November 16, 2005

Directors Report on the State of the Company's Affairs for the period ended September 30, 2005

We respectfully present the Directors' Report on the state of the affairs of "Bezeq" – The Israel Telecommunication Corp. Limited (hereinafter: the "Company") and the consolidated Group companies (the Company and the consolidated companies hereinafter collectively referred to as the "Group"), for the nine-month period ending September 30, 2005 (hereinafter: "the Directors' Report").

The Directors' Report contains a review of its subject matter, in condensed form, and is prepared on the assumption that the reader can also refer to the Directors' Report for the year ended December 31, 2004.

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

1) **Fixed-line domestic communications**
2) **Cellular**
3) **International communications and internet services**
4) **Multi-channel television**

Below is information detailing the financial statements which were fully consolidated during the period of account and which were not included in the entire corresponding period in the prior year:

1. Pelephone Communications Ltd. – full consolidation since August 26, 2004 (until that date, 50% proportional consolidation).

2. D.B.S. Satellite Services (1998) Ltd. – full consolidation since June 21, 2004.

1. Financial Position

A. The Group's assets as at September 30, 2005, amounted to approximately NIS 20.65 billion, compared with NIS 19.99 billion as at September 30, 2004. Of these, approximately NIS 10.12 billion (approximately 49%) are fixed assets compared with approximately NIS 10.72 billion (approximately 53.6%) on September 30, 2004.

   In the fixed-line domestic communications segment, there was a decrease in the net book value of fixed assets resulting from the difference between depreciation expenses and the investment made during the period of account. Conversely, there was an increase in cash balances and short-term investments compared with the prior year.

   In the cellular segment, there was an increase in cash and cash equivalents, short-term investments and trade receivables, which contributed to the increase in total assets. Conversely, there was a reduction in the deferred tax balances due to utilization of prior years' losses for tax purposes.

   In the international communications and internet services segment, there was an increase in total assets compared with the prior year, mainly due to an increase in cash balances. Conversely, net investments in fixed assets decreased in this segment compared with the prior year.

   In the multi-channel television segment, total assets increased compared with the prior year, mainly due to a rise in broadcasting rights and in the customer credit balance. Conversely, there was a decrease in net investments in fixed assets

B. The Group's shareholders' equity as at September 30, 2005, amounted to approximately NIS 8.01 billion, comprising approximately 38.8% of the total balance sheet, compared with approximately NIS 7.36 billion on September 30, 2004, which comprised approximately 36.8%

of the total balance sheet. The increase in shareholders' equity derived from the Group's net earnings accumulated since the end of the corresponding period.

C. Total Group debt to financial institutions and debenture holders as at September 30, 2005, amounted to approximately NIS 9.08 billion, compared with approximately NIS 8.26 billion on September 30, 2004. The increase derives mainly from an offering of debentures which was offset by repayment of long-term loans in the cellular and fixed-line domestic communications segments.

D. Group balances in cash and short-term investments as at September 30, 2005, amounted to approximately NIS 4.16 billion, compared with approximately NIS 2.57 billion on September 30, 2004. The increase derives mainly from the cash flow from operating activities in the principal segments in which the Group operates (excluding multi-channel television), and from an offering of debentures and loans raised. The increase was moderated as a result of repayment of long-term loans and the acquisition of fixed assets.

2. Results of Operations

A. Principal results

Net earnings for the first nine months of 2005 amounted to approximately NIS 547 million, compared with net earnings of approximately NIS 517 million for the corresponding period in the prior year. The difference in the results derives mainly from differences in the period in which Pelephone and DBS were consolidated in the period of account compared with the corresponding period in the prior year, and from changes in the operating income of the Group companies, as well as Other revenues (expenses) in the Company, as described below.

Below are details of the changes in the results of the segments compared to the corresponding period (not including Other income / expenses, net).

	For the nine-month period ended September 30	
Segment	**2005 NIS millions**	**2004 NIS millions**
Fixed-line domestic communications	681	782
Cellular[1]	384	257
International communications and internet services	69	93
Multi-channel television[2]	(79)	(33)
Others	(2)	9

Net earnings per share for the first nine months of 2005 amounted to NIS 0.21 per NIS 1 par value, compared with net earnings per share of NIS 0.198 per NIS 1 par value in the corresponding period in the prior year.

B. Revenues

Group revenues in the first nine months of 2005 amounted to approximately NIS 8.34 billion compared with earnings of approximately NIS 6.49 billion in the corresponding period in the prior year. The increase of approximately NIS 1.99 billion derives from first-time consolidation implemented during 2004. Eliminating the effects of the first-time consolidation, there was a decrease in the Group's revenues which derived from the fixed-line domestic communications segment.

Revenues from fixed-line domestic communications decreased from approximately NIS 3.75 billion in the first nine months of 2004 to approximately NIS 3.57 billion during the period of account (a decrease of approximately 4.9%). Most of the decrease in the segment's revenue derived from a tariff reduction in June 2004 and June 2005, a decrease in call and internet dial-up traffic, a decrease in revenues from the sale of equipment to subscribers, and a decrease in royalties received from Pelephone. The decrease in revenues was moderated by the ongoing

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(1) First-time full consolidation.
(2) First-time consolidation.

growth in the number of customers who subscribe to high-speed internet service (ADSL). The auditors drew attention to the ongoing opening of the communications industry to competition and to expected tariff changes.

Revenues from the cellular telephone segment increased from approximately NIS 1.86 billion in the first nine months of 2004 to approximately NIS 3.35 billion during the period of account, mainly as a result of the effect of the first-time full consolidation implemented during 2004. In addition, the segment's revenues increased as a result of an increase in revenues from sales of terminal equipment to customers and from terminal equipment services. Amendment of the cellular network interconnect regulations and the reduction of interconnect tariffs commencing March 1, 2005 eliminated almost completely the upward trend in the segment's revenues despite the increase in the number of customers.

Revenues from the international communications and internet services segment decreased from approximately NIS 614 million in the first nine months of 2004 to approximately NIS 604 million during the period of account. The decrease derives mainly from a decrease in revenues from outgoing calls due to a significant decrease in traffic and in the outgoing call tariffs as a result of greater competition. This decrease was offset by a considerable increase in the routing of international call traffic and in internet revenues, which derived from a rise in the number of high-speed internet customers.

Revenues in the multi-channel television segment increased from approximately NIS 269 million in the first nine months of 2004 to approximately NIS 896 million in the period of account, mainly due to the consolidation of DBS during the course of 2004. In addition, there has been an increase in revenues in this segment compared with the corresponding period as a result a net increase of approximately 56,000 in the number of net subscribers and an increase in the average revenue per subscriber from new services.

C. General and operating expenses

The Group's general and operating expenses for the first nine months of 2005 amounted to approximately NIS 5.34 billion compared with approximately NIS 3.73 billion during the corresponding period in the prior year. Approximately NIS 1.5 billion of the increase derives from first-time consolidation.

In the fixed-line domestic communications segment, general and operating expenses increased from approximately NIS 1,728 million in the first nine months of 2004 to approximately NIS 1,733 million during the period of report. The increase derives mainly from a rise in the costs of vehicle and building maintenance and a decrease in salaries charged to fixed assets which was set off by a decrease in material consumption expenses and general expenses.

In the cellular segment, general and operating expenses increased from approximately NIS 1,376 million in the first nine months of 2004 to approximately NIS 2,506 million during the period of account, due mainly from the first-time full consolidation. In addition, expenses in the segment increased compared with the corresponding period mainly due to increased revenues and subscriber acquisition costs which derive from winning the tender of the Accountant General at the Ministry of Finance. The increase was offset by a decrease in marketing expenses.

In the international communications and internet services segment, there was an increase in general and operating expenses from approximately NIS 426 million in the first nine months of 2004 to approximately NIS 460 million during the period of account, resulting from the increase in foreign managers expenses deriving mainly from a significant increase in traffic routed from one foreign operator to another foreign operator.

In the multi-channel television segment, general and operating expenses increased from approximately NIS 228 million in the corresponding period to approximately NIS 733 million during the period of account, mainly due to the consolidation of DBS during 2004. In addition, expenses increased in the segment due to the increase in subscribers which resulted in increased content and other operating expenses.

D. Depreciation

The Group's depreciation expenses increased from approximately NIS 1,495 million in the first nine months of 2004 to approximately NIS 1,749 million during the period of account, resulting from the first-time consolidation in respect of which depreciation expenses increased by approximately NIS 321 million. Eliminating this increase, depreciation expenses decreased as a result of fully depreciated fixed assets and a decrease in investments in new assets in the fixed-line domestic communications segment and the international communications and internet services segment.

E. Royalties to the Government of Israel

The Group's royalties expenses amounted to approximately NIS 195 million compared with NIS 156 million during the corresponding period in the prior year. The source of the increase is the first-time consolidation referred to above.

F. Operating income

The Group's operating income in the first nine months of 2005 amounted to approximately NIS 1,053 million, compared with NIS 1,108 million during the corresponding period in the prior year, a decrease of approximately NIS 55 million. The decrease in operating income derives from the changes in the results of the revenues and expenses sections of the segments described above. These changes led to a reduction in the profitability of the Group's main segments of operation (except for the multi-channel television segment). The Group's operating income was partially influenced by the first-time consolidation of DBS's financial results and the full consolidation of Pelephone's financial results as described above.

G. Financing expenses

The Group's net financing expenses for the first nine months of 2005 amounted to approximately NIS 272 million compared with approximately NIS 137 million during the corresponding period in the prior year. Approximately NIS 133 million of the expenses derives from the first-time consolidation.

The effect of the changes in foreign currency and shekel rates on the Company's liabilities were partially neutralized by hedging transactions carried out, and by investment in financial assets.

The Group's financing expenses were influenced by income from the capital markets as a result of investments in marketable securities, and by an increase in exchange rates and the consumer price index.

H. Other income (expenses)

Income amounting to approximately NIS 131 million was recorded in the Group's Other income (expenses) item, compared with income of approximately NIS 109 million during the corresponding period in the prior year.

Most of the income in the corresponding period was a reduction in the provision for early retirement. The income recorded in the period of account derives mainly from capital gains of approximately NIS 109 million and a reduction of approximately NIS 83 million in the provision for early retirement (due to transfer to an insurance company). The income was partially offset by amortization of goodwill in respect of companies consolidated for the first time in the financial statements (see Note 10 to the financial statements).

I. Group's equity in losses of affiliates

The Group's equity in losses of affiliates during the first nine months of 2005 amounted to approximately NIS 13 million compared with losses of approximately NIS 131 million recorded during the corresponding period in the prior year. Most of the decrease during the period of account derives from DBS becoming a consolidated company during 2004, and the results of its operations are presented in the financial statements on a consolidated basis, rather than by the equity method (see Note 4 to the financial statements).

The Company's auditors drew attention to the financial condition of DBS, and to the fact that its continued operation is contingent upon arranging its sources of finance for next year. In the opinion of DBS's management, based on, *inter alia,* its work plan for the year 2006, there are reasonable changes of arranging the sources of finance that will be required by DBS in the coming year, including the completion of the amounts required pursuant to the work plan.

3. Liquidity and sources of financing

Consolidated cash flows generated by operating activities during the first nine months of 2005 amounted to approximately NIS 1,807 million, compared with approximately NIS 2,027 million during the corresponding period in the prior year. Eliminating an increase of approximately NIS 297 million which derives from first-time consolidation, cash flows from operating activities decreased by approximately NIS 517 million. The decrease derived mainly from the fixed-line domestic communications and cellular segments, and was mainly due to changes in the assets and liabilities items. Additionally, the decrease in the earnings from operating activities in those segments contributed further to the decrease in cash flows from operating activities.

Cash flows generated by operating activities are the principal source of financing of the Group's investments, which during the period of report included, *inter alia*, approximately NIS 1,331 million in the development of communications infrastructure and approximately NIS 717 million in short-term investments.

During the period, the Group repaid approximately NIS 1,440 in debts, of which approximately NIS 1,258 million was on account of long-term loans and approximately NIS 182 million was on account of debentures.

The Group raised new debt in a total amount of approximately NIS 2,165 million by an issuance of debentures and receipt of new long-term loans and short-term credit.

The average monthly short-term credit during the period was approximately NIS 106 million. The average monthly long-term liabilities for the period was approximately NIS 8,691 million.

Working capital as at September 30, 2005, was positive and amounted to approximately NIS 1,784 million, compared with negative working capital of approximately NIS 1,314 million on September 30, 2004. The increase derives mainly from an improvement in working capital in the multi-channel television segment, in the amount of approximately NIS 1,287, as a result of changes in credit terms.

In the cellular segment, working capital improved by approximately NIS 788 million, most of which derived from an increase in cash and short-term investments designated for the gradual repayment of bank loans. In addition, current liabilities decreased mainly due to a decrease in trade payables.

In the fixed-line domestic communications segment working capital improved by approximately NIS 867 million compared with September 30, 2004, as a result of an increase in cash and short-term investments.

4. Comparison of the results of the third quarter of 2005 with the results of the corresponding quarter last year

The following are details of the changes in the results of segments in comparison with the corresponding period (not including Other income/expenses, net):

	For the three-month period ended September 30	
Segment	**2005**	**2004**
	NIS millions	**NIS millions**
Fixed-line domestic communications	225	231
Cellular[(1)]	130	117
International communications and internet services	26	27
Multi-channel television[(2)]	(29)	(33)
Others	(2)	4

(1) First-time full consolidation.
(2) First-time consolidation.

Revenue during the third quarter of 2005 increased by approximately NIS 365 million compared with the corresponding quarter in the prior year. The increase derived mainly from the full consolidation of Pelephone.

Operating and general expenses increased by approximately NIS 325 million compared with the corresponding quarter in the prior year. An increase of approximately NIS 270 million derives from the first-time consolidation of Pelephone. In addition, the increase also derives from the increase in the operating and general expenses recorded mainly in the cellular and multi-channel television segments.

The results of the third quarter in comparison with the corresponding quarter in the prior year were influenced mainly by the Other expenses/income item due to recording income of approximately NIS 145 million in the corresponding period, which derived from a reduction in the provision in respect of employees' claims.

Financing expenses during the third quarter of 2005 increased by approximately NIS 39 million compared with the corresponding quarter in the prior year. The increase was mainly due to the first-time consolidation.

The behavior of the various income and expense items and the causes of the differences between the quarters are similar to the explanations set out in the results of the period.
The changes described above in the items of the statements of operations brought about net earnings of approximately NIS 103 million in the third quarter, compared with net earnings of approximately NIS 243 million in the corresponding quarter of the prior year.

5. Group involvement in the community and donations

During the period of the account, the Company was active in the community through its involvement in social institutions and organizations such as the education system in distressed areas and the confrontation line.

As part of the campaign launched by the Company to mark the twentieth anniversary of its establishment, the Company made donations to various organizations during the 12 months commencing February 20, 2004. The amount of the monthly donation was the higher of 5% of its call revenues on the twentieth day of each month of its anniversary year, or NIS 200,000. During the period of account the Company donated NIS 231,000 and overall throughout the campaign, a total of NIS 2,792 thousand.

In the "Summer for the Community" campaign, initiated by the Company for the second consecutive year, the teenage children of employees worked during the summer in medical institutions and community centers. The cost of the project to the Company was approximately NIS 1 million.

6. Details concerning exposure to and management of market risks

A. Further to that described in the Directors’ Report for 2004, as a result of hedging transactions against market risks relating to exposure in changes of exchange rates, the Group incurred no material financing expenses or income during the period of report.

B. The report of positions of derivatives as at September 30, 2005, is not significantly different from the report as at December 31, 2004.

C. The report on linkage bases as at September 30, 2005, is not significantly different from the report as at December 31, 2004.

Surplus monetary liabilities over monetary assets denominated in or linked to foreign currency as at September 30, 2005, amounted to approximately NIS 2.6 billion in the Group. As a result of forward currency transactions, the net balance of foreign currency liabilities not hedged as aforesaid as at September 30, 2005, amounts to approximately NIS 503 million.

Surplus monetary liabilities over monetary assets linked to the CPI as at September 30, 2005, amount to approximately NIS 4.6 billion in the Group.

7. Utilization of proceeds from securities

An offer for sale and an issuance to the public pursuant to a prospectus was published on May 24, 2004. The application of proceeds from the offering will be decided by the Company from time to time, in accordance with its requirements, including, taking into account the necessity of replacing loans by early repayment. As at the date of approval of the financial statements there has been no requirement to replace such loans (except for a loan in the amount NIS 5 million which was repaid by the Company before its due date).

8. Miscellaneous

A. Adoption of a Code of Ethics

On April 20, 2005, the Board of Directors of the Company adopted a code of ethics formulated by the Company for business conduct. The code of ethics sets out principles and rules of behavior for guiding the activities of Company officers, managers and employees. The Acting Vice President of Human Resources was appointed compliance officer for the implementation of the provisions of the code of ethics.

B. Peer Review

On July 20, 2005, a directive was published by the Securities Authority requiring disclosure regarding the provision of consent for the performance of a "peer review", the purpose of which, as set out in the directive, is to commence the process of monitoring the performance of accountancy firms. The directive raises questions, including legal issues mainly as to the confidentiality of the material transferred to accountants, and the damage that might be caused to the Company as a result of disclosure of such information. In light of this, the Company, together with its legal counsel, is assessing the matter, including methods of solving the problem of confidentiality, and will present its recommendations for the discussion and approval of the Board.

C. Sale of the Controlling Share

On October 11, 2005, the sale of the controlling interest in the Company and the transfer of the State's share holding to Ap.Sb.Ar. Holding Ltd. was completed. See note 1(f) to the financial statements. With the completion of the transaction, all directors serving on behalf of the State resigned from the Board of Directors and the appointment of the new directors took effect. The new directors were previously approved by the general meeting of shareholders. The external directors who served prior to the completion of the transaction continue to serve on the Board.

D. Directors with Accounting and Financial Skills

Current serving directors with accounting and financial skills are: Yigal Cohen Orgad (external director), Adam Chesnoff, Menachem Inbar, and Stephen Grabiner.

E. Chairman of the Board and Chief Executive Officer

On October 11, 2005, Mr. Moshe Arkin began serving as Chairman of the Board of Directors and Mr. Yacov Gelbard as Chief Executive Officer.

Moshe Arkin Chairman of the Board	Yacov Gelbard Chief Executive Officer