

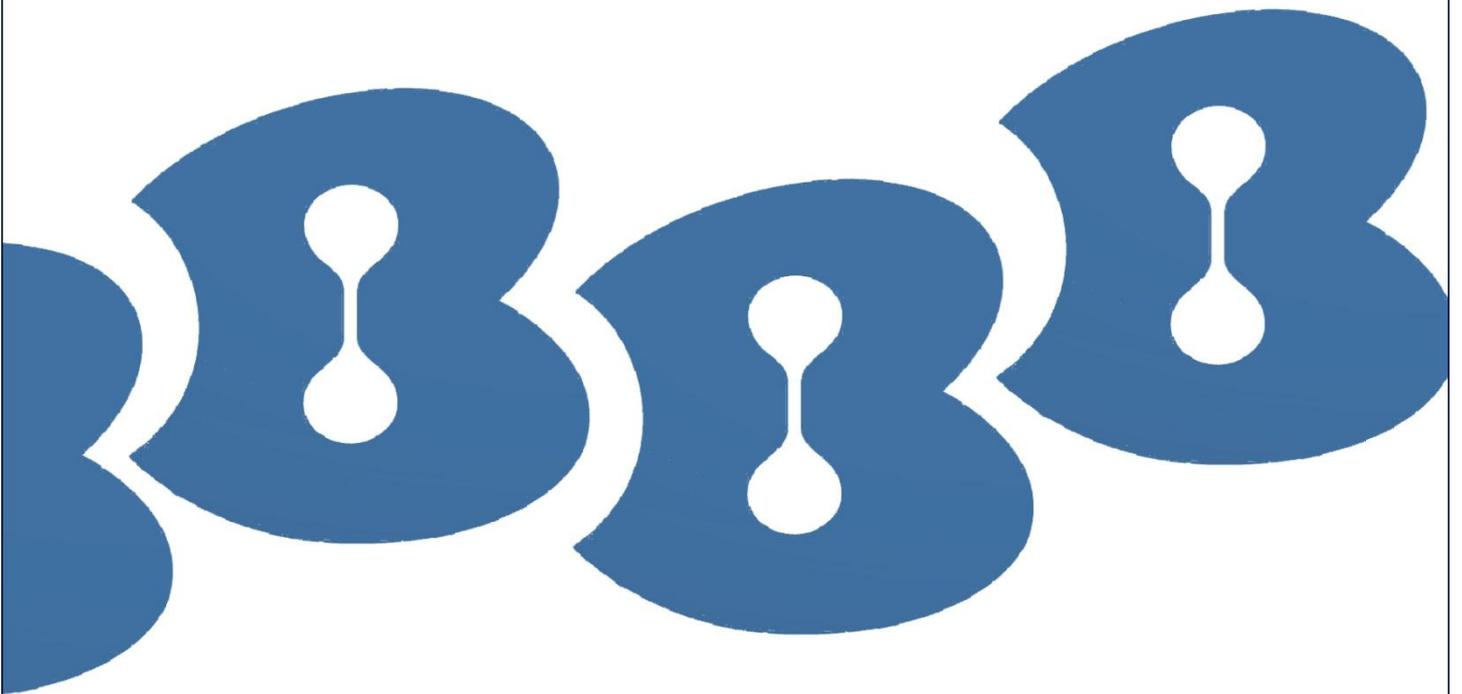
August 1, 2012

# Quarterly report for period ended June 30, 2012

- Update to Chapter A (Description of Company Operations) of the Periodic Report for 2011
- Directors' Report on the State of the Company's Affairs for the period ending June 30, 2012
- Interim Financial Statements as at June 30, 2012



# Update to Chapter A (Description of Company Operations) of the Periodic Report for 2011



**Update to Chapter A (Description of Company Operations) <sup>1</sup>  
of the Periodic Report for 2011 ("Periodic Report")  
of "Bezeq" - The Israel Telecommunication Corporation Ltd. ("the Company")**

**1. Description of the general development of Bezeq Group's business**

**Section 1.1 - Bezeq Group activities and business development**

**Section 1.1.1 – General**

Beginning April 9, 2012, the Company holds all the shares of Walla!, further to completion of a full tender offer for the shares of Walla! held by the public (regarding this, see update to Section 1.1.2).

Following are details of the current holdings in the Company including fully diluted holdings, assuming exercise of all the options allotted to the Group's employees and managers as at June 30, 2012 and July 30, 2012:

Shareholders	Percentage of holdings		
	As at June 30, 2012	As at July 30, 2012	Fully diluted as at July 30, 2012
B Communications (through B Tikshoret) <sup>3</sup>	31.15%	31.15%	30.29%
The public	68.85%	68.85%	69.71%

**Section 1.1.2 - Mergers and acquisitions**

Concerning the full tender offer for Walla! shares - pursuant to publication of the full tender offer for the purchase of all the shares in Walla! held by shareholders from the public, on April 5, 2012 the tender offer was accepted by the majority stipulated in the Companies Law (of the number of shares offered for sale, 12,980,972 shares accounting for 28.45% of the share capital of Walla!, notice of acceptance was provided for 11,371,893 shares, accounting for 24.92% of the share capital of Walla!), and accordingly all the shares of Walla! that were held by the public were acquired, so that subsequent to the acquisition and beginning April 15, 2012, Walla! was delisted from the Tel Aviv Stock Exchange and became a private company wholly owned by the Company. Regarding this, also see Note 4.1 to the Company's consolidated financial statements for the period ended June 30, 2012.

**Section 1.4 - Distribution of dividends**

**Section 1.4.2 - Distribution of a dividend**

On April 24, 2012, the General Meeting of the Company's shareholders (further to a recommendation of the Board of Directors from March 14, 2012), approved the distribution of a cash dividend to the Company's shareholders in the total sum of NIS 1,074 million, which on the determining date for the distribution (May 4, 2012) amounts to NIS 0.3951788 per share and 39.51788% of the Company's issued and paid-up share capital. The dividend was paid on May 21, 2012. Together with this distribution, the third portion of the special distribution, in the amount of NIS 500 million, was paid, which on the determining date for the distribution (May 4, 2012) amounts to NIS 0.1839752 per share

<sup>1</sup> The update is further to Article 39A of the Securities Regulations (Periodic and Immediate Reports), 5730-1970, and includes material changes or innovations that have occurred in the corporation in any matter which must be described in the periodic report. The update relates to the Company's periodic report for the year 2011 and refers to the section numbers in Chapter A (Description of Company Operations) in the said periodic report.

<sup>2</sup> The calculation of full dilution assumes that all the allotted options will be exercised into shares. In view of the mechanism of net exercise of stock appreciation rights in the plan for managers and senior employees of the Group from November 2007 and the employee stock option plan (2010) this assumption is only theoretical, since in practice, the recipients exercising the stock options, will not be allotted all the shares deriving from them, but only shares of an amount that reflects the financial benefit embedded in the stock options.

<sup>3</sup> From the total holdings described above, 3,000,000 shares are held jointly by the Chairman of the Board of Directors, Mr. Shaul Elovitch, and his brother Mr. Josef Elovitch, the Company's controlling shareholders (in concatenation). 72,360 shares are held by Mrs. Iris Elovitch, wife of controlling shareholder Shaul Elovitch, and 11,566 shares are held by Mrs. Orna Elovitch, daughter-in-law of Mr. Shaul Elovitch. These holdings amount to a total of 0.11% of all holdings in the Company.

and 18.39752% of the Company's issued and paid-up share capital (regarding this, also see the update to Section 1.4.3).

The outstanding, distributable profits at the reporting date amount to NIS 997 million.<sup>4</sup>

On August 1, 2012, the Company's Board of Directors decided to make a recommendation to the general meeting of the Company's shareholders (convened for September 6, 2012) to distribute a cash dividend in the total amount of NIS 997 million to the shareholders. The determining date for the distribution is September 23, 2012 and the payment date is October 10, 2012. Together with this distribution (insofar as it is approved), the fourth portion of the special dividend in the amount of NIS 500 million will be distributed, as specified in the update to section 1.4.3, and the distribution dates for the current dividend (the determining date and payment date) will also be relevant for this distribution.

#### **Section 1.4.3 - Distribution that is not in compliance with the earnings test**

On March 29, 2012 and on April 4, 2012, two objections were filed in the Economic Department of the Tel Aviv District Court to the continuation of payments in respect of the distribution which is not in compliance with the earnings test which was approved by the same court on March 31, 2011. The motions were filed by two holders of Debentures (Series 5) of the Company who had also filed a similar objection in 2011 and an application to be included therein as detailed in the Periodic Report for 2011. The Company submitted its response to the objections, rejecting the arguments detailed in the objections, and requesting the court to dismiss the objections in limine and in substance. On May 14, 2012, the court decided to dismiss the aforementioned objections, and as requested by the Company, on May 22, 2012, the court stated that as per its decision from May 14, 2012, there is no need for the Company to apply to the court before payment of each of the remaining portions (three portions) of the special dividend, which the court approved on March 31, 2011. The Company therefore intends to continue to pay the distributions as it has in the past, while reviewing its compliance with the earnings test prior to the payments, and without this review necessitating any further application by the Company to the court. Regarding this, also see the Company's Immediate Report dated May 15, 2012, and supplementary immediate reports to this report dated May 21, 2012, May 22, 2012, and May 30, 2012, presented here by way of reference.

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<sup>4</sup> Subject to complying with the distribution tests.

## Section 1.5 - Financial information concerning Bezeq Group's operations

### Section 1.5.4 - Principal results and operational data

#### B. Bezeq Fixed Line (the Company's operations as a domestic carrier)

	Q2 2012	Q1 2012	Q4 2011	Q3 2011	Q2 2011	Q1 2011
Revenues (NIS millions)	1,161	1,199	1,114	1,186	1,170	1,178
Operating profit (NIS millions)	437	539	384	546	517	211
Depreciation and amortization (NIS millions)	178	178	175	180	171	162
EBITDA (NIS millions) (7)	615	717	559	726	688	373
Net profit (NIS millions)	263	348	301	311	330	123
Cash flow from operating activities (NIS millions)	376	651	550	641	496	419
Payments for investments in property, plant & equipment and intangible assets (NIS millions) (6)	238	269	259	268	319	319
Proceeds from sale of property, plant & equipment and intangible assets (NIS millions) (6)	22	46	40	68	48	72
Free cash flow (NIS millions) (1)(8)	160	428	216	441	225	287
Number of active subscriber lines at end of period (in thousands) (2)	2,335	2,368	2,367	2,363	2,356	2,358
Average monthly revenue per line (NIS) (ARPL) (3)	73	74	70	78	77	79
No. of outgoing minutes (millions)	2,228	2,359	2,340	2,481	2,415	2,521
No. of incoming minutes (millions)	1,518	1,543	1,526	1,602	1,535	1,577
No. of internet subscribers at end of period (thousands) (2)	1,136	1,121	1,111	1,100	1,088	1,079
Ratio of subscribers using NGN services out of total Internet subscribers connected to the NGN network (%) (4)	57%	55%	51%	47%	43%	40%
Average monthly revenue per internet subscriber (NIS)	80	84	81	81	80	79
Average bandwidth per internet subscriber (Mbps)	8.3	7.5	6.7	6.0	5.3	4.8
Churn rate (5)	3.8%	3.1%	2.7%	2.7%	2.7%	3.2%

- (1) Cash from operating activities less purchase of property, plant and equipment, and intangible assets, net.
- (2) Inactive subscribers are subscribers whose Bezeq lines have been physically disconnected (except for a subscriber during (approximately) the first three months of the collection process).
- (3) Excluding revenues from transmission services and data communication, Internet services, services to communications operators and contractor and other works. Calculated based on the average lines for the period.
- (4) The numbers for 2011 and the first quarter of 2012 were corrected due to the revised number of internet subscribers connected to the NGN network, as a result of data optimization.
- (5) The number of telephony subscribers who left Bezeq Fixed Line during the period divided by the average number of registered telephony subscribers in the period. The numbers for 2011 are presented after correction of an insignificant accounting error of 0.1% per quarter.
- (6) Excluding the purchase and sale (Back to Back) of a real-estate asset in the amount of NIS 115 million during 2011.
- (7) EBITDA is a financial index which is not based on GAAP. The Company presents this index as an additional index for estimating its business results, as it is an accepted index for company activities which disregards aspects arising from variance in the equity structure, various taxation perspectives, and the manner and period of the depreciation of property plant and equipment and intangible assets. This index is not a substitute for indices which are based on GAAP and it is not used as a sole index for estimating the results of the Company's activities or cash flows. Additionally, the index presented in this report may not be calculated in the same manner as parallel indices among other companies.
- (8) Free cash flow is a financial index which is not based on GAAP. Free cash flow is defined as cash from operating activities less cash for the purchase/sale of property, plant and equipment, and intangible assets, net. The Company presents free cash flow as an additional index for estimating business performance and cash flows, given that the Company is of the opinion that the free cash flow is an important liquidity index which reflects the Company's cash from its operating activities after the investment of cash in infrastructure, property plant and equipment and in other intangible assets.

C. Pelephone

	Q2 2012	Q1 2012	Q4 2011	Q3 2011	Q2 2011	Q1 2011
Revenues from services (NIS millions)	857	834	849	914	925	949
Revenues from the sale of terminal equipment (NIS millions)	291	410	390	507	513	501
Total revenues (NIS millions)	1,148	1,244	1,239	1,421	1,438	1,450
Operating profit (NIS millions)	259	267	262	342	357	399
Depreciation and amortization (NIS millions)	137	135	140	139	143	139
(EBITDA)(NIS millions)(1)	396	402	401	481	500	539
Net profit (NIS millions)	194	216	204	263	279	310
Cash flow from operating activities (NIS millions)	556	294	223	168	101	308
Payments for investments in property, plant & equipment and intangible assets, net (NIS millions)	109	115	92	71	86	133
Free cash flow (NIS millions) (1)	447	179	131	97	15	175
Number of subscribers at end of period (thousands) (2), (6)	2,859	2,876	2,847	2,842	2,827	2,861
Average number of minutes per subscriber per month (MOU) (3), (6)	409	399	384	385	370	359
Average monthly revenue per internet subscriber (NIS) (ARPU) (4), (6)	99	97	100	107	109	110
Revenues from value added services (included in revenues from services) (NIS millions)	312	307	311	310	297	283
Revenues from value added services as percentage of revenues from cellular services	39.0%	39.6%	39.5%	36.3%	34.5%	32.1%
Churn rate (5), (6)	6.0%	3.9%	5.3%	6.1%	6.6%	5.0%

- (1) Regarding the definition of EBITDA and free cash flow, see comments (7) and (8) in the Bezeq Fixed Line table.
- (2) Subscriber data includes Pelephone subscribers (excluding subscribers to other operators who are hosted on the Pelephone network), and does not include subscribers connected to Pelephone services for six months or more but who are inactive. Inactive subscribers are those who in the past six months have not received or made at least one call or have not paid for Pelephone services.
- (3) Average monthly use per subscriber in minutes. The index is calculated by the average monthly total outgoing minutes and incoming minutes in the period, divided by the average number of subscribers in the same period.
- (4) Average monthly revenue per subscriber. The index is calculated by dividing the average total monthly revenues from cellular services, from Pelephone subscribers and other telecom operators, including revenues from cellular operators who use Pelephone's network (from which revenues began in 2012), repair services and warranty in the period, by the average number of active subscribers in the same period.
- (5) The churn rate is calculated according to the ratio of subscribers who disconnected from Pelephone's services and subscribers who became inactive during the period to the average number of active subscribers during the period.
- (6) In the report for 2011, due to greater movement of subscribers to prepaid tracks in the initial months after the reduction of the disconnect fees, Pelephone decided not to include subscribers who had not made calls during the fourth quarter as active subscribers. Consequently, Pelephone deleted 91,000 subscribers. These subscribers were deleted retroactively from each quarter in which they were transferred to prepaid tracks. As a result of the foregoing, data for subscribers, ARPU, MOU and churn rates were amended retroactively in each quarter of 2011.

D. Bezeq International

	Q2 2012	Q1 2012	Q4 2011	Q3 2011	Q2 2011	Q1 2011
Revenues (NIS millions)	330	332	342	351	332	329
Operating profit (NIS millions)	53	50	59	61	60	61
Depreciation and amortization (NIS millions)	34	34	31	28	26	24
(EBITDA)((NIS millions)(1)	87	84	89	89	87	85
Net profit (NIS millions)	39	36	44	46	46	46
Cash flow from operating activities (NIS millions)	64	58	76	57	68	42
Payments for investments in property, plant & equipment and intangible assets, net (NIS millions)(2)	36	71	103	92	47	46
Free cash flow (NIS millions) (1)	28	(13)	(27)	(35)	21	(4)
Churn rate (3)	4.1%	4.3%	3.7%	3.2%	2.8%	2.9%

(1) Regarding the definition of EBITDA and free cash flow, see comments (7) and (8) in the Bezeq Fixed Line table.

(2) This item also includes long-term investments in assets.

(3) The number of internet subscribers who left Bezeq International during the period divided by the average number of registered internet subscribers in the period.

E. DBS

	Q2 2012	Q1 2012	Q4 2011	Q3 2011	Q2 2011	Q1 2011
Revenues (NIS millions)	409	417	404	405	404	406
Operating profit (NIS millions)	74	52	106	63	65	61
Depreciation and amortization (NIS millions)	54	66	62	74	71	69
(EBITDA)((NIS millions)(1)	128	118	168	137	136	130
Net profit (loss) (NIS millions)	(107)	(64)	7	(76)	(88)	(73)
Cash flow from operating activities (NIS millions)	100	116	119	134	119	141
Payments for investments in property, plant & equipment and intangible assets, net (NIS millions)	69	56	62	67	64	71
Free cash flow (NIS millions) (1)	31	60	57	67	55	70
No. of subscribers (at end of period, thousands) (2)	582	585	586	585	581	580
Average monthly revenue per subscriber (ARPU) (NIS) (3)	234	237	229	232	232	234
Churn rate (4)	3.9%	3.6%	2.8%	2.8%	2.9%	3.3%

(4) Regarding the definition of EBITDA and cash flows, see comments (7) and (8) in the Bezeq Fixed Line table.

(5) Subscriber - a single household or small business customer. In the event of a business customer with multiple reception points or a large number of decoders (such as a hotel, collective community settlement, or gym), the number of subscribers is calculated by dividing the total payment received from the business customer by the average revenue from a small business customer.

(6) Average monthly revenue per subscriber is calculated by dividing DBS's total revenues (revenues from content and equipment, premium channels, technical service, advanced products, one-time sale of content, revenues from channels, internet and other) by the average number of customers.

(7) Number of DBS subscribers who left DBS during the period divided by the average number of registered DBS subscribers in the period.

## Section 1.6 - Group forecast

As a result of the increased level of competition in the cellular market, the Bezeq Group is updating its full year Group financial guidance accordingly. The Group's forecast for 2012 is:

- Revenues: NIS 10.2 - 10.5 billion.
- Net profit for the shareholders: NIS 1.75 - 1.85 billion.
- EBITDA: NIS 4.4 - 4.5 billion.

The Group expects free cash flow to improve materially during 2012 compared to 2011 and to amount to above NIS 2.5 billion. This is primarily due to the improvement in working capital and the progress made in large infrastructure projects.

The Group is prepared to compete with the challenges in the industry and is implementing streamlining measures which are expected to reduce the impact of the cellular segment on the Bezeq Group. These measures are expected to influence the Group's operations in the short to medium term.

**The Company's forecasts in this section are forward-looking information, as defined in the Securities Law, which are based on the Company's assessment of, among other things, the structure of competition in the communications market and the applicable regulation, the economic situation in the country as a whole, the Company's investments, and that there will be no further employee retirement plans this year, other than those that have been discussed and approved. Actual results may differ significantly from the aforementioned if any of the above assessments do not materialize or insofar as one or more of the risk factors listed in Sections 2.21, 3.24, 4.22 and 5.22 of the chapter - Description of Company Operations in the Periodic Report for 2011 materialize.**

### **Section 1.7 - General environment and the impact of outside factors on the Group's activity**

In recent months, competition in the telecommunications industry, particularly in cellular telephony, has become stronger (with the entry of the new operators - Golan Telecom and Hot Mobile), with comprehensive service packages and communications packages being offered for a fixed price with unlimited use. The strengthening of this competition has led to lower prices, increased movement of customers and higher churn rates (in fixed-line services, also due to cancellation of the charge for the ADSL only service), and this in turn has affected the Group's results. In an effort to limit the impact on performance, the companies are introducing streamlining measures as well as various moves to improve the services they provide and to differentiate themselves from their competitors.

#### **Section 1.7.2 - Activities of Bezeq Group as a communications group and the structural separation restriction**

Sub par. B - Easing of structural separation - joint service bundles- on July 3, 2012, the Company's license was amended so that it is also permitted to offer business subscribers joint service bundles with the subsidiaries, subject to their approval by the Ministry of Communications, and subject to the unbundling conditions specified in sub-par. B above. The marketing of joint service bundles to the business sector by the subsidiaries, which include the Company's services, is also subject, according to their licenses, to similar restrictions, including unbundling. This excludes a bundle which is marketed by a subsidiary and only consists of the Company's internet services; additionally, pursuant to the Ministry's clarification in the hearing decision document, the Ministry does not view the amendment to the licenses as a change in the previously existing practice, with respect to the ability of ISPs belonging to the Group and others outside the Group to offer business customers the ISP component as well as the Company's infrastructure which is purchased as an input, without this being considered a "joint service bundle".

#### **Section 1.7.3 - Regulatory oversight and changes in the regulatory environment**

Sub-section A - Policy for regulating competition - Hayek Commission

On May 2, 2012, the Ministry of Communications published a policy document on the expansion of competition for fixed-line communications - wholesale market, according to which the Minister of Communications ("the Minister") adopted the key recommendations of the "Committee for reviewing and revising Bezeq's rate structure and setting wholesale service tariffs for fixed-line communications", headed by Amir Hayek CPA ("Hayek Committee"), in the manner specified in that document which was included in the Company's Immediate Report dated May 2, 2012, presented here by way of reference.

Following are the main points of the policy document:

1. Owners of universal fixed-line access infrastructures who provide retail services, including the Company, will be obligated to sell wholesale services to holders of telecommunications licenses, including Bitstream Access, lease of access segments, dark fibers, tubes and transmission services, on a non-discriminatory basis and with no discounts for size. In this regard, a procedure was established whereby an agreement for these services will be negotiated and as soon as such agreement is signed, the infrastructure owner will publish a shelf offering for sale of the services based on the agreement and which also includes additional services as the Ministry determines from time to time ("the Shelf Offering"). In certain

circumstances, the Minister has the power to stipulate conditions or prices for the services. The infrastructure owners must submit to the relevant license owners the distribution of their existing infrastructures, with exceptions to be defined.

2. Upon publication of the shelf offering, corporations with an interest in the infrastructure owner may also purchase wholesale services from it, without discrimination. The Company will be able to provide wholesale telephony services to its subsidiaries that are not supplied over a broadband network, provided that these services are also available to everyone and without discrimination.
3. Within 9 months of publication of the shelf offering, the Minister will order elimination of the structural separation between the infrastructure provider who published the aforementioned offering and the international call providers and ISPs), replacing it with accounting separation (unless the Minister believes that this will adversely affect competition or the public interest), so that the Company will be able to offer subsidized plans. Furthermore, insofar as the wholesale market develops and the degree of competition based on joint service bundles that combine fixed-line and mobile services in the private sector (according to indices or conditions stipulated by the Minister) allows this, the Minister will consider an easing or cancellation of the structural separation between an infrastructure provider and a cellular operator who has an interest in the said provider.
4. The Minister will review the subject of the unbundling of broadcast services included in the joint service packages, which also include Bezeq services (fixed or mobile) or broadband access services. The structural separation between the infrastructure providers and multi-channel TV area will be eliminated by granting suppliers without nation-wide fixed-line infrastructure a reasonable possibility to provide a basic TV service package over the internet.
5. If no wholesale market develops in the correct manner (based on indices to be defined for this purpose) within 24 months of the publication of the policy document, the Minister will take action to implement structural separation between the infrastructure and the services provided by general domestic carrier license holders.
6. Within six months of publication of the shelf offering, the Minister will take action to change the method of oversight of the Company's prices so that prices will be controlled by the setting of a maximum price.
7. Within 9 months, the Ministry of Communications will formulate regulations aimed at increasing the investment in and upgrading fixed-line communications infrastructure in Israel.

At this stage, the Company is unable to estimate the effect of the policy document on its business performance.

On June 12, 2012, the Ministry of Communications began to convene an engineering forum of the operators regarding wholesale services, which discusses, inter alia, a service portfolio for providing certain service configurations. This is concurrent with negotiations that the Company is conducting directly with the different operators.

Sub-par. B - Increase in the rate of royalties - on July 24, 2012, the Ministers of Finance and Communications signed the amendment to the Royalties Regulations which is relevant for the Company, Pelephone, DBS, BIP and Bezeq International, so that the rate of royalties for 2012 will be reduced on average to 1.75% for the Company and DBS, to - 1.3% for Pelephone, (the rate of royalties for Bezeq International and BIP is 1%), and from 2013 it will be 0% for all of them.

Sub-par. D – Limitation of the exit penalty that a license-holder can collect from a subscriber - concerning cancellation of exit fees on mobile telephony networks, see update to Section 3.7.2(D).

Sub-par. F - Enforcement and financial sanctions - concerning government bills to amend the Communications Law, the Protection of Privacy Law and the Antitrust Law which address enforcement and the imposition of financial sanctions - on May 14, 2012, an amendment to the Antitrust Law was published on this subject. On July 24, 2012, a second and third reading of the amendment to the Communications Law were passed by the Knesset. The other bills are in the advanced stages of legislation.

#### **GBE connection (Gigabit Ethernet) for ISPs**

On June 26, 2012, the Ministry of Communications published a hearing asking for the operators' comments on changes in the existing regulations for connecting ISPs to the Company's network and to the Hot Telecom network, whereby the "high-speed access by means of internet providers" (the Company's XDSL) portfolio, and Hot Telecom's "broadband access for ISPs" portfolio, will be

amended so that these services will include all the necessary components for providing those buying the service with surfing speed, including conveying traffic on the core and access networks, and payments imposed on the ISPs for GBE will be eliminated. The infrastructure owners will price the internet access services for the end customers, including the GBE segment, and excluding the P2P transmission segment which connects networks with infrastructure to the ISPs' facilities, which will be priced separately. Likewise, the infrastructure owners will be obligated to provide GBE connections at a speed to be derived from the "load ratio" (the ratio between the volume of GBE connections provided to the supplier and the scope of the aggregate speeds ordered by all the supplier's subscribers) as the Ministry determines from time to time. At present, the Ministry is of the opinion that the appropriate load ratio is 5%. The Company objects to this change, which is far from the norm in the telecommunications industry, and believes that the hearing and the proposed arrangement contain administrative flaws and are unreasonable. Submission of a response to the hearing has been scheduled for August 8, 2012.

## **2. Domestic fixed-line communications; "Bezeq" - The Israel Telecommunication Corporation Ltd. ("the Company")**

### **Section 2.6.4 - Additional factors that could influence competition**

Sub-section B - regarding the process of choosing an investor for a communications venture with IEC, as far as the Company is aware, the scheduled date for submittal of basic offers (April 23, 2012) was postponed and the participants will receive notice of the new date in due course.

### **Section 2.9.6 - Compensation plans for employees**

Sub-section A - on March 24, 2012, five years after the end of the allotment period, the stock options plan from 2007 came to an end (as part of this plan, 78,107,470 options were exercised).

### **Section 2.7.3 - Computerization (and Section 2.10.3 - Dependence on suppliers, and Section 2.19.4 - Main projects, planned and in progress)**

Concerning sub-par. D, Company-wide systems -, on July 2, 2012, the Board of Directors of the Company decided to terminate the Oracle based CRM system integrated with Matrix, while continuing to use modules that have already been developed and which can still be utilized. The Company is reviewing alternatives to this system. Regarding this, see also Note 13.2 to the Company's consolidated financial statements for the period ended June 30, 2012.

### **Section 2.7.4 - Real estate (and also Section 2.20 - Forecast for developments in the coming year)**

Sub-par. E - concerning negotiations to acquire a plot slated for the construction of offices and communications facilities to replace the existing offices that are currently rented for the Group's companies - on July 2, 2012, the Company's Board of Directors decided to stop the negotiations to acquire the aforementioned plot. The Company intends to continue to examine various alternatives, including rental, to house the offices and communications facilities for the Group's companies.

### **Section 2.9.7 - Officers and senior management in the Company**

On April 24, 2012, Mr. Yehuda Porat's service as an employee director came to an end.

### **Section 2.10.3 - Dependence on suppliers concerning CRM, see update to Section 2.7.3 above.**

Concerning dependence in the area of supply service systems on Anubex NV, which supplied the Company with an open work environment allowing systems that were converted from the MF systems to work in an open environment - the Company is no longer dependent on this company.

### **Section 2.11 - Working capital**

At June 30, 2012, the Company has a working capital deficit in the amount of NIS 987 million (this figure refers to the Company's separate financial statements. In the Company's consolidated financial statements as at June 30, 2012 there is working capital surplus in the amount of NIS 642 million). On August 1, 2012, the Company's Board of Directors determined that despite its deficit in working capital, the Company does not have a liquidity problem. See par. 1.4 of the Board of Directors' Report.

### **Section 2.13.2 - Limitations on credit obtaining**

Sub-par. A - Limitations included in the Company's loans - as at the date of the financial statements and as at the publication date of this report, the Company is in compliance with all the applicable limitations.

### **Section 2.13.6 - Credit rating**

On July 4, 2012, the Company received notice from Standard & Poor's Maalot reaffirming the current Company ratings of AA+/Negative Outlook and its debentures AA+. <sup>5</sup>

On July 19, 2012, the Company received notice from the rating agency Midroog Ltd., which rates the Company's debentures (Series 5, 6, 7, 8), that it had downgraded these debentures (Series 5, 6, 7, 8) from Aa1/Negative Outlook, to Aa2/Stable Outlook.

### **Section 2.16.2 – The Company's domestic carrier license**

Sub-par. C - Tariffs - on May 31, 2012, the Communications Regulations (Telecommunications and Broadcasts) (Calculation and linkage of Bezeq payments) (Amendment), 2012, was published which includes a Temporary Provision according to which the payments will not be updated on June 1, 2012, and that the update of tariffs to be made in June 2013, will include an aggregate update for the last two years.

### **Section 2.16.9 - The Telegraph Ordinance**

Concerning the termination of the claim filed by the State authorities regarding radio frequencies in the Administered Territories, see the update to Section 2.18.6.

### **Section 2.17.1 – Material agreements concerning debentures**

Section A - Deed of trust for Debentures (Series 5) - on March 21, 2012, the appointment of Hermetic Trust Services (1975) Ltd. ("Hermetic") was approved as the trustee for Debentures (Series 5) of the Company, replacing Mizrahi-Tefahot Trust Company Ltd., and accordingly from that date Hermetic serves as the trustee for the aforementioned debentures.

### **Section 2.18 – Legal proceedings**

Section 2.18.1(B) - regarding a claim and application for its certification as a class action that was filed by a former employee of the Company concerning the inclusion of wage components, on April 29, 2012 the Tel Aviv Regional Labor Court handed down a ruling striking out the application and the application for certification as a class action, upon the plaintiff's request and further to the court's recommendation.

Section 2.18.3 - regarding two claims and applications for their certification as class actions claiming unlawful collection of money in cases of disconnection due to non-payment - one claim (claim from February 2011 in the amount of NIS 44 million) and an application for its certification as a class action were dismissed in limine on March 28, 2012, at the Company's request. On May 8, 2012, an appeal was filed against the ruling.

Section 2.18.5 - regarding a claim filed and an application for its recognition as a class action concerning subscribing to call tracks for a fixed monthly payment - in June 2012 the court approved publication of a compromise settlement reached by the parties at a cost of NIS 6.5 million to the Company, and instructed that the settlement be sent to the relevant parties before it hands down the verdict.

Section 2.18.6 - regarding a claim filed by the State authorities for payment of frequency fees in the Administered Territories in the amount of NIS 74 million - on April 2, 2012, a compromise settlement between the parties to the procedure was validated as a court ruling, in which the Company will pay the plaintiffs the total amount of NIS 26 million (plus CPI linkage from February 11, 2010).

Section 2.18.8 - regarding an application to approve a derivative claim against directors of the Company concerning the taking of loans, which as alleged in the application were not used for the Company's benefit and were designated for the distribution of dividends - on June 14, 2012, the court

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<sup>5</sup> The same notice also included confirmation of the rating for Pelephone and its debentures. Regarding this, see the update to Section 3.15.5.

decided to dismiss the application in limine after ruling that the applicant in this procedure is not a "shareholder" of the Company and he is therefore not entitled to file a derivative claim in the Company's name. Subsequently, on July 15, 2012, a new application to approve a derivative claim was filed in the Tel Aviv District Court (Economic Department) by the father of the applicant whose application had been dismissed in limine, (against directors of the Company, the CEO, Deputy CEO, and the CFO of the Company) on the same subject.

It should be noted that on July 4, 2012, a new request for exhaustion of the Company's rights was received by way of the filing of an action prior to applying to the District Court to approve a derivative claim the subject of which is similar to this application. The Company has not yet responded to this request.

Section 2.18.10 - regarding an application to approve a distribution that is not in compliance with the earnings test, see the update to Section 1.4.3.

Section 2.18.15 - regarding a claim by a group of pensioners of the Company from September 2000 which was dismissed by the District Labor Court on December 16, 2008 and an appeal on the case which was dismissed by the National Labor Court on December 21, 2011 - on July 25, 2012, the Company received a petition to the High Court of Justice for the issue of an order nisi against the National Labor Court and the Company, in which the plaintiffs are petitioning to revoke the ruling and decisions of the National Labor Court. According to HCJ's decision, the company must file a preliminary response to the petition.

### **3. Mobile radio-telephone (cellular telephony) - Pelephone Communications Ltd. ("Pelephone")**

#### **Section 3.1.5 A - Technology changes that can affect the area of operation**

According to the Ministry of Communications plan for 2012, which was published in March 2012, the ministry will work to allocate Generation 4 frequencies (LTE).

#### **Section 3.7.2 - Regulatory moves and legislative amendments for increasing competition in the cellular area**

In May 2012, Golan Telecom Ltd. and Mirs Communications Ltd. under the brand Hot Mobile ("the New Operators"), launched their operations. The entry of the New Operators immediately caused much stronger competition in the cellular market between all the cellular operators. After launching their operations, the New Operators offered customers cellular communications packages which are significantly cheaper than the packages offered by the cellular operators who were in the market prior to the launch. Like the other cellular operators, Pelephone responded to this new competition by launching new packages which reflect a substantial decline in income per subscriber.

As part of the competitive measures, Partner launched a discount brand called 012mobile, and Cellcom launched a communications package offering a combination of cellular communications, fixed-line communications internet and international calls.

As part of the competition, in the second quarter of 2012 "unlimited" communications packages were offered for the first time. In these packages, the subscriber pays fixed usage fees and is entitled to make unlimited use of the services. These packages are the principal packages currently being offered on the cellular market, alongside the basic packages which include low usage fees, if any, allowing customers to use the services up to a certain amount, and beyond this limit they are charged according to their excess consumption. The new packages have intensified the trend of buying a "SIM Only" package - i.e. a communications package that does not include buying a handset. Pelephone expects sales of terminal equipment to decline even further .

This more intense competition has led to a higher churn rate and significantly lower prices for communications packages for thousands of subscribers. The ARPU data and churn rate for the second quarter of 2012, reflect the trends described above to some extent.

Pelephone expects these trends to continue, leading to a significant erosion of revenues and profitability. Pelephone is introducing streamlining measures in an effort to reduce the impact on profit.

Pelephone's aforementioned estimates are forward-looking information, as defined in the Securities Law. These estimates may not materialize, may materialize in part or may materialize in a manner materially different from that forecast.

### Section 3.7.2 D - Increased competition and the removal of barriers to switching among operators

Pursuant to the approval of the Knesset Economic Affairs Committee, on March 21, 2012, the Knesset approved the amendment to the Communications Law according to which:

1. Exit penalties will be eliminated as specified in the Periodic Report for 2011.
2. A license holder will not make a subscriber's commitment to receive cellular services dependent on that subscriber's agreement with it or with any other license holder to purchase, rent, borrow or lease terminal equipment, either in one agreement or in separate agreements, including by way of providing a discount or any other benefit in one agreement that is dependent on the other agreement. The Amendment will take effect on January 1, 2013. The Minister of Communications has the power to postpone the applicability date by six months. The principal sales method currently applied is to offer discounts on the price of the services that are dependent on the terminal equipment in the customer's possession. From the validation of this amendment, it will no longer be possible to offer such benefits. Elimination of the connection between communications service agreements and the sale of terminal equipment, may affect the volume of the sale of terminal equipment by Pelephone.

In June 2012, the Knesset Economic Committee approved a reform of the import of cellular devices regarding the removal of barriers on the import of cellular devices. At the request of the Ministry of Defense, a further discussion of the reform will take place on security perspectives only. The reform includes two alleviations which are exemption from obtaining a trade license and exemption from obtaining class approval for the import of cellular devices that comply with accepted European and American standards. The reform will become valid 30 days after its publication in the Official Gazette, after final approval by the Knesset Economic Committee. Pelephone estimates that implementation of the reform may increase competition in the terminal equipment market.

### Section 3.15.2 - Restrictions

Sub-section A - Liabilities towards banks - pursuant to legal position 104-15 of the Securities Authority from October 30, 2011, following are further disclosures in connection with compliance with financial covenants of reportable credit:

Financial covenants to which Pelephone is obligated:	As at June 30, 2012	Maximum required ratio
Pelephone's total debts will not exceed 3 times its equity.	0.67	3.00
Total debts are not to exceed NIS 3.8 billion (linked to the CPI known in January 2002. As at December 31, 2012 = NIS 4.87 billion).	2.06	4.87
Liability to a particular bank that debts to it will not exceed 40% of Pelephone's total cumulative debts to financial entities including debenture holders.	13.7%	40%

### Section 3.15.5 – Credit rating

In July 2012, Standard & Poor's Maalot, which rates Pelephone's debentures, announced that it is reaffirming the local rating of Pelephone's debentures at AA+/Negative Outlook.

### Section 3.18.4 – Site construction licensing

In May 2012, Pelephone and the other old operators filed an application to cancel and alternatively to limit the temporary injunction prohibiting the construction of wireless access facilities that are exempt from a building permit. Concurrently, the New Operators also filed applications to extend the validity of the limit to the temporary injunction. HCJ held a hearing on this matter and instructed all parties to respond to the applications prior to making a decision.

### Section 3.21 – Legal proceedings

Section 3.21.1(A) – regarding a claim filed by the State of Israel with the Central Region District Court in respect of a request for royalties in the amount of NIS 260 million, and the appeal which Pelephone filed in the Supreme Court on the amount of the charge – on August 1, 2012, the appeal was dismissed.

Section 3.21.1(C) - regarding a claim filed in December 2007, in the Tel Aviv District Court against Pelephone, Cellcom and Partner, together with an application for its certification as a class action in the amount of NIS 1 billion, which relates to radiation damage from cellular antennae which were

ostensibly erected unlawfully - in June 2012, the Court approved the plaintiff's abandonment of the action.

Section 3.21.1(D) - regarding a claim and application for its recognition as a class action in the amount of NIS 240 million, which was filed against Pelephone in July 2008, alleging, inter alia, the collection of payment for standing orders, ostensibly in contravention of Pelephone's license - in May 2012, an additional claim was filed in the Tel Aviv District Court and an application for its recognition as a class action in the amount of - NIS 74 million, alleging the same cause of unlawful billing for payment by standing order, but immediately afterwards the plaintiff abandoned the claim in view of the previous proceeding on the same matter.

Section 3.21.1 (I) - regarding a claim and application for its certification as a class action in the amount of NIS 285 million, which was filed against Pelephone in November 2011 and alleged that Pelephone recorded service conversations by Pelephone customers at the service stations without their knowledge and without terminating the recording when the representative was not with them, thus infringing on their right to privacy - in April 2012, the court decided to approve abandonment of the claim and of the application for its certification as a class action.

In March 2012, a claim was filed against Pelephone in the Tel Aviv District Court together with an application for its certification as a class action. The claim alleges that Pelephone makes false representations to the public, according to which it provides a surfing experience on its network at extremely high speeds. According to the plaintiffs, they conducted dozens of measurements showing that the surfing speed on the respondent's cellular network is lower than specified. According to the claim, this state of affairs caused and causes cumulative personal loss of NIS 560. The amount of the application is estimated in the total amount of NIS 242 million, subject to data to be produced by Pelephone as part of the proceeding.

In June 2012, a claim was filed against Pelephone in the Tel Aviv District Court together with an application for its certification as a class action. The applicants allege that the Company is in violation of Section 30A of the Communications Law, by sending marketing messages (spam), despite the applicants' failure to agree to receive them. The amount of the application is estimated in the total amount of NIS 455 million.

#### **4. International communication and internet services– Bezeq International**

##### **Section 4.15.1 - Financing - General**

On March 29, 2012, a loan of NIS 40 million was received from the Company to be repaid in five equal principal and interest installments commencing March 2013.

##### **Section 4.20- Legal proceedings**

Section 4.20.4 - On June 20, 2012, the Tel Aviv District Court approved the plaintiff's abandonment of a claim and the application for its recognition as a class action in the amount of NIS 39 million, which had been filed against Bezeq International, alleging that Bezeq International does not provide its customers with a written document as required under the Consumer Protection Law when entering into an agreement for changing or adding to a continuing transaction<sup>6</sup>.

#### **5. Multi-channel television- DBS Satellite Services (1998) Ltd. ("DBS")**

##### **Section 5.1.4 - Market developments in the segment of operation**

Sub-par. A - in April 2012, the Broadcasting by means of Digital Broadcast Stations Law, 2012, was published in the Official Gazette.

##### **Section 5.1.5 - Technology changes that can materially affect the segment of operation**

Sub-par. A - as far as DBS is aware, some of the cellular operators have announced their intention of offering the public video content which will include DTT broadcasts together with additional content to be transmitted through the internet.

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<sup>6</sup> Similar claims against the Company, Pelephone, and DBS also ended after the plaintiffs abandoned the claims or they were dismissed as noted in Sections 2.18.6, 3.21.2G and 5.20.2B of the 2011 financial statements.

According to DBS, insofar as such services are offered, they may partially substitute DBS' service, thus harming its performance, which may worsen insofar as the services are offered without regulatory supervision.

This opinion is forward-looking information, as defined in the Securities Law, based, in part, on the announcements by some of the cellular operators and on the estimated development of competition in the broadcasts market in relation to the launching of such services. This opinion concerning possible harm may not materialize, or may materialize on a different scale, in part, depending on the services and conditions which are actually offered by the cellular operators, on the actual development of competition in the broadcasts market, and on regulatory decisions which may be made pertaining to the operation of these services or affecting them (see also update to Section 5.17).

### Section 5.15.2 - Bank financing

The debt coverage target under the financing agreement as at June 30, 2012 was 1.1. DBS was in compliance with this covenant (debt coverage ratio as at June 30, 2012 was 1.2). DBS was in compliance with the supplier credit covenant (supplier credit as at June 30, 2012 was NIS 457 million).

In July 2012, DBS repaid all the long-term bank credit at its disposal (by means of a loan provided to it according to the debenture and in consideration of an expansion of DBS's debentures (Series B), as noted in the update to Section 5.15.3), and upon this repayment, the amendment to the financing agreement was validated ("Amendment to the Agreement" and "Amended Financing Agreement"). According to the Amended Financing Agreement, the amount of DBS's current credit limits was increased to NIS 170 million, but utilization of this framework was restricted to the total working capital requirements of DBS.<sup>7</sup> Additionally, as part of the Amended Financing Agreement, the obligations and limitations that applied to DBS under the financing agreement were eliminated or reduced (including those pertaining to its compliance with the business plan, to undertaking liabilities from third parties, transactions with interested parties, the purchase of securities in other corporations, to the offering of securities to the public and mandatory repayment of cash flow surpluses or the issuance of debentures). According to the terms of the Amendment to the Agreement, the collaterals created by the Company and Eurocom in favor of the banks to secure DBS's bank credit and their liabilities towards the banks in connection with the bank credit of DBS were also cancelled, including the Company's guarantee to the banks.

According to the Amended Financing Agreement, the financial covenants which had applied until now were cancelled, and instead DBS must comply every quarter with both the following financial covenants (subject to periods of improvement and improvement conditions defined in the Amendment to the Agreement): (a) compliance with a maximum debt/EBITDA<sup>8</sup> ratio, and (b) compliance with a maximum debt/E-C<sup>9</sup> ratio. Additionally, according to the Amended Financing Agreement, the restrictions on the repayment of shareholders' loans and distribution of a dividend, stipulated in the Debenture mentioned in Section 5.15.3, apply to the lenders according to the Debenture (replacing the restrictions that applied until now in relation to the repayment of shareholders' loans and the prohibition on distributing a dividend).

The Amended Financing Agreement further stipulates that immediate settlement, or the presence of cause for the immediate settlement of amounts that DBS owes the debenture holders, other banks or financial institutions constitutes cause for immediate recall of the bank credit. According to the Amended Financing Agreement, if S&P Maalot downgrades the loan in accordance with the aforesaid

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<sup>7</sup> Calculated according to a formula set forth in the Amended Financing Agreement, which is contingent on the customer balances of DBS, the total unutilized broadcasting rights of DBS, the depreciated cost of the decoders and the total supplier balance of DBS, according to its financial statements.

<sup>8</sup> The ratio between the total debt (debts to financial institutions as defined in the Amended Financing Agreement) at the end of the relevant quarter and the EBITDA of DBS, for the 12 months ending at the end of that quarter. The term "EBITDA" means: with respect to any period of calculation - the total operating profit of DBS from ordinary operations (before finance and tax expenses), plus depreciation and amortization, plus expenses classified under investments in the financial statements of DBS as at December 31, 2010 (and were reclassified to expenses due to accounting policy or the instruction of an authority), and plus extraordinary one-time expenses and provisions. The maximum ratio for a review period ending at the end of 2013 is 5, and for a review period ending at the end of 2015 - 4.65.

<sup>9</sup> The ratio between the total debt, as it is at the end of the relevant quarter, and the E-C of DBS for the 12 months ending at the end of that quarter. The term: "E-C" means: the EBITDA of DBS for the 12 months ending at the end of that quarter, minus the CAPEX (amount of the additions to property, plant and equipment, without the deduction of depreciation and amortization) of DBS for that period, where the maximum ratio is 9.5.

Debenture to "iBBB" (or a corresponding rating by another rating company, whichever is lower), the annual interest payable to the banks will increase by 0.25% for each notch reduction on the rating scale, as long as the downgrade is valid.<sup>10</sup>

### Section 5.15.3 - Debentures

As at June 30, 2012, DBS was in compliance with the debt/EBITDA ratio covenant specified in Deed of Trust B (the ratio of the debt of DBS to its EBITDA as at June 30, 2012 was 2.94).

In May 2012, DBS and several institutional entities (in this section: "the Lenders") signed a debenture whereby the Lenders will provide DBS with a loan of NIS 392 million (in this section: "the Debenture"). DBS received the loan in July 2012, after compliance with conditions precedent defined in the Debenture.

The loan provided according to the Debenture is to be repaid in ten (unequal) annual principal payments in April of the years 2013-2022,<sup>11</sup> and it bears annual interest at a rate of 6.4%, as mentioned, to be paid in semi-annual installments. The principal and interest on the loan are CPI linked. According to the Debenture, if the loan rating is downgraded to iBBB or a corresponding rating (whichever is lower), the annual interest paid on the loan will increase by 0.5%, and it will increase by a further 0.25% for each additional notch reduction on the rating scale, as long as the downgrade is valid.

Furthermore, the Debenture sets forth various events (similar to those noted in Deed of Trust B), which if they occur (sometimes after a long period) establish an entitlement to immediate recall of the loan, subject to the provisions of the Debenture, including immediate settlement (not at the initiative of DBS) of another series of debentures that was issued and/or will be issued by DBS and/or of DBS's debts towards a financial institution, subject to the conditions set forth in the Debenture.

Pursuant to the terms of the Debenture, each quarter DBS must comply with two financial covenants which are identical to the financial covenants stipulated in the Amended Financing Agreement (see update to Section 5.15.2).<sup>12</sup> The Debenture also sets forth restrictions in relation to the distribution of a dividend and the repayment of shareholders' loans similar to the restrictions that apply according to Deed of Trust B.<sup>13</sup>

In May 2012, S&P Maalot determined a rating of iIA for the Debenture and the expansion of debentures (Series B) of DBS, in relation to a total raising of up to NIS 450 million, par value.

In July 2012, DBS issued additional debentures (Series B), by way of an expansion of the series, in the amount of NIS 10 million. The proceeds from this issuance, together with the money from the loan which is the subject of the Debenture, were used to repay the full amount of the long-term bank credit (see Section 5.15.2).

For additional information about the collaterals which were created to guarantee the Debenture and the changes in the conditions of the Debenture and the collaterals if the Company provides a loan in favor of the lenders under the conditions set forth in the Debenture - see Note 6 to the financial statements of DBS as at June 30, 2012.

### Section 5.17 - Restrictions and supervision of the corporation

In March 2012, the Council announced that it is considering carrying out a pilot scheme in which HOT and DBS will offer their subscribers limited broadcast packages consisting of a "confined" package, smaller than their currently available basic package which will include the compulsory channels (the TV and radio channels which the license holders are obligated to broadcast by law) as well as several pre-defined channels, at a price that is cheaper than the basic package, or alternatively, a select package of channels to include the compulsory channels and channels to be chosen by the subscriber

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<sup>10</sup> Except if the said downgrade does not provide any lender, according to the Debenture, with additional interest in respect of the loan due to the Company providing a guarantee in its favor - see Note 6 to the financial statements of DBS as at June 30, 2012.

<sup>11</sup> In each of the years 2013-2017, payment of the principal will be 8% of the nominal value of the debentures, and in each year thereafter payment of the principal will be 12% of the nominal value of the debentures.

<sup>12</sup> Where the maximum ratio of debt to EBITDA in respect of the review period commencing in 2016 is 4.3 and the maximum ratio of debt to E-C that applies from January 1, 2016 is 7.8

<sup>13</sup> The target of the financial covenant applicable to this is lower (more stringent) than the covenant which applies according to Deed of Trust B.

for additional payment. The Council has initiated an invitation process to present public opinion prior to making a final decision on this subject.

In July 2012, the Council announced that it is considering amending the Communications Rules so as to obligate DBS and HOT to offer subscribers a limited group of channels as a package consisting of at least four channels in addition to the obligatory channels. In addition, the proposed amendment will regulate the obligation of HOT and DBS to invest in various categories of local productions for the channels they choose to broadcast in the limited range of broadcasts, and the amendment will also determine the scope of sports broadcasts in the limited group of broadcasts. The foregoing amendment of the rules being considered by the Council will be valid for six months, and towards the end of the period the Council will review its decision on the basis of the information it has received. The Council published the text of the proposed amendment and initiated a procedure for inviting the public to present its positions on the request. DBS believes that insofar as the Communications Rules are amended as proposed by the Council, its performance will be affected.

DBS's opinion is forward-looking information, as defined in the Securities Law, based, in part, on the aforesaid announcements by the Council, which as noted are still subject to a hearing and regulation. This estimate may not materialize, or it may materialize on a different scale, in part depending on the decisions that are actually made, if they are made, by the Council and with the changes in competition that may occur, taking note of the regulatory procedures.

#### **Section 5.17.7 - Requirement to transmit channels**

In April 2012, the HCJ issued an order nisi instructing the Knesset, the State and the other respondents to the petition to explain why the court should not declare that the amendment to the law should not be applied to DBS until reasonable compensation is arranged for DBS, and alternatively why the amendment to the law should not be revoked.

#### **Section 5.20 - Legal proceedings**

Section 5.20.1.A - On March 13, 2012, DBS submitted its response to the Attorney General's position, and on March 15, 2012, the applicant submitted his response to the Attorney General's position. At a hearing held on April 4, 2012, the court suggested that the parties retract their request to approve the settlement and that the applicant and his attorney should withdraw the application for certification. The parties were requested to submit their positions by April 19, 2012. On April 22, 2012, following a joint application by the parties, and in view of the difficulties encountered in the application for certification, the court approved the applicant's abandonment of the application, without ordering expenses.

August 1, 2012

Date

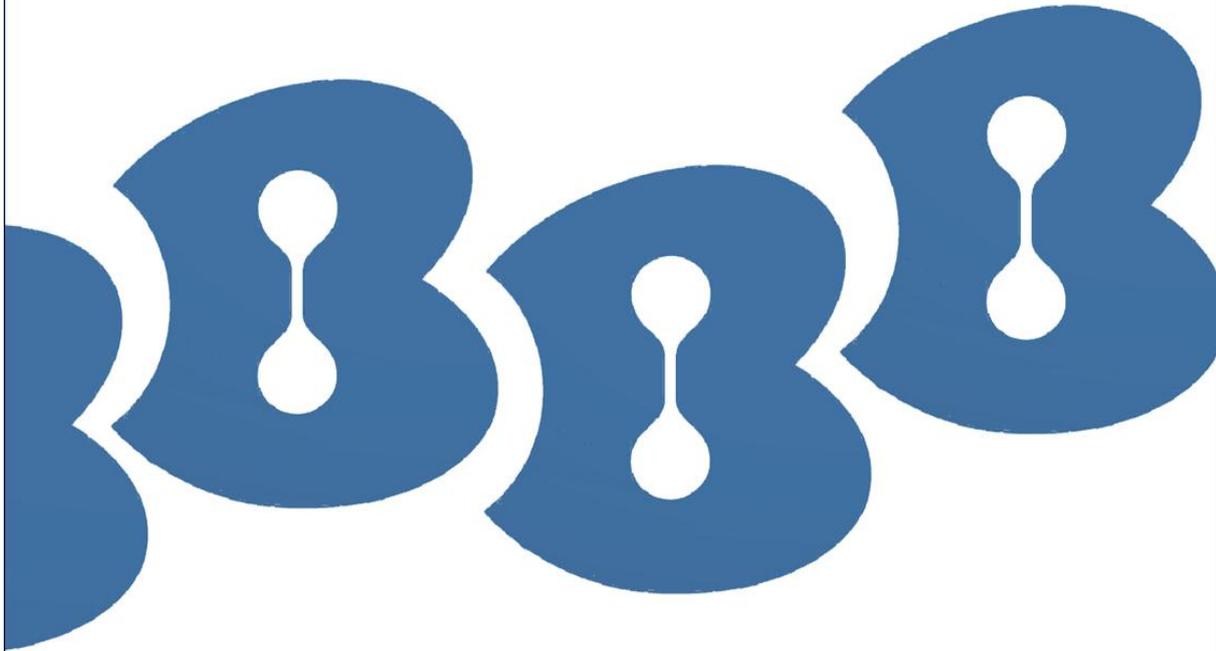
"Bezeq" - The Israel Telecommunication Corp. Ltd.

Names and titles of signatories:

Shaul Elovitch, Chairman of the Board of Directors

Avi Gabbay, Chief Executive Officer

**Directors' Report on the  
State of the Corporation's  
Affairs for the six and three  
month periods ended  
June 30, 2012**



The information contained in this report constitutes a translation of the directors' report published by the Company. The Hebrew version was submitted by the Company to the relevant authorities pursuant to Israeli law, and represents the binding version and the only one having legal effect. This translation was prepared for convenience only.

We respectfully present the Directors' Report on the state of affairs of "Bezeq" – The Israel Telecommunication Corp. Limited ("the Company") and the consolidated Group companies (the Company and the consolidated companies together: "the Group"), for the six-month period ended June 30, 2012 "the Reporting Period") and for the three-month period then ended ("Quarter").

The Directors' Report contains a condensed review of its subject-matter and was prepared assuming that the Directors' Report for December 31, 2011 is also available to the reader.

The Group reports on four main segments in its financial statements:

1. **Domestic Fixed-Line Communications**
2. **Cellular**
3. **International Communications, Internet and NEP Services**
4. **Multi-Channel Television**

It should also be noted that the Company's consolidated financial statements also include an "Others" segment which comprises mainly Internet services and Internet portal operation (through Walla) and customer call center services (through Bezeq On-Line). This Others segment is not material at the Group level.

Profit for the Reporting Period attributable to the owners of the Company amounted to NIS 997 million, compared with NIS 992 million in the corresponding period last year, an increase of 0.5%.

Profit for the Reporting Period amounted to NIS 1,003 million, compared with NIS 991 million in the corresponding period last year, an increase of 1.2%.

The Group's EBITDA (operating profit before depreciation and amortization) increased from NIS 2,283 million in the corresponding period last year to NIS 2,312 million in the Reporting Period, an increase of 1.3%.

Profit for the Quarter attributable to the owners of the Company amounted to NIS 415 million, compared with NIS 585 million in the corresponding quarter last year, a decrease of 29.1%.

Profit for the Quarter amounted to NIS 412 million compared with a profit of NIS 585 million in the corresponding quarter last year, a decrease of 29.6%.

The Group's EBITDA decreased from NIS 1,283 million in the corresponding quarter last year to NIS 1,104 million in the Quarter, a decrease of 14%.

The results for the Reporting Period and the Quarter compared with the corresponding period and quarter were affected by various factors described in this report, including a decrease in revenue which was moderated by a decrease in operating and general expenses, as well as expenses in respect of due to early retirement recorded in the first quarter of 2011 in the Domestic Fixed-Line Communications segment.

## 1. Explanations of the Board of Directors for the state of the corporation's affairs, the results of its operations, its equity, cash flows and other topics

### 1.1 Financial position

#### 1.1.1 Assets

The Group's assets at June 30, 2012 amounted to NIS 16.14 billion, compared with NIS 15.20 billion on June 30, 2011, of which NIS 6.14 billion (38%) are property, plant and equipment, compared with NIS 5.89 billion (39%) on June 30, 2011.

The increase in the Group's assets stems primarily from the Domestic Fixed-Line Communications segment, as described below.

In the Domestic Fixed-Line Communications segment, total assets, without loans and investment in associates, increased, compared with June 30, 2011 by NIS 769 million. The increase stems mainly from an increase in current financial assets as a result of receipts generated from operating activities and the proceeds from an issue of debentures received in the second half during the six month period ending June 30, 2011, and a rise in the balances of property, plant and equipment resulting from continued deployment of the NGN.

In the Cellular segment, total assets increased from NIS 5.32 billion on June 30, 2011 to NIS 5.40 billion at June 30, 2012. The increase stems primarily from a rise in the balance of cash and cash equivalents and in the customer balance, which was partially offset by a decrease in property, plant and equipment and intangible assets and a decrease in inventory.

In the International Communications, Internet and NEP segment, assets increased by NIS 137 million. Most of the increase occurred in property, plant and equipment balances following investment in setting up the Seabed Cable.

In the Multi-Channel Television segment total assets increased by NIS 78 million, which stemmed mainly from a rise in the balances of property, plant and equipment that stems mainly from an increase in the balance of decoders.

#### 1.1.2 Liabilities

The Group's debt to financial institutions and debenture holders at June 30, 2012 amounted to NIS 9.12 billion, compared with NIS 6.98 billion on June 30, 2011.<sup>1</sup> The increase in debt stemmed from the Domestic Fixed-Line Communications segment following an issue of debentures and receipt of loans from banking corporations in the second half of 2011. The increase was moderated by the repayment of loans and debentures in the Domestic Fixed-line Communications segment and in the Cellular segment.

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<sup>1</sup> The Group's debt to financial institutions and debenture-holders net of cash and cash equivalents and current investments at June 30, 2012, amounted to NIS 7.90 billion, compared with NIS 6.50 billion on June 30, 2011.

## 1.2 Results of operations

### 1.2.1 Principal results

Condensed consolidated statement of income:

	For the six-month period ended				For the three-month period ended			
	June 30				June 30			
	2012	2011	Increase	Change	2012	2011	Increase	Change
	NIS millions	NIS millions	(decrease)	%	NIS millions	NIS millions	(decrease)	%
Revenue	<b>5,335</b>	5,806	(471)	(8%)	<b>2,595</b>	2,893	(298)	(10%)
Operating expenses	<b>3,739</b>	4,206	(467)	(11%)	<b>1,849</b>	1,958	(109)	(6%)
Operating profit	<b>1,596</b>	1,600	(4)	-	<b>746</b>	935	(189)	(20%)
Finance expenses, net	<b>33</b>	82	(49)	(60%)	<b>77</b>	62	15	24%
Profit after finance expenses, net	<b>1,563</b>	1,518	45	3%	<b>669</b>	873	(204)	(23%)
Share in losses of associates	<b>141</b>	137	4	3%	<b>83</b>	72	11	15%
Profit before income tax	<b>1,422</b>	1,381	41	3%	<b>586</b>	801	(215)	(27%)
Income tax	<b>419</b>	390	29	7%	<b>174</b>	216	(42)	(19%)
<b>Profit for the period</b>	<b>1,003</b>	991	12	1%	<b>412</b>	585	(173)	(30%)
<b>Attributed to:</b>								
Owners of the Company	<b>997</b>	992	5	0.5%	<b>415</b>	585	(170)	(29%)
Non-controlling interests	<b>6</b>	(1)	7	-	<b>(3)</b>	-	(3)	-
<b>Profit for the period</b>	<b>1,003</b>	991	12	1%	<b>412</b>	585	(173)	(30%)
<b>Earnings per share (NIS)</b>								
Base earnings per share	<b>0.37</b>	0.37	-	-	<b>0.15</b>	0.22	(0.07)	(32%)
Diluted earnings per share	<b>0.37</b>	0.36	0.01	3%	<b>0.15</b>	0.21	(0.06)	(29%)

The Group's revenue in the Reporting Period amounted to NIS 5,335 million, compared with NIS 5,806 million in the corresponding period, a decrease of 8.1%.

The Group's revenue in the Quarter amounted to NIS 2,595 million, compared with NIS 2,893 million in the corresponding quarter, a decrease of 10.3%.

The decrease in the Group's revenue stemmed from the Cellular segment, as a result of a decrease in revenues from services and from the sale of terminal equipment.

The Group's depreciation and amortization expenses in the Reporting Period amounted to NIS 716 million compared with NIS 683 million in the corresponding quarter, an increase of 4.8%.

Depreciation and amortization expenses in the Quarter amounted to NIS 358 million, compared with NIS 348 in the corresponding quarter, an increase of 2.9%.

The increase stems from the Domestic Fixed-Line Communications segment and the International Communications, Internet and NEP segment, as explained below.

The Group's salary expenses in the Reporting Period amounted to NIS 1,016 million compared with NIS 1,072 million in the corresponding period, a decrease of 5.2%.  
 The Group's salary expenses in the Quarter amounted to NIS 505 million compared with NIS 540 million in the corresponding quarter, a decrease of 6.5%.  
 The decrease stems from the Domestic Fixed-Line Communications segment and the Cellular segment, as explained below.

The Group's operating and general expenses in the Reporting Period amounted to NIS 2,013 million compared with NIS 2,263 million in the corresponding period, a decrease of 11%.

Operating and general expenses in the Quarter amounted to NIS 969 million compared with NIS 1,132 million in the corresponding quarter, a decrease of 14.4%.

The decrease stems primarily from the Cellular segment, mainly as a result of a decrease in sales of terminal equipment.

Other operating income, net, in the Reporting Period amounted to NIS 6 million compared with expenses of NIS 188 million in the corresponding period.

Other operating expenses, net, in the Quarter amounted to NIS 17 million compared with income of NIS 62 million in the corresponding quarter.

Expenses in the corresponding period stemmed from recording a provision of NIS 281.5 million due to severance and early retirement in the Domestic Fixed-Line Communications segment in the first quarter of 2011.

The transition from income to expenses in the current Quarter stems from recognition of a loss of NIS 54 million following a decision of the Company to terminate the Customer Relations Management (CRM) system project. See below for more information.

The Group's finance expenses, net, in the Reporting Period amounted to NIS 33 million, compared with NIS 82 million in the corresponding period, a decrease of approximately 60%.

Most of the decrease stems from the sale of all the shares held by Stage One Venture Capital Fund (Israel) L.P. in Traffix Communication Systems Ltd., which were classified by the Group as an investment available for sale. As a result, finance income of NIS 74 million was recorded in the consolidated financial statements in the first quarter of 2012 (see Note 4.3 to the financial statements). The decrease was offset mainly by a rise in net finance expenses in the Domestic Fixed-Line Communications segment.

The Group's finance expenses, net, in the Quarter amounted to NIS 77 million, compared with NIS 62 million in the corresponding quarter, an increase of 24.2%. See below for more information.

### 1.2.2 Segments of operation

A The table shows revenue and operating profit by segment of operation:

	For the six-month period ended				For the three-month period ended			
	June 30				June 30			
	2012		2011		2012		2011	
	NIS millions	% of total revenue	NIS millions	% of total revenue	NIS millions	% of total revenue	NIS millions	% of total revenue
<b>Revenue by segment of operation</b>								
Domestic Fixed-Line Communications	2,360	44.2%	2,348	40.4%	1,161	44.7%	1,170	40.4%
Cellular	2,392	44.8%	2,888	49.7%	1,148	44.2%	1,438	49.7%
International Communications, Internet and BEP Services	662	12.4%	662	11.4%	330	12.7%	333	11.5%
Multi-Channel Television	825	15.5%	810	14%	409	15.8%	404	14%
Others and set-offs*	(904)	(16.9%)	(902)	(15.5%)	(453)	(17.4%)	(452)	(15.6%)
<b>Total Group revenue</b>	<b>5,335</b>	<b>100%</b>	<b>5,806</b>	<b>100%</b>	<b>2,595</b>	<b>100%</b>	<b>2,893</b>	<b>100%</b>

	For the six-month period ended June 30				For the three-month period ended June 30			
	2012		2011		2012		2011	
	NIS millions	% of total revenue	NIS millions	% of total revenue	NIS millions	% of total revenue	NIS millions	% of total revenue
<b>Operating profit by segment of operation</b>								
Domestic Fixed-Line Communications	976	44.2%	728	31%	437	37.6%	517	44.2%
Cellular	526	44.8%	756	26.2%	259	22.6%	357	24.8%
International Communications, Internet and BEP Services	103	12.4%	121	18.3%	53	16.1%	60	18%
Multi-Channel Television	126	15.5%	127	15.7%	74	18.1%	66	16.3%
Others and set-offs*	(135)	(16.9%)	(132)	-	(77)	-	(65)	-
Consolidated operating income / percentage of Group revenue	1,596	100%	1,600	27.6%	746	28.8%	935	32.3%

\* Set-offs are mainly due to the Multi-Channel Television segment, which is an associate.

## B Domestic Fixed-Line Communications segment

### Revenues

The segment's revenues in the Reporting Period amounted to NIS 2,360 million compared with NIS 2,348 million in the corresponding period, an increase of 0.5%. The increase in the segment's revenues in the Reporting Period stems mainly from an increase in revenue from high-speed Internet, mainly as a result of an increase in revenue per subscriber as surfing speeds are upgraded, and as a result of an increase in the number of Internet subscribers. Revenues from data communications also increased. The increase in revenues was offset by a decrease in revenues from telephony, mainly as a result of erosion of revenue per telephone line and a moderate decrease in the number of subscribers.

The segment's revenues in the Quarter amounted to NIS 1,161 million compared with NIS 1,170 million in the corresponding quarter, a decrease of 0.8%.

Revenues in the Quarter decreased primarily as a result of the decrease in revenues from telephony, which was moderated by an increase in revenues from Internet and data communications, for the reasons described above.

### Costs and expenses

Depreciation and amortization expenses in the Reporting Period amounted to NIS 356 million, compared with NIS 333 million in the corresponding period, an increase of 6.9%.

Depreciation and amortization expenses in the Quarter amounted to NIS 178 million, compared with NIS 171 million in the corresponding quarter, an increase of 4.1%.

The increase in depreciation and amortization expenses stems from investment in the NGN project and was moderated due to the end of depreciation of other property, plant and equipment.

The salary expenses in the Reporting Period amounted to NIS 534 million compared with NIS 575 million in the corresponding period, a decrease of 7.1%.

The salary expense in the Quarter amounted to NIS 267 million compared with NIS 291 million in the corresponding quarter, a decrease of 8.3%.

The decrease in salary expenses stemmed mainly from a decrease in share-based payments and a decrease in the number of employees, and was partly offset by wage creep.

Operating and general expenses in the Reporting Period amounted to NIS 500 million compared with NIS 524 million in the corresponding period, a decrease of 4.6%.

Operating and general expenses in the Quarter amounted to NIS 263 million compared with NIS 253 million in the corresponding quarter, a decrease of 4%.

The decrease in expenses in the Period is mainly due to the decrease in the payment of frequency fees in the first Quarter of 2012 (see Note 13.1 to the financial statements). The decrease was moderated by a rise in terminal equipment and materials expenses in the Reporting Period and the Quarter, and in royalties expenses following an increase in their rate compared with the corresponding period and quarter. It is noted that after the date of the financial statements, a decision was made to lower the rate of royalties (see Note 13.3 to the financial statements).

Other operating income, net, in the Reporting Period amounted to NIS 6 million compared with expenses of NIS 188 million in the corresponding period.

Other operating expenses, net, in the Quarter amounted to NIS 16 million compared with income of NIS 62 million in the corresponding quarter.

The transition from expenses to income in the Reporting Period stemmed from recording provision expenses of NIS 281.5 million in the first quarter of 2011 due to severance at early retirement. Conversely, the Company recognized a loss of NIS 54 million in the Quarter, following the Company's decision to terminate the CRM project (see Note 13.2 to the financial statements). There was also a decrease in capital gains from the sale of real estate properties in the Reporting Period.

### **Profitability**

Operating profit in the segment for the Reporting Period amounted to NIS 976 million compared with NIS 728 million in the corresponding period, an increase of 34.1%.

Operating profit in the segment in the Quarter amounted to NIS 437 million compared with NIS 517 million in the corresponding quarter, a decrease of 15.5%.

The change in operating profit stems from the changes described above in the revenue and expense items in the Reporting Period, primarily from the provision for severance in early retirement which was recorded in the first quarter of 2011, and in the Quarter mainly from termination of the CRM project.

### **Finance expenses, net**

Finance expenses, net in the Reporting Period amounted to NIS 125 million, compared with NIS 99 million in the corresponding period, an increase of 26.3%.

Finance expenses, net in the Quarter amounted to NIS 76 million, compared with NIS 73 million in the corresponding quarter, an increase of 4.1%.

The increase in both the Reporting Period and the Quarter stems primarily from an increase in interest expenses due to debentures issued at the beginning and during the six month period ending June 30, 2011, a rise in bank credit at fixed and variable shekel interest, and in the Reporting Period from finance expenses due to revaluation of the liability to distribute a dividend which is not in compliance with the earnings test. The increase was moderated mainly by finance income from loans extended to associates, profits from financial assets held for trade, recording finance income following a reduction in the liability for payment of frequency fees in the first quarter of 2012 (see Note 13.1 to the financial statements), and a smaller rise in the known CPI compared with the corresponding period. In addition, the finance expenses due to revaluation of the liability to distribute a dividend that is not in compliance with the earnings test, decreased in the Quarter.

## **C Cellular segment**

### **Revenue**

The segment's revenues in the Reporting Period amounted to NIS 2,392 million compared with NIS 2,888 million in the corresponding period, a decrease of 17.2%.

The segment's revenues in the Quarter amounted to NIS 1,148 million compared with NIS 1,438 million in the corresponding quarter, a decrease of 20.2%.

The segment's revenues from services (including value added services) in the Reporting Period amounted to NIS 1,691 million compared with NIS 1,874 million in the corresponding period, a decrease of 9.8%.

Revenues from services in the Quarter amounted to NIS 857 million compared with NIS 925 million in the corresponding quarter, a decrease of 7.4%

The decrease in the service revenues stemmed from tariff erosion as a result of intensifying competition, which led to a decrease in average revenue per user (ARPU).

Revenues in the segment from the sale of terminal equipment in the Reporting Period amounted to NIS 701 million, compared with NIS 1,014 million in the corresponding period, a decrease of 30.9%.

Revenues in the segment from the sale of terminal equipment in the Quarter amounted to NIS 291 million, compared with NIS 513 million in the corresponding quarter, a decrease of 43.3%.

The decrease stemmed primarily from fewer upgrades and sales, which were partly offset by a rise in the average price of handsets sold.

### **Costs and expenses**

Depreciation and amortization expenses in the Reporting Period amounted to NIS 272 million compared with NIS 282 million in the corresponding period, a decrease of 3.5%.

Depreciation and amortization expenses in the Quarter amounted to NIS 137 million compared with NIS 143 million in the corresponding quarter, a decrease of 4.2%.

The decrease in these expenses stemmed primarily from the termination of capitalization of the amortization on subscriber acquisition costs.

Salary expenses in the Reporting Period amounted to NIS 262 million compared with NIS 299 million in the corresponding period, a decrease of 12.4%.

Salary expenses in the Quarter amounted to NIS 130 million compared with NIS 149 million in the corresponding quarter, a decrease of 12.8%.

The decrease in the salary expenses stems primarily from a decrease in the number of positions.

Operating and general expenses in the Reporting Period amounted to NIS 1,332 million compared with NIS 1,551 million in the corresponding period, a decrease of 14.1%.

The decrease stemmed mainly from a decrease in the cost of terminal equipment as a result of a decline in the number of handsets upgraded and sold, which was partly offset by a rise in handset prices.

Operating and general expenses in the Quarter amounted to NIS 622 million compared with NIS 789 million in the corresponding quarter, a decrease of 21.2%.

The decrease stemmed mainly from a decrease in the cost of terminal equipment, mainly as a result of fewer handsets upgraded and sold, and a fall in the prices of upgraded handset prices, which was offset by a rise in the prices of handsets sold.

### **Profitability**

Operating profit in the segment in the Reporting Period amounted to NIS 526 million compared with NIS 756 million in the corresponding period, a decrease of 30.4%.

Operating income in the segment in the Quarter amounted to NIS 259 million compared with NIS 357 million in the corresponding quarter, a decrease of 27.5%.

The decrease in operating profit stemmed primarily from erosion of revenues from services and a decline in quantities of terminal equipment sold, as noted above.

### **Finance income, net**

The segment's finance income, net, in the segment amounted to NIS 22 million in the Reporting Period, compared with NIS 19 million in the corresponding period, an increase of 15.8%.

The increase stemmed primarily from an increase in the credit embodied in the sale of terminal equipment on installments and from a decrease in the rate of rise in the known CPI compared with the corresponding period. The increase was partly offset by higher interest expenses in due to loans from the parent company and by exchange rate differences due to the rise in the dollar rate in the Reporting Period compared with the corresponding period.

In the Quarter the segment had no finance income, net, compared with income of NIS 9 million in the corresponding quarter.

The decrease stems mainly from higher interest expenses due to loans from the parent company and exchange rate differences due to a rise in the dollar rate in the Quarter compared with the corresponding quarter. The decrease was partly offset by finance income from an increase in the credit embodied in the purchase of terminal equipment on installments.

**D International Communications, Internet and NEP**

**Revenue**

The segment's revenues for the Reporting Period amounted to NIS 662 million, similar to the corresponding period.

Revenues in the Quarter amounted to NIS 330 million compared with NIS 333 million in the corresponding quarter, a decrease of 1%.

The decrease in revenues from incoming and outgoing calls that stems from a decline in the volume of traffic throughout the market and a decrease in revenues from transferring calls between carriers worldwide, was offset by an increase in revenues due primarily to an increase in Internet revenues as a result of increasing numbers of subscribers and of growth in the Reporting Period in Information and Communications Technology (ICT) operations for business.

**Costs and expenses**

Depreciation and amortization expenses in the Reporting Period amounted to NIS 69 million compared with NIS 51 million in the corresponding period, an increase of 35%.

Depreciation and amortization expenses in the Quarter amounted to NIS 34 million compared with NIS 37 million in the corresponding period, an increase of 26%.

Most of the increase stems from the start of depreciation of the Seabed Cable this year.

Salary expenses in the Reporting Period amounted to NIS 136 million compared with NIS 129 million in the corresponding period, an increase of 5.4%.

The increase in the salary expenses stems mainly from an increase in the number of workers employed via outsourcing in the ICT operation, and from the termination of capitalization of subscriber acquisition costs.

Salary expenses in the Quarter amounted to NIS 66 million, similar to the corresponding quarter.

Operating and general expenses in the Reporting Period and the Quarter amounted to NIS 354 million and NIS 176 million respectively, compared with NIS 361 million and NIS 180 million in the corresponding period and quarter, a decrease of 2%.

The decrease in these expenses stems from the erosion of revenues in some of the segment's operations as described above, and from streamlining as a result of setting up the Seabed Cable.

**Profitability**

Operating profit in the Reporting Period amounted to NIS 103 million compared with NIS 121 million in the corresponding period, a decrease of 14.9%.

Operating profit in the Quarter amounted to NIS 53 million compared with NIS 60 million in the corresponding quarter, a decrease of 11.7%.

The decrease stems from the changes described above in the revenue and expense items.

**E Multi-channel television segment (stated by the equity method)**

**Revenue**

The segment's revenues in the Reporting Period amounted to NIS 825 million compared with NIS 810 million in the corresponding period, an increase of 1.9%.

Revenues in the Quarter amounted to NIS 409 million compared with NIS 404 million in the corresponding quarter, an increase of 1.2%.

Most of the increase stems from a rise in revenues from the use of advanced converters, increased revenues from premium channels, and one-time sales of content in the first quarter of 2012.

### **Costs and expenses**

Cost of sales in the Reporting Period amounted to NIS 528 million, compared with NIS 541 million in the corresponding period, a decrease of 2.4%.

Cost of sales in the Quarter amounted to NIS 256 million, compared with NIS 269 million in the corresponding quarter, a decrease of 4.8%.

Most of the decrease stems from a decrease in depreciation expenses.

Sales, marketing, administrative and general expenses in the Reporting Period amounted to NIS 171 million, compared with NIS 142 million in the corresponding period, an increase of 20%.

Sales, marketing, administrative and general expenses in the Quarter amounted to NIS 79 million, compared with NIS 70 million in the corresponding quarter, an increase of 12.9%.

The increase in these expenses stemmed from the termination of capitalization of subscriber acquisition costs and from an increase in advertising costs and depreciation.

### **Profitability**

Operating profit in the Reporting Period amounted to NIS 126 million compared with NIS 127 million in the corresponding period.

Operating profit in the Quarter amounted to NIS 74 million compared with NIS 66 million in the corresponding quarter, an increase of 12.1%.

The change in operating profit stems from the above-mentioned changes in the revenue and expense items.

#### **1.2.3 Income tax**

The Group's tax expenses in the Reporting Period amounted to NIS 419 million, which is 26.8% of profit after net finance expenses, compared with NIS 390 million and 25.7% of profit after net finance expenses in the corresponding period.

The Group's tax expenses in the Quarter amounted to NIS 174 million, which is 26% of profit after net finance expenses, compared with NIS 216 million and 24.7% of profit after net finance expenses in the corresponding quarter.

The increase in the percentage of tax after net finance expenses stems mainly from the rise in the corporate tax rate (from 24% in 2011 to 25% in 2012), and from unrecognised expenses in the Reporting Period and in the Quarter (mainly share-based payments).

### **1.3 Equity**

Equity attributable to the Company's owners at June 30, 2012 amounted to NIS 2.58 billion, compared with NIS 2.44 billion on June 30, 2011, and is approximately 16% of the total balance sheet for both dates.

The increase in equity, which stemmed mainly from the Group's profits and also from share-based payments, was largely offset by the distribution of a dividend of NIS 2.07 billion during the six month period ended December 31, 2011 and during the six month period ended June 30, 2012, in respect of profits in 2011.

### **1.4 Cash flows**

Consolidated cash flows from operating activities in the Reporting Period amounted to NIS 1,988 million, compared with NIS 1,445 million in the corresponding period, an increase of NIS 543 million. Consolidated cash flow in the Quarter amounted to NIS 990 million, compared with NIS 670 million in the corresponding quarter, an increase of NIS 320 million.

Most of the increase in the Reporting Period stems from the Cellular segment, owing to a decrease in working capital resulting primarily from the decline in sales of terminal equipment on installments, and from the deduction of transactions in installments paid by credit card (see Note 10.2 to the financial statements), offset by a decrease in net profit. The increase in the Quarter was also from the Cellular segment, and was moderated by the decrease in the Quarter in cash flow from operating activities in operations the Domestic Fixed-Line Communications segment.

Cash flow from operating activities is one of the sources of finance for the Group's investments, which during the Reporting Period included NIS 700 million in the development of communications infrastructures and NIS 142 million in intangible assets and deferred expenses, compared with NIS 797 million and NIS 158 million, respectively, in the corresponding period. In

the Domestic Fixed-Line Communications segment, net proceeds received from the sale of financial assets held for trading amounted to NIS 324 million, and a sum of NIS 68 million in proceeds from the sale of property, plant and equipment was received, compared with NIS 235 million in the corresponding period.

In addition, the Group received NIS 93 million in proceeds from the realization of non-current investments and loans, including proceeds from the sale of available-for-sale assets (see Note 4.3 to the financial statements).

In the Reporting Period, the Group repaid debts and paid interest totaling NIS 764 million, of which NIS 384 million of debentures, NIS 104 million of loans, and NIS 276 million of interest payments. This compares with repayment of debt and interest payments of NIS 977 million in the corresponding period. Conversely, no debt was raised in the Reporting Period, whereas in the corresponding period the Domestic Fixed-Line Communications segment raised NIS 2 billion of debt.

In the Quarter, the Group paid NIS 77 million to finance a rise in the percentage of its holding in a subsidiary. Also in the Quarter, a dividend of NIS 1.57 billion was paid, compared with NIS 1.66 billion in the corresponding quarter.

Average of long-term liabilities (including current maturities) to financial institutions and debenture holders in the Reporting Period amounted to NIS 9,391 million.

Average supplier credit in the Reporting Period was NIS 895 million, and average short-term customer credit was NIS 3,102 million. The average long-term customer credit was NIS 1,371 million.

The Group's working capital surplus at June 30, 2012 amounted to NIS 642 million, compared with a working capital deficit of NIS 1,298 million on June 30, 2011.

The Company (according to its separate financial statements) has a working capital deficit of NIS 987 million at June 30, 2012, compared with a deficit of NIS 2,360 million on June 30, 2011. The decrease in the Company's working capital deficit stems from raising long-term debentures that were used to repay current liabilities of the Company and were invested, inter alia, in financial assets held for trading.

In addition, there is also an increase in the working capital surplus in the Cellular segment.

The Board of Directors of the Company reviewed the existing and future cash sources and needs in the foreseeable future, the investment needs of the Company and the sources of finance and potential amounts available to the Company. Based on its review of all these factors, the Board of Directors concluded that despite the Company's working capital deficit (according to its separate financial statements), the Company does not have a liquidity problem. The Company can meet its existing and future cash needs for the foreseeable future, by means of generating cash from operations, by receipt of dividends from subsidiaries, and also by raising debt, should the Company so choose, from bank and non-bank sources.<sup>2</sup>

The above information includes forward-looking information based on the Company's assessments of its liquidity. The actual data could differ significantly from those assessments if a change occurs in one of the factors taken into account in making them.

## **2. Explanations of the Board of Directors relating to exposure to market risks and their management**

- 2.1** Fair value sensitivity tests and the effects of changes in the market prices of the fair value of the balances on and off the balance sheet for which there is a strong commitment at June 30, 2012, do not differ significantly from the report at December 31, 2011.
- 2.2** The linkage base report at June 30, 2012 does not differ significantly from the report at December 31, 2011.

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<sup>2</sup> For this reason, there are no warning signs in the Company as provided in Article 10(b)(14) of the Securities (Periodic and immediate reports) Regulations for adding a projected cash flows report.

### 3. Aspects of Corporate Governance

#### 3.1 Disclosure of the process for approval of the financial statements

##### 3.1.1 Committee

The Committee for Examination of the Company's Financial Statements is a separate committee which does not also serve as the Audit Committee (each committee has a different chairman). However, it is noted that all of the members of the Audit Committee are also members of the Committee for the Examination of the Financial Statements.

##### 3.1.2 Committee members

The committee comprises the following four members: Yitzhak Idelman, chairman (external director), Mordechai Keret (external director), Eldad Ben-Moshe (independent director), and Dr. Yehoshua Rosenzweig (independent director), each of whom has accounting and financial expertise. All the committee members gave declarations prior to their appointment. For additional details about the directors who are members of the committee, see Chapter D of the Company's Periodic Report for 2011.

##### 3.1.3 Approval of the financial statements

- A The Committee for the Examination of the Financial Statements discussed and formulated its recommendations for the Board at its meetings on July 25 and July 30, 2012.
- B The meeting on July 25, 2012 was attended by Yitzhak Idelman, Dr. Yehoshua Rosenzweig and Mordechai Keret. All the members of the committee attended the meeting on July 30, 2012.
- C Other than the committee members, the meeting on July 25, 2012 was attended by Chairman of the Board Mr. Shaul Elovitz, Deputy CEO and CFO Mr. Alan Gelman, Company Controller Mr. Danny Oz, Company Secretary Ms. Linor Yocheiman, internal auditor Mr. Lior Segal, General Counsel Mr. Amir Nachlieli, director Mr. Rami Nomkin, the external auditors and other officer-holders in the Company. Other than the committee members, the meeting on July 30, 2012 was attended by Chairman of the Board Mr. Shaul Elovitz, Company CEO Mr. Avi Gabbay, Deputy CEO and CFO Mr. Alan Gelman, Company Controller Mr. Danny Oz, internal auditor Mr. Lior Segal, director Mr. Rami Nomkin, Company Secretary Ms. Linor Yocheiman, General Counsel Mr. Amir Nachlieli, the external auditors and other officer-holders in the Company.
- D The Committee reviewed the assessments and estimates made in connection with the financial statements, internal controls relating to the financial reporting, the integrity and propriety of the disclosure in the financial statements, and the accounting policy adopted in the corporation's material affairs.
- E The committee's recommendations were forwarded in writing to the Board on July 30, 2012.
- F The Board discussed the recommendations for the examination of the financial statements on August 1, 2012.
- G The Board believes that the recommendations of the Committee for the Examination of the Financial Statements were submitted a reasonable time (about two business days) prior to the Board meeting, even taking into account the scope and complexity of the recommendations.
- H The Board accepted the recommendations of the Committee for the Examination of the Financial Statements, and resolved to approve the Company's financial statements for the second quarter of 2012.

#### 3.2 Application of the Provisions of the Sarbanes-Oxley Act of 2002 (SOX)

Commencing 2011, the Company ceased to apply the provisions of the Securities (Periodic and immediate reports) (Amendment) Regulations, 2009, in the matter of internal control, and applies instead the provisions of the Sarbanes-Oxley Act of 2002 (SOX), as a significant subsidiary of a company traded in the U.S. (foreign private issuer).

## 4. Disclosure concerning the financial reporting of the corporation

### 4.1 Critical accounting estimates

Preparation of the financial statements in accordance with IFRS requires management to make assessments and estimates that affect the reported values of the assets, liabilities, income and expenses, as well as the disclosure in connection with contingent assets and liabilities. Management bases these assessments and estimates on past experience and on valuations, expert opinions and other factors which it believes are relevant in the circumstances. Actual results might differ from these assessments with different assumptions or conditions. Information about primary topics of uncertainty in critical estimates and judgments made in the application of the accounting policy is provided in the annual financial statements. We believe that these assessments and estimates are critical since any change in these assessments and assumptions could potentially have a material effect on the financial statements.

4.2 Owing to the materiality of the claims filed against the Group, which cannot yet be assessed or the exposure estimated, the auditors drew attention to them in their opinion on the financial statements.

### 4.3 Material events after the date of the financial statements

4.3.1 On August 1, 2012, the Board of Directors of the Company resolved to recommend to the general meeting of its shareholders to distribute a cash dividend to the shareholders in the amount of NIS 997 million. See Note 6.5 to the financial statements.

4.3.2 On the matter of repayment of a long-term bank loan of DBS and a new debt repayment schedule with DBS, see Notes 4.2.5 and 4.2.6 to the financial statements.

## 5. Details of series of liability certificates

### 5.1 Debentures Series 5

5.1.1 On March 21, 2012, the appointment of Hermetic Trust (1975).Ltd. ("Hermetic") was approved as trustee for the Debentures (Series 5) of the Company, replacing Mizrachi Tefahot Trust Co. Ltd., and accordingly, from that date, Hermetic serves as trustee for those debentures.

The trust company:

Hermetic Trust (1975).Ltd.

Contact person in the trust company – Dan Avnon, CEO

Email address – [avnon@hermetic.co.il](mailto:avnon@hermetic.co.il), telephone: 5274867

Address – 113 Hayarkon Street, Beit Hermetic, Tel Aviv

5.1.2 On June 1, 2012, NIS 397,827,833 of Debentures Series 5 was repaid.

The fair value and the stock exchange value of Debentures Series 5 is NIS 2,118,035,385 at June 30, 2012.

5.2 Other than the above, the details relating to the series of liability certificates at June 30, 2012 do not differ significantly from the report on December 31, 2011.

5.3 On July 4, 2012, the Company was notified by Standard & Poor's Maalot, which rates the Company (AA+/Negative outlook) and its debentures (AA+), of ratification of the above ratings with no change.

On July 19, 2012 the Company was notified by rating company Midroog Ltd., which rates the Company's Debentures (Series 5, 6, 7, 8), of lowering the rating of the Company's Debentures (Series 5, 6, 7, 8) from Aa1/Negative outlook to Aa2/Stable outlook.

The rating reports are attached to this Directors' Report.

## 6. Miscellaneous

For information about the liability balances of the reporting corporation and the subsidiaries or the proportionately consolidated companies in its financial statements at June 30, 2012, see the report form filed by the Company on Magna on August 2, 2012

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

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Shaul Elovitz  
Chairman of the Board of  
Directors

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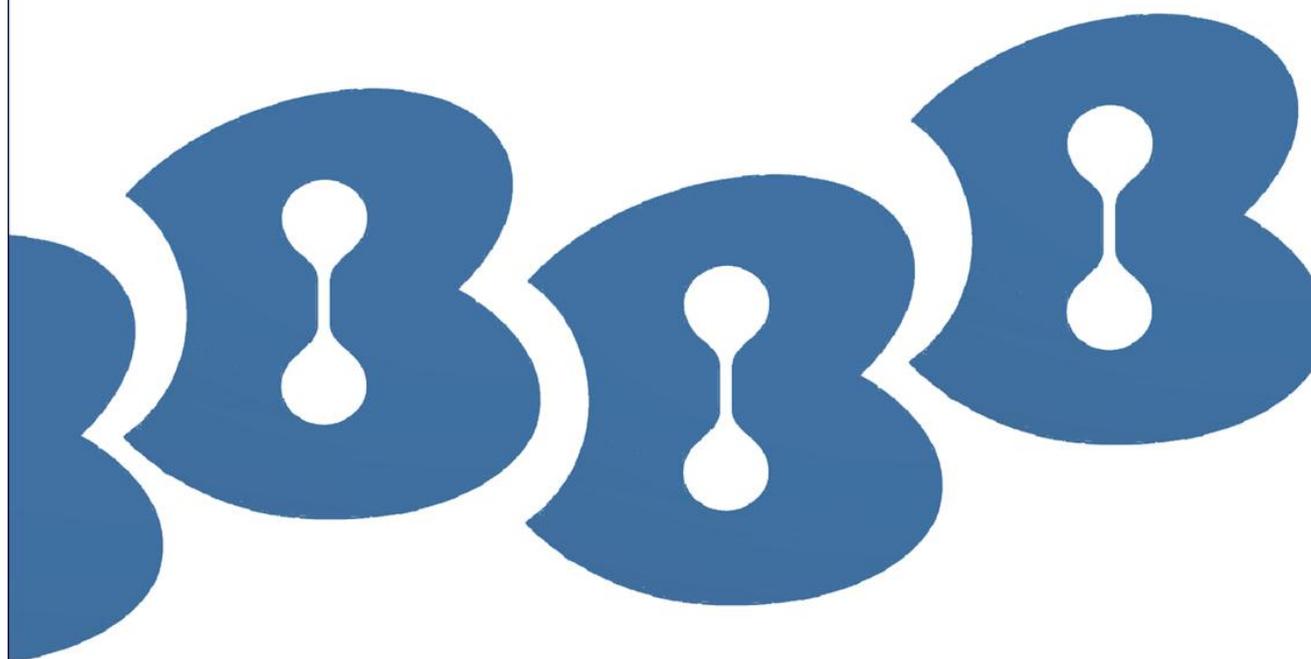
Avraham Gabbay  
CEO

Date of signature: August 1, 2012.

**Bezeq The Israel Telecommunication  
Corporation Ltd.**

**Condensed Consolidated Interim  
Financial Statements**

**June 30, 2012  
(Unaudited)**



The information contained in these financial statements constitutes a translation of the financial statements published by the Company. The Hebrew version was submitted by the Company to the relevant authorities pursuant to Israeli law, and represents the binding version and the only one having legal effect. This translation was prepared for convenience purposes only.

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<b>Review Report</b>	<b>2</b>
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**Condensed Consolidated Interim Financial Statements as at June 30, 2012  
(Unaudited)**

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## **Review Report to the Shareholders of "Bezeq" -The Israel Telecommunication Corporation Ltd.**

### Introduction

We have reviewed the accompanying financial information of "Bezeq" -The Israel Telecommunication Corporation Ltd. and its subsidiaries (hereinafter – "the Group") comprising of the condensed consolidated interim statement of financial position as of June 30, 2012 and the related condensed consolidated interim statements of income, comprehensive income, changes in equity and cash flows for the six and three month periods then ended. The Board of Directors and Management are responsible for the preparation and presentation of the financial information for these interim periods in accordance with IAS 34 "Interim Financial Reporting", and are also responsible for the preparation of financial information for these interim periods in accordance with Section D of the Securities Regulations (Periodic and Immediate Reports), 1970. Our responsibility is to express a conclusion on the financial information for these interim periods based on our review.

We did not review the condensed interim financial information of certain consolidated subsidiaries whose assets constitute approximately 2.1 % of the total consolidated assets as of June 30, 2012, and whose revenues constitute approximately 1.8 % of the total consolidated revenues for the six and three month periods then ended. The condensed interim financial information of those companies was reviewed by other auditors whose review reports thereon were furnished to us, and our conclusion, insofar as it relates to amounts emanating from the financial information of such companies, is based solely on the said review reports of the other auditors.

### Scope of Review

We conducted our review in accordance with Standard on Review Engagements 1, "Review of Interim Financial Information Performed by the Independent Auditor of the Entity" of the Institute of Certified Public Accountants in Israel. A review of interim financial information consists of making inquiries, primarily of persons responsible for financial and accounting matters, and applying analytical and other review procedures. A review is substantially less in scope than an audit conducted in accordance with generally accepted auditing standards in Israel and consequently does not enable us to obtain assurance that we would become aware of all significant matters that might be identified in an audit. Accordingly, we do not express an audit opinion.

### Conclusion

Based on our review and the review reports of other auditors, nothing has come to our attention that causes us to believe that the abovementioned financial information is not prepared, in all material respects, in accordance with IAS 34.

In addition to that mentioned in the previous paragraph, based on our review and the review reports of other auditors, nothing has come to our attention that causes us to believe that the abovementioned financial information does not comply, in all material respects, with the disclosure requirements of Section D of the Securities Regulations (Periodic and Immediate Reports), 1970.

Without qualifying our abovementioned conclusion, we draw attention to lawsuits filed against the Group which cannot yet be assessed or the exposure in respect thereof cannot yet be estimated, as set forth in Note 5.

Somekh Chaikin  
Certified Public Accountants (Isr.)  
August 1, 2012

**Condensed Consolidated Interim Statements of Financial Position**

Assets	June 30, 2012	June 30, 2011	December 31, 2011
	(Unaudited)	(Unaudited)	(Audited)
	NIS million	NIS million	NIS million
Cash and cash equivalents	603	463	1,352
Investments, including derivatives	626	24	946
Trade receivables	3,116	2,855	3,059
Other receivables	336	233	286
Inventory	206	277	204
Assets classified as held for sale	28	20	23
<b>Total current assets</b>	<b>4,915</b>	<b>3,872</b>	<b>5,870</b>
Investments, including derivatives	95	112	119
Trade and other receivables	1,324	1,474	1,499
Property, plant and equipment	6,135	5,890	6,022
Intangible assets	2,203	2,269	2,257
Deferred and other expenses	279	274	282
Investments in equity-accounted investees (mainly loans)	1,019	1,050	1,059
Deferred tax assets	169	259	223
<b>Total non-current assets</b>	<b>11,224</b>	<b>11,328</b>	<b>11,461</b>
<b>Total assets</b>	<b>16,139</b>	<b>15,200</b>	<b>17,331</b>

The attached notes are an integral part of these condensed interim financial statements

**Consolidated Statements of Financial Position (Contd.)**

Liabilities and capital	Note	June 30, 2012	June 30, 2011	December 31, 2011
		(Unaudited)	(Unaudited)	(Audited)
		NIS million	NIS million	NIS million
Debentures, loans and borrowings		735	1,249	765
Trade payables		900	1,005	890
Other payables, including derivatives		627	855	792
Current tax liabilities		483	309	397
Deferred income		59	39	56
Provisions		174	253	186
Employee benefits		325	488	389
Dividend payable	6.3	970	972	971
<b>Total current liabilities</b>		<b>4,273</b>	<b>5,170</b>	<b>4,446</b>
Debentures		4,317	2,034	4,663
Loans		4,073	3,701	4,150
Employee benefits		228	267	229
Other liabilities		79	43	93
Provisions		70	70	69
Deferred tax liabilities		55	66	69
Dividend payable	6.3	467	1,369	924
<b>Total non-current liabilities</b>		<b>9,289</b>	<b>7,550</b>	<b>10,197</b>
<b>Total liabilities</b>		<b>13,562</b>	<b>12,720</b>	<b>14,643</b>
Equity				
Total equity attributable to equity holders of the Company		2,577	2,438	2,650
Non-controlling interests		-	42	38
<b>Total equity</b>		<b>2,577</b>	<b>2,480</b>	<b>2,688</b>
<b>Total liabilities and equity</b>		<b>16,139</b>	<b>15,200</b>	<b>17,331</b>

**Shaul Elovitch**  
Chairman of the Board of

**Avi Gabbay**  
CEO

**Alan Gelman**  
Deputy CEO and CFO

Date of approval of the financial statements: August 1, 2012.

The attached notes are an integral part of these condensed consolidated interim financial statements.

**Consolidated Statements of Income**

	For the Six month period ended		For the Three month period ended		For the Year ended
	June 30		June 30		December 31
	2012	2011	2012	2011	2011
	(Unaudited)	(Unaudited)	(Unaudited)	(Unaudited)	(Audited)
	NIS million	NIS million	NIS million	NIS million	NIS million
<b>Revenues (Note 8)</b>	<b>5,335</b>	<b>5,806</b>	<b>2,595</b>	<b>2,893</b>	<b>11,373</b>
<b>Operating results</b>					
Depreciation and amortization	716	683	358	348	1,395
Salaries	1,016	1,072	505	540	2,103
General and operating expenses (Note 9)	2,013	2,263	969	1,132	4,494
Other operating expenses (income), net – see also Note 13.2	(6)	188	17	(62)	139
	<b>3,739</b>	<b>4,206</b>	<b>1,849</b>	<b>1,958</b>	<b>8,131</b>
<b>Operating profit</b>	<b>1,596</b>	<b>1,600</b>	<b>746</b>	<b>935</b>	<b>3,242</b>
<b>Financing expenses (income)</b>					
Financing expenses	325	259	193	157	599
Financing income	(292)	(177)	(116)	(95)	(389)
Financing expenses, net	33	82	77	62	210
<b>Profit after financing expenses, net</b>	<b>1,563</b>	<b>1,518</b>	<b>669</b>	<b>873</b>	<b>3,032</b>
<b>Share in losses of equity-accounted investees</b>	<b>141</b>	<b>137</b>	<b>83</b>	<b>72</b>	<b>216</b>
<b>Profit before income tax</b>	<b>1,422</b>	<b>1,381</b>	<b>586</b>	<b>801</b>	<b>2,816</b>
<b>Income tax</b>	<b>419</b>	<b>390</b>	<b>174</b>	<b>216</b>	<b>755</b>
<b>Profit for the period</b>	<b>1,003</b>	<b>991</b>	<b>412</b>	<b>585</b>	<b>2,061</b>
<b>Attributable to:</b>					
Owners of the Company	997	992	415	585	2,066
Non-controlling interests	6	(1)	(3)	-	(5)
<b>Profit for the period</b>	<b>1,003</b>	<b>991</b>	<b>412</b>	<b>585</b>	<b>2,061</b>
<b>Earnings per share (NIS)</b>					
Basic earnings per share	0.37	0.37	0.15	0.22	0.76
Diluted earnings per share	0.37	0.36	0.15	0.21	0.76

The attached notes are an integral part of these condensed consolidated interim financial statements.

**Condensed Consolidated Interim Statements of Comprehensive Income**

	For the Six month period ended		For the Three month period ended		For the Year ended
	June 30		June 30		December 31
	2012	2011	2012	2011	2011
	(Unaudited)	(Unaudited)	(Unaudited)	(Unaudited)	(Audited)
	NIS million	NIS million	NIS million	NIS million	NIS million
Profit for the period	1,003	991	412	585	2,061
Actuarial gains, net of tax	-	-	-	-	27
Net change in fair value of financial assets classified as available for sale transferred to profit or loss, net of tax	(6)	-	-	-	-
Effective portion of the change in fair value of instruments used for cash flow hedging, net of tax	(2)	-	(2)	-	-
Other items of comprehensive income for the period, net of tax	-	(1)	-	(1)	8
<b>Total comprehensive income for the period</b>	<b>995</b>	<b>990</b>	<b>410</b>	<b>584</b>	<b>2,096</b>
<b>Attributable to:</b>					
Owners of the Company	989	991	413	584	2,101
Non-controlling interests	6	(1)	(3)	-	(5)
<b>Total comprehensive income for the period</b>	<b>995</b>	<b>990</b>	<b>410</b>	<b>584</b>	<b>2,096</b>

The attached notes are an integral part of these condensed consolidated interim financial statements.

Condensed Consolidated Interim Statements of Changes in Equity

	Share capital	Share premium	Capital reserve for employee options	Capital reserve for a transaction between a corporation and a controlling shareholder	Other reserves	Deficit	Total	Non-controlling interests	Total equity
	NIS million	NIS million	NIS million	NIS million	NIS million	NIS million	NIS million	NIS million	NIS million
<b>Attributable to owners of the Company</b>									
<b>Six months ended June 30, 2012</b>									
<b>Balance as at January 1, 2012 (Audited)</b>	3,826	68	220	390	(2)	(1,852)	2,650	38	2,688
Profit for the period (Unaudited)	-	-	-	-	-	997	997	6	1,003
Other comprehensive income for the period, net of tax (Unaudited)	-	-	-	-	(8)	-	(8)	-	(8)
Total comprehensive income for the period	-	-	-	-	(8)	997	989	6	995
<b>Transactions with owners recognized directly in equity</b>									
Dividends to Company shareholders (Unaudited)	-	-	-	-	-	(1,074)	(1,074)	-	(1,074)
Share-based payments (Unaudited)	-	-	39	-	-	-	39	-	39
Exercise of options for shares (Unaudited)	5	14	(17)	-	-	-	2	-	2
Exercise of options for subsidiary shares (Unaudited)	-	-	-	-	2	-	2	6	8
Acquisition of non-controlling interests (Unaudited)	-	-	-	-	(31)	-	(31)	(46)	(77)
Distribution to holders of non-controlling interests less investment in a subsidiary (Unaudited)	-	-	-	-	-	-	-	(4)	(4)
<b>Balance as at June 30, 2012 (Unaudited)</b>	<b>3,831</b>	<b>82</b>	<b>242</b>	<b>390</b>	<b>(39)</b>	<b>(1,929)</b>	<b>2,577</b>	<b>-</b>	<b>2,577</b>

The attached notes are an integral part of these condensed consolidated interim financial statements

Condensed Consolidated Interim Statements of Changes in Equity (Contd.)

	Share capital	Share premium	Capital reserve for employee options	Capital reserve for a transaction between a corporation and a controlling shareholder	Other reserves	Deficit	Total	Non-controlling interests	Total equity
	NIS million	NIS million	NIS million	NIS million	NIS million	NIS million	NIS million		
<b>Attributable to owners of the Company</b>									
<b>Six months ended June 30, 2011</b>									
<b>Balance as at January 1, 2011 (Audited)</b>	6,213	378	146	390	(10)	(1,790)	5,327	43	5,370
Profit for the period (Unaudited)	-	-	-	-	-	992	992	(1)	991
Other comprehensive income for the period, net of tax (Unaudited)	-	-	-	-	(1)	-	(1)	-	(1)
<b>Total comprehensive income for the period</b>	-	-	-	-	(1)	992	991	(1)	990
<b>Transactions with owners recognized directly in equity</b>									
Dividends to Company shareholders – distribution not in compliance with the earnings test (Unaudited)	(2,415)	(396)	-	-	-	-	(2,811)	-	(2,811)
Dividends to Company shareholders (Unaudited)	-	-	-	-	-	(1,163)	(1,163)	-	(1,163)
Share-based payments (Unaudited)	-	-	84	-	-	-	84	-	84
Exercise of options for shares(Unaudited)	16	53	(59)	-	-	-	10	-	10
<b>Balance as at June 30, 2011 (Unaudited)</b>	3,814	35	171	390	(11)	(1,961)	2,438	42	2,480

The attached notes are an integral part of these condensed consolidated interim financial statements

Condensed Consolidated Interim Statements of Changes in Equity (Contd.)

	Share capital	Share premium	Capital reserve for employee options	Capital reserve for a transaction between a corporation and a controlling shareholder	Other reserves	Deficit	Total	Non-controlling interests	Total equity
	NIS million	NIS million	NIS million	NIS million	NIS million	NIS million	NIS million	NIS million	NIS million
<b>Attributable to owners of the Company</b>									
<b>Three months ended June 30, 2012</b>									
<b>Balance as at April 1, 2012 (Unaudited)</b>	3,830	80	224	390	(8)	(1,270)	3,246	43	3,289
Profit for the period (Unaudited)	-	-	-	-	-	415	415	(3)	412
Other comprehensive income for the period, net of tax (Unaudited)	-	-	-	-	(2)	-	(2)	-	(2)
<b>Total comprehensive income for the period</b>	-	-	-	-	(2)	415	413	(3)	410
<b>Transactions with owners recognized directly in equity</b>									
Dividends to Company shareholders (Unaudited)	-	-	-	-	-	(1,074)	(1,074)	-	(1,074)
Share-based payments (Unaudited)	-	-	19	-	-	-	19	-	19
Exercise of options for shares (Unaudited)	1	2	(1)	-	-	-	2	-	2
Exercise of options for subsidiary shares (Unaudited)	-	-	-	-	2	-	2	6	8
Acquisition of non-controlling interests (Unaudited)	-	-	-	-	(31)	-	(31)	(46)	(77)
<b>Balance as at June 30, 2012 (Unaudited)</b>	<b>3,831</b>	<b>82</b>	<b>242</b>	<b>390</b>	<b>(39)</b>	<b>(1,929)</b>	<b>2,577</b>	<b>-</b>	<b>2,577</b>

The attached notes are an integral part of these condensed consolidated interim financial statements

Condensed Consolidated Interim Statements of Changes in Equity (Contd.)

	Share capital	Share premium	Capital reserve for employee options	Capital reserve for a transaction between a corporation and a controlling shareholder	Other reserves	Deficit	Total	Non-controlling interests	Total equity
	NIS million	NIS million	NIS million	NIS million	NIS million	NIS million	NIS million		
<b>Attributable to owners of the Company</b>									
<b>Three months ended June 30, 2011</b>									
<b>Balance as at April 1, 2011 (Unaudited)</b>	3,803	-	170	390	(10)	(1,383)	2,970	42	3,012
Profit for the period (Unaudited)	-	-	-	-	-	585	585	-	585
Other comprehensive income for the period, net of tax (Unaudited)	-	-	-	-	(1)	-	(1)	-	(1)
<b>Total comprehensive income for the period</b>	-	-	-	-	(1)	585	584	-	584
<b>Transactions with owners recognized directly in equity</b>									
Dividends to Company shareholders (Unaudited)	-	-	-	-	-	(1,163)	(1,163)	-	(1,163)
Share-based payments (Unaudited)	-	-	41	-	-	-	41	-	41
Exercise of options for shares(Unaudited)	11	35	(40)	-	-	-	6	-	6
<b>Balance as at June 30, 2011 (Unaudited)</b>	3,814	35	171	390	(11)	(1,961)	2,438	42	2,480

The attached notes are an integral part of these condensed consolidated interim financial statements.

Condensed Consolidated Interim Statements of Changes in Equity (Contd.)

	Share capital	Share premium	Capital reserve for employee options	Capital reserve for a transaction between a corporation and a controlling shareholder	Other reserves	Deficit	Total	Non-controlling interests	Total equity
	NIS million	NIS million	NIS million	NIS million	NIS million	NIS million	NIS million	NIS million	NIS million
<b>Attributable to owners of the Company</b>									
<b>Year ended December 31, 2011</b>									
<b>Balance as at January 1, 2011 (Audited)</b>	6,213	378	146	390	(10)	(1,790)	5,327	43	5,370
Profit for the period (Audited)	-	-	-	-	-	2,066	2,066	(5)	2,061
Other comprehensive income for the year, net of tax (Audited)	-	-	-	-	8	27	35	-	35
Total comprehensive income for the year (Audited)	-	-	-	-	8	2,093	2,101	(5)	2,096
<b>Transactions with owners recognized directly in equity</b>									
Dividends to Company shareholders not in compliance with the earnings test (Audited)	(2,415)	(396)	-	-	-	-	(2,811)	-	(2,811)
Dividends to Company shareholders (Audited)	-	-	-	-	-	(2,155)	(2,155)	-	(2,155)
Share-based payments (Audited)	-	-	167	-	-	-	167	-	167
Exercise of options for shares (Audited)	28	86	(93)	-	-	-	21	-	21
<b>Balance as at December 31, 2011 (Audited)</b>	<b>3,826</b>	<b>68</b>	<b>220</b>	<b>390</b>	<b>(2)</b>	<b>(1,852)</b>	<b>2,650</b>	<b>38</b>	<b>2,688</b>

The attached notes are an integral part of these condensed consolidated interim financial statements.

**Condensed Consolidated Interim Statements of Cash Flows**

	For the six month period ended		For the three month period ended		For the year ended
	June 30		June 30		December 31
	2012	2011	2012	2011	2011
	(Unaudited)	(Unaudited)	(Unaudited)	(Unaudited)	(Audited)
	NIS million	NIS million	NIS million	NIS million	NIS million
<b>Cash flows from operating activities</b>					
Profit for the period	1,003	991	412	585	2,061
Adjustments:					
Depreciation	556	527	278	268	1,080
Amortization of intangible assets	146	143	73	73	287
Amortization of deferred and other expenses	14	13	7	7	28
Share in losses of equity-accounted investees	141	137	83	72	216
Financing expenses, net	109	119	110	83	293
Capital loss (gain), net	2	(87)	26	(43)	(181)
Share-based payments	39	84	19	41	167
Income tax expenses	419	390	174	216	755
Income for derivatives, net	(6)	-	(11)	-	(19)
Change in inventory	(7)	(104)	16	(34)	(33)
Change in trade and other receivables	94	(507)	174	(186)	(756)
Change in trade and other payables	(123)	(69)	(159)	(164)	(131)
Change in provisions	(12)	2	(7)	(7)	(64)
Change in employee benefits	(65)	182	(34)	(49)	82
Change in deferred and other income	(14)	-	4	-	50
Net income tax paid	(308)	(376)	(175)	(192)	(649)
<b>Net cash from operating activities</b>	<b>1,988</b>	<b>1,445</b>	<b>990</b>	<b>670</b>	<b>3,186</b>
<b>Cash flow used in investing activities</b>					
Investment in intangible assets and deferred expenses	(142)	(158)	(67)	(80)	(355)
Refund from the Ministry of Communications for frequencies	-	-	-	-	36
Proceeds from the sale of property, plant and equipment	69	236	22	49	230
Acquisition of financial assets held for trading	(1,855)	(2)	(755)	-	(2,859)
Proceeds from the sale of financial assets held for trading	2,175	-	1,425	6	1,967
Purchase of property, plant and equipment	(700)	(797)	(315)	(375)	(1,548)
Proceeds from disposal of investments and long-term loans	93	6	5	5	11
Acquisition of investments and long-term loans	(1)	(3)	-	(2)	(5)
Proceeds (payment) for derivatives	10	(11)	6	-	(5)
Dividends received	2	3	2	-	3
Interest received	8	9	4	9	34
<b>Net cash from (used in) investment activities</b>	<b>(341)</b>	<b>(717)</b>	<b>327</b>	<b>(388)</b>	<b>(2,491)</b>

The attached notes are an integral part of these condensed consolidated interim financial statements.

**Condensed Consolidated Interim Statements of Cash Flows (Contd.)**

	Six months ended		Three months ended		Year ended
	June 30		June 30		December 31
	2012	2011	2012	2011	2011
	(Unaudited)	(Unaudited)	(Unaudited)	(Unaudited)	(Audited)
	NIS million	NIS million	NIS million	NIS million	NIS million
<b>Cash flows financing activities</b>					
Issue of debentures	-	400	-	400	3,092
Bank loans received	-	1,600	-	1,600	2,200
Repayment of debentures	(384)	(757)	(316)	(665)	(835)
Repayment of loans	(104)	(24)	(13)	(15)	(648)
Net short-term borrowing	3	(3)	3	(2)	(5)
Dividends paid	(1,574)	(1,663)	(1,574)	(1,663)	(3,155)
Interest paid	(276)	(193)	(230)	(161)	(377)
Proceeds (payment) for derivatives, net	10	-	10	-	(1)
Distribution to holders of non-controlling interests, net	(4)	-	-	-	-
Increase in the rate of holding in a subsidiary	(77)	-	(77)	-	-
Proceeds from exercise of options	10	10	10	6	21
<b>Net cash from (used in) finance activities</b>	<b>(2,396)</b>	<b>(630)</b>	<b>(2,187)</b>	<b>(500)</b>	<b>292</b>
<b>Increase (decrease) in cash and cash equivalents</b>	<b>(749)</b>	<b>98</b>	<b>(870)</b>	<b>(218)</b>	<b>987</b>
Cash and cash equivalents at the beginning of the period	1,352	365	1,473	681	365
<b>Cash and cash equivalents at the end of the period</b>	<b>603</b>	<b>463</b>	<b>603</b>	<b>463</b>	<b>1,352</b>

The attached notes are an integral part of these condensed consolidated interim financial statements.

## Notes to the Financial Statements

### 1. Reporting Entity

- 1.1 Bezeq – The Israel Telecommunication Corp. Ltd. (“the Company”) is a company registered in Israel whose shares are traded on the Tel Aviv Stock Exchange. The condensed consolidated financial statements of the Company include those of the Company and its subsidiaries (together referred to as “the Group”), as well as the Group’s interests in associates. The Group is a principal provider of communication services in Israel (see also Note 11 – Segment Reporting).
- 1.2 As from April 14, 2010, the ultimate controlling shareholder in the Company is Shaul Elovitch, together with his brother, Yosef Elovitch, through their holdings in Eurocom Communications Ltd., the controlling shareholder in Internet Gold-Golden Lines Ltd., which controls B Communications Ltd. (“B Communications”). B Communications holds Company shares through companies that it controls, and as at June 30, 2012, this company held 31.04% of the Company’s shares. Each of these companies is also considered as a controlling shareholder in the Company. In addition to these holdings, the controlling shareholder and his relatives hold, directly or indirectly, another 0.11% of the Company’s shares.

### 2. Basis of Preparation

- 2.1 The condensed interim consolidated financial statements have been prepared in accordance with IAS 34 – Interim Financial Reporting, and Chapter D of the Securities Regulations (Periodic and Immediate Reports), 1970.
- 2.2 The condensed consolidated interim financial statements do not contain all the information required in full annual financial statements, and should be reviewed in the context of the annual financial statements of the Company and its subsidiaries as at December 31, 2011 and the year then ended, and their accompanying notes (“the Annual Financial Statements”). The notes to the interim financial statements include only the material changes that have occurred from the date of the most recent Annual Financial Statements until the date of these consolidated interim financial statements.
- 2.3 The condensed consolidated interim financial statements were approved by the Board of Directors on August 1, 2012.

#### 2.4 **Use of estimates and judgment**

The preparation of the condensed consolidated interim financial statements in conformity with IFRS requires management to make judgments and use estimates, assessments and assumptions that affect the application of accounting policies and the reported amounts of assets, liabilities, income and expenses. Actual results may differ from the estimates used.

The judgments made by management, when applying the Group’s accounting policies and the key assumptions used in assessments that involve uncertainty, are consistent with those applied in the Annual Financial Statements.

### **3. Reporting Principles and Accounting Policy**

The significant accounting policies applied in these condensed consolidated interim financial statements are consistent with those applied in the Financial Statements for the year ended December 31, 2011, except as described below.

#### **3.1. Recognition of actuarial gains or losses**

The Group did not recognize actuarial gains or losses in the six- and three-month period ended June 30, 2012, since in the interim period, there were no significant changes in the principal actuarial assumptions in a defined benefit plan: discount rate, expected return on plan assets, life expectancy, employee churn rate and the rate of future salary increases.

It is noted that on July 11, 2012, the Commissioner of the Capital Market, Insurance and Savings issued a draft circular regarding a new study about life expectancy. The draft circular indicates the need to revise the mortality tables and other actuarial assumptions that the Company uses to calculate some of its employee benefit liabilities. A study carried out by the Company indicates that a change in actuarial assumptions, based on the draft circular, is not expected to have a material effect on its employee benefit liabilities. The proposed change in the assumptions is not reflected in these financial statements.

#### **3.2. Hedge accounting**

The Company engages from time to time in CPI forward contracts to hedge exposure to future changes in the CPI relating to debentures issued by the Company as described in Note 10 below. The Company's forward contracts in the reporting period were presented in these financial statements for the first time with application of cash flow accounting hedges as follows:

Forward contracts are measured at fair value. Attributable transaction costs are recognized in the statement of income as incurred. Subsequent to initial recognition, changes in the fair value of derivatives designated as a cash flow hedge are recognized in other comprehensive income, directly in a hedging reserve, to the extent that the hedge is effective. To the extent that the hedge is ineffective, changes in fair value are recognized in profit or loss. The amount recognized in the hedging reserve is reclassified to the statement of income in the same period as the cash flows affect the statement of income and is recognized in the same line item in the statement of income as the hedged item.

On initial designation of the hedge, the Company formally documented the relationship between the hedging instrument and hedged item, including the risk management objectives and strategy in undertaking the hedge transaction, together with the methods that will be used to assess the effectiveness of the hedging relationship.

The Company estimated, both at the inception of the hedge and in subsequent periods, that the hedging instruments are expected to be "highly effective" in generating the cash flows in respect of the hedged risk items during the period for which the hedge is designated, and that the actual results of the hedge are within a range of 80-125%.

#### **3.3. New standards and interpretations not yet adopted**

Further to Note 3.20.4, Significant Accounting Policies in the Annual Financial Statements regarding the amendment to IAS 19, Employee Benefits ("the Amendment"), the Group assessed the effect of the Amendment on the financial statements. The Group estimates that implementation of the revised standard will not have a material impact on the financial statements.

## **4. Group Entities**

A detailed description of the Group entities appears in Note 12 to the Group's Annual Financial Statements as at December 31, 2011. Below are details of the material changes that occurred in connection with the Group entities since publication of the Annual Financial Statements.

### **4.1. Walla! Communications Ltd. ("Walla")**

- 4.1.1 Further to Note 32.3 to the financial statements as at December 31, 2011, regarding the Company's complete tender offer to purchase all the shares of Walla held by the public, on April 5, 2012, the tender offer was accepted by the majority stipulated in the Companies Law (of the number of shares offered for sale, 12,980,972 shares representing 28.45% of the share capital of Walla, notices of acceptance were received for 11,371,893 shares representing 24.92% of the share capital of Walla) and accordingly, all the shares of Walla held by the public were acquired for NIS 77 million (including exercise of employee options), so that subsequent to the acquisition and as from April 15, 2012, Walla was delisted from the TASE and became a private company wholly owned by the Company. Following the purchase of Walla shares from the public, in the three month period ended June 30, 2012, the Company recognized a decrease of non-controlling interests amounting to NIS 46 million and a decrease in equity (under capital reserve) amounting to NIS 31 million.
- 4.1.2 On August 1, 2012, the Board of Directors of the Company approved a bank guarantee for Teletel Communication Channels Ltd. (a wholly-owned subsidiary of Walla) for a loan of NIS 70 million which was received in the past. The guarantee is for the unpaid balance of the loan (amounting to NIS 66 million at the approval date) plus interest and other payments related to the loan. The guarantee will be provided against cancellation of a similar guarantee provided by Walla and cancellation of Walla's letter of undertaking to comply with financial covenants.

### **4.2. DBS Satellite Services (1998) Ltd. (an equity-accounted associate)**

- 4.2.1 The Group attaches the condensed interim financial statements of DBS Satellite Services (1998) Ltd. to these condensed consolidated interim financial statements.
- 4.2.2 Since the beginning of its operations, DBS has accumulated substantial losses. The losses of DBS in 2011 amounted to NIS 230 million and the loss in the six month ended June 30, 2012 amounted to NIS 171 million. As a result of these losses, the capital deficit and working capital deficit of DBS as at June 30, 2012 amounted to NIS 3,821 million and NIS 951 million, respectively.
- 4.2.3 As at June 30, 2012, DBS is in compliance with the financial covenants under the financing agreements and the debentures.

The management of DBS believes that the financial resources at its disposal will be sufficient for its operations for the coming year, based on the cash flow forecast approved by DBS's Board of Directors. If additional resources are required to meet its operational requirements for the coming year, DBS will adapt its operations to preclude the need for additional resources beyond those available to it. In recent years, DBS was required to raise external financial resources intended, inter alia, to expand its investments. At the reporting date, a significant increase in the investments of DBS will require an expansion of the financial resources at its disposal.

For further information about the financing resources, see also the Notes below.

#### 4. Group Entities (contd.)

##### 4.2 DBS Satellite Services (1998) Ltd. (an equity-accounted associate)

4.2.4 In May 2012, a debenture was signed by DBS and a number of institutional entities ("the Lenders") whereby the Lenders would extend to DBS a loan of NIS 392 million ("the Debenture"). The proceeds of the funds raised will be used for full repayment of the long-term credit granted to the Company by the banks. Receipt of the loan granted under the Debenture is subject to the fulfillment of certain preconditions that have yet to be fulfilled as of June 30, 2012. Until fulfillment of the securities and registration of the securities, the loan funds were deposited in trust.

The loan granted under the Debenture will be used to repay the principal in ten annual unequal installments, where from 2013 - 2017, the payment of the principal will be 8% of the par value of the debenture, and in each subsequent year the payment of the principal will be 12% of the par value of the debenture.

The Debenture will bear annual interest of 6.4% payable in six-monthly installments. The principal and interest of the loan are linked to the CPI. The Debenture includes terms for adjusting the interest rate, terms for early repayment and liens, including financial covenants which DBS is required to fulfill. In addition, limitations were set for the Debenture in respect of the distribution of the dividends and repayment of owners loans similar to the restrictions applicable under the deed of trust.

4.2.5 Further to Note 12.1.5 to the Annual Financial Statements regarding the financial covenants and stipulations applicable to DBS, in July 2012, DBS repaid the long-term bank credit in full (through a loan granted under the Debenture as described in section 4.2. 4 above and expansion of debentures (Series B) amounting to NIS 10 million). Upon repayment, the amendment to the financing agreement came into effect, according to which the terms of the credit facility of DBS were revised and the liabilities and restrictions that applied to DBS under the financing agreement were canceled or reduced.

In addition, in accordance with the amendment to the agreement, the collaterals provided by the Company in favor of the banks to secure DBS's bank credit and its liabilities to the banks for DBS's bank credit, including the Company's guarantee to the banks (described in Note 19.6 to the Annual Financial Statements) were canceled.

The financial covenants that were applicable to date have been canceled and instead, in each quarter, DBS is required to comply with two financial covenants that are the same as the financial covenants set out in the new debenture as described in section 4.2.4 above.

4.2.6 The balance of DBS's current debt to the Group companies as at June 30, 2012 amounts to NIS 42 million, of which NIS 34 million is to the Company.

Subsequent to the reporting date, on August 1, 2012, the Board of Directors of the Company approved an agreement between the Company and DBS regarding a new debt arrangement. In accordance with the agreement, all payments by virtue of prior debt arrangements with a payment date from August 1, 2012 to June 10, 2013 (including additional payments in accordance with prior debt arrangements with an original payment date subsequent to December 31, 2011, other than current payments) will each be postponed for 18 months from the designated repayment date, and in this postponement period, each payment will bear interest at a rate of prime + 4% plus VAT. The deferred payments amount to NIS 26.7 million. Each party may terminate the agreement unilaterally, with advance notice as set out in the agreement.

The Board of Directors also approved a similar arrangement for DBS's debt of NIS 5.9 million to Bezeq International. The agreements are subject to approval of the general meeting of the Company's shareholders.

#### **4. Group Entities (contd.)**

##### **4.3. Stage One Venture Capital Fund (Israel) L.P. ("the Fund")**

Further to Note 12.2,3 (F) to the financial statements as at December 31, 2011, in February 2012, the Fund signed an agreement to sell all its holdings in Traffix Communications Systems Ltd. Following the agreement, in March 2012, the Group recognized financing revenues of NIS 74 million from the disposal of available-for-sale assets.

#### **5. Contingent Liabilities**

During the normal course of business legal claims were filed against Group companies or there are pending claims (in this section: "Legal Claims").

In the opinion of the managements of the Group companies, based, inter alia, on legal opinions as to the likelihood of success of the Legal Claims, the financial statements include appropriate provisions of NIS 154 million, where provisions are required to cover the exposure arising from such legal claims.

In the opinion of the managements of the Group companies, the additional exposure (beyond these provisions) as at June 30, 2012, due to claims filed against Group companies on various matters and which are unlikely to be realized, amounts to NIS 11 billion in addition to NIS 1.5 billion for claims, which at this stage cannot be assessed, as set out in section 5.2 below. This amount and all the amounts of the additional exposure in this note are linked to the CPI and are stated net of interest.

For motions for certification of class action suits to which the Group has exposure beyond the aforesaid (since the claims do not state an exact amount), see sections 5.2 and 5.4 below.

For updates regarding changes subsequent to the reporting date, see sections 5.1 and 5.6 below.

A detailed description of the Group's contingent liabilities appears in Note 17 to the Group's financial statements as at December 31, 2011. Following is a description of the Group's contingent liabilities as at June 30, 2012, classified into groups with similar characteristics.

##### **5.1. Employee claims**

The financial statements include provisions of NIS 73 million for employee claims.

As at June 30, 2012, the additional exposure (beyond the provisions included in these financial statements) for employee claims amounts to NIS 227 million and relates mainly to claims filed by groups of employees or individual claims, which are expected to have wide ramifications in the Company.

Subsequent to the reporting date, a petition was filed at the High Court of Justice for a temporary injunction against the National Labor Court and the Company. The plaintiffs (a group of the Company's pensioners) petitioned to revoke the ruling of the National Labor Court that dismissed the plaintiffs' appeal of the dismissal of their claim at the National Labor Court. There are a number of legal proceedings against the Company for matters that are similar to and/or the same as this petition. Therefore, the possible exposure for this petition was included in the total exposure for employee claims as at June 30, 2012, as set out above. At this stage, the chances of the claim cannot be assessed.

## **5. Contingent Liabilities (Contd.)**

### **5.2. Customer claims**

The financial statements include provisions of NIS 25 million for customer claims.

As at June 30, 2012, the amount of the additional exposure for customer claims amounts to NIS 5.4 billion (beyond the provisions included in these financial statements). In addition, of these claims, there are claims amounting to NIS 1.5 billion, which at this stage the chances of the claim cannot be assessed. An amount of NIS 361 million is for a claim filed against the Company, Pelephone and other communication companies unrelated to the Group, without details of the amount claimed from each defendant.

In addition, there are other claims for which the Group has additional exposure beyond the aforesaid, which cannot be quantified, as the exact amount of the claim is not stated in the claims.

### **5.3. Supplier and communication provider claims**

The financial statements include provisions of NIS 12 million for supplier and communication provider claims.

As at June 30, 2012, the amount of the additional exposure for supplier and communication supplier claims amounts to NIS 1 billion (beyond the provisions included in these financial statements).

### **5.4. Claims for punitive damages**

The financial statements include provisions of NIS 1 million for punitive damages.

As at June 30, 2012, the additional exposure for punitive damages amounts to NIS 4 billion (beyond the provisions included in these financial statements). This amount does not include claims for which the insurance coverage is not disputed. In addition, there are other claims for which the Group has additional exposure beyond the aforesaid, which cannot be quantified, as the exact amount of the claim is not stated in the claim.

### **5.5. Claims by enterprises and companies**

The financial statements include provisions of NIS 11 million for claims by enterprises and companies.

As at June 30, 2012, the additional exposure for claims by enterprises and companies amounted to NIS 84 million (beyond the provisions included in these financial statements).

### **5.6. Claims by the State and authorities**

The financial statements include provisions of NIS 32 million for claims by the State and authorities.

As at June 30, 2012, the additional exposure for claims by the State and authorities amounted to NIS 182 million (beyond the provisions included in these financial statements).

Further to Note 17.6 to the annual financial statements regarding the claim filed in December 2000 by the government to the district court for royalties of NIS 260 million, and the appeal filed by Pelephone at the Supreme Court regarding the amount of the debt, subsequent to the reporting date, the appeal was dismissed.

### **5.7. Contingent claims referring to the associate DBS Satellite Services (1998) Ltd. ("DBS")**

As at June 30, 2012, the exposure for claims against DBS for various matters amounted to NIS 167 million (before linkage and interest) In addition, subsequent to the reporting date, a motion for certification of a class action suit amounting to NIS 29 million was filed against DBS.

## 6. Equity and Share-based Payments

6.1 Below are details of the Company's equity:

Registered			Issued and paid up		
June 30, 2012	June 30, 2011	December 31, 2011	June 30, 2012	June 30, 2011	December 31, 2011
(Unaudited)	(Unaudited)	(Audited)	(Unaudited)	(Unaudited)	(Audited)
Number of shares	Number of shares	Number of shares	Number of shares	Number of shares	Number of shares
2,825,000,000	2,825,000,000	2,825,000,000	2,718,419,726	2,702,114,767	2,713,627,744

6.2 Following the exercise of options by employees in accordance with the options plans set out in Note 26 to the financial statements as at December 31, 2011, in the six months ended June 30, 2012, the Company issued 4,791,982 ordinary shares of NIS 1 par value each.

6.3 Further to Note 20.2.2 of the financial statements as at December 31, 2011 regarding a distribution not in compliance with the earnings test, the balance of the dividend payable as at June 30, 2012 is presented as follows:

	June 30, 2012	
	Dividend payable, undiscounted	Presented in the statement of financial position *
	NIS million	NIS million
Current liabilities	1,000	970
Non-current liabilities	500	467
	1,500	1,437

\* Dividend payable for the special distribution presented in the statement of financial position at present value as at March 31, 2011 (the date of court approval for the distribution), plus financing expenses accumulated up to June 30, 2012

Further to Note 20.2.2 to the financial statements as at December 31, 2011 regarding applications to the Tel Aviv District Court concerning the objection to the distribution of the dividend which is not in compliance with the earnings test, on March 29, 2012 and April 4, 2012, two motions were filed at the Tel Aviv District Court (Economic Division), objecting to the continued payments for a distribution which is not in compliance with the earnings tests, which was approved by the court on March 31, 2011. The two motions were filed by two holders of Debentures (Series 5) of the Company, who had also filed a similar objection in 2011, seeking to join as set out in this Note

On May 14, 2012, the Court decided to dismiss these objections and further to the Company's request, on May 22, 2012, the court clarified that in accordance with its decision of May 14, 2012, the Company is not required to apply to the court for each payment of the remaining (three) lots of the special dividend approved by the court on March 31, 2011. Therefore, the Company intends to continue payments of the distribution as in the past, while assessing its compliance with the solvency test prior to payment, without having to apply to the court for an additional application relating to this assessment.

6.4 On May 21, 2012, a cash dividend of NIS 1,074 million was paid to the Company's shareholders (after approval of the general meeting of the Company's shareholders), representing NIS 0.3951788 per share and 39.51788% of the issued and paid up share capital of the Company. In addition, on May 21, 2012, the third lot of the special distribution of NIS 500 million was paid, representing NIS 0.1839752 per share and 18.39752% of the issued and paid up capital of the Company.

## **6. Equity and Share-based Payments (Contd.)**

- 6.5** On August 1, 2012, the Board of Directors of the Company resolved to recommend to the general meeting (which will convene on September 6, 2012) the distribution of a cash dividend to the shareholders in the amount of NIS 997 million. The record date for the distribution is September 23, 2012 and the payment date is October 10, 2012. As well as this distribution (to the extent that it is approved), the fourth lot of the special dividend amounting to NIS 500 million will be distributed as set out in Note 20.2.2 to the Annual Financial Statements, and the distribution dates of the regular dividend (the record date and the payment day) will be relevant for this distribution as well.

## **7. Transactions with interested and related parties**

- 7.1** Further to Note 29.5.2(A)(3) to the financial statements as at December 31, 2011, regarding the Board of Directors' approval of the amendment to the agreement between DBS and Eurocom Digital Communications Ltd. and ADB, on March 27, 2012, the general meeting of the Company's shareholders approved the amendment to the agreement.
- 7.2** Further to Note 29.5.2(A)(4) to the financial statements as at December 31, 2011, regarding the Board of Directors' approval of the engagement of DBS in transactions to acquire converters from Eurocom Digital Communications Ltd. and ADB and regarding receiving credit from suppliers, on April 24, 2012, the general meeting of the Company's shareholders approved the amendment to the agreement.
- 7.3** On May 8, 2012, the Company's Board of Directors resolved (after the approval of the audit committee) that the Company would vote in favor of DBS's transaction to raise capital of up to NIS 450 million at the general meeting of the shareholders of DBS. For further information about the capital raised by DBS, see Note 4.2.4 above.
- 7.4** On July 25, 2012, the general meeting of the Company's shareholders approved the Company's vote at the general meeting of the shareholders of DBS in favor of the amendment to the agreement between Eurocom Digital Communications Ltd. and ADB, in accordance with the approval of the general meeting on August 4, 2011 ("the Original Agreement") as set out in section 29.5.2.A. (2) of the Annual Financial Statements, which amended the agreement regarding some of the converters (42% of the original approved quantity) so that the maximum additional total cost for the Original Agreement (due to an increase in the price of hard drives) will be up to USD 1.337 million. In addition, the date of supply was extended to September 30, 2013 for 16% of the original approved quantity
- 7.5** On July 25, 2012, the general meeting of the Company's shareholders resolved to vote at the general meeting of shareholders of DBS in favor of DBS's purchase of yesMaxTotal converters from Eurocom and ADB, in accordance with an existing framework agreement, for a total cost of USD 20.7 million, for the period up to March 31, 2014. The general meeting also resolved that insofar as the state of the global market for hard drives necessitates additional cost, the additional cost for this acquisition will be up to USD 3.245 million, and will serve only as a supplement following the increase in the price of hard drives. The general meeting also approved USD supplier credit from Eurocom Digital Communications for an additional 60 days ("the Additional Credit Period"), over and above the period defined in the framework agreement, for the purchase of converters as set out above. The payment terms set out in the framework agreement are EOM + 35 days and DBS will pay interest at a rate of 1% (6% in nominal annual terms) for the Additional Credit Period. The scope of the credit is estimated at an average of NIS 15 million and payment of the annual interest is estimated at NIS 900 thousand.
- 7.6** For information about the Board of Director's approval of the new debt arrangement with DBS subsequent to the reporting date, see Note 4.2.6 above.

## 8. Revenues

	For the six month period		For the three month period		For the year
	June 30		June 30		December 31
	2012	2011	2012	2011	2011
	(Unaudited)	(Unaudited)	(Unaudited)	(Unaudited)	(Audited)
	NIS million	NIS million	NIS million	NIS million	NIS million
<b>Domestic fixed-line communication</b>					
Fixed-line telephony	1,124	1,184	550	587	2,320
Internet - infrastructure	581	534	285	269	1,092
Transmission and data communication	393	371	197	188	749
Other services	120	120	54	56	215
	<b>2,218</b>	<b>2,209</b>	<b>1,086</b>	<b>1,100</b>	<b>4,376</b>
<b>Cellular telephony</b>					
Cellular services and terminal equipment	1,030	1,251	524	606	2,346
Value added services	619	580	312	297	1,201
Sale of terminal equipment	700	1,014	290	513	1,911
	<b>2,349</b>	<b>2,845</b>	<b>1,126</b>	<b>1,416</b>	<b>5,458</b>
<b>International communications, internet and NEP services</b>	<b>638</b>	<b>629</b>	<b>316</b>	<b>314</b>	<b>1,289</b>
<b>Other</b>	<b>130</b>	<b>123</b>	<b>67</b>	<b>63</b>	<b>250</b>
	<b>5,335</b>	<b>5,806</b>	<b>2,595</b>	<b>2,893</b>	<b>11,373</b>

## 9. Operating and General Expenses

	For the six month period		For the three month period		For the Year
	June 30		June 30		December 31
	2012	2011*	2012	2011*	2011
	(Unaudited)	(Unaudited)	(Unaudited)	(Unaudited)	(Audited)
	NIS million	NIS million	NIS million	NIS million	NIS million
Terminal equipment and materials	672	873	293	443	1,693
Interconnectivity and payments to domestic and international operators	446	446	222	224	910
Maintenance of buildings and sites	320	320	158	159	641
General and marketing expenses - see Note 13.1	274	314	152	158	655
Services and maintenance by sub-contractors	77	89	34	43	170
Vehicle maintenance expenses	77	75	39	33	142
Content services expenses	48	65	24	32	123
Royalties and collection fees	99	81	47	40	160
	<b>2,013</b>	<b>2,263</b>	<b>969</b>	<b>1,132</b>	<b>4,494</b>

\* Certain expenses were reclassified to present all expenses according to their nature.

## **10. Financial instruments**

### **10.1. Hedging transactions**

During the second quarter of 2012, the Company entered into four forward contracts amounting to NIS 370 million to reduce exposure to changes in the CPI for CPI-linked debentures issued by the Company. These contracts hedge a specific cash flow of part of the CPI-linked debentures and are recognized as cash-flow hedge accounting. The contracts expire on June 2, 2013 and comply with the repayment schedule of the relevant debentures. As at the reporting date, the Company recognized a loss of NIS 2 million for these contracts, recognized in other comprehensive income. The fair value of the forward contracts is based on available market information.

It is noted that as at the reporting date, the Company has additional forward contracts amounting to NIS 500 million (to reduce its exposure to CPI changes for CPI-linked debentures) for which the Company does not apply hedge accounting. These contracts are recognized as liabilities at their fair value of NIS 0.4 million under current liabilities.

### **10.2. Debt factoring**

Pelephone factors trade receivables debts arising from the sale of terminal equipment in payment transactions paid using credit cards. Factoring transactions are made on a non recourse basis. Trade receivables debts are derecognized in accordance with the criteria set out in IAS 39, Financial Instruments: Recognition and Measurement. In the six months ended June 30, 2012, Pelephone factored NIS 77 million (gross, undiscounted)

## 11. NOTE – SEGMENT REPORTING

### 11.1. Operating segments

	For the six month period ended June 30, 2012 (Unaudited)						
	Domestic fixed-line communication	Cellular	International communications and internet services	Multi- channel television	Other	Adjustments	Consolidated
	NIS million	NIS million	NIS million	NIS million	NIS million	NIS million	NIS million
Revenues from external sources	2,214	2,347	638	825	127	(825)	5,326
Inter-segment revenues	146	45	24	-	17	(223)	9
Total revenues	2,360	2,392	662	825	144	(1,048)	5,335
Depreciation and amortization	356	272	69	120	11	(112)	716
Segment results – operating profit (loss)	976	526	103	126	(1)	(134)	1,596
Financing expenses	294	52	9	297	2	(329)	325
Financing income	(169)	(74)	(5)	(1)	-	(43)	(292)
Total financing expenses (income), net	125	(22)	4	296	2	(372)	33
Segment profit (loss) after financing expenses, net	851	548	99	(170)	(3)	238	1,563
Share in earnings (losses) of equity accounted investees	-	-	-	-	-	141	141
Segment profit (loss) before income tax	851	548	99	(170)	(3)	97	1,422
Income tax	240	138	24	-	-	17	419
Segment results – net profit (loss)	611	410	75	(170)	(3)	80	1,003

## 11. Segment Reporting (contd.)

### 11.1 Operating segments (Contd.)

	For the six month period ended June 30, 2011 (Unaudited)						
	Domestic fixed-line communication	Cellular	International communications and internet services	Multi- channel television	Other	Adjustments	Consolidated
	NIS million	NIS million	NIS million	NIS million	NIS million	NIS million	NIS million
Revenues from external sources	2,208	2,844	629	810	118	(810)	5,799
Inter-segment revenues	140	44	33	-	18	(228)	7
<b>Total revenues</b>	<b>2,348</b>	<b>2,888</b>	<b>662</b>	<b>810</b>	<b>136</b>	<b>(1,038)</b>	<b>5,806</b>
Depreciation and amortization	333	282	51	140	11	(134)	683
Segment results – operating profit	728	756	121	127	5	(137)	1,600
Financing expenses	215	36	5	298	2	(297)	259
Financing income	(116)	(55)	(5)	(10)	-	9	(177)
<b>Total financing expenses (income), net</b>	<b>99</b>	<b>(19)</b>	<b>-</b>	<b>288</b>	<b>2</b>	<b>(288)</b>	<b>82</b>
Segment profit (loss) after financing expenses, net	629	775	121	(161)	3	151	1,518
Share in losses of equity accounted investees	-	-	-	-	-	137	137
<b>Segment profit (loss) before income tax</b>	<b>629</b>	<b>775</b>	<b>121</b>	<b>(161)</b>	<b>3</b>	<b>14</b>	<b>1,381</b>
Income tax	176	186	29	-	1	(2)	390
<b>Segment results – net profit (loss)</b>	<b>453</b>	<b>589</b>	<b>92</b>	<b>(161)</b>	<b>2</b>	<b>16</b>	<b>991</b>

## 11. Segment Reporting (Contd.)

### 11.1 Operating segments (Contd.)

	For the three month period ended June 30, 2012 (Unaudited)						
	Domestic fixed-line communication	Cellular	International communications and internet services	Multi- channel television	Other	Adjustments	Consolidated
	NIS million	NIS million	NIS million	NIS million	NIS million	NIS million	NIS million
Revenues from external sources	1,083	1,125	317	409	65	(409)	2,590
Inter-segment revenues	78	23	13	-	8	(117)	5
Total revenues	1,161	1,148	330	409	73	(526)	2,595
Depreciation and amortization	178	137	34	54	6	(51)	358
Segment results – operating profit (loss)	437	259	53	74	1	(78)	746
Financing expenses	174	35	4	181	-	(201)	193
Financing income	(98)	(35)	(2)	-	-	19	(116)
Total financing expenses (income), net	76	-	2	181	-	(182)	77
Segment profit (loss) after financing expenses, net	361	259	51	(107)	1	104	669
Share in losses of equity accounted investees	-	-	-	-	-	83	83
Segment profit (loss) before income tax	361	259	51	(107)	1	21	586
Income tax	98	65	12	-	1	(2)	174
Segment results – net profit (loss)	263	194	39	(107)	-	23	412

**11. Segment Reporting (contd.)**
**11.1 Operating segments (Contd.)**

	For the three month period ended June 30, 2011 (Unaudited)						
	Domestic fixed-line communication	Cellular	International communications and internet services	Multi-channel television	Other	Adjustments	Consolidated
	NIS million	NIS million	NIS million	NIS million	NIS million	NIS million	NIS million
Revenues from external sources	1,100	1,416	314	404	59	(404)	2,889
Inter-segment revenues	70	22	19	-	10	(117)	4
<b>Total revenues</b>	<b>1,170</b>	<b>1,438</b>	<b>333</b>	<b>404</b>	<b>69</b>	<b>(521)</b>	<b>2,893</b>
Depreciation and amortization	171	143	27	71	4	(68)	348
Segment results – operating profit	517	357	60	66	4	(69)	935
Financing expenses	135	21	2	160	1	(162)	157
Financing income	(62)	(30)	(3)	(6)	-	6	(95)
<b>Total financing expenses (income), net</b>	<b>73</b>	<b>(9)</b>	<b>(1)</b>	<b>154</b>	<b>1</b>	<b>(156)</b>	<b>62</b>
Segment profit (loss) after financing expenses, net	444	366	61	(88)	3	87	873
Share in losses of equity accounted investees	-	-	-	-	-	72	72
<b>Segment profit (loss) before income tax</b>	<b>444</b>	<b>366</b>	<b>61</b>	<b>(88)</b>	<b>3</b>	<b>15</b>	<b>801</b>
Income tax	114	87	15	-	1	(1)	216
<b>Segment results – net profit (loss)</b>	<b>330</b>	<b>279</b>	<b>46</b>	<b>(88)</b>	<b>2</b>	<b>16</b>	<b>585</b>

## 11. Segment Reporting (Contd.)

### 11.1 Operating segments (Contd.)

	For the year ended December 31, 2011						
	Domestic fixed-line communication	Cellular	International communications and internet services	Multi- channel television	Other	Adjustments	Consolidated
	NIS million	NIS million	NIS million	NIS million	NIS million	NIS million	NIS million
Revenues from external sources	4,371	5,454	1,288	1,619	236	(1,619)	11,349
Inter-segment revenues	277	94	66	-	41	(454)	24
<b>Total revenues</b>	<b>4,648</b>	<b>5,548</b>	<b>1,354</b>	<b>1,619</b>	<b>277</b>	<b>(2,073)</b>	<b>11,373</b>
Depreciation and amortization	688	561	109	276	21	(260)	1,395
Segment results – operating profit	1,658	1,360	241	295	3	(315)	3,242
Financing expenses	531	67	11	547	5	(562)	599
Financing income	(291)	(105)	(9)	(23)	-	39	(389)
<b>Total financing expenses (income), net</b>	<b>240</b>	<b>(38)</b>	<b>2</b>	<b>524</b>	<b>5</b>	<b>(523)</b>	<b>210</b>
Segment profit (loss) after financing expenses, net	1,418	1,398	239	(229)	(2)	208	3,032
Share in earnings (losses) of equity accounted investees	-	-	1	-	-	(217)	(216)
<b>Segment profit (loss) before income tax</b>	<b>1,418</b>	<b>1,398</b>	<b>240</b>	<b>(229)</b>	<b>(2)</b>	<b>(9)</b>	<b>2,816</b>
Income tax	353	342	58	1	4	(3)	755
<b>Segment results – net profit (loss)</b>	<b>1,065</b>	<b>1,056</b>	<b>182</b>	<b>(230)</b>	<b>(6)</b>	<b>(6)</b>	<b>2,061</b>

## 11. Segment Reporting (contd.)

### 11.1. Adjustments for segment reporting of revenue and profit or loss

	For the six month period ended		For the three month period ended		For the year ended
	June 30		June 30		December 31
	2012	2011	2012	2011	2011
	(Unaudited)	(Unaudited)	(Unaudited)	(Unaudited)	(Audited)
	NIS million	NIS million	NIS million	NIS million	NIS million

#### Revenues

Revenues from reporting segments	6,239	6,708	3,048	3,345	13,169
Revenues from other segments	144	136	73	69	277
Cancellation of revenues from inter-segment sales except for revenues from sales to an associate reporting as a segment	(223)	(228)	(117)	(117)	(454)
Cancellation of revenue for a segment classified as an associate	(825)	(810)	(409)	(404)	(1,619)
<b>Consolidated revenues</b>	<b>5,335</b>	<b>5,806</b>	<b>2,595</b>	<b>2,893</b>	<b>11,373</b>

	For the six month period ended		For the three month period ended		For the year ended
	June 30		June 30		December 31
	2012	2011	2012	2011	2011
	(Unaudited)	(Unaudited)	(Unaudited)	(Unaudited)	(Audited)
	NIS million	NIS million	NIS million	NIS million	NIS million

#### Profit or loss

Operating profit for reporting segments	1,731	1,732	823	1,000	3,554
Cancellation of segment results for a segment classified as an associate	(126)	(127)	(74)	(66)	(295)
Other financing income (expenses), net	(33)	(82)	(77)	(62)	(210)
Share in losses of equity-accounted investees	(141)	(137)	(83)	(72)	(216)
Profit (loss) for operations classified in other categories	(1)	5	1	4	3
Other adjustments	(8)	(10)	(4)	(3)	(20)
	<b>1,422</b>	<b>1,381</b>	<b>586</b>	<b>801</b>	<b>2,816</b>

## 12. Condensed Financial Statements of Pelephone Communications Ltd. and Bezeq International Ltd.

### 12.1. Pelephone Communications Ltd.

#### Statement of financial position

	June 30, 2012	June 30, 2011	December 31, 2011
	(Unaudited)	(Unaudited)	(Audited)
	NIS million	NIS million	NIS million
Current assets	2,492	2,220	2,280
Non-current assets	2,907	3,103	3,124
	<b>5,399</b>	<b>5,323</b>	<b>5,404</b>
Current liabilities	1,036	1,406	1,263
Long-term liabilities	1,269	645	992
<b>Total liabilities</b>	<b>2,305</b>	<b>2,051</b>	<b>2,255</b>
Equity	3,094	3,272	3,149
	<b>5,399</b>	<b>5,323</b>	<b>5,404</b>

#### Statement of income

	For the six month period ended		For the three month period ended		For the year ended
	June 30		June 30		December 31
	2012	2011	2012	2011	2011
	(Unaudited)	(Unaudited)	(Unaudited)	(Unaudited)	(Audited)
	NIS million	NIS million	NIS million	NIS million	NIS million
Revenues from services	1,072	1,294	545	628	2,436
Revenue from value added services	619	580	312	297	1,201
Revenues from sales of terminal equipment	701	1,014	291	513	1,911
<b>Total revenues from services and sales</b>	<b>2,392</b>	<b>2,888</b>	<b>1,148</b>	<b>1,438</b>	<b>5,548</b>
Cost of services and sales	1,583	1,829	752	927	3,587
<b>Gross profit</b>	<b>809</b>	<b>1,059</b>	<b>396</b>	<b>511</b>	<b>1,961</b>
Selling and marketing expenses	227	242	111	125	480
General and administrative expenses	56	61	26	29	121
	<b>283</b>	<b>303</b>	<b>137</b>	<b>154</b>	<b>601</b>
<b>Operating profit</b>	<b>526</b>	<b>756</b>	<b>259</b>	<b>357</b>	<b>1,360</b>
Financing expenses	52	36	35	21	67
Financing income	(74)	(55)	(35)	(30)	(105)
<b>Financing expenses (income), net</b>	<b>(22)</b>	<b>(19)</b>	<b>-</b>	<b>(9)</b>	<b>(38)</b>
<b>Profit before income tax</b>	<b>548</b>	<b>775</b>	<b>259</b>	<b>366</b>	<b>1,398</b>
Income tax	138	186	65	87	342
<b>Profit for the period</b>	<b>410</b>	<b>589</b>	<b>194</b>	<b>279</b>	<b>1,056</b>

## 12. Condensed Financial Statements of Pelephone Communications Ltd. and Bezeq International Ltd. (Contd.)

### 12.2. Bezeq International Ltd.

Statement of financial position:

	June 30, 2012	June 30, 2011	December 31, 2011
	(Unaudited)	(Unaudited)	(Audited)
	NIS million	NIS million	NIS million
Current assets	484	489	500
Non-current assets	803	661	768
	<b>1,287</b>	<b>1,150</b>	<b>1,268</b>
Current liabilities	295	299	292
Long-term liabilities	178	20	147
<b>Total liabilities</b>	<b>473</b>	<b>319</b>	<b>439</b>
Equity	814	831	829
	<b>1,287</b>	<b>1,150</b>	<b>1,268</b>

Statement of income:

	For the six month period ended		For the three month period ended		For the year ended
	June 30		June 30		December 31
	2012	2011	2012	2011	2011
	(Unaudited)	(Unaudited)	(Unaudited)	(Unaudited)	(Audited)
	NIS million	NIS million	NIS million	NIS million	NIS million
Revenues from services	662	662	330	333	1,354
Operating expenses	396	387	195	194	788
Gross profit	266	275	135	139	566
Selling, marketing and development expenses	103	100	53	53	209
General and administrative expenses	60	54	29	26	116
	163	154	82	79	325
Operating profit	103	121	53	60	241
Financing expenses	9	5	4	2	11
Financing income	(5)	(5)	(2)	(3)	(9)
Financing expenses (income), net	4	-	2	(1)	2
Share in the earnings of equity-accounted associates	-	-	-	-	1
Profit before income tax	99	121	51	61	240
Income tax	24	29	12	15	58
Profit for the period	75	92	39	46	182

### **13. Material Events During the Reporting Period and Subsequent Events**

- 13.1** On April 2, 2012, the settlement between the Company and the Ministry of Communications regarding the claim of government authorities to pay frequency fees in Judea, Samaria and Gaza according to which the Company will pay the plaintiffs NIS 26 million (plus linkage to the CPI of February 11, 2010), was given the validity of a ruling. Following the settlement, in the first quarter of 2012, the Company reduced liabilities for frequency fees and decreased operating and general expenses by NIS 37 million and financing expenses by NIS 13 million.
- 13.2** On July 2, 2012, the Board of Directors of the Company resolved to suspend the customer relations management (CRM) project, while continuing to use the suitable models that have already been developed. Therefore, in the three months ended June 30, 2012, the Company recognized a loss of NIS 54 million under other operating expenses.
- 13.3** Further to Note 18.3 to the Annual Financial Statements, on July 24, 2012, the Ministers of Finance and Communications signed an amendment to the Royalties Regulations relevant to the Company, Pelephone and DBS, so that the rate of royalties for 2012 will be reduced to an average of 1.75% for the Company and DBS, 1.3% for Pelephone (the rate of royalties for Bezeq International is 1%), and as from 2013, 0% for all the companies.

# **DBS Satellite Services (1998) Ltd.**

## **Condensed Interim Financial Statements**

**June 30, 2012**



The information contained in these financial statements constitutes a translation of the financial statements published by the Company. The Hebrew version was submitted by the Company to the relevant authorities pursuant to Israeli law, and represents the binding version and the only one having legal effect. This translation was prepared for convenience purposes only.



**Condensed Interim Financial Statements as at June 30, 2012**

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**Somekh Chaikin**

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**Review Report to the Shareholders of D.B.S. Satellite Services (1998) Ltd.**

*Introduction*

We have reviewed the accompanying financial information of DBS Satellite Services (1998) Ltd (hereinafter- "the Company") comprising the condensed interim statement of financial position as of June 30, 2012 and the condensed interim statements of operations, comprehensive income, changes in equity and cash flows for the six and three month periods then ended. The Board of Directors and Management are responsible for the preparation and presentation of these interim financial information in accordance with IAS 34 "Interim Financial Reporting", and are also responsible for the preparation of financial information for these interim period in accordance with Section D of the Securities Regulations (Periodic and Immediate Reports), 1970. Our responsibility is to express a conclusion on the financial information for these interim periods based on our review.

*Scope of Review*

We conducted our review in accordance with Standard on Review Engagements 1, "Review of Interim Financial Information Performed by the Independent Auditor of the Entity" of the Institute of Certified Public Accountants in Israel. A review of interim financial information consists of making inquiries, primarily of persons responsible for financial and accounting matters, and applying analytical and other review procedures. A review is substantially less in scope than an audit conducted in accordance with generally accepted auditing standards in Israel and consequently does not enable us to obtain assurance that we would become aware of all significant matters that might be identified in an audit. Accordingly, we do not express an audit opinion.

*Conclusion*

Based on our review, nothing has come to our attention that causes us to believe that the abovementioned interim financial information is not prepared, in all material respects, in accordance with IAS 34.

In addition to that mentioned in the previous paragraph, based on our review, nothing has come to our attention that causes us to believe that the abovementioned interim financial information does not comply, in all material respects, with the disclosure requirements according to Section D of the Securities Regulations (Periodic and Immediate Reports), 1970.

Without qualifying our above conclusion, we draw attention to Note 4 regarding the financial condition of the Company.

Somekh Chaikin  
Certified Public Accountants (Isr.)

July 30, 2012

## Condensed Interim Financial Statements as at June 30, 2012

## Condensed Interim Statements of Financial Position at

	June 30, 2012	June 30, 2011	December 31, 2011
	(Unaudited)	(Unaudited)	(Audited)
	NIS thousands	NIS thousands	NIS thousands
<b>Assets</b>			
Cash and cash equivalents	20,050	19,990	13,325
Trade receivables	162,073	158,291	159,596
Other receivables	6,402	10,613	8,020
<b>Total current assets</b>	<b>188,525</b>	<b>188,894</b>	<b>180,941</b>
Broadcasting rights, net of rights exercised	364,948	313,778	330,572
Property, plant and equipment, net	705,268	670,921	675,954
Intangible assets, net	93,204	100,728	94,227
<b>Total non-current assets</b>	<b>1,163,420</b>	<b>1,085,427</b>	<b>1,100,753</b>
<b>Total assets</b>	<b>1,351,945</b>	<b>1,274,321</b>	<b>1,281,694</b>

The attached notes are an integral part of these condensed interim financial statements.



## Condensed Interim Financial Statements as at June 30, 2012

## Condensed Interim Statements of Financial Position at

	June 30, 2012	June 30, 2011	December 31, 2011
	(Unaudited)	(Unaudited)	(Audited)
	NIS thousands	NIS thousands	NIS thousands
<b>Liabilities</b>			
Borrowings from banks	403,998	41,702	85,998
Current maturities for debentures	58,213	57,271	57,494
Trade payables and service providers	454,067	394,083	409,298
Other payables	184,954	161,028	177,201*
Provisions	37,888	85,456	40,647*
<b>Total current liabilities</b>	<b>1,139,120</b>	<b>739,540</b>	<b>770,638</b>
Debentures	1,135,793	1,172,863	1,120,806
Bank loans	-	393,958	337,679
Loans from shareholders	2,888,656	2,502,366	2,677,916
Long-term trade payables	2,953	41,434	18,766
Employee benefits	6,211	6,777	6,171
<b>Total non-current liabilities</b>	<b>4,033,613</b>	<b>4,117,398</b>	<b>4,161,338</b>
<b>Total liabilities</b>	<b>5,172,733</b>	<b>4,856,938</b>	<b>4,931,976</b>
<b>Capital deficit</b>			
Share capital	29	29	29
Share premium	85,557	85,557	85,557
Options	48,219	48,219	48,219
Capital reserves	1,537,271	1,537,271	1,537,271
Capital reserve for share-based payments	10,280	9,990	10,280
Accumulated deficit	(5,502,144)	(5,263,683)	(5,331,638)
<b>Total capital deficit</b>	<b>(3,820,788)</b>	<b>(3,582,617)</b>	<b>(3,650,282)</b>
<b>Total liabilities and equity</b>	<b>1,351,945</b>	<b>1,274,321</b>	<b>1,281,694</b>

**David Efrati**  
(Authorized to sign as Chairman of the Board)  
(See Note 8)

**Ron Eilon**  
CEO

**Mickey Naiman**  
CFO

Date of approval of the financial statements: July 30, 2012

\* Reclassified

The attached notes are an integral part of these condensed interim financial statements.



## Condensed Interim Financial Statements as at June 30, 2012

## Condensed Interim Income Statements

	For the six month period ended		For the three month period ended		For the year ended
	June 30		June 30		December 31
	2012	2011	2012	2011	2011
	(Unaudited)	(Unaudited)	(Unaudited)	(Unaudited)	(Audited)
	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands
<b>Revenues</b>	<b>825,436</b>	809,510	<b>408,732</b>	403,960	1,618,809
Cost of revenues	<b>527,991</b>	540,896	<b>255,754</b>	268,997	1,028,168
<b>Gross profit</b>	297,445	268,614	152,978	134,963	590,641
Selling and marketing expenses	<b>95,092</b>	74,797	<b>41,585</b>	34,738	152,737
General and administrative expenses	<b>76,260</b>	67,134	<b>36,905</b>	34,912	143,036
<b>Operating profit</b>	<b>126,093</b>	126,683	<b>74,488</b>	65,313	294,868
Financing expenses	<b>86,329</b>	96,651	<b>56,700</b>	51,723	168,991
Financing income	<b>(924)</b>	(10,453)	<b>(435)</b>	(6,481)	(23,163)
Financing expenses for shareholder loans	<b>210,741</b>	201,979	<b>124,614</b>	108,258	377,529
Financing expenses, net	<b>296,146</b>	288,177	<b>180,879</b>	153,500	523,357
<b>Loss before income tax</b>	<b>(170,053)</b>	(161,494)	<b>(106,391)</b>	(88,187)	(228,489)
Income tax	<b>453</b>	248	<b>253</b>	177	1,128
<b>Loss for the period</b>	<b>(170,506)</b>	(161,742)	<b>(106,644)</b>	(88,364)	(229,617)
<b>Basic and diluted loss per share (NIS)</b>	<b>5,703</b>	5,410	<b>3,567</b>	2,956	7,681

The attached notes are an integral part of these condensed interim financial statements



## Condensed Interim Financial Statements as at June 30, 2012

## Condensed Interim Statements of Comprehensive Income

	For the six month period ended		For the three month period ended		For the year ended
	June 30		June 30		December 31
	2012	2011	2012	2011	2011
	(Unaudited)	(Unaudited)	(Unaudited)	(Unaudited)	(Audited)
	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands
<b>Loss for the period</b>	<b>(170,506)</b>	(161,742)	<b>(106,644)</b>	(88,364)	(229,617)
<b>Other items of comprehensive income:</b>					
Actuarial losses from a defined benefit plan	-	-	-	-	(80)
Other comprehensive profit (loss) for the period	-	-	-	-	(80)
<b>Total comprehensive loss for the period</b>	<b>(170,506)</b>	(161,742)	<b>(106,644)</b>	(88,364)	(229,697)

The attached notes are an integral part of these condensed interim financial statements



## Condensed Interim Financial Statements as at June 30, 2012

## Condensed Interim Statements of Changes in Equity

	Share capital	Share premium	Option warrants	Capital reserve	Capital reserve for share-based payments	Accrued deficit	Total
	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands
<b>Six months ended June 30, 2012 (unaudited)</b>							
Balance as at January 1, 2012 (audited)	29	85,557	48,219	1,537,271	10,280	(5,331,638)	(3,650,282)
<b>Total comprehensive loss for the period</b>							
Loss for the period	-	-	-	-	-	(170,506)	(170,506)
Other comprehensive loss for the period	-	-	-	-	-	-	-
Total comprehensive loss for the period	-	-	-	-	-	(170,506)	(170,506)
<b>Balance as at June 30, 2012 (unaudited)</b>	<b>29</b>	<b>85,557</b>	<b>48,219</b>	<b>1,537,271</b>	<b>10,280</b>	<b>(5,502,144)</b>	<b>(3,820,788)</b>
<b>Six month ended June 30, 2011 (unaudited)</b>							
Balance as at January 1, 2011 (audited)	29	85,557	48,219	1,537,271	9,391	(5,101,941)	(3,421,474)
<b>Total comprehensive loss for the period</b>							
Loss for the period	-	-	-	-	-	(161,742)	(161,742)
Other comprehensive loss for the period	-	-	-	-	-	-	-
Total other comprehensive loss for the period	-	-	-	-	-	(161,742)	(161,742)
<b>Transactions with owners recognized directly in equity</b>							
Share-based payments	-	-	-	-	599	-	599
<b>Balance as at June 30, 2011 (unaudited)</b>	<b>29</b>	<b>85,557</b>	<b>48,219</b>	<b>1,537,271</b>	<b>9,990</b>	<b>(5,263,683)</b>	<b>(3,582,617)</b>

The attached notes are an integral part of these condensed interim financial statements



## Condensed Interim Financial Statements as at June 30, 2012

## Condensed Interim Statements of Changes in Equity (Contd.)

	Share capital	Share premium	Option warrants	Capital reserve	Capital reserve for share-based payments	Accrued deficit	Total
	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands
<b>Three months ended June 30, 2012 (unaudited)</b>							
Balance as at April 1, 2012 (audited)	29	85,557	48,219	1,537,271	10,280	(5,395,500)	(3,714,144)
<b>Total comprehensive income for the period</b>							
Loss for the period	-	-	-	-	-	(106,644)	(106,644)
Other comprehensive loss for the period	-	-	-	-	-	-	-
Total comprehensive loss for the period	-	-	-	-	-	(106,644)	(106,644)
<b>Balance as at June 30, 2012 (unaudited)</b>	<b>29</b>	<b>85,557</b>	<b>48,219</b>	<b>1,537,271</b>	<b>10,280</b>	<b>(5,502,144)</b>	<b>(3,820,288)</b>
<b>Three months ended June 30, 2011 (unaudited)</b>							
Balance as at April 1, 2011 (audited)	29	85,557	48,219	1,537,271	9,689	(5,175,319)	(3,494,544)
<b>Total comprehensive loss for the period</b>							
Loss for the period	-	-	-	-	-	(88,364)	(88,364)
Other comprehensive loss for the period	-	-	-	-	-	-	-
Total other comprehensive loss for the period	-	-	-	-	-	(88,364)	(88,364)
<b>Transactions with owners recognized directly in equity</b>							
Share-based payments	-	-	-	-	301	-	301
<b>Balance as at June 30, 2011 (unaudited)</b>	<b>29</b>	<b>85,557</b>	<b>48,219</b>	<b>1,537,271</b>	<b>9,990</b>	<b>(5,263,683)</b>	<b>(3,582,617)</b>

The attached notes are an integral part of these condensed interim financial statements



## Condensed Interim Financial Statements as at June 30, 2012

## Condensed Interim Statements of Changes in Equity (Contd.)

	Share capital	Share premium	Option warrants	Capital reserve	Capital reserve for share-based payments	Accrued deficit	Total
	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands
<b>Year ended December 31, 2011 (audited)</b>							
Balance as at January 1, 2011 (audited)	29	85,557	48,219	1,537,271	9,931	(5,101,941)	(3,421,474)
<b>Total comprehensive loss for the year</b>							
Loss for the year	-	-	-	-	-	(229,617)	(229,617)
Other comprehensive loss for the year	-	-	-	-	-	(80)	(80)
Total comprehensive loss for the year						(229,697)	(229,697)
<b>Transactions with owners recognized directly in equity</b>							
Share-based payments	-	-	-	-	889	-	889
<b>Balance as at December 31, 2011 (audited)</b>	<b>29</b>	<b>85,557</b>	<b>48,219</b>	<b>1,537,271</b>	<b>10,280</b>	<b>(5,331,638)</b>	<b>(3,650,282)</b>

The attached notes are an integral part of these condensed interim financial statements



## Notes to the Financial Statements

## Condensed Interim Statements of Cash Flow

	For the six month period ended		For the three month period ended		For the year ended
	June 30		June 30		December 31
	2012	2011	2012	2011	2011
	(Unaudited)	(Unaudited)	(Unaudited)	(Unaudited)	(Audited)
	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands
<b>Cash flows from operating activities</b>					
Loss for the period	(170,506)	(161,742)	(106,644)	(88,364)	(229,617)
Adjustments:					
Depreciation and amortization	119,644	139,724	53,802	71,131	276,393
Financing expenses, net	286,203	278,601	165,852	137,650	519,716
Profit (loss) from sale of property, plant and equipment	466	(65)	522	(15)	(515)
Share-based payments	-	599		301	889
Income tax expenses	453	248	253	177	1,128
Change in trade receivables	(2,477)	10,556	4,598	5,009	9,251
Change in other accounts receivable	1,618	537	(719)	1,173	3,130
Change in trade payables and service providers	26,239	8,870	7,144	(5,846)	32,457
Change in other payables and provisions	(10,818)	(7,733)	(4,521)	2,654	(71,868)
Increase in broadcasting rights, net of rights exercised	(34,376)	(9,288)	(19,836)	(4,847)	(26,082)
Change in employee benefits	40	81	(114)	(45)	(605)
	386,992	422,130	206,981	207,342	743,894
Income tax paid	(453)	(248)	(253)	(177)	(1,128)
<b>Net cash from operating activities</b>	<b>216,033</b>	<b>260,140</b>	<b>100,084</b>	<b>118,801</b>	<b>513,149</b>
<b>Cash flows from investment activities</b>					
Proceeds from the sale of property, plant and equipment	172	198	63	69	747
Acquisition of property, plant and equipment	(104,185)	(105,004)	(55,722)	(47,551)	(207,741)
Payments for software and licenses	(21,439)	(10,990)	(13,527)	(7,177)	(32,181)
Payments for subscriber acquisition	-	(19,517)	-	(9,667)	(24,414)
<b>Net cash used in investment activities</b>	<b>(125,452)</b>	<b>(135,313)</b>	<b>(69,186)</b>	<b>(64,326)</b>	<b>(263,589)</b>

The attached notes are an integral part of these condensed interim financial statements.



## Notes to the Financial Statements

## Condensed Interim Statements of Cash Flow (Contd.)

	For the six month period ended		For the three month period ended		For the year ended
	June 30		June 30		December 31
	2012	2011	2012	2011	2011
	(Unaudited)	(Unaudited)	(Unaudited)	(Unaudited)	(Audited)
	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands
<b>Cash flows from financing activities</b>					
Repayment of bank loans	(23,379)	(84,851)	(8,426)	(12,425)	(97,277)
Repayment of debenture principal	-	-	-	-	(57,271)
Short-term bank credit, net	(442)	(85,736)	-	(3,788)	(85,294)
Payment for financing lease obligation	(650)	-	(316)	-	(768)
Interest paid	(59,385)	(52,803)	(24,372)	(16,925)	(114,178)
Issue of debentures, net	-	118,553	-	(1,347)	118,553
<b>Net cash used for financing activities</b>	<b>(83,856)</b>	<b>(104,837)</b>	<b>(33,114)</b>	<b>(34,485)</b>	<b>(236,235)</b>
<b>Increase in cash and cash equivalents</b>	<b>6,725</b>	<b>19,990</b>	<b>(2,216)</b>	<b>19,990</b>	<b>13,325</b>
Cash and cash equivalents at the beginning of the period	13,325	-	22,266	-	-
<b>Cash and cash equivalents at the end of the period</b>	<b>20,050</b>	<b>19,990</b>	<b>20,050</b>	<b>19,990</b>	<b>13,325</b>

The attached notes are an integral part of these condensed interim financial statements



**Notes to the Financial Statements**

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**NOTE 1 –REPORTING ENTITY**

DBS Satellite Services (1998) Ltd. (“the Company”) was incorporated in Israel on December 2, 1998. The Company’s head offices are located at 6 Hayozma St., Kfar Saba, Israel.

In January 1999, the Company received a license from the Ministry of Communications for satellite television broadcasts (“the License”). The License is valid until January 2017 and may be extended for an additional six years under certain conditions. The Company’s operations are subject, inter alia, to the Communications Law (Telecommunications and Broadcasts), 1982 (“the Communications Law”) and the regulations and rules promulgated thereunder and to the license terms.

Pursuant to its license, Bezeq The Israel Telecommunication Corporation Limited (“Bezeq”) is required to maintain full structural separation between it and its subsidiaries and between it and the Company. Additionally, under the licenses of the Company and Bezeq, there are restrictions on the joint marketing of services (service bundles).

In August 2009, the Supreme Court accepted the Israel Antitrust Authority’s appeal of the ruling of the Antitrust Tribunal approving the merger (as defined in the Antitrust Law, 1988) between the Company and Bezeq by exercising the options held by Bezeq into Company shares, subject to certain conditions, and ruled against the merger.

The Company believes that as a result of the development of competition between the telecommunications groups and the increasing importance of providing comprehensive communications services, if the restrictions on Bezeq’s control of the Company and on Bezeq’s cooperation with the Company remain intact, the adverse effect of these restrictions on the Company’s results is likely to increase.

**NOTE 2 - BASIS OF PREPARATION****A. Statement of compliance**

The condensed interim financial statements have been prepared in accordance with IAS 34, Interim Financial Reporting, and do not contain all of the information required for full annual financial statements. They should be read in conjunction with the financial statements for the year ended December 31, 2011 (“the annual statements”). In addition, these condensed interim financial statements have been prepared in accordance with the provisions of Chapter D of the Securities Regulations (Periodic and Immediate Reports), 1970.

The condensed interim financial statements were approved by the Company’s Board of Directors on July 30, 2012.

**B. Use of estimates and judgments**

The preparation of the condensed financial statements in accordance with IFRS requires management to make judgments, estimates and assumptions that affect the application of accounting policies and the reported amounts of assets, liabilities, income and expenses. Actual results may differ from these estimates.

The judgment of management when applying the Company’s accounting policy and the principal assumptions used in assessments that involve uncertainty are consistent with those applied in the annual financial statements.



## Notes to the Financial Statements

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### NOTE 3 - SIGNIFICANT ACCOUNTING POLICIES

The significant accounting policies applied in these condensed interim financial statements are consistent with those applied in the annual financial statements for the year ended December 31, 2011, except as described below:

#### Recognition of actuarial gains or losses

The Company does not produce an updated actuarial assessment for measuring employee benefits in every interim reporting period unless there are significant changes during the interim period in the principal actuarial assumptions in a defined benefit plan: discount rate, expected return on plan assets, employee leave rate and the rate of future salary increases. As a result, actuarial gains or losses are not recognized in the reporting period.

### NOTE 4 – FINANCIAL POSITION OF THE COMPANY

- A.** Since the beginning of its operations, the Company has accumulated substantial losses. The Company's losses in 2011 amounted to NIS 230 million and losses in the six months ended June 30, 2012 amounted to NIS 171 million. As a result of these losses, the Company's capital deficit and working capital deficit as at June 30, 2012 amounted to NIS 3,821 million and NIS 951 million, respectively. See Note 6.
- B.**
1. As at June 30, 2012, the Company is in compliance with the financial covenants under the financing agreements and the debentures.
  2. The Company's management believes that the financial resources at its disposal will be sufficient for the Company's operations for the coming year, based on the cash flow forecast approved by the Company's Board of Directors. If additional resources are required to meet its operational requirements for the coming year, the Company will adapt its operations to preclude the need for additional resources beyond those available to it. In recent years the Company was required to raise external financial resources intended, inter alia, to expand its investments. At the reporting date, a significant increase in its investments will require an expansion of the financial resources at its disposal. In addition, see Notes 6 and 7 which describe the material events in and after the balance sheet period.

### NOTE 5 – CONTINGENT LIABILITIES

#### Legal claims

Legal claims have been filed against the Company or various legal proceedings are pending against it (in this section: "legal claims").

In the opinion of the management of the Company, which is based, inter alia, on legal opinions as to the likelihood of success of the claims, appropriate provisions have been included in the financial statements where provisions are required to cover the exposure resulting from such claims.

As at June 30, 2012, the exposure resulting from the legal claims filed against the Company in respect of various matters amounts to NIS 167,374 thousand. These amounts and all the amounts of the claims in this note do not include interest and linkage.

Following is a description of the material legal claims against the Company as at June 30, 2012, classified by groups with similar characteristics.



**NOTE 5 – CONTINGENT LIABILITIES (CONTD.)****A. Employee claims**

During the normal course of business, employees and former employees filed collective and individual claims against the Company. Most of these claims are for alleged non-payment of salary components and delay in salary payment. As at June 30, 2012, these claims amounted to NIS 54,312. In the opinion of the management of the Company, which is based, inter alia, on legal opinions as to the likelihood of success of the claims, the financial statements include appropriate provisions of NIS 1,596 thousand where provisions are required to cover the exposure resulting from such claims.

**B. Customer claims**

During the normal course of business, the Company's customers filed claims against the Company. These are mainly motions for certification of class actions (and claims by virtue thereof) which are usually allegations of unlawful collection of money and harm to the services provided by the Company. As at June 30, 2012, these claims amounted to NIS 112,498 thousand. In the opinion of the management of the Company, which is based, inter alia, on legal opinions as to the likelihood of success of the claims, the financial statements include appropriate provisions of NIS 2,992 thousand where provisions are required to cover the exposure resulting from such claims.

With regard to a claim against the Company regarding omitted transmissions which is contained in customer claims and listed in note 31C to the annual financial statements for 2011, on April 22, 2012 a ruling was handed down by the Tel Aviv District Court approving dismissal of the claim and motion for certification as a class action in the amount of NIS 600 million.

On June 10, 2012 a motion was filed for certification of a class action in the Central District Court, alleging that the Company had ceased, unilaterally and in breach of the law, granting a benefit which it had been granting where it undertook to permit the viewing of VOD movies, at no charge, for a period of 36 months, before the end of the contractual period which was part of its agreement with them. The sum of the class action filed by the applicant amounts to NIS 7,500 thousand. The Company's response is to be filed by October 25, 2012. In the opinion of the Company's lawyers, financial resources will not be needed to dismiss these claims.

**C. Supplier and communication provider claims**

During the normal course of business, suppliers of goods and/or services to the Company filed various claims against the Company. As at June 30, 2012, these claims amounted to NIS 563 thousand. In the opinion of the Company's lawyers, financial resources will not be needed to dismiss the claim.



## Notes to the Financial Statements

### NOTE 6 –EVENTS IN THE BALANCE SHEET PERIOD

In May 2012 a debenture was signed by the Company and a number of institutional entities (“the lenders”) whereby the lenders would extend to the Company a loan of NIS 392 million (“the debenture”). The proceeds of the funds raised will be used for full repayment of the long-term credit granted to the Company by the banks. Receipt of the loan is conditional upon the existence of conditions precedent which were not fulfilled by June 30, 2012. The loan funds have been deposited in trust until fulfilment of the conditions precedent and registration of the lenders’ collateral.

In May 2012, S&P Maalot awarded the debenture a rating of ilA. This rating was determined as part of an overall rating set by S&P Maalot for the raising of debt of up to NIS 450 million par value as part of the debenture and as part of a possible expansion of the Company’s debenture (Series B).

The loan granted under the debenture will be used to repay the principal in ten annual unequal installments, where from 2013 – 2017 the payment of the principal will be 8% of the par value of the debentures and in each subsequent year the payment of the principal will be 12% of the par value of the debentures.

The debenture will bear annual interest of 6.4% payable in six-monthly installments. The principal and interest of the loan will be linked to the CPI. Under the terms of the debenture, if the rating of the loan is downgraded to BBBil or its equivalent (the lower of the two), the annual interest will be increased by 0.5%, and for each additional notch the annual interest will increase by a further 0.25% throughout the period in which the downgraded rating remains in effect.

In addition, the debenture stipulated various events (similar to the events stipulated in Deed of Trust B. The occurrence of these events (sometimes after an extension period) creates a right to demand immediate repayment of the loan, subject to the provisions of the debenture, including a demand for immediate repayment (not initiated by the Company) of another series of debentures issued or which will be issued by the Company and/or of debts owed by the Company to a financial institution subject to the terms set out in the debenture.

Under the provisions of the debenture, the Company must comply with the following two financial covenants every quarter (subject to the cure periods and cure terms determined in the debentures):

(A) Compliance with the total debt / EBITDA ratio – the ratio between the total debt (debts to the financial institutions listed in the debenture) at the end of the relevant quarter and the EBITDA of the Company in the 12-month period ending at the end of said quarter. The term “EBITDA” is defined – in relation to the period of any calculation – as the Company’s total operating profit from ordinary operations (before financing expenses and taxes) plus depreciation and amortization, plus expenses which are included in the investments item of the Company’s financial statements as at December 31, 2010 (and whose classification was changed to expenses as a result of accounting policy or directives from an authority) plus provisions and extraordinary non-recurring expenses. The maximum ratio set out in the debenture for a trial period up to the end of 2013 will be 5, for a review period up to the end of 2015 the ratio will be 4.65, and for a review period up to the end of 2016 the ratio will be 4.3.

(B) compliance with the debt / E-C ratio (EBITDA less CAPEX as defined in the agreement) will not exceed the maximum debt / E-C ratio set out in the debenture where until December 31, 2015 the ratio will be 9.5 and from January 1, 2016 the ratio will be 7.8.

The debenture determined certain restrictions regarding the distribution of dividends and repayment of shareholder loans similar to the restrictions applicable to Deed of Trust B. The financial condition ratio is lower (worse) than that applicable to Deed of Trust B.



**Notes to the Financial Statements**

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**NOTE 6 –EVENTS IN THE BALANCE SHEET PERIOD (CONTD.)**

The debenture will be secured by charges similar to those created in favor of the holders of debentures (Series B). The lenders' collateral will be of first and equal rank (*pari passu*) to the collateral created by the Company in favor of the banks to secure the bank credit for the collateral of the holders of debentures (Series A), the collateral of the holders of debentures (Series B), and the collateral financing the additional secured entities, if any. According to the debenture, the Company may take credit secured by assets, which represent collateral for the lenders subject to compliance with the general financial covenant relating to the debt / EBITDA ratio, and if a secured series of debentures is issued, subject to submission of a rating report that the loan rating at that time will not be downgraded as a result of the issuance of an additional series.

In the event that Bezeq provides a guarantee in favor of the lenders, and as long as the Company's rating does not fall below (iIAA-) or its equivalent in another rating company (the lower of the two), the collateral granted to the lenders will be abolished and a number of provisions relating to the terms governing funding secured by the Company, the financial covenants, certain grounds for immediate repayment, and the restrictions on the distribution of dividends and repayment of shareholder loans will be abolished. If such a guarantee is provided (and with certain changes also in the event of a merger between the Company and between Bezeq), the annual interest rate of the loan will be reduced by a further 1% (in other words to 5.4%, but no lower than the yield of Bezeq's debenture 6 after an adjustment for the difference in duration, and in any event no lower than 6.4%). Interest additions for a fall in the loan rating, if any, will also be abolished.

Further to that stated above, the Company's loans from bank institutions are presented under current liabilities because the Company expects to repay them in full after the balance sheet date, see note 7 below.

For further details of debentures A and B, see Note 14 to the Company's annual financial statements as at December 31, 2011.



## Notes to the Financial Statements

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### NOTE 7 – MATERIAL EVENTS SUBSEQUENT TO THE REPORTING DATE

- A.** In July 2012 the Company expanded its debenture series (Series B) by issuing additional debentures in the sum of NIS 10 million, the proceeds of which, together with the funds from the debenture loan, were used in full repayment of the long-term bank credit.
- B.** In July 2012 after the conditions precedent determined in the debenture were fulfilled, the Company made full repayment of its long-term bank credit (by means of a loan provided in accordance with the debenture and in consideration of an expansion of the Company's debenture series (Series B). With this repayment, an amendment to the financing agreement ("the agreement amendment" and "the amended financing agreement came into force". Under the amended financing agreement, the amount of the Company's ongoing credit facility was increased to NIS 170 million, but use of this facility was restricted to the Company's total working capital requirements (calculated on the basis of the formula set out in the amended financing agreement which is dependent on the Company's receivables balance, the amount of unexercised broadcasting rights, the depreciated cost of the decoders and the Company's payables balance according to its financial statements). In addition, under the amended financing agreement, the undertakings and restrictions imposed on the Company by the financing agreement were either abolished or reduced. The provisions of the amendment to the agreement also abolished the collateral created by Bezeq and Eurocom DBS in favor of the banks to secure the Company's bank credit and the undertakings they made to the banks in connection with the Company's bank credit, among them Bezeq's guarantee to the banks.

The new financing agreement abolished the financial covenants which had been in force and which were replaced by the Company's quarterly obligation to comply with two financial covenants which were identical to those set out in the new debenture.

The amended financing agreement also determined that a demand for immediate repayment or the existence of grounds to make a demand for immediate repayment of amounts owed by the Company to debenture holders, other banks or financial institutions constitutes grounds for immediate repayment of the bank credit. According to the amended financing agreement, if the rating of the loan is downgraded by S&P Maalot to iBBB (or its equivalent by another rating company, the lower of the two), the annual interest paid to the banks for each additional notch will increase by 0.25% on the rating scale throughout the period in which the downgraded rating remains in effect, (unless, according to the debenture, the downgraded rating does not grant any lender additional interest for the loan owing to the Bezeq guarantee in its favor).

- C.** On July 10, 2012, a motion for certification of a class action was filed in the Central District Court, alleging that the Company had breached the agreement between it and its subscribers who had signed up to the VOD service. The sum of the class action filed by the applicant amounts to NIS 28,608 thousand. The Company's response is to be filed by December 9, 2012. The Company has not yet formulated its response to the motion for certification.

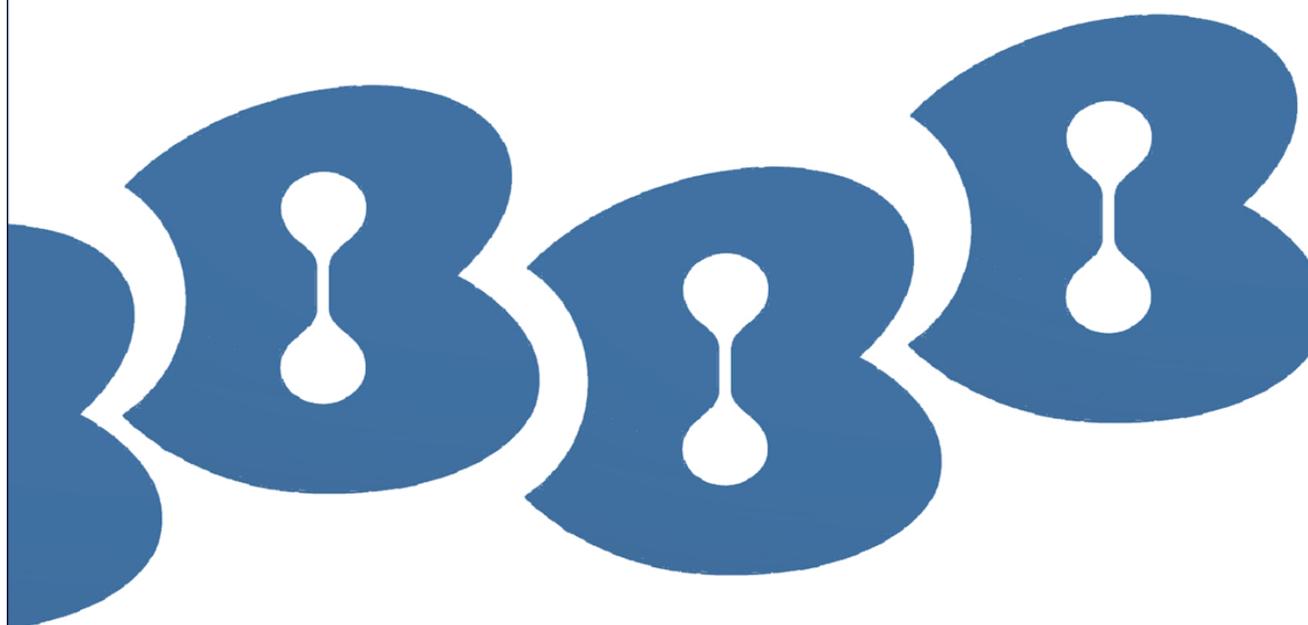
### NOTE 8 – APPOINTMENT OF THE CHAIRMAN OF THE BOARD OF DIRECTORS FOR THE APPROVAL MEETING

At the date of approval of the financial statements, the Company's Board of Directors does not have an incumbent chairman. Consequently, on July 30, 2012, the Company's Board of Directors authorized David Efrati, a director in the Company, to serve as chairman of the Board of Directors' meeting convened to approve the financial statements and to sign the Company's financial statements as at June 30, 2012.



**Bezeq The Israel  
Telecommunication Corporation  
Ltd.**

**Condensed Separate Interim  
Financial Information as at  
June 30, 2012  
(Unaudited)**



The information contained in these financial reports constitutes a translation of the financial reports published by the Company. The Hebrew version was submitted by the Company to the relevant authorities pursuant to Israeli law, and represents the binding version and the only one having legal effect. This translation was prepared for convenience purposes only.

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To:  
The Shareholders of "Bezeq"- The Israel Telecommunication Corporation Ltd.

**Special auditors' report on the separate interim financial information according to Regulation 38D of the Securities Regulations (Periodic and Immediate Reports) - 1970**

**Introduction**

We have reviewed the separate interim financial statements presented in accordance with Regulation 38D of the Securities Regulations (Periodic and Immediate Reports) -1970 of "Bezeq"- The Israel Telecommunication Corporation Ltd. (hereinafter- "the Company") as of June 30, 2012 and for the six and three month periods then ended. The separate interim financial information is the responsibility of the Company's Board of Directors and of its Management. Our responsibility is to express a conclusion on the separate interim financial information for these periods based on our review.

We did not review the separate interim financial information from the financial statements of investee companies in which investments amounted to NIS 243 million as of June 30, 2012, and the Company's share in the profit from these investee companies amounted to NIS 68 million and NIS 3.8 million for the six and three month periods then ended, respectively. The financial statements of those companies were reviewed by other auditors, whose review reports thereon were furnished to us, and our conclusion, insofar as it relates to amounts emanating from the financial statements of such companies, is based solely on the said review reports of the other auditors.

**Scope of Review**

We conducted our review in accordance with Standard on Review Engagements 1 – "Review of Interim Financial Information Performed by the Independent Auditor of the Entity" of the Institute of Certified Public Accountants in Israel. A review of separate interim financial information consists of making inquiries, primarily of persons responsible for financial and accounting matters, and applying analytical and other review procedures. A review is substantially less in scope than an audit conducted in accordance with generally accepted auditing standards in Israel and consequently does not enable us to obtain assurance that we will become aware of all significant matters that might be identified in an audit. Accordingly, we do not express an audit opinion.

**Conclusion**

Based on our review and the review reports of other accountants, nothing has come to our attention that causes us to believe that the abovementioned separate interim financial information is not prepared, in all material respects, in accordance with the Regulation 38D of the Securities Regulations (Periodic and Immediate Reports) -1970.

Without qualifying our abovementioned conclusion, we draw attention to lawsuits filed against the Company which cannot yet be assessed or the exposure in respect thereof cannot yet be estimated, as set forth in Note 4

Somekh Chaikin  
Certified Public Accountants (Isr.)

August 1, 2012

## Condensed Interim Statements of Financial Position

	June 30, 2012	June 30, 2011	December 31, 2011
	(Unaudited)	(Unaudited)	(Audited)
	NIS million	NIS million	NIS million
<b>Assets</b>			
Cash and cash equivalents	184	208	1,096
Investments, including derivatives	615	17*	940
Trade receivables	790	749	731
Other receivables	223	79	212
Inventories	28	8	13
Loans and guarantees granted to investees	318	462*	546
Assets classified as held for sale	28	20	23
<b>Total current assets</b>	<b>2,186</b>	<b>1,543</b>	<b>3,561</b>
Investments, including derivatives	72	81	77
Trade and other receivables	119	223	116
Property, plant and equipment	4,405	4,255	4,319
Intangible assets	345	308	368
Investments in investees	6,216	6,424*	6,303
Loans and guarantees granted to investees	1,515	712*	1,256
Deferred tax assets	160	252	216
<b>Total non-current assets</b>	<b>12,832</b>	<b>12,255</b>	<b>12,655</b>
<b>Total assets</b>	<b>15,018</b>	<b>13,798</b>	<b>16,216</b>

## Condensed Interim Statements of Financial Position (contd.)

	December 31,		
	June 30, 2012	June 30, 2011	2011
	(Unaudited)	(Unaudited)	(Audited)
	NIS million	NIS million	NIS million
<b>Liabilities</b>			
Debentures, loans and borrowings	674	1,241	757
Trade payables	197	167	177
Other payables, including derivatives	401	572	592
Current tax liabilities	459	250	361
Deferred income	36	21	28
Provisions (Note 4)	150	233	163
Employee benefits	286	447	351
Dividend payable	970	972	971
<b>Total current liabilities</b>	<b>3,173</b>	<b>3,903</b>	<b>3,400</b>
Debentures	4,581	2,338	5,034
Bank loans	3,996	3,523	3,996
Employee benefits	183	221	182
Deferred and other income	41	6	30
Dividend payable	467	1,369	924
<b>Total non-current liabilities</b>	<b>9,268</b>	<b>7,457</b>	<b>10,166</b>
<b>Total liabilities</b>	<b>12,441</b>	<b>11,360</b>	<b>13,566</b>
<b>Equity</b>			
Share capital	3,831	3,814	3,826
Share premium	82	35	68
Reserves	593	550	608
Deficit	(1,929)	(1,961)	(1,852)
<b>Total equity</b>	<b>2,577</b>	<b>2,438</b>	<b>2,650</b>
<b>Total liabilities and equity</b>	<b>15,018</b>	<b>13,798</b>	<b>16,216</b>

**Shaul Elovitch**  
Chairman of the Board of  
Directors

**Avi Gabbay**  
CEO

**Alan Gelman**  
Deputy CEO and CFO

\* Reclassified See Note 1.3

Date of approval of the financial statements: August 1, 2012

The accompanying notes to the condensed separate financial information are an integral part thereof.

## Condensed Interim Statements of Income

	For the six month period ended		For the three month period ended		For the year ended
	June 30		June 30		December 31
	2012	2011	2012	2011	2011
	(Unaudited)	(Unaudited)	(Unaudited)	(Unaudited)	(Audited)
	NIS million	NIS million	NIS million	NIS million	NIS million
<b>Revenues (Note 2)</b>	<b>2,360</b>	<b>2,348</b>	<b>1,161</b>	<b>1,170</b>	<b>4,648</b>
Cost of Activities					
Depreciation and amortization	356	333	178	171	688
Salaries	534	575	267	291	1,089
Operating and general expenses (Note 3)	500	524	263	253	1,074
Other operating expenses (income), net	(6)	188	16	(62)	139
	<b>1,384</b>	<b>1,620</b>	<b>724</b>	<b>653</b>	<b>2,990</b>
<b>Operating profit</b>	<b>976</b>	<b>728</b>	<b>437</b>	<b>517</b>	<b>1,658</b>
<b>Financing expenses (income)</b>					
Financing expenses	294	215	174	135	531
Finance revenues	(169)	(116)	(98)	(62)	(291)
Financing expenses, net	<b>125</b>	<b>99</b>	<b>76</b>	<b>73</b>	<b>240</b>
<b>Profit after financing expenses, net</b>	<b>851</b>	<b>629</b>	<b>361</b>	<b>444</b>	<b>1,418</b>
<b>Share in earnings of investees, net</b>	<b>406</b>	<b>539</b>	<b>152</b>	<b>255</b>	<b>1,001</b>
<b>Profit before income tax</b>	<b>1,257</b>	<b>1,168</b>	<b>513</b>	<b>699</b>	<b>2,419</b>
<b>Income tax (see Note 5.4)</b>	<b>260</b>	<b>176</b>	<b>98</b>	<b>114</b>	<b>353</b>
<b>Profit for the period</b>	<b>997</b>	<b>992</b>	<b>415</b>	<b>585</b>	<b>2,066</b>

The accompanying notes to the condensed separate interim financial information are an integral part thereof.

## Condensed Interim Statement of Comprehensive Income

	For the six month period ended		For the three month period ended		For the year ended
	June 30		June 30		December 31
	2012	2011	2012	2011	2011
	(Unaudited)	(Unaudited)	(Unaudited)	(Unaudited)	(Audited)
	NIS million	NIS million	NIS million	NIS million	NIS million
<b>Profit for the period</b>	<b>997</b>	<b>992</b>	<b>415</b>	<b>585</b>	<b>2,066</b>
<b>Items of other comprehensive income</b>					
Actuarial gains (losses) net of tax	-	-	-	-	28
Other items of comprehensive income (loss) for the period, net of tax	-	(1)	-	(1)	3
Effective portion of the change in fair value of the instruments used for cash flow hedging, net of tax	(2)	-	(2)	-	-
Other comprehensive income (loss) for the period, net of tax with respect to investees	(6)	-	-	-	4
<b>Other comprehensive income (loss), net of tax</b>	<b>(8)</b>	<b>(1)</b>	<b>(2)</b>	<b>(1)</b>	<b>35</b>
<b>Total comprehensive income for the period</b>	<b>989</b>	<b>991</b>	<b>413</b>	<b>584</b>	<b>2,101</b>

The accompanying notes to the condensed separate interim financial information are an integral part thereof.

## Condensed Interim Statement of Cash Flows

	For the six month period ended		For the three month period ended		For the year ended
	June 30		June 30		December 31
	2012	2011	2012	2011	2011
	(Unaudited)	(Unaudited)	(Unaudited)	(Unaudited)	(Audited)
	NIS million	NIS million	NIS million	NIS million	NIS million
<b>Cash flows from operating activities</b>					
Profit for the period	997	992	415	585	2,066
Adjustments:					
Depreciation	310	296	153	152	613
Amortization of intangible assets	46	37	25	19	75
Share in the profits of equity-accounted investees, net	(406)	(539)	(152)	(255)	(1,001)
Financing expenses, net	173	94	121	65	243
Capital loss (gain), net	2	(87)	26	(43)	(181)
Share-based payment transactions	39	83	19	42	165
Income tax expenses	260	176	98	114	353
Expenses (income) for derivatives, net	(6)	-	(11)	2	(21)
Change in inventory	(14)	7	(9)	1	2
Change in trade and other receivables	(82)	32	(11)	29	95
Change in trade and other payables	(91)	(162)	(181)	(77)	(80)
Change in provisions	(13)	3	(8)	(7)	(67)
Change in employee benefits	(64)	176	(32)	(50)	79
Change in deferred income	10		3		27
Net cash from (used in) operating activities with respect to transactions with investees	(17)	(29)	(25)	6	(34)
Net income tax paid	(117)	(164)	(55)	(87)	(228)
<b>Net cash from operating activities</b>	<b>1,027</b>	<b>915</b>	<b>376</b>	<b>496</b>	<b>2,106</b>
<b>Cash flow used in investing activities</b>					
Investment in intangible assets	(70)	(69)	(34)	(39)	(167)
Proceeds from the sale of property, plant and equipment	68	235	22	48	228
Acquisition of financial assets held for trading	(1,851)	-	(751)	-	(2,850)
Proceeds from the sale of financial assets held for trading:	2,175		1,425	8	1,961
Purchase of property, plant and equipment	(437)	(569)	(204)	(280)	(998)
Net proceeds (payment) for derivatives	10	(11)	6	-	(5)
Proceeds from disposal of investments and long-term loans	3	3	6	2	7
Interest and dividends received	5	10	3	8	33
Increase in holdings in a subsidiary	(77)	-	(77)	-	-
Net cash from (used in) investment activities with respect to transactions with investees	452	450	855	231	507
<b>Net cash from (used in) investment activities</b>	<b>278</b>	<b>49</b>	<b>1,251</b>	<b>(22)</b>	<b>(1,284)</b>

The accompanying notes to the condensed separate interim financial information are an integral part thereof.

## Condensed Interim Statements of Cash Flows (cont.)

	For the six-month period ended		For the three-month period ended		For the year ended
	June 30		June 30		December 31
	2012	2011	2012	2011	2011
	(Unaudited)	(Unaudited)	(Unaudited)	(Unaudited)	(Audited)
	NIS million	NIS million	NIS million	NIS million	NIS million
<b>Cash flows used in financing activities</b>					
Bank loans received	-	1,600	-	1,600	2,200
Issue of debentures	-	400	-	400	3,092
Repayment of bank loans	(77)	-	-	-	(600)
Repayment of debentures	(316)	(691)	(316)	(666)	(702)
Dividend paid	(1,574)	(1,663)	(1,574)	(1,663)	(3,155)
Interest paid	(262)	(177)	(228)	(157)	(346)
Net proceeds (payment) for derivatives	10		10		(1)
Proceeds from exercise of options	2	10	2	6	21
Net cash from (used in) financing activities with respect to transactions with investees	-	(433)	-	(230)	(433)
<b>Net cash from (used for) financing activities</b>	<b>(2,217)</b>	<b>(954)</b>	<b>(2,106)</b>	<b>(710)</b>	<b>76</b>
<b>Increase (decrease) in cash and cash equivalents</b>					
	<b>(912)</b>	10	<b>(479)</b>	(236)	898
Cash and cash equivalents at the beginning of the period	1,096	198	663	444	198
<b>Cash and cash equivalents at the end of the period</b>	<b>184</b>	<b>208</b>	<b>184</b>	<b>208</b>	<b>1,096</b>

The accompanying notes to the condensed separate interim financial information are an integral part thereof.

## Notes to the Condensed Separate Interim Financial Information

**1. Manner of preparing financial information****1.1. Definitions**

The Company - "Bezeq" The Israel Telecommunication Corporation Limited.

Investee, the Group, Subsidiary, Interested Party as these terms are defined in the Company's consolidated financial statements for 2011.

**1.2. Principles for preparing financial information**

The condensed separate interim financial information is presented in accordance with Regulation 38D of the Securities Regulations (Periodic and Immediate Reports) -1970 and do not include all the information required under Regulation 9(C) and the Tenth Addendum of the Securities Regulations (Periodic and Immediate Reports) -1970 with respect to the separate financial information of the corporation. It should be read in conjunction with the separate financial information for the year ended December 31, 2011 and in conjunction with the condensed consolidated interim financial statements as at June 30, 2012 ("the Consolidated Financial Statements").

The accounting policies used for this condensed separate interim financial information are in accordance with the accounting policies specified in the separate financial information for the year ended December 31, 2011.

- 1.3.** Some of the amounts in the comparative information were reclassified to the relevant sections in the financial statements for the current period

**2. Revenue**

	For the six-month period ended		For the three-month period ended		For the year ended
	June 30		June 30		December 31
	2012	2011	2012	2011	2011
	(Unaudited)	(Unaudited)	(Unaudited)	(Unaudited)	(Audited)
	NIS million	NIS million	NIS million	NIS million	NIS million
Fixed-line telephony	1,160	1,224	572	607	2,393
Internet - infrastructure	581	534	285	269	1,092
Transmission and data communication	492	461	247	233	931
Other services	127	129	57	61	232
	<b>2,360</b>	<b>2,348</b>	<b>1,161</b>	<b>1,170</b>	<b>4,648</b>

**3. General and operating expenses**

	For the six-month period ended		For the three-month period ended		Year ended
	June 30		March 31		December 31
	2012	2011	2012	2011	2011
	(Unaudited)	(Unaudited)	(Unaudited)	(Unaudited)	(Audited)
	NIS million	NIS million	NIS million	NIS million	NIS million
Interconnectivity and payments to operators	147	157*	72	78*	314
Sales and marketing expenses	50**	89*	42	42*	194
Terminal equipment and materials	51	39	27	17	89
Maintenance of buildings and sites	122	122	59	60	247
Services and maintenance by sub-contractors	39	38	19	18	76
Vehicle maintenance expenses	37	41	18	20	78
Royalties and others	54	38	26	18	76
	<b>500</b>	<b>524</b>	<b>263</b>	<b>253</b>	<b>1,074</b>

\* Reclassified

\*\* See Note 13.1 to the consolidated financial statements with regard to a settlement arrangement between the Company and the Ministry of Communications concerning the State of Israel government authorities' claim for payment of frequency fees in Judea, Samaria and Gaza. Following the settlement the Company reduced its liabilities for frequency fees and decreased operating and general expenses by NIS 37 million and financing expenses by NIS 13 million.

**4. Contingent liabilities**

During the normal course of business, legal claims were filed against the Company or there are pending claims ("in this section: "Legal Claims").

In the opinion of the Company's managements, based, inter alia, on legal opinions as to the likelihood of success of the claims, the financial statements include appropriate provisions of NIS 150 million where provisions are required to cover the exposure resulting from such claims.

In the opinion of the Company's management, the amount of additional exposure (in addition to the foregoing provisions) as of June 30, 2012, due to claims filed against the Company on various matters and which are unlikely to be realized, amounts to NIS 2 billion. In addition there is further exposure in the amount of NIS 388 million regarding legal claims for which at this stage the likelihood of their success cannot be assessed. Of the above amount, an amount of NIS 361 million is for legal claims filed against the Company and other related companies without specifying the portion of the amount claimed from each of the defendants.

All the foregoing amounts are linked to the CPI and are stated net of interest.

In addition, there are other claims for which the Company has additional exposure beyond the aforesaid, which cannot be quantified, as the exact amount of the claim is not stated in the claim.

For further information pertaining to contingent liabilities see Note 5 to the Consolidated Statements, Contingent Liabilities.

## **5. Material agreements and transactions with investee companies during the reporting period and thereafter**

### **5.1. Loans to investees**

- 5.1.1 On March 29, 2012 the Company granted a loan in the amount of NIS 440 million to Pelephone Communications Ltd. ("Pelephone"). The loan bears fixed annual interest of 5.7%. The loan is repayable in ten equal annual payments commencing from March 15, 2013.
- 5.1.2 The loan granted by the Company to Pelephone on May 17, 2011 in the amount of NIS 280 million was repaid on May 17, 2015, in accordance with the terms of the loan.
- 5.1.3 During July 2012, Pelephone notified the Company of its intention to make early payment in August 2012 of NIS 270 million of the loan granted to it in December 2011, in a total amount of NIS 450 million.
- 5.1.4 On March 29, 2012 the Company granted a loan in the amount of NIS 40 million to Bezeq International Ltd. ("Bezeq International"). The loan bears fixed annual interest of 4.7%. The loan is repayable in five equal annual payments commencing from March 15, 2013.
- 5.1.5 On January 17, 2012 the Company granted a loan in the amount of NIS 3 million to Bezeq Online Ltd. The loan bears fixed annual interest of 4.2%. The loan is repayable in three equal annual payments commencing from January 17, 2013.

### **5.2. Financial guarantees**

For information pertaining to the approval of the Company's Board of Directors on August 1, 2012 with regard to providing guarantees to a bank with respect to a loan for Teletel Communication Channels Ltd. (a wholly owned subsidiary of Walla! Communication Ltd.), see Note 4.1.2 to the consolidated financial statements.

### **5.3. Dividends**

- 5.3.1 During May 2012, Pelephone paid to the Company a NIS 466 million dividend, which was announced during that month.
  - 5.3.2 During May 2012, Bezeq International paid to the Company a NIS 90 million dividend, which was announced during that month.
  - 5.3.3 On July 25, 2012, the board of directors of Bezeq International resolved to distribute a dividend in the amount of NIS 74 million in October 2012.
  - 5.3.4 On July 24, 2012, the board of directors of Pelephone resolved to distribute a dividend in the amount of NIS 410 million in October 2012.
- 5.4.** In February 2012, Stage One Venture Capital Fund (Israel) L.P. ("the Fund") signed an agreement to sell its entire holdings in Traffix Communications Systems Ltd. In March 2012 the Company received its share in the distribution of profits of the Fund in the amount of NIS 80 million. The profits from the sale are included under the profits of equity accounted investees in the Company, net of tax. Consequently, the Company's tax expenses include tax expenses for these profits.