29 May, 2001

Directors' Report on the State of the Company's Affairs
for the Year ended March 31, 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 three-month period ended March 31, 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 March 2001.

1. The Business Environment

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

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. The license has not yet been utilized, pending the decision requested of the Attorney General on the matter.

   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. It is possible that the principles in this draft will form the basis of a new license that will replace the Company's present license. The Company has submitted its comments on the draft license to the Ministry of Communications.

   c. At the beginning of February 2001 the Ministry of Communications granted a license for operating domestic fixed-line communications services to another company.

   The granting of licenses for providing domestic fixed-line services by means of the cable infrastructure is delayed due to incomplete legislative actions.

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

3. In accordance with 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) to the financial statements.

4. At its meeting on August 27, 2000, the Ministerial Committee for Privatization decided to sell the State's holdings in the Company by way of a private sale which would be accompanied by raising capital for the Company. The sale will include shares comprising at least 50.1% of the Company's share capital. The Companies Authority was authorized to carry out the actions required for implementation of the decision, including actions listed in the decision. It was further decided that if possible, the sale process would end within 9 - 12 months from the date of the decision. The method of privatization as provided in the resolution of the Ministerial Committee was approved on September 6, 2000 by the Knesset Finance Committee. The General Meeting that convened on 30 April 2001 resolved to approve an increase of the registered capital of the Company, and to amend By-Law 64 of the Company's By-laws, in order to enable capital to be raised for the Company in accordance with the privatization resolution.

5. Concerning exercise of a right of first refusal 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 an agreement of principles 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 investment of Bezeq International in the project will be about 20%, with an option to increase its share, on certain terms, to 33% of the joint venture. The parties are supposed to prepare for singing a detailed agreement by June 4, 2001. The Board of Directors of the Company approved an outlay of up to $78 million by the Company for financing the project.

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 communications companies.

2. Details concerning exposure to and management of market risks

In addition to that described in the Directors' Report for the year 2000, as a result of hedging transactions against market risks associated with exposure to changes in exchange rates, the Company sustained no material increases in financing expenses, despite the real devaluation of the shekel against foreign currencies in the report period.

3. Financial position

a. The Group's assets as at March 31, 2001 amounted to approximately NIS 17.3 billion, compared with NIS 16.02 billion on March 31, 2000, of which about NIS 11.15 billion (about 64.4%) are fixed assets, compared with NIS 12.26 billion (about 76.5%) on March 31, 2000. The increase in total assets derived mainly from a rise in the cash balances in investments and long-term debts and in deferred taxes. The rise was offset by the decrease in the depreciated cost of the fixed assets as a result of the difference between depreciation expenses and the investment made during the report period.

b. The Group's shareholders' equity as at March 31, 2001 amounted to approximately NIS 7 billion, which comprised about 40.4% of the total balance sheet, compared with NIS 7.48 billion on March 31, 2000, which comprised about 46.7% of the total balance sheet.

c. Total Group debt to financial institutions and to the holders of its debentures as at March 31, 2001 amounted to approximately NIS 6.77 billion, compared with NIS 6.32 billion on March 31, 2000.

d. The balances of the Group's cash and short-term investments as at March 31, 2001 amounted to approximately NIS 1.33 billion, compared with NIS 573 million on March 31, 2000.

e. The Group's surplus of monetary liabilities over monetary assets in or linked to foreign currencies as at March 31, 2001 amounted to NIS 2.38 billion.

This exposure has an adverse effect on the Group's profitability, due to the costs of hedging. During the report period, the Company made forward currency transactions to reduce the exposure, and plans to continue with this policy.

As a result of the forward currency transactions and the Company's investment in dollar-linked convertible debentures (in connection with the Pelephone transaction described in Note 4(a) to the financial statements), the Company has surplus foreign currency assets over liabilities amounting to approximately NIS 820 million.

f. The Group's surplus of monetary liabilities over monetary assets linked to the CPI as at March 31, 2001, amounts to approximately NIS 2.04 billion. This exposure is partially covered by a tariff update mechanism that takes into account the price rises in the economy.

4. Results of operations

a. Principal results

Net earnings for the first quarter of 2001 amounted to approximately NIS 71 million, compared with a net earnings of about NIS 93 million in the corresponding period last year.

The difference between the results was generated mainly by a decrease of about NIS 74 million (before tax) in the Other expenses/income item. In the first quarter of 2000, this item included income of approximately NIS 90 million (before tax), mainly from the recording of revenues from foreclosing on the bank guarantee of a billing system supplier, as well as income from recording a debt in connection with the Company's investment in India. Eliminating the effects of the other expenses/income item in the two periods, the net earnings for the first quarter of 2001 would be approximately NIS 60 million, compared with about NIS 36 million in the same quarter of the previous year.

A further decline in the Group's profitability derived from a downturn in the financial results of the Company's investee companies.

In contrast, the Group's financing expenses decreased by approximately NIS 79 million.

Earnings per share in the first quarter of 2001 were NIS 0.029 per NIS 1 par value, compared with earnings of NIS 0.04 per share in the corresponding period last year.

b. Revenues

Group revenues in the first quarter of 2001 amounted to approximately NIS 2.03 billion, compared with NIS 2.25 billion in the corresponding period last year, a decrease of about 9.6%. Revenues in the corresponding period last year included revenues from airtime for two months, whereas in the current reporting period, a change in the Company's settlement arrangements with the cellular communication companies exclude airtime revenues. Eliminating airtime, revenues in the corresponding period last year would have been only NIS 1.97 billion. Revenues from domestic fixed-line communications traffic decreased as a result of tariff reductions in May 2000 and March 2001, 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 quarter of 2001 amounted to approximately NIS 1.05 billion, compared with approximately NIS 1.23 billion in the corresponding period last year. The decrease in total expenses resulted mainly from 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 airtime. The Company's wages expenses increased, while sub-contractor expenses decreased, mainly as a result of adding to the payroll workers who were previously employed through manpower companies.

d. Operating income

The Group's operating income in the first quarter of 2001 amounted to approximately NIS 261 million, compared with approximately NIS 256 million in the corresponding period last year, an increase of approximately NIS 5 million. The increase in operating income resulted from the changes described above in income and operating and general expenses items, and as a result of a decrease in the Group's depreciation expenses.

e. Financing expenses

The Group's financing expenses in the first quarter of 2001 amounted to approximately NIS 52 million, compared with approximately NIS 131 million in the corresponding period last year. The decrease in financing expenses derives from the decrease in the Group's monetary liabilities less monetary assets. In addition, as a result of hedging transactions, the rise in foreign currency exchange rates in the period was fully neutralized so that the Company incurred no expense due to differences between the shekel interest rate and the rise in the CPI, as occurred in the corresponding period last year.

f. Other income (expenses)

In the first quarter of 2001, an expense of approximately NIS 16 million (before tax) was recorded in this item, which consisted mainly of a capital gain from the sale of part of the Company's holdings in a satellite communications association. The corresponding period last year includes income of about NIS 82 million from foreclosure on the guarantee of a billing system supplier, as well as income of approximately NIS 23 million from a debt in connection with the Company's investment in India. This item also includes costs incurred by Bezeq International in connection with subscriber allocation.

5. Liquidity and sources of financing

Consolidated cash flows generated by operating activities in the first quarter of 2001 amounted to approximately NIS 826 million, compared with approximately NIS 705 million in the corresponding period last year. The increase in cash flows from current operations resulted primarily from a decrease in payments for financing the retirement of employees and from changes in current assets and liabilities items. The cash flow generated by operating activities is the principal source of the Group's financing, and was used primarily for financing investments in developing telecommunications infrastructures, amounting to approximately NIS 391 million, and for investment in convertible debentures investee of approximately NIS 990 million in connection with the Pelephone transaction, as described in note 4(a) to the financial statements. During the first quarter of 2001, the Company repaid approximately NIS 75 million of long-term loans, NIS 111 million of debentures - a total of approximately NIS 186 million. Conversely, the Group issued other debentures of approximately NIS 501 million and received short-term bank credit of approximately NIS 118 million, so that approximately NIS 619 million was raised in total.

The monthly average of short-term credit for the period was approximately NIS 865 million. The monthly average of long-term liabilities for the period was approximately NIS 5,778 million.
The Group recycles part of the payments for past debts and uses its surplus cash flow for the investment activities. Due to limitations on a single borrower in the local market, the Company is required to borrow considerable sums from foreign sources.

Working capital as at March 31, 2001 was negative, and amounted to approximately NIS 994 million, compared with negative working capital of NIS 1,261 on March 31, 2000. The negative working capital does not limit the Group in is current operations, since the cycle of collection of revenues from customers is short.

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

Ido Dissentshik Chairman of the Board	Ilan Biran CEO