Chapter B of the Periodic Report

Directors Report on the State of the Company's Affairs
For the three months ending March 31, 2007

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 three-month period ending March 31, 2007 (hereinafter: "the Directors' Report").

The Directors' Report contains a review, in condensed form, of the matters dealt with by the board of directors, and is drafted taking into account the fact that the reader of the Report is also equipped with a copy of the Directors' Report for the year ended December 31, 2006.

The Group operates in four 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 Company has an additional area of operations which is not substantial to the Group's operations, and which has been included in the financial statements for March 31, 2007 as a business sector, which mainly includes customer call center services.

The financial statements are drafted in accordance with the International Financial Reporting Standards (IFRS). The financial statements for the first quarter of 2006 have been redrafted in accordance with IFRS. The effect of the transition to reporting in accordance with international standards, on the Company's financial situation and on the results of its operations and cash flows are set out in Note 14 to the financial statements. In order to properly reflect the financial situation of the Group under Israeli accepted accounting rules prior to the transition to IFRS, the Financial Statements of the Group were adjusted by way of restatement as set out in Note 14L to the financial statements.

1. Financial Position

A. The Group's assets, as at March 31, 2007, amount to approximately NIS 15.69 billion, compared with approximately NIS 19.35 billion as at March 31, 2006. Of these, approximately NIS 6.33 billion (approximately 40%) are property, plant and equipment, compared with approximately NIS 7.05 billion (approximately 36%) as at March 31, 2006.

Most of the decrease stems from the fixed-line domestic communications segment. There was a decline in total assets in this segment compared with the previous year, in the sum of approximately NIS 3.18 billion, mainly due to the realization of commercially held financial assets and a reduction in cash balances which were mainly used for the distribution of dividends. 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.

In the cellular segment, the segment's assets decreased from approximately NIS 4.58 billion as at March 31, 2006 to the sum of approximately NIS 4.11 billion as at March 31, 2007. The decrease stemmed mainly from realization of commercially held financial assets used in the payment of dividends and in the repayment of loans, and from a decrease in the depreciated cost of property, plant and equipment. Additionally, there was a reduction in the deferred tax balances due to the utilization of past losses for tax purposes.

In the international communications, internet and NEP services segment, there was an increase in total assets compared with March 31, 2006, mainly due to the merger with BezeqCall which commenced in January 2007.

In the multi-channel television segment, there was a decrease in total assets compared with March 31, 2006, which stemmed mainly from a decrease in the balance of net investments in property, plant and equipment.

B. The shareholders' equity ascribed to the shareholders of the Company as at March 31, 2007 amounted to approximately NIS 4.35 billion, comprising approximately 28% of the total balance sheet, compared with approximately NIS 5.69 billion as at March 31, 2006, which comprised approximately 29% of the total balance sheet. The decrease in shareholders' equity stemmed from a dividend paid in the sum of NIS 2.5 billion. The decrease was partially offset by the Group's net profit and share-based payments to Company employees from its shareholders.

C. The Group's total debt amounted to approximately NIS 7.83 billion as at March 31, 2007, compared with approximately NIS 9.25 billion as at March 31, 2006. The Group's debt to financial institutions and debenture holders as at March 31, 2007 amounted to approximately NIS 7.25 billion, compared with approximately NIS 8.73 billion as at March 31, 2006. The decrease stemmed mainly from payment of liabilities in the cellular segment and in the domestic fixed-line communications segment.

The Company's auditors drew attention to the financial position of DBS, as set out in Note 7A, including the assessment made by management of DBS, based on the budget for 2007 and an alternative business plan, that the chances of arranging the sources of financing required by it in the coming year are good.

D. The Group's cash and other current investment balances as at March 31, 2007 amounted to the sum of approximately NIS 1.88 billion compared with approximately NIS 4.75 billion as at March 31, 2006. The decrease stemmed mainly from the realization of commercially held securities in the cellular segment and in the domestic fixed-line communications segment, which were used in the payment of a dividend in the sum of NIS 3.7 billion, and for payment of liabilities. The decrease was partially offset by cash flow from current operations in the principal segments of the Group's operations.

2. Results of Operations

A. Principal Results

Net earnings ascribed to shareholders of the Company for the first quarter of 2007 amounted to approximately NIS 399 million as opposed to net earnings of approximately NIS 314 million for the corresponding period. The increase in net earnings stemmed mainly from an increase in operating profit and a decrease in financing expenses.

The following are details of changes in the results of the various segments, compared with the corresponding quarter:

Segment	**For the three months ending March 31, 2007 NIS millions profit (loss)**	**For the three months ending March 31, 2006 NIS millions profit (loss)**
Fixed-line domestic communications	369	308
Cellular	213	175
International communications, internet services and NEP	51	35
Multi-channel television	24	(2)
Others	-	-

Basic and diluted earnings per share for the first quarter of 2007 amounted to NIS 0.15 per NIS 1.00 par value compared with a profit of NIS 0.12 per share for the corresponding quarter.

B Revenues

The Group's revenues in the first quarter of 2007 amounted to approximately NIS 3.09 billion compared with approximately NIS 3.01 billion in the corresponding period.

Revenues from fixed-line domestic communications decreased from approximately NIS 1.45 billion in the first quarter of 2006 to approximately NIS 1.44 billion in the reporting period (a decrease of approximately 0.8%). The decrease in the segment's revenues stemmed from a reduction of tariffs as of July 2006, and from a reduction in call traffic. The decrease in revenues was offset primarily by ongoing growth in the number of customers who subscribe to high-speed internet service (ADSL). The Company's auditors drew attention to the continued opening up of the communications sector to competition and the effects of regulation.

Revenues in the cellular segment increased from the sum of approximately NIS 1.09 billion in the first quarter of 2006 to approximately NIS 1.15 billion in the reporting period. The increase stemmed from an increase in revenues from cellular services, following an increase in content revenues and an increase in the number of customers, which was set off mainly by price erosion. In addition, there was an increase in revenues from the sale of terminal equipment, which stemmed mainly from an increase in the quantity of handsets sold and upgraded in the first quarter of 2007.

Revenues in the international communications, internet and NEP services segment increased from the sum of approximately NIS 317 million in the first quarter of 2006 to approximately NIS 323 million in the reporting period. The increase stemmed from an increase in internet revenues and from inclusion of the revenues of the subsidiary Actcom, alongside a decrease in global operations.

Revenues from the multi-channel television segment increased from the sum of approximately NIS 327 million in the first quarter of 2006 to approximately NIS 354 million in the reporting period, as a result of an increase in the number of subscribers and an increase in average revenue per customer.

C. Depreciation and amortization

The Group's depreciation and amortization expenses decreased from the sum of approximately NIS 460 million in the first quarter of 2006 to the sum of approximately NIS 441 million in the reporting period, mainly as a result of a decrease in depreciation expenses due to the end of depreciation of property, plant & equipment and a decrease in investments in new property in the domestic fixed-line communications segment.

D. Salaries

The Group's salary expenses increased from the sum of approximately NIS 567 million in the first quarter of 2006 to the sum of approximately NIS 575 million in the report period, due mainly to an increase in salary expenses in the cellular segment and in the international communications, internet and NEP services segment.

In the domestic fixed-line communications segment, there was no change compared with the corresponding period, due to a reduction in salary expenses on account of retiring employees, which was set off against salary increases.

E. General and Operating Expenses

The Group's general and operating expenses for the first quarter of 2007 amounted to approximately NIS 1.42 billion compared with approximately NIS 1.46 billion during the corresponding period.

Revenues in the domestic fixed-line communications segment decreased from the sum of approximately NIS 566 million in the first quarter of 2006 to approximately NIS 533 million in the reporting period. The decrease stemmed mainly from a decrease in cellular expenses, services and maintenance by sub-contractors and royalty expenses.

In the cellular segment, general and operating expenses increased from the sum of approximately NIS 650 million in the first quarter of 2006 to the sum of approximately NIS 668 million in the reporting period as a result of an increase in costs of terminal equipment due to an increase in the quantity of handsets sold. This increase was set off in part by a decrease in the costs of spare parts and laboratory repairs. Likewise, there was an increase in advertising expenses, which was partially set off by a decrease in expenses for doubtful debts.

In the international communications, internet and NEP services segment, there was a decrease in general and operating expenses from the sum of NIS 201 million in the first quarter of 2006 to the sum of approximately

NIS 189 million in the report period. The decrease stemmed mainly from a reduction in global operations.

Revenues in the multi-channel television segment decreased from the sum of approximately NIS 226 million in the first quarter of 2006 to approximately NIS 219 million in the reporting period, as a result of a decrease in content expenses and in royalty expenses.

F. Other operating expenses (income), net

The Group's net other operating income amounted to approximately NIS 8 million in the first quarter of 2007, compared with net other operating expenses in the sum of approximately NIS 12 million during the corresponding period. The income in the reporting period was due to a decrease in the provision for contingent liabilities and an increase in capital gains.

G. Operating income

The Group's operating income during the first quarter of 2007 amounted to approximately NIS 657 million, compared with approximately NIS 516 million in the corresponding period, an increase of approximately NIS 141 million. The increase in operating income stems from changes in the results of the segments as described above under the revenue and expense items. These changes brought about an increase in operating income in all of the main segments in which the Group operates and a transition from operating loss to operating profit in the multi-channel television segment.

H. Financing expenses, net

The Group's net financing expenses in the first quarter of 2007 amounted to approximately NIS 58 million compared with approximately NIS 82 million in the corresponding period, a reduction of approximately NIS 24 million.
This decrease arises out of a decrease in financing expenses in the cellular segment, stemming from an erosion of CPI-linked loans and a reduction in the number of loans in the segment, and from a reduction in financing expenses in the domestic fixed-line communications segment. The reduction in expenses in this segment stemmed mainly from a reduction in the provision of loans, and from erosion of CPI-linked and Euro-linked loans. Concurrently, financing revenues from capital market investments also decreased due to the realization of investments compared with the corresponding period.

3. Liquidity and sources of financing

The consolidated cash flows from current operations for the first quarter of 2007 amounted to approximately NIS 853 million, compared with approximately NIS 856 million in the corresponding period, a decrease of approximately NIS 3 million. The decrease in cash flows from current operations is due mainly to revenues and expenses which do not involve cash flows, and changes in asset and liability items which were offset by an increase in net earnings for the period.

Cash flows generated by operating activities are the principal source of financing of the Group's investments, which during the reported period included, *inter alia*, approximately NIS 177 million in the development of communications infrastructure, compared with an investment in the sum of approximately NIS 307 million in the corresponding period. During the reported period, the Group realized investments in net financial assets in the sum of approximately NIS 124 million compared with a net investment in the sum of approximately NIS 53 million during the corresponding period.

During the reporting period, the Group repaid debts and paid interest in the total sum of approximately NIS 258 million, of which, approximately NIS 82 million in debentures, approximately NIS 69 million in loans, approximately NIS 32 million in short-term credit, and approximately NIS 75 million in interest payments. During the corresponding period, the Group paid net debt and interest payments of approximately NIS 353 million. In the report period, cash dividends in the sum of NIS 2,100 million were paid.

The monthly average short-term credit average from banks in the first quarter of 2007 amounted to approximately NIS 112 million. The monthly average of long-term liabilities to financial institutions and debenture holders in the first quarter of 2007 amounted to approximately NIS 7,243 million.

The working capital as at March 31, 2007 was negative, and amounted to approximately NIS 2,547 million, compared with negative operating capital as at March 31, 2006, which amounted to approximately NIS 136 million. The decrease stems from the domestic fixed-line communications segment, as a result of an increase in current debenture maturities, a decrease in cash balances and exercise of commercially held financial assets. The decrease was moderated to some extent by an increase in the working capital of the other principal Group companies.

4. Group involvement in the community and donations

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, employees of the Group volunteer for a variety of other communal activities.
During the report period, the Company donated approximately NIS 50,000 to the Council for Children at Risk.
In the project “Children and Parents Study Computer and Internet”, which has been ongoing for some five years, the Company’s employees voluntarily mentor underprivileged parents and children on selected subjects in the field of computers and the internet. The cost of the project, in addition to the hours volunteered by the employees, amounts to approximately NIS 250,000 per year.
The Company’s employees and retirees have set up a charitable association called Halav. The association works together with local councils to locate families in distress, with the aim of providing them with basic food products.

Pelephone has no binding policy regarding donations and its management discusses each case on an individual basis. During the report period, Pelephone donated approximately NIS 8,500 to various associations.

Bezeq International is involved in ongoing operations on behalf of underprivileged communities in Petach Tikva, it adopted “lone” soldiers, adopted a fighting division and participated in projects for special needs children. During the reporting period, Bezeq International's expenses amounted to approximately NIS 125,000.

5. Details Concerning Exposure to and Management of Market Risks

A. Further to the statements made in the Directors’ Report for 2006, hedging transactions against the market risks involved in exposure to exchange rate fluctuations substantially reduced this exposure.

B. The report on positions on derivatives for March 31, 2007 is not very substantially different from the report as at December 31, 2006.

C. Analyses of sensitivity to fair value and the affect of the change in market prices on the fair value of the balance-sheet and off-balance-sheet surpluses in respect of which there are strong contracts as at March 31, 2007, are not very substantially different from the report as at December 31, 2006. It should be noted that there was a decrease in dollar liability exposure to suppliers and a reduction in the sensitivity to changes in securities rates due to the realization of investments mainly used for the payment of dividends.

D. The report on linkage bases for March 31, 2007 is not substantially different from the report as at December 31, 2006.

The Group’s surplus monetary liabilities over monetary assets denominated in or linked to foreign currency as at March 31, 2007 amounted to approximately NIS 1.69 billion. As a result of forward currency transactions as at March 31, 2007, the net balance of foreign currency liabilities not hedged by such forward transactions amounted to approximately NIS 173 million.

Surplus monetary liabilities over monetary assets linked to the CPI as at March 31, 2007 amounted to approximately NIS 4.47 billion in the Group.

The Group’s main segments have hedging policies which reduce CPI exposures caused by tax expenses being calculated on real profit.

6. Disclosure regarding internal auditor in reporting corporation

A. The internal auditor’s procedures were updated and approved by the audit committee of the board of directors on January 4, 2005.

B. During the course of 2006, the internal auditor’s term of office at the Company terminated and an acting replacement was appointed. During 2007, in the framework of the Company's reorganization and streamlining measures, the unit was reduced by another six audit employees.

C. The audit plan approved for 2007 is for 10,000 work hours (compared with the work plan of 12,000 hours in 2006).

D. In March 2007, the audit committee authorized the acting internal auditor to continue in office. The audit committee is taking the necessary steps to appoint a permanent internal auditor.

E. During the course of 2007, CEO and audit committee discussions were held on three audit reports. A further ten audit reports have not yet been discussed by the Company's management and have therefore not been brought up for discussion.

F. As of March 15, 2007, the external director Eyal Yaniv has been acting as chairman of the audit committee.

G. The Audit Committee of the Board of Directors is currently reviewing the entire subject of allotment of the resources required for internal auditing in the Company.

7. Critical Accounting Estimates

The preparation of the financial statements according to international accounting principles obligates 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 estimating values and opinions and additional factors which it believes are relevant, taking into account the circumstances. The actual results can differ from those assessments based on various assumptions and conditions. The main issues of uncertainty regarding critical estimates and considerations involved in implementing accounting policy are similar to those that were implemented in the annual statements (see Note 4 to the Financial Statements). We are of the opinion that these estimates and assessments are critical because any change in the estimates and presumptions has the potential of substantially affecting the financial statements.

8. Miscellaneous

Event subsequent to the date of the financial statements

On March 29, 2007, the board of directors of the Company resolved to appoint Adv. Dr. Yoram Danziger as external examiner to examine the issues arising out of the immediate report of the Company dated March 20, 2007 regarding approval of an option scheme for employees and executives, the immediate report of the Company dated March 26, 2007 regarding approval of grants to officers and the immediate report of the Company dated March 26, 2007 regarding restatement, in accordance with the provisions of letters from the Securities Authority to the Company dated March 25, 2007 and March 28, 2007. The findings of the examiner, and the resolutions of the board of directors as a result thereof, including approval of the CEO's notice of termination of office as CEO of the Company, are set out in Note 16 to the Financial Statements, and in the Company's immediate reports dated April 12, 2007 and April 26, 2007.

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

Dov Weisglass	**Ika Abravanel**
Chairman of the Board of Directors	**Acting CEO**