17.09 billion, compared with NIS 17.6 billion on September 30, 2000. Of these, approximately NIS 10.69 billion (approximately 62.6%) are fixed assets, compared with approximately NIS 12.14 billion (69.0%) on September 30, 2000.

The decrease in total assets is derived mainly from a decrease in the depreciated cost of the fixed assets as a result of the differential between the depreciation expenses and the investment made in the report period, from a decrease in the cash balances, and from a decrease in deferred taxes. The decrease was mainly offset by an increase in long-term investments.

b. The shareholders' equity of the Group as at September 30, 2001 amounted to approximately NIS 7.27 billion, which comprise 42.5% of the total balance sheet, compared with approximately NIS 6.98 billion on September 30, 2000, which comprised about 39.7% of the total balance sheet.

c. Total Group debt to financial institutions and to the holders of its debentures as at September 30, 2001 amounted to approximately NIS 6.39 billion, compared with approximately NIS 6.88 billion on September 30, 2000.

d. The balances of the Group's cash and short-term investments as at September 30, 2001 amounted to approximately NIS 1,386 million, compared with approximately NIS 1,747million on September 30, 2000.

e. The Group's surplus of monetary liabilities over monetary assets in foreign currency or linked thereto as at September 30, 2001 amounted to approximately NIS 2.1 billion. The Company's investment in dollar-linked convertible debentures (in connection with the Pelephone transaction referred to above), contributed to reducing the dollar exposure. Furthermore, during the report period, the Company made forward currency transactions to reduce the exposure, and the Company intends to continue pursuing this policy.

As a result of the forward currency transactions, the Company's surplus of foreign currency assets over liabilities as at September 30, 2001 amounted to approximately NIS 565 million.

f. The Group’s surplus of CPI-linked liabilities in excess of linked monetary assets as at September 30, 2001 amounted to approximately NIS 2.05 billion. This exposure is partly covered by a mechanism for updating tariffs which takes into account price rises in the economy. In addition, the Company made hedging transactions that limit the exposure to rises in the CPI.

4. Results of Operations

a. <u>Principal results</u>

Net earnings for the first nine months of 2001 amounted to approximately NIS 165 million, compared with a net loss of approximately NIS 605 million in the corresponding period last year.

The difference between the results was caused mainly by a decrease of approximately NIS 1,331 million (before tax) in the other expenses item. In 2000, an expense of approximately NIS 1,393 million was recorded under this item which was mainly for the early retirement plan. Eliminating the effects of the other expenses item in the two periods, net profit for the first nine months of 2001 would be about NIS 165 million, compared with NIS 247 million in the corresponding period last year. This decrease derives mainly from the decrease in the Company's operating income and from an increase in the operating loss of Pelephone. These effects were partially offset by a decrease in the Company's financing expenses.

Earnings per share for the first nine months of 2001 amounted to NIS 0.133 per NIS 1 par value share, compared with NIS 0.249 per share in the corresponding period last year.

b. Revenues

Group revenues for the first nine months of 2001 amounted to approximately NIS 6.16 billion, compared with approximately NIS 6.46 billion in the corresponding period last year. Revenues in the corresponding period last year include Company revenues from airtime for two months, whereas in the report period, no airtime is included because of the change in the Company's method of settlement arrangements with the cellular communication companies. Eliminating the airtime component, revenues in the corresponding period last year would have been only approximately NIS 6.22 billion.

Revenues from domestic fixed-line communications traffic decreased as a result of tariff reductions in May 2000 and March 2001, and as a result of a decrease in call traffic, the effects of which were offset to some extent by the increase in Internet access traffic. Revenues from international calls decreased due to a 30% reduction in access fees and a decrease in the revenues of Bezeq International. Revenues from installations and sales of equipment decreased due to various discount campaigns. The decrease in the Group's income was offset mainly by a rise in revenues from fixed usage fees and by revenues from cellular calls which are not airtime.

c. Operating and general expenses

The Group's operating and general expenses for the first nine months of 2001 amounted to approximately NIS 3.35 billion, compared with approximately NIS 3.26 billion in the corresponding period last year.

Expenses are affected, on the one hand, by the change in the Company's settlement arrangements with the cellular communication companies starting in March 2000, following which the Company's expenses do not include expenses related to airtime; on the other hand, the implications of the agreement with Pelephone as described in Note 1(b)(3) to the financial statements, increased the Company's expenses.

In addition, the operating expenses of Pelephone increased, as did salary expenses and general expenses, while sub-contractor expenses decreased. Most of the increase in salary expenses and the decrease in sub-contractor expenses derived from the absorption of workers from temporary employment agencies as employees of the company.

d. Depreciation

The depreciation expenses of the Group are decreasing as a result of the end of depreciation of the Company's fixed assets and a decrease in investments in new assets. This trend could accelerate in the future, with the end of depreciation of assets that were transferred from the State to the Company at the time of its establishment.

e. Royalties to the Government of Israel

The decrease in royalties rate as described in Note 1(b)(5) to the financial statements, led to a decrease in the royalties obligation of the Group, mainly for Pelephone, which in the past had paid royalties at 8% of its revenues.

f. Operating income

The Group's operating income for the first nine months of 2001 amounted to approximately NIS 652 million, compared with approximately NIS 887 million in the corresponding period last year, a decrease of approximately NIS 235 million. The decrease in operating income results from the changes described above in the operating income and the operating and general expense items, and from a decrease in depreciation and royalties to the Government of Israel. The decrease in operating income was recorded mainly on the Company’s and Pelephone’s books.

g. Financing expenses

The Group's financing expenses for the first nine months of 2001 amounted to approximately NIS 99 million, compared with approximately NIS 294 million in the corresponding period last year. The decrease is derived from the decrease in net interest expenses as a result of the decrease in net financial liabilities, from an increase in interest income from investments, and from interest income from the Income Tax Authority (approximately NIS 73 million) as a result of a settlement reached regarding the tax assessment for preceding years. The effects of changes in foreign currency exchange rates were mainly neutralized by hedging transactions.

h. The Company's share in the losses of affiliates

The increase in the Company's share in the losses of affiliates was due to an increase in the Company's share in the losses of D.B.S. Satellite Services (1998) Ltd., and an increase in the losses of Walla Communications Ltd. These increases were offset mainly by the Company's share in the profits deriving from the disposal of an indirect holding of the Company in Hungary – see also Notes 4(b), 4(c) and 4(d) to the financial statements.

i. Other expenses, net

In the first nine months of 2000, this item includes a provision of NIS 1,393 million for early retirement, in respect of the plan described in Note 5 to the financial statements.

5. Liquidity and sources of financing

Consolidated cash flows generated by operating activities during the first nine months of 2001 amounted to approximately NIS 2,378 million, compared with approximately NIS 2,465 million in the corresponding period last year. The cash flow generated by operating activities is the principal source for financing the Group's investments, and was used during the report period, inter alia, for the investment of about NIS 1,034 million in the development of telecommunications infrastructures, approximately NIS 380 million in investee companies, and about NIS 1,087 million in convertible debentures in connection with the Pelephone transaction (see Note 4(a) to the financial statements). Investments which were not financed by cash flow from current operations were financed by a reduction in the cash balances of the Group. In the first nine months of the year, the Group repaid approximately NIS 1,357 million of debts, of which approximately NIS 913 million in long-term loans, NIS 207 million were on account of debentures and NIS 237 million in short-term credit. In contrast, the Group raised new debt of approximately NIS 1,200 million, of which approximately NIS 686 million were new long-term loans and NIS 514 million were issues of debentures.

The average monthly short-term credit in the period was approximately NIS 567 million, and the average of monthly long-term liabilities in the period was approximately NIS 6,040 million.

Working capital as at September 30, 2001 was positive, and amounted to approximately NIS 253 million, compared with negative working capital of NIS 225 on September 30, 2000. The improvement in the Group's working capital derived from a decrease in current liabilities to banks and debenture-holders, from a decrease in liabilities to suppliers, and in liabilities in connection with financing the early retirement plan.

6. Comparison of results of the third quarter of 2000 with the results of the corresponding period in 2000

Revenues in the third quarter of 2001 decreased by approximately NIS 88 million compared with the corresponding period last year, a decrease of about 4.2%. Operating and general expenses increased compared with the third quarter of last year by approximately NIS 109 million, an increase of about 10.9%.

Operating income in the quarter decreased by approximately NIS 133 million compared with the same quarter last year.

Financing expenses in the third quarter of 2001 decreased by approximately NIS 78 million compared with the corresponding quarter last year.

Net other expenses in the third quarter of 2000 included a provision of approximately NIS 1,393 million for early retirement, as described in Note 5 to the financial statements.

The behavior of the income and expense items and the causes of the differences between the quarters are similar to the explanations for the changes in the results in the first nine months of 2001 compared with the corresponding period last year.

The changes described above in the items of the statement of income resulted in net earnings of approximately NIS 7 million in the third quarter of 2001, compared with net earnings of approximately NIS 811 million in the corresponding period last year. Eliminating the effects of the other expenses item in the two periods, the net profit of the Company in the third quarter of 2001 would be about NIS 23 million, compared with about NIS 98 million in the third quarter of 2000.

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

Ido Dissentshik Chairman of the Board	Ilan Biran CEO