

INTERNET GOLD GOLDEN LINES LTD

Form 20-F

April 24, 2013

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SECURITIES AND EXCHANGE COMMISSION

Washington D.C. 20549

FORM 20-F

REGISTRATION STATEMENT PURSUANT TO SECTION 12(b) OR (g) OF THE SECURITIES EXCHANGE ACT OF 1934

OR

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 2012

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

SHELL COMPANY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

Date of event requiring this shell company report \_\_\_\_\_

Commission file number: 0-30198

INTERNET GOLD – GOLDEN LINES LTD.  
(Exact name of Registrant as specified in its charter  
and translation of Registrant's name into English)

Israel

(Jurisdiction of incorporation or organization)

2 Dov Friedman Street, Ramat Gan 52503, Israel  
(Address of principal executive offices)

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(Name, Telephone, E-mail and/or Facsimile Number and Address of Company Contact Person)

Securities registered or to be registered pursuant to Section 12(b) of the Act:

Title of each class	Name of each exchange on which registered
Ordinary Shares, NIS 0.01 Par Value	NASDAQ Global Select Market

Securities registered or to be registered pursuant to Section 12(g) of the Act: None

Securities for which there is a reporting obligation pursuant to Section 15(d) of the Act: None

Indicate the number of outstanding shares of each of the issuer's classes of capital or common stock as of the close of the period covered by the annual report:

Ordinary Shares, par value NIS 0.01 per share .....19,203,186  
(as of December 31, 2012)

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes  No

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If this report is an annual or transition report, indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.

Yes  No

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer  Accelerated filer  Non-accelerated filer

Indicate by check mark which basis of accounting the registrant has used to prepare the financial statements included in this filing:

U.S. GAAP  International Financial Reporting Standards as issued by the International Accounting Standards Board  Other

If "Other" has been checked in response to the previous question, indicate by check mark which financial statement item the registrant has elected to follow:

Item 17  Item 18

If this is an annual report, indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes  No

## INTRODUCTION

We are a leading communications group in Israel. Our shares are listed on the NASDAQ Global Select Market and on the Tel Aviv Stock Exchange, or TASE. Our subsidiaries are B Communications Ltd. (formerly known as 012 Smile.Communications Ltd.) and Goldmind Media Ltd. (formerly known as Smile.Media Ltd.). As used in this annual report, the terms “we,” “us” and “our” mean Internet Gold - Golden Lines Ltd. and its subsidiaries, “B Communications” means B Communications Ltd., “SP1” means B Communications (SP1) Ltd., “SP2” means B Communications (SP2) Ltd., Goldmind means Goldmind Media Ltd., “Eurocom Communications” means Eurocom Communications Ltd., “Bezeq” means Bezeq - The Israel Telecommunications Corp., Ltd.; “Pelephone” means Pelephone Communications Ltd., “Bezeq International” means Bezeq International Ltd. and “DBS” or “YES” (the trade name for DBS) means DBS Satellite Service (1998) Ltd. Bezeq, Pelephone, Bezeq International and DBS are sometimes referred to as the Bezeq Group in this annual report.

On April 14, 2010, our principal subsidiary, B Communications, completed the acquisition of the controlling 30.44% interest in Bezeq (TASE:BZEQ), Israel’s largest telecommunications provider, from Ap.Sb.Ar. Holdings Ltd. (a consortium of Apax Partners, Saban Capital Group and Arkin Communications) for an aggregate cash purchase price of approximately NIS 6.5 billion. In accordance with the terms of the transaction, effective as of the closing of the acquisition, B Communications designated seven directors to replace the Apax-Saban-Arkin Group’s representatives on Bezeq’s Board of Directors, which numbers 13 directors. We began consolidating Bezeq’s financial results into our financial statements effective as of the closing of the acquisition. As of April 22, 2013 B Communications owned 30.97% of Bezeq’s outstanding ordinary shares.

Prior to January 2010, B Communications offered a wide range of broadband and traditional voice services in Israel, which we refer to in this annual report as the legacy communications business. As part of its acquisition of the controlling interest in Bezeq, on November 16, 2009, B Communications entered into an agreement to sell its legacy communications business (excluding certain retained indebtedness and liabilities) to a wholly-owned subsidiary of Ampal-American Israel Corporation, or Ampal, for NIS 1.2 billion. The sale of B Communications’ legacy communications business to Ampal was completed on January 31, 2010, and was effective as of January 1, 2010.

B Communications changed its name from 012 Smile.Communications Ltd. to B Communications Ltd. on March 16, 2010 in connection with its acquisition of the controlling interest in Bezeq. B Communications’ ordinary shares are listed on the NASDAQ Global Select Market (symbol: BCOM) and on the TASE. We currently own 78.11% of the ordinary shares of B Communications.

Effective as of January 1, 2009, we adopted International Financial Reporting Standards, IFRS, as issued by the International Accounting Standards Board, or the IASB, replacing the previous reporting standard which was generally accepted accounting principles in the United States, or U.S. GAAP. Accordingly, beginning January 1, 2009, we have prepared our consolidated financial data according to IFRS as issued by the IASB. Our transition date to IFRS under First Time Adoption of International Financial Reporting Standards was January 1, 2008. Comparative data of our financial statements has been restated to retrospectively reflect the adoption of IFRS. Our consolidated financial statements appearing in this annual report are prepared in New Israeli Shekels and are translated into U.S. dollars at the representative rate of exchange at December 31, 2012 (NIS 3.733 = \$1.00). The dollar amounts so presented should not be construed as representing amounts receivable, payable or incurred in dollars or convertible into dollars. All references in this annual report to “dollars” or “\$” are to U.S. dollars and all references in this annual report to “NIS” are to New Israeli Shekels.

Statements made in this annual report concerning the contents of any contract, agreement or other document are summaries of such contracts, agreements or documents and are not complete descriptions of all of their terms. If we filed any of these documents as an exhibit to this annual report or to any registration statement or annual report that

we previously filed, you may read the document itself for a complete description of its terms.

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### Forward Looking Statement

Except for the historical information contained in this annual report, the statements contained in this annual report are “forward-looking statements” within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, and the Private Securities Litigation Reform Act of 1995, as amended, with respect to our business, financial condition and results of operations. Such forward-looking statements reflect our current view with respect to future events and financial results. We urge you to consider that statements which use the terms “anticipate,” “believe,” “do not believe,” “expect,” “plan,” “intend,” “estimate,” “anticipate” and similar expressions are intended to identify forward-looking statements. We remind readers that forward-looking statements are merely predictions and therefore inherently subject to uncertainties and other factors and involve known and unknown risks that could cause the actual results, performance, levels of activity, or our achievements, or industry results, to be materially different from any future results, performance, levels of activity, or our achievements expressed or implied by such forward-looking statements. Such forward-looking statements are also included in Item 4 – “Information on the Company” and Item 5 – “Operating and Financial Review and Prospects.” Readers are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date hereof. Except as required by applicable law, including the securities laws of the United States, we undertake no obligation to publicly release any update or revision to any forward-looking statements to reflect new information, future events or circumstances, or otherwise after the date hereof. We have attempted to identify significant uncertainties and other factors affecting forward-looking statements in the Risk Factors section that appears in Item 3.D. “Key Information - Risk Factors.

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## PART I

## ITEM 1. IDENTITY OF DIRECTORS, SENIOR MANAGEMENT AND ADVISERS

Not applicable.

## ITEM 2. OFFER STATISTICS AND EXPECTED TIMETABLE

Not applicable.

## ITEM 3. KEY INFORMATION

## A. Selected Financial Data

Effective as of January 1, 2009, we adopted International Financial Reporting Standards, or IFRS, as issued by the International Accounting Standards Board, or the IASB, replacing the previous reporting standard which was generally accepted accounting principles in the United States, or U.S. GAAP. Accordingly, beginning January 1, 2009, we prepare our consolidated financial data according to IFRS as issued by the IASB. Our transition date to IFRS under First Time Adoption of International Financial Reporting Standards was January 1, 2008.

The tables below as of and for the five years ended December 31, 2012 set forth selected consolidated financial data, which is derived from our audited consolidated financial statements. The audited consolidated financial statements as of December 31, 2011 and 2012 and for the years ended December 31, 2010, 2011 and 2012 appear in this annual report.

## Consolidated Statement of Income Data:

	2008	2009	Year Ended December 31,		2012	2012
			2010	2011		(\$ in millions, except share and per share data)
	(NIS in millions, except share and per share data)					
Revenues	1,167	1,243	8,732	11,376	10,278	2,753
Depreciation and amortization	117	99	2,295	2,984	2,367	634
Salaries	184	171	1,500	2,122	1,986	532
General and operating expenses	741	811	3,711	4,468	3,997	1,070
Other operating expenses	(6 )	2	(3 )	323	(1 )	-
	1,037	1,083	7,503	9,897	8,349	2,236
Operating income	130	160	1,229	1,479	1,929	517
Finance expense	139	134	716	1,077	995	266
Finance income	(27 )	(132 )	(327 )	(497 )	(582 )	(156 )
Finance expense, net	112	2	389	580	413	110
Income after financing expenses (income), net	18	158	840	899	1,516	407
	-	-	235	216	245	66

## Share of losses in

## equity-accounted investee

Income before income tax	18	158	605	683	1,271	341
Income tax	22	58	385	653	555	149
Net income (loss) for the year	(4 )	100	220	30	716	192
Income (loss) attributable to owners of the Company	(18 )	62	(209 )	(266 )	(38 )	(10 )
Income (loss) attributable to non-controlling interest	14	38	429	296	754	202
Net income (loss) for the year	(4 )	100	220	30	716	192
Basic earnings (loss) per share.	(0.85 )	3.39	(11.11 )	(13.56 )	(1.97 )	(0.53 )
Diluted earnings (loss) per share	(0.89 )	3.39	(11.23 )	(13.60 )	(2.01 )	(0.54 )

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## Statements of Financial Position:

	2008	2009	December 31,		2012	2012
			2010	2011		(\$ in millions)
	(NIS in millions)					
Cash and cash equivalents	86	1,350	404	1,447	764	205
Total assets	1,901	2,846	24,320	25,259	22,804	6,109
Total current liabilities	424	1,009	4,305	4,787	4,906	1,314
Non-current liabilities	885	1,144	12,304	16,231	14,413	3,861

## Exchange Rate Information

The following table sets forth, for the periods and dates indicated, certain information regarding the Bank of Israel representative rate of exchange for dollars, expressed in NIS per one dollar. The representative rate is the average between the buying rate and the selling rate of exchange. We do not use such rates in the preparation of our consolidated financial statements included elsewhere herein. See Note 2 to the consolidated financial statements included elsewhere in this Form 20-F.

Period	Average
Year ended December 31, 2008	3.586
Year ended December 31, 2009	3.923
Year ended December 31, 2010	3.732
Year ended December 31, 2011	3.579
Year ended December 31, 2012	3.733

Period	High	Low
November 2012	3.952	3.810
December 2012	3.835	3.726
January 2013	3.791	3.714
February 2013	3.733	3.663
March 2013	3.733	3.637
April 2013 (through April 21)	3.633	3.618

On April 22, 2013, the representative rate of exchange was NIS 3.629= \$1.00 as published by the Bank of Israel.

## B. Capitalization and Indebtedness

Not applicable.

C. Reasons for the Offer and Use of Proceeds

Not applicable.

D. Risk Factors

Investing in our ordinary shares involves a high degree of risk and uncertainty. You should carefully consider the risks and uncertainties described below before investing in our ordinary shares. If any of the following risks actually occurs, our business, prospects, financial condition and results of operations could be harmed. In that case, the value of our ordinary shares could decline and you could lose all or part of your investment.

Risks Related to the Business of Bezeq

Bezeq's competition from other telecommunications providers and recent and potential changes in the competitive environment and communications technologies could adversely affect its business and our results of operations.

Competition in the voice, cellular, Internet services and television broadcast markets in Israel is intensifying. In the last year, competition in the telecommunications industry, particularly in cellular telephony, has intensified with the entry of the new operators, Golan Telecom Ltd., or Golan Telecom, and Hot Mobile Ltd. (previously known as Mirs Communications Ltd.), or Hot Mobile, and with comprehensive service packages and communications packages being offered by our competitors at fixed prices with unlimited use. This has led to lower prices and higher customer churn rates, which in turn has affected the Bezeq Group's results. In an effort to lessen the impact of these developments on their performance, the Bezeq Group companies are taking measures to streamline their operations and improve the services they provide to differentiate themselves from their competitors; however, there are no assurances that these efforts will be successful.

In addition to the entrance of new competitors, competition among the existing communications groups in Israel is intensifying. Four main groups, consisting of companies under common or joint control, hold a significant amount of the communications market in Israel today: the Bezeq Group, the IDB group, the Partner Communications Company Ltd., or Partner, group, and the HOT Telecom, or HOT, group. This competition can make it difficult for the Bezeq Group to attract new customers and retain existing customers, thereby increasing churn levels. Increased competition, tiered offerings that include lower priced entry level products and special promotions and discounts for customers who subscribe for service packages (packages containing various communications services such as telephony, Internet and broadcast services) from the Bezeq Group may contribute to increased average revenue per unique customer, or ARPU, but would likely reduce the Bezeq Group's ARPU on a per-service basis for each service included in a package of services.

Bezeq expects competition to continue to increase amid the changing legislation in Israel and consolidation in the telecommunications industry. Recently, the availability of service packages has accelerated with the transition to technologies based on IP protocol, which promotes technology convergence between the different communications systems and with the start of penetration of integrated products enabling various communications solutions on the same communications device (e.g. cellular and fixed-line telephony services in one handset). At present, joint service packages consisting of different communications services of the companies in each communications group are being offered. The marketing of joint service packages enables the communications groups to offer customers packages that are generally more attractive than individually priced services. We believe that the Bezeq Group is subject to stricter limitations than those which apply to the other communications groups, including among other things structural separation limitations and a limitation on marketing "joint" service packages. Also, technological developments and falling equipment prices could enable other operators to provide services similar to those provided by the Bezeq Group at much lower costs.

These trends may accelerate at such time as a retail market develops, which will allow mobile virtual network operators, or MVNOs, that do not own infrastructures to offer full end-to-end service bundles (including infrastructure) to their customers. Following the Israeli government's decision to encourage competition in the cellular market, nine or more MVNO licenses have been granted to date to virtual operators. To the best of our knowledge, only three of the recipients of MVNO licenses currently provide services: Rami Levy Cellular Communications Ltd., or Rami Levy, Alon Cellular Ltd., or Alon Cellular and Home Cellular Ltd.

On May 2, 2012, the Ministry of Communications published a policy document with respect to the expansion of competition in the fixed-line communications - wholesale market, which adopted the key recommendations of a committee appointed by the Israeli Ministers of Communications and Finance, or the Hayek Committee, for significant regulatory reforms in the Israeli communications market. For more information on the regulatory changes see Item 4B "Business Overview" under "Changes in the Regulatory Environment - Competition Policy of the Ministry of Communications."

**Fixed-Line Telephony.** Competition in providing fixed-line telephony service is intense, with providers introducing substantial price reductions over the years. We believe that competition in this market will increase due to the low barriers to entry primarily as a result of regulations permitting new service providers who receive a license to provide telephony services using voice over internet protocol, or VoIP, or voice over broadband, or VoB, technology over the infrastructure network owned by either Bezeq or HOT (the end user will still need to purchase access to the infrastructure network directly from Bezeq or HOT). As a result of the wholesale market implementation, the VoB service providers may be entitled to procure the access to the network infrastructure by itself. The Ministry of Communications requires the various telephony service providers to provide interconnection access in return for payment of an "interconnection fee" set by the Ministry. Competition may also increase following the commencement of operations by the proposed Israeli Electric Corporation, or IEC, joint venture, if successful, and as the result of the policy to develop a wholesale market in telecommunications services.

Cellular services have exacerbated the competitive pressures that Bezeq faces as a fixed-line telephony operator. In addition, increasing use of alternative communications technologies may continue to negatively affect Bezeq's fixed-line call usage volumes and subscriber growth. As new competitors and new technologies enter the market and prices decrease in line with the downward pressure on telephony prices, Bezeq's fixed-line telephony business may become less profitable and experience a decline in revenues and market share.

**Broadband Internet Infrastructure Access.** Bezeq's principal competitor in high-speed broadband Internet infrastructure access service market is HOT, which is the sole cable operator in Israel. In addition, Bezeq faces competition from mobile operators as they are increasingly able to utilize a combination of progressively powerful handsets and high bandwidth technologies, such as universal mobile telecommunications system, or UMTS and, potentially, long-term-evolution, or LTE, technology. Further, the Israeli Ministry of Communications has issued regulatory instructions in an attempt to create a wholesale market for broadband Internet infrastructure access which would allow service providers to provide services to their customers by using Bezeq's infrastructure. Competition may also increase following the proposed creation of a public-private joint venture between the government-owned IEC and a private company to be selected in a tender procedure, which, if successful, will use the electric transmission and distribution network in Israel owned by IEC to provide wholesale products to telecommunication services providers, and thus compete with Bezeq and HOT in the wholesale market as well as providing such services directly to large business customers. Bezeq expects competition, including price competition, from HOT, new startups and other companies to increase in the future and we cannot assure you that the joint service packages and other measures that Bezeq has introduced in response to these developments will be successful in attracting and retaining customers.



Cellular Services. The cellular market in Israel is characterized by saturation and a very high penetration level in excess of 100%. Until 2012, four companies operated in Israel's cellular communications market. During 2012, a number of other cellular operators began to operate. The entry of the new operators led to intensified competition, resulting in higher churn rates among the existing operators, a significant decrease in tariffs and consequently a decrease in profits. Pelephone's principal competitors, Cellcom, Partner and Hot Mobile (since February 2012), also provide Internet access services and domestic communications, and they market diverse joint service packages. Pelephone also faces increased competition from Golan Telecom, which launched its services at the same time as HOT Mobile, and MVNOs that provide cellular services under their own brand using the network infrastructure of another service provider. In addition, the Ministry of Communications has granted a special license to a few of the new operators to conduct a marketing experiment that will examine the provision of domestic telephony services using (VoIP over Cellular, or VoC, technology. VoC services may provide an alternative to traditional cellular services or virtual mobile networks, offering an easier and more cost efficient services. If the VoC marketing experiment is successful and the Ministry of Communications grants licenses to offer VoC service, demand for cellular services may be reduced, which would negatively impact revenues and profits from that segment.

International telephony. The international telephony market in Israel is characterized by a high degree of competition. At the end of 2012, there were eight companies offering international direct dialing services to private and business customers in Israel. Changes in licensing policy and the expanded use of VoIP technology have significantly reduced the barriers of entry into this market. In addition, during 2012, cellular operators began to offer international direct dial services as part of the unlimited packages they offered. Bezeq expects competition in this market, including price competition, to increase in the future.

Pay Television. The Israeli television market is characterized by a very high penetration rate and an increasing emphasis on new television technology, in particular digital, high-definition, or HD, and interactive television services such as video on demand, or VOD, requiring high-bandwidth and bi-directional distribution platforms. In the multi-channel television market, DBS has only one competitor, HOT. Other factors also have an impact on competition in the market, including the availability of free-to-air digital terrestrial television, or DTT channels and the increasing availability of video content that may be offered through the Internet. In addition, we believe that the implementation of certain regulatory changes may have an impact on competition in the market, including the expansion in the number of free-to-air DTT channels.

Competition can make it difficult to attract new customers and retain existing customers, thereby increasing churn levels, and may lead to increased price pressure. There can be no assurance that the Bezeq Group will be able to continue to compete successfully against its current or future competitors in any of its businesses. Bezeq's failure to do so could have a material adverse effect on its business, financial condition and results of operations.

Bezeq operates in a highly regulated telecommunications market which limits its flexibility in managing its business and may materially and adversely affect our results of operations.

The Bezeq Group operates in a highly regulated industry in Israel, which limits its flexibility in managing its business efficiently. The Bezeq Group is subject to government supervision and regulation relating to, among other things, its operations, licensing, determining permitted areas of activity, determining tariffs, competition, environmental matters, payment of royalties (zero rate as of 2013), obligation to provide universal service, ability to hold its shares, relationships between Bezeq and its subsidiaries and in certain events, prohibitions against terminating or restricting its services (which may force Bezeq to provide services at a loss).

The Ministry of Communications has recently taken active steps to increase competition in the fixed-line and cellular telecommunications industries, including providing licenses to MVNOs and eliminating termination fees that operators can charge, except in limited circumstances, and beginning in January 2013 prohibiting the linkage between the price of services or benefits of the cellular contract and the terms of purchasing handsets. The Ministry of Communications has also introduced a policy for the establishment of a wholesale market for fixed telephony and broadband Internet infrastructure access pursuant to which certain limitations on structural separation and bundling of products may be reduced, but Bezeq would also be required to provide access to its network infrastructure to other service providers on a wholesale basis. The price for such access would be determined based on a commercial agreement between Bezeq and any such service provider, but the Israeli Minister of Communications will be entitled to intervene in the determination of the terms or the price that have been agreed or that is sought by Bezeq if it should find that such price is either unreasonable or could harm the competition, or if the parties have been unable to enter into a commercial agreement. Should the wholesale market develop, certain requirements for structural separation and bundling of products that apply to Bezeq and HOT may be lifted, and thus competition in the broadband Internet infrastructure access market may increase significantly, which could negatively affect Bezeq's results of operations.

Historically, the Bezeq Group was required to make certain royalty payments to the State of Israel in connection with its broadband and fixed-line services domestic license, DBS's broadcast license, Pelephone's cellular license and Bezeq International's international long distance telephony services. Although these royalty payments decreased in recent years and were reduced to zero in January 2013, there is no assurance that the Ministry of Communications and Ministry of Finance would not reinstate or increase them in the future, which could have a material effect on the Bezeq Group's results of operations.

The pervasive supervision and regulation has at times led to the intervention of the State of Israel. Bezeq's business and operations could be adversely affected by decisions by regulators, in particular the Ministry of Communications as well as changes in laws, regulations or government policy affecting its business activities. Further risks and uncertainties result from the fact that changes in such laws, regulations or government policies may not be adopted or implemented in the manner that Bezeq expects and may be further amended, interpreted or enforced in an unexpected manner or in a manner adverse to Bezeq's business and results of operations.

Bezeq's tariffs for its services are subject to government control, which harms its ability to compete and results in an erosion of its tariffs, which adversely affects its business.

Bezeq's tariffs for its services are subject to government control. Some of these tariffs are stipulated in regulations and these regulations also stipulate a formula for updating tariffs. Bezeq is restricted in its ability to give discounts on its principal services and to offer differential tariffs. Further, alternative payment packages, which should provide an immediate alternative to the regulated tariffs, are currently subject to certain conditions which often render the alternative payment package option moot. The foregoing factors harm Bezeq's ability to compete and results in an erosion of its tariffs, which adversely impacts its business. Under the policy document that was published by the Ministry of Communications on May 2, 2012, the Ministry has the power to set the price at which Bezeq sells its services to license holders. The application of low prices for such services may adversely affect Bezeq's revenues and profits.

Bezeq is subject to restrictions on intercompany relations with affiliated companies, which harms its ability to compete and adversely affects its business.

Bezeq's general license for fixed-line communication services obligates it to ensure that its relationships with its principal subsidiaries do not result in favoring them over their competitors. Bezeq is also subject to various limitations as a result of its declaration as a monopoly in the fixed line services business, as well as limitations set forth in merger approvals granted by the Israeli Antitrust Commission. Separation is required between the managements of Bezeq and

its principal subsidiaries, as well as separation between the financial and marketing systems, assets and employees, which result in high administrative overheads. Bezeq is also subject to limitations with respect to the offering of joint service packages with those companies, which adversely impacts its business, particularly in light of the entry into the market of communications companies competing directly with Bezeq in most of its areas of operation based on the provision of bundled services to the customer.

Actual and alleged health risks related to cellular network sites and mobile telecommunication devices could have a material adverse effect on Pelephone's business, operations and financial condition.

A number of studies have been conducted to examine the health effects of cellular phone use and network sites, and some of these studies have been construed as indicating that radiation from cellular phone use causes adverse health effects. Media reports have suggested that radio frequency emissions from cellular network sites, cellular handsets and other cellular telecommunication devices may raise various health concerns. On May 31, 2011, the World Health Organization's International Agency for Research on Cancer (IARC) announced that radiofrequency electromagnetic fields associated with the use of mobile phones may be carcinogenic to humans.

Several lawsuits have been filed against cellular operators and other participants in the cellular industry alleging adverse health effects and other claims relating to radio frequency transmissions to and from sites, handsets and other cellular telecommunications devices, including lawsuits against Pelephone, which were settled during 2012 with no material expenses incurred in such settlements.

Pelephone takes steps to ensure that the levels of radiation emitted by these transmission facilities, equipment and devices do not exceed the levels of radiation permitted in the directives of the Israeli Ministry of Environment Protection (levels adopted in accordance with international standards). However, health risks may be found to exist and transmission sites or devices and equipment may emit more radiation than that allowed in radiation standards, causing a risk to health, which may have an adverse effect on our business and could result in a reduction in the use of cellular services, difficulty in renting sites, claims for physical and property damages in substantial amounts and attempts to exercise the deeds of indemnity that Pelephone deposited with the planning authorities pursuant to the Planning and Building Law. Pelephone's third-party liability insurance policy does not currently cover electromagnetic radiation.

The Bezeq Group may face difficulties in obtaining some of the building and environmental permits required for the establishment and operation of its network sites, which could have an adverse effect on the coverage, quality and capacity of its network.

Bezeq, mainly with respect to its Pelephone cellular operations, is subject to the Israeli Non-Ionizing Radiation Law, 5766-2006, or the Radiation Law, which regulates the emission of electromagnetic radiation from broadcast facilities. The Radiation Law prohibits, among other things, the erection or operation of a source of radiation in contravention of any applicable permit and the erection or operation of a source of radiation without a permit. After receiving a written warning from the authorities, failure to remedy a violation will subject the permit holder to criminal prosecution on a strict liability basis. Pelephone is constantly working to obtain or renew permits to set up and operate its various broadcasting installations; however, the policies maintained by the various relevant entities and amendments to applicable statutes and standards could adversely impact the infrastructure of such installations and the regularity of the services using the infrastructure. As a result, Bezeq's revenues from these services could be adversely affected.

In addition, the establishment and operation of cellular antennas are subject to building permits from various planning and building committees, a process that involves a number of approvals from Israeli state entities and regulatory bodies. The foregoing may impair the quality and capacity of Bezeq's and Pelephone's existing networks and the deployment of new networks.

To promote compliance Bezeq has established procedures for the erection, operation and measurement of sources of non-ionizing radiation that was approved by its Board of Directors. Bezeq has also assigned an officer to oversee implementation of the compliance procedure. Periodic reports on the status of sources of radiation are submitted to Bezeq's chief executive officer and to its Board of Directors.

Breaches of network or information technology security, natural disasters or terrorist attacks could have an adverse effect on Bezeq's business.

Cyber-attacks or other breaches of network or information technology, or IT, security, natural disasters, terrorist acts or acts of war may cause equipment failures or disrupt Bezeq's systems and operations. In particular, both unsuccessful and successful cyber-attacks on companies have increased in frequency, scope and potential harm in recent years. To date, neither we nor the Bezeq Group have been subject to cyber-attacks or other cyber incidents which, individually or in the aggregate, resulted in a material impact to our operations or financial condition. However, we expect that Bezeq's inability to operate its facilities as a result of such events, even for a limited period of time, may result in significant expenses and/or loss of market share to other telecommunications providers. The potential liabilities associated with these events could exceed the insurance coverage Bezeq maintains.

The Bezeq Group accumulates, stores and uses data in the ordinary course of its operations that is protected by data protection laws. Although the Bezeq Group takes precautions to protect subscriber and employee data in accordance with the applicable Israeli privacy requirements, it may fail to do so and certain subscriber and employee data may be

leaked or otherwise used inappropriately. Violation of data protection laws may result in fines, loss of reputation and subscriber churn and could have an adverse effect on the Bezeq Group's business, financial condition and results of operations.

Bezeq's growth prospects depend on a continued demand for fixed-line telephony, Internet, cellular and pay television services.

The use of Internet, cellular and pay television services in Israel has increased sharply in recent years making Israel one of the most highly penetrated countries for such services in the world. The Bezeq Group has benefited from this growth and its growth and profitability depend, in part, on a continued demand for these services and fixed-line telephony services in the coming years. If demand for the Bezeq Group's current services and products does not increase, its business, financial condition and results of operations could be adversely affected.

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Bezeq's systems and operations are vulnerable to damage or interruption, which could expose it to material risk of loss or litigation.

Bezeq provides services using various infrastructure systems that include exchanges, transmission, data communication and access systems, cables and computerized systems. Any failure to manage the growth and complexity of Bezeq's networks could lead to a degradation of service and network disruptions that could harm its reputation and result in a loss of subscribers. If any part of the Bezeq Group's infrastructure, including its IT systems, becomes subject to a flood, fire, other natural disaster, terrorism, acts of war, a computer virus, a power loss, material bugs in software or other catastrophe or unauthorized access, its operations and customer relations could be materially adversely affected. Although some of Bezeq's systems have backup, damage to some or all of these systems, whether due to a technical fault or natural disaster, could cause extreme difficulties in providing services. If the Bezeq Group were to experience a breakdown of equipment or technology that it cannot timely repair, it might lose subscribers.

Pelephone's operations in the cellular market are exposed to losses in the event of malfunctions in the networks that it operates, terminal equipment that it sells, including various property risks and liabilities. Pelephone's cellular information systems are networked throughout Israel through designated communications lines and via the Internet, and its cellular business is highly dependent upon these systems. Wide-scale malicious harm or malfunction might adversely affect Pelephone's cellular business and financial results. Also, Pelephone's cellular communications network is deployed around the country through network core sites and antenna sites and its cellular business is totally dependent upon these systems. Damage caused by natural or other disasters, war or damage to the switching farm and/or servers used by Pelephone for its core cellular activities could have an adverse effect on its business and results of operations. Pelephone's cellular business uses two frequency ranges: 850 MHz and 2100 MHz. These frequencies are exposed to interruptions which could impair the service quality of the networks that Pelephone operates.

Any catastrophe or other damage that affects the Bezeq Group's networks could result in substantial uninsured losses. In addition, disaster recovery, security and service continuity protection measures that the Bezeq Group companies have, or may in the future undertake, and their monitoring of network performance, may be insufficient to prevent losses.

Additionally, although no incidents have occurred in numbers that are statistically significant, the Bezeq Group's networks and other technical equipment has been and may continue to be subject to occasional malfunctions due to material bugs in software or technical shortcomings or imperfect interfaces with equipment in private homes, the networks of other operators or its own networks or with other surrounding equipment. The Bezeq Group might incur liabilities or reputational damages as a result of such malfunctions.

Pelephone's assigned frequency may not easily support the implementation of new technologies, which could have an adverse effect on Pelephone's competitive position in the cellular market.

In certain situations the 850/2100 MHz frequencies available to Pelephone may not easily support the implementation of new technologies emerging in the cellular communication sector, which could make it difficult for Pelephone to implement them. This would have an adverse effect on Pelephone's competitive status, since the other licensees have other frequencies available to them, some of which may support those technologies, while obtaining new frequencies may be difficult. Furthermore, Pelephone's frequencies are exposed to interference and could impair service quality of networks operated by Pelephone. The factors that could cause interference include among other things, the fact that the 850 MHz frequency is also used for terrestrial television broadcasts, and by television stations broadcasting in the Middle East (mainly in Cyprus), which use could cause interference in Pelephone's networks.

Bezeq and its subsidiaries are parties to legal proceedings, which could result in them being ordered to pay significant sums.

Bezeq and its subsidiaries are parties to legal proceedings, including class actions, which could result in them being ordered to pay significant sums, the amount of which cannot be estimated. Class action claims can reach large amounts due to the large amount of consumers of Bezeq's services and a claim that relates to a minor loss for a single consumer can become a material claim for Bezeq if it is certified as a class action applicable to all consumers or a significant portion of them. In addition, since Bezeq provides communications infrastructure as well as billing services to other licensees, parties suing those licensees in other class actions may also try to involve Bezeq as a party to such proceedings.

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The market in which Bezeq operates is characterized by material capital investments in infrastructure and subscriber equipment and changing technology, which imposes a heavy financial burden on Bezeq and its capital expenditures may not generate a positive return.

The market in which Bezeq operates is characterized by material capital investments in infrastructure and subscriber equipment and changing technology. The frequent technological changes in infrastructure and terminal equipment and the intense competition in various market segments impose a heavy financial burden on the companies operating in the market, requiring them to update their infrastructure technology from time to time or to introduce new devices into the market at heavy cost. The development of new technologies can render existing technologies obsolete, resulting in the need for large monetary investments in order to retain a competitive position. Bezeq's future success will depend on its ability to develop and introduce, on a timely and cost-effective basis, new infrastructure and subscriber equipment that keep pace with technological developments. If Bezeq is unable to respond promptly and effectively to changing technology, it will be unable to compete effectively in the future and its business could be adversely affected. No assurance can be given that the Bezeq Group's recent or future capital expenditures will generate a positive return or that it will have adequate capital available to finance such future upgrades. If the Bezeq Group is unable to, or elects not to, pay for costs associated with expanding or upgrading its networks, or making other capital expenditures, its growth and competitive position could be materially adversely affected.

The Bezeq Group's brands are subject to reputational risks.

The Bezeq Group's brands are well-recognized in Israel. The companies in the Bezeq Group, including Bezeq International, Pelephone and DBS have developed their brands through extensive marketing campaigns, website promotions, customer referrals, and the use of sales forces and dealer networks. The Bezeq Group's brands represent a material and valuable asset.

Although the Bezeq Group companies try to manage their brands, we cannot guarantee that such brands will not be damaged by circumstances that are outside their control or by third parties with a resulting negative impact on the Bezeq Group's activities.

Bezeq's results of operations are subject to market risks such as currency fluctuations, inflation in Israel and the general economic environment and financial condition of the capital market in Israel and worldwide.

Bezeq's results of operations are subject to market risks such as currency fluctuations, the general economic environment, inflation in Israel and the financial condition of the capital market in Israel and worldwide. Bezeq measures exposure to changes in exchange rates and inflation by the surplus or deficit of assets against liabilities, based on the type of linkage. In addition, Bezeq is exposed to inflationary changes in Israel as well as to market risks associated with changes to the interest rates relating to its borrowings.

Bezeq collects payments from some of its customers in foreign currency, primarily U.S. dollars. In addition, Bezeq consumes services from suppliers outside Israel and pays for these services in foreign currency, primarily U.S. dollars. Changes in the exchange rates of the currencies in which Bezeq operates, primarily the NIS against the U.S. dollar, could have an adverse effect on Bezeq's cash flow and profitability.

Market and financial stability and the strength of the economy in Israel and worldwide have recently been subject to great volatility and led to a global economic slowdown. Although global economic conditions have begun to stabilize or improve, if the local market weakens, Bezeq's business results could be harmed and its revenues may decrease. Recently, the general economic and capital market conditions in the EMEA region, including Israel, and other parts of the world have undergone significant turmoil. In addition, general market volatility has resulted from uncertainty about sovereign debt and fear that the governments of countries such as Greece, Portugal, Spain, Ireland and Italy may



default on their financial obligations. Furthermore, continued hostilities in the Middle East and recent tensions in North Africa could adversely affect the Israeli economy. If these conditions continue or become worse, Bezeq's future cost of debt and access to the capital markets could be adversely affected.

Negative developments in, or the general weakness of, Israel's economy, in particular increasing levels of unemployment, may have a direct negative impact on the spending patterns of retail consumers, both in terms of the products they subscribe for and usage levels. Because a substantial portion of our revenue is derived from residential subscribers who may be impacted by these conditions, it may be (i) more difficult to attract new subscribers, (ii) more likely that certain of our subscribers will downgrade or disconnect their services and (iii) more difficult to maintain ARPUs at existing levels. In addition, we can provide no assurances that a deterioration of the economy will not lead to a higher number of non-paying customers or generally result in service disconnections. Therefore, a weak economy and negative economic development may jeopardize our growth targets and may have a material adverse effect on Bezeq's business, financial condition and results of operations.

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A significant portion of Bezeq Group's workforce is represented by labor unions, and the companies in the Bezeq Group could incur additional costs or experience work stoppages as a result of the negotiation of their labor contracts or organizing activities.

As of December 31, 2012, a significant portion of the employees of the Bezeq Group is represented by the New General Federation of Workers, or the Histadrut. In December 2006, a special collective agreement was signed between Bezeq, its workers' representatives and the Histadrut, regulating the labor relations in Bezeq following its privatization.

Pelephone received a notice from the Histadrut in September 2012, that it constitutes a representative workers union of Pelephone employees. On November 26, 2012, Pelephone received a notice from the Histadrut of a strike beginning December 10, 2012, due to its alleged failure to recognize the Histadrut as a representative organization and its refusal to conduct negotiations on a collective agreement, as well as wage-related demands and employee dismissal issues. On January 7, 2013, Pelephone notified the Histadrut that it recognized it as the representative organization for Pelephone and the parties began to negotiate a collective labor agreement. The negotiating process may cause labor unrest and harm Pelephone's on-going activity. The collective labor agreement may limit management flexibility and impose additional costs on Pelephone.

The Bezeq Group depends on hardware, software and other providers of outsourced services, who may discontinue their services or products, seek to charge prices that are not competitive or choose not to renew their contracts.

The Bezeq Group has important relationships with several suppliers of hardware, software and related services that are used to operate its businesses. In certain cases, substantial investments have been made in the equipment or software of a particular supplier, making it difficult to quickly change supply and maintenance relationships in the event that the initial supplier refuses to offer favorable prices or ceases to produce equipment or provide the support that the Bezeq Group requires. Further, in the event that hardware or software products or related services are defective, it may be difficult or impossible to enforce recourse claims against suppliers, especially if warranties included in contracts with suppliers have expired or are exceeded by those in Bezeq's contracts with its subscribers, in individual cases, or if the suppliers are insolvent, in whole or in part. In addition, there can be no assurances that the Bezeq Group will be able to obtain the hardware, software and services it needs for the operation of its business, in a timely manner, at competitive terms and in adequate amounts.

The Bezeq Group's ability to renew its existing contracts with suppliers of products or services, or enter in to new contractual relationships, upon the expiration of such contracts, either on commercially attractive terms, or at all, depends on a range of commercial and operational factors and events, which may be beyond its control. The occurrence of any of these risks could create technical problems, damage the Bezeq Group's reputation, result in the loss of customer relationships and have a material adverse effect on its business, financial condition and results of operations.

The Bezeq Group may be subject to claims of intellectual property infringement, which could have an adverse impact on its businesses or operating results.

The Bezeq Group is subject to the risk of intellectual property rights claims against it. The Bezeq Group has and may receive in the future claims of infringement or misappropriation of other parties' proprietary rights, particularly creative rights with respect to DBS's broadcasted programs or Pelephone's music streaming. In addition to claims relating to broadcasts on channels DBS owns, it may be subject to intellectual property infringement claims with respect to programs broadcast on foreign channels that it carries. Successful challenges to DBS's rights to intellectual property could require DBS to enter into royalty or licensing agreements on unfavorable terms, incur substantial monetary liability or be enjoined preliminarily or permanently from further use of the intellectual property in question.

This could require a change in business practices and limit the ability to provide customers with the content that they expect. If DBS is required to take any of these actions, it could have an adverse impact on its businesses or operating results.

Even if the claims of intellectual property infringement are without merit, defending against the claims can be time-consuming and costly and divert management's attention and resources away from its businesses. Israeli law relating to intellectual property contains provisions allowing the owner of an intellectual property right to apply the Israeli courts to grant various enforcement measures and other remedies, such as temporary and permanent injunctive relief, a right to confiscate infringing goods and damages. If any of these claims succeed, the Bezeq Group may be forced to pay damages or may be required to obtain licenses for the infringing product or service and may incur liabilities or reputational damages as a result thereof. If the Bezeq Group cannot obtain all necessary licenses on commercially reasonable terms, it may be forced to stop using or selling the products and services, which could adversely affect its ability to provide certain services and products.

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Operating in the Israeli domestic fixed-line communications segment has major entry and exit barriers.

Operating in the domestic fixed-line communications segment requires receipt of the appropriate domestic carrier licenses. Traditionally, the main entry barrier to this segment arose from the need for heavy investment in technological infrastructure and in surrounding systems until obtaining economies of scale, and from high costs involving the establishment of marketing, sales, collection and customer support systems and the building of a brand. In recent years, these traditional entry barriers to Bezeq's segments of operation have lessened considerably as a result of the following factors: technological improvements, lower infrastructure and equipment prices, easing of regulation granted to new competitors, the mandatory obligation to allow the use of Bezeq's (and Hot's) infrastructures and services, and the ability to use existing networks, including Bezeq's network, by competing communications carriers or those destined to compete with Bezeq.

The regulation of competition in VoB-based telephony, which enables telephony services to be provided based on a broadband infrastructure of another operator without need for an independent line telephony infrastructure (and in the future, if it becomes possible, competition based on dividing the network into sections and wholesale sale of services), significantly reduces the size of investment required from those competing with Bezeq, thereby making entry barriers to the segment much lower.

The main exit barriers relate to the commitment of Bezeq incorporated in its license to provide its services universally (to the entire public in Israel) and to a defined quality, its subordination to the provisions of the Communications Order (Determination of Essential Service Provided by "Bezeq" The Israel Telecommunication Corp. Limited), 5757-1997, or the Communications Order, the regulations accompanying the Israeli Communications Law (Telecommunications and Broadcasting), 1982 or the Communications Law, the provisions of Section 13A of the Communications Law relating to emergency operation, Bezeq's commitment to those of its employees who are employed under collective agreements, long-term agreements with infrastructure suppliers, the large investments requiring the passage of time before seeing a return and Bezeq's commitment to the repayment of long-term loans taken to finance the investments.

If DBS is unable to obtain attractive programming on satisfactory terms for its pay television services, the demand for these services could be reduced, thereby lowering revenue and profitability.

The success of DBS's services depends on access to an attractive selection of television programming from content providers. The ability to provide movie, sports and other programming, including VOD content, is a major factor that attracts subscribers to pay television services, especially premium services.

DBS relies on digital programming suppliers for a significant portion of its programming content and VOD services. It may not be able to obtain sufficient high-quality programming from third-party producers for our digital cable television services on satisfactory terms or at all in order to offer compelling digital cable television services. Further, there can be no assurance that the local content that DBS provides will continue to be successful. The inability to obtain high-quality content may also limit DBS's ability to migrate customers from lower priced packages to higher tier programming, thereby inhibiting its ability to execute its business strategy. Any or all of these factors could result in reduced demand for, and lower revenue and profitability from, DBS's satellite broadcast services.

#### Risks Related to Our Company

We and B Communications have a substantial amount of debt, which could restrict our financing and operating flexibility and have other adverse consequences; our ability to repay our debt may be affected by Bezeq's distribution policy and the amount of dividends we receive from Bezeq.

To facilitate the funding of its acquisition of the controlling interest in Bezeq, B Communications entered into two financing agreements under which it received loans in a total principal amount of NIS 5.1 billion, of which NIS 2.6 billion (approximately \$0.7 billion) was outstanding at December 31, 2012. As of April 22, 2013, the financing agreements include certain financial covenants, including, among other things, the requirement that Bezeq maintain certain minimum shareholders equity and minimum ratio of shareholders' equity. In addition, B Communications' wholly-owned subsidiary that directly holds the Bezeq interest must maintain a minimum ratio of debt to EBITDA and a debt service coverage ratio. The Bezeq shares that were acquired and all of the rights and assets of such subsidiary (except for 29,662,168 ordinary shares of Bezeq that were acquired in 2011 and such additional Bezeq shares that may be acquired in the future) have been pledged to the lenders as security under the loan agreements. In addition, B Communications has pledged the entire equity of the subsidiary established to acquire the Bezeq shares. Our ability to repay our debt and B Communications' ability to repay its debt may be affected by Bezeq's distribution policy and the amount of dividends received from Bezeq. If we and B Communications are unable to meet our debt obligations or comply with our debt covenants, we could be forced to renegotiate or refinance our indebtedness, seek additional equity capital or sell assets. We may be unable to obtain financing or sell assets on satisfactory terms, or at all. For more information regarding our debt instruments and our consolidated indebtedness, see Item 5.B "Operating and Financial Review and Prospects - Liquidity and Capital Resources."

Our operating results may be adversely affected by significant fluctuations in the Israeli consumer price index and in interest rates.

As the principal amount of, and interest that we pay on, certain of our debentures and a significant portion of our bank loans are linked to the Israeli Consumer Price Index, or CPI, or are subject to variable interest rate, any increase in the Israeli CPI or in the interest rate will increase our financial expenses and could adversely affect our results. In addition, Bezeq's tariff updating mechanism, which is subject to government regulation, is reviewed once a year and is influenced by the CPI. As a result, the annual rate of inflation and its distribution during the year can have a material influence on the erosion of Bezeq's tariffs and its revenues and expenses during the year.

Our exposure to market risk for changes in interest rates also relates to our investment in marketable securities. Investments in both fixed rate and floating rate interest bearing securities carry a degree of interest rate risk. The market pricing for such fixed rate securities may be adversely impacted due to a rise in interest rates, while floating rate securities may produce less income than predicted if interest rates fall. Due in part to these factors, our future financial results may be negatively affected in the event that interest rates fluctuate.

We, B Communications and other members of the Eurocom group are subject to a control permit for holding the controlling interest in Bezeq. Failure to comply with this permit or other regulatory provisions relating to the control of Bezeq may result in the revocation of the control permit and our rights with respect to our Bezeq interest would be adversely impacted, which would materially and adversely affect our business and financial position.

As part of the acquisition of the controlling interest in Bezeq, we, B Communications, B Communications (SP2) Ltd., or SP2, B Communications (SP1) Ltd., or SP1 and other members of the Eurocom group were granted a permit to control Bezeq, pursuant to the Communications Law and the Communications Order. The control permit includes several conditions, including, among others, the requirement that SP2 be controlled exclusively by the other parties to the control permit and that the parties to the control permit hold not less than 30% of any type of means of control of Bezeq and SP2. In February 2011, Israel's Prime Minister and Minister of Communications, or the Ministers, permitted such percentage to decrease to 29% for a period of six months commencing from the date such holdings fall below 30%, in the event of dilution resulting from the exercise of stock options by Bezeq employees. In addition, the control permit requires that a certain percentage of SP2 be held at all times by an "Israeli Party," as defined in the Communications Order. The control permit also includes certain notice requirements regarding changes in the composition of the board of directors and certain holdings in us and B Communications. If we, B Communications or any other member of the Eurocom group subject to the control permit fails to comply with the terms of the control permit or with other regulatory provisions relating to the control of Bezeq, such permit could be revoked and our rights with respect to our Bezeq interest would be adversely impacted, which would have a material adverse effect on our business and financial position.

If we do not maintain control of Bezeq we may be deemed to be an "investment company" under the Investment Company Act of 1940, which could materially and adversely affect our business.

Section 3(a)(1)(A) of the Investment Company Act of 1940, or the Investment Company Act, defines an investment company as any issuer that is, holds itself out as being, or proposes to be, primarily engaged in the business of investing, reinvesting or trading in securities and Section 3(a)(1)(C) of the Investment Company Act defines an investment company as any issuer that is engaged or proposes to engage in the business of investing, reinvesting, owning, holding or trading in securities and owns or proposes to acquire "investment securities" (within the meaning of the Investment Company Act) having a value exceeding 40% of the value of the issuer's total assets (exclusive of U.S. government securities and cash items) on an unconsolidated basis. However, an issuer will be deemed not to be an investment company if no more than 45% of the value of such issuer's total assets (exclusive of government securities and cash items) consists of, and no more than 45% of such issuer's net income after taxes (for the last four fiscal

quarters combined) is derived from, securities other than, among other things, securities issued by companies which are controlled primarily by such issuer. Primary control is presumed if the issuer owns over 25% of the controlled company's voting securities and the issuer has control greater than that of any other person. Accordingly, so long as we maintain control of Bezeq, we will not be deemed an investment company.

If we were to no longer maintain the control of Bezeq, we could, among other things, be required either (i) to change substantially the manner in which we conduct our operations to avoid being subject to the Investment Company Act or (ii) to register as an investment company. An investment company that is organized under the laws of a foreign country may not register as an investment company, or publicly offer its securities through interstate commerce in the United States, unless the company applies to the Securities and Exchange Commission, or the SEC, for an order permitting the company to register under the Investment Company Act, and to make a public offering in the United States. The SEC may issue an order granting the application if it finds that, by reason of special circumstances or arrangements, it is both legally and practically feasible effectively to enforce the provisions of the Investment Company Act against the issuer, and further finds that granting the application is otherwise consistent with the public interest and the protection of investors.

If we were required to register as an investment company under the Investment Company Act, we would become subject to substantial regulation with respect to our capital structure (including our ability to use leverage), management, operations, transactions with certain affiliates, reporting, record keeping, voting, proxy and disclosure requirements, and meeting these requirements would be costly, if at all possible.

We may fail to maintain effective internal control over our financial reporting in accordance with Section 404 of the Sarbanes-Oxley Act of 2002, which could have an adverse effect on our financial results and the market price of our ordinary shares.

Section 404 of the Sarbanes-Oxley Act requires any company subject to the reporting requirements of the U.S. securities laws to do a comprehensive evaluation of its and its combined subsidiaries' internal control over financial reporting. To comply with this statute, we are required to document and test our internal control over financial reporting, and our management is required to assess and issue a report concerning our internal control over financial reporting. The rules governing the standards that must be met for management to assess our internal control over financial reporting are relatively new and complex and require significant documentation, testing and possible remediation to meet the detailed standards under the rules.

Beginning in the 2010 second quarter, we began consolidating Bezeq's financials results into our financial statements following our acquisition of the controlling interest in Bezeq. Commencing with our management report on internal control over financial reporting for the year ended December 31, 2011, our management report on internal control over financial reporting must include an assessment with of Bezeq's internal control over financial reporting. Prior to our acquisition of the controlling interest, Bezeq was not subject to Section 404 of the Sarbanes-Oxley Act. We may in the future identify a material weakness in Bezeq's internal control over financial reporting. Failure to maintain effective internal control over financial reporting could result in investigation or sanctions by regulatory authorities and could have a material adverse effect on our operating results, investor confidence in our reported financial information and the market price of our ordinary shares.

#### Risks Related to Our Relationship with Eurocom Communications Ltd.

Because Eurocom Communications controls substantially all the voting power of our ordinary shares, investors will not be able to affect the outcome of all shareholder votes.

Eurocom Communications beneficially owned 78.97% of our outstanding ordinary shares, as of April 22, 2013. For as long as Eurocom Communications has a controlling interest in our company, it, Mr. Shaul Elovitch, the chairman of our board of directors and the chairman of the board of directors of Eurocom Communications, and the controlling shareholder of Eurocom Communications will have the power to determine or significantly influence the outcome of matters submitted to a vote of our shareholders that require a simple majority, including the power to elect all of the members of our board of directors (except outside directors, within the meaning of Israeli law) and will have the ability to exercise a controlling influence over our business and affairs, including any determinations with respect to potential mergers or other business combinations involving us, our acquisition or disposition of assets, our incurrence of indebtedness, our issuance of any additional ordinary shares or other equity securities, our repurchase or redemption of ordinary shares and our payment of dividends. Because the interests of Eurocom Communications and Mr. Elovitch may differ from the interests of our other shareholders, actions taken by Eurocom Communications with respect to us may not be favorable to our other shareholders.

Conflicts of interest may arise between Eurocom Communications, B Communications, other companies within the Eurocom group and us that could be resolved in a manner unfavorable to us and result in reduced revenues and income.



Conflicts of interest may arise between B Communications, Eurocom Communications and us in a number of areas relating to our past and ongoing relationships. Areas in which conflicts of interest between B Communications, Eurocom Communications and us could arise include, but are not limited to, the following:

- Cross officerships, directorships and share ownership. The ownership interests of our directors in our ordinary shares could create, or appear to create, conflicts of interest when directors and executive officers are faced with decisions that could have different implications for the two companies. For example, these decisions could relate to the nature, quality and cost of services rendered to us by Eurocom Communications and B Communications, disagreements over the desirability of a potential acquisition opportunity or employee retention or recruiting. In addition, Eurocom Communications may take an opportunity for itself or preclude us from taking advantage of a corporate opportunity; and

- Intercompany transactions. From time to time, Eurocom Communications, B Communications or other companies within the Eurocom group may enter into transactions with us or our subsidiaries or other affiliates. Although the terms of any such transactions will be established based upon negotiations between employees of such companies and us and, when appropriate, subject to the approval of our independent directors or a committee of disinterested directors and in some instances a vote of shareholders, the terms of any such transactions may not be as favorable to us or our subsidiaries or affiliates as may otherwise be obtained in arm's-length negotiations with unaffiliated third parties. For more information about intercompany transactions, see Item 7B. "Major Shareholders and Related Party Transactions - Related Party Transactions."

#### Risks Related to Our Ordinary Shares

Our share price has been volatile and may decrease in the future.

The market price of our ordinary shares has been subject to significant price movements and could be subject to wide fluctuations in the future in response to factors such as the following, some of which are beyond our control:

- Quarterly variations in our operating results;
- Global economic conditions;
- Price movements in the market price of B Communications' and Bezeq's ordinary shares;
- Operating results that vary from the expectations of securities analysts and investors;
- Changes in expectations as to our future financial performance, including financial estimates by securities analysts and investors;
  - Regulatory changes that impact pricing of services and competition in Bezeq's markets;
  - Changes in market valuations of other communications companies;
  - Announcements of technological innovations or new services by Bezeq or its competitors;
- Announcements by Bezeq or its competitors of significant contracts, acquisitions, strategic partnerships, joint ventures or capital commitments;
  - Changes in the status of Bezeq's intellectual property rights;
  - Announcements by third parties of significant claims or proceedings against us or Bezeq;
    - Additions or departures of key personnel;
    - Future sales of our ordinary shares; and
    - Stock market price and volume fluctuations.

Domestic and international stock markets often experience extreme price and volume fluctuations. Market fluctuations, as well as general political and economic conditions, such as a recession or interest rate or currency rate fluctuations or political events or hostilities in or surrounding Israel, could adversely affect the market price of our

ordinary shares.

We have never paid cash dividends to our shareholders and have not adopted a dividend distribution policy.

We have never declared or paid cash dividends on our ordinary shares and have not adopted a dividend distribution policy. B Communications' indirect wholly-owned subsidiary, SP2, which directly holds Bezeq's shares and our principal source of revenues and income, is subject to limitations on the payment of dividends under the terms of the financing agreements entered into in connection with its acquisition of the controlling interest in Bezeq. You should not rely on an investment in our company if you require dividend income from your investments.

We may in the future be classified as a passive foreign investment company, which will subject our U.S. investors to adverse tax rules.

We may be treated in the future as a "passive foreign investment company," which could result in a reduction in the after-tax return to the U.S. holders of our ordinary shares and may cause a reduction in the value of such shares. A foreign corporation will be treated as a passive foreign investment company for U.S. federal income tax purposes if either (1) at least 75% of its gross income for any taxable year consists of certain types of "passive income," or (2) at least 50% of the average value of the corporation's gross assets produce, or are held for the production of, such types of "passive income." For purposes of these tests, "passive income" includes dividends, interest and gains from the sale or exchange of investment property; and cash is considered to be an asset that produces passive income. If we are classified in the future as a passive foreign investment company for U.S. federal income tax purposes, highly complex rules would apply to U.S. shareholders owning ordinary shares. Accordingly, you are urged to consult your tax advisors regarding the application of such rules. United States residents should carefully read "Item 10E. Additional Information - Taxation, United States Federal Income Tax Consequences" for a more complete discussion of the U.S. federal income tax risks related to owning and disposing of our ordinary shares.

### Risks Related to the Operations of Bezeq and Our Company in Israel

Political, economic and military instability in Israel may disrupt our operations and negatively affect our business condition, harm our results of operations and adversely affect our share price.

We and Bezeq are incorporated and based in the State of Israel and Bezeq derives substantially all of its revenues from markets within the State of Israel. As a result, political, economic and military conditions affecting Israel directly influence us. Any major hostilities involving Israel, a full or partial mobilization of the reserve forces of the Israeli army, the interruption or curtailment of trade between Israel and its present trading partners, or a significant downturn in the economic or financial condition of Israel could adversely affect our business, financial condition and results of operations.

Since its establishment in 1948, Israel has been involved in a number of armed conflicts with its Arab neighbors and a state of hostility, varying from time to time in intensity and degree, has continued into 2013. In recent years, there was an escalation in violence among Israel, Hamas, the Palestinian Authority and other groups. Also, since 2011, riots and uprisings in several countries in the Middle East and neighboring regions have led to severe political instability in several neighboring states and to a decline in the regional security situation. Such instability may affect the local and global economy, could negatively affect business conditions and, therefore, could adversely affect our operations. In addition, Iran has threatened to attack Israel and is widely believed to be developing nuclear weapons. Iran is also believed to have a strong influence among extremist groups in areas that neighbor Israel, such as Hamas in Gaza and Hezbollah in Lebanon.

To date, these matters have not had any material effect on our business and results of operations; however, the regional security situation and worldwide perceptions of it are outside our control and there can be no assurance that these matters will not negatively affect us in the future. Ongoing violence between Israel and the Palestinians as well as tension between Israel and other countries in the Middle East may materially affect our business, financial condition and results of operations.

Our results of operations may be negatively affected by the obligation of our personnel to perform military service.

Many of Bezeq's and our executive officers and employees in Israel are obligated to perform annual reserve duty in the Israeli Defense Forces and may be called for active duty under emergency circumstances at any time. If a military conflict or war arises, these individuals could be required to serve in the military for extended periods of time. Bezeq's operations could be disrupted by the absence for a significant period of one or more of its executive officers or key employees or a significant number of other employees due to military service. Any disruption in Bezeq's operations could adversely affect its business.

Bezeq may be restricted in the conduct of its operations during periods of national emergency, which could negatively affect its business operations.

During periods of national emergency, the Minister of Communications and other governmental authorities may issue various instructions regarding the use of Bezeq's network, including the use of the network by the Israeli security forces. In addition, the Israeli Equipment Registration and IDF Mobilization Law, 1987 permits the registration, taking and use of engineering equipment and facilities by Israel's Defense Forces. These actions could adversely affect Bezeq's business operations.

Our operating results may be adversely affected by significant fluctuations of the NIS against foreign currencies.

We report our financial results in NIS. Bezeq receives payments in NIS for most of its sales. As a result, fluctuations in rates of exchange between NIS and the U.S. dollar may affect our operating results and financial condition. In addition, when the Israeli inflation rate exceeds the rate of the NIS depreciation against foreign currencies, some of our NIS expenses increase to the extent of the difference between the rates. A significant disparity of this kind may have a material adverse effect on our operating results.

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From time to time, the Bezeq Group engages in currency hedging transactions to reduce the impact on its cash flows and results of operations of currency fluctuations. The Bezeq Group recognizes freestanding derivative financial instruments as either assets or liabilities in the statements of financial position and it measures those instruments at fair value. However, accounting for changes in the fair value of a derivative instrument, such as a currency hedging instrument, depends on the intended use of the derivative instrument and the resulting designation. For derivative instruments that are not designated as cash flow hedges, changes in fair value are recognized in our income statement without any reference to the change in value of the related budgeted expenditures. These differences could result in fluctuations in our reported net income on a quarterly basis.

As a foreign private issuer whose shares are listed on the NASDAQ Global Select Market, we may follow certain home country corporate governance practices instead of certain NASDAQ requirements.

As a foreign private issuer whose shares are listed on the NASDAQ Global Select Market, we are permitted to follow certain home country corporate governance practices instead of certain requirements of the NASDAQ Stock Market Rules. As a foreign private issuer listed on the NASDAQ Global Select Market, we may follow home country practice with regard to, among other things, the composition of the board of directors, compensation of officers, director nomination process and quorum at shareholders' meetings. In addition, we may follow home country practice instead of the NASDAQ requirement to obtain shareholder approval for certain dilutive events (such as for the establishment or amendment of certain equity-based compensation plans, an issuance that will result in a change of control of the company, certain transactions other than a public offering involving issuances of a 20% or more interest in the company and certain acquisitions of the stock or assets of another company). A foreign private issuer that elects to follow a home country practice instead of NASDAQ requirements must submit to NASDAQ in advance a written statement from an independent counsel in such issuer's home country certifying that the issuer's practices are not prohibited by the home country's laws. In addition, a foreign private issuer must disclose in its annual reports filed with the SEC each such requirement that it does not follow and describe the home country practice followed by the issuer instead of any such requirement. Accordingly, our shareholders may not be afforded the same protection as provided under NASDAQ's corporate governance rules.

Our shareholders generally may have difficulties enforcing a U.S. judgment against us, our executive officers and directors and some of the experts named in this annual report, or asserting U.S. securities law claims in Israel.

We are incorporated in Israel and all of our executive officers and directors named in this annual report reside outside the United States. Service of process upon them may be difficult to effect within the United States. Furthermore, all of our assets and most of the assets of our executive officers and directors and some of the experts named in this annual report are located outside the United States. Therefore, a judgment obtained against us or any of them in the United States, including one based on the civil liability provisions of the U.S. federal securities laws may not be collectible in the United States and may not be enforced by an Israeli court. It also may be difficult for you to assert U.S. securities law claims in original actions instituted in Israel.

Provisions of Israeli law, the licenses of Bezeq and our articles of association may delay, prevent or make difficult an acquisition of our company, which could prevent a change of control and, therefore, depress the price of our shares.

Following our acquisition of the controlling interest in Bezeq, we and our shareholders are required to comply with the Communications Law, the Communications Order and regulations promulgated by the Ministry of Communications.

Pursuant to the Communications Order, we were required to obtain the prior written consent of the Ministers in order to acquire the controlling interest in Bezeq. Under the Communications Order, no person may hold, directly or indirectly, "significant influence" over Bezeq or 5% or more of any particular class of means of control in Bezeq, nor

may any person, together with any other person, appoint, elect or dismiss the general manager of Bezeq or cause the election, appointment or dismissal of any director of Bezeq, without the prior written consent of the Ministers. Subject to certain exceptions, prior written approval of the Ministers is also required to increase the holdings or other rights in excess of those determined in the initial approval, including by means of an agreement (including a voting agreement). Furthermore, under the Communications Order, no person may transfer control, "significant influence" or means of control in Bezeq to another, if, as a result of the transfer, the holdings of the transferee would require approval pursuant to the Communications Law or Communications Order and the transferee is not in possession of the requisite approval. For the foregoing purposes, "significant influence" means the ability to significantly influence the activity of a corporation, whether alone or together with or through others, directly or indirectly, other than as a result of holding "means of control" in that corporation or in another corporation, and including ability derived from the corporation's articles of association, a written, oral or other kind of agreement, or from any other source. In this context, the right to appoint an office holder holding 25% of our means of control is presumed to confer significant influence. "Means of control" means the right to vote at a general meeting of the company, to appoint a director or general manager of the company, to participate in the profits of the company or a share of the remaining assets of the company after payment of its debts upon liquidation.

Israeli corporate law regulates mergers, requires tender offers for acquisitions of shares above specified thresholds, requires special approvals for transactions involving directors, officers or significant shareholders and regulates other matters that may be relevant to these types of transactions. Furthermore, Israeli tax considerations may make potential transactions unappealing to us or to some of our shareholders, including Israeli shareholders and shareholders whose country of residence does not have a tax treaty with Israel exempting such shareholders from Israeli tax. For example, Israeli tax law does not recognize tax-free share exchanges to the same extent as U.S. tax law. With respect to mergers, Israeli tax law allows for tax deferral in certain circumstances but makes the deferral contingent on the fulfillment of numerous conditions, including a holding period of two years from the date of the transaction during which sales and dispositions of shares of the participating companies are limited. Moreover, with respect to certain listed share swap transactions, the tax deferral is limited in time, and when the time expires, tax then becomes payable even if no actual disposition of the shares has occurred. These provisions of Israeli law may delay, prevent or make difficult an acquisition of our company, which could prevent a change of control and therefore depress the price of our shares. For additional discussion about some anti-takeover effects of Israeli law, see Item 10B. "Additional Information - Memorandum and Articles of Association" and Item 10E. "Taxation -Israeli Tax Considerations."

The rights and responsibilities of our shareholders are governed by Israeli law and differ in some respects from those under Delaware law.

Because we are an Israeli company, the rights and responsibilities of our shareholders are governed by our articles of association and by Israeli law. These rights and responsibilities differ in some respects from the rights and responsibilities of shareholders in a Delaware corporation. In particular, a shareholder of an Israeli company has a duty to act in good faith towards the company and other shareholders and to refrain from abusing his, her or its power in the company, including, among other things, in voting at the general meeting of shareholders on certain matters. Israeli law provides that these duties are applicable to shareholder votes on, among other things, amendments to a company's articles of association, increases in a company's authorized share capital, mergers and interested party transactions requiring shareholder approval. In addition, a shareholder who knows that it possesses the power to determine the outcome of a shareholders' vote or to appoint or prevent the appointment of a director or executive officer of the company has a duty of fairness towards the company. However, Israeli law does not define the substance of this duty of fairness. There is little case law available to assist in understanding the implications of these provisions that govern shareholder behavior.

#### ITEM 4. INFORMATION ON THE COMPANY

##### A. History and Development of the Company

We were incorporated under the laws of the State of Israel in April 1992 under the name Euronet Golden Lines (1992) Ltd. In June 1999 we changed our name to Internet Gold - Golden Lines Ltd. We are a public limited liability company under the Israeli Companies Law 1999 and our shares are traded on the NASDAQ Global Select Market and TASE. Our registered offices and principal place of business are located at 2 Dov Friedman Street, Ramat Gan 52503, Israel, and our telephone number is +972-72-924-0000. Our address on the Internet is [www.igld.com](http://www.igld.com). The information on our website is not incorporated by reference into this annual report on Form 20-F.

We are a leading communications group in Israel. Our principal subsidiary, B Communications, is the controlling shareholder of Bezeq (TASE: BZEQ), Israel's largest telecommunications provider. Since B Communications' initial public offering in October 2007, its ordinary shares have been listed on the NASDAQ Stock Market (symbol: BCOM) and the TASE, and since January 1, 2011 its ordinary shares are listed on the NASDAQ Global Select Market. We currently own 79.94% of the ordinary shares of B Communications. B Communications maintains a website at [www.bcommunications.co.il](http://www.bcommunications.co.il). The information on B Communications' website is not incorporated by reference into this annual report on Form 20-F.



We began providing Internet access services in 1996, and began offering broadband services in 2001 and traditional voice services in 2004. As part of our internal restructuring in 2006, we transferred our broadband and traditional voice services businesses, which we refer to in this annual report as the legacy communications business, to B Communications (formerly named 012 Smile. Communications), and our media operations to Goldmind Ltd. (formerly named 012 Smile.Media). During 2010 and 2011 we sold all of our media assets.

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## Acquisition of the Controlling Interest in Bezeq

On April 14, 2010, B Communications completed the acquisition of 30.44% of Bezeq's outstanding shares from Ap.Sb.Ar. Holdings Ltd. for a purchase price of approximately NIS 6.5 billion in cash and became the controlling shareholder of Bezeq. The Bezeq interest was directly acquired by an indirect wholly-owned subsidiary of B Communications. In accordance with the terms of the transaction, effective as of the closing of the acquisition, we designated seven directors to replace the Apax-Saban-Arkin Group's representatives on Bezeq's 13 person Board of Directors. We began consolidating Bezeq's financial results into our financial statements effective as of the closing of the acquisition and began reporting the consolidated results in our 2010 second quarter earnings release. As of April 22, 2013, B Communications holds a 30.97% ownership interest of Bezeq.

Bezeq is the principal provider of communications services in Israel. Bezeq and its subsidiaries implement and provide a broad range of telecommunications operations and services, including domestic fixed-line, cellular, Internet services, international communication services, multi-channel television, satellite broadcasts, customer call centers, maintenance and development of communications infrastructures, provision of communications services to other communications providers, television and radio broadcasts, and supply and maintenance of equipment on customer premises (such as network endpoint services). Bezeq, which was established as a government company in 1980, became a public company in 1990 and its shares are traded on the TASE and included in the TA-25 Index.

Below are details of the ownership interest in Bezeq at December 31, 2012 and at March 31, 2013, and on a fully diluted basis at April 22, 2013, assuming the exercise of all options granted to employees and managers of the Bezeq Group at April 22, 2013.

Shareholders	On an outstanding basis		With full
	At December 31, 2012	At March 31, 2013	dilution at April 22, 2013 (1)
B Communications (2)	30.97%	30.97%	30.19%
Public	69.03%	69.03%	69.81%

(1) Full dilution calculation assumes that all outstanding options are exercised pursuant to the Stock Appreciation Rights (SAR) mechanism of the 2007 Stock Option Plan for Managers and Senior Employees in the Bezeq Group and the 2007 Employee Stock Options Plan in the Bezeq Group. This assumption is theoretical as under the terms of the plans the offerees who exercise their options will not receive the number of shares underlying them, but as a cashless exercise they will receive the number of shares that reflect the financial benefit embodied in the options.

(2) Including shares held directly by B Communications and its wholly-owned subsidiary.

In addition to our ownership of Bezeq shares as described above, a total of 4,000,000 ordinary shares of Bezeq are jointly held by Mr. Shaul Elovitch, our controlling shareholder, and his brother Mr. Yossef Elovitch. Further, 72,360 ordinary shares of Bezeq are held by Ms. Iris Elovitch, the wife of Mr. Elovitch, and 11,556 ordinary shares of Bezeq are held by Ms. Orna Elovitch, the daughter-in-law of Mr. Elovitch. These shares total approximately 0.15% of the outstanding ordinary shares of Bezeq.

Permit to Control Bezeq Granted to Members of the Eurocom Group

As part of B Communications' acquisition of the controlling interest in Bezeq, we, SP2, SP1 and other members of the Eurocom group applied for authorization to control Bezeq, pursuant to the Communications Law and Communications Order. On April 13, 2010, the control permit was granted subject to the condition that SP2 continues to be controlled exclusively by the other parties to the control permit, referred to as the Companies' Control Permit. Concurrently, a separate control permit was also granted to Messrs. Shaul Elovitch and Yossef Elovitch, our controlling shareholders, referred to as the Individuals' Control Permit.

According to the Companies' Control Permit, the parties (through SP2) must hold not less than 30% of any type of means of control of Bezeq. Such percentage is permitted to decrease to 29% for a period of six months commencing from the date such holdings fall below 30%, in the event of dilution resulting from the exercise of stock options by Bezeq employees. B Communications' SP2 subsidiary which owns most of the Bezeq shares is deemed to hold the Bezeq shares directly notwithstanding that ownership is recorded in the name of a trust company wholly-owned by Bank Hapoalim, which was granted a lien over the Bezeq shares that were purchased from Ap.Sb.Ar. Holdings Ltd. as security for the repayment of the debt owed to Bank Hapoalim and other banking and financial institutions (approximately NIS 2.7 billion at December 31, 2012), referred to as the Lending Parties, for the funding of B Communications' acquisition of the Bezeq interest. In December 2012, SP2 transferred 29,662,168 ordinary shares of Bezeq (1.09%, of the outstanding Bezeq shares) to B Communications, which shares are not subject to the abovementioned lien and trust arrangement.

In accordance with the Companies' Control Permit, SP2, which holds the Bezeq shares is required to notify the Ministers of any changes in the composition of its board of directors every six months and if the change represents half or more of the members of the board of directors, within 30 days of the change. We and B Communications are also required to notify the Ministers of any "Exceptional Holdings" immediately upon becoming aware of such event. We and B Communications are also required to notify the Ministers in the event a shareholder becomes a "Principal Shareholder" and regarding any 1% or more change in the holdings of a Principal Shareholder within 48 hours of becoming aware of such change. The terms "Exceptional Holdings" and "Principal Shareholder" are defined in the Communications Order and in our Articles of Association and are described below in Item 10B "Additional Information - Memorandum and Articles of Association - Rights Attached to Shares - Exceptional Holdings; Principal Shareholders."

The parties to the Companies' Control Permit may not transfer means of the control in Bezeq at a rate which requires the approval of the Ministers under the Communications Order, without their prior written approval. The foregoing includes a transfer of the Bezeq interest in one transaction or a series of transactions, by one party or together with the other parties to the Companies' Control Permit or the parties to the Individuals' Control Permit. However, the parties may transfer the means of control of Bezeq among themselves, subject to compliance with certain conditions set forth in the Companies' Control Permit

The Lending Parties undertook to comply with the provisions of the Communications Law, Communications Order and the lien permit granted to them relating to their rights under the credit agreement entered into among SP2 and the Lending Parties and the realization of the lien. The rights granted to the Lending Parties are deemed to be an encumbrance of collateral and the Lending Parties may not exercise rights pursuant to the means of control except as set forth in the lien permit. The lien permit was granted exclusively to the Lending Parties and any change in the composition of the Lending Parties or a modification of the credit agreement entered into among SP2 and the Lending Parties requires the prior written consent of the Ministers. The appointment of a receiver, on any grounds whatsoever, with respect to the holdings in SP2 or SP2's holdings in Bezeq, will constitute grounds for canceling the Company's Control Permit. The violation of the lien permit by the Lending Parties will constitute grounds for canceling such permit and for the appointment of a receiver and trustee, in accordance with the terms of such permit.

According to the Companies' Control Permit, SP2 must at all times be held by an "Israeli Party," as defined in the Communications Order, to the following extent:

- At least 19% of each of the means of control of SP2 must be held by an Israeli Party at all times; or
- At least 19% of the rights to vote at the general meeting of shareholders of SP2 and the rights to appoint directors of SP2 must be held by an Israeli Party at all times; and
- The right to appoint at least one-fifth of the directors of Bezeq and Bezeq's subsidiaries and not less than one director of each such company will be held by an Israeli Party at all times, provided that the percentage of the Israeli Party's direct or indirect shareholdings in Bezeq is not less than 3% of any of the means of control of Bezeq. Indirect shareholdings will be calculated as the product of the Israeli Party's lowest rate of holdings in each of the means of control in SP2, multiplied by the percentage of the holdings of the parties to the control permit in each of the means of control in Bezeq.

The Ministers have determined that we and B Communications are deemed to be "Israeli Parties," so long as we and B Communications are controlled by a citizen and resident of Israel and that the ownership interest of Messrs. Shaul Elovitch and Yossef Elovitch in our company and our ownership in B Communications does not fall below 50% at all times.

The parties to the Companies' Control Permit may not be controlled by any country, government company or a company controlled by a government company. The Companies' Control Permit will terminate if the foregoing condition ceases to exist with respect to any such party without the approval of the Ministers. The Ministers may authorize a government company to hold an interest in any such party, provided that the government company's aggregate direct or indirect holdings in Bezeq do not exceed 5% of any type of means of control of Bezeq and that it does not control such party.

In the event the Ministers find that the information they were provided is incorrect, that there has been a material change in the details provided by the parties to the Companies' Control Permit which justifies its cancellation, or such parties failed to submit a required report, and the Ministers determine that there is probable cause to believe that the provision of the services that Bezeq is required to provide pursuant to its general license (including basic telephone, infrastructure, transmission and data transmission services and ancillary services) or the grounds for determining that any such service has been harmed, the Ministers may take action to cancel the Companies' Control Permit. Upon its cancellation, all the shareholdings purchased under the Companies' Control Permit will be deemed "Exceptional Holdings," as described above.

The Companies' Control Permit also authorizes an interested party in B Communications and our company that is not a party to the Companies' Control Permit or the Individuals' Control Permit to hold means of control in Bezeq, provided that such interested party does not hold more than 15% of any type of means of control of B Communications and our company. The foregoing authorization is subject to the condition (among others) that the percentage of holdings of the parties to the Companies' Control Permit in B Communications, and of Eurocom Communications' holdings in our company exceed 50% of the means of control in each of such companies at all times. We and B Communications are required to notify the Ministers of the shareholdings of any such interested party.

The provisions of the Companies' Control Permit are subject to the terms of the Communications Order and Communications Law, as they may be amended from time to time.

## B. Business Overview

Since April 14, 2010, we, through our B Communications subsidiary have been the controlling shareholder of Bezeq (TASE:BZEQ), Israel's largest telecommunications provider.

Bezeq is the principal provider of communications services in Israel, providing a broad range of telecommunications operations and services, including domestic fixed-line, cellular and international communication services, Internet services, multi-channel television, television and radio broadcasts, satellite broadcasts, customer call centers, maintenance and development of communications infrastructures, provision of communications services to other communications providers and the supply and maintenance of equipment on customer premises, which is referred to as network end point, or NEP services. Bezeq was founded as a government company in 1980 and became a public company in 1990 with its shares traded on the TASE.

### The Telecommunications Industry in Israel

The State of Israel is a highly developed, industrialized democracy. Real gross domestic product, or GDP, increased annually by 3.9% on average between 1996 and 2011, and GDP grew by 4.8% in 2011. Israel has seen marked improvements in most economic indicators in recent years. GDP growth has been steady and consistent over the past decade, with the exception of a contraction during the global slowdown early in the last decade and fluctuating growth rates surrounding the global financial crisis and the European debt crisis.

At December 31, 2012, the population of Israel was approximately eight million persons. The GDP of Israel was approximately \$241 billion in 2012 and the GDP per capita was approximately \$30,500. In 2012, Israel exported \$91 billion of goods and services and the change in its consumer price index, or CPI, was 1.6%. Standard & Poor's issued a long-term local currency sovereign credit rating of A+ (Stable) in 2012. This financial information was translated to US dollars based on the average representative rate of exchange for 2012 and the sources for that data are the Central Bureau of Statistics, Ministry of Finance of Israel and the Bank of Israel.

The Israeli telecommunications services industry had revenues of approximately NIS 30 billion (approximately \$8 billion) in 2011. Telecommunications services consist of several segments, which are highly competitive. Of the total telecommunications services revenues in 2011, approximately 56% was attributable to cellular services, approximately 26% was attributable to local landline voice and Internet access services, approximately 5% was attributable to international voice services and approximately 13% was attributable to multichannel television services. These figures changed substantially in 2012, reflecting a decrease in the overall revenues in the cellular market as a result of the increased competition and accelerated price erosion. Cellular spending in 2012 was approximately 1.4% of GDP, in line with developed European economies and the United States. Israel has high penetration rates across all telecommunications services that are in line with developed economies such as in the European Union and the United States. These levels of penetration can be attributed to the rapid adoption rate of new

technologies, high expenditures on telecommunications services by consumers and businesses and a relatively young population.

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## Bezeq Group's Strategy

The Bezeq Group's objective is to be the market leader in all areas of the communications industry in Israel in both the business and private sectors. Bezeq's strategy is to maintain its competitive position and continue being the customer's first choice in telephony, internet and telecommunications. To attain this goal, Bezeq has imposed on itself a number of challenges:

- Preservation of leadership status in an environment of intensifying competition (leader in service and strengthening of perceived values – innovative products, reliability, proximity to the customer);
  - Encourage the recruitment of new customers and enhance existing customer loyalty;
  - Creation of new sources of income by launching new services and products; and
- Ongoing adaptation of the organization to the competitive environment and maintaining operational excellence.

To implement this strategy and attain these objectives, Bezeq uses and intends to continue to use the following means: leverage its leading position among business customers; offer diverse bundles of products and services that meet the business needs of customers; offer a total solution according to customer needs, while applying a strategy of commitment to service quality and availability; encourage customer to migrate from basic services to managed solutions for organizational and inter-organizational connectivity; provide higher bandwidth to customers and sell advanced products and services on the new NGN; supply different billing solutions to suit customer needs; strengthen the position of Bezeq's telephony services, with emphasis on advanced applications and the penetration of advanced terminal handsets; and leverage the Bezeq Group's assets for the purpose of providing customers a comprehensive communications solution. In order to attain its strategic objectives, Bezeq is working on improving its existing network and adapting it to its business goals, including by the deployment of optical fibers and investment in the core of the network.

## Pelephone

Pelephone's strategy is to grow its business to maintain its dominance in the provision of data services. To achieve its strategy, Pelephone intends to:

- Increase revenues from data services by focusing on a target audience, increased marketing of mobile devices, cellular modems (NetStick) and smartphones;
- Market supplemental value-added services to Internet surfing including anti-virus solutions, backup and data storage, and music and video services;
- Increase data transfer speeds and maintain our reputation as the leading carrier with the fastest network in Israel;
  - Continue the recruitment and retention of customers;
  - Increase customer satisfaction;
  - Constantly improve its network infrastructures; and
  - Continue to streamline its operations.



Bezeq International

Bezeq International's strategy is to continue to maintain its leadership position in the internet services market in Israel for private and business customers, while maintaining its revenue in its traditional markets. To achieve its strategy, Bezeq International intends to:

- continue its leadership in the Internet access market while continuing to realize the potential inherent in the migration to the new generation of infrastructure networks;
  - Expand its range of cloud-based solutions;
- Strengthen its status as one of the leading Information Communications Technology, or ICT, players in Israel; and
- Increase customer satisfaction by intensifying and expanding service offerings (automated services, social networks, etc.).

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## DBS

DBS's objective is to maintain its business and competitive status in the broadcast market while increasing its operating margins. To achieve these goals, along with its efforts to reduce costs and streamline operations, DBS intends to:

- Invest considerable effort in marketing and sales;
- Develop a marketing strategy designed to attract new subscribers;
- Retain existing customers;
- Continue to improve the array of services offered to subscribers;
- Create differentiation and innovation in its broadcast content and expand the range of content relative to HOT's content;
  - Increase the amount of content purchased by each subscriber and expand DBS's value-added services; and
    - Invest in the development and integration of advanced technologies and new services.

These efforts include DBS's efforts to increase the rate of penetration of advanced services, including the use of personal video recorder, or PVR, decoders and VOD and HD services among its subscribers and to provide its content on additional platforms to increase DBS revenues and enhance subscriber loyalty to DBS's services.

## Bezeq's Ownership Interests

The following chart illustrates Bezeq's ownership interests in its principal subsidiaries and affiliates, as at April 22, 2013:

The Group has four principal areas of operation, which are reported as business segments in Bezeq's consolidated financial statements:

Bezeq domestic fixed-line communications - Primarily includes Bezeq's operation as a domestic operator, including fixed-line telephony services, Internet services, transmission services and data communications.

Pelephone Communications Ltd. - Provides cellular mobile services (cellular communications), marketing of end-user equipment, installation, operation and maintenance of cellular communications equipment and systems.

Bezeq International Ltd. - Bezeq International is an Internet service provider, or ISP, and also provides international communications services and NEP services.

D.B.S. Satellite Services (1998) Ltd. - Provides multi-channel broadcast and value added services via satellite.

As a result of the August 2009 decision of the Israeli Supreme Court to not approve the merger of Bezeq and DBS, Bezeq ceased consolidating the results of DBS into its financial statements and accounts for its investment in DBS under the equity method. Bezeq reports the operations of DBS as a segment in its consolidated financial statements. Bezeq holds 49.78% of the shares of DBS as well as options to purchase additional shares, with the balance held by

Eurocom D.B.S. Ltd., or Eurocom DBS, which is indirectly controlled by Mr. Shaul Elovitch. Accordingly, cooperative ventures between it and the Bezeq Group companies (such as agreements for mutual marketing of products and services) must currently be approved as transactions in which the controlling shareholder in Bezeq has a personal interest, which process could impede the business flexibility of the Bezeq Group in such cooperative ventures. In view of the position taken by the Israeli Antitrust Commissioner and the ruling of the Supreme Court in 2009, Bezeq is not permitted to increase its holdings in DBS or control it, which limits the Bezeq Group's ability to benefit fully from the advantages that could have been achieved from the inclusion of DBS in the Bezeq Group. DBS believes that if these regulatory limitations and structural separation and the other limitations applicable to cooperative ventures between it and the other companies in the Group remain in effect, they will have a detrimental effect on DBS's financial results.

Bezeq also includes a category of “Other” in its consolidated financial statements, which includes customer call center services through its Bezeq Online Ltd. subsidiary, investments in a venture capital fund and its ownership of Walla! Communications Ltd., or Walla!, a popular Israeli provider of Internet and portal services. In April 2012, a tender offer published by Bezeq for the purchase of all the shares held by the public in Walla! was successfully completed. Accordingly, all of the Walla shares held by the public were acquired and Walla! was delisted from the TASE and became a wholly owned subsidiary of Bezeq.

The Bezeq Group holds over 200 trademarks including its principal trademarks: Bezeq, B (Bezeq's logo) and Pelephone.

For detailed information about Bezeq’s business, see Bezeq’s Periodic Report for 2012, prepared in accordance with Israeli Securities Regulation (Periodic and Immediate Reports), 5730-1970, which we filed on a Form 6-K with the SEC on March 25, 2013.

### Regulatory Environment

The Israeli communications industry is regulated and controlled by the Israeli Ministry of Communications and to a lesser degree by other governmental authorities. The Bezeq Group is subject to government supervision and regulation relating to, among other things, its operations, licensing, determining permitted areas of activity, determining tariffs, competition, environmental matters, payment of royalties, obligation to provide universal service, ability to hold its shares, relationships between Bezeq and its subsidiaries and, in certain events, prohibitions as to the termination or restriction of its services (which may force Bezeq to provide services at a loss). This supervision and regulation has resulted in governmental intervention in the past. Bezeq’s business and operations could be adversely affected by decisions of its regulators, in particular the Ministry of Communications as well as changes in laws, regulations or government policy affecting its business activities.

### Competition Policy of the Ministry of Communications

On May 2, 2012 the policy document concerning expansion of competition in the fixed-line communications wholesale market was published, pursuant to which the Minister of Communications adopted the main recommendations of the Hayek Committee. The key points in this policy document are as follows:

- Owners of universal fixed-line access infrastructures, who provide retail services, including Bezeq, 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 for negotiating an agreement for these services and as soon as such agreement is signed, the infrastructure owner will publish a “shelf offering” for the sale of the services based on the agreement and which also includes additional services as the Ministry of Communications determines from time to time. In certain circumstances, the Minister of Communications 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.
- Upon publication of such “shelf offering,” other entities may also purchase wholesale services on the same terms from the infrastructure owner. Under this procedure, Bezeq 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.
- Within nine months of publication of the “shelf offering,” the Minister of Communications will eliminate the structural separation between the infrastructure provider who published the aforementioned offering and the

international call providers and ISPs, changing it to an accounting separation, unless the Minister believes that this will adversely affect competition or the public interest. As a result, Bezeq will be able to offer subsidized plans. If the wholesale market develops and the degree of competition allows, the Minister of Communications will consider an easing or cancellation of the structural separation between an infrastructure provider and a cellular operator who has an interest in such provider.

- The Minister of Communications will review the subject of the unbundling of broadcast services included in the joint bundles, which also include Bezeq services (fixed or mobile) or broadband access services. The structural separation between the infrastructure providers and multi-channel television sector will be eliminated by granting suppliers without nation-wide fixed-line infrastructure a reasonable possibility to provide a basic television service package over the Internet.
- If a wholesale market does not develop in an approved manner (based on indices to be defined for this purpose) within 24 months of the publication of the policy document, the Minister of Communications will take action to implement structural separation between the infrastructure and the services provided by general domestic carrier license holders.
- Within six months of publication of the “Shelf Offering”, the Minister of Communications is required to take action to change the method of oversight of Bezeq's prices so that prices will be controlled by fixing a maximum price.
- Within nine months of publication of the “Shelf Offering”, the Ministry of Communications is required to formulate regulations aimed at increasing the investment in and upgrade of fixed-line communications infrastructures in Israel.

Bezeq is preparing to implement a wholesale market and to provide wholesale services. The effects on Bezeq will depend, to a large extent, on the conditions, arrangements, and similar variables, which have not yet been defined. Bezeq believes that in addition to the possible negative impact on revenues and the rendering of end-to-end services to subscribers, the implementation of the wholesale market may have positive effects, including the possible elimination of Bezeq's structural separation and the regulatory control over Bezeq's prices.

On June 12, 2012, the Ministry of Communications convened an engineering forum of the operators to discuss the wholesale services, including the service portfolios for the provision of certain service configurations of Bitstream Access and passive infrastructures, concurrent with advanced negotiations that Bezeq is holding directly with various operators. In November 2012, Bezeq entered into an agreement with Partner to provide Bitstream Access. The agreement defines the principles and configuration of the service for the provision of Internet access that will support media, voice and TV Internet services. Should the parties fail to reach agreement on prices, they will wait for the peremptory decision of the Ministry of Communications. Bezeq and Partner agreed to work towards signing a detailed agreement based on the principles prescribed in the agreement and that after signing such detailed agreement, Bezeq will be able to publish the agreement as a shelf offering (as described above), whereby any other entity may apply and receive the service under the same conditions. Similarly, in March 2013, Bezeq entered an agreement with Xfone for the provision of Bitstream Access for a “small supplier,” which agreement will also serve as a shelf offering.

On December 9, 2012, the Ministry of Communications' hearing of Bezeq's instruction was received, whereby Bezeq will provide to Cellcom or to any license holder who applies to it for the purpose of exercising a wholesale market, detailed information about the sites, facilities and distribution of its network. Bezeq submitted a detailed opinion to the Ministry concerning its objections to the aforementioned instruction and process, which Bezeq believes contains administrative deficiencies, lack of jurisdiction and are unreasonable.

## Royalties

The Communications Law states that a holder of a license for the provision of telecommunications services shall pay royalties to the State of Israel out of its revenues from providing the services named in the applicable Israeli royalties regulations. Such regulations impose on a general domestic carrier licensee (which includes Bezeq), an international call service license (which includes Bezeq International) and a cellular licensee (which includes Pelephone), a duty to pay royalties on its revenues (excluding VAT) from the services listed under such regulations.

In 2012, the applicable rate of royalties was reduced on average to 1.75% for Bezeq and DBS, to 1.3% for Pelephone, (the rate of royalties for Bezeq International is 1%), and from 2013 it will be 0% for all of the Bezeq Group companies.

Bezeq's paid approximately NIS 52 million in royalties in 2012 compared to NIS 56 million in royalties in 2011. The royalty rate for 2012 and 2011 was 1.75% of taxable income (as defined in the regulations).

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#### Limitation on the exit penalty a license-holder may collect from a subscriber

Under an amendment to the Communications Law, exit fees cannot be collected from a subscriber whose average monthly bill is less than NIS 5,000 who entered into an agreement after August 8, 2011, nor can the subscriber be denied a benefit that he or she would have received had he or she not terminated the agreement. Commencing November 8, 2011, the amendment also applies to subscribers who entered into agreements before the amendment became effective and subsequently cancelled their agreements. Such subscribers are subject to a cancellation fee of up to 8% of their average monthly bill, multiplied by the number of months remaining to the end of the term of the commitment. In addition, a license-holder may not demand immediate payment of the balance for the terminal equipment in the event of cancellation of the agreement. This amendment resulted in an increase in the churn rate and in certain adjustments to the terms in the subscriber agreements in order to conform them to the amendment.

Cellular license-holders are regulated by provisions limiting the exit fee that may be collected from certain subscribers who terminate their agreement before the end of the commitment period to 8% of the subscriber's average monthly bill at the cancellation date. On April 1, 2012, an amendment to the Communications Law was published, eliminating disconnection fees for customers that hold up to 100 phone lines and who entered into agreements with the cellular operator subsequent to November 1, 2011. Also effective in 2013, a subscriber's commitment to receive cellular services may not be dependent on such subscriber's agreement with a license holder to purchase, rent, borrow or lease terminal equipment.

#### Consumer protection

Changes in consumer legislation regularly affect the operations of Bezeq and its subsidiaries. Bezeq and its subsidiaries are subject, among other things, to the Consumer Protection Law, 5741-1981, or the Consumer Protection Law and regulations. The Consumer Protection Law allows consumers to cancel transactions and to disconnect from on-going services and requires customers to give their express consent to continue the service after the end of the term of the contract. Provisions concerning a refund of charges collected from subscribers, which are not in accordance with an agreement plus fixed handling charge are prescribed by law, as well as a maximum waiting time for a human response. In addition, a number of pending legislative proposals provide for additional consumer protection and may affect the conduct of Bezeq and its subsidiaries with their subscribers.

#### Limitations on creating charges on the assets of the Bezeq Group

The Communications Law, the Communications Order and some of the communications licenses of the Bezeq Group, contain limitations on the grant of rights to a third party in assets used to provide the essential service or in the assets of the license, including the need to obtain regulatory approval to create charges on these assets. In some instances, such as Pelephone's cellular operator's license and Bezeq International's general (ITS) license, there are exceptions permitting the creation of charges in favor of banks without the need to obtain the regulator's approval in advance, provided that the charge agreement includes provisions to ensure that the enabled services will not be affected if the bank exercises the charge. In addition, under the provisions of the law and the communications licenses, the license and the resulting rights are not transferrable and they cannot be pledged or confiscated (with certain exceptions).

Bezeq and Pelephone have provided undertakings to certain financing entities that they will not pledge their assets without simultaneously creating a charge of the same class, rank and amount (negative charge) in favor of those financing entities. DBS created current charges on all its assets and fixed charges on certain of its assets, which include, among other things, restrictions on the creation of additional charges without obtaining the agreement of the financing entities.

#### Gigabit Ethernet connection for ISPs



On June 26, 2012, the Ministry of Communications published the findings of a hearing seeking operators' comments on changes to the existing regulations for connecting ISPs to Bezeq's network and to the Hot Telecom network, which determined that: (i) the "high-speed access by means of Internet providers" (Bezeq'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; (ii) the payments imposed on the ISPs for gigabits will be eliminated; and (iii) infrastructure owners will increase the price for the Internet access services for the end customer to include the gigabit segments. According to the hearing, the infrastructure owners will be obligated to provide gigabit connections at a speed to be derived from the "load ratio" (a percentage 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%. Bezeq objected to this change and believes it is not generally accepted in the telecommunications industry, and expressed its opinion that the hearing and the proposed arrangement contain administrative flaws and are unreasonable. Bezeq published new tariffs for these services.

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The regulations affecting the operating segments of the Bezeq Group are described in the sections of this annual report relating to each of such segments.

#### Competition in the Israeli Communications Market

The communications industry around the world and in Israel has developed rapidly. The technology and corporate structure and regulations governing the communications industry in Israel has undergone and continues to undergo significant changes. A number of communications groups operate in the Israeli communications market on the basis of cooperative marketing among a number of companies and/or among companies with common ownership for the supply of comprehensive communications service packages, thus utilizing the marketing and operational advantages inherent in such a structure.

In 2011, a tender for the grant of frequencies and a license to cellular operators that own infrastructure was issued. The tender was won by Hot Mobile, which is one of the four existing operators, and Golan Telecom. In May 2012, Golan Telecom and Hot Mobile launched their operations, which immediately caused intensified competition in the cellular market among all the cellular operators.

The Ministry of Communications has also prompted increased competition by:

separating infrastructure and service providers;

granting new licenses and encouraging new and innovative technologies; and

mandating number portability. Number portability exists in the fixed-line and cellular telephony market, enabling customers to immediately switch between various communication operators without changing their telephone number. Bezeq believes that number portability has significantly increased the churn rate in its fixed-line telephony services.

In 2012, competition in the telecommunications industry, particularly in cellular telephony, intensified with the entry of the new operators, Golan Telecom and Hot Mobile, and the introduction of comprehensive service packages, including communications packages for a fixed price with unlimited use. This intensified competition resulted in lower prices, a decrease in the sale of cellular terminal equipment, a decrease in the use of fixed-line telephony minutes and higher churn rates, which has affected the Bezeq Group's revenues and operational results. To reduce the impact on performance, the Bezeq Group's companies are introducing streamlining and other measures to improve the services they provide and differentiate them from their competitors.

While in the past competition in the communications market was mainly among the independent communications service providers in each segment, more recently the communications market has consolidated and competition evolved to be among large communication groups operating in most, if not all, of the segments of this market.

The Israeli communications market is dominated by four main groups, the Bezeq Group, the IDB group (which controls Cellcom and 013 NetVision), the Partner group, which purchased 012 Smile Communications Ltd., or 012 Smile, and the HOT group, each having interests in some, or all, of the main communications sub-sectors.

**IDB Group** - The IDB Group provides communications services through Cellcom, a publicly held company, and its wholly owned subsidiary, Netvision Ltd., or Netvision. These companies provide cellular telephony services (including cellular Internet), fixed-line telephony mainly to business customers through its own infrastructure, transmission and data communication services for business customers through Cellcom's own transmission network, ISP services, international call services and fixed-line telephony services using VoB technology.

Partner Group - The Partner Group provides communications services through Partner, a public company, and 012 Smile, which provide cellular telephony services (including cellular Internet), fixed-line telephony, transmission and data communications, ISP services, international call services and fixed-line telephony using VoB technology

HOT Group - The HOT Group provides communications services through HOT and through Hot Mobile which are commonly owned. The Hot Group owns a cable infrastructure that is deployed nationwide, and it provides multi-channel television services through HOT, as well as fixed-line telephony services. The HOT Group also has a nationwide Internet infrastructure and provides transmission and data communications services through HOT Telecom, a subsidiary of HOT. Hot Mobile (previously known as Mirs Communications Ltd., which was acquired by HOT in 2011) provides cellular communication services using iDEN technology. The HOT Group is subject to limitations separating the structure of Mirs Communications Ltd. from that of HOT Telecom and HOT Broadcasting, including full segregation of management, as well as the separation of assets and employees. Hot Mobile is prohibited from transferring commercial information to HOT Telecom and HOT Broadcasting, or from receiving such information. However, Hot Mobile is permitted to offer and market HOT Telecom or HOT Broadcasting services that are not part of the joint bundles and to transfer relevant information for this purpose.

In December 2009, HOT-Net, a subsidiary of HOT, was granted an ISP license, subject to similar structural separation limitations between HOT-Net, HOT and HOT Telecom and limitations on marketing joint service packages that include HOT-Net's Internet access. Among the limitations are an obligation to market service packages that correspond to competing ISPs, and an obligation to sell ISP services separately and on the same terms as they are sold when part of the service package (unbundling). In February 2012, HOT-Net launched operations.

#### Other Developments in Competition

In addition to HOT's cable and optical fiber network and the optical fiber infrastructures of Cellcom and Partner, there are a number of utility and transportation infrastructures in Israel that have the potential to serve as communications infrastructures, based on optical fibers networks, which are mostly owned by government companies and entities. Among these are the Israel Electric Company, Israel Railways, Mekorot (water grid), pipeline infrastructures companies and the Cross Israel Highway Company. Some municipalities are also trying to create an alternative to cable network services of communications license-holders by deploying their own infrastructures.

The government of Israel is conducting a public process to choose an investor for a communications venture that will control the establishment of a third communications infrastructure company in Israel, which will use and operate a fixed-line communications infrastructure based on the electricity grid. Under this proposal the Israel Electric Company will own 40% of the share capital in the venture. According to various publications, on December 26, 2012, a group of investors headed by "Viva Europa" submitted an offer to the selection committee. The selection committee will review the economic, technology, and legal aspects of the offer submitted by that group to determine if the offer meets the conditions of the selection process. In Bezeq's estimation, the establishment of such a communications company, which would compete with Bezeq in providing infrastructure, and particularly if that new company is permitted to provide services to operators and business customers while easing the obligation for universal deployment of a fiber to the home network, could adversely affect its operations and results.

### BEZEQ FIXED-LINE BUSINESS

#### General

Bezeq has a general license to provide domestic fixed-line communication services in Israel. As a domestic carrier, Bezeq provides fixed-line telephony services, Internet infrastructure and access services, transmission and data communication services.

The following table provides summary condensed information concerning Bezeq's fixed-line communications segment for the three years ended December 31, 2012.

	2010	2011	2012
Revenues (NIS millions)	5,263	4,648	4,630
Operating profit (NIS millions)	2,043	1,695	1,923
Depreciation and amortization (NIS millions)	690	688	730
Operating profit before depreciation and amortization (NIS millions)	2,733	2,383	2,653
Net profit (NIS millions)	1,426	1,102	1,194
Cash flow from operating activities (NIS millions)	2,140	2,106	2,009
Payments for investments in property, plant and equipment and intangible assets (NIS millions)	1,032	1,165	958
Proceeds from the sale of property, plant and equipment and intangible assets (NIS millions)	132	228	300

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Free cash flow (in NIS millions) (1)	1,240	1,169	1,351
Number of active subscriber lines at the end of the period (2) (in thousands)	2,366	2,367	2,268
Average monthly revenue per line (NIS) (3)	81	76	73
Number of outgoing minutes (in millions)	10,699	9,758	8,691
Number of incoming minutes (in millions)	6,547	6,240	6,225
Number of Internet subscribers at the end of the period(2) (in thousands)	1,066	1,111	1,169
Percentage of subscribers using NGN services out of total Internet subscribers	34%	51%	62%
Average monthly revenue per Internet subscriber (NIS)	75	80	81
Average bandwidth per Internet subscriber (Mbps)	4.3	6.7	9.6
Churn rate (4)	12.6%	11.6%	15.3%

(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 (roughly) the first three months of the collection process).
- (3) Excluding revenues from transmission and data communication, Internet services, services to communications operators and contract and other works, calculated according to average lines for the period.
- (4) Number of telephony subscribers who left Bezeq fixed-line services during the period, divided by the average number of registered subscribers in the period.

Number of active subscriber lines, average monthly revenue per line, and number of outgoing usage minutes were corrected retrospectively and are presented after eliminating the effect of public call boxes operated with cards. Additionally, the number of active subscriber lines and average monthly revenue per line, or ARPL, were corrected retrospectively and include IP Centrex lines.

#### Government Regulations

Bezeq is subject to control and restrictions under the Antitrust Law and was declared a monopoly in its main fields of activity, including basic telephone services, provision of communications infrastructure services, transfer and transmission of broadcasting services to the public, provision of high-speed access services through the access network to subscribers and provision of high-speed access services for ISPs through a central public telecommunications network.

Bezeq was also declared a provider of essential telecommunications services under the Communications Order. By virtue of that declaration, Bezeq is required to provide certain types of services and may not interrupt its provision of such services or narrow them. Among these services are basic telephone services, infrastructure services, transmission services and data communication services including, interconnect, and other services listed in the schedule to the Communications Order.

The main provisions of the Communications Order are:

Limitations on the transfer and acquisition of means of control, which includes a ban on holding 5% or more of means of control of a certain kind without the prior written approval of the Ministers.

Transfer or acquisition of control in Bezeq requires the approval of the Ministers by means of a Control Permit. The Control Permit establishes the minimum holding percentage in each of the means of control in Bezeq by the holder of the Control Permit where a transfer of shares or an issuance of shares by Bezeq, as a result of which the percentage of ownership of the Control Permit holder falls below the minimum percentage, is prohibited without the prior approval of the Ministers, subject to permitted exceptions (including, an issuance to the public under a prospectus, or sale or private placement to institutional investors).

Holdings not approved in compliance with the Communications Order will be considered “exceptional holdings” and any exercise of a right by virtue of exceptional holdings will not be valid. The Communications Order also contains provisions authorizing the Ministers and Bezeq to apply to the courts with an enforced sale of exceptional holdings.

A duty to report to the Ministers upon demand is imposed on Bezeq with respect to any information on matters relating to provision of an essential service.

75% of the members of the Board of Directors of Bezeq must be Israeli citizens and residents who have security clearance from the General Security Service.

The Chairman of the Board of Directors of Bezeq, the external directors (within the meaning of the Israeli Companies Law), the chief executive officer, the deputy chief executive officer and other office-holders in Bezeq as listed in the Communications Order, must be Israeli citizens and residents and have a security clearance appropriate to their functions.

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Nationality requirements are established for the controlling shareholder in Bezeq: an individual must be an Israeli Entity (as defined in the Communications Order); a corporation must be incorporated of Israel, the center of its business must be in Israel, and an Israeli Entity must hold at least 19% of the means of control of such company.

The approval of the Ministers is required for the grant of rights in certain assets of Bezeq (switches, cable network, transmission network and data bases and banks). In addition, the grant of rights in means of control in the subsidiaries of Bezeq, including allotment of more than 25% of the shares in a subsidiary, requires the approval of the Ministers.

Provisions were established for the protection of computerized systems and the purchase of hardware and software.

Certain actions of Bezeq require the approval of the Minister of Communications, including voluntary liquidation, a settlement or arrangement between Bezeq and its creditors, a change or reorganization of the structure of Bezeq and a merger or split of Bezeq.

The Minister of Communications granted Bezeq immunity from liability from certain types of damages listed in the Communications Law. In addition, the Communications Law contains exceptions to criminal and civil liability for an act done in fulfillment of a directive to provide services to the security forces.

#### Competition Laws

Bezeq's general license for fixed-line communication services obligates it to ensure that its relationships with its principal subsidiaries do not result in favoring them over their competitors. Bezeq is also subject to various limitations as a result of its declaration as a monopoly in the fixed line services business, as well as limitations set forth in merger approvals granted by the Israeli Antitrust Commission. Separation is required between the managements of Bezeq and its principal subsidiaries, as well as separation between the financial and marketing systems, assets and employees, which result in high administrative overheads. Bezeq is also subject to limitations with respect to the offering of joint service packages with those companies, which adversely impacts its business, particularly in light of the entry into the market of communications companies competing directly with Bezeq in most of its areas of operation based on the provision of bundled services to the customer.

On October 11, 2011, Bezeq was notified by the Israeli Antitrust Commissioner of the possible finding that Bezeq violated the provisions of the Antitrust Law by, among other things, not providing infrastructure and transmission services for telephony and Internet services (domestic operator) to its competitors, Cellcom, and Partner. In October 2010, Bezeq started to provide infrastructure and transmission services to competing telecommunications operators.

On October 16, 2012, the Ministry of Communications published a hearing according to which it is considering granting permission to the domestic carrier license holders to offer the use of WLAN (Wireless Local Access Network) technology by installing access points throughout Israel and the removal of the connection restriction on "delineated premises." The Ministry of Communications has not published a final decision as yet.

On February 11, 2013, the Antitrust Authority informed Bezeq that the Commissioner was considering issuing a ruling to the effect that Bezeq had abused its position as a monopoly in that it had adopted a prohibited practice in connection with a campaign in which it had offered new subscribers a certain promotional rate. The Commissioner contends that the price set by Bezeq places competitors who wish to offer this service at a disadvantage, as the price of the critical input for supply of the service is higher than the price of the final service which Bezeq offered its customers. Bezeq believes that it acted lawfully and in accordance with the Ministry of Communication's approval, and it intends to exercise its right to seek a hearing.



Bezeq has adopted an internal compliance procedure containing guidelines and an internal reporting and control system, the purpose of which is to ensure that the activities of Bezeq and its employees are carried out in accordance with the provisions of the Antitrust Law.

#### Control of Bezeq's Tariffs

Bezeq's telephony tariffs are prescribed in regulations promulgated by the Minister of Communications with the consent of the Minister of Finance. As a result of a deliberate regulatory policy, the monthly usage tariff for a telephone line is set at a level that does not cover the costs involved in providing it (a situation known as "accessibility deficit"). This deficit has been reduced over the years, but still exists. The tariffs for Bezeq's controlled services (telephony and others) which are fixed in regulations promulgated under the Communications Law were updated so that on average, Bezeq's controlled tariffs will erode in real terms.

As a result of a ruling by the Minister of Communications, who adopted the majority of a report from a commission on the rules of competition in the communications industry, or the Gronau Report, so long as the Bezeq Group's market share remains higher than 60%, control of Bezeq's prices will continue in the format of mandatory price fixing. On May 31, 2012, new regulations were published, which provide that an update of tariffs to be made in June 2013 will include an aggregate update for the prior two years.

Under the Communications Law, if tariffs are fixed for controlled services, the Minister of Communications may, with the consent of the Minister of Finance, approve a request made for an alternative payment package for a service package. Bezeq may offer an alternative payment package after the period defined in the law unless either Minister of Communications or Minister of Finance announces their objection. The Gronau Report states that an alternative payment package will be approved only if it is worthwhile for 30% or more of the subscribers who consume the services offered in the package and the smaller the market share of the Bezeq Group in fixed-line telephony, the higher the maximum discount rate permitted in an alternative payment package may be.

Bezeq's controlled tariffs are reviewed by a public committee every few years, at which time Bezeq is exposed to material changes in its tariff structure and tariff levels. The review mechanism for the controlled tariffs has resulted in the erosion of the tariffs over time. Control of the tariffs creates or could create difficulties for Bezeq in providing an appropriate and competitive response to changes in the market and in offers of competitive prices on short notice. In addition, the restrictions on granting discounts on tariffs limit Bezeq's ability to participate in certain tenders.

Under the Communications Law, a license holder can demand reasonable payment for a telecommunications service for which payment is not fixed. Bezeq sets the tariffs for these types of services.

#### Service Packages

Historically, the structural separation limitations prevented Bezeq from marketing joint service bundles. Following the decrease of Bezeq's market share to below 85%, in May 2010 Bezeq was permitted to offer private subscribers joint service bundles with the subsidiaries, and in July 2012 Bezeq was permitted to offer a joint bundle to business subscribers, subject to approvals by the Ministry of Communications and other conditions contained in the Domestic Carrier license, including the following:

The service packages must be able to be unbundled so that a service included in a package will be offered separately and on the same terms; and

At the time a request for approval of a service packages is submitted, there must be a group of services in similar format being marketed to a private subscriber as a package by a license-holder who is not a subsidiary of Bezeq, or there is a group that includes license-holders who provide a private subscriber with all the services included in the joint service packages.

Joint service packages marketed by Bezeq's subsidiaries that include the services of Bezeq are also subject to similar limitations, including unbundling (except for a service package marketed by a subsidiary that only contains Bezeq's Internet infrastructure service). The Ministry does not view these amendments to the licenses as changes in the previously existing practice with respect to the ability of ISPs to offer business customers the ISP component, without this being considered a "joint services" package.

These limitations, and in particular the unbundling obligation, which severely limit the Bezeq Group's ability to offer discounts on the components of a service package, place the Bezeq Group in a competitively inferior position compared to the competing communications groups, that are not subject to similar limitations in marketing joint service packages (other than a limitation on marketing a joint service packages by HOT-Net and other companies in

the HOT Group).

On July 3, 2012, Bezeq's license was amended to permit the offer of joint service bundles with its subsidiaries to business subscribers, subject to the approval by the Ministry of Communications and subject to the other limitations set forth in Bezeq's license.

#### Deployment of Communications Facilities

The deployment and manner of set-up of communication facilities in Israel are regulated by the National Outline Plan for Communications 36, or NOP 36, and NOP 56 (in the Palestinian Administered Territories). These plans were designed to ensure coverage for transmitting and receiving radio, television and wireless communications, while avoiding radiation hazards, minimizing damage to the environment and simplifying and increasing the efficiency of the processes involved in setting up new facilities.

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NOP 36. Part A of NOP 36 deals with guidelines for erecting small and miniature broadcasting installations. Bezeq has obtained building permits for most of its small broadcasting installations in accordance with NOP 36A. From time to time, a need arises to add broadcasting installations which require that building permits be obtained in accordance with NOP 36A. Given the exemption granted under the orders of the Planning and Construction Law and of the Communications Law, Bezeq believes that it is not obliged to obtain building permits for miniature broadcasting installations, which are “wireless access facilities” under those laws. There are a number of initiatives to cancel this exemption, and its cancellation could have materially adverse implications, including making it difficult for Bezeq to provide universal service as required by the provisions of its license.

NOP 56. NOP 56 became effective in June 2008 and regulates the manner of erection and licensing of communications facilities in the Palestinian Administered Territories. NOP 56 has transition provisions for facilities erected with a permit for small installations. The guidelines also include a requirement for obtaining a communications license and the receipt of necessary consents from the Commissioner of Government Property at the Civil Administration. Bezeq has obtained licenses for 72 installations in the Palestinian Administered Territories and is in the process of obtaining licenses for an additional nine installations in the Palestinian Administered Territories.

#### Bezeq's Carrier License

The principal provisions of Bezeq's Carrier License include:

Scope of license - Bezeq must provide its services to all on equal terms for each type of service, irrespective of the location or unique cost. The license is unlimited in time; the Minister may modify or cancel the license or make it contingent; the license and any part of it cannot be transferred, no charge can be imposed on it, nor can it be subject to attachment.

Principles of structural separation - Bezeq must operate under the principles of structural separation. In order to comply with this requirement, Bezeq employs various compliance procedures and provides its employees with training sessions and periodic refresher courses on the relevant procedures. On July 3, 2012, Bezeq's license was amended to permit the offer to business subscribers of joint service bundles with its subsidiaries, subject to the approval by the Ministry of Communications and subject to the other limitations set forth in Bezeq's license.

Marketing joint service bundles - Bezeq may request permission to market joint service bundles, subject to certain limitations.

Tariffs – If Bezeq provides a service or package of services for which no tariff is set under the Communications Law, it must be offered at a reasonable price to all, without discrimination and at a uniform tariff.

Operations of networks and service standards - Bezeq is required to maintain and operate its network and provide its services at all times, including at times of emergency, in an orderly and proper manner commensurate with the technical requirements and the nature of the service, and to work towards improving its services. The license includes an appendix, “Service Standards for the Subscriber”, which is to be amended after Bezeq provides the Ministry with data. Bezeq submitted its proposal for an amendment to the appendix, adapting it to the current state of affairs and the licenses of other operators, but the amendment has not yet been adopted.

Interconnect and use - Bezeq is required to provide interconnect services to other public switching networks and to provide the option of use of such services by other license holders. Bezeq has a duty to provide infrastructure services to other license holders on reasonable and equal terms and must refrain from providing preferable terms to its affiliates.

Security arrangements - Provisions have been made for the operation of Bezeq's network in times of emergency. Bezeq is required to design and operate its network in a manner that will prevent its collapse in an emergency. Bezeq provides special services to the defense forces and is required to provide telecommunications services and maintain terminal equipment infrastructure for the security forces in Israel and abroad, as provided in its agreements with the defense forces. Bezeq is required to appoint a security officer and to comply fully with the security instructions contained with the applicable provisions in its license.

Supervision and reporting – The license imposes on Bezeq extensive reporting requirements to the Ministry of Communications. In addition, the Director General of the Ministry of Communications has the authority to enter the facilities and offices used by Bezeq and to seize documents.

Miscellaneous –

- oThe Carrier License includes limitations on the acquisition, maintenance and transfer of means of control pursuant to the Communications Order, as well as on cross-ownership, which are mainly a ban on cross-holdings by entities with an interest in another material domestic carrier, and limitations on cross-holdings by entities with Carrier Licenses or general licenses in the same segment of operation.
- oBezeq is required to prepare a draft of any agreements it plans to offer to subscribers and to submit them for the review by the Director General upon demand. The Director General has the authority to instruct that changes be made. Bezeq is in the process of preparing such an agreement.
- oPursuant to the requirement of the license, Bezeq submitted to the Director General a \$10 million bank guarantee to secure its fulfillment of the terms of the license and to indemnify the State of Israel against any loss it may incur due to violations. The Minister may declare the guarantee or part of it forfeit based on the terms of the license.
- oThe Director General has the power to impose a monetary sanction for violation of any of the terms of the license.
- oDuring a calendar year, Bezeq may invest up to 25% of its annual income in activities not connected with the provision of its services (the income of its subsidiaries is not considered income for this purpose). The Minister of Communications is authorized to grant a variance from that percentage.

Products and Services

Telephony

Bezeq's telephony services include basic telephony services on domestic telephone lines and associated services such as voice mail, caller ID, call waiting, call forwarding, speed dial, and conference calls. Bezeq also provides national services for businesses (1-800, 1-700) that offer full or partial payment for incoming calls by businesses. Bezeq currently operates approximately 12,500 public telephones around the country. As part of its marketing strategy, Bezeq is working on the development and launch of new services in both the private and business sectors. Bezeq plans to continue to launch additional products on the basis of market trends and customer needs.

Bezeq's telephony services are its principal business, and in recent years the use of and revenues from these services have decreased, mainly due to competition from other fixed-line telephony service providers and from cellular companies. The decrease in demand is reflected in the gradual decrease in the number of calls originating in the fixed-line networks. Bezeq believes that this trend is primarily due to the increase in the number of cellular subscribers and the volume of use of cellular telephones, the increasing popularity of comprehensive call minutes packages which the cellular companies have marketed extensively over the last year (Bezeq estimates that 75% of all calls originate on the cellular network), from voice-over-Internet calls and from competition with other domestic operators. As of December 31, 2012, Bezeq had 2,268,000 active fixed telephone lines compared with 2,367,000 active lines as of December 31, 2011, a decrease of 4%. The decrease was due in part to the elimination of the NDSL service and falling cellular prices. In addition, the number of call minutes (incoming and outgoing) on Bezeq's fixed telephone lines decreased by 7% in 2012 compared to 2011. Average monthly revenues per phone line decreased by approximately 4% in 2012 compared to 2011.

The following chart illustrates changes in the number of fixed telephone lines compared with the number of cellular phone lines in Israel during the period of 1995 to 2012:

The figures are based on a Ministry of Communications publication on cellular lines, the reports of HOT to the public and assessments of the other operators. Accordingly, some of the data is based on estimates and the actual data might differ. Commencing in 2008, the calculation of fixed lines includes IP Centrex lines (lines in a virtual private exchange in a public network). For this purpose, the number of IP Centrex lines is measured by the maximum number of calls that can be made simultaneously.

The following chart illustrates changes in the number of call minutes from fixed telephone lines compared with the number of call minutes from cellular phone lines in Israel during the period of 1995 to 2012:

The data in the chart is based on Bezeq's traffic data and assessments of the traffic of other operators in the market. Accordingly, some of the data in the figure is based on estimates and the actual data might differ.

#### Internet Access Infrastructure Services

The Internet market has been one of the fastest growing communication markets in recent years (although the growth in the number of subscribers has been at a slower rate than in the growth of demand for greater bandwidth) and this service has become a central focus for Bezeq's investments in technology, marketing, advertising and customer acquisition and upgrades. In September 2009, Bezeq launched a gradual roll-out of a next generation network, or NGN, based on a core IP network and deployment of an optical fiber network to street cabinets, known as fiber to the curb, or FTTC.

As of December 31, 2012, Bezeq had 1,169,000 Internet subscribers compared with 1,111,000 subscribers as of December 31, 2011. As of December 31, 2012, Bezeq had substantially completed the full deployment of its NGN and the percentage of subscribers using NGN services (those with packages of 10 mbps or higher) was 62% of all of its subscribers connected to the NGN network (approximately 60% of all of Bezeq's Internet subscribers).

In 2012, an increase of approximately 5.2% was recorded in the number of Bezeq's Internet subscribers, and an increase of approximately 1.25% in the average monthly revenue per Internet subscriber, compared to 2011. The increase in revenues is attributable to the increase in the speeds offered in Bezeq surfing packages and the adoption of advanced services and value added applications.

The following chart illustrates changes in the number of internet lines and rate of growth in the Internet segment during the period of 2003 to 2012:

The data for 2003 to 2011 is based on Bezeq's data and Hot's reports to the public. The data for 2012 is based on Bezeq's data and an assessment of the number of HOT's active lines (HOT has not yet published its financial statements for 2012). Accordingly, some of the data is based on estimates and the actual data might differ.



The following chart illustrates changes in the surfing speeds of Bezeq's Internet subscribers during the period of 2006 to 2012 (in Mbps at the end of each year):

#### Data Transmission and Communication Services

Data communications services are network services for point-to-point transfer of data, transfer of data between computers and various communications networks, services to connect communications networks to the Internet, and remote access services.

Transmission services are transfer services for electromagnetic signals or a series of bits between telecommunications facilities of a license-holder (excluding terminal equipment). Bezeq offers high speed transmission services to communications operators in a range of interfaces.

#### Other services

Services to communications operators. Bezeq provides services to other communications operators, including the cellular and international operators, HOT, NEP operators, ISPs, domestic operators, and Palestinian Authority communications providers. Bezeq's services include infrastructure, infrastructure upgrades, connection to Bezeq's network, transmission, billing and collection, rental of space and provision of services in its rented properties.

Broadcasting services. Bezeq operates and maintains radio transmitters which are operated by radio stations and operators including, the Israel Broadcasting Corporation and the Israeli Defense Force Radio (Galei Zahal). Bezeq also operates DTT transmitters for the Second Authority for Television and Radio, or the Second Authority. Bezeq is responsible for the operation and maintenance of the transmitters, but not for the content of the broadcasts.

Contract work. Bezeq performs setup and operation work on networks and sub-networks for various customers such as the Ministry of Defense, HOT, radio and television broadcasting companies, cellular and international communication operators, local authorities, municipalities and government agencies. Bezeq and HOT have agreements for the provision of installation and maintenance services of cable networks, on Bezeq's infrastructure, from the starting point of those licensees' operating center, up to the point of delivery at the entrance to subscribers' homes. The connection and maintenance from these points to the subscribers' homes is not Bezeq's responsibility.

IP Centrex. The IP Centrex service is a virtual private exchange service.

Data Centers. Data Center service enables provision of a solution for customers from the aspects of backup and survivability.

144 Internet site (B144). A search engine for finding business and private telephone numbers.

Free WiFi service. This service allows Bezeq's customers to share a portion of their wireless bandwidth with other customers in return for the ability to browse outside of their homes.

In addition to its 144 information service, Bezeq operates a unified telephone directory ( telephone code (1344)) established by the Ministry of Communications for fixed-line and cellular telephony operators, as well as a unified website which is free of charge. A "unified" directory service is an information service containing data on the subscribers of all the operators. Fixed-line and cellular telephony operators are obliged, under the terms of their licenses, to provide unified information services. The operation of this service is exempted from the need to obtain governmental cartel approval until July 27, 2014.



The table below shows data for the distribution of Bezeq's revenues by principal product and service in its segment of operation:

	2010	2011	2012
	(in NIS millions)		
Revenues from fixed-line telephony	3,160	2,393	2,254
Percentage out of total Bezeq Group revenues	60.04%	51.49%	48.68%
Revenues from Internet infrastructure services	977	1,092	1,166
Percentage out of total Bezeq Group revenues	18.56%	23.49%	25.18%
Revenues from transmission and data communication services	882	931	976
Percentage out of total Bezeq Group revenues	16.76%	20.03%	21.07%
Revenues from other services	244	232	234
Percentage out of total Bezeq Group revenues	4.64%	4.99%	5.07%
Total revenues from domestic fixed-line communications services segment	5,263	4,648	4,630

#### Customers

Bezeq's sales are divided into two main sectors: the private sector which accounts for approximately 59% of revenues and the business sector which accounts for approximately 41% of revenues. Bezeq is not dependent on any single customer or small number of customers, the loss of which would materially affect its operation, and there is no customer, which accounts for 10% or more of Bezeq's total revenue.

The following table provides Bezeq's revenues from its private and business customer sectors during the three years ended December 31, 2012:

	2010	2011	2012
	(in NIS millions)		
Revenues from private customers	3,128	2,777	2,716
Revenues from business customers	2,134	1,871	1,914
Total revenues	5,263	4,648	4,630

#### Tariffs

Bezeq charges its fixed-line customers interconnect fees for calls originating in its network and terminating in the cellular networks, and pays the cellular operators the same amount for transferring call traffic from their networks to its network.

In Bezeq's domestic communications segment, it charges its customers for interconnect fees originating in its network and terminating in the cellular networks, and pays the cellular operators the same amount for transferring call traffic in their networks.

On February 28, 2013, Bezeq received a hearing from the Ministry of Communications stating that it is considering a reduction of the interconnect fee for call completion on the network of a domestic fixed-line operator, including Bezeq. The maximum tariff, which would be the same at all times, would be NIS 0.0104 per minute (instead of NIS 0.0421 at peak hours and NIS 0.0232 during non-peak hours, without VAT). This change, which would reduce Bezeq's interconnect revenues, could be offset on the Bezeq Group level by reducing the costs incurred by Bezeq and its

subsidiaries for interconnect fees. Bezeq estimates that the impact of such a change in the tariff would not be material. Bezeq intends to file its response to the hearing.

The table below indicates the impact of the reduction in the interconnect tariffs on the interconnect revenues Bezeq received from its fixed-line domestic subscribers in the three years ended December 31, 2012 (in NIS millions):

	2010	2011	2012
Revenue, net	801	256	226

## Competition

Bezeq believes that at the end of 2012, its market share in the fixed-line telephony market was approximately 59% of the private sector and 75% of the business sector, compared with 63% in the private sector and 76% in the business sector, at the end of 2011.

Bezeq and HOT Telecom both own nationally-deployed fixed-line telephony infrastructure and they are engaged in lively competition which is reflected, among other things, in the marketing of service bundles combining Hot Internet infrastructure, telephony and cable television, and possibly cellular services as well, aimed mainly at households. In addition, HOT markets telephony services to business customers.

Bezeq also has competition from license-holders for domestic fixed-line communications services, including VoB. The implementation of a wholesale market is expected to increase the competition.

The penetration rate of cellular telephony in Israel is among the highest in the world. Bezeq believes that the high level of penetration combined with the increase in the capacity of the cellular network along with technological improvements, low airtime rates on an international scale and large-scale bundles of minutes at fixed monthly prices have made cellular telephones a substitute for landline telephones. Bezeq believes that this trend is one of the reasons for the growing reduction in the number of telephone lines.

In 2012, competition in the cellular communications market in Israel continued to intensify with the launch of the operations of Golan Telecom (as a new infrastructure operator) and Hot Mobile's UMTS network, and to a lesser degree from the launch of other virtual cellular operators. These developments led to a drop in prices and a higher rate of customer churn among the cellular providers. These developments aggravated the trend of lower average traffic per fixed-line and the growing rate of removal fixed-line telephone lines.

Partner and Cellcom also provide fixed-domestic fixed-line services through corporations they own, and they sell service bundles that combine fixed-line, cellular telephony and Internet services.

On November 21, 2012, the Ministry determined that VoB or VoC services (broadband telephony services provided by a virtual cellular operator) will be regulated through a general Domestic Carrier license or special license, as applicable. The Ministry announced that it will publish an amendment to the general and special Domestic Carrier licenses which currently apply to VoB services. Bezeq believes that the marketing of VoC services as part of a Domestic Carrier license in telephony will increase competition and will enable telephony services to be provided at fixed-line call prices on the cellular network.

On April 5, 2012, the decision of the Ministry of Communications to cancel NDSL services became effective. Accordingly, Bezeq may not apply different ADSL pricing for subscribers who use the service together with telephony service and for subscribers who only use the ADSL service. Cancellation of the tariff led to a decrease in Bezeq's revenues from Internet infrastructure services (and indirectly to the loss of fixed telephone lines) and increased the pace of recruiting customers to the Internet infrastructure.

Bezeq's preparation and methods of coping with the intensifying competition in Israel

Bezeq deals with competition in domestic fixed-line telecommunications services in several ways. Bezeq launches new communications services, value added applications and product packages, and services, in order to broaden the scope of use of subscriber lines, to respond to customer needs and to strengthen its image of technological innovation. It invests in the enhancement and modernization of its infrastructure to enable it to provide advanced services and products for its subscribers. Beginning in 2010, upon receipt of the requisite permit, Bezeq started marketing joint

products packages in the private sector and in May 2012 in the business sector, while broadening the range of offered services and offering packages that correspond to some of those offered by its competitors.

Bezeq has focused on the penetration of its high-speed NGN internet infrastructure and on increasing the number of its customers for the service, including by offering new applications for businesses. NGN enables the provision of advanced telephony applications, customer upgrades to higher speeds, and the creation of added value for the customer by means of broader consumption of content, leisure and entertainment applications. In addition, Bezeq is constantly seeking to improve the quality of its services and to maintain its customers.

Bezeq has simplified its tariff structure and offers its customers alternative payment packages, tracks and campaigns. It offers bundles of services which combine the services of the Bezeq Group's subsidiaries (excluding DBS). Bezeq utilizes use-based packages and service tracks to in order to promote subscriptions to its telephony services. In selling services to its customers, Bezeq also sells terminal equipment (home networks), laptop computers, streamers, etc., as well as telephony terminal equipment, as a tool for competitive differentiation and to increase its revenues

Bezeq also focuses its investments in fixed assets for growth activities and in projects that result in reduced operating costs. Nevertheless, Bezeq's ability to reduce its expenses in the short and medium term is limited due to the structure of its costs, which are mainly fixed in the short and medium term. These costs include depreciation expenses and expenses related to wages and wage incidentals. In addition, Bezeq has operating expenses such as infrastructure maintenance and the lease and upkeep of buildings, which are also fixed in the short term.

Positive and negative factors that affect the competitive status of Bezeq

The positive factors that affect Bezeq's competitive status are:

- Nationally deployed, quality infrastructure through which a range of services are provided;
  - Presence in most businesses and households;
  - Strong and familiar brand;
  - Technological innovation;
  - Strong capital structure and positive cash flows;
  - Broad service infrastructure and varied customer interfaces; and
  - Professional, experienced and skilled human resources.

Bezeq believes that various limitations imposed upon it by existing regulation, impede its ability to compete in its areas of operation. The main limitations in this context are the following:

- Absence of tariff flexibility - Bezeq is limited in its ability to grant discounts on its principal services and to offer different tariffs.
  - Regulatory structural separation.
- Bezeq's duty to provide universal service - Bezeq operates under an obligation to provide service to the entire public in Israel (universal service). Due to this obligation, Bezeq could be required to provide services in circumstances which are not financially viable (subject to the possibility of obtaining an exemption from an exemptions committee in extraordinary circumstances following the recommendations of the advisory committee and the Minister of Communications decision on this matter). This obligation is not imposed on the holders of special Domestic Carrier licenses, who can offer their services to the most profitable of Bezeq's customers, mainly business customers, who are a material source of Bezeq's income.
- Access deficit - Bezeq's telephony tariffs are determined in regulations established by the Minister of Communications in consultation with the Minister of Finance. As a result of a deliberate regulatory policy, the monthly usage tariff for a telephone line is set at a level that does not cover the cost involved in providing it. This deficit has been reduced over the years but still exists. The negative factor of this deficit is exacerbated by competitor's use of Bezeq's infrastructure to supply their services.
  - Limitations in marketing joint service bundles of Bezeq and other Bezeq Group companies.
- Fixed-line terminal equipment is technologically less advanced than the cellular terminal equipment. Accordingly, the range of advanced services that can be offered to fixed line customers is limited.
  - The creation of a wholesale market

Internet Infrastructure Market

While the Internet segment has grown in recent years in terms of the number of customers, the growth rate is slowing as a result of the saturation of the market. The Internet segment is characterized by the continued demand for increased surfing speeds and by the adoption of advanced services and value added applications. In 2012, the number of Bezeq's Internet subscribers rose by 5%, in part due to the elimination of the NDSL service, and average monthly revenue per Internet subscriber rose by approximately 1% compared to 2011. The increase in revenues is attributable to the higher bandwidths offered to subscribers.

Bezeq believes that its market share in the Internet infrastructure market was approximately 60% at the end of 2012, compared to 59% at the end of 2011. Bezeq faces significant competition from the HOT Group and the cellular operators. The Ministry of Communications' policy requires Bezeq and HOT to provide ISPs with "open access" to their infrastructure.



HOT is currently Bezeq's principal competitor in the private sector. HOT's Internet infrastructure is deployed in Israel nationwide and provides a range of communications services and interactive applications. In December 2010, HOT-Net was granted an ISP license, subject to structural separation limitations between HOT-Net, HOT and HOT Telecom, and limitations on marketing joint service packages that include HOT-Net's Internet access. Among the limitations are an obligation to market service packages that correspond to competing ISPs and an obligation to sell the ISP services separately and on the same terms as they are sold when part of the package. The grant of the ISP license to HOT-Net has increased the level of competition in Internet access. The upgrade of the infrastructure and grant of an ISP license to HOT-Net are expected to increase the level of competition in Internet access and could also increase the number of HOT customers who subscribe to service packages.

The cellular companies have deepened their Internet activities on the cellular networks both in the private sector and in the business sector. Unlike the fixed-line communications segment (where the provision of access infrastructure services by HOT is separate from the provision of Internet access services by the ISP), cellular Internet service is provided as one unit. Surfing services are provided both from the cellular handset and through a cellular modem that connects laptop and desktop computers in combination with Internet access services.

#### Transmission and Data Communication Services

The companies operating in this field are Cellcom, Partner (which acquired the Med-1 operations), HOT, and Internet companies that also use leased infrastructures. To the best of Bezeq's knowledge, Cellcom has deployed and set up a transmission network, which it uses both for its own needs (instead of transmission services provided for it in the past by Bezeq) and for competition with Bezeq in the transmission and data communications market. Cellcom offers its customers a complete package of solutions that includes domestic telephony, data communication and cellular communication, using its own infrastructure and its own sales array. Partner also provides transmission and data communication services combined with telephony, for business customers.

Under the terms of its license, Bezeq is obliged to provide some of its communications services to the entire public in Israel. According to the Ministry of Communications interpretation of this and other provisions in the Carrier License regarding the provision of infrastructure services to license-holders, Bezeq is also obliged to provide infrastructure and transmission services to competing communications operators for services which compete with those of Bezeq. Bezeq is acting in accordance with the Ministry's interpretation.

#### Marketing

Bezeq has marketing, sales and service groups for both the private and business sectors, which include customer managers for the business sector, combined sales and service centers located throughout Israel, technical support centers for private and business customers and 15 points of sale and service (the Bezeq Store network) in Israel, as well as a virtual online shop.

Bezeq markets its fixed-line services mainly through mass media advertising and telesales centers, customer managers, and a system of independent dealers including ISPs, and outsourced points of sale.

#### Networks and Equipment

Bezeq's property and equipment consist primarily of domestic telecommunications infrastructure, exchanges, various networks, real estate (land and buildings), computer systems, vehicles and office equipment.

The main equipment used by Bezeq are exchanges, copper cables, fiber optical cables, transmission equipment, data communication systems and equipment, servers, Internet modems and routers. Bezeq purchases most of the equipment

needed for its communications infrastructure from Israeli companies affiliated with international communications equipment manufacturers. Hardware and software are purchased from a number of suppliers.

#### Next Generation Network

The demand for communications services in Israel and worldwide includes a demand for ever-increasing bandwidths and an advanced IP platform. In order to meet this demand, Bezeq at the end of 2009 started the gradual set-up of an NGN based on a core IP network and the deployment of an optical fiber network to street cabinet (known as fiber to the curb, or FTTC).

The NGN network is also based on an access network (a system which connects NEPs on the subscriber's premises with the network and engineering systems). The connection from the home to the access network is based on copper cables and optical cables connecting the access systems to the backbone (in a special conduit or over-ground network), and to a very limited degree through wireless systems. Subscribers utilize the service through the use of their terminal equipment (equipment which is installed on the subscriber's premises, e.g. the actual telephone, private exchanges, fax machines, modems, routers, etc.).

In this network and using VDSL2 technology, bandwidth of up to 100 Mbps download speed can be provided, as well as innovative added value services. Other advantages of the NGN technology are simplification of the network structure and better management capability. Bezeq launched the NGN in September 2009. At the end of 2012, Bezeq had substantially completed its deployment of the NGN and a considerable number of its customers upgraded their surfing speeds to the newly available levels.

In August 2012, Bezeq decided to extend its optical fiber deployment so that the fibers will be as close as possible to its customers' premises (FTTH/FTTB). This will facilitate the future provision of more advanced and broader-band communications services than those currently provided. In this context, a detailed plan for the project will be prepared. The project will be modular and Bezeq will review the scope and outline of the project, as well as the need for adjustments, on a regular basis. Bezeq intends to accelerate the deployment of optical fibers to the customers' homes and residential buildings (FTTH/FTTB), so that it will have significant fiber optic coverage in 2013. The pace of this deployment is expected to increase in the following years. Conversely, these developments that have enabled IP-based telephony services are one of the factors that have led to the decline in the consumption of Bezeq's fixed-line telephony services.

### Computing

Bezeq's IT system supports four central areas: (i) marketing and customer management; (ii) information systems for engineering infrastructures of the telecommunications networks; (iii) information systems for management of Bezeq fixed-line resources; and (iv) company - wide systems.

Marketing and customer management. The system supports management of a database of Bezeq's customers, service order management, management of follow-up of customer complaints, management of the sales and service process, application of the number portability plan, and billing. The billing array includes the production of phone bills to customers for services provided by Bezeq and for the services of other communications operators. The billing array also includes the management of accounting for transactions with other communications operators.

Information systems for the engineering infrastructures of the telecommunications networks. These systems support the planning, management, control and maintenance of engineering resources for the provision and assurance of the services.

Information systems for management of the Company's resources. These systems support the management, control and maintenance of the expense side of Bezeq's activities, including, financial information (including budget and control), purchasing and stock processes, property, real estate, human resources, salary control, fleet management, company projects, etc.

Company-wide systems. Bezeq maintains large and complex computer information systems that support critical work processes and handle very large volumes of data. The array of information systems consist of a large number of systems, some of which are legacy systems which were developed many years ago and operate on mainframe computers, and more modern systems, whose applications were developed more recently and operate in open computerization environments. The systems support decision-making processes utilizing a data warehouse operated by Bezeq. Bezeq also operates a website which provides information about its services and enables the display of information about telephone bills, payment information and other services. Bezeq also maintains computerized office systems (e-mail, decision follow-up, etc.), and knowledge management systems.

### Suppliers

During 2012, no supplier accounted for more than 5% of the Bezeq Group's total annual purchases, nor did any supplier account for more than 10% of total purchases in a specific segment of operation. Most of the equipment purchased by Bezeq for data communication, switching, transmission and radio systems have been specially modified or developed for its use and the ability to obtain support other than through the manufacturer is limited.

Bezeq believes that, in light of the importance of manufacturer support for certain of its systems, it may become dependent in the areas of public switching and metro transmission on Alcatel Group, represented in Israel by Alcatel Telecom Israel Ltd., Dialogic Networks (Israel) Ltd., which supplies Bezeq with migration exchanges for linking operators to Bezeq's switching network and Comverse, Inc., which supplies Bezeq with switching exchanges for end customers on the NGN network. Bezeq may also become dependent on: (i) the NGN of Adtran Holdings Ltd. and IEC, (ii) Oracle in the area of databases;(iii) EMC which supplies Bezeq with hardware solutions for back-up, recovery and archiving of systems and infrastructures; (iv) VMware which supplies Bezeq with infrastructure for the entire virtualization of its servers; and (v) on ECI Telecom which supplies Bezeq with systems for connecting Bezeq's network and business customers on the transmission network.

Agreements with suppliers on which Bezeq may be dependent are generally long term and usually include a warranty period for a specified period, followed by another period of maintenance or support. Where necessary, Bezeq may enter into an agreement with a supplier for the supply of support and/or maintenance services for further periods. These agreements usually contain various forms of recourse for Bezeq should the supplier breach the agreement.

### Property

Bezeq initially obtained its real estate assets from the State of Israel in 1984 and has acquired additional properties since then, including properties leased from third parties. Bezeq owns or has long term ownership rights in approximately 395 properties throughout Israel. The total area for which Bezeq has full ownership rights or capitalized lease rights (including joint lease rights as described below) is 1,060,000 square meters of land, of which 270,000 square meters have been improved. Of the 395 properties, approximately 380 properties consisting of 980,000 square meters of land and improved properties of 220,000 square meters are used for communications purposes, with the remainder used for administrative purposes. Of the foregoing properties, 40 are jointly owned with the Ministry of Communications, the Israel Postal Co. Ltd, or both. Bezeq's rights to a substantial number of its real estate assets are not registered in the Israeli Lands Registry, and therefore they correspond to contractual rights. Bezeq is in the process of registering in its name those properties which can be registered in the Lands Registry.

In addition to the 395 properties referred to above, Bezeq holds approximately 60 properties in the Administered Territories, covering a total area of 9,300 square meters of land and approximately 1,500 square meters of improved space. There is no written regulation of the contractual rights for these properties, but Bezeq believes that this does not create a material exposure. The real estate assets are used by Bezeq for communications activities (exchanges, neighborhood rooms, broadcasting sites, etc.) and for other activities (offices, storage areas, etc.). Some of the properties are undeveloped or partially developed and can be used for other purposes.

Bezeq also leases approximately 290 properties consisting of 63,000 square meters (approximately 280 of these properties have improved space of approximately 9,400 square meters, which are used for communications purposes, while the rest are used for administrative purposes).

Bezeq also has rights to approximately 70,000 square meters, net of land in Sakia, Israel for warehouse and office use. Bezeq is in advanced stages of negotiation with the Israeli Lands Administration, or ILA, to obtain an authorization to prepare development plans for the area.

Bezeq has an interest (transition rights, etc.) in other real estate, including for the erection of transmitters and for laying cables. Bezeq also has at its disposal approximately 550 neighborhood rooms (for cables and installations used for neighborhood communications) having a total area of approximately 8,310 square meters. No written agreements exist as to the rights of usage for most of these rooms.

According to a settlement agreement entered into in 2004 between Bezeq, the ILA and the State of Israel, which concerns most of the real estate that was transferred to Bezeq pursuant to the 1984 asset transfer agreement with the State of Israel, the assets remaining in Bezeq's possession have the status of a capitalized lease and are subject to the execution of individual lease contracts (to date contracts have been signed for approximately 90 of the 205 properties for which contracts are required). The settlement agreement allows Bezeq to enter into transactions and to enhance the properties beyond the rights according to plans approved in the settlement agreement and it provides for a mechanism for payment to the ILA for such enhancements, if undertaken, at the rate of 51% of the increase in value of the property following the enhancement (less part of the amounts paid for a betterment levy, if paid). The settlement agreement also provides that 17 properties must be returned to the ILA. Bezeq has returned 15 of those properties and the two remaining properties will be returned after Bezeq receives substitute properties, as provided in the settlement agreement.

Following a review by Bezeq's management, Bezeq's Board of Directors approved further sales of properties which are not currently utilized or which can be easily vacated without incurring significant expenses. The transition to the NGN allowed Bezeq to increase the efficiency of its network and to vacate and sell some of its real estate assets. The sale of real estate assets that are not active or that can easily be vacated without incurring significant expenses, if and when be sold, may generate NIS hundreds of millions of capital gains for Bezeq, before taxes. During 2012, Bezeq sold 13 properties for approximately NIS 118 million.

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## Employees

The following table provides data relating to the number of persons employed by Bezeq as of December 31, 2011 and 2012:

Description of employment framework	Number of employees	
	2011	2012
Senior managers excluded from application of the Company's collective bargaining agreements	63	61
Permanent employees employed under collective agreements (without new permanent employees)	2,847	2,742
Permanent employees employed under collective agreements (new permanent employees)	437	596
Employees employed under personal agreements that are not part of the collective agreements	666	635
Employees employed under individual agreements on the terms of the collective agreement	44	26
Employees employed in accordance with the special collective agreement of December 2006, on an hourly basis	1,948	2,288
Employees employed under the special collective agreement of December 2006, on a monthly basis	1,071	1,074
Total	7,076	7,422

The increase in the number of employees in 2012, compared to 2011, is primarily the result of hiring service representatives and customer service technicians in order to improve the level of customer service.

Bezeq's Board of Directors currently consists of 12 directors, including three external directors, two employee-directors and two "independent" directors pursuant to the Israeli Companies Law. In addition, senior management has 12 member representatives. Our Chairman, Mr. Shaul Elovitch, also serves as Chairman of the Board of Directors of Bezeq.

On January 17, 2013, Bezeq's chief executive officer announced that he was resigning as of April 14, 2013. On March 6, 2013, Bezeq's Board of Directors approved the appointment of Ms. Stella Handler, a former chief executive officer of our company, as the new chief executive officer of Bezeq, as of April 14, 2013.

The members of senior management are employed under personal agreements which include, pension coverage, payment of bonuses based on targets, and additional retirement benefits. Bezeq also allots options to the members of senior management at its discretion.

Labor relations are regulated by the collective agreements between Bezeq, its workers' representatives and the Histadrut, and by personal contracts. Additionally, expansion orders to certain general collective agreements apply to Bezeq employees, such as cost-of-living increment agreements.

In December 2006, a special collective agreement was signed between Bezeq, its workers' representatives and the Histadrut, regulating the labor relations in Bezeq following the privatization of Bezeq. Under the agreement, all prior agreements, arrangements and traditional behavior in Bezeq, including the linkage of wages to the public sector, would continue to apply only to the veteran permanent employees. According to the agreement, any hiring of existing and future temporary workers is made on the basis of monthly/hourly wage agreements based on a wage model according to occupation, with high managerial flexibility. The agreement sets out limitations on certain kinds of future

organizational changes and a mechanism of notification, negotiation and arbitration with the workers' representatives in the event such organizational changes. The agreement also allowed Bezeq, at its discretion, to terminate the employment of 245 permanent employees in each of the years 2009 – 2013. Under the agreement, during the term of the agreement, two employee-directors will serve on the Board of Directors of Bezeq, to be proposed by the workers' representatives. The employee-directors are not entitled to payment for their service as directors and do not participate in Board discussions of the terms of employment of senior employees.

On December 19, 2010, an amendment to Bezeq's collective agreement, which will be in effect until December 31, 2015 (with an option for an extension until December 31, 2017) was entered into. Under the terms of the amendment:

Retirement arrangements under the collective agreement were extended to December 31, 2016. Under these retirement arrangements, Bezeq may, at its discretion, terminate the employment of up to 245 permanent employees in each of the years 2010 – 2016.



"New Permanent Employees" will be entitled to reduced retirement compensation.

On December 4, 2011, Bezeq's Board of Directors approved the early retirement of 91 employees at a total cost of NIS 80 million. This retirement completed the early retirement plan for 2011 as well as early retirement on account of an option for employee retirement in 2012, based on the terms of the special collective agreement from December 2006 and amended in December 2010. On November 7, 2012, the Board of Directors of Bezeq approved an additional budget of NIS 16 million for the early retirement of 19 employees during 2012. This supplement is in addition to an expense of NIS 16 million which was recognized for updating the provision in 2012. During the course of 2012, 122 tenured employees retired from Bezeq, based on the early retirement plan.

#### Employee Training

Bezeq conducts in-house training (including through a communications college) by company employees, who are professional experts, and at times with outside assistance in all areas of its operations. The training activities include professional certification in technology, sales, management, service and other areas. Bezeq also participates in funding university studies and courses at outside facilities for its employees.

#### Option Plans

Bezeq has two option plans settled in cash through a net exercise mechanism and a phantom option plan, settled in cash. All of the options that were granted are non-transferrable and each option grant will vest in three equal installments. The exercise prices are adjusted for changes in equity and distributions of dividends. Below are additional details as of December 31, 2012:

Name of plan	Number of options granted (before forfeitures) (in thousands)		Number of options in circulation as at December 31, 2012 (in thousands)		Weighted average of exercise price as at December 31, 2012 (NIS)	Weighted average of remaining contractual life
Employee option plan of 2010	69,495	(1)	66,938	(1)	5.16	3
Option plan for senior managers and employees of the Group of 2007	65,250		3,089		2.84	4.25
Phantom options plan for senior officers in the Group granted in December 2010	16,400		16,400		7.91	3

(1) Subsequent to the date of Bezeq's financial reports for the year ended December 31, 2012 and until April 22, 2013, 406,000 Bezeq shares were issued pursuant to exercises of options under this plan.

#### PELEPHONE

##### General

Pelephone provides cellular communications services and sells and repairs terminal equipment. Pelephone's revenues include revenue from cellular communications customers (payments for call minutes, regular subscriptions, value-added services and roaming services), revenue from the sale of terminal equipment and revenues from other communications providers with respect to terminal equipment services and interconnect fees.

## The Cellular Market

In view of the intensified competition, during the course of 2012 the manner of pricing services in the cellular market changed significantly. Instead of charging customers for actual usage or communications packages which are limited to a certain level of use with additional charges for extra use, the cellular carriers moved to offering unlimited packages. The increased competition and change in the format of the communications packages has led to a significant decrease in average revenue per subscriber and higher churn rates. Average monthly revenue per subscriber dropped by 11.2% in 2012. During 2012, there was an increase in the average monthly minutes used per subscriber, an increase in the number of messages (SMS) sent and a significant increase in the use of data communications (DATA).

The new operators that own infrastructure, the reform in the import of handsets and regulatory changes have led to lower demand for handsets and the amount of cellular terminal equipment sold by the cellular operators. In 2012, Pelephone's revenues from terminal equipment amounted to NIS 1.2 billion, accounting for 27% of total revenues, as against NIS 1.9 billion, accounting for 34.4% of revenues in 2011. The decline in sales of terminal equipment led to a drop in the number of customers, in parallel to a decline in the volume of payments to suppliers of terminal equipment.

The cellular market has been characterized by lower growth rates due to saturation of the market. The penetration rate as at December 31, 2012 was 126%.

The following table provides summary condensed financial information concerning Bezeq's Pelephone cellular segment for the three years ended December 31, 2012:

	2010	2011	2012
Revenues from services (NIS millions)	4,550	3,637	3,261
Revenues from sale of terminal equipment (NIS millions)	1,182	1,911	1,207
Total revenue (NIS millions)	5,732	5,548	4,468
Operating profit (NIS millions)	1,383	1,360	892
Depreciation and amortization (NIS)	601	561	531
Operating profit plus depreciation (EBITDA) (NIS millions)	1,984	1,921	1,423
Net profit (NIS millions)	1,033	1,056	698
Cash flow from operating activities (NIS millions)	1,219	800	1,728
Payments for investments in property, plant and equipment and intangible assets (NIS millions)	397	382	381
Free cash flow (in NIS millions) (1)	822	418	1,347
Number of subscribers at the end of the period (thousands) (2) (7)	2,857	2,847	2,800
Average number of minutes per subscriber per month (MOU) (3) (7)	349	375	419
Average monthly revenue per subscriber (NIS) (ARPU) (4) (7)	135	107	95
Average monthly revenue per subscriber (NIS) (ARPU) (based on reduced interconnect tariffs) (5) (7)	111	107	95
Churn rate (6) (7)	15.3%	22.9%	22.4%

(1) Cash from operating activities less purchase of property, plant and equipment and intangible assets, net.

(2) Subscriber data does not include subscribers connected to Pelephone services for six months or more but who are inactive. An inactive subscriber is one who in the past six months has not received or made at least one call or who has not paid for Pelephone services.

(3) Average monthly use per subscriber (in minutes) 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 is calculated by dividing average monthly total revenues from cellular services, repair and other services in the period, by the average number of active subscribers in the same period. The revenue was calculated based on the interconnect tariffs in force for each period.

(5) In view of the reduction in interconnect tariffs commencing January 1, 2011, average monthly revenue data per subscriber for all three years is based on the reduced interconnect tariffs, for comparison with the 2011 data.

(6) The churn rate is calculated at the ratio of subscribers who disconnected from the company's services and subscribers who became inactive during the period, to the average number of active subscribers during the period.

(7) Due to increased movement of subscribers to pre-paid tracks in the initial months after reduction of the exit penalties, Pelephone decided not to include subscribers who had made no outgoing calls during the fourth quarter in the number of active subscribers. As a result, Pelephone deducted 91,000 subscribers. These subscribers were deducted retrospectively from each quarter in which they were moved to the pre-paid tracks. Consequently, figures

for subscribers, ARPU, MOU and churn rates were corrected retroactively in each quarter.

The competition in the sector increased in 2012 due to the entrance of new competitors and regulatory changes that simplified the mobility of subscribers between cellular companies. This led to a decrease in income and continued high churn rates. The churn rate was 22.9% in 2011 and 22.4% in 2012.

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## Products and Services

Pelephone provides its subscribers with comprehensive services of voice transmission, transmission of text messages, data communications and advanced multimedia services. Pelephone also offers its customers a broad range of packages and tracks that combine various services.

The following describes the services that Pelephone provides for its customers:

- Basic telephone services (voice) – including basic call services, call completion services and auxiliary services such as call waiting, call forwarding, voice mail, voice conference call and caller ID.
- Browsing and data services – Internet browsing using a mobile device with maximum download speeds of 42 mbps. Pelephone also offers its customers Internet browsing by means of a cellular modem.
  - Messaging service – a service for sending and receiving SMS text messages and multimedia MMS messages.
- Content services - Pelephone offers its customers content services such as information and entertainment services on Pelephone's Internet portal, navigating services, Super TV and musixmatch, which makes it possible to listen to a variety of music via cellphone and PC.
- Roaming services – Pelephone provides roaming services based on agreements it has with cellular operators abroad, enabling it to use their networks. Pelephone is able to offer its customers with handsets in that technology, roaming services using their personal handsets to countries all over the world, and also provides these customers with roaming coverage in 212 countries. Pelephone also provides incoming roaming services for the customers of foreign operators staying in Israel.
- Repair services – Pelephone offers its customers a repair service for a monthly payment entitling the customer to a warranty for the cellular handset, or for a one-time payment at the time of repair. Pelephone provides its customers with these services, and in addition, it provides, as part of hosting agreements, basic telephone (voice) services, surfing and data communications services, sending and receiving text messages, and roaming services to other cellular operators (Hot Mobile and Rami Levy).
- Handsets – Pelephone offers its customers various types of cellular telephone, on-board telephones and hands-free devices, as well as support for its range of services.
- Pelephone also supplies its customers with modems, laptop computers and tablets for surfing the Internet through the Pelephone network.

## Cellular technologies used by Pelephone

Technological developments in terminal equipment and the desire to widen the range and quality of the services offered to the customers compel the cellular operators to periodically upgrade their network technologies, mostly on Generation 3.5 UMTS/HSPA technology. Pelephone currently operates communications networks based on two main technologies:

- UMTS/HSPA, a digital technology based on the GSM standard. This technology is widespread throughout the world and enables subscriber identification and the provision of service by means of a SIM card, which can be transferred from one handset to another. Among the advantages of this technology is its support for download speeds of up to 42 Mbps and upload speeds of up to 5.7 Mbps. This cellular communications network is Pelephone's

primary network.

- CDMA, a digital technology, which is less widespread than UMTS/HSPA and in which subscriber identification is by the identification of details burned onto the terminal equipment rather than by means of a SIM card. Until 2009, the CDMA network was Pelephone's only network and it continues to operate nationwide. This network serves a limited number of subscribers who seldom use the network. Since the UMTS/HSPA network was launched, Pelephone has sought to transfer existing subscribers from CDMA to UMTS/HSPA, and offers subscribers an upgrade of their handsets to connect to the new network. It is not increasing its investments in the CDMA network beyond the needs of current maintenance.

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The cellular communications market is dynamic and is characterized by frequent technological changes in all its areas of operation (handsets, network technology and value added services). These changes impact the segment of operation on a number of levels: technological developments in terminal equipment and the desire to widen the range and quality of the services offered to the customer require cellular operators to periodically upgrade their network technologies. Pelephone constantly reviews new technologies that come onto the market and the need to upgrade its existing network technologies, depending on competition and the economic viability of the investment.

LTE technology is a data transfer technology based on an Internet Protocol that can transfer data at higher speeds than the existing Generation 3.5 technology. This technology is used by many operators around the world. In 2012, smartphones which support this technology were introduced into the Israeli market, including the iPhone 5. In March 2012, the Ministry of Communications published a work plan on this subject. As at reporting date there is no certainty as to the allocation of a frequency range for use of LTE technology. Such a policy, as well as technological developments in this area, could have a significant effect on Pelephone. Pelephone expects that during 2013, the Ministry of Communications will make progress on the proposed tender for allocating LTE frequencies and will allocate the frequencies.

The penetration of smartphones, cellular phones with integrated operating systems allowing the use of advanced applications, has led to a rise in the consumption of data transfer services while increasing the supply of alternative applications and services to the Pelephone products and services provided by other entities. Pelephone expects that as a result of the decrease in tariffs and the increase in the number of subscribers using smartphones, there will be greater use of data communications and the average number of minutes used per subscriber will increase. Technologies that enable voice telephony and Internet (data) services in a VoC network could compete with Pelephone's services and materially affect its operations in the future.

In 2013, Pelephone expects to continue to invest in its UMTS/HSPA network and solidify its position as the fastest, highest quality and most advanced network. Together with the investment in the network, Pelephone expects to launch and promote several services which will help increase its revenues and improve its image compared with competitors. These services include anti-virus, data storage and backup, music and video services and surfing packages for tablets and cellular modems (Netstick).

Pelephone's UMTS/HSPA infrastructure is based principally on two switch farms that are connected to more than 2,100 sites. Subsequent to the launch of the UMTS/HSPA network, Pelephone expanded the network. Investments in 2013 are projected to be NIS 396 million, including continued significant enlargement of network capacity, consistent with its investment of NIS 381 million in 2012.

Pelephone paid approximately NIS 32 million in royalties for 2012, or 1.3% of its revenues subject to royalties. For 2011, Pelephone paid approximately NIS 48 million, or 1.75% of its revenues subject to royalties.

#### Standards

Pelephone conducts routine durability and quality control tests of its facilities. Pelephone complies with the requirements of Israeli Standard ISO 9001, 2008 version for mobile radio telephone (cellular) services and it undergoes periodic inspections by the Standards Institute of Israel to confirm compliance with the standard. The current control and quality certifications (IQC) are valid through December 2013. Once a year, an inspection is conducted to ensure that Pelephone's operations comply with the requirements of the standard. The last inspection was carried out in December 2012 and was successful.

The following table provides a breakdown of Pelephone's revenues by product and service for the three years ended December 31, 2012:

	2010	2011	2012
	(in NIS millions)		
Revenue from services (1)	4,550	3,637	3,261
Percentage of total revenue	79.4%	65.6%	73.0%
Revenue from terminal equipment	1,182	1,911	1,207
Percentage of total revenue	20.6%	34.4%	27.0%
Total revenue	5,732	5,548	4,468

(1) Revenue from services includes revenues from cellular services (airtime, usage fees, call completion fees, roaming fees, value added services and others), and revenues from repair services and warranty.



## Competition

Until 2012, four companies with a general license for the provision of cellular services operated in Israel's cellular communications market. During 2012, a number of other cellular operators began to operate. The entry of the new operators has led to intensified competition, resulting in higher churn rates among the existing operators, a significant decrease in tariffs and consequently a decrease in profits. Pelephone's principal competitors, Cellcom, Partner and Hot (since February 2012), also provide Internet access services (ISPs) and domestic communications, and they market diverse joint service packages.

During 2011, Hot Mobile and Golan Telecom won a tender to receive frequencies and licenses for cellular operators that own infrastructure. Following a required deployment of a cellular network that initially covers 10% of the population of the State of Israel, the new operators are able to utilize the existing operator networks for a period of up to seven years (with a possible extension based on approval for three more years) based on the national roaming model. According to the tender, Hot Mobile and Golan Telecom are scheduled to pay NIS 710 million and NIS 360 million, respectively, in license fees at the end of five years. To guarantee payment of the license fees, the two new operators provided bank guarantees in favor of the Ministry of Communications in the amount of the above mentioned license fees. Such license fees will be reduced by one seventh (approximately 14.3%) for every 1% market share accumulated in the private sector over a five-year period from the date of grant of the license. Accordingly, if a new operator is able to gain 7% of the private market it will not be required to pay any license fees. In May 2012, Golan Telecom and Hot Mobile launched their operations, which immediately caused intensified competition in the cellular market among all the cellular operators. After launching their operations, Golan Telecom and Hot Mobile offered customers cellular communications packages which were significantly cheaper than the packages offered by the incumbent cellular operators. Pelephone and the other cellular operators responded to this new competition by offering new packages that reflect a substantial decrease in revenue per subscriber.

In addition, following the government's decision to encourage competition in the cellular market, nine MVNO licenses were granted to virtual operators (cellular operators that do not own their own infrastructure and provide their services using the networks of the existing operators). To the best of Pelephone's knowledge, only three of the MVNO license holders actually provide services: Rami Levy, Hot Mobile, and Alon Cellular.

The table below shows, to the best of Pelephone's knowledge, the approximate numbers of subscribers of Pelephone and its competitors in 2011 and 2012 (in thousands of subscribers), not including virtual operators.

	Pelephone	Partner	Cellcom	Golan Telecom (1)	Hot Mobile	Total in market
At Dec. 31, 2011						
No. of subscribers (2)	2,847	3,176	3,349	-	444	9,816
Market share	29.0 %	32.4 %	34.1 %	-	4.5 %	
At Sep. 30, 2012						
No. of subscribers (2)	2,839	3,042	3,338	110	687	10,016
Market share	28.3 %	30.4 %	33.3 %	1.1 %	6.9 %	

(1) Since Golan Telecom is a private company, it does not publish data about numbers of subscribers. The numbers in the table are an assessment.

(2) The numbers of subscribers are as at September 30, 2012 and December 31, 2011, based on the reports of Cellcom, Partner and Hot Mobile to the public. (Hot Mobile is now a private company and therefore its figures are based on estimates.)

The number of subscribers of the virtual operators (MVNOs) is estimated to be approximately 100,000 subscribers, or approximately 1% of all cellular subscribers, as at December 31, 2012.

In 2012, Partner launched a discount brand called 012 mobile, and Cellcom introduced a communications package offering a combination of cellular communications, fixed-line communications, Internet and international calls. Pelephone responded to this new competition by introducing similar new packages which reflect a substantial reduction in revenue per subscriber.

During the second quarter of 2012, Pelephone's competitors offered "unlimited" communications packages for the first time. In these packages, the subscribers can pay fixed usage fees and receive unlimited use of the services in accordance with the terms of their plans. These packages are the principal packages currently being offered in 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 (with additional charge for over-usage).

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Pelephone expects these trends to continue in 2013, leading to a significant decrease in revenues and profitability. Pelephone is introducing streamlining measures in an effort to reduce the impact of these trends on its margins. This intense competition has led to a higher churn rate and significantly lower prices for communications packages for hundreds of thousands of subscribers.

Positive and negative factors that affect the competitive status of Pelephone

The positive factors that affect Pelephone's competitive status are:

- A high quality cellular network with extensive deployment;
- A high-speed, advanced cellular network;
- A broad array of services and diverse service interfaces for customers, enabling a high grade of customer service;
- A distribution network that is skilled in providing appropriate solutions for every type of customer, with a skilled staff;
- Strong capital structure and positive cash flow; and
- Use of the Pelephone network by other cellular operators.

The negative factors that affect Pelephone's competitive status are:

- As a subsidiary of Bezeq, Pelephone is subject to regulatory restrictions, which do not apply to its competitors, with respect to its entry into other areas of operation and the expansion of its service bundle for customers;
  - Limitations relating to its joint activities with Bezeq, including the marketing of joint service bundles;
- The frequencies available to Pelephone might not be suitable, in certain cases, to the application of new cellular technologies that are under development. This could impede Pelephone in applying new technologies and could also impact adversely on its competitive status with other license-holders who may have frequencies that are suitable for those technologies and Pelephone may encounter difficulties in obtaining new frequency allocations; and
- A disadvantageous position in the pre-paid market (use of terminal equipment at lower cost), due to the absence of a range of low-cost terminal equipment that operate in the UMTS/HSPA network.

Critical success factors in Pelephone's market position and the changes occurring in the market

Pelephone has addressed the strong competition in this sector by streamlining its operations and completing the nationwide deployment of an advanced and high-quality network. Pelephone seeks to retain its technological leadership by regular maintenance of the network to a high standard and significant and regular investments in the cellular infrastructure, both for quality coverage of the whole country, which is a basic condition for providing Pelephone's services, and in order to provide customers with the most advanced services by means of the most advanced infrastructure and technology. Another factor that has contributed to Pelephone's success is its nationwide deployment of sales and service centers that provide efficient customer support and service.

The principal entry barriers to the cellular market are:

- The high penetration rate in the cellular market;
- The need for a cellular license, the allocation of frequencies, which involves high costs and the subjection of operations to the regulatory supervision that applies to the market;
- The need for significant financial resources necessary to make substantial and ongoing investments in infrastructure resulting from frequent technological changes and advances; and
  - The difficulty in erecting radio sites due to regulatory limitations and public opposition.

These entry barriers do not apply to virtual operators and new cellular operators that own infrastructure which benefit from considerable easements granted to them to enable entry into the segment.

The principal exit barriers to the cellular market are:

- The large investments and the time required to recoup such investments; and
- The commitment to provide services for customers arising from the terms of the cellular license and agreements made in accordance with those terms.

#### Customers

At the end of 2012, Pelephone had approximately 2.8 million subscribers. The table below provides the revenues from Pelephone's private and business customers in each of the three years ended December 31, 2012 (in NIS millions):

	2010	2011	2012
Revenues from private customers	2,899	2,985	2,461
Revenues from business customers			2,007
(1)	2,833	2,563	
Total revenue	5,732	5,548	4,468

(1) Revenues from business customers include revenue from hosting agreements which amounted to NIS 129 million in 2012.

In addition to Pelephone's end-user subscribers, Pelephone provides services subject to hosting agreements to other cellular operators that use Pelephone's network to provide services to their customers.

Pelephone has an agreement with the Accountant General in the Ministry of Finance to supply mobile telephone services to government ministries through February 2014. Pelephone has an option to extend this agreement for two additional years. As of December 31, 2012, Pelephone was supplying end equipment and mobile telephone service to 106,000 subscribers in the framework of this agreement.

#### Tariffs

The interconnect fees (call and text message (SMS) completion fees collected by Pelephone from other operators) are fixed in the Interconnect Regulations, which set the interconnect tariffs to be paid to domestic carriers, as well as limitations on the interconnect tariffs to be paid to a cellular operator. The other tariffs collected by Pelephone from its customers are not controlled, but the types of payments it can collect from its subscribers and the mechanisms for setting regulated tariffs, are regulated in the license. Commencing January 1, 2011, the interconnect tariffs were lowered significantly. The tariffs, which are denominated in agorot (100 agorot are equal to 1 NIS) are linked to an index (the base index being the average CPI for 2009), and both VAT and the rate of royalties applicable to cellular operators multiplied by the indexed interconnect tariff will be added.

Below are the interconnect tariffs in agorot for the cellular operators as of December 31 of each year, which do not include VAT and are calculated at the royalty rate agreed upon by the government and the Supreme Court:

	2010	2011	2012	2013	From 2014 onwards
Call minute completion tariff	25.1	7.28	6.80	6.43	6.01
SMS (text) completion tariff	2.85	0.17	0.16	0.15	0.14

Pelephone pays the other cellular operators interconnect fees for calls originating in its network and terminating in their cellular networks, while the other operators (cellular, domestic and international) pay Pelephone interconnect fees for calls terminating in its cellular network.

The table below indicates Pelephone's interconnect revenues from the other communications networks in respect of incoming text messages (SMS) to its network and its expenses in respect of interconnect fees paid to the other cellular networks during the three years ended December 31, 2012 (in NIS millions):

	2010	2011	2012
Revenue	1,054	343	363
Expenses	813	265	300

The figure is calculated according to the relevant minutes and SMS messages actually used/transmitted in the previous period, multiplied by the difference between the interconnect fees in the present period and the interconnect fees in the corresponding period.

## Marketing

Pelephone's distribution system is based on 40 service and sales centers, including facilities throughout Israel, which provide service, customer sales, repairs or provision of substitute handsets while a handset is under repair, installation of handsets, and customer retention. The distribution system is reinforced with stores and stands at 90 points of sale, some of which are operated by Pelephone employees and others by authorized dealers. In addition, Pelephone utilizes dealers who operate a door to door system, and service and sales representatives for the business sector. As a rule, payment to the dealers is in the form of a commission on sales.

Pelephone's subscriber service system includes the company's website and 17 designated telephone call centers that provide information, service on various matters, technical support, data on customer billing, value added services, sales and general information in three languages.

## Governmental Regulation

Pelephone operates in accordance with an operating license from the Ministry of Communications - General License for the Provision of Mobile Radio Telephone Services, which is valid until 2022. The operating license prescribes conditions and rules that apply to Pelephone's operations, which conditions and rules are subject to amendment. In April 2001, the Civil Administration for the Judea and Samaria Region awarded Pelephone a general license for the provision of cellular services in the region of Judea and Samaria. The provisions of the general license awarded to Pelephone by the Ministry of Communications are generally applicable to this license.

As part of the approval of the merger of Bezeq and Pelephone on August 26, 2004, restrictive terms were imposed, mainly prohibiting discrimination in favor of Pelephone in the supply of a product in which Bezeq holds a monopoly, prohibiting the bundling of the supply of certain products by either of the companies when purchasing products or services from the other and limitations on certain joint activities. In October 2010, certain restrictions were removed, particularly the sweeping ban on joint marketing of Bezeq's and Pelephone's services. Nevertheless, the conditions include certain restrictions on the joint marketing of services.

## Regulatory changes in the cellular market

Over the past few years, the Ministry of Communications has promoted various regulatory actions to increase competition in the cellular market. These actions have materially impacted the structure of the market and the competition in it.

In July 2011, the Ministry of Communications issued a press release listing the following main recommendations of the inter-ministerial committee on "the sharing of infrastructures in the cellular market:"

A model of forced sharing of sites will be defined, giving preference to the possibility of involving the new operators;

Obtaining a permit to set up a site will be conditional on a proposal for cooperation for all operators;

The operators will be obligated to erect sites that facilitate sharing with up to four participants;

All the components and infrastructures used for broadcasting from the facility will be shared, excluding active designated equipment (radio equipment);

That the costs of sharing sites be shared; and

All license holders will be encouraged and obligated to reduce the number of unshared sites each year.

If the recommendations are enacted into legislation, they may impose significant restrictions on Pelephone's ability to expand its network. Pelephone has written to the State Attorney, submitting its reservations, which focus on the requirement to reduce the number of existing sites that are not shared and the economic model for the sharing of costs, whereas new participants in existing sites will only be required to bear their share of the "adjustment costs" and not the full costs of erecting the site.

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#### Domestic roaming agreements

In November 2011, Pelephone signed an agreement with Hot Mobile, according to which Hot Mobile will acquire from Pelephone (exclusively) domestic roaming services for its subscribers on Pelephone's UMTS/HSPA network and the parties will cooperate on the sites. The agreement is until December 31, 2014.

Following a malfunction on Pelephone's network in February 2013, which lasted less than four hours, Hot Mobile sent a letter to Pelephone demanding compensation for the malfunction and stated that it was entitled to enter into national roaming agreements with other operators, despite its exclusivity agreement with Pelephone. Pelephone rejected this demand outright in a detailed reply.

In October 2011, Cellcom announced that it had signed a domestic roaming services agreement and an agreement to share infrastructure with Golan Telecom.

#### Reform of exit penalties

In the past, agreements with customers included exit fees if the customer terminated an agreement before the end of the commitment period. In 2011, the amount which could be collected from a cellular subscriber for terminating an agreement before the end of the commitment period was severely restricted and in March 2012, customer exit penalties were completely eliminated for customers that have up to 100 phone lines.

#### Separation between the sale of terminal equipment and the sale of cellular services

In January 2013, an amendment to the Communications Law became effective, under which a license holder may 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. In the past, the principal sales method was to offer discounts on the price of the services that are dependent on the purchase of the terminal equipment in the customer's possession. This amendment has had a negative effect on the sale of terminal equipment.

#### Import of Cellular Handsets

In September 2012, a reform of the regulations relating to the importation of cellular handsets became effective. The reform includes an exemption from obtaining a trade license and an exemption from the need to obtain approval for the import of cellular devices that comply with accepted European and American standards. Pelephone believes that implementation of the reform may intensify competition in the terminal equipment market.

#### Ministry of Communications policy concerning WiFi

In October 2012, a Ministry of Communications hearing was published on the grant of an exemption from the need to obtain a license to establish and operate access points which operate on WLAN (WiFi) technology frequencies. The hearing document includes, among other things, an option to allow Domestic Carrier operators, but not cellular operators, to provide services on a best effort basis utilizing this technology as part of their existing licenses.

Pelephone submitted its comments on the hearing in which it objected to the exclusion of the cellular operators from the arrangement, based in part on the fact that the use of the WiFi technology is critical for cellular operators, as this technology is currently an important instrument in regulating loads on the mobile radio telephony (cellular) networks. Additionally, Cellcom and Partner have Domestic Carrier licenses, allowing them to use WiFi technology according

to the proposed arrangement, while discriminating against Pelephone and putting it at a disadvantage against its competitors. No decision or response has been received from the Ministry of Communications on this hearing.

Statutory provisions relating to the environment that are applicable to Pelephone's operations

The broadcasting sites used by Pelephone are "sources of radiation" as defined in the Radiation Law and the erection and operation of these sites, excluding those listed in the Schedule to the Radiation Law, requires a radiation permit. The law incorporates a two-step licensing mechanism: the applicant first requests a permit to construct a radiation source, or the Erection Permit, which remains in effect for no more than three months and can be extended by the commissioner for up to nine months; and then a permit to operate the radiation source, or the Operation Permit, which remains in effect for five years or as otherwise determined by the Minister for Protection of the Environment.

The provision of an Erection Permit is contingent on an assessment of the maximum radiation levels to which human beings and the environment are expected to be exposed from the radiation source, including in the event of a malfunction, and on implementation of the measures needed to limit the exposure levels of human beings and the environment to the radiation expected from the radiation source, including implementation of technological means that are in use, or the Limiting Measures.

The grant of an Operation Permit is contingent upon the implementation of the Limiting Measures and to measuring the exposure levels of human beings and the environment to the radiation generated when operating the source of radiation, in an amount not to exceed the maximum exposure levels set by the Commissioner. The grant of the Operation Permit is also contingent upon presentation of a license under the Communications Law and presentation of a permit pursuant to the Planning and Construction Law, except when a building permit is not required, in which case the law directs that the applicant submit a statement to the local committee specifying the reasons that a building permit is not required for the source of radiation. If the local council engineer or district planner does not object to the grant of the Operation Permit within 21 days from the day the statement is submitted, the applicant must submit an additional statement stating that the aforementioned period has passed and no such objection has been made.

The law includes punitive provisions which provide in part that the construction or operation of a source of radiation in contravention of the provisions of the permit and the construction or operation of a source of radiation without a permit, after a warning in writing is given by the Commissioner, are strict liability offenses.

A small number of city engineers from local municipalities have acted according to the mechanism provided in the law and have announced that in their opinion, a particular access facility requires a building permit, and have objected to the grant an Operation Permit for that facility.

The Minister for Protection of the Environment also promulgated regulations pursuant to the Radiation Law ("the Regulations") that address issues such as fees for permits, the method of measuring radiation, etc.

In January 2009, the Radiation Supervisor at the Ministry for Protection of the Environment published guidelines regarding safety ranges and maximum permitted exposure levels with respect to radio frequency radiation, including from cellular aerials.

Consumer Protection Regulations (Information regarding Non-Ionizing Radiation from a Cellular Telephone) 2002, specify the maximum permitted radiation level for a cellular phone measured in units of Specific Absorption Rate, or SAR, and informing Pelephone's customers accordingly. As far as Pelephone is aware, all the cellular phones that it markets comply with the relevant SAR standards.

Pelephone conducts periodic radiation tests in order to ascertain its compliance with permitted operation standards and the standards of the International Radiation Protection Agency. These tests are outsourced and performed by companies authorized by the Ministry for Protection of the Environment. Pelephone has an internal enforcement procedure for supervision of implementation of the provisions of the Radiation Law, which is supervised by a senior manager. The purpose of the procedure is to incorporate the provisions of the law into the procedures of Pelephone and limit the possibility of violations.

#### Transparency for consumers

Pelephone is subject to laws that define obligations to publicize and inform customers about the sources of the radiation that it operates and the mobile handsets that it supplies. The Radiation Supervisor at the Ministry for Protection of the Environment publishes information on the Ministry's website about active cellular broadcasting facilities and those that are under construction. The Ministry for Protection of the Environment continuously monitors the cellular broadcasting facilities that Pelephone erects and operates, as it does to the other operators. On its website, Pelephone publishes information about radiation emitted from cellular phones and Ministry of Health regulations regarding preventive caution when using cellular phones.

#### Communications Law and the cellular license

Pelephone's provision of cellular services is subject to the provisions of the Communications Law and its regulations. The law authorizes the Director General of the Ministry of Communications to impose financial sanctions for various breaches of the provisions of the law and ordinances and provisions by virtue thereof, and for breaches of the terms of the permit.

#### Wireless Telegraph Ordinance

The Wireless Telegraph Ordinance regulates the use of the electromagnetic spectrum and is applicable to Bezeq's use of radio frequencies as part of its infrastructure. Under the Telegraph Ordinance, the establishment and operation of a system using radio frequencies requires a license, and the use of radio frequencies requires designation and allocation of a suitable frequency. The Telegraph Ordinance imposes license fees and fees for designation and allocation of frequencies. For several years, the Government has been coping with the existing shortage of radio frequencies for public use in Israel, by limiting the number of licenses issued for the use of frequencies, on the one hand, while increasing fees payable in respect of the allocation of frequencies on the other. The shortage of frequencies may cause difficulties in implementing certain technologies.

## Site licensing

Pelephone's cellular service is provided through cellular sites spread over Israel in accordance with engineering requirements. The constant need to upgrade and improve the quality of the cellular services necessitates setting-up cellular sites and changes in configuration and existing antenna systems. Pelephone deploys two main types of broadcasting sites: macro sites that require a building permit from planning and building councils and wireless access devices (access devices), which are exempt from a building permit.

The licensing of cellular broadcasting sites that require building permits is governed by NOP 36. The purpose of NOP 36, which came into effect in 2002, is to regulate the deployment and manner of setting-up broadcasting facilities, so that the entire country is covered for transmission and reception, with minimal damage to the environment and the landscape. Pelephone and its competitors have encountered difficulties in obtaining some of the required approvals, and in particular approvals from planning and building authorities. There is a pending proposal to amend NOP 36, which may result in more stringent regulations that could complicate and impede the process of obtaining building permits for cellular sites. Pelephone is aware of an initiative to appoint a joint technical consultant to the Ministry of the Interior and the Ministry of Communications to assist in the review the proposal to amend NOP 36.

Pelephone's ability to maintain and preserve its cellular service quality as well as its coverage is partially dependent on its ability to set up cellular sites and install infrastructure equipment, including broadcasting sites. Any difficulties encountered by Pelephone in obtaining the required permits and approvals may adversely affect the performance of its existing network and the establishment of additional cellular sites required by the network. The inability to resolve these problems on a timely basis may prevent Pelephone from attaining the service quality goals specified in its license.

A number of sites established several years ago still do not have approvals from the Civil Aviation Administration and the Israeli Defense Forces even though the applications for the approvals were submitted years ago. Similarly, there are administrative or other delays in some planning and building councils in the issue of building permits for sites. Therefore, Pelephone is operating a number of broadcasting sites that have not yet received building permits. Pelephone has applied to the planning and building authorities for the building permits and these applications are at various stages of discussion and approval.

The establishment of a broadcasting site without obtaining a building permit constitutes a breach of the Planning and Building Law, 5725-1965, and in some instances, this has resulted in demolition orders against sites or indictments or the initiation of civil proceedings against Pelephone and some of its officers.

Pelephone has succeeded in most of these instances to avoid demolition or to delay the execution of demolition orders pursuant to arrangements it reached with the planning and building authorities to resolve the lack of licensing. These arrangements have not required any admission of guilt by officers of Pelephone and/or their conviction. However, it is not certain that this state of affairs will continue in the future, or that there will be no further instances in which demolition orders are issued and indictments are filed in respect of building permits, including against officers.

Pelephone, similar to other cellular operators in Israel, may be required to dismantle broadcasting sites for which the necessary approvals and permits have not been obtained in accordance with the dates prescribed by law. If it is legally required that sites in a geographic area be simultaneously demolished, service in that area may deteriorate until substitute broadcasting sites can be built.

Pelephone establishes broadcasting sites using access devices. Access devices require specific radiation permits according to the radiation law but are exempt from a building permit if they are constructed pursuant to the conditions provided in the exemption provision. Some local authorities have disputed the applicability of the exemption

provision to access devices of a cellular network and to their use. Pelephone's position regarding the applicability of the exemption was accepted in a number of rulings and decisions by local courts and the use of such facilities and the supporting equipment were approved. One verdict provided an opposite ruling. Appeals have been filed for some of these rulings and decisions.

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### Pelephone's cellular licenses

Pelephone's general license is valid until September 8, 2022. In addition, in April 2001, the Civil Administration for the Administered Territories granted Pelephone a general license for the provision of cellular services in the Administered Territories that is valid until September 2022 and the provisions of the general license granted to Pelephone by the Ministry of Communications are also applicable to this license. The following are the principal provisions of Pelephone's general cellular license:

Under certain circumstances, the Minister is entitled to modify, restrict or suspend the terms of the license, and in certain instances to revoke it.

The license is non-transferable, and it contains restrictions on the acquisition or transfer (including by means of a charge), directly or indirectly, of control of 10% or more of any means of control in Pelephone, including an encumbrance on such means of control, unless the Minister has given his consent beforehand.

Pelephone is obliged to provide interconnect services under equal terms to all other operators and must refrain from any discrimination in the implementation thereof.

Pelephone must refrain from giving a preference in providing its infrastructure services to a licensee with an interest (as defined in the license), such as a related party, over another licensee.

Pelephone is generally not entitled to sell, lease or mortgage any of the assets used for the implementation of the license without the consent of the Minister of Communications, except as stipulated in the license.

In periods of emergency, the relevant governmental authority may issue certain instructions to Pelephone with respect to its mode of operation and/or manner of provision of services.

The license sets forth the types of payments that Pelephone may collect from its subscribers for cellular services, mechanisms for setting tariffs, reports that Pelephone must submit to the Ministry of Communications and also the duty of serving notice to the Ministry of Communications prior to modifying its tariffs. The license also determines the Minister's power to intervene in setting tariffs in certain instances.

The license commits Pelephone to provide a minimal standard of service, including setting up of service call centers, the determination of a maximum period for repair of malfunctions, an accounts collection procedure and protection of the privacy of the recipient of the service.

To secure Pelephone's undertakings and to compensate and indemnify the State of Israel for any damage caused by acts committed by Pelephone, Pelephone is required to furnish a bank guarantee of \$10 million, which is subject to forfeiture.

### Changes in Pelephone's license

In January 2013, the Ministry of Communications published a hearing on "Charges for roaming services abroad," with the following principal points

- New and existing subscribers browsing services abroad would be blocked by default.
- An alert via text message (SMS) would be sent to subscribers who have purchased an overseas roaming package and reached a utilization rate for each component of the package purchased.

- Subscribers would be blocked from using roaming services abroad after they have fully utilized the package they purchased.
- Subscribers who use overseas roaming services only occasionally would be blocked when their bill reaches approximately NIS 100.

Pelephone's revenues from roaming services could be adversely affected depending on the results of this hearing. Pelephone submitted a detailed response to the Communications Ministry and asked that a hearing be held before a decision is made.

### Suppliers

#### Terminal equipment suppliers

Pelephone sells a wide range of cellular telephones and auxiliary accessories (such as batteries, hand-free kits, earphones, data cables and chargers). Pelephone also maintains spare parts to supply repair services to its customers and an inventory of used handsets.



Pelephone purchases the terminal equipment and accessories from a variety of suppliers and importers in Israel. Contractual engagements with most of the suppliers are based on framework agreements setting forth the technical support provided by the supplier for the terminal equipment it supplies, availability of the spare parts turnaround time for repairs. These agreements do not include a commitment to make acquisitions, which are implemented regularly by means of purchase orders. Generally, if an agreement with a particular supplier of terminal equipment is cancelled, Pelephone can increase the quantity purchased from other suppliers or purchase equipment from a new supplier.

Pelephone has an agreement with Apple Distribution International for the purchase and distribution of iPhone handsets in Israel, which is in force until May 2013. Pelephone is negotiating to extend the agreement, which will probably include an undertaking to purchase a minimum quantity of handsets. These handsets account for a substantial percentage of the handsets sold by Pelephone. In 2012, Pelephone's purchases from Apple accounted for less than 10% of its purchases from all of its suppliers. Other than Apple, the purchase of terminal equipment among the other suppliers is such that it does not create any significant dependence on any one equipment supplier or model.

An agreement between Pelephone and Eurocom Cellular Communications Ltd., the Israeli distributor of Nokia and ZTE terminal equipment, regulates the purchase and supply of Nokia and ZTE products to Pelephone and the maintenance service for those products, through December 31, 2015. The agreement was approved by the general meetings of Pelephone and Bezeq, as a transaction in which the controlling shareholder of Bezeq has a personal interest (Eurocom Cellular Communications Ltd. is an affiliate of our controlling shareholder).

#### Infrastructure suppliers

The infrastructure equipment needed for the UMTS/HSPA network is produced by Ericsson and the infrastructure equipment for the CDMA network is produced by Nortel and Motorola. Pelephone has long-term agreements for the maintenance, support and upgrading of software for the UMTS/HSPA network and a maintenance agreement with Ericsson for the Nortel network. In the opinion of Pelephone, it could become dependent on Ericsson in connection with support for this network. Pelephone maintains the Motorola equipment independently. In addition, the cellular network uses transmission facilities for which Bezeq is Pelephone's main supplier.

#### Equipment, Software, Computer Systems and Databases

Pelephone's equipment includes infrastructure equipment of the core network, radio sites, electronic equipment, computers, vehicles, terminal equipment, office furniture and equipment, and improvements to leased premises.

Pelephone uses software and computer systems, some under licenses purchased by Pelephone and others developed by Pelephone's IT division. Most of these licenses are restricted in time and are periodically renewed. The main systems that Pelephone uses are Oracle Application and an Amdocs billing system.

#### Property

Pelephone does not own any land and leases the premises which it uses for its operations from others, including Bezeq. The land which Pelephone uses for installation of radio and switching sites are spread out around the country, and are leased for various periods (in many instances, for five years plus an option to extend the agreement for another five years).

Pelephone's headquarters are located in Givatayim, Israel, and cover a total area of 17,800 square meters. The lease for these premises expires on December 31, 2015 and there is an option to extend the lease until November 2020. Pelephone leases 58 service and sale centers throughout Israel and has additional lease agreements with respect to warehouses, offices and telephone call centers which it uses for its operations.

Some of the leased communications sites are in areas owned by the ILA. Pelephone entered into an agreement with the ILA to use land in those areas for the erection and operation of communications sites. Among other things, the agreement regulates payments to which the ILA is entitled for the period ended December 31, 2010. At the end of the term of the agreement and in the event of its cancellation for causes, Pelephone must vacate the site. To the best of Pelephone's knowledge, the other cellular operators have similar agreements with the Administration. Since 2010 negotiations have been held with the Administration to conclude the terms for further use of the sites in the Administration areas. In October 2012, ILA began to use umbrella agreements with the cellular operators. The terms under the umbrella agreements are for the use of the sites for the period from January 1, 2011 until December 31, 2019.

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## Employees

The table below provides data with respect to the number of Pelephone employees at December 31, 2011 and 2012.

	2011	2012
Management and HQ	279	223
Content and product marketing	96	57
Service – Private customers	2,206	1,592
Business customers	533	463
Operation and logistics	344	347
Engineering and information systems	583	505
Total	4,041	3,187

All Pelephone employees are employed under standard personal agreements according to their professions and the roles in which they are employed. Most of Pelephone's employees are employed under monthly or hourly wage agreements. Most of the service and sales employees are shift workers who work part time and are employed on an hourly basis. Pelephone customarily gives its employees and managers bonuses and incentive pay on a monthly, quarterly or annual basis, depending on the attainment of defined targets and on the type of work done by the employee.

Pelephone received a notice from the Histadrut in September 2012, that it constitutes a representative workers union of Pelephone employees. On November 26, 2012, Pelephone received a notice from the Histadrut of a strike beginning December 10, 2012, due to its alleged failure to recognize the Histadrut as a representative organization and its refusal to conduct negotiations on a collective agreement, as well as wage-related demands and employee dismissal issues. On January 7, 2013, Pelephone notified the Histadrut that it recognized it as the representative organization for Pelephone and the parties began to negotiate a collective labor agreement. The negotiating process may cause some labor unrest and harm Pelephone's on-going activity. The collective labor agreement may limit management flexibility and impose additional costs on Pelephone.

## BEZEQ INTERNATIONAL

## General

Bezeq International provides communication solutions to its customers in the private and business sectors in four key areas of operation: (i) Internet access services; (ii) international and domestic telephony services; (iii) network end point, or PBX, services; and (iv) ICT solutions.

The following table reflects Bezeq International's revenue (in NIS millions) for the three years ended December 31, 2012:

	2010	2011	2012
Revenues from international carrier services	501	413	383
% of total revenues	36.30%	30.51%	28.58%
Revenues from Internet and communication services for businesses (ISP, ICT, data)	879	941	957
% of total revenues	63.70%	69.49%	71.42%
Total revenue	1,380	1,354	1,340

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Operating profit	320	241	219
Depreciation and amortization	94	109	136
Operating profit before depreciation and amortization	414	350	355
Net profit	254	182	160
Cash flow from current activities	292	243	272
Payments for investments in property, plant and equipment and intangible assets(1)	180	288	173
Free cash flow (2)	112	(44)	99
Churn rate (3)	12.7%	12.6%	18.4%

(1) The item also includes long-term investments in long-term assets.

(2) Cash from operating activities less purchase of property, plant and equipment and intangible assets, net.

(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.

In 2012, there was a continued slow-down in the growth rate of high-speed Internet users compared to previous years, while the upgrade of the Internet infrastructure in Israel by Bezeq and HOT continued, marked by the availability of a range of speeds from 10MB through 100MB on Bezeq's NGN network and HOT's UFI network. In addition, in 2012, the trend of selling service bundles continued as did the trend for increased sales of value-added services. This has led to market saturation (approximately 68% of Israeli households are connected to the Internet), with competitors attempting to differentiate themselves by strengthening customer loyalty.

As a rule, an increase in demand for higher bandwidth requires an increase from time to time in Bezeq International's Internet bandwidth capacity. In January 2012, Bezeq International launched its Power NGN network, a high-speed Internet access network which relies on the advanced technology capabilities of the new submarine cable that it owns, or the Jonah Cable, together with its new state-of-the-art core and access systems.

#### Products and Services

Voice services. In the voice services sector Bezeq International provides: (i) international direct dialing, or IDD, services to private and business customers; (ii) toll-free number services for business customers overseas; (iii) international call routing and termination services – transfer of international calls between foreign communication providers (hubbing); (iv) calling card services enabling prepaid and postpaid dialing from and to Israel; and (v) outbound dialing services from Israel to other countries. Bezeq International also provides domestic telephony services by means of VoB through its subsidiary, B.I.P. Communications Solutions (Limited Partnership), or BIP.

Internet services. In the Internet services sector Bezeq International provides: (i) Internet access services for private and business customers, including terminal equipment and support, with an emphasis on broadband Internet based on ADSL transmission or cable infrastructures; (ii) hosting services – website and server hosting and co-location services in a designated data center, or IDC; (iii) installations, including value-added services (such as monitoring and control); (iv) information security services (services securing Internet connections and LAN networks using the required terminal equipment or software), including monitoring; (v) data services with IP based international data communication solutions for business customers; and (vi) high-speed wireless (WIFI) access, including in various public locations (hotspots).

International data service. Bezeq International supplies international data communication solutions for business customers, including customized global deployment. The customer is able to choose from a range of the most advanced data communication methods through the optic cables deployed from Israel to Europe including Bezeq International's own Jonah Cable system and networks of other leading global telecom providers, such as BT, which make available to its customers their sophisticated global network services.

PBX services. Bezeq International markets and provides maintenance and technical support services for advanced PBX systems sold by a wide range of manufacturers. Bezeq International also provides managed telephony exchange services for enterprises and business compounds.

Business customer services. As part of its comprehensive ICT solutions business, Bezeq International provides extensive communications services, including: international data communication services, server and website hosting services, ICT systems' technical maintenance and support services, networking and system services, outsourcing and out-tasking services, security and risk management solutions and IP based managed services, as well as innovative cloud computing services.

Jonah Cable. On November 1, 2010, Bezeq International entered into a turnkey agreement with Alcatel-Lucent Submarine Networks for the laying of a submarine optic communication cable, known as the Jonah Cable, between Israel and Italy. In 2011, Bezeq International purchased indefeasible rights of use in a terrestrial infrastructure which

links its point of presence in Italy to sites in Western Europe. In December 2011, Alcatel-Lucent Submarine Networks successfully completed the installation of the Jonah Cable and commercial service using that cable was initiated. At that time, Bezeq International entered into agreement with the MECMA consortium for maintenance of the cable. In January 2011, Tamares Ltd. announced that it completed laying a submarine cable between Israel and Cyprus and the purchase of continuing capacity to Western Europe. On November 3, 2011, the Ministry of Communications published a hearing concerning regulation of the submarine cable sector. The decision of the Ministry of Communications on this matter could affect the activities of Bezeq International in this market.

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Technology. Bezeq International utilizes Veraz SoftSwitch switches to route its voice traffic, and its value-added services, including dialing cards, are based on an intelligent network.

#### Customers

Bezeq International has no customer whose revenues account for over 10% of its revenues. Below is a breakdown of revenues (in NIS millions) from private and business customers:

	2010	2011	2012
Revenues from private customers	523	540	546
Revenues from business customers	857	813	794
Total revenues	1,380	1,354	1,340

#### Marketing

The marketing department coordinates all the operations for a number of permanent suppliers, among them advertising companies representing Bezeq International, which are used by Bezeq International to remain in contact with the advertising media (television, Internet, radio and the daily national press), production and post-production companies (this changes depending on the requirements of each campaign), design and printing companies, and sales promotion and PR companies.

#### Competition

During 2012, cellular operators began to offer international direct dial services as part of the unlimited packages they offered. This resulted in an increase in call minute volume in the fourth quarter of 2012.

At the end of 2012, there were eight competitors in the International telephony services market: 014 Bezeq International, 013 Netvision, 012 Smile, 018 Xfone, HILAT Telzar International Communication Services Ltd., Golan Telecom, Hot Mobile and NGN International Communications 015 Ltd. The international call market in Israel has in recent years been characterized by a decrease in call volume. In 2012 and 2011, the volume of call minutes (incoming and outgoing) decreased by 0.7% and 4.4%, respectively. Bezeq International estimates that its market share of outgoing international calls from customers in Israel is 27.2% compared to a market share of approximately 30% at the end of 2011.

There are a number of competitors in the Internet access services market, including Bezeq International, 013 Netvision which merged with Cellcom, 012 Smile, which merged with Partner, Hot Net (which began providing internet access services under a special license to provide ISP services in February 2012) and two minor niche players. To date, approximately forty companies have received licenses to provide Internet access, five of which have international operator (ITS) licenses. Bezeq International believes that its market share of the Internet services sector is 38.85% compared with a market share of 37.5% at the end of 2011. While there has been growth in the Internet access segment in recent years in terms of the number of customers, the rate of growth is slowing as a result of the saturation of penetration rates. Approximately 68% of all households in Israel are connected to the Internet, which is a high penetration rate in comparison with the rest of the world. There are currently two principal infrastructure alternatives for customers in the market, Bezeq's ADSL and the HOT cable infrastructure. HOT frequently cooperates with Bezeq International's direct ISP competitors and provides ISP services through its subsidiary, HOT-Net.

Bezeq International's estimate of its market share in the Internet access sector is based on a calculation of the ratio between the number of subscribers it has, and the total number of ISP subscribers (based on public data regarding

Internet infrastructure services provided by Bezeq and HOT).

Bezeq International is facing new competitors in its provision of communications solutions to the business sector from companies such as Binat, Taldor and IBM. In 2012, Bezeq International continued to establish its position in the ICT market and to gain recognition and accreditation from leading providers in the market. In addition, the continued penetration of VoIP technology (such as Skype) intensified the competitive environment.

The traditional field of PBX (telephone exchanges) is characterized by a large number of competitors and by fierce competition which has given rise to an erosion of service prices. Bezeq International's most prominent competitors are Tadiran, Eurocom, GlobeCall and Tel-Yad. Data communications and IP telephony (adapting switchboards and terminal equipment to IP technology) is characterized by the entry of new players from the IT world. These companies include Binat, Teldor, Malam Tim and IBM. These companies are substantially different from traditional PBX service companies and operate on a higher technological level. New operators are entering the market with the intention of providing customers with total communications solutions such as telephony, transmission, data communications, Internet, and information security.

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#### Principal entry and exit barriers

The principal entry barrier in the international call market is the requirement for a license under the Communications Law and investments in infrastructure (the amount of investment in infrastructure is lower than the required amount of investment in a domestic carrier or cellular infrastructure), which is affected by frequent technological changes. However, changes in the licensing policy, as described below and the expansion of the use of VoIP technology have significantly reduced the effect of these barriers.

The principal entry barrier into the data and internet services market arises from the required investment in infrastructure (international capacity, access to the internet network and broad service network).

The principal exit barriers for these markets arise from long-term agreements with infrastructure suppliers and from investments that require long periods of time to provide satisfactory returns. In addition, Bezeq International is committed to providing service to its customers throughout the period of their contract and would not be able to easily exit these markets.

#### Governmental Regulation

Bezeq International operates under a general license for the provision of international voice and data services, which is valid until 2022. Bezeq International also operates under a general license for the provision of domestic telephony services, and special licenses for the provision of Internet services and PBX services.

Following the entry into the market of additional cellular operators that also hold general licenses for the provision of international telephony services, there have been a large number of changes in the international calls market from mobile phones. These changes affect the scope of services provided by Bezeq International in this area and its revenues.

#### Amendment to the licenses of Bezeq to allow for service bundles that include services of Bezeq International

In August 2010, Bezeq began selling joint service bundles which include Bezeq International's Internet access services. In July 2012, the Ministry of Communications amended the license of Bezeq and its subsidiaries, allowing Bezeq to offer subsidized plans which combine the services of its subsidiaries to customers in the business sector. The rules for the supply of these bundles are the same as those imposed on Bezeq relating to the marketing of joint service bundles to the private sector.

#### Change of tariff structure for overseas calls from a cellular network

On November 1, 2011, the interconnect charges for the cellular operators were reduced and on January 1, 2012 they were further reduced.

In November 2012, the Ministry of Communications decided that VoC/VoB services will be regulated through a domestic carrier license (general or special and not through a MVNO license). This decision could have a positive impact on Bezeq International's operations.

#### Internet license amendment

On October 31, 2012, the Ministry of Communications amended the special license of Bezeq International for the provision of Internet access services (ISP). The amendment sets new provisions, including the format of the agreement with subscribers, conditions for performing a remote transaction and a transaction in the presence of the

parties, provisions for documenting a subscriber's application for service, provisions for a refund in respect of an overcharge or services that were not requested, conditions for discontinuing the service, provisions concerning the format and sending of bills to subscribers, provisions concerning the option to contact the ombudsman, provisions concerning the possibility of changing plans and tariffs, provisions for the collection of debts from subscribers, provisions concerning the treatment of subscribers' complaints and the obligation to document and submit documents about this treatment and provisions concerning the obligation to publish information about plans and tariffs. The amendment will be fully effective on May 1, 2013. Bezeq International made the necessary preparations and is continuing to implement the provisions of the amendment.

#### Amendment to the Communications Law on the filtering of offensive content

In August 2012, the Ministry of Communications amended the licenses of the ISPs (fixed and mobile), adding provisions to the licenses concerning filters for offensive sites and content, as a supplementary measure to the provisions of the law on this subject. The amendment stipulates that a license holder will be required, inter alia, to inform its subscribers about offensive sites and content on the internet which are not suitable for children and teenagers, and to include details of ways of blocking access to these sites and content. Likewise, the license holder must offer its subscribers an effective service for filtering offensive sites and content, for no additional payment.

Change in the format of the settlement of accounts between cellular operators and the ITS companies in the prepaid calling cards market of the cellular companies

The Ministry of Communications issued an administrative instruction which prescribed that commencing September 2012, the ITS companies will be able to split the tariff so that the price of the international call will be separate from the interconnect fee payable to the cellular company. Cellular companies may not market or give preference to one international operator over another and they may not publish the services of any particular international operator. The commissions which the cellular companies collected from the international call companies for marketing this service were also cancelled.

Sending a detailed list of annual charges

Pursuant to the provisions of an amendment to the Consumer Protection Law, effective in 2013, Bezeq International must send all subscribers an annual list of charges for all the amounts charged from January 1 to December 31 of each year.

Suppliers

Bezeq International has cooperation agreements with approximately 200 foreign operators for approximately 240 destinations worldwide. Bezeq International is dependent upon Bezeq for domestic capacity in the provision of its services and for connecting the subscriber to the international exchange.

Under its agreement with Med Nautilus, Bezeq International purchased indefeasible rights of use to an unparticular non-specific part of the communication capacity of the undersea cable system operated by Med Nautilus between Israel and Europe for a period of up to 15 years from the date on which it started using this capacity (with an option to extend the period of use). The periods of use are at least until 2017 – 2027, depending on the date of the start of use of the capacity. Bezeq International paid for these rights of use a non-recurring payment around the date on which it started using the capacity. In addition, in October 2011, Bezeq International entered into an agreement with Med Nautilus to expand and change the existing user rights in the international optic network that it operates, which will be used as a backup for Bezeq International's Jonah Cable.

On January 18, 2010, Bezeq International signed an exclusive partnership agreement with British Telecom for the provision of global communications services to Israeli and multi-national companies operating in Israel. As part of the strategic agreement, Bezeq International operates as the exclusive partner of the BT Alliance in Israel and markets IT services and products from British Telecom's global range of services.

Property

Bezeq International has a long-term lease for its two principal facilities which expires in 2015. Bezeq International's technological infrastructures, which support its voice, data and internet setups, are deployed in five sites, inside and outside Israel, in order to provide redundancy and high survivability of the networks.

Financing

Bezeq International has no liabilities to banks and its approved credit line was unused at March 31, 2014. At the beginning of December 2011, Bezeq entered into a loan agreement with Bezeq International, according to Bezeq provided Bezeq International a NIS 160 million loan which is to be repaid in five equal, annual installments of principal and interest beginning in December 2012. During 2012, Bezeq provided Bezeq International with two additional loans, each in the amount of NIS 40 million.

In accordance with the requirements of the Ministry of Communications, Bezeq International was required to provide a bank guarantee of NIS 10 million to fulfill all of the conditions of the license for provision of international telecommunications services. Bezeq International has provided NIS 16 million of additional bank guarantees in order to meet contractual commitments in bids for tenders and legal proceedings.

In accordance with the requirements of the Ministry of Communications, Bezeq International provided a bank guarantee in the amount of NIS 11 million to fulfill all of the conditions of the exclusive general license to provide domestic fixed line telecommunication services to B.I.P.

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## Employees

Bezeq International has a number of employee groups whose wage structure includes a component of performance-linked commissions and incentives. These groups include sales employees, telephone sales representatives and telephone service and support representatives. Employees have arrangements for pension and health insurance that are fully subsidized by Bezeq. Bezeq International is not a party to any collective bargaining agreement.

The following table shows the number of persons employed by Bezeq International, including outsourced employees, at December 31, 2011 and 2012:

	Number of employees	
	2011	2012
Head office employees	1,209	1,261
Sales and service representatives	1,053	841
<b>Total</b>	<b>2,262</b>	<b>2,102</b>

## DBS

DBS, also known by its trade name YES, provides encoded and digital multi-channel broadcast services as well as other satellite services to subscribers in Israel and the Judea and Samaria region (the West Bank). DBS is the only company in Israel currently operating in the satellite multi-channel television broadcasting sector. It operates this service under a non-exclusive license.

### Control of DBS

On August 20, 2009, the Israeli Supreme Court accepted the Antitrust Commissioner's objection to the contemplated merger between Bezeq and DBS. In view of the Supreme Court's ruling, Bezeq determined that it would not be able to control DBS and accordingly, as of August 21, 2009, it ceased to consolidate DBS's financial statements into its consolidated financial statements and its investment in DBS is presented as of that date according to the equity method.

In April 2010, in the context of the Ministry of Communications' approval of our acquisition of control in Bezeq, the Ministry approved DBS's request, as required by its license, for the transfer of Eurocom DBS's holdings in DBS to a trustee, subject to certain conditions.

The approval of the Antitrust Commissioner for our acquisition of control in Bezeq was made contingent, among other things, the sale by Eurocom of its holdings in DBS within a defined period of time. To the best of our knowledge, the Antitrust Commissioner is currently considering the enumerated conditions relating to the Eurocom Group's holdings in DBS.

### Products and Services

DBS's wide range of broadcasts include approximately 140 different video channels (of which 5 are pay per view channels and 20 are HD channels), in addition to radio channels, music channels and interactive services.

DBS markets personal video recorder, or PVR, decoders which interface with DBS's electronic broadcast schedule and enable receipt of special services, including ordering recordings in advance, recording series and pausing live broadcasts. The PVR decoders also enable viewing of content which is transferred from time to time to the decoder's

memory stored in the decoder's memory which is updated from time to time by DBS (push video).

DBS provides HD broadcasts which can be received through special decoders. These broadcasts allow superior quality viewing. DBS also markets HDPVR decoders. The majority of DBS subscribers use PVR decoders.

DBS believes that an increase in the number of subscribers using PVR decoders contributes to an increase in its revenues from these subscribers and to their retention as subscribers, but it will require a material financial investment.

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The following table provides summary condensed financial information concerning DBS's multi-channel broadcast services for the two years ended December 31, 2012:

	2011	2012
Revenues (NIS millions)	1,619	1,636
Operating profit (NIS millions)	295	253
Depreciation and amortization (NIS millions)	276	248
Operating profit before depreciation (NIS millions)	571	501
Net (loss) (NIS millions)	(230)	(310)
Cash flow from current operations (NIS millions)	513	418
Payments for investments in property, plant and equipment and intangible assets (NIS millions)	264	284
Free cash flow (NIS millions) (1)	250	134
Number of subscribers (2) (at the end of the period, in thousands)	586	578
Average monthly revenues per subscriber (ARPU) (3) (NIS)	232	234
Churn rate (4)	11.9%	15.4%

- (1) Cash from operating activities less purchase of property, plant and equipment and intangible assets, net.
- (2) Subscriber – one household or small business customer. Where a business customer has many reception points or many decodes (such as a hotel, kibbutz or gym), the number of subscribers is calculated by dividing the total payment received from the business customer by the average revenue per small business customer.
- (3) Monthly ARPU is calculated by dividing total DBS revenues (from content and equipment, premium channels, technical service, advanced products, one-to-one sale of content, revenues from channels, Internet and other) by average number of customers.
- (4) Number of DBS subscribers who left DBS during the period, divided by the average number of DBS registered subscribers in the period.

DBS provides a service enabling the viewing of certain Internet content on TV screens through the use of advanced decoders (streamers).

DBS provides its subscribers with VOD services via the Internet. This service has limitations with regard to the types of decoders enabling service reception and with regard to the availability of services due to constraints connected with the Internet infrastructure and bandwidth installed in subscribers' homes. These limitations have decreased in recent years with the increase in the available bandwidth in subscribers' homes. In recent years, the number of DBS subscribers connected to VOD services and the use of VOD services has increased significantly.

Furthermore, DBS is subject to restrictions on its broadcasting content, one of which is a ban on broadcasting commercials and restrictions on the ownership of the channels it broadcasts, including the News Channel. Similar restrictions are also applicable to HOT.

#### Broadcasting rights

DBS has the broadcasting rights to two types of video content:

Content purchased from third parties, including content and channels; and

Content which DBS produces (wholly or partially) and has the right to use in its broadcasts. In most instances, DBS is also entitled to authorize the use of the content to third parties and share in the revenues arising from additional use of the content.

The broadcast and distribution of content by DBS on various media involves the payment of royalties to the owners of copyrights of musical works, voice records, scripts and content direction, included under the Copyright Law, 2007 and the Performers and Broadcasters Rights Law, 1984. Payment of royalties is made through a number of organizations that operate in Israel that collect the royalties for the owners of the intellectual property rights. DBS has blanket licenses with these organizations. Payments by DBS under these licenses are, at times, based on a fixed payment and at other times on various pricing methods. With respect to some of the organizations, DBS may be required to pay additional amounts as royalties for transmitting content via certain media and for secondary broadcasting of certain content. Such payments are not expected to be significant. DBS is also expected to pay royalties for secondary broadcasts of certain content, in amounts that DBS believes are not significant.

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In October 2012, DBS and Association of Composers, Authors and Publishers of Music in Israel, or ACUM, signed a settlement agreement, settling a dispute over the amount of royalties owed by DBS for the years 2003 to 2011. Concurrently, the annual rates of royalties that DBS must pay for the years 2012 to 2016 were agreed upon and DBS and ACUM signed a licensing agreement in which DBS received a permit from ACUM to use the broadcast, copying and recording rights of ACUM's works until December 31, 2016.

Given the many content providers from which DBS purchases broadcasting rights, DBS does not have a main content provider and is not materially dependent on any single content provider. However, with respect to broadcasts of Israeli sports, at the date of this report there is dependence on the purchase of the broadcasting rights of local sports channels by these providers.

#### Customers

The overwhelming majority of DBS's subscribers are private customers. DBS's subscriber agreements regulate the rights and obligations of subscribers in their relations with DBS. Pursuant to the provisions of the broadcasting license, the subscriber agreement was approved by the Council for Cable TV and Satellite Broadcasting, or the Council, and the Standard Contracts Tribunal. However the term of such approval has expired. DBS is working to renew the approval of the subscriber agreement from the Council and once such approval is obtained, DBS intends to take action to obtain the approval of the Standard Contracts Tribunal.

#### Strategy

DBS's goals are to increase its operating margins and to continue its streamlining efforts while maintaining its business and competitive status in the broadcasting market. To achieve these goals, DBS intends to:

invest considerable effort in marketing and sales and to formulate an appropriate marketing strategy designed to attract new subscribers and retain existing customers;

continuously improve the array of services offered to subscribers;

create differentiation and innovation in its broadcasting content which is to be expanded relative to HOT's content;

increase the amount of content purchased by each subscriber and expand DBS's value-added services; and

invest in the development and integration of advanced technologies and new services.

DBS also intends to continue its efforts to increase the rate of penetration of advanced services, including the use of PVR decoders and VOD and HD services among its subscribers, as well as to provide its content on additional platforms, in order to increase revenues and enhance subscriber loyalty.

#### Marketing and Distribution

DBS advertises in the various media outlets to market its services. DBS's sales operations are carried out through three main distribution channels:

Sales persons employed by DBS who recruit subscribers;

Call centers operated by DBS employees that receive telephone enquiries from customers wishing to obtain DBS services, as well as telemarketing campaigns to potential subscribers; and

External resellers.

## Competition

Approximately 62% of all homes in Israel subscribe for multi-channel television services. Multi-channel television broadcasts services are also provided by HOT, which provides cable television services. HOT has a monopoly declared under the Antitrust Law in the area of multi-channel television broadcasting. HOT Telecom, a fully-controlled subsidiary of HOT, has a cable network infrastructure, including terminal equipment and broadcasting centers and it provides Internet infrastructure services as well as fixed-line telephone services. DBS also regards the DTT setup and video content offered via the Internet as competition for its services. DBS believes that there is a low probability for it to penetrate an additional material segment because most of the remaining households are not considered to be potential customers for DBS and HOT.

To the best of DBS's knowledge, in recent years there has been a decrease in the total number of subscribers for the services of DBS and HOT, mainly due to the strengthening of alternative products in this field. For example, since 2009, the Second Authority has operated a terrestrial digital radio broadcasting system, which freely broadcasts the television channels of the Broadcasting Authority (Channel 1 and Channel 33), commercial television channels (Channel 2 and Channel 10) and the Knesset Channel (Channel 99) in Israel. This setup constitutes a limited alternative to the multi-channel television broadcasts.

In 2012, there has been a moderate decrease in DBS's market share. Below is DBS' number of subscribers and its market share according to DBS' estimations:

2010		2011		2012	
Subscribers	Market share	Subscribers	Market share	Subscribers (1)	Market share
577,700	39%	586,400	40%	578,404	39%

(1) A subscriber is either one household or one small business customer. For business customers with many reception points or a large number of decoders (such as a hotel, kibbutz 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.

Competition in the broadcasting arena focuses on content, packages and channels, on service and on offering additional services such as VOD services, PVR decoders, and HD broadcasts. In recent years there has been a discernible trend toward demand and supply of personal television services which allow the customer to choose which content to view and when to view it (in contrast to viewing linear channels where the content broadcasting sequence is determined by the broadcasting entity). This trend is supported by the expansion of PVR services, VOD services and other services.

DBS believes that competition may increase due to the additional communication services offered by HOT as part of its "service bundle."

Positive and negative factors that affect the competitive status of DBS

The positive factors that affect DBS's competitive status are:

- Use of state-of-the-art advanced technology to provide its services;
- Quality and variety of content broadcast to subscribers;
- Level, quality and availability of DBS's customer service;
- Ability to provide broadcasts in remote or isolated areas where there is no deployment of cable infrastructure; and
  - The acceptance of the "yes" brand as a preferred, popular brand with a high level of loyalty.

The negative factors that affect DBS's competitive status are:

- Inferior infrastructure – DBS's infrastructure is inferior because the satellite infrastructure does not enable: (i) bidirectional communication, (ii) the provision of VOD services, and (iii) the transmission of telephony and internet services. Hot's cable infrastructure enables the supply of these services;
  - Regulatory restrictions;
  - Restrictions on its broadcast content, including a ban on broadcasting commercials;
  - Restrictions on the ownership of the channels it broadcasts, including the News Channel; and
    - The high cost of utilizing space segments to reach its subscribers.

Main methods employed by DBS to maintain its competitive position

The following are the main methods employed by DBS to deal with its competition:

- DBS seeks to purchase, produce and broadcast high-quality, innovative and varied content, creating differentiation of its content;
- DBS seeks to cultivate, promote and differentiate its YES brand;
- DBS places an emphasis on its customer service; and
- DBS invests in order to expand its technological capabilities, while placing an emphasis on technological innovation. To achieve this goal, it attaches great importance to the supply of personal television broadcasts as part of the range of services it offers its subscribers, including VOD, PVR and HD services.

Critical success factors in DBS's market position and the changes occurring in the market

DBS regards the following factors as critical to the success of its operations:

- The quality, differentiation, innovation and originality in the content, variety, branding and packaging of its broadcasts;
- Provision of television services while using advanced technologies such as personal television services, and in particular, PVR decoders and VOD services, as well as HOT services;

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- Its ability to offer bundles of communications services including television services and other services such as telephony services and internet services;

- High level of customer service; and

- The Yes brand strength and its identification with quality, innovation and industry-leading content and services.

#### Principal entry and exit barriers

The principal entry barriers to the broadcast market are:

- The need to obtain licenses under the Communications Law;
- The significant investment required of carriers in this segment of operations, including the deployment of appropriate infrastructure and the purchase and production of attractive content;
- The limited size of the broadcast market, which reduces the size advantage characteristics of the broadcast field elsewhere; and
- Saturation of the broadcast market.

In recent years, some of these entry barriers have started to fall as a result of regulatory changes, such as DTT, and as a result of technological developments enabling the transfer of content over existing communication infrastructures.

The principal exit barriers are:

- the regulatory barrier - termination of operations under the Broadcasting License is dependent on a decision of the Minister of Communications to cancel the license prior to the end of the license term, including arrangements (which could be imposed on the licensee) for ensuring the continuation of broadcasts and services and minimization of harm to subscribers; and
- existing contracts with customers, important suppliers and with entities that provided long-term loans to DBS.

#### Governmental Regulation

The television broadcasting industry in Israel is highly regulated. Broadcasting is carried out pursuant to various broadcast licenses and is subject to the ongoing supervision of the Ministry of Communications and the Council. DBS's operations are regulated by and subject to an extensive system of laws that apply to the area of broadcasting, including primary legislation (and specifically the Communications Law and subsequent regulations), secondary legislation (including the Communications Rules), as well as administrative directives and Council decisions).

#### Licenses

DBS owns the following main licenses:

Broadcasting license. DBS's broadcasting license is valid through January 2017 and may be extended for additional periods of six years. This license is the main regulatory permit for DBS's operations. The Minister of Communications and the Council have parallel authority to amend DBS's broadcasting license. The Minister of Communications is authorized to cancel or postpone the broadcasting license for causes set out in the Communications Law and the

broadcasting license.

The Communications Law and broadcasting license includes restrictions on the transfer, attachment and encumbrance of the broadcasting license and any of the assets associated with the broadcasting license. The broadcasting license requires receipt of the approval of the Minister of Communications for specific changes in the holding of the means of control in DBS and imposes a reporting requirement regarding the holders of the means of control; adversely affect competition in terms of provision of broadcasting and services is prohibited, including terminal equipment and other telecommunications services unless approved in advance and in writing by the Council; the obligation to file reports to the Ministry of Communications was defined as well as conditions regarding the regulation of the activity of the licenses; and an obligation was agreed upon to provide bank guarantees of NIS 40 million to the Ministry of Communications to guarantee DBS's undertakings under the license.

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The broadcasting license contains provisions regarding the types of payments the licensee may collect from its subscribers, and they appear in the DBS price list. The vast majority of DBS's subscribers subscribe to special offers, which include different combinations of content packages and related services, at prices below the listed price for each component of the special offer.

License for satellite television broadcasts in the Judea and Samaria region. This license is valid through 2016, and by power of this license whose provisions are similar to those of DBS's main broadcasting license, DBS broadcasts to the Judea and Samaria region.

License to perform uplink operations. DBS holds a license to perform uplink operations (transfer of broadcasts from DBS's broadcasting center to the broadcasting satellite and performance of setup and ancillary operation activities), which is valid through January 2017 or until the end of DBS's broadcasting license.

#### Statutory restrictions and special constraints

Pursuant to the Communications Rules (Broadcasting Licensee) 1987, or the Communications Rules, various obligations and restrictions apply to DBS, including those relating to broadcast content and the amount and manner of investment in local productions. DBS may own up to 30% of the local channels broadcast by it.

The broadcasting license includes provisions relating to the content of DBS's broadcasts, including an obligation to obtain the Council's approval of the channels broadcast by DBS. The Communications Law prohibits the broadcast of advertisements, subject to several exceptions. Additionally, the broadcasting license includes conditions regarding the terms of the services to subscribers and prohibition of discrimination between subscribers as well as an obligation to have the Council and the Standard Contracts Tribunal approve the subscriber agreement.

Under the amendment to the Second Authority Law dated April 2012, the DTT system, which competes with DBS, will be expanded by the end of 2013, to include additional channels under certain conditions. DBS believes that an increase in the number or range of channels distributed through the DTT system will increase the number of alternatives to DBS services and may therefore have a detrimental effect on DBS's revenues.

#### Market developments

In accordance with a decision of the Council, beginning December 2012, DBS and HOT must allow customers to purchase, in addition to the basic package of channels that licensees are obligated to offer to all their subscribers by law, a package of channels that includes the obligatory channels and at least four channels produced in Israel, including a sports channel and a channel for pre-schoolchildren or a channel for children and teens based on the conditions defined in the Council's decision. According to the decision, DBS and HOT must offer these channels until May 31, 2013, and during this period the Council will review its decision based on the data it receives from DBS and HOT. DBS believes that a significant movement of subscribers to this limited package of channels may harm its results.

#### Royalties

Under the Royalties Regulations (Satellite Broadcasts), DBS must pay royalties on its revenues from the provision of broadcast services. For 2011, DBS paid approximately NIS 17.4 million in royalties and for 2012, it paid a total of approximately NIS 17 million in royalties. The rate of royalties in both of these years averaged 1.75% of the applicable revenues).

#### Transmission fees

DBS is required to allow the producers of channels identified in Communications Law to use its infrastructures to transmit broadcasts to its subscribers in exchange for payment, or a transmission fee, to be determined in their agreement with DBS, and in the absence of an agreement, in exchange for a payment to be determined by the Minister of Communications, after consulting with the Council.

In accordance with an amendment to the Communications Law in 2010, the dedicated channels are exempt from payment of transmission fees to HOT and DBS. DBS filed a claim with the High Court of Justice against the validity and applicability of this amendment in 2010. This claim is still pending.

#### Wiring in subscribers' homes

In October 2012, the Ministry of Communications announced that it was canceling the administrative order which applied until that time that regulated the movement of subscribers between DBS and HOT. This announcement was made subsequent to a request by DBS and HOT to institute an administrative order that would cancel the obligation to give advance notice of connecting a subscriber to another service provider. In January 2013, DBS and HOT applied to the Ministry of Communications to amend its decision, so that the administrative instruction would not be cancelled (as ordered), but would be amended to cancel the advance notice requirement.



### Service bundles

According to its broadcasting license, DBS may offer joint service bundles that include services provided by Bezeq and services by DBS, subject to obtaining Ministry of Communications approval (and if no objections are raised within the period specified in the license, such approval will be deemed granted) and subject to conditions, the most important of which are the "unbundling" obligation, and whether a corresponding bundle is marketed by a licensee that is unrelated to Bezeq. The joint service bundle with Bezeq includes infrastructure service for Bezeq's Internet only, does not require Ministry of Communications approval and the unbundling obligation does not apply to it.

In October 2012, the Antitrust Authority informed DBS that in its opinion, cooperation between DBS and Bezeq which markets the joint service bundle, constitutes cooperation between (potential) competitors in this area of competition, which might be construed as a restrictive agreement and requires approval under the Antitrust Law (even if it complies with the conditions of the broadcasting license), and that the Commissioner does not intend to grant an exemption from the need for approval of the arrangement.

DBS believes that in view of the development of competition between the communications groups and the growing importance of the supply of comprehensive communications services, as long as the restrictions in relation to Bezeq's control of DBS with respect to Bezeq's cooperation with it remain in place, the negative impact of these limitations on DBS's results may increase.

### Regulation of the transmission of video content via media infrastructures

In 2011, the recommendations of the joint Ministry of Communications and Council task force were submitted to the Minister of Communications. The task force was appointed to review the question of regulating broadcasts on new technologies and platforms, with respect to the method and process of prescribing regulations for semi-TV broadcasts (audio-visual content) over the Internet. The primary recommendation is to shift from regulation based on transmission and recording methods to regulation based on output, so that Internet-TV broadcasts should have the same features as the broadcasts currently offered by the broadcasting entities (the criteria for determining these features were included in the task force recommendations and are subject to regulation by the Council and any other relevant regulating entity). It was also recommended that a follow-up team be established, involving all the relevant entities, including the Ministry of Communications, the Council, the Israel Broadcasting Authority and the Second Authority, for the purpose of reviewing and adapting the regulations currently applicable to the present realm of broadcasting to the developing realm of broadcasting, in an effort to create a standard, comprehensive set of regulations for both the existing and new realm of broadcasts (including a recommendation on appropriate legislative amendments). The task force noted that it must continue to take into account possible changes in the distribution of revenues between the broadcasting entities and the new entities and the expansion of the range of broadcasting entities that will be subject to the new regulations. The task force also recommended that if the new broadcasting entities continue to replace the regulated broadcasting entities (the task force found that the replacement rate is still low), which will have a negative economic impact on the regulated broadcasting entities even before the recommended regulations are adopted, the regulating entities should work for the adoption of urgent, temporary regulations to include temporary relief for the supervised entities and/or impose obligations tailored to the web-based broadcasting entities. As of the date of this annual report, the Minister of Communications has yet to make a decision regarding these recommendations.

DBS believes that its VOD services are not subject to the regulations that currently apply to multi-channel TV broadcasts and as far as it is aware, this is the position of the Ministry of Communications. Nevertheless, implementation of the recommendations of the joint Ministry of Communications and Council task force may have repercussions for regulating VOD services provided by DBS. It may also affect the development of the transfer of video content over the Internet.

## Suppliers

DBS purchases decoders from two suppliers. The main agreement for the purchase of decoders (including the PVR decoders) is a framework agreement from August 2000, as amended from time to time, between it and Advanced Digital Broadcast S.A., or ADB, and Eurocom Digital Communication Ltd., or Eurocom Digital Communication, which is controlled by Mr. Shaul Elovitch, a controlling shareholder of Bezeq, who is also a controlling shareholder of DBS. Under this agreement, decoders are purchased from Eurocom Digital Communication, which imports them from ADB and provides the warranty for the decoders which ADB undertook to issue under the agreement. In 2012, DBS purchased from Eurocom Digital Communication HDPVR decoders in the total amount of NIS 89 million and purchased HD Zapper decoders from Pace Micro Technology PLC in the total amount of NIS 19 million. DBS may become dependent upon these suppliers.

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DBS purchases services for the operating systems of its broadcast and encryption setup from NDS Ltd., or NDS, as well as hardware for these services. DBS is dependent on the regular supply of these services and products, including integration in connection with the various types of decoders it uses for the operating systems for which NDS provides services. Under the terms of the agreement with NDS, NDS supplies development, licensing, supply, training, assimilation and maintenance services for encryption, broadcasting and ancillary software and equipment required for DBS's broadcasts and services. NDS has undertaken to adapt the equipment and services it supplies to the various decoders and systems purchased by DBS and also to supply a warranty for its products and also support services. DBS makes one-time payments and periodic payments for the services and products of NDS. These payments are based primarily on the number of decoders it uses and the number of its active subscribers. The agreement with NDS expires at the end of May 2015.

#### Computerized billing system

DBS uses computer software and systems to manage agreements with its subscribers, including its billing and collection system. In this context, DBS entered into a set of agreements with Netcracker Technology Solutions Ltd., or Netcracker, in which Netcracker provided DBS with a non-exclusive license to use the system and Netcracker undertook to provide DBS with maintenance services as specified in the agreement. DBS is dependent on Netcracker's systems and services, due to their importance for billing its subscribers. Malfunctions of the system or a suspension of DBS's services would likely cause operational difficulties until they can be repaired or the system or supplier is replaced. In 2012, DBS paid Netcracker NIS 12 million.

#### Space segment lease agreements

DBS and Spacecom Communications Ltd., or Spacecom, have entered into a number of agreements under which DBS uses space segments from the Amos 2 and Amos 3 satellites. Pursuant to these agreements, the term of use of these space segments is through the earlier of April 2016 or the end of life of AMOS 2. The lease fees in 2012 amounted to approximately NIS 93 million. The consideration depends on the number of segments DBS utilizes.

According to the agreement, DBS must use 13 space segments, however, DBS may temporarily suspend the use of one segment, where each party is entitled to cause a resumption of the use of such segment once a year. DBS is currently using 12 space segments (ten on Amos 2 and two on Amos 3). To date, DBS has not begun to use the 13th segment due to the negotiations between the parties regarding the continuation of the agreement. Under the agreement, if the supplied capacity becomes unusable, Spacecom will make every effort to provide alternative capacity, and if Spacecom is not able to do so, it will attempt to provide such services through a satellite belonging to another operator. A mechanism was set up for partial backup on Amos 3 in the event of non-availability of space segments on Amos 2. Additionally, Spacecom undertook to make every reasonable effort to provide back up on Amos 2 in the event of non-availability of both space segments used by DBS on Amos 3.

In March 2013, DBS approved an amendment to the agreement with Spacecom, extending the leases for space segments on the Amos 2, Amos 3 and Amos 6 satellites or another satellite to be agreed between the parties, until the end of 2028 for an aggregate consideration of approximately \$227 million for the entire period. The agreement is subject to the approval of the competent bodies in Spacecom and the approval of DBS's shareholders in their next general meeting.

DBS is materially dependent on Spacecom, as the exclusive holder of the rights and the sole provider of space segments used by DBS. The number of channels DBS is capable of broadcasting to its subscribers depends on the number of space segments it is using, its compression capability and the bandwidth required for the transmission of all types of channels. An increase in the number of channels DBS broadcasts, particularly an increase in the number of HD channels (which require greater bandwidth) would require additional space segments or an improvement in the

compression systems it uses.

#### Property

DBS's central broadcasting center is located in Kfar Saba, Israel. The secondary broadcasting center is operated by a third party which makes available to DBS its services for operating and maintaining the secondary broadcasting center in accordance with an agreement which is valid until the end of 2018 (with an extension option available to DBS). Its two broadcasting centers contain reception and transmission equipment and also include computer and communication systems.

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DBS leases a number of real estate assets which serve as its offices, broadcast centers, logistics center and employee recruitment centers. Its principal offices and its central broadcast center are located on leased land in Kfar Saba. The lease periods for the Kfar Saba sites expire in 2019, while the balance of the lease periods for the remaining properties leased by DBS vary from a few months to approximately six (6) years (these periods are based on the assumption that DBS will exercise its extension options for these leases).

## Employees

The table below provides data with respect to the number of DBS employees at December 31, 2011 and 2012:

Department	Number of Employees	
	2011	2012
Marketing Department	34	38
Customer Service	1,467	1,462
Content Department	70	74
Engineering Department	102	101
Finance and Operations Department	114	118
Human Resources Department	50	52
Regulation and Legal Management Department	6	4
Information Systems Department	138	100
Management and Spokesperson	7	15
Sales	284	263
Total	2,276	2,227

DBS employees are employed under personal employment agreements, on the basis of a monthly salary or an hourly wage, with some of the employees also entitled to performance-based compensation. The employment agreements are generally for an undefined period, and each party may terminate the agreement by prior notice in accordance with the agreement or the law. DBS employs personnel in some of its departments on the weekly day of rest and on days of rest prescribed by the State, and it has an appropriate permit for such employment.

## C. Organizational Structure

Eurocom Communications, our controlling shareholder, is the beneficial owner of 78.97% of our ordinary shares (15,164,929 ordinary shares) as of April 22, 2013. Mr. Shaul Elovitch, our chairman and the chairman of the board of directors of Eurocom Holdings (1979) Ltd., or Eurocom Holdings, holds 80% of Eurocom Holdings' shares and 75% of Eurocom Holdings' management shares, and Mr. Yossef Elovitch, his brother and our director, holds 20% of Eurocom Holdings' shares and 25% of Eurocom Holdings' management shares. Eurocom Communications is 50.33% owned by Eurocom Holdings and 49.0% of its shares are held by four holding companies, which are 80% owned by Mr. Shaul Elovitch and 20% owned by Mr. Yossef Elovitch. The remaining 0.67% interest in Eurocom Communications is directly owned by Mr. Shaul Elovitch. Accordingly, Mr. Shaul Elovitch may be deemed to have the sole voting and dispositive power over our ordinary shares held by Eurocom Communications. Mr. Shaul Elovitch may also be deemed to be the beneficial owner of 26,893 ordinary shares held of record by his wife, Mrs. Iris Elovitch. In addition 10,650 shares are held by other family members of Mr. Shaul Elovitch.

Eurocom Communications' other principal controlled holdings are: Eurocom Cellular Communications Ltd., the representative of Nokia mobile phones in Israel; Eurocom Industries (1986) Ltd., a holding company that owns Eurocom Digital Communications Ltd., or Eurocom Digital, which markets electronic office equipment and consumer

electronic products; Trans-Global Industries PTE Ltd., a provider of customized networking solutions to businesses based on telephone network equipment and home digital telephones; Satcom Systems Ltd., a global provider of satellite broadband communications services and Gilat Satcom Ltd., a fully owned subsidiary of Satcom Systems Ltd., which specializes in providing fixed and mobile communication services via satellite; Space-Communication Ltd., the owner and operator communication satellites; Satlink Communication Ltd., a satellites serviced provider; E,G,R,E Ltd. Eitag Ltd. and Eurocom Real Estate Ltd., a real estate companies; Enlight Renewable Energy Ltd. which specializes in initiating, developing, constructing and operating clean electricity production projects from renewable energy sources.

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We operate through our 79.94% ownership interest in B Communications, which is the controlling shareholder of Bezeq, Israel's largest telecommunications provider. B Communications and its wholly-owned subsidiaries own 30.97% of Bezeq's outstanding shares.

D. Property, Plants and Equipment

Our corporate headquarters are located in a 30 square meter facility in Ramat Gan, Israel, which we lease from Eurocom Communications at a token rent. The lease is for a three-year period ending June 2014, which may be extended each year for an additional one year period on the mutual consent of the parties.

ITEM 4A. UNRESOLVED STAFF COMMENTS

Not applicable.

ITEM 5. OPERATING AND FINANCIAL REVIEW AND PROSPECTS

A. Operating Results

The following discussion of our results of operations should be read together with our audited consolidated financial statements and the related notes, which appear elsewhere in this annual report. The following discussion contains forward-looking statements that reflect our current plans, estimates and beliefs and involve risks and uncertainties. Our actual results may differ materially from those discussed in the forward-looking statements. Factors that could cause or contribute to such differences include those discussed below and elsewhere in this annual report.

Adoption of IFRS

Effective as of January 1, 2009, we adopted IFRS as issued by the IASB, replacing the previous reporting standard which was U.S. GAAP. Accordingly, beginning January 1, 2009, we prepare our consolidated financial data according to IFRS as issued by the IASB. Our transition date to IFRS under First Time Adoption of International Financial Reporting Standards was January 1, 2008.

Acquisition of Controlling Interest in Bezeq

On April 14, 2010, B Communications completed the acquisition of 30.44% of the outstanding shares of Bezeq, Israel's largest telecommunications provider, for approximately NIS 6.5 billion. We began consolidating Bezeq's financial results into our financial statements effective as of the closing of the acquisition and began to report the consolidated results in our 2010 second quarter earnings release.

To facilitate the funding of our acquisition of the controlling interest in Bezeq, B Communications entered into a series of long-term and short-term loans. See Item 5B "Operating and Financial Review and Prospects - Liquidity and Capital Resources."

Overview

Bezeq is the leading provider of communications services in Israel, providing a broad range of telecommunications operations and services, including domestic fixed-line, cellular and international communication services, multi-channel television, satellite broadcasts, Internet services, customer call centers, maintenance and development of communications infrastructures, provision of communications services to other communications providers, television and radio broadcasts, and supply and maintenance of equipment on customer premises, which is referred to

as network end point, or NEP services.

Bezeq's management evaluates Bezeq's performance through focusing on key performance indicators, which include among others: number of subscribers, churn rate, ARPU and operating income and net income. These key performance indicators are primarily affected by the competitive and regulatory landscape in which Bezeq operates and its ability to adapt to the challenges it faces.

#### How Bezeq Generates Revenue

Bezeq has four principal operating segments: (i) fixed-line domestic communications; (ii) cellular; (iii) international communications, Internet and NEP services; and (iv) multi-channel television (DBS). Effective August 21, 2009, Bezeq no longer consolidates the results of DBS in its financial statements and its investment in DBS is accounted for under the equity method. In addition to the four principal segments, Bezeq has other areas of operation that are not material to its consolidated operations and they are aggregated in the financial statements as "Other."

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Revenue from Bezeq's fixed-line domestic communications segment is derived primarily from fees received for (i) its telephony services, including mainly the basic telephony service on the domestic telephone line, plus associated services such as voice mail, caller ID, call waiting, call forwarding, speed dial, conference calls, public telephones and a unified telephone directory; (ii) inter Internet access infrastructure services in xDSL technology; (iii) data communication services, including network services for transferring data from point to point, transferring data between computers and between various communications networks, services connecting communications networks to the Internet and remote access services; and (iv) other services including, services to communications operators, broadcasting services, contract work, IP Centrex services, data center services, a search engine for finding phone numbers (including a classified search) and new services.

Revenue from the Pelephone cellular segment is derived primarily from fees received from its service offerings, including, voice transmission, transmission of text messages, roaming, data communications and advanced multimedia services. Pelephone also sells cellular phones and devices, modems and laptop computers and offers repair services.

Bezeq International's revenues are primarily derived from Internet access services for private and business customers, including terminal equipment and support, voice services including, international direct dialing services to business and private customers and international call routing and termination services, hosting services, supply of international data communication solutions for business customers and ICT solutions for business customers and PBX services.

DBS's revenues are primarily derived from the sale of subscriptions for its multi-channel satellite broadcast services. DBS offers approximately 150 different video channels (of which 20 are pay per view channels and 10 are High Definition channels) and 20 radio channels, 30 music channels and interactive services. Revenue from subscriptions is recognized ratably over the contract period, which is generally one to 12 months. As of August 21, 2009, the value of Bezeq's investment in DBS was estimated by an independent assessor to be approximately NIS 1.145 to 1.234 billion and Bezeq estimated its investment at NIS 1.175 billion.

Bezeq also includes a category of "Other" in its consolidated financial statements, which mainly includes customer call center services through its Bezeq Online Ltd. subsidiary, investments in a venture capital fund and ownership of Walla!, a popular Israeli provider of Internet and portal services.

#### Significant Costs and Expenses

**Depreciation and Amortization.** Subsequent to B Communications' acquisition of the controlling interest in Bezeq, we adopted Bezeq's policies regarding the depreciation and amortization expenses related to its communications business network equipment and capacity. Depreciation and amortization expenses primarily consist of depreciation on computer equipment, software, leasehold improvements, capitalized software development costs and amortization of purchased intangibles.

**Salaries.** Salaries include salary costs, social, statutory and employment benefits, and commissions of all our employees. Bezeq's consolidated salary expenses primarily consist of operating and general and administrative salaries, benefits, stock-based compensation and incentive compensation.

**General and Operating Expenses.** Bezeq's consolidated general and operating expenses primarily consist of cellular telephone expenses, general expenses including outside consulting, legal and accounting services, materials and spare parts, building maintenance, services and maintenance by sub-contractors, international communication expenses, vehicle maintenance expenses, royalties paid to the State of Israel and collection fees.

Other operating expenses. Other operating expenses primarily include provision for severance pay on early retirement, capital gains from the sale of property, plant and equipment, provisions for contingent liabilities and loss from copper forward contracts.

Finance Expense. Our finance expense includes exchange rate differences arising from changes in the value of monetary assets and monetary liabilities stated in currencies other than the NIS, as well as interest charged on loans from banks. We also incurred interest expense attributable to our debentures and the debentures of B Communications. Our finance expense also includes interest expense attributable to the loans B Communications incurred to facilitate the funding of its acquisition of the controlling interest in Bezeq. Bezeq's financing expenses primarily consist of interest expenses for its financial liabilities, linkage and exchange rate differences, changes in fair value of financial assets measured at fair value through profit or loss, financing expenses for employee benefits and other financing expenses.

Income Tax. Income tax expense is comprised of current and deferred tax. Bezeq recognizes current and deferred tax expense in profit or loss except to the extent that it relates to items recognized directly in equity or in other comprehensive income. Current tax is the expected tax payable on the taxable income for the year, using tax rates enacted or substantively enacted at the reporting date, and any adjustment to tax payable in respect of previous years. Our assessment considers that deferred tax is recognized using the statements of financial position method, providing for temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for taxation purposes. under our assessment deferred tax is measured at the tax rates that are expected to be applied to temporary differences when they reverse, based on the laws that have been enacted or substantively enacted by the reporting date. Deferred tax assets and liabilities are offset if there is a legally enforceable right to offset current tax liabilities and assets, and they relate to income taxes levied by the same tax authority on the same taxable entity, or on different tax entities, but they intend to settle current tax liabilities and assets on a net basis or their tax assets and liabilities will be realized simultaneously. A deferred tax asset is recognized to the extent that it is probable that future taxable profits will be available against which the temporary difference can be utilized. Deferred tax assets are reviewed at each reporting date and are reduced to the extent that it is no longer probable that the related tax benefit will be realized.

The applicable Israeli company income tax rate for 2010 was 25% and it decreased to 24% in 2011. At the end of 2011 the Knesset passed an amendment to the Income Tax Ordinance pursuant to which the 2010 corporate tax rate of 25% was reinstated for an indefinite period, commencing on January 1, 2012.

## Results of Operations

The following table sets forth our results of operations in NIS in millions and as a percentage of revenues for the three years ended December 31, 2012 (IFRS):

	Year ended December 31,		2011		2012					
	2010		2011		2012		2012			
	NIS	%	NIS	%	NIS	%	NIS	%		
Revenues	8,732	100	11,376	100	10,278	100				
Depreciation and amortization	2,295	26.3	2,984	26.2	2,367	23.0				
Salaries	1,500	17.2	2,122	18.7	1,986	19.3				
General and operating expenses	3,711	42.5	4,468	39.3	3,997	38.9				
Other operating expenses	(3 )	(0.1 )%	323	2.8	(1 )	-				
Operating income	1,229	14.1	1,479	13.0	1,929	18.8				
Finance expense	716	8.2	1,077	9.5	995	9.7				
Finance income	(327 )	(3.7 )%	(497 )	(4.4 )%	(582 )	(5.6 )%				
Income after financing expenses (income), net	840	9.6	899	7.9	1,516	14.8				
Share of losses in equity-accounted investee	235	2.7	216	1.9	245	2.4				
Income before income tax	605	6.9	683	6.0	1,271	12.4				
Income tax	385	4.4	653	5.7	555	5.4				
Income for the year	220	2.5	30	0.3	716	7.0				
Income (loss) attributable to owners of the Company	(209 )	(2.4 )%	(266 )	(2.3 )%	(38 )	(0.4 )%				
Income attributable to non-controlling interest	429	4.9	296	2.6	754	7.4				
Income for the year	220	2.5	30	0.3	716	7.0				
Basic earnings (loss) per share	(11.11 )		(13.56 )		(1.97 )					
Diluted earnings (loss) per share	(11.23 )		(13.60 )		(2.01 )					

The following three tables provide summary financial information regarding the operating results of the individual operating segments of the Bezeq Group and on a consolidated basis for the three years ended December 31, 2012.

As a result of the Bezeq acquisition, we assigned fair value to the assets acquired and liabilities assumed using the acquisition method. Adjustments to record the allocation of the consideration paid for assets acquired and liabilities assumed for Bezeq have not been reflected in the separate reporting of the segments because they are not being reviewed by our Chief Operating Decision Maker in order to make decisions about resources to be allocated to the

segments and assess their performance. Accordingly, the purchase accounting adjustments are presented under the “adjustments” column.

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Year ended December 31, 2012

	Domestic fixed-line communications NIS	Cellular communications NIS	International communications and Internet services NIS	Multi-channel television NIS	Others NIS	Adjustments NIS	Consolidated NIS	Convenience translation into U.S. dollars (Note 2D) US\$
Revenue from external entities	4,339	4,371	1,286	1,636	256	(1,636 )	10,252	2,746
Inter-segment revenues	291	97	54	-	36	(452 )	26	7
Total revenue	4,630	4,468	1,340	1,636	292	(2,088 )	10,278	2,753
Depreciation and amortization	730	531	136	248	25	697	2,367	634
Segment results - operating income	1,923	892	219	253	(13 )	(1,345 )	1,929	517
Finance income	312	146	10	2	-	112	582	156
Finance expenses	(579 )	(101 )	(18 )	(563 )	(7 )	273	(995 )	(266 )
Total finance income (expense), net	(267 )	45	(8 )	(561 )	(7 )	385	(413 )	(110 )
Segment profit (loss) after finance expenses, net	1,656	937	211	(308 )	(20 )	(960 )	1,516	407
Share in losses of equity-accounted investee	-	-	1	-	-	(246 )	(245 )	(66 )
Segment profit (loss) before income tax	1,656	937	212	(308 )	(20 )	(1,206 )	1,271	341
Income tax	462	239	52	2	(3 )	(197 )	555	149
Segment results - net profit (loss)	1,194	698	160	(310 )	(17 )	(1,009 )	716	192
Additional information:								
Segment assets	8,096	4,704	1,251	1,387	288	3,237	18,963	5,080
Goodwill	-	-	6	-	87	2,743	2,836	760
Investment in equity-accounted investee	-	-	2	-	-	1,003	1,005	269
Segment liabilities	11,690	1,735	436	5,349	258	(143 )	19,319	5,175
Investments in property, plant and equipment and intangible assets	945	397	169	324	32	(324 )	1,543	413



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Year ended December 31, 2011

	Domestic fixed-line communications NIS	Cellular communications NIS	International communications and Internet services NIS	Multi-channel television NIS	Others NIS	Adjustments NIS	Consolidated NIS
Revenue from external entities	4,371	5,454	1,288	1,619	236	(1,616 )	11,352
Inter-segment revenues	277	94	66	-	41	(454 )	24
Total revenue	4,648	5,548	1,354	1,619	277	(2,070 )	11,376
Depreciation and amortization	688	561	109	276	21	1,329	2,984
Segment results - operating income	1,695	1,360	241	295	3	(2,115 )	1,479
Finance income	304	105	9	23	-	56	497
Finance expenses	(531 )	(67 )	(11 )	(547 )	(5 )	84	(1,077 )
Total finance income (expense), net	(227 )	38	(2 )	(524 )	(5 )	140	(580 )
Segment profit (loss) after finance expenses, net	1,468	1,398	239	(229 )	(2 )	(1,975 )	899
Share in losses of equity-accounted investee	-	-	1	-	-	(217 )	(216 )
Segment profit (loss) before income tax	1,468	1,398	240	(229 )	(2 )	(2,192 )	683
Income tax	366	342	58	1	4	(118 )	653
Segment results - net profit (loss)	1,102	1,056	182	(230 )	(6 )	(2,074 )	30
Additional information:							
Segment assets	9,202	5,404	1,260	1,282	314	3,902	21,364
Goodwill	-	-	6	-	144	2,743	2,836
Investment in equity-accounted investee	-	-	2	-	-	1,057	1,059
Segment liabilities	13,529	2,255	439	4,932	272	(409 )	21,018
Investments in property, plant and equipment and intangible assets	1,174	442	285	-	38	-	1,939





	Year ended December 31, 2010						
	Domestic fixed-line communications NIS	Cellular communications NIS	International communications and Internet services NIS	Multi-channel television NIS	Others NIS	Adjustments NIS	Consolidated NIS
Revenue from external entities	3,581	3,957	949	1,187	162	(1,112 )	8,724
Inter-segment revenues	195	186	38	5	26	(442 )	8
Total revenue	3,776	4,143	987	1,192	188	(1,554 )	8,732
Depreciation and amortization	496	431	68	221	14	1,065	2,295
Segment results - operating income	1,486	1,015	248	119	13	(1,652 )	1,229
Finance income	140	67	5	-	-	115	327
Finance expenses	(229 )	(101 )	(9 )	(424 )	(3 )	50	(716 )
Total finance income (expense), net	(89 )	(34 )	(4 )	(424 )	(3 )	165	(389 )
Segment profit (loss) after finance expenses, net	1,397	981	244	(305 )	10	(1,487 )	840
Share in losses of equity-accounted investee	-	-	5	-	-	(240 )	(235 )
Segment profit (loss) before income tax	1,397	981	249	(305 )	10	(1,727 )	605
Income tax	379	241	47	1	4	(287 )	385
Segment results - net profit (loss)	1,018	740	202	(306 )	6	(1,440 )	220

Year Ended December 31, 2012 Compared with Year Ended December 31, 2011

Revenues. Our revenues decreased by 9.7% to NIS 10.3 billion (approximately \$2.8 billion) for the year ended December 31, 2012 from NIS 11.4 billion for the year ended December 31, 2011. For both the current and the prior-year periods, our consolidated revenues consisted almost entirely of Bezeq's consolidated revenues. The decrease in revenues in 2012 was primarily due to the reduction in cellular communications segment revenues.

Bezeq's domestic fixed-line communications segment revenues in 2012 amounted to NIS 4.6 billion (approximately \$1.2 billion) compared with NIS 4.6 billion in 2011, a decrease of 0.4%. The decrease in the segment's revenues was primarily due to a decrease in revenues from telephony, primarily due to decreases in the number of subscribers, revenue per telephone line and from interconnect fees to the cellular networks. The decrease in revenues was partially offset by an increase in revenues from high-speed internet services, mainly the result of an increase in the number of internet subscribers and in revenue per subscriber as a result of surfing speed upgrades, as well as an increase in revenues from data communications.

Pelephone's revenues in 2012 amounted to NIS 4.5 billion (approximately \$1.2 billion) compared with NIS 5.5 billion in 2011, a decrease of 19.5%. The decrease is primarily attributable to the significant intensification in competition in the Israeli cellular market. Revenues from services in 2012 amounted to approximately NIS 3.3 billion (approximately \$874 million) compared to NIS 3.6 billion in the prior year, a decrease of 10.3%. The decrease in services revenues is attributable to a decrease in tariffs as a result of the intensified competition and the transition to unlimited packages that led to a decrease in ARPU, as well as a decrease in the number of relatively high-usage subscribers. The decrease in revenues was partially offset by revenues from cellular operators who utilize the segment's network. Revenues from the sale of terminal equipment in 2012 amounted to approximately NIS 1.2 billion (approximately \$323 million), compared to NIS 1.9 billion in 2011, a decrease of 36.8%. The decrease is primarily due to a decrease of terminal equipment sales as the terminal equipment market was opened to imports and numerous stores selling terminal equipment opened for business.

Bezeq International's revenues in 2012 amounted to NIS 1.3 billion (approximately \$359 million) compared with NIS 1.35 billion in 2011, a decrease of 1.0%. The decrease in revenues is primarily due to a decrease in the revenues from outgoing and incoming calls. This decrease is due to a transition in the cellular market to packages that include unlimited international calls and to a decrease in sales of exchanges (PBX), offset by an increase in Internet revenues as a result of an increase in the number of customers and growth in sales of business communication solutions (ICT).

Depreciation and Amortization. We recorded depreciation and amortization expenses of NIS 2.4 billion (approximately \$634 million) for the year ended December 31, 2012 compared to NIS 3.0 billion for the year ended December 31, 2011, a decrease of approximately 20.7%. The decrease was primarily due to the decrease in depreciation and amortization of B Communications arising from its purchase price allocation relating to the Bezeq transaction that resulted primarily from the end of depreciation of fully depreciated property, plant and equipment. B Communications' depreciation and amortization with respect to the purchase price allocation relating to the Bezeq transaction for the years ended December 31, 2012 and 2011 was NIS 931 million (approximately \$249 million) and NIS 1.5 billion, respectively.

Bezeq recorded consolidated depreciation and amortization expenses of NIS 1.4 billion (approximately \$385 million) for the year ended December 31, 2012 compared to NIS 1.4 billion for the year ended December 31, 2011, an increase of approximately 2.9%. The increase is mainly attributable to the domestic fixed-line communications and the international communications, Internet and NEP segments.

Bezeq's depreciation and amortization expenses in the fixed-line domestic communications segment amounted to NIS 730 million (approximately \$196 million) in 2012 compared with NIS 688 million in 2011, reflecting an increase of

6.1%. The increase was primarily due to depreciation of the old network that was taken out of service and depreciation of new investments in the NGN project. The increase was partially offset by the end of depreciation of fully depreciated other property, plant and equipment.

Pelephone's depreciation and amortization expenses in 2012 amounted to NIS 531 million (approximately \$142 million) compared to NIS 561 million in 2011, a decrease of 5.4%. The decrease resulted mainly from the termination of the capitalization of subscriber acquisition costs.

Bezeq International's depreciation and amortization expenses in 2012 amounted to NIS 136 million (approximately \$36 million) compared with NIS 109 million in 2011, an increase of 24.8%. The increase is attributable to the activation of the submarine communications cable and the initiation of depreciation in the beginning of 2012.

Salaries. Salaries decreased by 6.4% to NIS 2 billion (approximately \$532 million) for the year ended December 31, 2012 from NIS 2.1 billion for the year ended December 31, 2011, due to the decrease in salary expenses in the cellular and domestic fixed-line communications segments.

Bezeq's fixed-line domestic communications segment salary expenses decreased by 4.3% to NIS 1.0 billion (approximately \$279 million) for the year ended December 31, 2012 from NIS 1.1 billion for the year ended December 31, 2011. The decrease in salary expenses was primarily due to a decrease in share-based payments and employee retirement expenses, and was partially offset by an increase in wages, new employees and a decrease in capitalized salary expense.

Pelephone's salary expenses in 2012 amounted to NIS 491 million (approximately \$132 million) compared with NIS 602 million in 2011, a decrease of 18.4%. The decrease in salary expenses is primarily attributable to a decrease in the number of employees.

Bezeq International's salary expenses in 2012 amounted to NIS 278 million (approximately \$74 million) compared with NIS 265 million in 2011, an increase of 4.9%. The increase is primarily attributable to an increase in the number of outsourced employees in ICT activities, along with termination of the capitalization of subscriber acquisition costs.

General and Operating Expenses. Our general and operating expenses decreased by 10.5% to NIS 4 billion (approximately \$1 billion) for the year ended December 31, 2012 from NIS 4.5 billion for the year ended December 31, 2011 primarily due to the decrease in the cost of selling terminal equipment in the cellular segment.

Bezeq's consolidated general and operating expenses amounted to NIS 4 billion (approximately \$1 billion) in the year ended December 31, 2012 compared to NIS 4.5 billion in the year ended December 31, 2011, a decrease of 12.0%.

Bezeq's fixed-line domestic communications segment general and operating expenses in 2012 amounted to NIS 1.0 billion (approximately \$277 million) compared with NIS 1.1 billion in 2011, a decrease of 3.8%. The decrease is mainly attributable to the decrease in interconnect expenses to the cellular networks with a corresponding decrease in revenues from interconnect fees. The decrease was partially offset by an increase in expenses for terminal equipment and materials.

Pelephone's general and operating expenses in 2012 amounted to NIS 2.6 billion (approximately \$684 million) compared to NIS 3.0 billion in 2011, a decrease of 15.6%. The decrease is primarily attributable to a decrease in the costs of selling terminal equipment, mostly the result of a decrease in the number of handsets sold. The decrease was partially offset by an increase in the prices of the handsets and a decrease in content expenses along with a decrease in revenues from content.

Bezeq International's general and operating expenses in 2012 amounted to NIS 708 million (approximately \$190 million) compared with NIS 739 million in 2011, a decrease of 4.2%. The decrease is primarily attributable to a decrease in costs related to outgoing and incoming calls to PBX equipment, with a corresponding decrease in revenues, as well as from more efficient maintenance of international cables subsequent to the deployment of the submarine communications cable.

Other Operating Income (Expenses), net. We had other operating income, net of NIS 1 million (approximately \$0.3 million) in the year ended December 31, 2012 compared to other operating expenses, net of NIS 323 million in the year ended December 31, 2011. The transition from expenses to income is primarily attributable to a provision for severance pay with respect to employee early retirement of NIS 32 million (approximately \$9 million) in 2012 compared with NIS 369 million in 2011. Other operating income, net in 2012 was partially offset by the recognition of a loss of approximately NIS 54 million (approximately \$14 million) resulting from the termination of a CRM project.

Finance Expenses, net. Finance expense, net decreased by 28.8% to NIS 413 million (approximately \$110 million) for the year ended December 31, 2012 from NIS 580 million for the year ended December 31, 2011. The decrease is primarily attributable to lower interest and CPI linkage expenses with respect to the bank loans B Communications incurred to purchase the controlling interest in Bezeq resulting from the decrease in B Communications' debt. In addition higher earnings on our investments in marketable securities, lower inflation and a decrease in the variable interest during 2012 also contributed to the decrease in our finance expenses. The decrease was partially offset by an increase in Bezeq's interest expenses arising from the increase in its debt and additional interest expense incurred by us as a result of our issuance of additional Series C debentures during 2011 and the first quarter of 2012.

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Our finance expenses, net in 2012 amounted to NIS 299 million (approximately \$80 million) compared with NIS 450 million in 2011, a decrease of 33.6%. The decrease is primarily attributable to a decline of NIS 74 million (approximately \$20 million) in interest and CPI linkage expenses in 2012 compared with 2011. These resulted from the decrease of B Communications' debt and lower inflation in 2012. In addition, higher earnings on our and B Communications' investments in marketable securities of NIS 52 million (approximately \$14 million) in 2012 compared with 2011 also contributed to the decrease in our finance expenses. The decrease was partially offset by additional interest expense incurred by us as a result of our issuance of additional Series C debentures during 2011 and the first quarter of 2012.

Bezeq's consolidated finance expenses decreased to NIS 145 million (approximately \$39 million) in the year ended December 31, 2012 from NIS 197 million in the year ended December 31, 2011, a decrease of 17.8%. The decrease is primarily attributable to the sale of its entire holding in Traffix Communication Systems Ltd. at a profit of approximately NIS 74 million in the first quarter of 2012. The decrease was partially offset by an increase in interest expenses with respect to debentures issued during 2011 and bank credit received in the fourth quarter of 2012 and during 2011. There was also a decrease in profit from financial assets held for trading which resulted from the decrease in the balance of cash and cash equivalents.

Income Tax. Income tax expenses decreased by 15% to NIS 555 million (approximately \$149 million) for the year ended December 31, 2012 from NIS 653 million for the year ended December 31, 2011. The decrease is primarily attributable to a onetime adjustment made to the deferred taxes that B Communications allocated with respect to our Bezeq purchase price allocation. This adjustment was required because of changes in the Israeli tax rate that resulted in additional tax expenses in 2011.

Bezeq's income tax expenses in 2012 amounted to NIS 767 million (approximately \$205 million), representing 29.5% of its profit after net finance expenses, compared to income tax expenses of NIS 768 million, representing 26.8% of its profit after net finance expenses in 2011. The increase in tax expenses is primarily attributable to the increase of the domestic fixed-line communications segment's taxable income, which was partially offset by a decrease in profitability in the cellular segment. In addition, the corporate tax rate increased from 24% in 2011 to 25% in 2012.

Loss Attributable to the Owners of our Company. Loss attributable to the owners of our company was NIS 38 million (approximately \$10 million) for the year ended December 31, 2012, compared to a loss of NIS 266 million for the year ended December 31, 2011. The decrease is primarily attributable to B Communications' lower depreciation and amortization expenses with respect to the purchase price allocation relating to the Bezeq transaction and lower income tax expenses recorded in 2012.

Income Attributable to our Non-Controlling Interests. Income attributable to our non-controlling interests was NIS 754 million (approximately \$202 million) for the year ended December 31, 2012 compared to NIS 296 million for the year ended December 31, 2011. The increase in income attributable to our non-controlling interests resulted from B Communications lower depreciation and amortization expenses with respect to the purchase price allocation relating to the Bezeq transaction and lower income tax expenses recorded in 2012. The increase was partially offset by the decrease in Bezeq's net income.

Year Ended December 31, 2011 Compared with Year Ended December 31, 2010

Revenues. Our revenues increased by 30% to NIS 11.4 billion for the year ended December 31, 2011 from NIS 8.7 billion for the year ended December 31, 2010. The increase was primarily due to the consolidation of Bezeq's operations into our financial statements for a full year. Bezeq's consolidated revenues decreased by 5% to NIS 11.4 billion for the year ended December 31, 2011 from NIS 12 billion for the year ended December 31, 2010. The decrease was primarily due to the decrease in the revenues of its domestic fixed-line communications segment.

Bezeq's domestic fixed-line communications segment revenues in 2011 amounted to NIS 4.6 billion compared with NIS 5.3 billion in 2010, a decrease of 11.7%. The decrease in the segment's revenues stemmed mainly from a NIS 560 million decrease in revenue from interconnect fees to the cellular networks (with a corresponding decrease in the expense) due to the lower interconnect fee tariffs that were effective January 1, 2011. There was also a decrease in telephony revenues in 2011, mainly as a result of a decrease in revenue per telephone line. The decrease was moderated by a rise in revenue from high-speed Internet, largely as a result of increased revenue per subscriber against a backdrop of upgraded surfing speeds and an increase in sales of home networks, as well as from a slight increase in the number of Internet subscribers. There was also an increase in revenue from data communications.

Telephone's revenues in 2011 amounted to NIS 5.5 billion compared with NIS 5.7 billion in 2010, a decrease of 3.2%. Revenue from services (including value added services) amounted to NIS 4.6 billion in 2010 compared with NIS 3.6 billion in 2011, an decrease of 20.1%. The decrease in revenue from services was primarily due to lower interconnect fee tariffs and accounted for NIS 809 million of the revenue. In addition, competition intensified in 2011 among the cellular companies, which led to an erosion of tariffs for both new customers and for existing customers as part of the efforts to retain them. This erosion is reflected in a further decrease in ARPU. Revenue from the sale of terminal equipment in 2011 amounted to NIS 1.9 billion, compared with NIS 1.2 billion in 2010, an increase of 61.7%. The increase is primarily due to an increase in the sales and upgrade prices of terminal equipment, and from an increase in the number of sales and upgrades of smartphones.

Bezeq International's revenues in 2011 amounted to NIS 1.35 billion compared with NIS 1.38 billion in 2010, a decrease of 1.9%. The decrease in revenue is primarily due to a decrease in the number of outgoing and incoming minutes throughout the market, a market-wide trend, and a decrease in call transfers between communications carriers worldwide and in sales activity in private exchanges (PBX). Conversely there was an increase in Internet revenues as a result of an increase in the number of customers and from growth in integration activities (IT and communications solutions for businesses).

Depreciation and Amortization. We recorded depreciation and amortization expenses of NIS 3.0 billion for the year ended December 31, 2011 compared to NIS 2.3 billion for the year ended December 31, 2010, an increase of approximately 30.0%. The increase was primarily due to our consolidation of Bezeq's results of operations for a full year. The amortization with respect to the purchase price allocation relating to the Bezeq transaction for the years ended December 31, 2011 and 2010 was NIS 1.6 billion and NIS 1.3 billion, respectively.

Bezeq recorded depreciation and amortization expenses of NIS 1.4 billion for the year ended December 31, 2010 compared to NIS 1.4 billion for the year ended December 31, 2011, a decrease of approximately 1%. The decrease reflected a decrease in depreciation and amortization in the cellular segment.

Bezeq's fixed-line domestic communications segment depreciation and amortization expenses in 2011 amounted to NIS 688 million compared with NIS 690 million in 2010, reflecting an increase in depreciation expenses relating to its investment in the NGN project, offset by a decrease in depreciation and amortization expenses due to the end of depreciation of other property, plant and equipment.

Pelephone's depreciation and amortization expenses in 2011 amounted to NIS 561 million compared to NIS 601 million in 2010, a decrease of 6.7%. In 2011, Pelephone completed its depreciation of certain items of property, plant and equipment, primarily relating to its CDMA network, which was partially offset by an increase in depreciation on new investments.

Bezeq International's depreciation and amortization expenses in 2011 amounted to NIS 109 million compared with NIS 94 million in 2010, an increase of 16%. The increase is attributable to an increase in intangible assets (mainly subscriber acquisition, software and development expenses) and an increase in property, plant and equipment.



Salaries. Salaries increased by 40% to NIS 2.1 billion for the year ended December 31, 2011 from NIS 1.5 billion for the year ended December 31, 2010, due to our consolidation of Bezeq's results of operations for a full year. Bezeq's consolidated salary expenses in 2011 amounted to NIS 2.1 billion compared to NIS 2.0 billion in the prior year, an increase of 3.9%. The increase is attributable to the consolidation of the results of operations of Walla! in the financial statements of the Group for the full year in 2011 and from an increase in the salary expense in the Bezeq's segments.

Bezeq's fixed-line domestic communications segment salary expenses were approximately NIS 1.1 billion in both 2011 and 2010.

Pelephone's salary expenses in 2011 amounted to NIS 602 million compared with NIS 590 million in 2010, an increase of 2%. The increase in salary expenses is primarily attributable to an increase in incentives, an increase on account of temporary employees and a decrease in salary capitalizations on account of subscriber acquisition.

Bezeq International's salary expenses in 2011 amounted to NIS 265 million compared with NIS 248 million in 2010, an increase of 6.9%. Most of the increase is on account of an increase in the number of workers employed in integration activities, along with an increase in revenues from those activities.

General and Operating Expenses. Our general and operating expenses increased by 20% to NIS 4.5 billion for the year ended December 31, 2011 from NIS 3.7 billion for the year ended December 31, 2010 due to our consolidation of Bezeq's results of operations for a full year.

Bezeq's consolidated general and operating expenses amounted to NIS 4.5 billion in the year ended December 31, 2011 compared to NIS 5.0 billion in the year ended December 31, 2010, a decrease of 11.3%. Most of the decrease is attributable to the domestic fixed-line communications segment and the cellular telephony segment, due to a decrease in interconnects fee expenses. The decrease was offset in part by an increase in the cost of the sale of terminal equipment in the cellular segment.

Bezeq's fixed-line domestic communications segment general and operating expenses in 2011 amounted to NIS 1.1 billion compared with NIS 1.6 billion in 2010, a decrease of 33.3%. The decrease is attributable to a decrease in revenue from interconnect fees to the cellular networks (with a corresponding and similar decrease in revenue from interconnect fees from the cellular networks) since the tariffs were lowered. Royalty expenses also increased due to a rise in the rate from 1% in 2010 to 1.75% in 2011. This increase was offset by a decrease in vehicle maintenance expenses.

Pelephone's general and operating expenses in 2011 amounted to NIS 3.0 billion compared to NIS 3.2 billion in 2010, a decrease of 4.2%. The decrease is attributable to a decrease in the cost of services, mainly call completion costs as a result of a NIS 591 million decrease in interconnect fees, which was substantially offset by an increase in the cost of selling terminal equipment, largely due to the rise in terminal equipment prices and an increase in the number of handsets sold and upgraded.

Bezeq International's general and operating expenses in 2011 amounted to NIS 739 million compared with NIS 781 million in 2010, a decrease of 5.4%. The decrease is primarily attributable to the decrease in revenues in this segment.

Other Operating Expenses, net. We had other operating expenses, net of NIS 323 million in the year ended December 31, 2011 compared to other operating income, net of NIS 3 million in the year ended December 31, 2010. The increase in other operating expenses is primarily attributable to the increase in the provision for severance pay with respect to employee early retirement from NIS 36 million in the year ended December 31, 2010 to NIS 361.5 million in the year ended December 31, 2011.

Bezeq's other operating income, net, in 2011 amounted to NIS 139 million compared to a other operating expense of NIS 158 million in 2010. The transition from income to expense is attributable to its NIS 361.5 million provision on account of severance for early retirement in 2011. The increase was offset in part mainly by an increase in capital gains from the sale of copper and profits from forward transactions in copper.

Finance Expense. Finance expense increased by 50% to NIS 1.1 billion for the year ended December 31, 2011 from NIS 716 million for the year ended December 31, 2010. The increase is primarily due to our consolidation of Bezeq's results of operations for a full year and the impact of a full year's financing expenses of NIS 304 million associated with the incurrence of NIS 5.1 billion of bank debt by B Communications in connection with its purchase of the Bezeq controlling interest. In addition, we incurred additional finance expenses of NIS 79 million with respect to our debentures and those of B Communications.

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Bezeq's consolidated finance expenses increased to NIS 599 million in the year ended December 31, 2011 from NIS 391 million in the year ended December 31, 2010, an increase of 53%. The increase is primarily attributable to an increase in the amount of bank credit at fixed and variable shekel interest rates, from finance expenses on account of the revaluation of Bezeq's liability to distribute a special dividend that is not payable out of profits, and from an increase in interest and linkage difference expenses related to debentures issued in 2011. The increase in finance expenses was primarily attributable to an increase in the finance expenses of Bezeq's domestic fixed-line communications segment from NIS 90 million in 2010 to NIS 240 million in 2011 and was partially offset by a decrease in finance expenses in the cellular segment.

**Finance Income.** Finance income increased by 52% to NIS 497 million for the year ended December 31, 2011 from NIS 327 million for the year ended December 31, 2010. The increase was primarily due to our consolidation of Bezeq's results of operations for a full year.

Bezeq's consolidated finance income increased to NIS 402 million in the year ended December 31, 2011 from NIS 282 million in the year ended December 31, 2010, an increase of 43%. The increase in finance income was primarily attributable to income from investments in monetary funds and deposits and interest from shareholder loans to DBS.

**Income Tax.** Income tax expenses increased to NIS 653 million for the year ended December 31, 2011 from NIS 385 million for the year ended December 31, 2010. The increase is primarily attributable to one-time adjustment in the amount of NIS 295 million related to the deferred taxes that we allocated with respect to the Bezeq purchase price allocation. The adjustment was required because of changes in the Israeli tax rate enacted on December 5, 2011, including the cancellation of tax reductions that had been provided in the Economic Efficiency Law, resulting in the increase in the company tax rate in Israel to 25% beginning in 2012.

Bezeq's income tax expenses in 2011 amounted to NIS 768 million, representing 24.9% of its profit after net finance expenses, compared with NIS 932 million in 2010, representing 25.6% of its profit after net finance expenses. The decrease in the percentage of tax after net finance expenses is due to the lower corporate tax (which decreased from 25% in 2010 to 24% in 2011) and from a decrease in the tax expenses in the fourth quarter of 2011, primarily due to the revision of the deferred tax expenses in view of the imminent rise in the tax rate. The decrease was modified by unrecognized expenses, mainly share-based payments and finance expenses on account of a revaluation of the liability to distribute a dividend that does not pass the profit test.

**Loss Attributable to the Owners of our Company.** Loss attributable to the owners of our company was NIS 266 million for the year ended December 31, 2011 compared to a loss of NIS 209 million for the year ended December 31, 2010. The loss is primarily attributable to our consolidation of Bezeq's results of operations for a full year and the onetime tax adjustment mentioned above.

**Income Attributable to our Non-Controlling Interests.** Income attributable to our non-controlling interests was NIS 296 million for the year ended December 31, 2011 compared to NIS 429 million for the year ended December 31, 2011 as a result of our consolidation of Bezeq's results of operations for the full year.

#### Seasonality

Bezeq's consolidated operating results are generally not characterized by a seasonal pattern. In general, Bezeq's revenues from its cellular mobile phone services are slightly higher in the second and third quarters of the fiscal year than the first and fourth quarters due to different usage patterns prevailing in the summer months compared to the winter months and the holiday season in Israel. In general, Bezeq's revenues from international communications, Internet and NEP services are affected in a minor way by the seasons and holidays. For example, voice services for the business sector decrease in August and during the Passover holiday; voice services for the private sector increase in

the summer months and towards the end of the calendar year; sales of Internet services and NEP equipment usually increase in the fourth quarter; and Internet services for the business sector decrease in the summer months due to the closure of educational institutions.

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### Impact of Currency Fluctuations and Inflation

Although the majority of our revenues and expenses are denominated in NIS, we are subject to risks caused by fluctuations in the exchange rate between the NIS and the U.S. dollar.

The following table presents information about the rate of inflation in Israel, the rate of depreciation or appreciation of the NIS against the U.S. dollar, and the rate of inflation in Israel adjusted for the depreciation or appreciation:

Year ended December 31,	Israeli inflation rate %	NIS depreciation (appreciation) rate %	Israeli inflation adjusted for depreciation (appreciation) %
2008	3.8	(1.1)	4.9
2009	3.9	(0.7)	4.6
2010	2.7	(6.0)	8.7
2011	2.2	7.7	(5.5)
2012	1.6	(2.3)	3.9

The depreciation of the NIS in relation to the U.S. dollar has the effect of reducing the U.S. dollar value of any of our expenses or liabilities which are payable in NIS, unless those expenses or payables are linked to the dollar. This depreciation also has the effect of decreasing the U.S. dollar value of any asset which consists of NIS or receivables payable in NIS, unless the receivables are linked to the dollar. Conversely, the appreciation of the NIS in relation to the U.S. dollar has the effect of increasing the dollar value of any unlinked NIS assets and the dollar value of any unlinked NIS liabilities and expenses.

During 2012, the U.S. dollar depreciated against the NIS. A devaluation of the dollar in relation to the NIS has the effect of reducing the NIS value of any of our expenses or liabilities which are payable in dollars, unless those expenses or liabilities are linked to the dollar. This devaluation of the dollar also has the effect of decreasing the NIS value of any asset which consists of dollars or receivables payable in dollars, unless the receivables are linked to the dollar.

From time to time we use derivative financial instruments, such as forward currency contracts to hedge certain of our risks associated with foreign currency fluctuations. These derivative financial instruments are carried at fair value.

Because exchange rates between the NIS and the U.S. dollar fluctuate continuously, exchange rate fluctuations, particularly larger periodic depreciations, may have an impact on our profitability and period-to-period comparisons of our results in U.S. dollars. We cannot assure you that in the future our results of operations may not be materially adversely affected by currency fluctuations. We recommend comparing our results between periods based on our NIS reports.

### Effective Corporate Tax Rate

Israeli companies are generally subject to income tax on their taxable income. The applicable income tax rate for 2012 was 25% an increase from the 24% corporate tax rate in 2011. The 25% corporate tax rate was reinstated for an indefinite period, commencing on January 1, 2012.

As of December 31, 2012, we had tax loss carryforwards in the amount of NIS 230 million (\$62 million) compared to NIS 254 million as of December 31, 2011. Under current Israeli tax laws, tax loss carryforwards do not expire and may be offset against future taxable income.

#### Conditions in Israel

We are incorporated, based in and derive substantially all of our revenues from markets within the State of Israel. See Item 3.D. “Key Information – Risk Factors – Risks Relating to Our Operations in Israel” for a description of governmental, economic, fiscal, monetary or political policies or factors that have materially affected or could materially affect our operations.

#### Trade Relations

Israel is a member of the United Nations, the International Monetary Fund, the International Bank for Reconstruction and Development and the International Finance Corporation. Israel is a member of the World Trade Organization and is a signatory to the General Agreement on Tariffs and Trade, which provides for reciprocal lowering of trade barriers among its members. In addition, Israel has been granted preferences under the Generalized System of Preferences from the United States, Australia, Canada and Japan. These preferences allow Israel to export products covered by such programs either duty-free or at reduced tariffs.

Israel and the European Union Community concluded a Free Trade Agreement in July 1975, which confers certain advantages with respect to Israeli exports to most European countries and obligates Israel to lower its tariffs with respect to imports from these countries over a number of years. In 1985, Israel and the United States entered into an agreement to establish a Free Trade Area. The Free Trade Area has eliminated all tariff and specified non-tariff barriers on most trade between the two countries. On January 1, 1993, an agreement between Israel and the European Free Trade Association, known as EFTA, established a free-trade zone between Israel and the EFTA nations. In November 1995, Israel entered into a new agreement with the European Union, which included a refinement of rules of origin and other improvements, including providing for Israel to become a member of the research and technology programs of the European Union. In recent years, Israel has established commercial and trade relations with a number of other nations, including China, India, Russia, Turkey and other nations in Eastern Europe and Asia.

On May 10, 2010, the Organization for Economic Co-operation and Development, or OECD, invited Israel to become a member of the organization, whose mission is to promote co-operation between its members while keeping high international economic standards. The invitation resulted from the OECD Council's positive assessment of Israel's position with respect to OECD instruments, standards and benchmarks. On June 29, 2010 an accession agreement was signed in Paris, France. This agreement defined the obligations of OECD membership and included Israel specific remarks on acceptance of OECD legal instruments. On September 7, 2010, on signing the OECD Convention, Israel pledged its full dedication to achieving the Organization's fundamental aims. Israel is the 32nd country to join the organization, along with Estonia and Slovenia.

#### B. Liquidity and Capital Resources

Historically we funded our operations principally from cash flows from operations, short-term bank credit, revolving short-term bank loans and the proceeds of the initial public offering of our ordinary shares in August 1999.

In April 2005, we completed an offering of NIS 220 million of convertible debentures and warrants, in Israel, exclusively to Israeli residents. The debentures are to be repaid during the period April 2008 through April 2015, and were traded on the TASE. The interest rate of these debentures is 4% and are convertible into ordinary shares at a conversion price of NIS 50. Due to the significant increase in our share price, NIS 75.9 million of such convertible debentures were converted into 1,518,008 of our ordinary shares during 2010. In January 2008, our Board of Directors authorized the repurchase of up to NIS 112 million of the convertible debentures. In September 2011, we completed an early redemption of 242,561 par value Series A Debentures, together with index-linkage differentials and accrued interest. As a result of the early redemption, our Series A Debentures were delisted from the TASE on September 26, 2011. As of December 31, 2012, an immaterial amount of such convertible debentures were outstanding.

The warrants to purchase up to 2.5 million of our ordinary shares were exercised in full prior to October 15, 2007, their expiration date. Our proceeds from the exercise of such warrants totaled NIS 104 million. The proceeds were used for general corporate purposes including working capital.

In September 2007, we completed an offering of Series B debentures that was made exclusively to Israeli residents. We raised a total of NIS 423 million. The interest rate for the debentures, which are traded on the TASE, is 5%. In November 2008, our Board of Directors authorized the repurchase of up to NIS 100 million of our Series B debentures. The purchases were made from time to time by us or one of our wholly-owned subsidiaries in the open market on the TASE. We repurchased NIS 5,714,370 of the Series B Debentures under the program at a total purchase price of approximately NIS 4.4 million, or an average price of NIS 0.763 per bond.

In December 2009, we issued additional Series B debentures in two private placements to institutional investors in Israel for NIS 400 million. The terms of these additional Series B debentures issued in December 2009 are identical to those of the Series B debentures issued in September 2007. As of December 31, 2012, approximately NIS 366

million (\$98 million) of the Series B Debentures remained outstanding. The Series B Debentures continue to trade on the TASE.

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In 2009 we completed the repurchase of 5,481,859 of our ordinary shares for an aggregate of NIS 140 million, or an average price of NIS 25.3 per share, under two repurchase programs authorized in November 2007 and July 2008. In 2010, our Board of Directors authorized a third repurchase program, for the repurchase of up to an additional NIS 44 million of our ordinary shares in the open market from time to time at prevailing market prices. As of December 31, 2012, we had repurchased 330,756 ordinary shares under the third program at a total purchase price of approximately NIS 30 million (\$8 million), or an average price of NIS 90.7 (\$24.30) per share. No repurchases were made in 2012.

In September 2010, we completed the public offering in Israel of NIS 170 million of our Series C Debentures. The Series C Debentures are payable in four equal annual installments on March 10 of each of the years 2016 through 2019 and pay interest at a fixed annual rate of 4.45%, which is payable semi-annually on March 10 and September 10 of each of the years 2011 through 2019 (the last interest payment is payable on March 10, 2019). The Series C Debentures are NIS denominated and are not linked to the Israeli CPI. The Series C Debentures contain standard terms and conditions and are unsecured, non-convertible and do not restrict our ability to issue any new series of debt instruments or distribute dividends in the future. The Series C Debentures are listed for trading on the TASE. The net proceeds from the public offering, after deduction of arranger's fees, early commitment fees and other expenses and commissions, were approximately NIS 169 million. Midroog Ltd. awarded the newly issued Series C Debentures an A3 stable rating.

In December 2010, we issued additional Series C Debentures in a private placement to certain institutional investors, in a principal amount of NIS 148 million. We issued the additional Series C Debentures in exchange for approximately NIS 125 million principal amount of our outstanding Series B Debentures, reflecting an exchange ratio of 1:1.188. In February 2011, we issued additional Series C Debentures in a private placement to a number of Israeli institutional investors. The offering price was NIS 1.0275 per debenture, which represented a yield of 4.2%. The aggregate proceeds were approximately NIS 133.6 million. In December 2011 and January 2012, we completed private placements of NIS 65 million and NIS 14 million, respectively, of our Series C Debentures. The private placements were offered to a number of Israeli institutional investors pursuant to Regulation S under the Securities Act. The terms of all issued Series C Debentures are identical to the terms of Series C Debentures issued in 2010 and they are listed on the TASE. As of December 31, 2012, approximately NIS 680 million (\$182 million) of Series C Debentures are outstanding.

As of December 31, 2011 and 2012, we had on an unconsolidated basis cash and cash equivalents as well as marketable securities of NIS 343 million and NIS 179 million (approximately \$48 million), respectively.

#### Bezeq's Dividend Distributions

On August 4, 2009, Bezeq's board of directors adopted a dividend distribution policy according to which Bezeq will distribute to its shareholders, semiannually, a dividend at a rate of 100% of its semiannual net income after minority share in accordance with Bezeq's consolidated financial statements. The implementation of the dividend policy is subject to the provisions of applicable law, including the dividend distribution tests set forth in the Israeli Companies Law, as well as the estimate of Bezeq's board of directors regarding Bezeq's ability to meet its existing and anticipated liabilities from time to time. Each dividend distribution is subject to the approval of Bezeq's shareholders, pursuant to Bezeq's articles of association.

Bezeq paid total cash dividends of NIS 3.7 billion, NIS 3.2 billion and NIS 3.1 billion in each of the three years ended December 31, 2012.

On April 8, 2010, Bezeq's shareholders approved the distribution of a dividend of NIS 0.9170679 per share (a total of approximately NIS 2.45 billion) to Bezeq shareholders of record on April 15, 2010, which was paid on May 3, 2010. We received NIS 750 million in connection with such dividend distribution.

On September 12, 2010, Bezeq's shareholders approved the distribution of a dividend of NIS 0.4780459 per share (a total of approximately NIS 1.28 billion) to Bezeq shareholders of record on September 20, 2010 which was paid on October 7, 2010. We received NIS 390 million in connection with such dividend distribution.

On March 31, 2011, Bezeq received an approval from the Tel Aviv District Court for a NIS 3 billion distribution which will be distributed to Bezeq's shareholders in six equal, semi-annual payments during the period 2011-2013. Court approval was required as the amount of the distribution exceeded Bezeq's accounting profits according to its financial statements.

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On April 13, 2011, the general meeting of the shareholders of Bezeq approved the distribution of a cash dividend to its shareholders of NIS 1.163 billion, which on the record date for the distribution (May 4, 2011) represented NIS 0.4305716 per share. The dividend was paid on May 19, 2011 (together with the special dividend, as described above). Accordingly, B Communications received approximately NIS 364 million in dividends on the payment date.

On September 7, 2011, the general meeting of the shareholders of Bezeq approved the distribution of a cash dividend to its shareholders of NIS 992 million, which on the record date for the distribution (September 18, 2011) represented NIS 0.3662451 per share. The dividend was paid on October 5, 2011, and B Communications received approximately NIS 308 million in dividends on the payment date. In addition, on October 5, 2011, Bezeq made a second distribution of NIS 500 million, and B Communications received approximately NIS 156 million with respect to such distribution.

On July 3, 2011, a motion was filed with the Economic Department of the Tel Aviv District Court by a holder of Bezeq's Debentures (Series 5) seeking to cause Bezeq to re-examine its ability to make distributions and to file an updated opinion with the Court, so that the holders would have the ability to object to the distribution. On September 19, 2011, the Court confirmed an agreement between the parties, according to which the Court's approval of the distribution will not detract in any way from the obligations of Bezeq's directors and officers under any law. The Court stipulated that this was not intended to prevent a creditor from applying to the court if he or she is able to demonstrate that Bezeq's solvency has significantly deteriorated. Pursuant to this decision, Bezeq stipulated that the ruling does not change its ability to make additional payments of the Special Distribution and dividends pursuant to its on-going dividend policy, and that no further application to the Court is necessary before each payment is made.

On April 24, 2012, the general meeting of the shareholders of Bezeq approved the distribution of a cash dividend to its shareholders in the total sum of NIS 1.074 billion, which on the record date for the distribution (May 4, 2012) amounted to NIS 0.3951788 per share. The dividend was paid on May 21, 2012, together with the third portion of the special distribution, in the amount of NIS 500 million, which on the record date for the distribution (May 4, 2012) amounted to NIS 0.1839752 per share.

On September 6, 2012, the general meeting of the shareholders of Bezeq approved the distribution of a cash dividend to its shareholders in the total sum of NIS 997 million to shareholders of record on September 23, 2012. The dividend, which is based on Bezeq's dividend distribution policy, was paid on October 10, 2012. B Communications received NIS 309 million (approximately \$83 million) from this distribution. On October 10, 2012, Bezeq also distributed to Bezeq's shareholders of record on September 23, 2012, the fourth NIS 0.5 billion installment of the NIS 3 billion special dividend that was approved by shareholders on January 24, 2011.

On March 13, 2013, Bezeq's Board of Directors resolved to make a recommendation to the general meeting of Bezeq's shareholders to distribute a current cash dividend in the total amount of NIS 861 million to shareholders. At the date of the report, this dividend has not yet been approved by the general meeting. The determination date for the distribution is May 1, 2013 and the payment date is scheduled to be May 13, 2013. The fifth portion of the Special Distribution in the amount of NIS 500 million is scheduled to be paid together with May 2013 distribution, if approved.

On April 18, 2013, an objection to the distribution of the fifth installment of the special dividend was filed by the same debenture holder who filed previous motions on this issue. Bezeq rejects the arguments set forth in the objection and intends to argue that there is no basis to the relief sought by the objector and to move to dismiss the objection summarily and on the merits.

The sixth and last distribution of NIS 0.5 billion of the special dividend is scheduled to be made by the end of November 2013. To the extent possible, the November distribution will be made together with the regular dividend distribution (if such dividend will be approved) based on Bezeq's financial results for the six months ending June 30, 2013.

On April 8, 2013, C.F.A. Drilling Ltd., or C.F.A., purporting to be a shareholder of Bezeq, submitted a statement of claim for a declaratory judgment against Bezeq, B Communications and Mr. Shaul Elovich, to the District Court in Tel Aviv. In its claim, C.F.A. asserted that B Communications, as the controlling shareholder in Bezeq, has a personal interest in the distribution of dividends by Bezeq. C.F.A. is seeking a declaratory judgment to the effect that: (i) B Communications has a personal interest in connection with any proposed distribution of dividends at Bezeq's next general meeting; (ii) Bezeq should publicize, reasonably prior to that annual meeting, all the information made available to Bezeq's board of directors before it makes a decision whether to recommend the distribution of dividends, as well as the full minutes of the board's deliberations concerning this matter; and (iii) Bezeq should ensure the attendance at the annual meeting of the experts, if any, who delivered an opinion regarding Bezeq's solvency, in order to answer any questions that the shareholders may have prior to a decision being taken at the Meeting. On April 17, 2013, B Communications and Mr. Shaul Elovitch submitted a motion to dismiss the claim or, in the alternative, to stay the proceeding due to pending claims in related matters.

#### Financing for the Acquisition of the Bezeq Shares

On April 14, 2010, B Communications completed the acquisition of 30.44% of Bezeq's outstanding shares for approximately NIS 6.5 billion and became the controlling shareholder of Bezeq. The acquisition was funded with the proceeds that B Communications received from the sale of its legacy Communications Business and the following loans:

On the closing date of the acquisition of the Bezeq interest, B Communications' indirect fully owned subsidiary SP2, which holds the Bezeq interest acquired on that date, received a bank loan from certain banking and financial institutions led by Bank Hapoalim Ltd., or Bank Hapoalim, in a total principal amount of NIS 4.6 billion (approximately \$1.3 billion). The loan was divided into four tranches, as follows:

- Credit A - a "bullet" floating rate loan, in the amount of NIS 700 million; with principal and interest that was payable on November 30, 2010. Credit A is indexed to Bank Hapoalim's prime interest rate, plus a margin of 2%. Bank Hapoalim Prime on the date of the closing was equal to 1.62%. B Communications repaid this loan in full following its receipt of a dividend from Bezeq on May 3, 2010.
- Credit B - This tranche is divided into two parts. The first part, originally in the amount of NIS 1.1 billion, is a floating loan indexed to the Bank Hapoalim prime interest rate; and the second part, originally in the amount of NIS 900 million, is a fixed rate loan, linked to the Israeli CPI. Both parts of Credit B are payable in 13 equal semi-annual installments of both principal and interest, with the first payments made on November 30, 2010. The interest rate on the first part of Credit B is 4.58% and the interest rate on the second part of Credit B is 4.35%. As of December 31, 2012, NIS 715 million of the first part and NIS 627 million of the second part remained outstanding.
- Credit C - a "bullet" loan, originally in the principal amount of NIS 700 million, is a floating rate loan, indexed to the Bank Hapoalim prime interest rate, at an interest rate of 4.73%. The principal of Credit C will be paid in one payment on November 30, 2016; and the interest will be paid in 13 semi-annual installments, the first of which was made on November 30, 2010. As of December 31, 2012, NIS 32 million of this tranche remained outstanding.
- Credit D - two "bullet" loans, the principal of which will be paid in one payment on May 30, 2017 and the interest will be paid in 13 semi-annual installments, the first of which is due on November 30, 2010. The first loan of Credit D is

in the principal amount of NIS 800 million and is a floating rate loan, indexed to the Bank Hapoalim prime interest rate, at a rate of 4.75%. The second loan is in the principal amount of NIS 400 million and is a fixed rate loan, linked to the Israeli CPI, at a rate of 5.4%. As of December 31, 2012, NIS 800 million of the first part and NIS 430 million of the second part remained outstanding.

SP2 also created the following liens for the lenders as security for its obligations under the loan agreement:

- A floating charge on all the SP2 assets, property (current and fixed) and its present and future rights (with the exception of additional shares of Bezeq which may be purchased) and a first-ranking fixed charge on the share capital of SP2, which has not yet been realized and/or which has been exercised and not yet realized, on SP2's goodwill and its rights to a tax exemption and/or tax relief and/or tax dispensation.
- A fixed lien, assignment by way of lien and a floating charge on the rights and assets of SP2, as set forth below:

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- o All of SP2's rights in the SP2 account, and all the monies and/or assets deposited and/or located and/or to be deposited and/or located in SP2 account and/or credited and/or to be credited thereto, including securities and income and proceeds which SP2 has and is to have with respect to and in connection with SP2 account, the aforementioned monies, securities and/or assets, and the profits, all with the exception of additional shares of Bezeq which may be purchased.
- o SP2's rights under the Bezeq's shares purchase agreement.

In addition, SP2 agreed to pay the lenders certain fees, expenses and cost increases. SP2 also issued phantom stock options to the banks, under which they received option units, which reflect, in the aggregate, 2% of Bezeq's share equity (subject to adjustments in certain cases). The "base price" of each unit was NIS 8.62. The total amount payable by SP2 to the banks is limited to NIS 125 million (NIS 2.4289 per option unit) in the aggregate. The option units, which were exercisable by the lenders until May 30, 2017, were exercised in the fourth quarter of 2010. SP2 is obligated to pay the lenders a total of NIS 124 million in five equal annual installments, the first of which was paid in May 2012. The payments under the option agreements will be made from dividends that SP2 will receive from Bezeq, which in accordance with the loan agreement may not be withdrawn by SP2 from its account.

SP2's undertakings and limitations under the loan agreement include, among other things: (a) the obligation to provide the lenders with certain financial information; (b) limitations as to the use of amounts which will be received from Bezeq and the ability to withdraw and distribute them to SP2's shareholders; and (c) an undertaking to object to certain changes in Bezeq's incorporation documents if the lenders find such changes would prejudice their rights. In certain situations, payments from Bezeq must be used for early repayment of the loan or may not be withdrawn by SP2 to its parent company.

Instead of holding the deposit in cash, B Communications may purchase a securities portfolio, consisting of the following instruments: (a) short-term loans and bonds of the State of Israel; (b) no more than NIS 75 million of securities rated at least AA- (double-A-minus) (or an equivalent rating of another rating company), or which were issued by a corporation so rated, provided that not more than NIS 10 million is invested in a single security and no investments may be made in: (i) debentures of communication companies; (ii) debentures of companies controlled by Mr. Shaul Elovitch; or (iii) debentures with a duration exceeding 5 years. Subject to its satisfaction of the above conditions, we may manage the aforementioned securities portfolio, buy and sell securities from time to time (including by means of an automated trading system, provided that the proceeds from such transactions are deposited directly in our account), without requiring the bank's specific approval for the transactions.

Upon the occurrence of certain events of default, but subject to certain conditions, the lenders are entitled to call the loans for immediate repayment, subject to certain procedures and remedy periods set forth in agreement, including upon the following events:

- The failure of: (i) Bezeq to maintain minimum shareholders equity and minimum ratio of shareholder equity; (ii) Bezeq to exceed certain thresholds relating to the ratio of financial debt to EBITDA; and (iii) our wholly-owned subsidiary that directly holds the Bezeq interest to maintain a minimum ratio of debt to EBITDA and a debt service coverage ratio.
- Material breach of an undertaking or representation; certain restructuring, insolvency or debt restructuring events of SP2 or Bezeq; any material change in the nature of Bezeq's activities; certain changes in control of SP2 or dilution of SP2's holdings in Bezeq or if SP2 ceases to control Bezeq; if Bezeq's general license is adversely modified; if any of the permits or approvals issued in connection with our acquisition of controlling interest in Bezeq ceases to be in force or was amended; and if Bezeq or certain subsidiaries of Bezeq fail to make certain payments when due.

The Bezeq shares that were purchased by SP2 on the closing date, and all of SP2's other rights and assets (except additional shares of Bezeq that it may acquire in the future) have been pledged to the lenders as security of SP2's obligations under the loan agreement. In addition, B Communications' wholly-owned subsidiary, SP1, the direct parent company of SP2, has pledged to the lenders the entire equity it holds in SP2 and the debt owed to it by SP2 (other than the amounts that SP2 will pay SP1 according to the terms and the conditions of the loan agreement).

On February 19, 2010, B Communications' wholly-owned subsidiary, SP1, entered into a loan agreement with certain entities from the Migdal Insurance and Financial Holdings Ltd. or Migdal, group. According to the Migdal loan agreement, on the closing date of the acquisition of B Communications' Bezeq interest, SP1 was provided a loan of NIS 500 million (approximately \$141 million). The loan bears annual interest at a rate of 6.81%, linked to the Israeli CPI. In addition, a special interest payment is payable on the date of the final repayment of the loan in order to ensure a certain internal rate of return, or IRR, of the loan principal (without linkage to the Israeli CPI), which will be calculated according to a formula that takes into account amounts that SP1 may pay due to early repayment at Migdal's demand and amounts with respect to which Migdal may waive its right to demand early repayment. However, in any event the abovementioned IRR will not exceed the IRR which derives from a fixed interest of 6.95%.

The interest is payable semi-annually, and the principal is payable in one payment, on the earlier of: (i) March 31, 2017; or (ii) 60 days prior to the agreed repayment date of the entire amount of Credit D under the SP2 loan described above.

The Migdal loan is secured by a first ranking pledge on SP1's rights in the bank account into which all payments from SP2 are made, except for certain defined expenses, referred to as the Pledged Bank Account. SP1 undertook to maintain in the Pledged Bank Account minimum funds of NIS 22.5 million (linked to the Israeli CPI). The Migdal facility agreement includes limitations on distributions and payments from the Pledged Bank Account (including conditions as to total debt to EBITDA ratios that relate to SP1).

The Migdal loan agreement contains certain undertakings and covenants, including, among others, (i) certain undertakings for SP1 and its direct and indirect controlling shareholders to maintain (indirect) control in Bezeq, (ii) limitations on amendments to the SP2 loan described above; and (iii) an undertaking to comply with the terms of the regulatory approvals granted with respect to purchase of control in Bezeq.

#### Financing of Ongoing Operations

We expect to have sufficient funds to meet our long term working capital needs, capital expenditures, debt service and other funding requirements, both on a consolidated level (including B Communications which consolidates Bezeq's results) and with respect to our own debt service (not including B Communications and Bezeq),

For this long-term analysis we took into account the following:

#### The working capital and debt aspects of Bezeq

We believe that our base asset, Bezeq, is a strong and well capitalized company. Its cash flow from operating activities was approximately NIS 4 billion (approximately \$1 billion) in the year ended December 31, 2012, an increase of 26% compared to cash flow from operating activities of NIS 3.2 billion for the year ended December 31, 2011.

#### Analysis of our working capital and debt repayment over the long term

We expect to have sufficient funds to service our indebtedness (excluding Bezeq's indebtedness) from our current cash and cash equivalents, our ability to raise additional funds, including through the sale or pledge of a portion of our shareholdings in B Communications that are free from any encumbrances, and from future dividends from B Communications. In this context it is noteworthy that at this stage B Communication does not have sufficient "distributable profits", as required under the Israeli Companies Law, to declare a dividend. Nevertheless we expect that by the conclusion of 2012 B Communications will extinguish its retained earnings deficit and will be able to distribute dividends thereafter.

In 2013, B Communications expects to receive dividends from Bezeq totaling NIS 850 million and to make debt repayments of NIS 650 million, thereby creating a cash surplus of NIS 200 million. We expect that B Communications' total accumulated cash surplus at December 31, 2013 will be approximately NIS 894 million and that at least a portion of B Communications' cash surplus will be used for a dividend distribution.

#### Our Company's current liquid balances:

As of December 31, 2012, our cash and cash equivalents and current investments totaled NIS 179 million. In addition, we own 24 million unencumbered ordinary shares of B Communications having a value at December 31, 2012 of NIS



376 million (79.94% of B Communications' outstanding share capital). These shares can, if necessary, be used to support the refinance of existing debt or be sold for cash (up to 8 million shares can be sold without endangering our controlling interest in B Communications). We believe these funds, together with the expected dividends from B Communications, will be sufficient to service our debenture installments through December 31, 2014 that total approximately NIS 343 million. Beyond 2014, we expect to have sufficient funds to serve our expected indebtedness.

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## Bezeq

As of December 31, 2011 and 2012, Bezeq had cash and cash equivalents and current investments of NIS 2.3 billion and NIS 1.5 billion (approximately \$414 million), respectively. The decrease was primarily due to the payment of NIS 2 billion (approximately \$555 million) of dividends in 2012.

Bezeq's incurred consolidated capital expenditures in the years ended December 31, 2012 and 2011 were NIS 1.5 billion (approximately \$413 million) and NIS 1.9 billion, respectively. The capital expenditures in 2012 were primarily for the development of the Bezeq Group's communications infrastructure in the amount of NIS 1.3 billion (approximately \$340 million) and for investments in intangible assets and deferred expenses in the amount of NIS 269 million (approximately \$72 million). The decrease of NIS 774 million between 2012 and 2011 was primarily attributable to the reduction in capital expenditures as a result of completion of the deployment of the NGN project as well as an increase in proceeds from the sale of fixed assets by the domestic fixed-line communications segment and the completion of the submarine communications cable deployment.

In the year ended December 31, 2012, Bezeq repaid debts and paid interest totaling approximately NIS 1.2 billion (approximately \$318 million), compared with approximately NIS 1.9 billion in 2011. In contrast, the domestic fixed-line communications segment raised NIS 650 million (approximately \$174 million) of debt in 2012 compared to total debt raised by means of loans and an issuance of debentures of approximately NIS 5.3 billion in 2011. In addition, Bezeq paid a dividend of NIS 3.1 billion (approximately \$823 million) in 2012, compared to NIS 3.2 billion paid in 2011.

The average of long-term liabilities (including current maturities) to financial institutions and debenture holders in the year ended December 31, 2012 amounted to NIS 9.3 billion (approximately \$2.5 billion). Average credit from suppliers in the reporting year was NIS 851 million (approximately \$228 million) and the average short-term customer credit was NIS 3.1 billion (approximately \$823 million). The average long-term customer credit was NIS 1.3 billion (approximately \$337 million).

The Bezeq Group's working capital surplus as of December 31, 2012 amounted to approximately NIS 491 million (approximately \$132 million) compared to a working capital surplus of NIS 1.4 billion on December 31, 2011. Bezeq has (according to its unconsolidated financial statements) a working capital deficit of approximately NIS 790 million (approximately \$212 million) as of December 31, 2012, compared to a surplus of NIS 161 million on December 31, 2011. The transition from surplus to deficit in Bezeq's working capital is primarily attributable to a decrease in the balance of cash and cash equivalents, which on December 31, 2011 included receipts in respect of an issuance of debentures and receipt of long-term loans during 2011. There was also an increase in the current liabilities of Bezeq, primarily due to an increase in the current maturities of its long-term loans.

The Board of Directors of Bezeq reviewed the existing and projected resources and cash flows in the foreseeable future and the investment needs of Bezeq, as well as the sources of finance and the potential amounts that will be required by Bezeq. On the basis of its review of all these factors, the Board of Directors concluded that despite the deficit in Bezeq's working capital (according to its unconsolidated financial statements) it does not have a liquidity problem. Bezeq can meet its existing cash needs and its needs for the foreseeable future by generating cash from operations, by receipt of dividends from subsidiaries and by raising debt, should it decide to do so, from banking and non-banking sources.

The table below describes Bezeq's long term loans as at December 31, 2012:

Amount (NIS	Average interest	Effective interest	Interest range in 2012
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Source of finance	millions)	Currency or linkage	Type of interest and change mechanism	rate		rate		
Banks	2,306	Unlinked NIS	Variable, based on prime rate (1)	3.20	%	3.22	%	3.20%-4.20%
Banks	2,340	Unlinked NIS	Fixed	5.67	%	5.69	%	5%- 6.85 %
Non-bank	425	Unlinked NIS	Variable, based on annual STL rate (2)	3.26	%	3.41	%	3.26%-4.08%
Non-bank	1,729	Unlinked NIS	Fixed	5.92	%	6.11	%	5.70%-6.65%
Non-bank (3)	2,334	CPI-linked NIS	Fixed	3.86	%	3.95	%	3.70%-5.95%

(1) Prime interest rate in March 2013 – 3.25%.

(2) Based on Israeli government short term loan rate of 1.858% (calculated as the average last five trading days of November 2012 for the interest period that ended on March 1, 2013).

(3) Not including Debentures (Series 5) held by a wholly-owned subsidiary. Bezeq's loans in the total amount of NIS 7.8 billion include a cross-default mechanism that under certain conditions allows immediate recall of the debt should a third party demand immediate repayment of debt owed to it due to a breach of contract.

### Bezeq's Outstanding Debentures

In May 2004, the Bezeq Group issued 600 million of Series 5 debentures of NIS 1 par value each, repayable in six equal annual installments on June 1 of each of the years 2011 to 2016, which bear 5.3% annual interest, linked (principal and interest) to the CPI in April 2004. The debentures were sold to institutional investors and to Bezeq Zahav Holdings, whose entire activity is holding such debentures. An additional NIS 1.5 billion of Series 5 debentures were sold to Bezeq Zahav Holdings in 2004. On March 30, 2005, an additional NIS 287 million of Series 5 debentures was issued. As of December 31, 2012, NIS 1.6 billion of Series 5 debentures remained outstanding, of which NIS 587 million par value is held by Bezeq Zahav Holdings.

As of December 31, 2012, Bezeq had NIS 782 million of debentures that are not publicly traded. In addition, Bezeq created a negative pledge in favor of the debenture holders and in favor of a bank, which includes exceptions, such as, for the matter of a lien on assets that are purchased or expanded by Bezeq, if the undertakings for which the charge serves as security is created for the purchase or expansion of those assets and for the matter of a token charge. The lenders have a right to call the debentures for immediate payment in the event that Bezeq does not repay the debentures or if there is a breach of their terms, if a significant attachment is imposed on its assets, if a receiver is appointed for Bezeq's assets or a liquidation order is given against Bezeq, if Bezeq ceases to run its business, or if the holder of another charge realizes the charge it has on the assets of Bezeq. In Bezeq's opinion, at December 31, 2012 it was in compliance with all of the aforementioned terms.

### Additional Bank Loans

Between October 29, 2012 and November 15, 2012, Bezeq issued NIS 650 million of unlinked NIS denominated debt having a term of 4.3 years.

Between May 12, 2011 and May 18, 2011, Bezeq entered into NIS 2 billion of loans with Israeli banks and with a financial institution. NIS 1.4 billion of this amount is long-term debt (with an average duration of 6.2 years) and NIS 600 million of this amount is short-term debt. Some of the debt was raised as part of the exercise of a letter of liability for the extension of long-term credit that Bezeq received from a bank on February 17, 2011. As a result, the available credit under this letter was reduced from NIS 1.5 billion to NIS 700 million. Subsequently, on August 2, 2011, Bezeq obtained a long-term NIS 600 million loan (average duration - 5.3 years) from a bank, to replace the short-term loan of the same amount mentioned above. Upon taking this loan, the letter of undertaking was cancelled.

In connection with this debt, Bezeq made the following commitments towards each of the entities that had extended the credit, or the financing entities:

An undertaking not to create any other liens on its assets (negative lien) under the same conditions as those of the negative lien given in favor of the banks, and subject to exceptions defined therein.

The financing documents include grounds for recalling the credit, including violations, insolvency, liquidation procedures, receivership or the like, as well as the right to demand immediate repayment if a third-party lender demanded immediate repayment of Bezeq's debts towards it for an amount that is more than the defined amount.

Bezeq undertook that should it make a commitment towards any additional lending entity in connection with financial covenants, the financing entities may (under certain conditions) ask Bezeq to sign an identical undertaking towards them. for the outstanding long-term debt.

#### Israeli shelf prospectus

On June 1, 2011, Bezeq filed a shelf prospectus with the Israel Securities Authority and the TASE in Israel. The shelf prospectus is valid for a period of two years and may be used by Bezeq to raise capital or debt in the future through the issuance of ordinary shares, debt securities, debt securities convertible into ordinary shares, warrants to purchase ordinary shares, warrants to purchase debt securities, and commercial paper at the discretion of Bezeq, subject to filing a supplemental shelf offering report in which Bezeq would describe the terms of the securities offered and the specific details of the offering. Bezeq has not yet made any decision as to the offering of any securities, nor as to its scope, terms or timing, nor is there any certainty that such an offering will be made.

Subsequently, on June 22, 2011, Bezeq published an amendment to the Shelf Prospectus in which changes were made principally to the conditions of the debentures and deed of trust. On June 29, 2011, Bezeq published a shelf offering report offering its debentures to the public (Series 6-8). On July 3, 2011, Bezeq issued the following debentures (Series 6-8):

- NIS 958,088,000 par value of debentures (Series 6), bearing fixed annual interest of 3.70%. The debentures will be repaid in five (5) equal, annual installments, payable every year on December 1, from 2018 through 2022 (inclusive). The first interest payment was made on December 1, 2011 and subsequently interest is payable twice a year on June 1 and December 1 every year through 2016. The principal of the debentures (Series 6) and their interest will be linked to the CPI published in June 2011.
- NIS 424,955,000 par value of debentures (Series 7), bearing variable interest at the short-term government loan yield per annum, or base interest, plus a margin of 1.40%. The debentures will be repaid in five (5) equal, annual installments, payable every year on December 1 from 2018 through 2022 (inclusive). The first interest payment was made on September 1, 2011 and subsequently interest is payable four times a year on March 1, June 1, September 1, and December 1, through 2022. The debentures (Series 7) are not linked to the CPI or to any currency.
- NIS 1,329,363,000 par value of debentures (Series 8), bearing fixed annual interest of 5.70%. The debentures will be repaid in three (3) equal, annual installments, payable on June 1 every year from 2015 through 2017 (inclusive). The first interest payment was made on December 1, 2011 and subsequently interest will be paid twice a year on June 1 and December 1 every year through 2016. The last interest payment will be made on June 1, 2017. The debentures (Series 8) are not linked to the CPI or to any currency.

In connection with these three series of debentures totaling NIS 2.73 billion, bank loans amounting to NIS 4.65 billion (as at December 31, 2012) and NIS 400 million of debentures issued to financial institutions, Bezeq has undertaken the following:

- Bezeq will not create additional pledges on its assets unless pledges are created at the same time in favor of the debenture holders and the lending banks (negative pledge). Bezeq may create additional pledges under certain circumstances, including liens that are created for the purchase or expansion of Bezeq's assets and pledges of immaterial amounts.

- Standard grounds were included for immediate repayment of the debentures and loans, including breach events, insolvency, dissolution procedures or receivership. In addition, a right was provided to call for immediate repayment if a third party lender calls for immediate repayment of Bezeq's debts in an amount exceeding the amount determined.

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In addition, Bezeq has undertaken that if it gives an undertaking to any entity in respect of compliance with financial covenants, it will provide the same undertaking to its debenture holders and the banks (subject to certain exceptions).

Bezeq has also given an undertaking to holders of debentures (Series 6 to 8) to take steps, to the extent under its control, that the debentures will be rated by at least one rating company so long as there are debentures of the relevant series outstanding.

The par value of debentures (Series 5) is 1,591,311,333 of NIS 1 par value each, of which NIS 1,004,578,000 of debentures were issued to the public and the balance of NIS 586,733,333 were issued to Bezeq Zahav. Standard terms were established for immediate repayment of the debentures, including breach events, insolvency, dissolution procedures or receivership.

The bank loans and debentures of Pelephone (NIS 98 million and NIS 346 million as at December 31, 2012, respectively) are secured by an irrevocable undertaking by Pelephone to the credit providers not to encumber its assets without their consent (a negative pledge). Pelephone also has made an undertaking to comply with certain financial covenants. Pelephone was in compliance with such financial covenants as of December 31, 2012.

#### Credit rating

Bezeq is rated by two rating agencies. Below are details of the current rating of each of the agencies:

Rating agency	Rating	Changes in rating	Type of credit rated
S & P Maalot	i1AA+	February 6, 2011 – Ratification of Bezeq's rating of i1AA+ (removal from CreditWatch), with a negative outlook.	Bezeq and Debentures Series 5 – 8
		June 29, 2011 – Rating set at i1AA+ with a negative outlook for new debentures (Series 6-8) of up to NIS 3 billion.	
		July 4, 2012 – Ratification of the current rating without change.	
		February 21, 2013 – Rating of Bezeq and its debentures was lowered to i1AA with a stable outlook.	
Midroog	Aa2	January 2, 2011 – Transfer of rating of Bezeq's debentures to Watch List with negative outlook, following Bezeq's notice of NIS 3 billion dividend distribution in 2011 -2013, that is not in compliance with the profit test for dividends,	Series 5 – 8
		April 3, 2011 – Removal of above debentures from Watch List with an unchanged rating (Aa1) and negative outlook, following the approval of the NIS 3 billion distribution by	

shareholders and the District Court.

June 29, 2011 – Rating set at Aa1 with negative outlook for NIS 3 billion of new debentures (Series 6-8) issued by Bezeq, and the same rating for Bezeq's outstanding debentures..

July 19, 2012 –Rating of Bezeq's debentures (Series 5, 6, 7, 8) lowered from Aa1/Negative Outlook to Aa2/Stable Outlook)

During 2013, Bezeq expects to make approximately NIS 1.35 billion of principal and interest payments (including on its debentures). Bezeq incurs debt from time to time to manage its cash flows and it may issue debt during 2013. Bezeq's may enter into new bank loans or issue private or public debt, or both.



## Pelephone

Pelephone's operations are primarily financed out of its cash flow from operating activities and debt. It has long-term loans from banks, private (non-tradable) debentures, and loans received from Bezeq.

The average effective interest rate in 2012 for Pelephone's loans is provided below:

Source of finance	Amount at Dec. 31, 2012 (NIS millions)	Currency or linkage	Average interest rate	Effective interest rate
Banks	97	CPI-linked NIS	4.50 %	4.55 %
Non-bank	353	CPI-linked NIS	4.62 %	4.67 %
Loan from parent company	549	Fixed interest NIS	5.75 %	5.75 %

## Undertakings towards banks

As part of its arrangements with the banks in Israel providing it with credit, Pelephone gave an irrevocable undertaking to those banks to comply with certain financial covenants, including:

Pelephone's total debt will not exceed three times its equity.

If its debt exceeds 2.5 times its equity and for as long as it does so, Pelephone will not distribute dividends and will not pay management fees to its shareholders. If Pelephone violates this undertaking, it must repay the banks, within 120 days from the demand, the entire outstanding credit facility, or alternatively, remedy the violation by increasing its equity or repaying its debt so that the ratio is maintained.

Total debt (including guarantees and less cash and cash equivalents) should not exceed NIS 3.8 billion (linked to the CPI of January 2002). The amount of the debt will be reviewed once every quarter.

No fixed or floating charge can be imposed on Pelephone's assets unless it obtains the banks' prior written consent.

No security or charge on Pelephone's assets or guarantee to secure credit can be provided for Pelephone's shareholders or any third party, without the prior written consent of the banks.

No loans or credit can be provided for Pelephone's shareholders, except for Bezeq, without the prior written consent of the banks, and provided that its debt to equity ratio does not exceed 2.5 times its equity.

In addition to these covenants, Pelephone undertook to insure that the cumulative amount of all its debts and liabilities towards a particular bank does not exceed at any time a sum equal to 40% of its total debt to financial entities, including debenture-holders.

## Issuance of debentures

In 2004 and 2005, Pelephone issued three series of CPI-linked debentures in private placements to institutional investors, in the aggregate amount of NIS 1.1 billion par value. The debentures are not secured by a charge and the terms of the negative pledge and Pelephone's financial covenants towards the banking system in Israel apply also to the debenture-holders. The deed of trust includes standard clauses for immediate repayment of the debentures, including insolvency proceedings. The amount of debentures outstanding at December 31, 2012, was NIS 346 million.



## DBS

## Bank financing

DBS is party to a financing agreement with a consortium of banks dated May 23, 2001, which was amended in July 2012. According to the financing agreement, DBS was provided with an on-going credit facility of NIS 170 million and a hedge facility of \$10 million until the end of 2015.

The table below shows the average interest rates payable on DBS's loans:

	Source of financing	Amount at December 31, 2012 (NIS millions)	Currency or linkage	Average interest rate		Effective interest rate	
Short-term loans	Banks	69	NIS	5.2	%	5.4	%
	Banks (1)	0	NIS	5.65	%	5.72	%
Long-term loans	Non-bank (2)	1,539	CPI-linked NIS	6.3	%	6.4	%
	Shareholder loans(3)	3,086	CPI-linked NIS	6.1	%	6.2	%

(1) Until December 31, 2010, the long-term bank loans bore 5.6% annual fixed interest. As of December 31, 2010, some of these loans began bearing fixed interest at an average rate of 6.63%, and others variable interest at an average rate of prime plus 1.8%.

(2) The non-bank credit, which is valid to December 31, 2011, consists of debentures.

(3) Loans extended to DBS by its shareholders are linked to the CPI and are divided into three types: A. Non-interest bearing loans; B. Loans bearing annual interest of 5.5%; C. Loans bearing annual interest of 11%.

## Institutional financing

DBS issued a debenture series in 2007 (Series A) to institutional investors, which was listed on the Tel Aviv Continuous Trading platform for institutional and sophisticated investors on the TASE, or TACT Institutional, in accordance with a deed of trust between DBS and Hermetic Trust (1975) Ltd. DBS issued a debenture series in 2010 (Series B) to institutional investors which were listed on the TACT Institutional and which were expanded in 2011 and 2012, in accordance with a deed of trust between DBS and Hermetic Trust (1975) Ltd. as part of the long-term bank credit to DBS.

The Series A and B debentures are each secured by a first ranking floating charge, unlimited in amount, on all of DBS's assets (aside from exceptions attributable to the provisions of the Communications Law) placed by DBS in favor of the trustee of the relevant series, including a covenant that restricts the creation of additional charges (other than exceptions stipulated in the deed of trust), and a first ranking fixed charge, unlimited in amount, in favor of any such trustee, on the rights and assets of DBS that were charged by it in favor of the banks.

In July 2012, DBS issued NIS 392 million of debentures to several institutional entities. On March 21, 2013 and on April 14, 2013, DBS issued an additional NIS 73 million and NIS 26 million, respectively, of Series B debentures. Proceeds from the issuances were used to repay the long-term bank loans that DBS had previously obtained from the banks.

## Cash Flows

The following table summarizes our cash flows on a consolidated basis for the periods presented:

	Year Ended December 31,		
	2010	2011	2012
Net cash provided by operating activities	2,581	3,172	3,997
Net cash provided by investing activities	(6,282)	(2,075)	(1,160)
Net cash (used in) provided by financing activities	2,755	(54)	(3,520)
Net increase (decrease) in cash and cash equivalents	(946)	1,043	(683 )
Cash and cash equivalents at beginning of year	1,350	404	1,447
Cash and cash equivalents at end of year	404	1,447	764

### Operating Activities

Consolidated cash provided by operating activities in the year ended December 31, 2012 amounted to NIS 4.0 billion (approximately \$1.1 billion) compared to NIS 3.2 billion in 2011 and NIS 2.6 billion in 2010. The increase of NIS 825 between 2012 and 2011 was primarily attributable to an improvement in working capital of the cellular segment as a result of a decrease in the sale of handsets together with a decrease in payments to handset suppliers, as well as from the factoring of certain receivables from previously purchased handsets paid for in installments.

### Investing Activities

Consolidated cash used in investing activities in the year ended December 31, 2012 was NIS 1.3 billion (approximately \$310 million) compared to NIS 2.1 billion in 2011 and NIS 6.3 billion in 2010. The decrease of NIS 915 million between 2012 and 2011 was primarily attributable to the reduction in capital expenditures as a result of completion of the deployment of the NGN project as well as an increase in proceeds from the sale of fixed assets by the domestic fixed-line communications segment and the completion of the submarine communications cable deployment.

### Financing Activities

Consolidated cash used in financing activities in the year ended December 31, 2012 was NIS 3.5 billion (approximately \$942 million) compared to NIS 54 million in 2011 and cash provided by financing activities of NIS 2.8 billion in 2010. The increase of NIS 3.2 billion of cash used during 2012 compared to 2011 was primarily attributable to loans received and debentures issued by Bezeq of NIS 777 million compared with NIS 5.2 billion of new debt in 2011. The decrease was partially offset by lower debt repayments made in 2012 of NIS 1.2 billion compared with NIS 2.3 billion in 2011.

### Bezeq's Cash Flows

The following table summarizes the Bezeq Group's consolidated cash flows for the periods presented:

	Year ended December 31,		
	2010	2011	2012
	(NIS in millions)		
Net cash provided by operating activities	3,696	3,186	4,014
Net cash (used in) investing activities	(1,484)	(2,491)	(1,237)
Net cash (used in) provided by financing activities	(2,427)	292	(3,663)
Net (decrease) increase in cash and cash equivalents	(215)	987	(886)
Cash and cash equivalents at beginning of year	580	365	1,352
Cash and cash equivalents at end of year	365	1,352	466

### Operating Activities

Consolidated cash flows from operating activities in the year ended December 31, 2012 amounted to NIS 4 billion (approximately \$1.1 billion) compared to NIS 3.2 billion in 2011, an increase of NIS 828 million, and NIS 3.7 billion in 2010. The increase is mainly attributable to an improvement in working capital of the cellular segment as a result of a decrease in the sale of handsets together with a decrease in payments to handset suppliers, as well as from the factoring of certain receivables from previously purchased handsets paid for in installments.

## Investing Activities

Net cash used in investing activities was NIS 1.2 billion (approximately \$331 million) in 2012, compared to NIS 2.5 billion in 2011 and NIS 1.5 billion in 2010. Cash flow from operating activities is one of the sources of financing for the Bezeq Group's investments, which during 2012 included NIS 1.3 billion (approximately \$340 million) used in the development of communications infrastructures and NIS 269 million (approximately \$72 million) used in the acquisition of intangible assets and deferred expenses, compared to NIS 1.5 billion and NIS 355 million, respectively, in 2011. Furthermore, approximately NIS 131 million (approximately \$35 million) net was invested in financial assets held for trade and others, compared to NIS 892 million in the prior year. In addition, in 2012, the Bezeq Group received proceeds of approximately NIS 305 million (approximately \$82 million) from the sale of property, plant and equipment, as well as approximately NIS 100 million (approximately \$27 million) from the realization of assets and non-current loans, which includes the proceeds from the sale of assets available for sale.

## Financing Activities

In 2012, the net cash used in financing activities by the Bezeq Group was NIS 3.7 billion (approximately \$981 million) compared to net cash provided by financing activities of NIS 292 million in 2011. In 2012, the Bezeq Group repaid debts and paid interest totaling approximately NIS 1.2 billion (approximately \$317 million), compared with approximately NIS 1.9 billion in 2011. The domestic fixed-line communications segment incurred debt of NIS 650 million (approximately \$174 million) in 2012, while in 2011 it issued debentures and incurred debt of NIS 5.3 billion in the aggregate. In addition, in 2012, Bezeq paid dividends of NIS 3.1 billion (approximately \$823 million), compared to dividends of NIS 3.2 billion in 2011.

## Impact of Inflation and Currency Fluctuations on Results of Operations, Liabilities and Assets

We and Bezeq conduct most of our business in Israel. Our revenues are primarily denominated in NIS, while a portion of Bezeq's expenses, primarily purchases of equipment and payments to foreign telecommunications operators are made in other currencies, principally in U.S. Dollars. Additionally, certain assets, especially trade receivables, as well as part of both our direct liabilities and Bezeq's liabilities are denominated in NIS. As a result, fluctuations in rates of exchange between the NIS and non-NIS currencies may have a limited effect on our operating results and financial condition.

The following table presents information about the rate of inflation in Israel, the rate of devaluation or appreciation of the NIS against the dollar, and the rate of inflation in Israel adjusted for the devaluation:

Year ended December 31,	Israeli inflation rate %	NIS devaluation (appreciation) rate %	Israeli inflation adjusted for devaluation (appreciation) %
2008	3.8	(1.1)	4.9
2009	3.9	(0.7)	4.6
2010	2.7	(6.0)	8.7
2011	2.2	7.7	(5.5)
2012	1.6	(2.3)	3.9

To manage this risk, from time to time, the Bezeq Group has entered into forward exchange contracts to hedge some of its foreign currency exposure and to reduce the impact on its cash flows and results of operations. The Bezeq Group recognizes freestanding derivative financial instruments as either assets or liabilities in the statements of financial position and it measures those instruments at fair value. However, accounting for changes in the fair value of a derivative instrument, such as a currency hedging instrument, depends on the intended use of the derivative instrument and the resulting designation. For derivative instruments that are not designated as cash flow hedges, changes in fair value are recognized in our income statement without any reference to the change in value of the related budgeted expenditures. These differences could result in fluctuations in our reported net income on a quarterly basis.

## Conditions in Israel

We are incorporated under the laws of, and our principal executive offices and our operations are located in, the State of Israel. See Item 3D "Key Information – Risk Factors – Risks Relating to Our Location in Israel" for a description of governmental, economic, fiscal, monetary and political policies or factors that have materially affected or could materially affect our operations.





### Effective Corporate Tax Rate

Under the Tax Burden Reform (Legislative Amendments), 2011 which, among others, cancels the scheduled progressive reduction in the corporate tax rate, the effective corporate tax rate and capital gains tax was set at 25% in 2012 and thereafter.

### Critical Accounting Policies

The preparation of the consolidated financial statements in accordance with IFRS requires management to make estimates and assumptions that affect the valuation of assets and expenses during the reporting period. There can be no assurance that actual results will not differ from these estimates.

**Business combinations.** The Group opted for early application of IFRS 3 – Business Combinations (revised) and IAS 27 – Consolidated and Separate Financial Statements (2008) as from January 1, 2008. Business combinations are accounted for by applying the acquisition method. According to this method, the identifiable assets and liabilities of the acquired business are recognized and recorded at fair value on the acquisition date. The acquisition date is the date on which the acquirer obtains control over the acquiree. Control exists when the Company is able to govern the financial and operating policies of the entity so as to obtain benefits from its activities. In assessing control, potential voting rights were taken into account if they confer effective control.

The cost of the acquisition is the aggregate fair value of the assets transferred, liabilities incurred and equity interests issued by the acquirer on the date of acquisition. In addition, the consideration transferred includes the fair value of any contingent consideration. After the acquisition date, Bezeq Group recognizes changes in fair value of the contingent consideration in the statement of income. Contingent consideration is stated as a financial liability in the statement of financial position. On the acquisition date the acquirer recognizes a liability assumed in a business combination if there is a present obligation resulting from past events and its fair value can be reliably measured.

In a step acquisition, the difference between the fair value at the acquisition date of Bezeq Group's pre-existing equity rights in the acquiree and the carrying amount at that date is recognized in the statement of income under other operating revenue.

The Group recognizes goodwill at acquisition according to the fair value of the consideration transferred, including any amounts recognized in respect of rights that do not confer control in the acquiree as well as the fair value at the acquisition date of any pre-existing equity right of the acquirer in the acquiree, less the net amount of the identifiable assets acquired and the liabilities assumed. After initial recognition, goodwill is measured at cost less any accumulated impairment losses and is not systematically amortized.

Costs associated with the acquisition that were incurred by the acquirer in the business combination such as finder's fees, advisory, legal, valuation and other professional or consulting fees, other than those associated with an issue of debt or equity instruments connected to the business combination, are recognized as expenses in the period the services are received.

**Basis of consolidation.** The consolidated financial statements comprise the financial statements of our company and Bezeq. The Bezeq Group combines in its consolidated financial statements its share of the assets, liabilities, income and expenses of DBS with similar items in its financial statements. Significant intragroup balances and transactions and profits or losses resulting from transactions between the Bezeq Group and the jointly-controlled company are eliminated to the extent of the interest in the jointly-controlled company.

Non-controlling interests comprise the equity of a subsidiary that cannot be attributed, directly or indirectly, to the parent company and they include additional components such as share-based payments that will be settled with equity instruments of subsidiaries and share options of subsidiaries. Non-controlling interests that are instruments that give rise to a present ownership interest and entitle the holder to a share of net assets in the event of liquidation (for example, ordinary shares), are measured at the date of the business combination at fair value or at their proportionate interest in the identifiable assets and liabilities of the acquiree, on a transaction-by-transaction basis.

Profit or loss and any part of other comprehensive income are allocated to the owners of our company and the non-controlling interests, even when the result is a negative balance of the non-controlling interests.

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Transactions with non-controlling interests, while retaining control, are accounted for as equity transactions. Any difference between the consideration paid or received for change in non-controlling interests is recognized in capital reserve for transactions with non-controlling interests.

The Bezeq Group granted non-controlling shareholders a put option to sell part or all of their interests in several subsidiaries during a certain period. On the date of grant, the options that were granted to the non-controlling interests were classified as a financial liability. The Bezeq Group recognizes, at each reporting date, financial liabilities measured by the estimated present value of the consideration when exercising the put option. If the option is exercised in subsequent periods, the consideration from the exercise is accounted for as sale of a liability. If the option expires, the expiry is accounted for as sale of the investment in subsidiary.

Upon the loss of control, the Bezeq Group derecognizes the assets and liabilities of the subsidiary, any non-controlling interests and the other components of equity related to the subsidiary. If the Bezeq Group retains any interest, including any loans in the previous subsidiary, then such interest, including the loans, is measured at fair value at the date that control is lost. Subsequently, the retained interest is accounted for on an equity basis, depending on the level of influence retained by the Bezeq Group in the former subsidiary. Loss of control of a subsidiary is accounted for as a discontinued operation, regardless of whether the Company retains a non-controlling interest in its former subsidiary (for example, when the investee becomes, after loss of control, an equity-accounted associate). The difference between the consideration and the fair value of the retained interest and the derecognized amounts are recognized in the statement of income under discontinued operations.

Special purpose entities (SPEs) are consolidated if, based on an evaluation of the substance of their relationship with our company and the SPE's risks and rewards, we conclude that we control the SPE.

Associates are those entities in which the Bezeq Group has significant influence, but not control, over financial and operating policy. Associates are accounted for using the equity method and are recognized initially at cost or at their fair value at the date control is lost. The investment includes goodwill calculated at the acquisition date and is presented net of accumulated impairment losses. The consolidated financial statements include the Bezeq Group's share in the income and expenses of equity-accounted investees, adjustments to align the accounting policy with that of Bezeq Group, from the date that significant influence commences until the date that significant influence no longer exists. When the Bezeq Group's share of losses exceeds its interest in an associate, the carrying amount of that interest is reduced to zero and the recognition of further losses is discontinued except to the extent that the Bezeq Group has an obligation or has made payments on behalf of the associate.

When the Bezeq Group holds additional long-term interests in the associate, which are a part of Bezeq Group's net investment in the associate, and when Bezeq Group's proportionate share in the additional interests is different than Bezeq Group's share in the equity of the associate, the Bezeq Group recognizes its share in the additional losses of the associate at its proportionate share in the additional interests according to the percentage of its participation in all the levels of the additional interests and according to the order of priority of the additional levels of interests. If, subsequently, the Bezeq Group recognizes its share in the profits of the associate, it recognizes its share in the profits up to the amount of the cumulative profits previously recognized.

In respect of equity-accounted investments, goodwill is included in the carrying amount of the investment. Impairment loss for these investments is attributable to the entire investment and not to assets comprising the investment, such as goodwill. Therefore, the Bezeq Group recognizes the reversal of losses recognized for equity-accounted investments when their recoverable amount increases.

Intra-group balances and any unrealized income and expenses arising from intra-group transactions, are eliminated in the preparation of the consolidated financial statements. Unrealized gains arising from transactions with associates are

eliminated against the investment to the extent of the Bezeq Group's interest in these investments. Unrealized losses are eliminated in the same way as unrealized gains, but only to the extent that there is no evidence of impairment.

Transactions in foreign currency are translated into the functional currency of the Bezeq Group at the exchange rate on the dates of the transactions. Monetary assets and liabilities denominated in foreign currencies on the reporting date are retranslated to the functional currency at the exchange rate at that date.

Financial instruments. Non-derivative financial instruments comprise investments in shares and debentures, trade and other receivables, cash and cash equivalents, loans and borrowings, and trade and other payables, and debentures issued and loans taken by the us and the Bezeq Group. Both our company and the Bezeq Group initially recognize financial assets at the date we become a party to contractual provisions of the instrument, meaning the date that we fulfill our obligations under the contract. Financial assets are derecognized when our contractual rights to the cash flows from the asset expire, or we transfer the rights to receive the contractual cash flows on the financial asset in a transaction in which substantially all the risks and rewards of ownership of the financial asset are transferred. Financial liabilities are derecognized when our obligation, as specified in the agreement, expires or when it is discharged or cancelled.

An exchange of debt instruments having substantially different terms, between an existing borrower and lender are accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability at fair value. Furthermore, a substantial modification of the terms of the existing financial liability or part of it is accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability. The terms are substantially different if the discounted present value of the cash flows according to the new terms, including any commissions paid, less any commissions received and discounted using the original effective interest rate, is different by at least ten percent from the discounted present value of the remaining cash flows of the original financial liability. In addition to such quantitative criterion, we examine whether there have also been changes in various economic parameters inherent in the exchanged debt instruments, therefore exchanges of CPI-linked debt instruments with unlinked instruments are considered exchanges with substantially different terms even if they do not meet the aforementioned quantitative criterion.

Financial assets and liabilities are offset and the net amount presented in the statement of financial position when, and only when we or the Bezeq Group currently have a legal right to offset the amounts and intend either to settle on a net basis or to realize the asset and settle the liability simultaneously.

Derivative financial instruments. The Bezeq Group holds derivative financial instruments to hedge our exposure to foreign currency, the CPI and copper prices. Hedge accounting is not applied to derivative instruments that economically hedge financial assets and liabilities. Derivative instruments are recognized initially at fair value and attributable transaction costs are recognized in the statement of income as incurred. Subsequent to initial recognition, derivative financial instruments are measured at fair value and the changes in fair value are recognized in the statement of income as incurred. Embedded derivatives are separated from the host contract and accounted for separately if: (a) the economic characteristics and risks of the host contract and the embedded derivative are not closely related; (b) a separate instrument with the same terms as the embedded derivative would meet the definition of the derivative; (c) the combined instrument is not measured at fair value through profit or loss. Changes in the fair value of separable embedded derivatives are recognized in the statement of income as financing income or expense as incurred.

Property, plant and equipment. Items of property, plant and equipment are measured at cost less accumulated depreciation and accumulated impairment losses. Cost includes expenditures that are directly attributable to acquisition of the asset. The cost of self-constructed assets includes the cost of materials, direct labor and financing costs as well as any other cost directly attributable to bringing the asset to the condition for its use intended by the management, and the costs of dismantling and removing the items and restoring the site on which they are located in cases where Bezeq Group has an obligation to vacate and restore the site. The cost of purchased software that is integral to the functionality of the related equipment is recognized as part of the cost of the equipment. When major parts of the property, plant and equipment have different useful lives, they are accounted for as separate items (major components) of the property, plant and equipment. Changes in the obligation to dismantle the items and restore the site on which they are located, other than changes deriving from the passing of time, are added to or deducted from the cost of the asset in the period in which they occur. The amount deducted from the cost of the asset should not exceed its carrying amount, and any balance is recognized immediately in the statement of income.

Gains or losses on disposal of property, plant and equipment are determined by comparing the proceeds from disposal with the carrying amount of the asset, and are recognized net under "other income" in the statement of income. The cost of replacing part of an item of property, plant and equipment is recognized in the carrying amount of the item if it is probable that future economic benefit embodied in the replaced item will flow to the Group and its cost can be measured reliably. The costs of day-to-day servicing are recognized in the statement of income as incurred.



Specific and non-specific borrowing costs are capitalized as qualifying assets throughout the period required for completion and construction until they are ready for their intended use. Non-specific borrowing costs are capitalized using a rate which is the weighted-average cost of the credit sources which were not specifically capitalized. Other borrowing costs are recognized in the statement of income as incurred.

Depreciation. Depreciation is recognized in the statement of income on a straight-line basis over the estimated useful life of each part of an item of property, plant and equipment, since this most closely reflects the expected pattern of consumption of the future economic benefits embodied in the asset. Leased assets under finance lease agreements are depreciated over the shorter of the lease term and their useful lives. Depreciation of an asset starts when it is ready for use, meaning when it reaches the location and condition necessary for it to be capable of operating in the manner intended by management.

Leasehold improvements are depreciated over the shorter of the lease term, including the extension option held by Bezeq Group and intended to be exercised) and the expected life of the improvement. Assets are depreciated based on the following annual percentages:

	Years	Principal depreciation rate (%)
NGN equipment	8	13
Transmission and power equipment	5-10	10
Network equipment	8-25	4
Subscriber equipment and installations	3-7	25
Motor vehicles	6-7	17
Internet equipment	4	25
Office equipment	5-14	10
Electronic equipment, computers and internal communication systems	3-7	20
Cellular network	4-10	14
Buildings	25	4
Submarine communications cable	4-25	4

Depreciation methods, useful lives and residual values are reviewed at least at each reporting year and adjusted as required. Non-current assets which are expected to be realized by way of sale rather than ongoing use are classified as assets held for sale. These assets are presented at the lower of the carrying amount and fair value, less selling costs. Impairment losses at the time of initial classification of an asset held for sale, and subsequent gains or losses resulting from remeasurement, are recognized in the statement of income. Gains are recognized up to the cumulative amount of impairment loss recorded in the past.

Intangible assets. Goodwill that arises upon the acquisition of subsidiaries is included in intangible assets. Software development costs are recognized as an intangible asset only if the development costs can be measured reliably; the software is technically and commercially applicable; and Bezeq Group has sufficient resources to complete the development and intends to use the software. The costs recognized as an intangible asset include the cost of the materials, direct labor and overhead expenses directly attributable to preparation of the asset for its intended use. Other development costs are recognized in the statement of income as incurred. Capitalized development costs are measured at cost less amortization and accumulated impairment losses.

Direct sale commissions paid to dealers and salespersons in respect of sales and upgrades to subscribers who have signed long-term commitments are recognized as an intangible asset. Amortization expenses are recognized in the statement of income over the period of the subscribers' commitments (between 12 and 36 months), on a straight line basis. When the subscriber terminates the agreement period, the balance of the asset is amortized immediately.

Bezeq Group's assets include computer systems consisting of hardware and software. Software that is an integral part of the hardware, which cannot function without the programs installed on it, is classified as property, plant and equipment. However, licenses for stand-alone software, which adds functionality to the hardware, is classified (mainly) as intangible assets. Software depreciation is recognized in the statement of income using the straight-line method over the estimated useful life of the asset.



Rights to frequencies refer to Pelephone's rights to cellular communication frequencies according to a Ministry of Communications tender. Depreciation of the asset is recognized in the statement of income on the straight line method over the license term, which is 13 years and 7 months starting from the date of use of the frequencies.

Other intangible assets acquired by the Bezeq Group, which have a definite useful life, are measured at cost less amortization and accumulated impairment losses.

Amortization. Amortization is the systematic allocation of the amortizable amount of an intangible asset over its useful life. The amortizable amount is the cost of an asset, or another amount substituted for the cost, less its residual value. Amortization, except for goodwill brand name and customer relationships, is recognized in the statement of income on a straight-line basis over the estimated useful life of the intangible assets, from the date on which the assets are available for use. Goodwill and brand name is not systematically amortized but is tested for impairment. Amortization methods and useful lives are reviewed at each reporting date and adjusted if appropriate. Customer relationships are amortized according to the economic benefit expected from those customers each period which result in accelerated amortization during early years by the relationships.

Estimated useful lives for the current and comparative periods are as follows:

Type of Asset	Amortization Period
Development expenses	4 - 7 years
Other rights	3 - 10 years, depending on the useful life
Frequency usage right	Over the term of the license for 13 years starting from the use of the frequencies
Computer programs and software licenses	Over the term of the license or the estimated time of use of the program
Customer relationships	10 years

Leased assets. Leases where the Bezeq Group assumes substantially all the risks and rewards of ownership are classified as finance leases. Upon initial recognition, the leased asset is measured at an amount equal to the lower of its fair value and the present value of the minimum lease payments. Subsequent to initial recognition, the asset is accounted for in accordance with the accounting policy applicable to the asset. At inception or upon reassessment of an arrangement, Bezeq Group determines whether such an arrangement is or contains a lease. A specific asset is the subject of a lease if fulfillment of the arrangement is dependent on the use of that specified asset or assets. An arrangement conveys the right to use the asset if the arrangement conveys to Bezeq Group the right to control the use of the asset. At inception or upon reassessment of the arrangement, Bezeq Group separates payments and other consideration required by such an arrangement into those for the lease and those for other elements on the basis of their relative fair values.

Transactions for acquiring an indefeasible right of use (IRU) of seabed cable capacities are accounted for as service transactions. The prepaid expense is amortized on a straight-line basis as stated in the agreement and no more than the expected estimated useful life of those capacities.

Inventory. Inventories are measured at the lower of cost and net realizable value. The cost of inventories is based on the moving average principle. Slow-moving inventory of terminal equipment, accessories and spare parts are stated net of the provision for impairment. The inventories of a subsidiary include terminal equipment and accessories intended for sale and service, as well as spare parts used for repairs in the repair service it provides to its customers.

Impairment. The Bezeq Group tests a financial asset for impairment when objective evidence indicates that one or more loss events have had a negative effect on the estimated future cash flows of that asset. When testing available-for-sale financial assets that are equity instruments for impairment, Bezeq Group also examines the difference between the fair value of the asset and its original cost, the length of time the fair value of the asset is lower than its original cost and changes in the technological, economic or legal environment or in the market environment in which the issuer of the instrument operates. In addition a significant or prolonged decline in its fair value below its cost is objective evidence of impairment. An impairment loss in respect of a financial asset measured at amortized cost is calculated as the difference between its carrying amount and the present value of the estimated future cash flows, discounted at the original effective interest rate. An impairment loss in respect of an available-for-sale financial asset is calculated by reference to its fair value. Significant financial assets are tested for impairment on an individual basis. The remaining financial assets are assessed for impairment collectively, in groups that share similar credit risk characteristics. The financial statements include specific provisions and Group provisions for doubtful debts, which properly reflect, in the estimation of the management, the loss inherent in debts for which collection is in doubt.

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All impairment losses are recognized in the statement of income. Any cumulative loss in respect of an available-for-sale financial asset recognized previously in equity is transferred to the statement of income. An impairment loss is reversed if the reversal can be related objectively to an event occurring after the impairment loss was recognized. For financial assets measured at amortized cost and available-for-sale financial assets that are debt securities, the reversal is recognized in the statement of income. For available-for-sale financial assets that are equity securities, the reversal is recognized directly in other comprehensive income.

The carrying amounts of the Bezeq Group's non-financial assets, other than inventories and deferred tax assets, are reviewed at each reporting date to determine whether there is any indication of impairment. If any such indication exists, then the recoverable amount of the asset is estimated. In subsequent periods, the Bezeq Group assesses the recoverable amount of goodwill and of assets which are unavailable for use once a year, or more frequently if there are indications of impairment. The recoverable amount of an asset or cash-generating unit, or CGU, is the greater of its value in use and its net selling price (fair value less costs to sell). In assessing value in use, the estimated future cash flows are discounted to their present value using a pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the asset. For the purpose of impairment testing, the assets are grouped together into CGUs, the smallest group of assets that generates cash from continuing that are largely independent of other assets or groups of assets. For purposes of goodwill impairment testing, CGUs to which goodwill has been allocated are aggregated so that the level at which impairment testing is performed reflects the lowest level at which goodwill is monitored for internal reporting purposes, but in any event is not larger than an operating segment. Goodwill acquired in a business combination or the purpose of impairment testing is allocated to cash-generating units that are expected to generate benefits from the synergies of the combination. The annual impairment test date is December 31.

The estimated recoverable amounts of the various CGU that exceed their carrying amounts are as follows:

- Bezeq Fixed Line - approximately NIS 672 million;
- Telephone - approximately NIS 160 million; and
- Bezeq International - approximately NIS 29 million.

Management has identified certain key assumptions for which there reasonably could be a possible change that could cause the carrying amounts to exceed the recoverable amounts. Please see footnote 11 – Intangible Assets for information concerning these assumptions and the amounts that these assumptions are required to change individually in order for the estimated recoverable amounts to be equal to the carrying amounts of each CGU.

Impairment losses are recognized if the carrying amount of an asset or its CGU exceeds its estimated recoverable amount. Impairment losses are recognized in the statement of income. Impairment losses recognized in respect of CGUs are allocated first to reduce the carrying amount of any goodwill allocated to the units and then to reduce the carrying amounts of the other assets in the CGU on a pro rata basis. An impairment loss in respect of goodwill is not reversed. In respect of other assets, impairment losses recognized in prior periods are assessed at each reporting date for any indications that the loss has decreased or no longer exists. An impairment loss is reversed if there has been a change in the estimates used to determine the recoverable amount. An impairment loss is reversed only to the extent that the asset's carrying amount does not exceed the carrying amount that would have been determined, net of depreciation or amortization, if no impairment loss had been recognized. Goodwill that forms part of the carrying amount of an investment in an associate is not recognized separately, and therefore is not tested for impairment separately. If objective evidence indicates that the value of the investment may have been impaired, the investment is tested for impairment.



Employee benefits. The Bezeq Group has a number of post-employment benefit plans. The plans are usually financed by deposits with insurance companies and they are classified as defined contribution plans and defined benefit plans. The Bezeq Group's obligations for contributions to defined contribution pension plans are recognized as an employee benefit expense in the statement of income in the periods during which services are rendered by employees. The Bezeq Group's net obligation in respect of defined benefit pension plans is calculated separately for each plan by estimating the amount of future benefit that employees have earned in return for their service in the current and prior periods. That benefit is stated at present value and the fair value of any plan assets and the costs of past service not yet recognized are deducted. The discount rate is the yield at the reporting date on government bonds denominated in the same currency that have maturity dates approximating the terms of Bezeq Group's obligation. The calculation is performed by a qualified actuary. When the calculation results in a net asset for Bezeq Group, an asset is recognized up to the net present value of economic benefits received in the form of a refund from the plan or a reduction in future contributions to the plan. Gains or losses resulting from curtailments or settlements of a defined benefit plan are recognized in the statement of income. Such gains or losses include any resulting change in the present value of the obligation.

The Bezeq Group has executive insurance policies that were issued before 2004 according to which the profit in real terms accumulated on the severance pay component will be paid to the employees upon their retirement. In respect of such policies, plan assets include both the balance of the severance pay component and the balance of the profit in real terms (if any) on the severance pay deposits that accumulated until the reporting date, and are presented at fair value. These plan assets are for a defined benefit plan that includes two liability components: The defined benefit plan for compensation, which is calculated actuarially as described above, and liability for payment of any retained earnings accumulated at the date of severance. This component is measured at the balance of the actual profit in real terms that accumulated at the reporting date. The Bezeq Group recognizes immediately, directly in retained earnings through other comprehensive income, all actuarial gains and losses arising from defined benefit plans.

The Bezeq Group's net obligation in respect of long-term employee benefits other than pension plans is the amount of future benefit that employees have earned in return for their service in the current and prior periods. The amount of these benefits is stated at its present value. The discount rate is the yield at the reporting date on government bonds denominated in the same currency, that have maturity dates approximating the terms of Bezeq Group's obligations. The calculation is performed using the projected unit credit method. Any actuarial gains or losses are recognized in the statement of income in the period in which they arise.

Employment termination benefits are recognized as an expense when the Bezeq Group is committed demonstrably, without realistic possibility of withdrawal, to a formal detailed plan to terminate employment before the normal retirement date. Termination benefits for voluntary redundancies are recognized as an expense if Bezeq Group has made an offer of voluntary redundancy, it is probable that the offer will be accepted, and the number of acceptances can be estimated reliably.

A liability is recognized for the amount expected to be paid under short-term cash bonus or profit-sharing plans if Bezeq Group has a present legal or constructive obligation to pay this amount as a result of past service provided by the employee and the obligation can be estimated reliably. In the statement of financial position the employee benefits are classified as current benefits or as non-current benefits according to the time the liability is due to be settled.

The fair value on the grant date of options for Company shares granted to employees is recognized as a salary expense with a corresponding increase in equity over the period during which the employee becomes entitled to the options. The amount recognized as an expense is adjusted to reflect the actual number of share options that are expected to vest. For share-based payment awards with non-vesting conditions, the fair value of the share-based payment awards is measured to reflect such conditions, and therefore Bezeq Group recognized an expense in respect of the awards whether or not the conditions have been met. The fair value of the amount payable to employees in respect of

share-based payments, which are settled in shares, is recognized as an expense with a corresponding increase in liabilities, over the period that the employees become entitled to payment. The liability is remeasured at each reporting date until the settlement date. Any changes in the fair value of the liability are recognized as an expense or income in the statement of income.

Provisions. A provision is recognized if, as a result of a past event, the Bezeq Group has a present legal or constructive obligation that can be estimated reliably, and it is probable that an outflow of economic benefits will be required to settle the obligation. Provisions are determined by discounting the expected future cash flows. The carrying amount of the provision is adjusted each period to reflect the time that has passed and is recognized as a financing expense.

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#### Legal claims

Contingent liabilities are accounted for according to IAS 37 and its related provisions. Accordingly, the claims are classified by likelihood of realization of the exposure to risk, as follows: A. More likely than not – more than 50% probability; B. Possible – probability higher than unlikely and less than 50%; or C. Unlikely – probability of 10% or less.

For claims which the Bezeq Group has a legal or constructive obligation as a result of a past event, which are more likely than not to be realized, the financial statements include provisions which, in the opinion of Bezeq Group, based, among other things, on the opinions of its legal advisers retained in respect of those claims, are appropriate to the circumstances of each case, despite the claims being denied by the Bezeq Group companies. There are also a few legal proceedings, received recently, for which the risks cannot be assessed at this stage, therefore no provisions have been made.

#### Onerous contracts

A provision for onerous contracts is recognized when the benefits expected to be derived by Bezeq Group from the contracts are lower than the unavoidable cost of meeting its obligations according to the contracts. The provision is measured at the present value of the lower of the expected cost of terminating the contract and the expected net cost of continuing with the contract.

#### Site dismantling and clearing costs

A provision in respect of an obligation to dismantle and clear sites is made in accordance with IAS 37. The provision is made for those rental agreements in which the Bezeq Group has undertaken to restore the rental property to its original state at the end of the rental period, after dismantling and transferring the site, and restoring it as necessary.

#### Warranty

A subsidiary recognized a provision for warranty in respect of first-year insurance for cellular handsets. The warranty is limited to technical malfunctions defined by the subsidiary, and does not include a warranty as a result of customer caused damage. However, an asset exists in respect of the manufacturer's warranty for those handsets, which is limited to technical malfunctions defined by the manufacturer.

#### C. Research and Development, Patents and Licenses

We did not engage in any research and development during the last three fiscal years.

#### D. Trend Information

Bezeq experienced growth in its revenues in 2010 and a decrease in revenues in 2011 and 2012. Bezeq's revenues decreased from approximately NIS 12 billion for the year ended December 31, 2010 to approximately NIS 11.4 billion for the year ended December 31, 2011 and decreased further to approximately NIS 10.3 billion (\$2.8 billion) for the year ended December 31, 2012. The decrease in 2011 was primarily due to a decrease in revenues from Bezeq's domestic fixed line segment and in 2012 due to the continued decrease in revenues from Bezeq's domestic fixed line segment and to decreased revenues from Pelephone's cellular operations. The decrease in Pelephone's revenues was caused in great measure by increased competition and changes in the regulatory environment.

Bezeq has disclosed that it expects that the Bezeq Group's net profit attributable to its shareholders in 2013 will be between NIS 1.7 and NIS 1.8 billion. It also disclosed that it expects that the Bezeq Group's free cash flow (cash from

current operations less cash for the purchase or sale of fixed assets and intangible assets, net.) will exceed NIS 2.7 billion in 2013. In 2013, streamlining processes are expected to continue throughout the Bezeq Group to improve profitability.

E. Off-Balance Sheet Arrangements

We are not a party to any material off-balance sheet arrangements. In addition, we have no unconsolidated special purpose financing or partnership entities that are likely to create material contingent obligations.

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## F. Tabular Disclosure of Contractual Obligations

The following table summarizes our (including Bezeq's) minimum contractual obligations and commercial commitments as of December 31, 2012 and the effect we expect them to have on our liquidity and cash flow in future periods:

Contractual Obligations	Payments due by period (NIS in millions)				
	Total	less than 1 year	1-3 years	3-5 years	more than 5 years
Long-term debt obligations (including interest)	18,131	2,960	4,886	6,376	4,009
Operating lease obligations	830	247	383	120	80
Purchase obligations	286	286	-	-	-
Total	19,247	3,493	5,169	6,496	4,089

## ITEM 6. DIRECTORS, SENIOR MANAGEMENT AND EMPLOYEES

## A. Directors and Senior Management

Set forth below are the name, age, principal position and a biographical description of each of our directors and executive officers:

NAME	AGE	POSITION
Shaul Elovitch (1)	65	Chairman of the Board of Directors
Felix Cohen	59	Director
Yossef Elovitch	62	Director
Ronit Gottlieb (2)(3)	59	Outside Director
Orly Guy (2)(3)	53	Outside Director
Amikam Shorer	46	Director
Anat Winner (1) (2)(3)	54	Director
Doron Turgeman	45	Chief Executive Officer
Ehud Yahalom	35	Principal Financial Officer

(1) Director of B Communications

(2) Member of our Audit Committee

(3) Member of our Compensation Committee

Mr. Shaul Elovitch, Mr. Felix Cohen, Mr. Amikam Shorer, Ms. Anat Winner and Mr. Yossef Elovitch will serve as directors until our 2013 annual general meeting of shareholders. Ms. Orly Guy and Ms. Ronit Gottlieb will each serve as an outside director pursuant to the provisions of the Israeli Companies Law for a third three-year term until August 2014 (see Item 6C. "Directors, Senior Management and Employees - Board Practices - Outside and Independent Directors - Outside Directors"). Mr. Shaul Elovitch and Mr. Yossef Elovitch are brothers. There are no other family relationships among our directors or executive officers.

Shaul Elovitch has served as the chairman of our board of directors since our inception in 1992. Mr. Elovitch is the controlling shareholder of Eurocom Communications and its affiliated companies, one of Israel's largest private communications groups. Mr. Elovitch has served as the chairman of the board of directors and chief executive officer of Eurocom Holdings and Eurocom Communications, our parent company, since 1985. Mr. Elovitch serves as the chairman of the board of directors of Bezeq and as a director and chairman of various companies of the Bezeq Group and the Eurocom Group. Mr. Elovitch also serves as a member of the board of directors of Space Communications Ltd., Satcom Systems Ltd. and E.G.R.E. Ltd., Satlink Ltd., Eurocom Cellular Communications Ltd., Eurocom Digital Communications Ltd. and other various companies within the Eurocom Group. Mr. Elovitch has served as chairman of the board of directors of B Communications since 2000. Mr. Elovitch is the brother of Mr. Yossef Elovitch. Mr. Elovitch is the father of Mr. Or Elovitch, a director.

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Felix Cohen was elected to serve as a director by our Board of Directors in February 2010. Mr. Cohen has served as the Chief Financial Officer of the Eurocom Group since 1988, and also serves as a director and/or officer of various other companies within the Eurocom Group, including, Enlight Renewable Energy Ltd., Space-Communications Ltd. and D.M Engineering (3000) Ltd. Mr. Cohen also serves as a director of Bezeq and other companies within the Bezeq group.

Yossef Elovitch has served as a director since 1993. Mr. Elovitch has served as director of Eurocom Communications since 1985. Mr. Elovitch serves as a director of various other companies in the Eurocom group. Mr. Elovitch is the brother of Mr. Shaul Elovitch.

Ronit Gottlieb has served as an outside director since July 2005 and is a member of our audit committee. Mrs. Gottlieb serves as a managing partner of R. Gottlieb and Co., a Tel Aviv office in commercial law, corporate law and real estate law. From 1984 to 1999, Mrs. Gottlieb was employed as an attorney at B.A. Gottlieb-Law Offices. Since 2008, Mrs. Gottlieb has served as an outside director of Techno Ralco Ltd. and also as a member of their audit committee. Ms. Gottlieb holds an LL.B degree from Tel Aviv University and is a member of the Israeli Bar Association.

Orly Guy has served as an outside director since July 2005 and is a member of our audit committee. Ms. Guy has served as a managing partner of Guy Bachar and Co, a Tel Aviv law firm specializing in civil-commercial law including litigation, capital market law and real estate law, since 1994. Since 2000, Ms. Guy has served as a director of a pharmaceuticals company, Intec Pharma Ltd. Ms. Guy also served as an outside director in the following companies: Complex H. Alony Ltd., Mutual Insurance Fund of State Employees and in the Study Fund for Workers on Standard Scale. Ms. Guy holds an LL.B. degree from Tel Aviv University and is a member of the Israel Bar Association.

Amikam Shorer was elected to serve as a director by our Board of Directors in February 2010. Mr. Shorer has served as the vice chairman of Eurocom Communications since August 2011. Prior to that and from 2005, Mr. Shorer has served as the Executive Vice President of the Eurocom Group. Mr. Shorer also serves as a director and/or officer of various other companies within the Eurocom Group, including, Satcom Systems Ltd. (as chairman of the board of directors), Gaya Com Ltd., Gilat Satcom Ltd., IP Planet Network Ltd. (as well as other companies within the Satcom group), Space Communication Ltd., Eurocom Capital Underwriting Ltd., Eurocom Capital finance Ltd. Bezeq The Israel Telecommunication Corp, Ltd., Bezeq On Line Ltd., Bezeq Zahav (Holdings) Ltd., Bezeq International Ltd., Enlight Renewable Energy Ltd. and E.G.R.E Ltd. (as chairman of the board of directors) and other companies within the Bezeq Group. Mr. Shorer has also served as the chief executive officer of Sahar Investments Ltd. (today "Enlight"), also a member of the Eurocom Group since 2008 until 2010. Mr. Shorer holds an LL.B degree from Bar-Ilan University.

Anat Winner has served as a director of our company since August 2001 and is a member of our audit committee. She has served as a director of B Communications since October 2007 and is a member of its audit committee. Ms. Winner has been self employed as a business advisor since July 2003 and served as a director of Magal Security Systems Ltd., publicly traded on the NASDAQ Global Market and TASE from 2003 to 2010. From October 2001 to July 2003, Ms. Winner served as chief executive officer and chief financial officer of Israel News Ltd. From 1999 to October 2001, Ms. Winner served as chief financial officer of DBS. Ms. Winner holds a B.A. degree in Accounting and Economics from Haifa University and has been a certified public accountant (Israel) since 1986.

Doron Turgeman has served as our chief executive officer since October 2011 and previously had served as our deputy chief executive officer since October 2004 and as our chief financial officer since May 2001. Mr. Turgeman also serves as the chief executive officer of B Communications and as the chief financial officer of Eurocom Communications Ltd. Previously, Mr. Turgeman served as B Communications' chief financial officer and vice president of finance from February 2010 until October 2011 and served as a member of its board of directors from

January 2008 to February 2010. During the last five years, Mr. Turgeman also served as an executive officer of several of our media and Internet companies, which have been sold. Mr. Turgeman holds a B.A. degree in Economics and Accounting from the Hebrew University of Jerusalem and is a certified public accountant in Israel.

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Ehud Yahalom has served as our principal financial officer since October 2, 2011. Mr. Yahalom joined our company in May 2011 as a controller. Previously and from 2007, Mr. Yahalom served in Cellcom Israel Ltd.'s accounting department. Mr. Yahalom holds a B.A. degree in economics and accounting from the Haifa University, an M.B.A. degree from the College of Management Academic Studies in Rishon LeZion and is a Certified Public Accountant in Israel.

Set forth below are the name, age, principal position and a biographical description of each of the principal executives of Bezeq, our principal subsidiary:

Name	Age	Position
Shaul Elovitch	65	Chairman of the Board of Directors of Bezeq
Stella Handler	44	Chief Executive Officer of Bezeq
David Mizrahi	43	Chief Financial Officer and Deputy Chief Executive Officer

Shaul Elovitch Please see Mr. Elovitch's biographical description above.

Stella Handler. Ms. Handler was appointed as the new chief executive officer of Bezeq, as of April 14, 2013. Ms. Handler has held several senior positions in Israel's communications sector, among them the chairman of HOT from May 2011 until January 2013 and chief executive officer of our company (then known as 012 Golden Lines) from 2003 until January 2010. Ms. Handler holds B.A. and M.A. degrees in Economics and an M.B.A. degree, all from the Hebrew University of Jerusalem.

David Mizrahi. Mr. Mizrahi has served as Bezeq's deputy chief executive officer and chief financial officer since January 2013. Previously, from 2007 until December 2012, Mr. Mizrahi served as VP Economics and Budgets at Bezeq. Mr. Mizrahi holds a B.A. degree in Economics from the Hebrew University of Jerusalem.

## B. Compensation

We have two executive officers, Doron Turgeman, our chief executive officer and Ehud Yahalom, our principal financial officer, and seven directors. Other than such officers, we have three additional employees who are engaged in management, financial and administrative activities. The aggregate direct compensation we paid to our directors and executive officers as a group (9 persons) for the year ended December 31, 2012 was approximately NIS 1 million (\$270,000). This amount includes directors compensation and expenses related to salaries, but does not include expenses such as business travel, professional and business association dues and expenses reimbursed to officers and other fringe benefits commonly reimbursed or paid by companies in Israel. As of December 31, 2012, no amount was reserved for pension, retirement, recreation payments and vacation or similar benefits for our directors and executive officers.

We have entered into an arrangement with Eurocom Communications, and B Communications according to which Mr. Turgeman will provide management services to us, B Communications and Eurocom Communications. Each of Eurocom Communications, us and B Communications will bear 33% of Mr. Turgeman's management services costs.

During the year ended December 31, 2012, we paid to each of our outside directors, as well as to our independent director, annual fees of NIS 155,000 (approximately \$42,000) and a per meeting attendance fee of NIS 13,000 (\$3,000). Such fees are paid based on the fees set forth in regulations promulgated under the Israeli Companies Law.

Our other non-employee directors do not receive compensation for their services on our board of directors or any committee of our board of directors. All of our non-employee directors are reimbursed for their expenses for each meeting of the board of directors and audit committee attended.

C. Board Practices

Introduction

According to the Israeli Companies Law and our articles of association, the management of our business is vested in our board of directors. The board of directors may exercise all powers and may take all actions that are not specifically granted to our shareholders. Our executive officers are responsible for our day-to-day management. The executive officers have individual responsibilities established by our chief executive officer and board of directors. Executive officers are appointed by and serve at the discretion of the board of directors, subject to any applicable agreements.

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## Election of Directors

Our articles of association provide for a board of directors consisting of no less than six and no more than nine members or such other number as may be determined from time to time at a general meeting of shareholders. Our board of directors is currently composed of seven directors.

Pursuant to our articles of association, our board of directors is divided into three classes (other than outside directors). Generally, at each annual meeting of shareholders one class of directors is elected for a term of three years by a vote of the holders of a majority of the voting power represented and voting at such meeting. All the members of our board of directors (except the outside directors as detailed below) may be reelected upon completion of their term of office. Our board of directors may appoint additional directors to temporarily fill any vacancies in the board of directors, provided that the total number of directors will not exceed nine and that if the total number of directors decreases below six, the board of directors may only act in emergency situations, or to fill the minimum number of vacancies, or to call a general meeting of shareholders, so that following such meeting there will be at least six directors in office.

The board of directors of an Israeli public company is required to determine that at least one or more directors will have “accounting and financial expertise,” as defined by regulations promulgated under the Israeli Companies Law. Our board of directors determined, accordingly, that at least two directors must have “accounting and financial expertise.” Our Board of Directors has further determined that Mr. Shaul Elovitch, Ms. Orly Guy and Ms. Anat Winner have the requisite “accounting and financial expertise.”

As a controlled company within the meaning of the NASDAQ Stock Market Rules, we are exempt from the NASDAQ requirement regarding the nomination process of directors, and instead, follow Israeli law and practice, in accordance with which directors may be recommended by our board of directors for election by our shareholders. See Item 16G. “Corporate Governance - NASDAQ Exemptions for a Controlled Company.”

## Potential Conflicts of Interest

Some of our directors also serve in various capacities for entities affiliated with Eurocom Communications and its affiliates. These relationships may give rise to conflicts of interest from time to time relating to (i) contracts, (ii) corporate opportunities, and (iii) use of directors’ time and expertise. We have not adopted any formal plan or procedures to address such conflicts of interest and intend to review all related party transactions on a case-by-case basis. Under Israeli law, certain approvals are required for related party transactions (see below in this Item 6C. “Directors, Senior Management and Employees - Board Practices - Fiduciary Duties; Approval of Related Party Transactions under Israeli Law”).

## Outside and Independent Directors

### Outside Directors

Under the Israeli Companies Law, companies incorporated under the laws of the State of Israel whose shares have been offered to the public are required to appoint at least two outside directors. The outside directors must meet certain statutory requirements of independence.

At least one of the outside directors must have “accounting and financial expertise” and any other outside director must have “accounting and financial expertise” or “professional qualification,” as such terms are defined by regulations promulgated under the Israeli Companies Law.

The outside directors are elected for their first term of office by shareholders at a general meeting, provided that either:

- The majority of shares voting on the matter (not including abstentions), including at least a majority of the shares of the non-controlling shareholders (and of shareholders who do not have a personal interest in the election of the outside director as a result of their relationship with the controlling shareholder) voting on the matter, vote in favor of the outside director; or

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- The majority of shares voting on the matter (not including abstentions) vote in favor of the outside director and the total number of ordinary shares held by non-controlling shareholders (and of shareholders who do not have a personal interest in the election of the outside director as a result of their relationship with the controlling shareholder) that voted against the election of the outside director does not exceed 2% of all of the voting rights in the company.

In general, outside directors serve for a three-year term and may be reelected to two additional three-year terms if one of the following conditions is met:

- One or more shareholders holding at least 1% of the voting rights in the company nominated the outside director for an additional term of office and the appointment was approved by a majority of the shares voting on the matter, not including votes of controlling shareholders or shareholders who have a personal interest in the election of the outside director as a result of their relationship with the controlling shareholder; and provided that the total number of shares held by non-controlling persons and by persons who have no personal interest in the appointment of the outside director as a result of their relationship with the controlling shareholder, who voted in favor of the election of the nominee, exceeds 2% of the voting rights in the company; or
- The board of directors proposed the nominee for an additional term of office, and the election was approved by the general meeting of shareholders by the majority required for the election of an outside director for a first term of office, as described above.

Outside directors can be removed from office only by the same special percentage of shareholders as can elect them, or by a court, and then only if the outside directors cease to meet the statutory qualifications with respect to their appointment or if they violate their duty of loyalty to the company. If an outside directorship becomes vacant, the board of directors is required under the Israeli Companies Law to convene a shareholders meeting immediately to appoint a new outside director.

Each committee of the board of directors that is authorized to exercise powers vested in the board of directors must include at least one outside director, and the audit committee and compensation committee must include all the outside directors. An outside director is entitled to compensation as provided in regulations adopted under the Israeli Companies Law and is otherwise prohibited from receiving any other compensation, directly or indirectly, in connection with such service.

Ms. Orly Guy and Ms. Ronit Gottlieb each serve as an outside director pursuant to the provisions of the Israeli Companies Law for a second three-year term until August 2011. Ms. Guy has “accounting and financial expertise,” and Ms. Gottlieb has “professional qualification,” as such terms are defined under the Israeli Companies Law.

#### Independent Directors

In general, NASDAQ Stock Market Rules require that a NASDAQ-listed company have a majority of independent directors on its board of directors and its audit committee must consist solely of independent directors, as defined under NASDAQ Stock Market Rules. Because Eurocom Communications own more than 50% of our ordinary shares, we are considered a “controlled company” within the meaning of NASDAQ Stock Market Rules. Accordingly, we are exempt from certain requirements under NASDAQ Stock Market Rules, such as the requirement to have a majority of independent directors on our board of directors. If the “controlled company” exemption would cease to be available to us under the NASDAQ Stock Market Rules, we may instead elect to follow Israeli law and would not be required to elect any additional independent directors.

Pursuant to the Israeli Companies Law, a director may be qualified as an independent director if such director is either (i) an outside director; or (ii) a director who complies with the following requirements: (y) he or she is eligible for nomination as an outside director and the audit committee has approved such eligibility; and (z) he or she has not acted as a director of the company for a period exceeding nine consecutive years.

Our board of directors has determined that each of Ms. Guy and Ms. Gottlieb (both outside directors under Israeli law) and Ms. Anat Winner qualifies as an independent director under the requirements of the SEC, NASDAQ and Israeli law.

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## Audit Committee

Under the Israeli Companies Law, the board of directors of any public company must establish an audit committee. The audit committee must consist of at least three directors, must include all of the outside directors and must have a majority of independent directors. The audit committee may not include the chairman of the board of directors, any director employed by the company or by the controlling shareholder of the company, or any director who provides services on a regular basis to the company or the controlling shareholder or a company controlled by the controlling shareholder, or a director who is financially dependent on the controlling shareholder, or a controlling shareholder or any of the controlling shareholder's relatives.

Our audit committee also serves, in compliance with the Israeli Companies Regulations (Provisions and Conditions regarding the Financial Statements' Authorization Process), 2010 as the committee of our board of directors that is required to examine our financial statements.

In addition, the NASDAQ Stock Market Rules require us to establish an audit committee comprised of at least three members, all of whom must be independent directors, each of whom is financially literate and satisfies the respective "independence" requirements of the SEC and NASDAQ and one of whom has accounting or related financial management expertise at senior levels within a company.

Our audit committee assists our Board of Directors in overseeing the accounting and financial reporting processes of our company and audits of our financial statements, including the integrity of our financial statements, compliance with legal and regulatory requirements, our independent registered public accountants' qualifications and independence, the performance of our internal audit function and independent registered public accountants, finding any defects in the business management of our company and proposing to our Board of Directors ways to correct such defects, approving related-party transactions as required by Israeli law, and such other duties as may be directed by our Board of Directors. The role of our audit committee also includes the determination of whether certain related party transactions are regarded as material or extraordinary, the review of the internal audit program and the operation of the internal auditor, as well as setting procedures for whistleblower protection.

Our audit committee consists of three members of our Board of Directors who satisfy the respective "independence" requirements of the SEC, NASDAQ and Israeli law for audit committee members. Our audit committee is currently composed of Ms. Guy, Ms. Gottlieb and Ms. Winner, who serves as the chairperson of the audit committee. Our Board of Directors has determined that Ms. Winner qualifies as an audit committee financial expert. The audit committee meets at least once each quarter. Our audit committee charter is available on our website at [www.igld.com](http://www.igld.com).

## Compensation Committee

Our Board of Directors has established a Compensation Committee. Pursuant to a recent amendment to the Israeli Companies Law, or the Compensation Amendment, which became effective on December 12, 2012, a compensation committee must be comprised of no fewer than three members and must include all of the outside directors, whom must also constitute a majority of its members. All other members of the compensation committee must be directors who receive compensation that is in compliance with regulations promulgated under the Israeli Companies Law. In addition, the chairperson of the compensation committee must be an outside director. Directors who are not qualified to serve on the audit committee (as described above) may not serve on the compensation committee.

Under the Compensation Amendment, the compensation committee is responsible for: (i) making recommendations to the board of directors with respect to the approval of the compensation policy applicable to the company's office holders and any extensions thereto; (ii) providing the board of directors with recommendations with respect to any amendments or updates to the compensation policy and periodically reviewing the implementation thereof; (iii)

reviewing and approving arrangements with respect to the terms of office and employment of office holders; and (iv) determining whether or not to exempt a transaction with a candidate for chief executive officer from shareholder approval.

Pursuant to the Compensation Amendment, our Compensation Committee is required to adopt a compensation policy by September 11, 2013 and will be required to approve our compensation policies at least once every three years. The compensation policy must be based on those considerations, must include those provisions and needs to reference those matters as are detailed in the Israeli Companies Law. The compensation policy must be approved by our board of directors, after considering the recommendations of our Compensation Committee. In addition, the compensation policy needs to be approved by the company's shareholders by a simple majority, provided that (i) such majority includes at least a majority of the shareholders who are not controlling shareholders and who do not have a personal interest in the matter, present and voting (abstentions are disregarded), or (ii) the non-controlling shareholders or shareholders who do not have a personal interest in the matter who were present and voted against the policy, hold two percent or less of the voting power of the company. Under the Compensation Amendment, if the shareholders of the company do not approve the compensation policy, the compensation committee and board of directors may override the shareholders' decision if each of the compensation committee and board of directors provide detailed reasons for their decision. We have not yet adopted a compensation policy that complies with the Compensation Amendment.

Our Compensation Committee consists of three members of our Board of Directors who satisfy the respective “independence” requirements of the SEC, NASDAQ and Israeli law for audit committee members. Our current compensation committee members are Ms. Orly Guy and Ms. Ronit Gottlieb, our outside directors under Israeli law, and Ms. Winner, who serves as the chairperson of the compensation committee.

#### Internal Auditor

Under the Israeli Companies Law, the board of directors of a public company must appoint an internal auditor nominated by the audit committee. The role of the internal auditor is, among other things, to examine whether a company’s actions comply with applicable law and orderly business procedure. The internal auditor must meet certain statutory requirements of independence. In determining the ownership or voting interest of a person, Israeli law is expansive and aggregates that person’s direct and indirect holdings, including the holdings of certain affiliates, relatives and associates. Mr. Ilan Chaikin currently serves as our internal auditor.

#### Exculpation, Indemnification and Insurance of Directors and Officers

##### Indemnification of Office Holders

Under the Israeli Companies Law and the Israeli Securities Law, 5738-1968, or the Israeli Securities Law, a company may, if permitted by its articles of association, indemnify an office holder for any of the following liabilities or expenses that they may incur due to an act performed or failure to act in his or her capacity as the company's office holder, either pursuant to an undertaking given by the company in advance of the act or following the act:

monetary liability imposed on the office holder in favor of a third party in a judgment, including a settlement or an arbitral award confirmed by a court. However, if a company undertakes to indemnify an office holder in advance of such a liability, the undertaking must be limited to foreseeable events based on the company's activities when the company undertook such indemnification, and to amounts or standards that the board of directors has determined are reasonable under the circumstances;

reasonable litigation expenses, including attorneys' fees, expended by an office holder as a result of an investigation or proceeding instituted against the office holder by a competent authority, provided that such investigation or proceeding concludes without the filing of an indictment against the office holder and either: no financial liability was imposed on the office holder in lieu of criminal proceedings, or a financial liability was imposed on the office holder in lieu of criminal proceedings with respect to an alleged criminal offense that does not require proof of criminal intent;

reasonable litigation expenses, including attorneys' fees, expended by the office holder or for which the office holder is charged by a court:

o in an action brought against the office holder by the company, on behalf of the company or on behalf of a third party,

o in a criminal action from which the office holder is acquitted, or

o in a criminal action in which the office holder is convicted of a criminal offense which does not require proof of criminal intent.

a payment that the office holder is obligated to make to an injured party pursuant to Section 52(54)(a)(1)(a) of the Israeli Securities Law, and expenses that the office holder incurred in connection with an administrative proceeding

under the Israeli Securities Law, including reasonable litigation expenses and attorney fees.

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#### Insurance of Office Holders

A company may, if permitted by its articles of association and subject to the conditions set forth in the Israeli Companies Law, obtain insurance for an office holder against liabilities incurred in his or her capacity as an office holder. These liabilities include a breach of duty of care to the company or a third-party, a breach of duty of loyalty and any monetary liability imposed on the office holder in favor of a third-party.

In addition, under the Israeli Securities Law, a company may, if permitted by its articles of association, obtain insurance for an office holder against liabilities incurred in his or her capacity as an office holder in connection with a payment that the office holder is obligated to make to an injured party pursuant to Section 52(54)(a)(1)(a) of the Israeli Securities Law, and expenses that the office holder incurred in connection with an administrative proceeding under the Israeli Securities Law, including reasonable litigation expenses and attorney fees.

#### Exculpation of Office Holders

Under the Israeli Companies Law, a company may, if permitted by its articles of association, also exculpate an office holder from a breach of duty of care in advance of that breach. A company may not exculpate an office holder from a breach of duty of loyalty towards the company or from a breach of duty of care concerning dividend distribution or a purchase of the company's shares by the company or other entities controlled by the company.

#### Limitations on Exculpation, Insurance and Indemnification

Under the Israeli Companies Law, a company may indemnify or insure an office holder against a breach of duty of loyalty only to the extent that the office holder acted in good faith and had reasonable grounds to assume that the action would not prejudice the company. In addition, a company may not indemnify, insure or exculpate an office holder against a breach of duty of care if committed intentionally or recklessly (excluding mere negligence), or committed with the intent to derive an unlawful personal gain, or for a fine or forfeit levied against the office holder in connection with a criminal offense. According to the Israeli Administrative Enforcement Law, a company cannot insure or indemnify an office holder for an administrative enforcement procedure, regarding payments to victims of the infringement or for expenses expended by the officer with respect to certain proceedings held concerning him or her, including reasonable litigation expenses and legal fees.

Pursuant to the Israeli Companies Law, exculpation of, procurement of insurance coverage for, and an undertaking to indemnify or indemnification of, our office holders must be approved by our Compensation Committee and our Board of Directors and, if the office holder is a director or the chief executive officer, also by our shareholders.

Our articles of association allow us to insure, indemnify and exempt our office holders to the fullest extent permitted by law, subject to the provisions of the Israeli Companies Law and Israeli Securities Law. We maintain a directors' and officers' liability insurance policy with liability coverage of up to \$10 million per claim and in the aggregate. We have undertaken to indemnify all of our directors and officers to the extent permitted by law, in an aggregate amount for all directors and officers not to exceed 25% of our equity (on a consolidated basis) in accordance with the our last financial statements published before the actual payment of the indemnity amount, to the extent that their liability is not covered under our directors' and officers' liability insurance policy.

#### D. Employees

On December 31, 2012, we had five employees who also provided services to B Communications. Our direct employees are all located in Israel and are not represented by any labor union. Since our inception, we have not experienced any labor-related work stoppages and believe that our relations with our employees are good. We have

entered into an arrangement with B Communications according to which our employees will provide services to both companies and each company will pay 50% of their compensation. We entered into a similar arrangement with B Communications and Eurocom Communications with respect to the management services supplied by Mr. Doron Turgeman to the three companies.

As of December 31, 2012, the Bezeq Group employed 14,987 persons, of which 7,422 persons were employed by Bezeq, 3,187 persons were employed (or otherwise retained) by Pelephone, 2,262 persons were employed by Bezeq International and 2,276 persons were employed by DBS. As of December 31, 2011, the Bezeq Group employed 15,606 persons, of which 7,076 persons were employed by Bezeq, 4,041 persons were employed by Pelephone, 2,262 persons were employed by Bezeq International and 2,227 persons were employed by DBS. As of December 31, 2010, Bezeq Group employed a total of 15,690 persons, of which 7,364 persons were employed by Bezeq, 3,985 persons were employed by Pelephone, 2,112 persons were employed by Bezeq International and 2,229 persons were employed by DBS.

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Israeli labor laws and regulations are applicable to all of our employees. Israeli labor laws govern the length of the workday, minimum wages for employees, procedures for hiring and dismissing employees, determination of severance pay, annual leave, sick days and other conditions of employment. Israeli law generally requires severance pay upon the retirement or death of an employee or termination of employment by our company. For those of our employees who are entitled to a pension arrangement, we fund future severance pay obligations by contributing to managers' insurance or other pension arrangements. A provision in our financial statements covers severance pay to those employees who are not entitled to managers' insurance or other pension arrangements. Furthermore, we and our employees are required to make payments to the National Insurance Institute, which is similar to the U.S. Social Security Administration. Such amounts also include payments by the employee for health insurance.

Labor relations with Bezeq's employees involved in fixed-line communications are regulated by the collective agreements among Bezeq, the workers representatives and the Histadrut, as well as by personal contracts. Additionally, expansion orders to certain general collective agreements apply Bezeq's employees, such as cost-of-living increment agreements.

#### E. Share Ownership

As of April 22, 2013, none of our directors and executive officers beneficially owns any of our ordinary shares, other than Mr. Shaul Elovitch, the chairman of our board of directors, who is deemed to beneficially own 15,164,929 or 78.97% of our ordinary shares as of such date through his controlling interest in Eurocom Communications and Mr. Doron Turgeman, our Chief Executive Officer, who own 7,555 of our ordinary shares. Mr. Shaul Elovitch holds 80% of Eurocom Holdings' shares and 75% of Eurocom Holdings' management shares, and Mr. Yossef Elovitch, his brother and our director, holds 20% of Eurocom Holdings' shares and 25% of Eurocom Holdings' management shares. Eurocom Communications is 50.33% owned by Eurocom Holdings and 49.0% of its shares are held by four holding companies, which are 80% owned by Mr. Shaul Elovitch and 20% owned by Mr. Yossef Elovitch, respectively. The remaining 0.67% interest in Eurocom Communications is directly owned by Mr. Shaul Elovitch. Accordingly, Mr. Shaul Elovitch may be deemed to have the sole voting and dispositive power over our ordinary shares held of record by Eurocom Communications. In addition, Mr. Shaul Elovitch may be deemed to be the beneficial holder of 26,893 ordinary shares held of record by Mrs. Shaul Elovitch. In addition, 10,650 ordinary shares are held by other family members of Mr. Elovitch.

Mr. Shaul Elovitch also serves as the chairman of the board of directors of B Communications, Eurocom Communications and Eurocom Holdings. Accordingly, Mr. Shaul Elovitch may be deemed to have the sole voting and dispositive power over our ordinary shares beneficially owned by Eurocom Communications. See also Item 7A. "Major Shareholders and Related Party Transactions - Major Shareholders."

### ITEM 7. MAJOR SHAREHOLDERS AND RELATED PARTY TRANSACTIONS

#### A. Major Shareholders

The following table sets forth certain information as of April 22, 2013, regarding the beneficial ownership by all shareholders known to us to own beneficially 5% or more of our ordinary shares:

Name	Number of Ordinary Shares Beneficially Owned (1)	Percentage of Ownership (2)
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Eurocom Communications (3)	15,164,929	78.97%
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(1) Beneficial ownership is determined in accordance with the rules of the Securities and Exchange Commission and generally includes voting or investment power with respect to securities. Ordinary shares relating to options currently exercisable or exercisable within 60 days of the date of this table, are deemed outstanding for computing the percentage of the person holding such securities but are not deemed outstanding for computing the percentage of any other person. Except as indicated by footnote, and subject to community property laws where applicable, the persons named in the table above have sole voting and investment power with respect to all shares shown as beneficially owned by them.

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- (2) The percentages shown are based on 19,203,186 ordinary shares issued and outstanding (which exclude 5,862,615 ordinary shares held as treasury shares) as of April 22, 2013.
- (3) Mr. Shaul Elovitch, Mr. Yossef Elovitch, Eurocom Communications, Eurocom Holdings, Eurocom Communication Holdings 2005 Ltd., Eurocom Technologies Management (2005) Ltd., Eurocom Assets Ltd. and Eurocom Assets Holdings Ltd. are the beneficial owners of 15,164,929 ordinary shares of the Issuer that are held directly by Eurocom Communications. Mr. Shaul Elovitch and his brother, Mr. Yossef Elovitch, own 80% and 20%, respectively, of Eurocom Holdings. (Mr. Shaul Elovitch and Mr. Yossef Elovitch own 75% and 25%, respectively, of Eurocom Holdings' management shares). Eurocom Communications is 50.33% owned by Eurocom Holdings and 49% of its shares are held by four holding companies (Eurocom Communication Holdings 2005 Ltd., Eurocom Technologies Management (2005) Ltd., Eurocom Assets Ltd. and Eurocom Assets Holdings Ltd.). The four holding companies are 80% owned by Mr. Shaul Elovitch and 20% owned by Mr. Yossef Elovitch, respectively. Therefore Eurocom Holdings, Eurocom Communication Holdings 2005 Ltd., Eurocom Technologies Management (2005) Ltd., Eurocom Assets Ltd. and Eurocom Assets Holdings Ltd., together, hold 99.33% of Eurocom Communications. The remaining 0.67% interest in Eurocom Communications is directly owned by Mr. Shaul Elovitch. Accordingly, Mr. Shaul Elovitch may be deemed to have the sole voting and dispositive power as to the ordinary shares of the Issuer held of record by Eurocom Communications. Mr. Shaul Elovitch may also be deemed to be the beneficial holder of 26,893 of our ordinary shares held of record by his wife, Mrs. Iris Elovitch. In addition, 9,300 of our shares are held by other family members of Mr. Shaul Elovitch.

#### Significant Changes in the Ownership of Major Shareholders

As of December 31, 2010, Mr. Elovitch's beneficially owned 14,159,328 of our ordinary shares. In 2011, Eurocom Communications purchased an additional 1,022,296 of our ordinary shares in open market transactions, increasing Mr. Elovitch's ownership interest to 15,200,122 ordinary shares, or 79.16% of the shares. There has not been a change in Mr. Elovitch's beneficial ownership since December 31, 2011.

On February 16, 2010, Clal Insurance Enterprises Holdings Ltd. Clal Finance Ltd. and the other Reporting Persons (as defined in the Schedule 13G) filed Amendment No. 2 to their Schedule 13G reflecting beneficial ownership of 1,204,113.5 or 6.5% of our ordinary shares. On February 14, 2011, these Reporting Persons filed Amendment No. 3 to their Schedule 13G reflecting beneficial ownership of less than 5% of our ordinary shares.

#### Major Shareholders Voting Rights

Our major shareholders do not have different voting rights.

#### Record Holders

Based on a review of the information provided to us by our transfer agent, as of April 22, 2013, there were 25 holders of record of our ordinary shares, of which 22 record holders holding approximately 34% of our ordinary shares had registered addresses in the United States. These numbers are not representative of the number of beneficial holders of our shares nor are they representative of where such beneficial holders reside since many of these ordinary shares were held of record by brokers or other nominees (including one U.S. nominee company, CEDE & Co., which held approximately 33.9% of our outstanding ordinary shares as of such date). We believe that we have in excess of 1,000 beneficial holders at such date.

#### B. Related Party Transactions

We receive and provide various services and products to and from related parties at market rates and in the ordinary course of business. Other than the transactions described below, none of our related party transactions are material to us or to our related parties. If a related party wishes to supply products or services to us, we generally obtain a bid from a third party to enable us to determine whether the related party's bid is on arm's-length terms. Any of such transaction is subject to the approval of our Audit Committee and our board of directors (and our shareholders, if requires). In addition, generally we will not purchase a particular type of product or service solely from related parties, but will also have non-related vendors. Prices offered by non-related vendors are compared to those offered by related parties to ensure that the related parties are offering arm's length terms.

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In the ordinary course of business, some of our subsidiaries and affiliates engage in business activities with each other. Such business activities are primarily among Bezeq, Bezeq subsidiaries and other Eurocom Group companies, such as Eurocom Digital Communications, Eurocom Cellular Communications, Space-Communications (Spacecom), Gilat Satcom, Satlink Communications, and to a lesser extent other affiliated companies. Such business activities primarily relate to the provision, purchase or sale of communications and digital services and products, including, the provision of related satellite or broadcasting services, cellular and electronic products and equipment, and Internet and telephony services. The transactions among these related parties are made at prices and on terms equivalent to those charged in transactions with unrelated parties under similar conditions.

#### Relationship with Eurocom Communications and its affiliates

Messrs. Shaul Elovitch, chairman of our board of directors, and his brother Yossef Elovitch, a director of our company, also serve as directors of Eurocom Communications and various of its affiliates, together indirectly hold a majority of the outstanding shares of Eurocom Communications. During the past three years, we have entered into transactions with Eurocom Communications and several of their affiliates, referred to as the Eurocom group. We believe that the transactions with Eurocom Communications and its affiliates described below could have been entered into on comparable terms with unrelated parties and on an arm's length basis. Set forth below are summary descriptions of certain agreements, relationships and transactions between us and members of the Eurocom group.

#### Certain Related Party Transactions

We and B Communications lease our principal offices from Eurocom Communications for an annual rent of NIS 32,500 for each company. In addition, Eurocom Real Estate provides us and B Communications with parking spaces for NIS 13,000 a year for each company. Eurocom Digital Communications provides us and B Communications with additional services, such as computing services and car maintenance for an annual sum of NIS 32,000 for each company.

In addition, we receive and render various services and products to and from related parties at market rates and in the ordinary course of business. None of these transactions are material to us or to our related parties. If a related party wishes to supply products or services to us, we generally obtain a bid from a third party to enable us to determine whether the related party's bid is on arm's-length terms. Any of such transaction is subject to the approval of our Audit Committee and our board of directors (and our shareholders, if requires). In addition, generally we will not purchase a particular type of product or service solely from related parties, but will also have non-related vendors. Prices offered by non-related vendors are compared to those offered by related parties to ensure that the related parties are offering arm's length terms.

#### Registration Rights Agreement with Eurocom Communications

In July 1999, we entered into a registration rights agreement with Euronet Communications (which was subsequently assigned to Eurocom Communications) and our other than existing shareholders granting them the right to register their ordinary shares under the Securities Act of 1933, as amended. The registration rights include unlimited rights to request that their shares be included in any underwritten public offering of our ordinary shares (excluding any registration of employees' shares on Form S-8 or a similar form). Additionally, as of February 4, 2000, the holders of a majority of such shares are entitled to demand, up to three times in aggregate, that we register their shares. As of August 4, 2000, the holders of a majority of these shares are also entitled to request that we effect a registration of their shares on a shelf registration statement once in any 12-month period, up to three times in aggregate. All expenses incurred in connection with such registrations, other than underwriters' and brokers' discounts and commissions, will be payable by us.

Execution Services Agreement with Eurocom Capital Finance Ltd.

In November 2007, we entered into an execution services agreement with Eurocom Capital Finance Ltd., or Eurocom Capital, which is controlled by Mr. Shaul Elovitch, our controlling shareholder and the chairman of our Board of Directors, under which Eurocom Capital provides us with various financial services. Under the agreement, Eurocom Capital handles the execution of investments in our capital, pursuant to direct instructions from our chief executive officer. In consideration for these services, we agreed to pay Eurocom Capital fees which are customary for such agreements and on market terms. Eurocom Capital has agreed to act to preserve our financial resources according to a policy that will be set by our management and approved by the board of directors. We paid Eurocom Capital NIS 452,000, NIS 707,000 and NIS 403,000 (\$107,000) for the years ended December 31, 2010, 2011 and 2012, respectively.

#### Agreements with B Communications

##### Intercompany Loans

On March 31, 2007, we provided B Communications with a long-term loan of NIS 100.6 million, bearing the prime interest rate published from time to time by the Bank of Israel. As of December 31, 2009, B Communications had an outstanding balance payable to us of NIS 326 million. On March 24, 2010, NIS 302 million (\$85 million) of the loan was repaid as part of the proceeds from our participation in B Communications' March 2010 private placement, discussed below. On May 12, 2010, B Communications repaid the remaining outstanding balance of NIS 31.5 million (\$8.8 million).

In November 2009, we provided B Communications a NIS 217.5 million loan, which bears interest equal to the yield on Israel Government bonds with an average maturity that is closest to the maturity date of the loan, as such yield is reflected in the average closing price of Israel Government bonds for the seven trade days preceding the grant of the loan. On March 24, 2010, the loan was fully repaid as part of the proceeds from our participation in B Communications' March 2010 private placement, discussed below.

##### Private Placement

On March 24, 2010, B Communications completed a private placement of 3,478,000 of its ordinary shares to Israeli institutional investors and us. The offering price of NIS 116 (approximately \$3.27) per ordinary share was determined by means of a tender by third party, institutional investors. We purchased 2,599,310 ordinary shares of B Communications, which represented approximately 75% of the shares sold in the private placement. The private placement proceeds from us were paid by way of B Communications' partial repayment of the loan we provided to it in March 2007 and its full repayment of the loan we provided to it in November 2009, as described above.

##### Intercompany Agreement

In February 2008, B Communications entered into an execution services agreement with Eurocom Capital, which is controlled by Mr. Shaul Elovitch, our controlling shareholder and the chairman of our Board of Directors, under which Eurocom Capital provides B Communications with various financial services. Under the agreement, Eurocom Capital handles the execution of the financial investments of B Communications pursuant to direct instructions from our chief financial officer, which is based on a policy that was established by its management and approved by the Board of Directors of B Communications. In consideration for these services, B Communications agreed to pay Eurocom Capital fees which are customary for such agreements and on market terms. B Communications paid Eurocom Capital an aggregate amount of NIS 470,000, NIS 620,000 and NIS 403,000 (\$107,000) in fees for its services in the years ended December 31, 2010, 2011 and 2012, respectively.

##### Registration Rights Agreement with B Communications

We and B Communications have entered into a registration rights agreement under which B Communications has granted us the right to register the ordinary shares of B Communications that we hold under the Securities Act of 1933, as amended. Under the registration rights agreement, we have "demand" registration rights that allow us, at any time after one year following the initial public offering in the United States of B Communications, to request to register under the Securities Act of 1933, some or all of the ordinary shares of B Communications that we own. We are entitled to an aggregate of five demand registrations. B Communications is not required to effect any demand registration unless such demand registration is for a number of ordinary shares with a market value that is equal to at least \$7.5 million. B Communications is also not required to effect more than one demand registration during the first 12 months following its initial public offering in the United States or more than one demand registration during any

12-month period thereafter. B Communications is not obligated to grant a request for a demand registration within 90 days of any other demand registration. We also have “piggyback” registration rights that allow us to include the ordinary shares of B Communications that we own in any public offering of equity securities initiated by B Communications (other than public offerings pursuant to registration statements on Forms F-4, S-8 or any other successor forms). The “piggyback” registration rights are subject to proportional cutbacks based on the manner of the offering and the identity of the party initiating such offering. B Communications has also granted us the right to request a shelf registration on Form F-3, provided that it shall be eligible to utilize a registration statement on such form, providing for an offering to be made on a continuous basis, but for no longer than one year without the consent of the audit committee of B Communications.

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Under the registration rights agreement, B Communications has agreed to indemnify us against any losses or damages resulting from any untrue statement or omission of material fact in any registration statement or prospectus pursuant to which we sell ordinary shares, unless such liability arose in reliance upon and in strict conformity with information that we furnished in writing. B Communications will pay all expenses incident to any demand registration, and we will pay our respective portions of all underwriting discounts, commissions and fees attributable to the sale of our ordinary shares it owns under the registration rights agreement.

#### Chief Executive Officer Employment Agreement

We have entered into an arrangement with Eurocom Communications, and B Communications according to which Mr. Turgeman will provide Management services to us, B Communications and Eurocom Communications. In consideration for such services, each of Eurocom Communications, Us and B Communications will bear 33% of Mr. Turgeman services costs.

We have entered into an arrangement with B Communications with respect Mr. Eli Holtzman, our former chief executive officer, according to which we shared his employment costs with B Communications. In connection with Mr. Holtzman's retirement from his positions in both companies, we entered into an additional arrangement with B Communications, according to which we paid Mr. Holtzman a one-time retirement award of \$800,000 and a monthly payment and other benefits for a 15 month period commencing October 2011. B Communications paid Mr. Holtzman one half of one monthly payment.

#### Bezeq Group Interested Party Guidelines

On March 7, 2011, Bezeq's board of directors resolved to adopt guidelines and regulations to classify a transaction by Bezeq, its subsidiary or associate with an interested party as an insignificant transaction, which is not an extraordinary transaction, as set out in the Securities Regulations (Annual Financial Statements), 2010. These guidelines and regulations are used to examine the scope of disclosure in periodic reports, prospectuses (including shelf offering reports) and immediate reports regarding a transaction of Bezeq, a company under its control and a subsidiary or associate with a controlling shareholder or in which the controlling shareholder has a personal interest.

From time to time, Bezeq and its subsidiaries or associates enter into insignificant transactions, which are not extraordinary transactions, with an interested party in Bezeq or with related parties, including transactions for the sale or purchase of products and services, such as communication products and services, including fixed-line and cellular handsets, software development products and services, maintenance services, voice-mail service agreements, rental transactions of real estate properties and advertising services.

In the absence of special, qualitative considerations in the circumstances, a transaction that is in Bezeq's regular course of business, is carried out in market conditions and has no material effect on the Bezeq, is deemed insignificant if all the following parameters exist:

The amount of the transaction does not exceed NIS 10 million;

Bezeq is not required to issue an immediate report for the transaction under Article 36 of the periodic reports regulations or any other law; and

The transaction does not address the employment terms (as set out in the Companies Law) of the interested parties or their relatives.

According to the provisions of the Companies Law, as may be from time to time amended, the audit committee will once a year prior to publication of the annual reports, review the parameters set out above and the need to update them. The board of directors may, from time to time and at its discretion, amend the parameters for an insignificant transaction. This amendment will be duly reported.

In general, each transaction will be tested separately for insignificance. Nevertheless, separate transactions that are part of the same continuing transaction or very similar transactions that are carried out routinely and repeatedly, will be tested as one transaction on an annual basis for insignificance, provided the scope of the transaction does not exceed NIS 10 million.

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In 2010, 2011 and 2012, the Bezeq Group entered into insignificant transactions, which are not extraordinary transactions, with interested parties of Bezeq or entities in which the controlling shareholder has a personal interest, of the types and nature stipulated in the insignificant transactions above. The Group's transactions with a controlling shareholder or entity in which its controlling shareholder has a personal interest, and which are not extraordinary, are classified by the company as insignificant or not insignificant, based on the relevant guidelines and procedures.

#### Transactions deemed to be significant

##### Agreements to purchase satellite terminal equipment

On July 29, 2010, the general meeting of shareholders of Bezeq (following approval by the audit committee and the board of directors of Bezeq) approved Bezeq's vote at the general meeting of DBS in favor of the agreements between DBS and Advanced Digital Broadcast S.A., or ADB, and Eurocom Digital Communications Ltd. for the purchase of 47,500 yesMaxHD converters at a cost of \$9,796,400 and to obtain US dollar supplier's credit for a further period of 60 days from Eurocom Digital Communications Ltd. with respect to the purchase of the decoders.

On March 7, 2010, Bezeq's Board of Directors approved an agreement with DBS (after approval of Bezeq's audit committee) for an additional order of yesMaxHD decoders from Eurocom Digital Communications and from ADB, in accordance with the existing framework agreement and to upgrade at the discretion of DBS) the hard drives of the converters at an overall cost of \$10.3 million (by sea shipment) and the purchase of \$130,000 of power supplies for yesMaxHD converters from Eurocom Digital Communications and from ADB.. Should DBS require earlier delivery of the yesMaxHD decoders that requires air shipment, DBS will pay Eurocom the extra cost for the air shipment.. The Bezeq Board of Directors also approved, subject to the approval of shareholders at a general meeting of shareholders, receipt of US dollar supplier's credit from Eurocom Digital Communications for another 60 days ("the additional credit period") for the purchase of the converters (the payment terms set out in the framework agreement is EOM + 35 and for the additional credit period, DBS will pay interest at a rate of 1% (6% in nominal annual terms. The scope of the credit is estimated at an average of NIS 11 million (\$3 million) and payment of the annual interest is estimated as NIS 578,000 (\$62,836).

On April 13, 2011 the general meeting of the shareholders of Bezeq (following approval of Bezeq's audit committee and the board of directors) approved Bezeq's vote at the general meeting of DBS in favor of DBS's engagement with ADB and Eurocom in the following transactions: (a) Acquisition of yesMaxHD converters, based on the framework agreement, and upgrade (partial or full, at the discretion of DBS) of the hard-drives of the converters, at a total cost of USD 10.3 million. The price set is for marine shipment. Should Bezeq require earlier delivery that requires air shipment, DBS will pay Eurocom the extra cost for air delivery. (b) Receipt of dollar credit from Eurocom Digital Communications for another 60 days ("the additional credit period") for the purchase of the converters. The payment terms set out in the framework agreement is EOM + 35 and for the additional credit period, DBS will pay interest at a rate of 1% (6% in nominal annual terms). The average amount of the credit is estimated as NIS 11 million and payment of the annual interest is estimated as NIS 578,000; (c) purchasing power supply packs for yesMaxHD converters from Eurocom and from ADB, for the period through May 31, 2012, at a total cost of USD 131,000.

On August 4, 2011 the general meeting of the shareholders of Bezeq (following approval of Bezeq's audit committee and board of directors) approved Bezeq's vote at the general meeting of DBS in favor of DBS placing a supplemental order to the previously disclosed order for yesMaxHD decoders from Eurocom Digital Communications and from ADB, based on an existing framework, and the upgrade (at the discretion of DBS) the hard drives of the converters at an overall cost of \$ 20.7 million Should Bezeq require earlier delivery that requires air shipment, DBS will pay Eurocom the extra cost for air delivery. Bezeq's shareholders also approved Bezeq voting in favor of DBS's receipt of supplier's credit in US dollars from Eurocom Digital Communications for a further period of 60 days ("the additional credit period") for the purchase of the converters. The payment terms set out in the framework

agreement is EOM + 35 days and for the additional credit period DBS will pay interest at a rate of 1% (6% in nominal annual terms). The scope of the credit is estimated at an average of NIS 12 million and payment of the annual interest is estimated as NIS 724,000.

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In 2012, DBS acquired yesMaxHD converters, based on a framework agreement signed in 2011, and an upgrade of the hard-drives of the converters, at a total cost of \$10.3 million, from Eurocom Digital Communication, which is controlled by our controlling shareholder. In 2011, DBS ordered two additional shipments of yesMaxHD decoders from Eurocom Digital Communication and from ADB, based on the existing framework at an overall cost of \$20.7 million and \$9.8 million.

On March 7, 2012, the Bezeq board of directors also approved an order of power supply packs for yesMaxHD converters from Eurocom Digital Communication and from ADB, for a period until December 31, 2012, at a total cost of \$130,000. On March 27, 2012, the general meeting of the shareholders of Bezeq approved Bezeq's vote at the general meeting of DBS in favor of the amendment to DBS's engagement with Eurocom Digital Communication and ADB, approving the purchase of approximately 50% of the original quantity approved. The maximum overall increase of cost to the original engagement (due to the rise in hard drive prices) will be up to \$1,953,000.

On April 24, 2012 the general meeting of Bezeq's shareholders approved Bezeq's vote in the general meeting of DBS, in favor of DBS engaging with Eurocom Digital Communication and ADB in the following transactions: (1) the acquisition of power supply packs for yesMaxHD decoders from Eurocom and from ADB, for the period through to December 31, 2012 and at an overall cost of up to \$131,000; (2) the acquisition of yesMaxTotal3 decoders from Eurocom Digital Communication and ADB, under the existing framework contract, at a total price of \$9.8 million, for the period through to December 31, 2014; and (3) to obtain supplier credit in dollars for an additional period of 60 days from Eurocom, with regard to the foregoing acquisition of decoders.

On July 25, 2012 the general meeting of Bezeq's shareholders approved Bezeq's vote in the general meeting of DBS, in favor of DBS engaging with Eurocom Digital Communication and ADB in the following transactions: (1) an amendment to DBS agreement with Eurocom Digital Communication and ADB, with regard to some of the decoders (approximately 42% of the original quantity approved), the maximum overall increase in cost for the original engagement (due to the rise in hard drive prices) will be up to \$1,336,940 and with regard to 16% of the original quantity approved, to approve extending delivery date until September 30, 2013; and (2) DBS acquisition of YesMaxTotal decoders from Eurocom Digital Communication and ADB, under the existing framework contract, at a total price of \$20.7 million, for the period through to March 31, 2014. Furthermore, if the global hard disk market requires a further price increase, an additional cost was approved for the foregoing acquisition of up to \$3.245 million; (3) to obtain supplier credit in dollar for an additional period of 60 days to the period set in the framework agreement, from Eurocom, with regard to the foregoing acquisition of decoders.

On January 1, 2013 the general meeting of Bezeq's shareholders approved Bezeq's vote in the general meeting of DBS, in favor of DBS engagement with Eurocom Digital Communication and ADB, which was approved by the shareholders general meeting on April 24, 2012, and which relates to DBS's acquisition of power supply packs for yesMaxHD decoders from Eurocom and ADB at a cost of up to \$131,000 and for a period up to December 31, 2012, and the amendment to the foregoing engagement for the delivery of power supply packs at a cost of up to \$78,600.

#### Debt arrangements between Bezeq and Bezeq International and DBS

On September 6, 2012 the general meeting of Bezeq's shareholders approved manner of voting at the general shareholders meeting of DBS, in favor of the engagement between Bezeq and Bezeq International with DBS in the following transactions:

- Debt arrangement between Bezeq and DBS. Bezeq engaged in a new debt arrangement agreement according to which all the payments under earlier debt arrangements, which were due to be paid as of August 1, 2012 through to June 10, 2013 will be postponed, each for a period of 18 months from their expected repayment date, and during this period each installment will bear interest of prime + 4%, with the addition of VAT as required by law. The

total principal of these deferred payments amounts to NIS 26,663,027.

- Debt arrangement between Bezeq International and DBS. An agreement with regard to a new debt arrangement according to which the payments under the general meeting's resolution dated October 14, 2010 and the debt arrangement of June 10, 2010, the original due dates of which were as of August 1, 2012 through December 31, 2013, will be deferred for a period of 18 months from the expected repayment date, and during this period, each installment will bear interest of prime + 4%, with the addition of VAT as required by law. The total principal of these deferred payments amounts to NIS 5,928,750.

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Agreement (extension and amendment) to acquire Nokia and ZTE products

On October 11, 2012 the general meeting of Bezeq's shareholders approved Bezeq's vote in the general meeting of Pelephone, in favor of amending Pelephone's engagement with Eurocom Cellular Communications Ltd., which was previously approved by the general meeting of the shareholders on June 10, 2010. The agreement relates to Eurocom Cellular Communications Ltd.'s sale and supply of Nokia products to Pelephone from. Under the amendment, this engagement will be expanded to also include products manufactured by the Chinese electronics company, ZTE, which is expected to market cellular terminal equipment in Israel through its new official representative, Eurocom Communications. The period of the engagement will be extended by three years from the date of the termination of the existing agreement period (i.e. until December 31, 2015). The annual volume of purchases under the engagement may not exceed the NIS 300 million (before VAT) per calendar year.

Agreement for acquisition of satellite broadcast space segments

DBS entered into a series of agreements with Spacecom, a company controlled by Eurocom Holdings and Eurocom Communications, for the use of space segments of the Amos 2 and Amos 3 satellites owned by Spacecom. DBS paid Spacecom NIS 108 million and NIS 100 million in lease fees in 2012 and 2011, respectively.

On March 6, 2013, Bezeq's Board of Directors approved (subsequent to the approval of its audit committee) and recommend to the general meeting of Bezeq shareholders to vote in favor of DBS entering into an agreement with Spacecom for the lease of space segments. For additional information about this agreement see Item 4.B "Business Overview" under "Space segment lease agreements."

Amendment of letters of indemnification for directors and officers who are controlling shareholders or their relatives

On October 26, 2011, the shareholders at Bezeq's general meeting approved (subsequent to the approval of Bezeq's audit committee and the board of directors) an amendment to the letters of indemnification granted to officers currently employed by Bezeq who are directors, or officers who are controlling shareholders of Bezeq, or their relatives, with regard to the Securities Authority Streamlining of Administrative Enforcement Law, so that the amended letters of indemnification will also allow indemnity for officers regarding payment to victims of the infringement or for expenses expended by the officer with regard to certain proceedings held concerning him/her, including reasonable litigation expenses, and including legal fees.

On December 15, 2011, our shareholders at our extraordinary general meeting approved (subsequent to the approval of our audit committee and our board of directors) a similar amendment to the letters of indemnification. See Item 6C – "Board Practices - Exculpation, Indemnification and Insurance of Directors and Officers."

Framework transaction for Directors' and Officers' liability insurance

On April 13, 2011, the shareholders at Bezeq's general meeting (subsequent to the approval of Bezeq's audit committee and board of directors) approved a framework transaction for a period of three years from April 14, 2011 through to April 13, 2014, for Bezeq's engagement, during the normal course of business, in future insurance policies to cover the liability of directors and officers, as may be elected or appointed from time to time, including directors and officers who are or who are likely to be considered controlling shareholders in Bezeq, and all by way of a framework transaction as defined in the Companies Regulations (Reliefs in Transactions with an Interested Party), 2000. Bezeq will acquire a policy with a liability limit of \$100 million per claim and in total for each insurance year, and up to \$20 million per claim and in total for the insurance period for legal expenses in Israel only. The cumulative liability limit for Bezeq's subsidiaries is half of the above liability limit. The annual premium that Bezeq may pay will not exceed \$185,000 with the addition of up to 20% of this amount. Bezeq will be permitted to acquire insurance with liability

limit exceeding \$100 million provided that the annual premium that it will pay will not exceed \$185,000 with the addition of up to 20% of this amount. Any purchase of a new insurance policy in the future must be approved by Bezeq's audit committee and the board of directors, which will determine whether it complies with the terms of the framework transaction.

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#### Directors and officers' liability insurance

On April 13, 2011 the shareholders at Bezeq's general meeting (subsequent to the approval of Bezeq's audit committee and board of directors) approved Bezeq obtaining a directors and officers liability insurance policy for a one year period beginning April 14, 2011 and through April 13, 2012. The annual premium that Bezeq was authorized to pay was \$185,000. The liability limit is \$100 million per claim and in total for each insurance year, and up to \$20 million per claim and in total for the insurance period for legal expenses in Israel only. The cumulative liability limit for subsidiaries is half of this amount of the above liability limit.

On March 7, 2012, Bezeq's board of directors, subsequent to approval of its audit committee and after determining that it complies with the terms of the previously described framework transaction, determined to approve Bezeq's obtaining a directors and officers liability insurance policy for one year period beginning April 14, 2012 and through April 13, 2013. Bezeq will pay an annual premium of up to \$220,000. The liability limit is \$100 million per claim and in total for each insurance year and up to \$20 million per claim and in total for the insurance period for legal expenses in Israel only. The agreement was approved, including with regard to directors who are controlling shareholders or their relatives, in accordance with the applicable requirements.

On March 13, 2013, Bezeq's board of directors, subsequent to approval of the audit committee and the compensation committee and after determining that it complies with the terms of the foregoing framework transaction, decided to approve Bezeq engaging in a directors and officers liability insurance policy for one year from April 14, 2013 through April 13, 2014. Bezeq will pay an annual premium of up to \$210,000. The liability limit is \$100 million per claim and in total for each insurance year, and \$20 million per claim and in total for the insurance period for legal expenses in Israel only. The agreement was approved, including with regard to directors who are controlling shareholders or their relatives, in accordance with the Relief Regulations. Accordingly, in the event that an objection is lodged as stipulated in Regulation 1C(a) of the Relief Regulations, the policy will require the approval of the general meeting by majority vote as set forth in section 275 of the Companies Law.

#### Confirmation of receipt of preliminary commitments to purchase debentures

On June 28, 2011, Bezeq's board of directors approved (subsequent to approval of its audit committee) preliminary commitments from Eurocom Capital Underwriting Ltd., a company indirectly controlled by Eurocom Communications, in the tender for classified investors regarding a public offering of debentures (Series 6 to 8). In Bezeq's institutional tender of June 28, 2011, preliminary commitments were received from Eurocom Capital Underwriting amounting to 5% of the total debentures relevant to the preliminary commitments from classified investors for each of the three series. Eurocom Capital Underwriting did not hold any of the three series of debentures and they were sold in the open market.

#### Issuance of debt by DBS

On March 7, 2011 and May 8, 2012 Bezeq's board of directors (subsequent to approval of its audit committee) approved Bezeq's vote at the general meeting of shareholders of DBS in favor of debt issuance by DBS of up to NIS 120 million and up to NIS 450 million, respectively.

#### Management and consultation services

On June 10, 2010, the general meeting of Bezeq's shareholders (following approval by Bezeq's audit committee and board of directors) approved an agreement between Bezeq and Eurocom Communications, under which Eurocom Communications will provide Bezeq with ongoing management and consultation services for an annual fee of \$1.2 million over three years, commencing June 1, 2010 and ending May 31, 2013, unless one of the parties announces its

intention to terminate the agreement upon three-months prior notice. The main services provided by Eurocom Communications are consultation services for Bezeq's operations, including strategy, business development, regulation, marketing and such other consultation that Bezeq requires as a communications company and as a group of companies, and ongoing management services. The services are supplied by managers and/or employees and/or consultants of Eurocom Communications and/or its shareholders and such other persons that Eurocom Communications deems suitable to supply the services. Eurocom Communications has agreed to provide professional and skilled human resources and other resources that are required to supply the services, including managers and consultants with backgrounds in communications and with international experience, in order to provide the Bezeq Group professional and high-quality service. In addition, according to the consultation agreement, until otherwise decided, Bezeq's directors, except for outside directors, independent directors and the chairman of the Board of Directors, will not receive director's compensation from Bezeq or its subsidiaries.

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C. Interests of Experts and Counsel

Not applicable.

ITEM 8. FINANCIAL INFORMATION

A. Consolidated Statements and Other Financial Information

See the consolidated financial statements, including the notes thereto, beginning of page F-1 and the exhibits listed in Item 19 hereof and incorporated herein by this reference.

Legal Proceedings

The Bezeq Group is involved in certain legal and regulatory actions, all of which have arisen in the ordinary course of business, except for the matters described in the following paragraphs. Management believes that the ultimate resolution of such matters is unlikely to have a material adverse effect on our consolidated results of operations and/or financial condition, except as described below.

Bezeq makes provisions in its consolidated financial statements for certain of the legal proceedings to which it or other Bezeq Group Consolidated Companies is a party. These provisions are aggregated into groups based on the type of activity and claim. As of March 14, 2013, Bezeq has made an aggregate provision of NIS 142 million (\$38 million) for its pending litigation. In the opinion of the managements of the Bezeq Group companies, the additional exposure as at December 31, 2012, for claims filed against the Bezeq Group companies on various matters and which are unlikely to be realized, amounts to NIS 8.5 billion (approximately \$2.3 billion) of which NIS 429 billion (\$115 million) is for claims which at this stage cannot be assessed. All amounts in this section are linked to the CPI and are stated net of interest. The foregoing amounts do not include additional potential exposure that Bezeq may have attributable to pending motions to certify lawsuits as class actions that do not state the amount claimed if the motion is approved.

Since the date of Bezeq's financial reports, an additional claim in the amount of NIS 14 million was filed against the Bezeq Group and claims in the amount of NIS 93 million were dismissed, including a claim against DBS in the amount of NIS 72 million. In addition, after the publication of Bezeq's financial reports, a risk assessment was received by Bezeq regarding claims in the amount of NIS 48 million, which was previously unavailable. The assessment concluded that the probability that the Bezeq Group will need to use financial resources to pay such claims is less than 50%.

Our reporting policy is based on Bezeq's reporting policy, which is based on considerations of quality and of amount. Bezeq determined that the minimum reportable amount deemed to be material would be events affecting net profit by 5% or more of Bezeq's ongoing operations according to its latest annual consolidated financial statements. Accordingly, this section describes legal proceedings involving NIS 120 million or more which meet the 5% of pretax profit standard according to the Bezeq financial results for the year ended December 31, 2012, and legal proceedings in which the amount claimed is not stated in the statement of claim (except for claims that on their face do not reach the above amount), or claims that Bezeq believes have other aspects and/or implications beyond their monetary amount. In addition, the claims described below are updated in accordance with the updates we receive from Bezeq and with the public filings of Bezeq with respect to such claims.

Internet Gold

On September 2, 2007, a claim was filed with the Tel Aviv District Court together with a motion to certify it as a class action against several corporations operating eCommerce websites, including Goldmind's P1000 website, which was ours at the time, as well as against several suppliers. The petitioners claimed that these sites have deceived and defrauded participants in online auctions by unrightfully preventing them from winning products that the sites determined as "under-priced." The plaintiffs also claimed that this practice was carried out through the use of fictitious bidders during the auction process. On June 1, 2011, the Court rejected the motion to certify the claim as a class action against all respondents, as it ruled, among other things, that the plaintiffs did not prove any of the pre-conditions for the certification of a class action according to the Israeli law. The Court further ruled that the plaintiffs shall pay the respondents costs totaling approximately NIS 900,000. On July 17, 2011, the plaintiffs appealed the decision to the Supreme Court.

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On April 22, 2013, a claim was filed with the Central District Court together with a motion to certify the claim as a class action, against various electronic trade websites operating in Israel and against Goldmind. The claim alleges that the defendants violated the law and misled consumers and users of electronic trade websites who took part in "private sale" activities, in which the users made price quotes for purchasing various products without being aware of the actual price of the sold item, resulting in, allegedly, their deception and overcharging of consumers. The aggregate amount sought by the class action is approximately NIS 101 million.

#### Bezeq

In September 2000, a claim was filed against Bezeq in the Jerusalem District Labor Court by 2,423 pensioners of Bezeq who had been employees of the Ministry of Communications and were reassigned to Bezeq when it was established. The plaintiffs petitioned for declaratory relief to the effect that grossed up tax payments, clothing supplements and wage incentives are ordinary wages which should be considered part of their effective wage for pension purposes and for the purpose of payments given upon retirement, and should therefore be included in the hourly calculation and when calculating percentage supplements. The plaintiffs also petitioned for declaratory relief to the effect that their last effective wage for pension should be calculated based on their last wage (and not based on the average ranking). Subsequently, the claim was amended so that all the relief relating to the plaintiff's pension rights was deleted from the statement of claim. The plaintiffs also reduced their claim to the wage incentive component and retracted their claim to the grossed up tax and clothing components. On December 16, 2008, the court dismissed the claim and determined that the premium paid to the plaintiffs is a real contingent supplement and that the premium component should not be included in the hourly value for the purpose of calculating compensation for overtime or when redeeming annual vacation which is paid as part of post-employment benefits. On March 3, 2009, an appeal was filed in the National Labor Court which was dismissed on December 21, 2011. On July 25, 2012, Bezeq received a petition to the High Court of Justice for the issue of an order nisi against the National Labor Court and Bezeq, in which the plaintiffs are petitioning to revoke the ruling and decisions of the National Labor Court. In accordance with the decision of the High Court of Justice, Bezeq filed a preliminary response to the petition.

Several additional individual claims by employees and former employees are pending against Bezeq, concerning, among other things, recognition of various wage components as components for the purpose of calculating various payments, and claims in respect of overtime and other time.

Four claims were filed by various plaintiffs in the years 2003 to 2005 against Bezeq, the Broadcasting Authority and the State of Israel, for compensation for physical injury and damage to property, caused, according to the plaintiffs as a result of prohibited radiation from the Hallel broadcasting station. Three of the claims were for damage to person and they were heard in the Central District Court (the amounts of the claims were - one for more than NIS 15 million, in another there is no estimated amount, and the third for NIS 46 million). The plaintiffs in these three claims filed an application for consolidation of the hearings of the claims. The court ordered a stay of proceedings and resumption of the claims, as necessary, only after the plaintiffs comply with the Court's decision concerning the submittal of documents and affidavits. On November 25, 2012, the Court dismissed the plaintiffs' application to resume proceedings and stated that a new claim must be filed. Subsequently, on December 12, 2012, a new claim was filed in the Central District Court against the State of Israel, the Broadcasting Authority, and Bezeq, based on the three aforementioned claims for alleged damage to person for 31 people, 27 of which are against Bezeq).

The fourth claim is being heard in the Tel Aviv District Court and is for alleged damage to property and financial loss. The amount of the original claim was NIS 141 million, but following the failure to pay the court fees by some of the plaintiffs, some of the plaintiffs were removed from the action so that the revised amount is NIS 23 million. An evidentiary hearing has not been held as yet.

On December 31, 2003, Bezeq discontinued its broadcasts from the Hallel broadcasting station as requested by the State and the Broadcasting Authority, and from that date the site is no longer being used for broadcasting

In February 2002, a notice of a party to a collective dispute was filed in the Jerusalem District Labor Court by the Histadrut in the name of Bezeq's employees. The applicant alleged that payments for grossing up of tax, the administrative on-call duty component and clothing allowances payable to Bezeq employees are regular pay which form part of the determining salary of each employee, for calculation of the various payments. In April 2006, the court denied all parts of the notice. On February 10, 2010 a new party notice was filed, which relates only to the on-call fee component. Under the party notice, the Court was requested to determine that the on-call fee component be included in the hour value for calculating overtime pay and redemption of unused vacation pay.

In 2003, Bezeq filed a claim in the Tel Aviv District Labor Court against the Makefet Fund for compensation alleging breach of agreement between it and Makefet with respect to the calculation of the cost of early retirement of employees who were transferred to Bezeq from the Ministry of Communications. The amount claimed by Bezeq was NIS 280 million. The Makefet Fund denied the allegations and contended that it acted in accordance with the agreements. Summary statements are scheduled to be filed within the next few months.

In November 2006, a claim was filed against Bezeq in the Tel Aviv District Court together with an application for its recognition as a class action, in the amount of NIS 189 million, on the grounds of unlawful collection of money in cases of disconnection due to non-payment. In February 2011, the plaintiff filed an additional claim together with an application for its recognition as a class action in the amount of NIS 44 million, in the Central District Court concerning a refund of payment for "related services" for the period after the line had been disconnected. The second claim from February 2011, and the application for its recognition as a class action were dismissed on March 28, 2012. On May 8, 2012, an appeal was filed.

In November 2006, a claim and application for certification as a class action was filed with the Tel Aviv District Court against Bezeq, Pelephone, HOT, Cellcom and Partner, in the amount of NIS 158 million. The plaintiffs allege that when completing a call made from a cellular line to a fixed line, if the call is disconnected by the fixed line call recipient, Bezeq and HOT delay sending the disconnection signal for approximately 60 seconds, which is then reflected in airtime costs and interconnect fees. In a procedural arrangement among the parties, it was decided that the claim would be heard against Bezeq and HOT, while the claim against Pelephone, Partner and Cellcom would be heard as part of a similar claim filed against them in August 2006 alleging damages of NIS 100 million. On October 28, 2010 the Court denied the application and on December 16, 2010 the plaintiffs filed an appeal of the decision in the Supreme Court. On October 17, 2012, the Supreme Court denied the appeal.

In July 2010, an action was filed against Bezeq in the Central District Court, together with an application for its certification as a class action, alleging that Bezeq offers its customers to join call plans with a fixed monthly payment, which results in a financial loss to customers for whom the track is not worthwhile, thus misleading them. The plaintiff is claiming restitution of the difference between the amount paid by customers on the new track and the amount they would have paid on the ordinary track, which he estimates is "tens of millions of shekels", as well as compensation of NIS 1,500 per customer for an ostensible infringement of privacy. In June 2012 the Court approved publication of a compromise settlement reached by the parties at a cost of NIS 6.5 million to Bezeq, and instructed that the settlement be sent to the relevant parties before it hands down the verdict. Subsequently, an inspector was appointed to estimate the damage and the amount of the compensation.

In September 2010, a claim was filed against Bezeq with the Jerusalem District Court by the Ministry of Communications, the Israeli Defense Force Commander for the Palestinian Administered Territories and the Civil Administration in the Palestinian Administered Territories, in the matter of payment of fees of approximately NIS 74 million for the payment of taxes for erecting and operating microwave trunks in the Palestinian Administered Territories. On April 2, 2012 the Court approved a settlement agreement between the parties, according to which Bezeq would pay an aggregate of NIS 26 million linked to the Israeli CPI from February 2010.

In January 2011, the following four claims arising from a malfunction in Bezeq's network on January 25, 2011, together with applications for their certification as class actions were filed against Bezeq: (i) a claim estimated at NIS 104 million in the Nazareth District Court; (ii) a claim estimated at NIS 135 million in the District Court for the Central District; (iii) a claim estimated at NIS 84 million in the Haifa District Court; and (iv) a claim estimated at NIS 217 million in the Tel Aviv District Court. Subsequently, all four claims were transferred to the Tel Aviv District Court and on November 27, 2011, the court decided to consolidate the hearing of the last two claims and to dismiss the first two claims. The plaintiffs allege that Bezeq's customers were disconnected from Bezeq's services and were unable to make proper use of their telephone lines, resulting in losses. On October 9, 2012, the Court approved the

applicants' request to abandon their applications for certification as a class action.

In April 2011, a claim was filed against Bezeq in the Tel Aviv District Court together with an application for its certification as a class action, alleging that in contravention of the law, Bezeq does not include a call details record in the phone bills which it sends to its subscribers. The application estimates the amount of the class action at NIS 127 million. In September 2012, another claim was filed against Bezeq in the Tel Aviv District Court together with an application for its certification as a class action in the same matter, and the plaintiff estimates the amount of the claim at NIS 154 million. On April 4, 2013 and April 13 2013, respectively, the Court approved the withdrawal of both claims and ordered their dismissal. The Court approved the withdrawal pursuant to its assessment that the claim has low chances for success, if any.

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In October 2011, a former employee of Bezeq filed a claim against Bezeq with the Regional Labor Court in Tel Aviv. The main purpose of the claim was a request to refund wage differences that allegedly resulted from a failure to include on-call fees and premiums in the hourly rate when calculating overtime and the redemption of unused vacation days. The claimant applied for certification of the action as a class action in the amount of NIS 150 million in the name of certain of Bezeq's employees and pensioners. The claim was dismissed on April 29, 2012 pursuant to the claimant's request.

In October 2011, an action was filed at the Tel Aviv District Court, together with an application for its certification as a class action, alleging that Bezeq unlawfully broadcasts its own advertising on the Music on Hold (music played to callers while the dial-up to a Bezeq subscriber is under way) about subscribing to the service. The plaintiffs are seeking restitution of the service fees and compensation for prohibited advertising (for callers to subscribers to the service) and estimate the total amount of the claim to be NIS 200 million, for period commencing the date that Bezeq initiated this service.

On November 10, 2011, a person who claims to own 1,162 shares of Bezeq petitioned the Economic Department of the Tel Aviv-Jaffa District Court to approve the submittal of a derivative action in the amount of NIS 900 million against Bezeq's incumbent directors and against a former director. The application argued, among other things, that the Board members were in breach of their duty of care and fiduciary obligations towards Bezeq (and with respect to the controlling shareholder, his duty of fairness as well) by approving loans worth billions of shekels taken by Bezeq, which allegedly, were not used for Bezeq's benefit and were designated for the distribution of dividends for the purpose of reducing the financing costs of Bezeq's controlling shareholder, and were therefore in a conflict of interests between their own personal benefit and that of Bezeq. Consequently, the plaintiff argued that Bezeq suffered losses in the form of heavy financing expenses in respect of those loans. Alternatively, the plaintiff alleged that the resolutions passed by the Board of Directors with respect to the aforementioned loans, created a tax exposure for Bezeq due to the fact that the financing expenses are not recognized for tax purposes. On January 26, 2012, Bezeq and the Board of Directors submitted their response requesting a dismissal of the application. On June 14, 2012, the court resolved to dismiss the application after ruling that the applicant in this procedure was not a "shareholder" of Bezeq and was therefore not entitled to file a derivative claim in Bezeq's name. Subsequently, on July 15, 2012, a new application to approve a derivative claim was filed in the Economic Department of the Tel Aviv District Court against the directors and officers of Bezeq by the father of the applicant whose application had been dismissed on June 12, 2012.

On November 26, 2011, an additional application was filed for certification as a derivative claim together with a derivative action in the Economic Department of the Tel Aviv-Jaffa District Court by a shareholder of Bezeq who holds 1,500 shares. This additional application (which is essentially similar to the application filed in July 2012) was filed against Bezeq's incumbent directors, directors who no longer serve Bezeq and against the previous controlling shareholder of Bezeq (Ap.Sb.Ar. Holdings Ltd.). The application alleges, among other things, that the defendants approved the distribution of dividends and took loans with the purpose of serving the interests of the controlling shareholders, were in a conflict of interests between their own personal benefit and that of Bezeq. Consequently, the decision making process and the disclosure given by Bezeq regarding these decisions was allegedly flawed and therefore the defendants were in breach of their duty of care towards Bezeq and with respect to the former and present controlling shareholder, it was alleged that they were also in breach of their duty of fairness. Consequently, the applicant alleged that Bezeq suffered losses of NIS 3.4 billion (gross) or NIS 2.64 billion (net). The applicant is petitioning, among other things, for declarative relief concerning nullification of extraordinary loans taken by Bezeq from the date of the change of control and nullification of Bezeq's outstanding payments to its shareholders originating in a capital write-down, as well as the restitution of dividends by Bezeq's controlling shareholder. During February and March 2013, responses to the request were filed by Bezeq and claimants, asking to reject the request.

On January 17, 2013, the court instructed the consolidation of these two applications.

In February 2012, an action was filed in the Jerusalem District Court, together with an application for its certification as a class action, against Bezeq, Pelephone and two other cellular companies. The plaintiffs allege that the respondents do not offer the handicapped members of the public accessible handsets and services in a fitting manner and that they are therefore in breach of the law and the regulations. The plaintiffs are requesting certification of the claim as a class action in the name of a group of handicapped people and are claiming monetary compensation of NIS 361 million against all the defendants for the losses they allege (monetary loss, non-monetary loss, and infringement of autonomy) as well as other relief.

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On March 29, 2012 and on April 4, 2012, objections were filed with the Economic Division of the Tel Aviv District Court, opposing the continued payments of Bezeq's special dividend. Both objections were filed by holders of Bezeq's Debentures (Series 5) who filed similar objections in the second half of 2011. Both objections were dismissed by the District Court on May 15, 2012.

On July 4, 2012, a request for exhaustion of Bezeq's rights was received from a shareholder seeking to file a derivative claim on behalf of Bezeq. Subsequently, on August 27, 2012, the same applicant sent a supplementary letter which included, among other things, allegations relating to both the previous controlling shareholders of Bezeq and the members of the Board of Directors who had served before control of Bezeq was transferred, with respect to their conduct in connection with the transfer of control of the company. The applicant is also seeking that Bezeq exhaust its rights by filing an action against these entities as well. On August 29, 2012 and on October 10, 2012, Bezeq informed the applicant that it had decided to reject the demands contained in both the aforementioned applications.

#### Pelephone

In December 2000, the State of Israel filed a claim with the Tel Aviv District Court (subsequently moved to the District Court for the Central District) with respect of royalties allegedly owed for the period from January 1994 until February 1996. The amount claimed was NIS 260 million, including principal, linkage differences and interest. In September 2010, the Court accepted some of the State's arguments. The amount Bezeq was obligated to pay amounted to approximately NIS 150 million, including principal, linkage differences and interest. The sum was paid in October 2010. In October 2010, Pelephone filed an appeal with the Supreme Court, which was dismissed in August 2012.

In December 2007, a claim was filed with the Tel Aviv District Court against Pelephone, Cellcom and Partner, together with a motion to certify it as a class action in the amount of NIS 1 billion. The claim relates to alleged radiation damage from cellular antennas which were allegedly erected unlawfully. On February 28, 2012 the parties notified the Court that they need additional time to reach an agreed settlement. In June 2012, the Court approved the plaintiff's abandonment of the action.

In July 2008, a claim was filed with the Tel Aviv District Court together with a motion to certify it as a class action for the total amount of NIS 240 million. The claim is for the refund of amounts which the plaintiffs allege were over-collected from Pelephone's subscribers, in connection with its collections of interest in arrears from subscribers who are late in paying Pelephone, as well as from interest where payments are rescheduled. The plaintiff also alleges that Pelephone collects payment in respect of a standing order, handling fees for the voucher and commission for payment of a voucher at a service center, ostensibly in contravention of its license. On October 5, 2011, the Court gave the plaintiffs an option to abandon the claim without ordering expenses against them. On October 18, 2011, the plaintiffs notified the Court that they insist on proceeding with the claim and the parties agreed to submit written closing arguments. In May 2012, an additional claim and an application for its recognition as a class action in the amount of NIS 74 million was filed in the Tel Aviv District Court, alleging the unlawful billing for payment by standing order, which claim was subsequently abandoned.

In October 2009, a claim was filed with the Tel Aviv District Court, together with an application for its certification as a class action, against Pelephone. The plaintiff alleges that Pelephone was in breach of its license in that it offered benefits for purchase of a handset and refunded competitors' penalties, for a period that is longer than the 18-month commitment period. In February 2012, the Court approved the plaintiff's abandonment of the application for certification as a class action.

In March 2010, a claim was filed with the Tel Aviv District Court, together with a motion to certify it as a class action, against Pelephone and Cellcom. The total amount of the claim is approximately NIS 4.2 billion and the amount of the claim against Pelephone is NIS 2.1 billion. The plaintiffs claim that Pelephone acts in contravention of its

license and the law in that it does not purchase insurance covering its liability for bodily damage arising from exposure to cellular radiation. The application also seeks an order instructing Pelephone to take out such insurance. On October 25, 2010, the Court requested the Minister of Communication to provide its position on this issue. On November 19, 2012, the Court approved the withdrawal of both the claim and the motion to certify the claim as a class action.

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In May 2010 a claim was filed in the Tel Aviv District Court together with a motion to certify it as a class action. The claim was filed against the four cellular companies (Pelephone, Partner, Cellcom and Mirs Communications Ltd.) where the amount of the claim against each of Pelephone, Partner and Cellcom is NIS 3.68 billion and the total amount of the claim (against the four companies) is more than NIS 12 billion. The applicants argue that the cellular companies are in breach of the following duties: (1) to erect cellular antenna sites of the required scope, proportion and deployment; (2) to check, correct and provide information about the non-ionizing radiation values in cellular handsets after repair, etc.; (3) to warn against the risks involved in how the cellular handset is held. The application includes numerous other declaratory reliefs and applications for writs of mandamus relating to the above matter. In January 2013, Pelephone signed a compromise settlement with the plaintiffs to settle the claim in return for Pelephone verifying and ascertaining certain matters relating to the claim and in return for the sale of earphones to customers at a reduced price for a period. This arrangement has been submitted to the court and is awaiting approval.

In June 2010, a claim was filed with the District Court for the Central District, together with a motion to certify it as a class action, for a personal amount of NIS 958 (plus linkage and interest) against Pelephone. The total amount of the action is not stated, but the application notes that it is estimated to be in the hundreds of millions of shekels. According to the claim, Pelephone collects payment from its customers for services that the customers have not requested and transfers their personal information to external suppliers without their approval, which contravenes the agreement with its subscribers and the law. The claim is for restitution of those fees and for orders instructing Pelephone, among other things, to cease such actions. On March 12, 2012, the Court rejected the motion to certify the claim as a class action and dismissed the personal claim of the plaintiff.

In August 2010, a claim and a motion to certify it as a class action were filed in the Central District Court against Pelephone. The amount of the claim is not stated, but the application is estimated in the tens of millions of shekels. According to the applicant, Pelephone should refrain from collecting Value Added Tax from customers who use its services when they are outside Israel. The application also includes the relief of an order instructing Pelephone to cease charging its customers for the services they use outside Israel, and an order instructing that the money collected to date be restituted.

In December 2010, a claim was filed in the Central District Court together with an application for its certification as a class action. The amount of the claim is not specified. The applicant alleges that Pelephone withholds from its subscribers one or more monthly benefits due to the fact that the date of the first invoice is not necessarily the same as the actual date of joining the plan. In May 2012, the court dismissed the application for certification, and in June 2012 the decision was appealed in the Supreme Court.

In January 2011, a claim was filed with the Jerusalem District Court, together with an application to certify it as a class action. The plaintiff alleged that he purchased two Samsung handsets but was unable to use them for surfing the web, even though he purchased surfing services. In February 2012, the Court approved the applicant's abandonment of the certification and ordered him to pay court expenses.

In March 2011, a claim was filed in the District Court (Central Region) together with an application for its certification as a class action. The amount of the action is NIS 122 million. The applicants allege that Pelephone intentionally conceals significant limitations pertaining to benefits on selected destinations and even acts in contravention of the communications agreement with respect to these destinations.

In August 2011, a motion was filed with the District Court (Central Region) against Pelephone, Cellcom, and Partner, together with an application for its certification as a class action. The amount of the action against the respondents is not specified. The action addresses the charge for calls made overseas when the call time is rounded up to a whole minute, and this, as alleged by the claimant, is contrary to the provisions of the license and in contravention of the law. In September 2012 the court dismissed the claim and the motion for certification as a class action. In November 2012,

the applicants filed an appeal against the ruling in the Supreme Court.

In December 2011, a claim was filed with the Tel Aviv District Court, together with an application for its certification as a class action, against Pelephone for a total amount of NIS 381 million. The plaintiff alleged that Pelephone unlawfully updated its service tariffs for business customers. The Court asked the parties to consider the possibility of filing a mutually agreed upon notice of withdrawal.

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In January 2012, a claim was filed with the Tel Aviv District Court, together with a motion for its certification as a class action, against Pelephone. The claim alleged that Pelephone misled a portion of its business customers by unlawfully updating its rates. The total monetary relief sought was estimated by the petitioners at approximately NIS 381 million, which includes reimbursement of the amounts charged to Pelephone's business customers as a result of the updated rates and cancellation of the update. On February 7, 2013, the Tel Aviv District Court dismissed the claim and the motion to certify it as a class action. On April 10, 2013, an appeal was filed with the Supreme Court.

In February 2012, a claim was filed in the Jerusalem District Court against Pelephone, Cellcom, Partner and Bezeq, together with an application for its certification as a class action. The amount of the action is NIS 361 million. The claim relates to a failure to comply with the provisions of the law with respect to handicapped customers when rendering telecommunication services.

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 grounds for the claim are that Pelephone allegedly 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 total amount of the application is estimated to be approximately NIS 242 million, subject to data to be produced by Pelephone as part of the proceeding.

On April 23, 2012, the Haifa District Court approved the withdrawal of a claim and motion to certify the claim as a class action, which was filed against Pelephone in November 2011. The claim, which alleged damages of approximately NIS 285 million, contended that Pelephone's service centers were breaching their customers' rights to privacy by unlawfully recording their conversations without their knowledge.

In May 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 amount of the action is NIS 124 million. According to the applicant, Pelephone does not inform customers who wish to subscribe for its services utilizing a handset which was not purchased from Pelephone, that since the handset does not support the 850 MHz frequency, they will only have partial reception on one frequency rather than two.

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 Pelephone 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 alleged damages was NIS 455 million. In September 2012, the Court approved the abandonment of the claim and the motion for its certification as a class action.

In August 2012, a claim was filed against Pelephone in the Tel Aviv District Court together with a motion for its certification as a class action. The action was filed against Pelephone, Partner, and Cellcom. The amount of the claim is estimated at NIS 120 million for each of the defendants. Additionally, orders for mandamus and declaratory relief were requested. The applicants allege that as part of the repair services which the defendants provide for payment (payment for the repair or a monthly payment for the repair service), if a certain part in the handset must be replaced, the defendants do not provide the customer with the spare part, and this in contravention of the law. Additionally, the plaintiffs alleged that the defendants use the replaced part in future when providing repair services for other customers, thus enriching themselves twice.

In August 2012, a claim was filed against Pelephone in the Tel Aviv District Court together with a motion for its certification as a class action. The plaintiffs contended that Pelephone unlawfully collects a monthly fee from its customers for payment by standing order. The amount of the application is estimated in the total amount of NIS 161

million. In February 2013 the court approved the abandonment of the claim and the motion for its certification as a class action.

In September 2012, a claim was filed against Pelephone in the Tel Aviv District Court together with a motion for its certification as a class action. The plaintiff contends that Pelephone unlawfully collected money for: the cost of a cellular handset, a cancelled phone line, surfing services, various services, as well as for collection expenses and voucher fees. The amount of the application is estimated at NIS 57 million for the causes claimed plus NIS 1,000 for distress for each member of the group. A class action is currently pending against Pelephone, in which some of the allegations are similar to those in this claim.

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In September 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 applicant alleged that Pelephone does not include a call details record in its phone bill, and this is contrary to Ministry of Communication instructions and Pelephone's license. The total amount of the class action is about NIS 109 million. In February 2013, the request for approving a class action suit was erased by the court for inaction.

In February 2013, a claim was filed against Pelephone in the Nazareth District Court together with a motion for its certification as a class action. The applicant alleges that due to a nation-wide malfunction on Pelephone's network on February 3, 2012, the applicant as well as other Pelephone customers were disconnected from Pelephone's services for several hours and were unable to use their cellular handsets to receive or make calls and SMS messages. As a result, they incurred losses. The total amount of the class action is NIS 450 million. In March 2013, another claim arising from the same incident was filed in the Jerusalem District Court, with a petition for certification as a class action suit, for an amount estimated at approximately NIS 160 million. According to the applicant, the plaintiff group members are all cellular telephone customers, including customers of companies hosted on the network (Rami Levi and Hot Mobile).

#### Bezeq International

During the second quarter of 2008, four claims were filed with the District Court for the Central District together with an application for its certification as a class action against Bezeq International and two other holders of licenses to provide Bezeq International's services. The four claims were later consolidated into one claim. The claims related to the use of international calling cards to the Philippines, Thailand and Nepal. The plaintiffs, who are foreign workers, claimed, among other things, that (i) the calling cards provide an average of 50% of the call duration indicated to the purchasers of the cards; (ii) when Bezeq International deduct the time spent on unsuccessful call attempts it does not use units of round minutes as it indicates; (iii) Bezeq International provides misleading information about the number of units on the card; and (iv) it formed a cartel with other international communication companies that raised the prices of calling cards. The plaintiffs seek court approval to file their claim as a class action on behalf of groups of people that include anyone who purchased the relevant calling cards during the seven year period prior to filing the claim or during the proceedings themselves. The plaintiffs estimate that the damages caused to all the members of the group is NIS 1.1 billion. The plaintiffs also petitioned the Court to order the defendants to cease their alleged improper conduct. The court accepted the application for certification as a class action on the grounds of deception on November 3, 2010, but dismissed some of the grounds for the claimed action and ruled that the existence of deception, if existed, ceased after the purchase of a number of calling cards. Bezeq International filed a leave to appeal to the Supreme Court. The application for leave to appeal filed by Bezeq International was denied on September 19, 2012 due to the settlement agreement signed by the other defendants in the proceedings and the plaintiffs.

On May 4, 2009, a claim was filed with the Tel Aviv District Court, together with a motion to certify it as a class action, against Bezeq International. The plaintiff alleged the improper increase in the tariffs for Internet access services following the first year of operation and improper charges for services that that it did not order. The plaintiff sought reimbursement of the excess amounts paid by entire group of customers, for whom the price of the services provided to them was raised after the first year, by NIS 216 million. On June 5, 2011, the Court dismissed the claim and the motion to certifying it as a class action, and ordered the plaintiff to pay expenses of NIS 50,000. On September 4, 2011, the plaintiff appealed the decision to the Supreme Court.

In October 2010, a claim was filed with the Tel Aviv District Court, together with a motion to certify it as a class action, against Bezeq International in the amount of NIS 39 million. The claim alleges that Bezeq International does not provide its customers with a written document as required under the Consumer Protection Law, when entering into an agreement to change or add to a continuing transaction. On June 20, 2012, the Tel Aviv District Court approved the plaintiff's abandonment of the claim and the application for its recognition as a class action.

In December 2011, a claim was filed with the Tel Aviv District Court, together with a motion to certify it as a class action, against Bezeq International. The plaintiffs alleged that during October 2011, Bezeq International failed to provide its Internet customers with the speed it had undertaken in their contacts. The plaintiffs are seeking restitution of the monthly charge and compensation for distress, and they estimate the total monetary compensation claimed to be NIS 120 million.

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In February 2012, a claim was filed with the Tel Aviv District Court, together with an application for its certification as a class action, seeking monetary damages against Bezeq International and two other licensees based on facts similar to those alleged in the 2008 action with respect to the use of international calling cards. The plaintiff alleged that the Respondents misled customers who purchased dialing services by means of pre-paid international calling cards with respect to the number of minutes on the card. The applicant estimates the amount claimed from Bezeq International (as well as from each of the other respondents), in the name of the entire group, to be NIS 2.7 billion.

#### DBS

In December 2010, a claim was filed against DBS with the Tel Aviv District Court, asserting that DBS violated its obligation to its customers by omitting broadcasts it is committed to air in the Basic Package, removed channels without approval, did not comply with the obligation to invest in quality genres and violated obligations regarding the broadcast of commercials, promos and marketing and commercial content. In April 2012 the Court accepted the withdrawal request filed by the parties and approved the applicant's request to withdraw from his petition to approve a class action against DBS.

In March 2013, a claim was filed in the Tel Aviv District Court against DBS together with a motion to certify it as a class action. According to the claimant, DBS disconnected customers from channel 5+ and reconnected them only after the said customers contacted DBS and positively asked to be reconnected, but continued collecting fees for the channel from those customers who did not contact them and were, therefore, not reconnected. The claimant estimated that his own damage is NIS 1,065 of which NIS 1,000 is non-monetary damage, but did not include a total amount for the class action.

#### Dividend Distribution Policy

We have never paid cash dividends to our shareholders and do not currently have a dividend distribution policy in place. Our indirect wholly-owned subsidiary SP2, which directly holds Bezeq's shares and our principal source of revenues and income, is subject to limitations on the payment of dividends under the terms of the financing agreements entered into in connection with its acquisition of the controlling interest in Bezeq.

According to the Israeli Companies Law, a company may distribute dividends out of its profits (as such term is defined in the Israeli Companies Law), provided that there is no reasonable concern that payment of the dividend will prevent the company from satisfying all its current and foreseeable obligations, as they become due. Notwithstanding the foregoing, dividends may be paid with the approval of a court, at the company's request, provided that there is no reasonable concern that payment of the dividend will prevent the company from satisfying its current and foreseeable obligations, as they become due. In the event cash dividends are declared, such dividends will be paid in NIS.

#### B. Significant Changes

Except as otherwise disclosed in this annual report, no significant change has occurred since December 31, 2012.

### ITEM 9. THE OFFER AND LISTING

#### A. Offer and Listing Details

##### Annual Stock Information

The following table sets forth, for each of the years indicated, the high and low market prices of our ordinary shares on the NASDAQ Global Market and the TASE.

Year	NASDAQ		TASE	
	High	Low	High	Low
2008	\$12.20	\$2.20	NIS 46.28	NIS 8.67
2009	\$22.91	\$4.28	NIS 77.54	NIS 8.86
2010	\$34.19	\$17.81	NIS 125.90	NIS 67.01
2011	\$35.25	\$10.7	NIS 124.90	NIS 38.23
2012	\$11.98	\$1.81	NIS 45.51	NIS 7.50

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## Quarterly Stock Information

The following table sets forth, for each of the full financial quarters in the two most recent full financial years and any subsequent period, the high and low market prices of our ordinary shares on the NASDAQ Global Select Market (for periods subsequent to January 1, 2012), the NASDAQ and Global Market (for periods prior to January 1, 2012) and the TASE:

	NASDAQ		TASE	
	High	Low	High	Low
<b>2011</b>				
First Quarter	\$35.25	\$26.50	NIS 121.30	NIS 94.00
Second Quarter	\$30.69	\$21.15	NIS 106.00	NIS 73.50
Third Quarter	\$23.09	\$10.83	NIS 81.00	NIS 40.1
Fourth Quarter	\$18.50	\$10.07	NIS 65.63	NIS 38.23
<b>2012</b>				
First Quarter	\$11.98	\$6.68	NIS 45.51	NIS 25.01
Second Quarter	\$7.26	\$2.20	NIS 25.79	NIS 10.65
Third Quarter	\$3.46	\$1.81	NIS 13.10	NIS 7.50
Fourth Quarter	\$6.15	\$2.99	NIS 20.48	NIS 11.47
<b>2013</b>				
First Quarter	\$3.58	\$2.60	NIS 13.90	NIS 9.95
Second Quarter (through April 21)	\$3.48	\$2.89	NIS 12.76	NIS 10.65

## Monthly Stock Information

The following table sets forth, for the most recent six months, the high and low market prices of our ordinary shares on the NASDAQ Global Select Market and the TASE:

	NASDAQ		TASE	
	High	Low	High	Low
November 2012	\$ 4.91	\$ 3.22	NIS 18.80	NIS 13.90
December 2012	\$ 4.68	\$ 3.20	NIS 17.99	NIS 12.25
January 2013	\$ 3.57	\$ 2.60	NIS 13.90	NIS 9.95
February 2013	\$ 3.58	\$ 2.61	NIS 13.66	NIS 10.16
March 2013	\$ 3.06	\$ 2.74	NIS 11.45	NIS 10.20
April 2013	\$ 3.48	\$ 2.89	NIS 12.76	NIS 10.65

## B. Plan of Distribution

Not applicable.

C. Markets

Our ordinary shares were listed on the NASDAQ Global Market (symbol: IGLD) from our initial public offering in August, 1999 until July 21, 2001, at which date the listing of our ordinary shares was transferred to the NASDAQ Capital Market. From February 4, 2005 until December 31, 2010, our shares once again were listed on the NASDAQ Global Market and since January 1, 2011 our ordinary shares have been listed on the NASDAQ Global Select Market. Since March 1, 2005, our ordinary shares have also been traded on the TASE.

D. Selling Shareholders

Not applicable.

E. Dilution

Not applicable.

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F. Expense of the Issue

Not applicable.

ITEM 10. ADDITIONAL INFORMATION

A. Share Capital

Not applicable.

B. Memorandum and Articles of Association

Below is a description of certain provisions of our Articles of Association and of the Israeli Companies Law related to such provisions. This description is only a summary and does not purport to be complete and is qualified by reference to the full text of the Articles of Association, of our company which have been filed as an exhibit to this Annual Report and which are incorporated by reference, and to Israeli law.

Purposes and Objects of the Company

We are a public company registered under the Israel Companies Law, 1999-5759, or the Israeli Companies Law, as B Communications Ltd., registration number 512832742. Our objects and purposes, as provided by our Articles of Association, are to carry on any lawful activity.

The Powers of the Directors

Under the provisions of the Israeli Companies Law and our Articles of Association, a director cannot participate in a meeting nor vote on a proposal, arrangement or contract in which he or she is materially interested unless such proposal, arrangement or contract is in the ordinary course of business or the majority of directors are personally interested in such proposal, arrangement or contract. In the event the majority of the members of the board of directors have a personal interest in the proposed transaction, approval of our shareholders at a general meeting is required. In addition, our directors cannot vote compensation to themselves or any members of their body without the approval of our compensation committee and, unless exempted under the regulations promulgated under the Israeli Companies Law, our shareholders at a general meeting. If the compensation of our directors is inconsistent with our stated compensation policy, then the approval of our shareholders requires that either:

- at least a majority of the shares held by all shareholders who are not controlling shareholders and do not have a personal interest in such matter, present and voting at such meeting, are voted in favor of the compensation package, excluding abstentions; or
- the total number of shares of non-controlling shareholders and shareholders who do not have a personal interest in such matter voting against the compensation package does not exceed 2% of the aggregate voting rights in the company.

The authority of our directors to enter into borrowing arrangements on our behalf is not limited, except in the same manner as any other transaction by us.

Under our Articles of Association, retirement of directors from office is not subject to any age limitation and our directors are not required to own shares in our company in order to qualify to serve as directors.

Rights Attached to Shares

Our authorized share capital consists of 50,000,000 ordinary shares of a nominal value of NIS 0.1 each. All of our issued and outstanding ordinary shares are duly authorized, validly issued, fully paid and non-assessable. Our ordinary shares are not redeemable and do not have preemptive rights.

**Dividend and Liquidation Rights.** The holders of the ordinary shares will be entitled to their proportionate share of any cash dividend, share dividend or dividend in kind declared with respect to our ordinary shares. Our board of directors may declare a dividend to be paid to the holders of ordinary shares in proportion to the paid up capital attributable to the shares that they hold. Dividends may only be paid out of our profits and other surplus funds, as defined in the Israeli Companies Law, as of the end of the most recent fiscal year or as accrued over a period of two years, whichever is higher, provided that there is no reasonable concern that a payment of a dividend will prevent us from satisfying our existing and foreseeable obligations as they become due. If we do not meet the profit requirement, we may seek the approval of the court to distribute a dividend. The court may approve our request if it is convinced that there is no reasonable risk that a distribution might prevent us from satisfying our existing and anticipated obligations as they become due.



Under the Israeli Companies Law, a dividend declaration must be approved by the board of directors and does not require the approval of the shareholders of a company unless the company's articles of association provide otherwise. Our articles of association do not require shareholder approval of a dividend distribution.

In the event of our liquidation, after satisfaction of liabilities to creditors, our assets will be distributed to the holders of ordinary shares in proportion to the paid up capital attributable to the shares that they hold. Dividend and liquidation rights may be affected by the grant of preferential dividend or distribution rights to the holders of a class of shares with preferential rights that may be authorized in the future.

**Exceptional Holdings; Principal Shareholders.** Under the Communications Order, no person may hold, directly or indirectly, "significant influence" over Bezeq or 5% or more of any particular class of means of control in Bezeq, nor may any person, together with any other person, appoint, elect or dismiss the general manager of Bezeq or cause the election, appointment or dismissal of any director of Bezeq, without the prior written consent of the Prime Minister of Israel and the Israeli Minister of Communications. Subject to certain exceptions, prior written approval of such Ministers is also required to increase the holdings or other rights in excess of those determined in the initial approval, including by means of an agreement (including a voting agreement). Furthermore, under the Communications Order, no person may transfer control, "significant influence" or means of control in Bezeq to another, if, as a result of the transfer, the holdings of the transferee would require approval pursuant to the Communications Law or Communications Order and the transferee is not in possession of the requisite approval. Any such unauthorized acquisition is referred to as "Exceptional Holdings." For the foregoing purposes, "significant influence" means the ability to significantly influence the activity of a corporation, whether alone or together with or through others, directly or indirectly, other than as a result of holding "means of control" in that corporation or in another corporation, and including ability derived from the corporation's articles of association, a written, oral or other kind of agreement, or from any other source. In this context, the right to appoint an officer and holding 25% of our "means of control" is presumed to confer significant influence. "Means of control" means the right to vote at a general meeting of the company, to appoint a director or general manager of the company, to participate in the profits of the company or a share of the remaining assets of the company after payment of its debts upon liquidation.

In compliance with the Communications Law and Communications Order following our acquisition of the controlling interest in Bezeq, our Articles of Association provide that Exceptional Holdings will not entitle the holder to any rights in respect of such holdings, unless and to the extent permitted under the Communications Order. Accordingly, Exceptional Holdings will not have any voting rights at a general meeting of shareholders. Each shareholder participating in a general meeting of shareholders will be required to certify to us prior to the vote or, if the shareholder is voting by a proxy or any similar instrument, on such proxy card or similar instrument, as to whether or not his or her holdings in our company or his or her vote require the approval of the Prime Minister of Israel and the Israeli Minister of Communications, pursuant to the Communications Law and Communications Order. In addition, no director may be appointed, elected or removed from office by virtue of the vote of a holder of Exceptional Holdings. If a director is appointed, elected or removed from office by virtue of the vote of a holder of Exceptional Holdings, such appointment, election or removal from office shall have no effect.

Under our Articles of Association, any person holding a number of our shares that requires approval under the Communications Order shall notify us, Bezeq, the Prime Minister of Israel and the Israeli Minister of Communications of such holdings in writing, no later than 48 hours from the date of acquiring such holdings.

Our Articles of Association include reporting requirements applicable to "Principal Shareholders," meaning a holder, directly or indirectly, of 5% of our issued and outstanding share capital. Any person who, after acquiring, directly or indirectly, shares in our company becomes a "Principal Shareholder," is required, no later than 48 hours after becoming a Principal Shareholder, to notify us in writing, specifying the number of our shares held by such shareholder and the date on which such shareholder became a Principal Shareholder. Any person who ceases to be a Principal Shareholder

is required, no later than 14 days thereafter, to notify us in writing of the date on which such person ceased to be a Principal Shareholder. In addition, a Principal Shareholder is required to notify us in writing of any aggregate change in its holdings of our shares in an aggregate amount equal to 1% or more of our outstanding share capital compared to the last notice of holdings submitted by such Principal Shareholder, no later than 48 hours after such change. In the event a Principal Shareholder fails to provide any required notice, as discussed above, then until such Principal Shareholder provides us with the requisite notice, the Principal Shareholder will not be entitled to any rights in respect of such shares and the provisions of the Communications Order with respect to the exercise of rights underlying Exceptional Holdings will apply, and the undisclosed holdings shall also be deemed “dormant shares,” as defined under the Israeli Companies Law.

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Under our Articles of Associations, we are required to notify the Prime Minister of Israel and the Israeli Minister of Communications of any Exceptional Holdings immediately upon becoming aware of such event. We are also required to notify such Ministers in the event a shareholder becomes a Principal Shareholder and regarding any change in the holdings of a Principal Shareholder within 48 hours of becoming aware of such change.

**Voting Rights.** Holders of ordinary shares have one vote for each ordinary share held on all matters submitted to a vote of shareholders, subject to the restrictions described above relating to Exceptional Holdings and Principal Shareholders. Such voting rights may be affected by the grant of any special voting rights to the holders of a class of shares with preferential rights that may be authorized in the future.

#### Election of Directors

Our ordinary shares do not have cumulative rights for the election of directors. Rather, under our articles of association, our directors (other than the outside directors) are elected by a vote of the holders of a majority of the voting power represented and voting at our annual general meetings of shareholders, and hold office until the next annual general meeting of shareholders and until their successors have been elected. See Item 6C. "Directors, Senior Management and Employees - Board Practices - Election of Directors." Internet Gold, our controlling shareholder, is able to elect all of our directors other than our outside directors. For information regarding the election of outside directors, see Item 6C. "Directors, Senior Management and Employees - Board Practices - Outside Directors." All the members of our Board of Directors (except the outside directors) may be reelected upon completion of their term of office.

Under our Articles of Association, provisions relating to the election and removal of directors who are not outside directors, within the meaning of the Israeli Companies Law, may not be modified without the prior written consent of the Israeli Minister of Communications.

Regulations promulgated under the Communications Law require that our chief executive officer, any member of our board of directors holding an executive role, as well as a majority of the members of the board of directors, be citizens and residents of the State of Israel.

#### Annual and Extraordinary Meetings

Under the Israeli Companies Law and our articles of association, our board of directors must convene an annual meeting of shareholders at least once every calendar year and within 15 months of the last annual meeting. Depending on the matter to be voted upon, and subject to the Israeli Companies Law and regulations thereunder, notice of at least 14 days or 21 days or 35 days prior to the date of the meeting is required. Our articles of association provide that notice of a general meeting of shareholders will be delivered to all eligible shareholders by publication in two daily Hebrew language newspapers in Israel that have a reasonably-sized readership. Our board of directors may, in its discretion, convene additional meetings as "special general meetings." In addition, the board must convene a special general meeting upon the demand of: (a) two of the directors or 25% of the directors in office, (b) one or more shareholders having at least 5% of the outstanding share capital and at least 1% of the voting power in the company, or (c) one or more shareholders having at least 5% of the voting power in the company. The chairman of the board of directors presides at each of our general meetings. The chairman of the board of directors is not entitled to a vote at a general meeting in his capacity as chairman.

## Quorum

The quorum required for any general meeting is the presence, in person or by proxy, of shareholders holding or representing, in the aggregate, at least one third of the voting rights. No business shall be considered or determined at a general meeting, unless the requisite quorum is present within half an hour from the time designated for the general meeting. If within half an hour from the time designated for the general meeting a quorum is not present, the general meeting shall stand adjourned to the same day in the following week, at the same time and place, or to such other time as designated in the notice of such adjourned meeting. If within half an hour from the time designated for the adjourned meeting a quorum is not present, any number of shareholders present will constitute a quorum. However, if the general meeting was convened on the demand of shareholders, the adjourned meeting shall take place only if there are present at least the number of shareholders required to convene a general meeting under our articles of association (as discussed above).

A general meeting in which a quorum is present may resolve to adjourn the meeting, the discussion or the vote on a matter included in the agenda to such other time and place as it may determine. Only matters that were on the agenda and in respect of which no resolution was passed shall be discussed at the adjourned meeting.

## Resolutions

An ordinary resolution requires approval by the holders of a simple majority of the voting rights represented at the meeting, in person, by proxy or by written ballot, and voting on the resolution.

Under the Israeli Companies Law, unless otherwise provided in the articles of association or applicable law, all resolutions of the shareholders require a simple majority. A resolution for the voluntary winding up of the company requires approval by holders of 75% of the voting rights represented at the meeting, in person, by proxy or by written ballot and voting on the resolution.

## Modification of Class Rights

Under the Israeli Companies Law and our articles of association, any amendment, conversion, cancellation, expansion, addition to or other change in the rights, preferences, privileges, restrictions or provisions attached to any particular class of shares issued to shareholders of our company, shall require the written consent of holders of all issued shares of such particular class, or authorization by an ordinary resolution adopted at an extraordinary meeting of such class.

## Limitations on the Rights to Own Ordinary Shares in Our Company

None of our memorandum of association, our articles of association or the laws of the State of Israel restrict in any way the ownership or voting of ordinary shares by non-residents, except that shares held by citizens of countries which are in a state of war with Israel will not confer any rights to their holders unless the Minister of Finance consents otherwise.

In addition, pursuant to the Communications Order, so long as we control Bezeq, any state, government corporation or a corporation controlled by a government corporation cannot control our company. Ownership of our shares, directly or indirectly, by a government corporation requires the prior written approval of the Israeli Prime Minister and Israeli Minister of Communications, provided that the government corporation's total direct and indirect holdings in Bezeq does not exceed more than 5% of any type of "means of control" (as such term is described above) of Bezeq. Ownership by a government corporation, directly or indirectly, of 5% or more of Bezeq's outstanding shares or a "significant influence" (as such term is described above) in Bezeq requires the approval of the Prime Minister of Israel and the

Israeli Minister of Communications as well as the consent of the Israeli Minister of Defense. A “Hostile State,” as such term is defined in the Communications Order, a citizen or resident of a Hostile State, a corporation incorporated in a Hostile State or controlled by a resident or citizen of a Hostile State is not allowed to hold, directly or indirectly, 5% or more or a “significant influence” (as described above) in Bezeq For additional limitations on the right to own shares in Bezeq, see above “– Rights Attached to Shares - Exceptional Holdings; Principal Shareholders.”

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## Anti-Takeover Provisions; Mergers and Acquisitions

**Full Tender Offer.** A person wishing to acquire shares, or any class of shares, of a publicly traded Israeli company and who would as a result hold over 90% of the company's issued and outstanding share capital, or a class of shares which are listed, is required by the Israeli Companies Law to make a tender offer to all of the company's shareholders for the purchase of all of the remaining issued and outstanding shares of the company, or any class of shares, as the case may be. If (i) less than 5% of the outstanding shares are not tendered in the tender offer and the majority of the offerees who have no personal interest in the acceptance of the tender offer have accepted the offer; or (ii) less than 2% of the outstanding shares are not tendered in the tender offer, all of the shares that the acquirer offered to purchase will be transferred to the acquirer by operation of law. However, the shareholders may petition the court within six months after receipt of the offer to alter the consideration for the acquisition. The Israeli Companies Law allows an acquirer to determine in the terms of the offer that offerees who accepted the offer will not be entitled to appraisal rights. If the terms described above for the completion of a tender offer are not met, the acquirer may not acquire additional shares of the company from shareholders who accepted the tender offer if following such acquisition the acquirer would then own over 90% of the company's issued and outstanding share capital.

**Special Tender Offer.** The Israeli Companies Law provides that an acquisition of shares of a public company be made by means of a special tender offer if as a result of the acquisition the purchaser would hold 25% or more of the voting rights at the company's general meeting, unless one of the exemptions described in the Israeli Companies Law are met. This rule does not apply if there is already another shareholder who holds 25% or more of the voting rights at the company's general meeting. Our parent, Internet Gold, currently holds more than 25% of our outstanding ordinary shares as determined in accordance with the Israeli Companies Law. Similarly, the Israeli Companies Law provides that an acquisition of shares in a public company must be made by means of a tender offer if as a result of the acquisition the purchaser would hold more than 45% of the voting rights of the company, if there is no other shareholder of the company who holds more than 45% of the voting rights in the company. A tender offer is not required in the following circumstances: (i) the purchase was made in a private placement that was approved by the shareholders as a private placement and was meant to grant the purchaser 25% or more of the voting rights of a company in which no other shareholder holds 25% or more of the voting rights, or to grant the purchaser more than 45% of the voting rights of a company in which no other shareholder holds more than 45% of the voting rights, (ii) the purchaser would hold 25% or more of the voting rights after purchasing shares from a person that held 25% or more of the voting rights, or (iii) the purchaser would hold more than 45% of the voting rights after purchasing shares from a person that held more than 45% of the voting rights.

**Merger.** The Israeli Companies Law permits merger transactions if approved by each party's board of directors and, unless certain requirements described under the Israeli Companies Law are met, the majority of each party's shares voted on the proposed merger at a shareholders' meeting called on at least 35 days' prior notice. Under the Israeli Companies Law, if the approval of a general meeting of the shareholders is required, merger transactions may be approved by holders of a simple majority of the shares present, in person or by proxy, at a general meeting and voting on the transaction. In determining whether the required majority has approved the merger, if shares of the company are held by the other party to the merger, or by any person holding at least 25% of the outstanding voting shares or 25% of the means of appointing directors of the other party to the merger, then a vote against the merger by holders of the majority of the shares present and voting, excluding shares held by the other party or by such person, or anyone acting on behalf of either of them, is sufficient to reject the merger transaction. If the transaction would have been approved but for the exclusion of the votes of certain shareholders as provided above, a court may still approve the merger upon the request of holders of at least 25% of the voting rights of a company, if the court holds that the merger is fair and reasonable, taking into account the value of the parties to the merger and the consideration offered to the shareholders. Upon the request of a creditor of either party to the proposed merger, the court may delay or prevent the merger if it concludes that there exists a reasonable concern that, as a result of the merger, the surviving company will be unable to satisfy the obligations of any of the parties to the merger and the court may also provide instructions to

assure the rights of creditors. In addition, a merger may not be completed unless at least 50 days have passed from the date that a proposal for approval of the merger was filed with the Israeli Registrar of Companies and 30 days from the date that shareholder approval of both merging companies was obtained.

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Notwithstanding the foregoing, a merger is not subject to shareholders approval of (i) the target company, if it is a wholly-owned subsidiary of the acquiring company and (ii) the acquiring company, if no changes are required to its articles and memorandum of association and it is not issuing to the shareholders of the target company more than 20% of its voting rights and no person will become, as a result of the issuance, a controlling shareholder of the acquiring company, subject to certain limitations relating to the continuing of the votes, at a meeting of the shareholders of a company that is a party to the merger, of any entity or person that is either the other party to the merger or a control person thereof.

C. Material Contracts

None.

D. Exchange Controls

Israeli laws and regulations do not impose any material foreign exchange restrictions on non-Israeli holders of our ordinary shares. In May 1998, a new “general permit” was issued under the Israeli Currency Control Law, 1978, which removed most of the restrictions that previously existed under such law, and enabled Israeli citizens to freely invest outside of Israel and freely convert Israeli currency into non-Israeli currencies.

Non-residents of Israel who purchase our ordinary shares will be able to convert dividends, if any, thereon, and any amounts payable upon our dissolution, liquidation or winding up, as well as the proceeds of any sale in Israel of our ordinary shares to an Israeli resident, into freely repatriable dollars, at the exchange rate prevailing at the time of conversion, provided that the Israeli income tax has been withheld (or paid) with respect to such amounts or an exemption has been obtained.

E. Taxation

The following is a discussion of Israeli and United States tax consequences material to our shareholders. To the extent that the discussion is based on tax legislation which has not been subject to judicial or administrative interpretation, the views expressed in the discussion might not be accepted by the tax authorities in question or by court. The discussion is not intended, and should not be construed, as legal or professional tax advice and does not exhaust all possible tax considerations.

Israeli Tax Considerations

The following summary describes the current tax structure applicable to companies in Israel, with special reference to its effect on us. The following discussion also summarizes the material Israeli income tax consequences applicable to the purchase, ownership and disposition of our ordinary shares. This discussion does not address all of the tax consequences that may be relevant to purchasers of our ordinary shares in light of their particular circumstances, or certain types of purchasers of our ordinary shares subject to special tax treatment. Examples of this kind of investor include residents of Israel and traders in securities who are subject to special tax regimes not covered in this discussion. Each individual/entity should consult its own tax or legal advisor as to the Israeli tax consequences of the purchase, ownership and disposition of our ordinary shares. To the extent that part of the discussion is based on new tax legislation, which has not been subject to judicial or administrative interpretation, we cannot assure that the tax authorities or the courts will accept the views expressed in this section.

General Corporate Tax Structure



Generally, Israeli companies are subject to corporate tax at the rate of 25% for the 2012 and 2013 tax years. Israeli companies are generally subject to capital gains tax at the corporate tax rate. Following an amendment to the Israeli Income Tax Ordinance which came into effect on January 1, 2012, scheduled gradual reduction of the corporate tax rate in future years was canceled, and the 25% corporate tax rate is scheduled to remain for future tax years.

#### Tax on Capital Gains of Shareholders

Israeli law imposes a capital gains tax on the sale of capital assets by an Israeli resident and on the sale of capital assets located in Israel or the sale of direct or indirect rights to assets located in Israel, including on the sale of our Shares by some of our shareholders (see discussion below). The Israeli Income Tax Ordinance distinguishes between “Real Gain” and “Inflationary Surplus”. Real Gain is the excess of the total capital gain over Inflationary Surplus computed on the basis of the increase in the CPI between the date of purchase and the date of sale. In 2012, the Real Gain accrued on the sale of our Shares is generally taxed at a rate of 25% for corporations (24% in 2011) and a rate of 25% for individuals (20% in 2011). Additionally, if such individual shareholder is considered a “Significant Shareholder” at any time during the 12-month period preceding such sale (i.e. if such individual shareholder holds directly or indirectly, along with others, at least 10% of any means of control in the company), the tax rate will be 30% (25% in 2011). However, the foregoing tax rates will not apply to (i) dealers in securities; and (ii) shareholders who have acquired their shares prior to an initial public offering (that may be subject to a different tax arrangement). Inflationary surplus that accrued after December 31, 1993, is exempt from tax. Generally, a semi-annual detailed return, including a computation of the tax due should be submitted to the Israeli Tax Authorities and a tax advance amounting to the tax liability arising from the capital gain is payable. At the sale of traded securities, the aforementioned detailed return may not be submitted and the tax advance should not be paid, if all tax due was withheld at the source according to applicable provisions of the Israeli Tax Ordinance and regulations promulgated thereunder. Capital gains are also reportable on annual income tax returns.

## Individuals

As of January 1, 2012, a shareholder will generally be subject to tax at 25% rate on realized real capital gain (if the shareholder is a Significant Shareholder, as defined above, the tax rate will be 30%). To the extent that the shareholder claims a deduction of financing expenses, the gain will be subject to tax at a rate of 30% (until otherwise stipulated in bylaws that may be published in the future).

## Taxation of Non-Israeli Shareholders

### Taxation of Non-Israeli Shareholders on Receipt of Dividends

Non-residents of Israel are generally subject to Israeli income tax on the receipt of dividends paid on our ordinary shares at the rate of 25%, which tax will be withheld at source, unless a different rate is provided in a treaty between Israel and the shareholder's country of residence.

However, the tax rate on dividends paid to a "substantial shareholder" (a shareholder who alone, or together with another person, holds, directly or indirectly, at least 10% in one or all of any of the means of control in the corporation) is 30%.

Under the U.S.-Israel Tax Treaty, the maximum rate of tax withheld in Israel on dividends paid to a holder of our ordinary shares who is a U.S. resident (within the meaning of the U.S.-Israel Tax Treaty) is 25%. Furthermore, the maximum rate of withholding tax on dividends that are paid to a U.S. corporation holding 10% or more of our outstanding voting capital during the part of the tax year that precedes the date of the payment of the dividend and during the whole of its prior tax year, is 12.5%. This reduced rate will not apply if more than 25% of the Israeli company's gross income consists of interest or dividends, other than dividends or interest received from a subsidiary corporation 50% or more of the outstanding shares of the voting shares of which are owned by the company. Investors should consult their own tax advisors to determine if they are eligible for benefits under the U.S. Israel Tax Treaty.

A non-resident of Israel who receives dividends from which tax was fully paid is generally exempt from the duty to file returns in Israel in respect of such income, provided such income was not derived from a business conducted in Israel by the taxpayer, and the taxpayer has no other taxable sources of income in Israel.

Upon a distribution of dividend the following withholding tax rates will apply: (i) Israeli resident corporations — 0%, (ii) Israeli resident individuals — 25% and (iii) non-Israeli residents (whether an individual or a corporation) — 25%, subject to a reduced tax rate under the provisions of an applicable double tax treaty, provided that a certificate from the Israeli Tax Authorities allowing for a reduced withholding tax rate is obtained in advance.

## Capital Gains Taxes Applicable to Non-Israeli Shareholders

Israeli law imposes a capital gains tax on the sale of capital assets. The law distinguishes between real gain and inflationary surplus. The inflationary surplus is the portion of the total capital gain that is equivalent to the increase of the relevant asset's purchase price (net of depreciation) which is attributable to the increase in the Israeli CPI between the date of purchase and the date of sale. Foreign residents who purchased an asset in foreign currency may request that the inflationary surplus be computed on the basis of the depreciation of the NIS against such foreign currency. The real gain is the excess of the total capital gain over the inflationary surplus. The inflationary surplus accumulated from and after December 31, 1993, is exempt from any capital gains tax in Israel while the real gain is taxed at the applicable rate discussed above.



Dealers in securities in Israel are taxed at regular tax rates applicable to business income.

Under the convention between the United States and Israel concerning taxes on income, Israeli capital gains tax will not apply to the sale, exchange or disposition of ordinary shares by a person:

- who qualifies as a resident of the United States within the meaning of the U.S.-Israel tax treaty; and
- who is entitled to claim the benefits available to the person by the U.S.-Israel tax treaty.

However, this exemption does not apply, among other cases, if the gain is attributable to a permanent establishment of such person in Israel, or if the holder is a resident of the United States within the meaning of the U.S.-Israeli tax treaty who holds, directly or indirectly, shares representing 10% or more of our voting power during any part of the 12-month period preceding the sale, exchange or disposition, subject to specified conditions. Under these circumstances, the sale, exchange or disposition would be subject to Israeli tax, to the extent applicable. However, under the U.S.-Israel tax treaty, a U.S. resident generally would be permitted to claim a credit for the Israeli taxes paid against the U.S. federal income tax imposed on the sale, exchange or disposition, subject to the limitations under U.S. law applicable to foreign tax credits. The U.S.-Israel tax treaty does not relate to U.S. state or local taxes.

Under Israeli law, the capital gain from the sale of shares by non-Israeli residents is tax exempt in Israel provided that, in general, both of the following conditions are met: (A) the capital gain is not attributed to the foreign resident's permanent establishment in Israel, (B) if the seller is a corporation, less than 25% of its means of control are held by Israeli residents.

The purchaser of the shares, the stockbrokers who effected the transaction or the financial institution holding the shares through which payment to the seller is made are obligated, subject to the above-referenced exemptions if certain conditions are met, to withhold tax on the Real Gain resulting from a sale of shares at the rate of 25%.

#### United States Federal Income Tax Consequences

The following is a summary of certain material U.S. federal income tax consequences that apply to U.S. Holders who hold ordinary shares as capital assets. This summary is based on the United States Internal Revenue Code of 1986, as amended, or the Code, Treasury regulations promulgated thereunder, judicial and administrative interpretations thereof, and the U.S.-Israel Tax Treaty, all as in effect on the date hereof and all of which are subject to change either prospectively or retroactively. This summary does not address all tax considerations that may be relevant with respect to an investment in ordinary shares. This summary does not account for the specific circumstances of any particular investor, such as:

- broker-dealers,
- financial institutions,
- certain insurance companies,
- regulated investment companies,
- investors liable for alternative minimum tax,
- tax-exempt organizations,

- non-resident aliens of the U.S. or taxpayers whose functional currency is not the U.S. dollar,
- persons who hold the ordinary shares through partnerships or other pass-through entities,
- persons who acquired their ordinary shares through the exercise or cancellation of employee stock options or otherwise as compensation for services,
  - certain expatriates or former long-term residents of the United States,

- investors that own or have owned, directly, indirectly or by attribution, 10 percent or more of our voting shares, and
- investors holding ordinary shares as part of a straddle or appreciated financial position or a hedging or conversion transaction.

If a partnership or an entity treated as a partnership for U.S. federal income tax purposes owns ordinary shares, the U.S. federal income tax treatment of a partner in such a partnership will generally depend upon the status of the partner and the activities of the partnership. A partnership that owns ordinary shares and the partners in such partnership should consult their tax advisors about the U.S. federal income tax consequences of holding and disposing of ordinary shares.

This summary does not address the effect of any U.S. federal taxation other than U.S. federal income taxation. In addition, this summary does not include any discussion of state, local or foreign taxation.

You are urged to consult your tax advisors regarding the foreign and United States federal, state and local tax considerations of an investment in ordinary shares.

For purposes of this summary, a U.S. Holder is any beneficial owner of ordinary shares that is:

- an individual who is a citizen or, for U.S. federal income tax purposes, a resident of the United States;
- a corporation or other entity taxable as a corporation created or organized in or under the laws of the United States or any political subdivision thereof;
  - an estate whose income is subject to U.S. federal income tax regardless of its source; or
- a trust that (a) is subject to the primary supervision of a court within the United States and the control of one or more U.S. persons or (b) has a valid election in effect under applicable U.S. Treasury regulations to be treated as a U.S. person.

#### Taxation of Dividends

Subject to the discussion below under the heading “Passive Foreign Investment Companies,” the gross amount of any distributions received with respect to ordinary shares, including the amount of any Israeli taxes withheld therefrom, will constitute dividends for U.S. federal income tax purposes, to the extent of our current and accumulated earnings and profits as determined for U.S. federal income tax purposes. You will be required to include this amount of dividends in gross income as ordinary income. Distributions in excess of our earnings and profits will be treated as a non-taxable return of capital to the extent of your tax basis in the ordinary shares, and any amount in excess of your tax basis will be treated as gain from the sale of ordinary shares. See “--Disposition of Ordinary Shares” below for the discussion on the taxation of capital gains. Dividends will not qualify for the dividends-received deduction generally available to corporations under Section 243 of the Code.

Dividends that we pay in NIS, including the amount of any Israeli taxes withheld therefrom, will be included in your income in a U.S. dollar amount calculated by reference to the exchange rate in effect on the day such dividends are received. A U.S. Holder who receives payment in NIS and converts NIS into U.S. dollars at an exchange rate other than the rate in effect on the day of receipt may have a foreign currency exchange gain or loss that would be treated as ordinary income or loss. U.S. Holders should consult their own tax advisors concerning the U.S. tax consequences of acquiring, holding and disposing of NIS.

Subject to complex limitations, any Israeli withholding tax imposed on such dividends will be a foreign income tax eligible for credit against a U.S. Holder's U.S. federal income tax liability, subject to certain limitations set out in the Code (or, alternatively, for deduction against income in determining such tax liability). The limitations set out in the Code include computational rules under which foreign tax credits allowable with respect to specific classes of income cannot exceed the U.S. federal income taxes otherwise payable with respect to each such class of income. Dividends generally will be treated as foreign-source passive category income or general category income for United States foreign tax credit purposes. A U.S. Holder will be denied a foreign tax credit with respect to Israeli income tax withheld from dividends received on the ordinary shares to the extent such U.S. Holder has not held the ordinary shares for at least 16 days of the 31-day period beginning on the date which is 15 days before the ex-dividend date or to the extent such U.S. Holder is under an obligation to make related payments with respect to substantially similar or related property. Any days during which a U.S. Holder has substantially diminished its risk of loss on the ordinary shares are not counted toward meeting the 16-day holding period required by the statute. Further, there are special rules for computing the foreign tax credit limitation of a taxpayer who receives dividends subject to a reduced tax rate or from a passive foreign investment company, as discussed below. The rules relating to the determination of the foreign tax credit are complex, and you should consult with your personal tax advisors to determine whether and to what extent you would be entitled to this credit.

Subject to certain limitations, “qualified dividend income” received by a non-corporate U.S. Holder beginning January 1, 2013 will be subject to tax at a reduced maximum tax rate of 20 percent. The rate reduction does not apply to dividends received from passive foreign investment companies, see discussion below. Distributions taxable as dividends paid on the ordinary shares should qualify for the 20 percent rate provided that either: (i) we are entitled to benefits under the income tax treaty between the United States and Israel, or the Treaty, or (ii) the ordinary shares are readily tradable on an established securities market in the United States and certain other requirements are met. We believe that we are entitled to benefits under the Treaty and that the ordinary shares currently are readily tradable on an established securities market in the United States. However, no assurance can be given that the ordinary shares will remain readily tradable. The rate reduction does not apply unless certain holding period requirements are satisfied. With respect to the ordinary shares, the U.S. Holder must have held such shares for at least 61 days during the 121-day period beginning 60 days before the ex-dividend date. The rate reduction also does not apply in respect of certain hedged positions or in certain other situations. There are special rules for computing the foreign tax credit limitation of a taxpayer who receives dividends subject to the reduced tax rate. U.S. Holders of ordinary shares should consult their own tax advisors regarding the effect of these rules in their particular circumstances.

#### Disposition of Ordinary Shares

If you sell or otherwise dispose of ordinary shares, you will recognize gain or loss for U.S. federal income tax purposes in an amount equal to the difference between the amount realized on the sale or other disposition and the adjusted tax basis in ordinary shares. Subject to the discussion below under the heading “Passive Foreign Investment Companies,” such gain or loss generally will be capital gain or loss and will be long-term capital gain or loss if you have held the ordinary shares for more than one year at the time of the sale or other disposition. In general, any gain that you recognize on the sale or other disposition of ordinary shares will be U.S.-source for purposes of the foreign tax credit limitation; losses will generally be allocated against U.S. source income. Deduction of capital losses is subject to certain limitations under the Code.

In the case of a cash basis U.S. Holder who receives NIS in connection with the sale or disposition of ordinary shares, the amount realized will be based on the U.S. dollar value of the NIS received with respect to the ordinary shares as determined on the settlement date of such exchange. A U.S. Holder who receives payment in NIS and converts NIS into United States dollars at a conversion rate other than the rate in effect on the settlement date may have a foreign currency exchange gain or loss that would be treated as ordinary income or loss.

An accrual basis U.S. Holder may elect the same treatment required of cash basis taxpayers with respect to a sale or disposition of ordinary shares, provided that the election is applied consistently from year to year. Such election may not be changed without the consent of the Internal Revenue Service. In the event that an accrual basis U.S. Holder does not elect to be treated as a cash basis taxpayer (pursuant to the Treasury regulations applicable to foreign currency transactions), such U.S. Holder may have a foreign currency gain or loss for U.S. federal income tax purposes because of differences between the U.S. dollar value of the currency received prevailing on the trade date and the settlement date. Any such currency gain or loss would be treated as ordinary income or loss and would be in addition to gain or loss, if any, recognized by such U.S. Holder on the sale or disposition of such ordinary shares.

#### Passive Foreign Investment Companies

There is a risk that we may have been, be or become a passive foreign investment company, or PFIC, for U.S. federal income tax purposes. Our treatment as a PFIC could result in a reduction in the after-tax return to the U.S. Holders of our ordinary shares and may cause a reduction in the value of such shares.

For U.S. federal income tax purposes, we will be classified as a PFIC for any taxable year in which either (i) 75% or more of our gross income is passive income, or (ii) at least 50% of the average value of all of our assets for the taxable



year produce or are held for the production of passive income. For this purpose, cash is considered to be an asset which produces passive income. Passive income generally includes dividends, interest, royalties, rents, annuities and the excess of gains over losses from the disposition of assets which produce passive income. As long as we own at least 25% of Bezeq's shares, our PFIC status will be determined by considering us to own a proportionate share of Bezeq's assets and to receive a proportionate share of its income. As a result of our relatively substantial cash position at the time, we believe that we were a PFIC in certain periods in the past under a literal application of the asset test described above, which looks solely to the market value of our assets. We do not believe that we were a PFIC in the past three years.

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If we are a PFIC at any time during your holding period, dividends will not qualify for the reduced maximum tax rate, applicable to qualified dividend income, discussed above, you will be required to make an annual return on IRS Form 8621, and, unless you timely elect to “mark-to-market” your ordinary shares, as described below:

- you will be required to allocate income recognized upon receiving certain dividends or gain recognized upon the disposition of ordinary shares ratably over the holding period for such ordinary shares,
- the amount allocated to each year during which we are considered a PFIC other than the year of the dividend payment or disposition would be subject to tax at the highest individual or corporate tax rate, as the case may be, in effect for that year and an interest charge would be imposed with respect to the resulting tax liability allocated to each such year, and
- the amount allocated to the current taxable year and any taxable year before we became a PFIC would be taxable as ordinary income in the current year.

In addition, holders of stock in a PFIC may not receive a “step-up” in basis on shares acquired from a decedent.

The PFIC provisions discussed above apply to U.S. persons who directly or indirectly hold stock in a PFIC. Generally, a U.S. person is considered an indirect shareholder of a PFIC if it is:

- A direct or indirect owner of a pass-through entity, including a trust or estate, that is a direct or indirect shareholder of a PFIC,
  - A shareholder of a PFIC that is a shareholder of another PFIC, or
- A 50%-or-more shareholder of a foreign corporation that is not a PFIC and that directly or indirectly owns stock of a PFIC.

An indirect shareholder may be taxed on a distribution paid to the direct owner of the PFIC and on a disposition of the stock indirectly owned. Indirect shareholders are strongly urged to consult their tax advisors regarding the application of these rules.

If the ordinary shares are considered “marketable stock” and if you elect to “mark-to-market” your ordinary shares, you would not be subject to the rules described above. Instead, you will generally include in income any excess of the fair market value of the ordinary shares at the close of each tax year over your adjusted basis in the ordinary shares. If the fair market value of the ordinary shares had depreciated below your adjusted basis at the close of the tax year, you may generally deduct the excess of the adjusted basis of the ordinary shares over its fair market value at that time. However, such deductions generally would be limited to the net mark-to-market gains, if any, that you included in income with respect to such ordinary shares in prior years. Income recognized and deductions allowed under the mark-to-market provisions, as well as any gain or loss (to the extent of net mark-to-market gains) on the disposition of ordinary shares with respect to which the mark-to-market election is made, is treated as ordinary income or loss. Loss on a disposition, to the extent in excess of net mark-to-market gains, would be treated as capital loss. Gain or loss from the disposition of ordinary shares (as to which a “mark-to-market” election was made) in a year in which we are no longer a PFIC will be capital gain or loss. Loss on a disposition, to the extent in excess of net mark-to-market gains, would be treated as capital loss. Our ordinary shares should be considered “marketable stock” if they traded at least 15 days during each calendar quarter of the relevant calendar year in more than de minimis quantities.

A U.S. Holder of ordinary shares will not be able to avoid the tax consequences described above by electing to treat us as a qualified electing fund, or QEF, because we do not intend to prepare the information that U.S. Holders would

need to make a QEF election.

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#### Additional Tax on Investment Income

In addition to the taxes on dividends and dispositions of our ordinary shares described above, certain U.S. Holders that are individuals, estates or trusts are required to pay an additional 3.8% tax on net investment income, which includes dividends and capital gains.

#### Backup Withholding and Information Reporting

Payments in respect of ordinary shares may be subject to information reporting to the U.S. Internal Revenue Service and to U.S. backup withholding tax at a rate equal to the fourth lowest income tax rate applicable to individuals which, under current law, is 28%. Backup withholding will not apply, however, if you (i) are a corporation or come within certain exempt categories, and demonstrate the fact when so required, or (ii) furnish a correct taxpayer identification number and make any other required certification.

Backup withholding is not an additional tax. Amounts withheld under the backup withholding rules may be credited against a U.S. Holder's U.S. tax liability, and a U.S. Holder may obtain a refund of any excess amounts withheld under the backup withholding rules by filing the appropriate claim for refund with the IRS.

U.S. individuals that hold certain specified foreign financial assets, including stock in a foreign corporation, with values in excess of certain thresholds are required to file Form 8938 with their U.S. Federal income tax return. Such Form requires disclosure of information concerning such foreign assets, including the value of the assets. Failure to file the form when required is subject to penalties. An exemption from reporting applies to foreign assets held through a U.S. financial institution, generally including a non-U.S. branch or subsidiary of a U.S. institution and a U.S. branch of a non-US institution. Investors are encouraged to consult with their own tax advisors regarding the possible application of this disclosure requirement to their investment in ordinary shares.

Any U.S. Holder who holds 10% or more in vote or value of our ordinary shares will be subject to certain additional United States information reporting requirements.

#### F. Dividends and Paying Agents

Not applicable.

#### G. Statement by Experts

Not applicable.

#### H. Documents on Display

We are subject to certain of the reporting requirements of the Securities and Exchange Act of 1934, as amended, or the Exchange Act, as applicable to "foreign private issuers" as defined in Rule 3b-4 under the Exchange Act. As a foreign private issuer, we are exempt from certain provisions of the Exchange Act. Accordingly, our proxy solicitations are not subject to the disclosure and procedural requirements of Regulation 14A under the Exchange Act, and transactions in our equity securities by our officers and directors are exempt from reporting and the "short-swing" profit recovery provisions contained in Section 16 of the Exchange Act. In addition, we are not required under the Exchange Act to file periodic reports and financial statements as frequently or as promptly as U.S. companies whose securities are registered under the Exchange Act. However, we file with the SEC an annual report on Form 20-F containing financial statements audited by an independent accounting firm. We also submit to the SEC reports on Form 6-K containing (among other things) press releases and unaudited financial information. We post our annual report on

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Form 20-F on our website ([www.igld.com](http://www.igld.com)) promptly following the filing of our annual report with the SEC. The information on our website is not incorporated by reference into this annual report.

This annual report and the exhibits thereto and any other document we file pursuant to the Exchange Act may be inspected without charge and copied at prescribed rates at the SEC public reference room at 100 F Street, N.E., Room 1580, Washington, D.C. 20549. You may obtain information on the operation of the SEC's public reference room in Washington, D.C. by calling the SEC at 1-800-SEC-0330. The Exchange Act file number for our SEC filings is 000-30198.

The SEC maintains a website at [www.sec.gov](http://www.sec.gov) that contains reports, proxy and information statements, and other information regarding registrants that make electronic filings with the SEC using its EDGAR (Electronic Data Gathering, Analysis, and Retrieval) system.

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The documents concerning our company referred to in this annual report may also be inspected at our offices located at 2 Dov Friedman Street, Ramat Gan 52503, Israel. We will provide a copy of this annual report containing our financial statements upon shareholders' request.

#### I. Subsidiary Information

Not applicable.

### ITEM 11. QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISKS

We are exposed to a variety of risks, including foreign currency fluctuations and changes in interest rates. We regularly assess currency and interest rate risks to minimize any adverse effects on our business as a result of those factors.

#### Foreign Currency Exchange Risk

Bezeq is exposed to foreign currency effects mainly due to dollar-linked and euro-linked payments for purchases of terminal equipment and property, plant and equipment. In addition, it provides services for customers and receives services from suppliers worldwide for which it is paid and it pays in foreign currency, mainly the U.S. dollar. The Bezeq Group has surplus liabilities over assets in foreign currency. To hedge its exposure, the Bezeq Group makes forward transactions and purchases options against the U.S. dollar. The duration of the hedging transactions is the same as or shorter than the duration of the hedged exposures.

Bezeq Group holds derivative financial instruments to hedge its exposure to foreign currency, the CPI and copper prices. Hedge accounting is not applied to derivative instruments that economically hedge financial assets and liabilities. Derivative instruments are recognized initially at fair value; attributable transaction costs are recognized in the statement of income as incurred. Subsequent to initial recognition, derivative financial instruments are measured at fair value and the changes in fair value are recognized in the statement of income as incurred.

Embedded derivatives are separated from the host contract and accounted for separately if: (a) the economic characteristics and risks of the host contract and the embedded derivative are not closely related; (b) a separate instrument with the same terms as the embedded derivative would meet the definition of the derivative; (c) the combined instrument is not measured at fair value through profit or loss.

Changes in the fair value of separable embedded derivatives are recognized in the statement of income as financing income or expense as incurred.

#### Effects of Changes in Interest Rates and the Israeli Consumer Price Index

Our total net exposure to changes in the Israeli CPI was NIS 962 million (approximately \$258 million) at December 31, 2012. The exposure relates to NIS 1 billion (approximately \$276 million) of our outstanding debentures that are partially hedged by our investment in NIS 67 million (approximately \$18 million) of CPI linked marketable securities. Each increase or decrease of 1% in the Israeli CPI will result in an increase or decrease in our yearly financial expense of NIS 10 million (approximately \$3 million).

B Communications' total net exposure to changes in the Israeli CPI was NIS 1.6 billion (approximately \$417 million) at December 31, 2012. The exposure primarily relates to NIS 1.7 billion (approximately \$454 million) of the outstanding debt that B Communications incurred in connection with its acquisition of the controlling interest in Bezeq and NIS 252 million (approximately \$68 million) of its outstanding Series A Debentures. As at December 31, 2012, B Communications also holds forward contracts on the Israeli CPI that fully hedge its exposure with respect to

the Series A Debentures and NIS 140 million (approximately \$38 million) of CPI linked marketable securities. Each increase or decrease of 1% in the Israeli CPI will result in an increase or decrease in B Communications' yearly financial expense by NIS 16 million (approximately \$4 million).

B Communications' total net exposure to changes in the variable Israeli interest rate was NIS 1.5 billion (approximately \$399 million) at December 31, 2012. The exposure relates to NIS 1.6 billion (approximately \$416 million) of the outstanding debt that B Communications incurred in connection with its acquisition of the controlling interest in Bezeq, which is partially hedged by its NIS 63 million (approximately \$17 million) investment in marketable securities that are subject to the variable interest rate. Each increase or decrease of 1% in the Israeli interest rate will result in an increase or decrease in B Communications' yearly financial expense by NIS 15 million (approximately \$4 million).

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As of December 31, 2012, Bezeq had NIS 4.5 billion (approximately \$1.2 billion) of debt that is subject to variable interest rates and NIS 2.6 billion (\$688 million) of debt that is subject to changes in the Israeli CPI. Each increase or decrease of 1% in the variable interest rate will result in an increase or decrease in Bezeq's yearly financial expense by NIS 2 million (approximately \$0.5 million) and each increase or decrease of 1% in the Israeli CPI will result in an increase or decrease in Bezeq's yearly financial expense by NIS 15 million (approximately \$4 million).

#### Cash Investments, Marketable Securities and Interest Rate Risk Management

Our cash investment policy seeks to preserve principal and maintain adequate liquidity while maximizing the income we receive from our investments without significantly increasing the risk of loss. To minimize investment risk, we maintain a diversified portfolio across various maturities, types of investments and issuers, which may include, from time to time, money market funds, U.S. government bonds, state debt, bank deposits and certificates of deposit, and investment grade corporate debt. As of December 31, 2012, we had NIS 8 million (approximately \$2 million) in cash and cash equivalents and NIS 171 million (approximately \$46 million) in marketable securities (not including the amounts of B Communications or Bezeq).

The performance of the capital markets affects the values of the funds we hold in marketable securities. These assets are subject to market fluctuations. In such case, the fair value of our investments may decline. We periodically monitor our investments for adverse material holdings related to the underlying financial solvency of the issuers of the marketable securities in our portfolio.

Our exposure to market risk for changes in interest rates relates primarily to our investment in marketable securities. Investments in both fixed rate and floating rate interest bearing securities carry a degree of interest rate risk. The fair market value of fixed rate securities may be adversely impacted due to a rise in interest rates, while floating rate securities may produce less income than predicted if interest rates fall. Due in part to these factors, our future financial results may be negatively affected in the event that interest rates fluctuate.

#### Bezeq's and B Communications' Exposure to Market Risks

Bezeq and B Communications are exposed to market risks, mainly as a result of changes in interest rates, exchange rates, inflation, the prices of raw materials and equipment, and the prices of securities. Bezeq and B Communications seek to mitigate against such risks in accordance with a financial exposure management policy adopted by both board of directors. Pursuant to their policy, they take partial hedging actions depending on the circumstances and its own judgment, primarily for reducing its exposure to changes in the Israeli CPI and foreign currency exchange rates. Both monitor and review their exposure management every month, including, when necessary, making recommendations for change, if required, in the exposure management.

Bezeq and B Communications have a surplus of liabilities that are CPI linked and the bulk of their financial exposure stems from the risk of a rise in inflation. The rate of inflation also affects their operating income and operating expenses in the course of the year. In addition, Bezeq's tariff updating mechanism, which is subject to government regulation, is reviewed once a year and is influenced by the CPI. As a result, the annual rate of inflation and its distribution during the year can have a material influence on the erosion of Bezeq's tariffs and its revenues and expenses during the year.

Bezeq's exposure to change in the interest rate largely depends on the character of its financial liabilities and assets as well as future financing needs. Most of Bezeq's debt bears fixed interest, and therefore a change in the interest rate will affect its fair value rather than its carrying value.



B Communications' exposure to change in the interest rate largely depends on the character of its financial liabilities and assets as well as future financing needs. Most of B Communications' debt bears fixed interest, and therefore a change in the interest rate will affect its fair value rather than its carrying value.

Bezeq has investments in negotiable bonds that are stated in its books at their market value. This market value is influenced by changes in the interest rates in the economy. In addition, a change in the NIS exchange rate constitutes economic exposure that can affect Bezeq's future profit and cash flows, mainly the repayment of currency-linked liabilities and payments for currency-linked purchases of equipment and raw materials.

The cash flow generated by Bezeq's operations is used partially for investment in equipment. The prices of the equipment are affected by the indices to which they are linked, including industry price indices, exchange rates and global prices. Bezeq does not hedge against this exposure. Bezeq is also exposed to changes in copper prices that result in a change in the residual value of its copper cable infrastructure. In deploying its NGN, Bezeq removes copper cables previously used to provide its services and sells the copper from such cables, and the prices received are subject to the volatility of the copper market.

ITEM 12. DESCRIPTION OF SECURITIES OTHER THAN EQUITY SECURITIES

Not applicable.

PART II

ITEM 13. DEFAULTS, DIVIDEND ARREARAGES AND DELINQUENCIES

None.

ITEM 14. MATERIAL MODIFICATIONS TO THE RIGHTS OF SECURITY HOLDERS AND USE OF PROCEEDS

Material Modifications to the Rights of Security Holders

None.

Use of Proceeds

Not applicable.

ITEM 15. CONTROLS AND PROCEDURES

Disclosure Controls and Procedures

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in our Exchange Act reports is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to our chief executive officer and chief financial officer to allow timely decisions regarding required disclosure. Our management, including our chief executive officer and chief financial officer, conducted an evaluation of our disclosure controls and procedures, as defined under Exchange Act Rule 13a-15(e), as of the end of the period covered by this annual report on Form 20-F. Based upon that evaluation, our chief executive officer and principal financial officer have concluded that, as of such date, our disclosure controls and procedures were effective.

Management's Annual Report on Internal Control Over Financial Reporting

Our management, including our chief executive officer and principal financial officer, is responsible for establishing and maintaining adequate internal control over financial reporting, as defined under Exchange Act Rules 13a-15(f) and 15d-15(f). Our internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with accounting principles generally accepted in the United States. Internal control over financial reporting includes those policies and procedures that: (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of our assets, (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that our receipts and expenditures are being made only in accordance with appropriate authorizations; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of our assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Our management assessed the effectiveness of our internal control over financial reporting as of December 31, 2012. In conducting its assessment of internal control over financial reporting, management based its evaluation on the framework in “Internal Control – Integrated Framework” issued by the Committee of Sponsoring Organizations, or the COSO, of the Treadway Commission. Based on that assessment, our management has concluded that our internal control over financial reporting was effective as of December 31, 2011. This annual report does not include an attestation report of our registered public accounting firm regarding internal control over financial reporting. Management's report was not subject to attestation by our registered public accounting firm pursuant to rules of the Securities and Exchange Commission that permit us to provide only management's report in this annual report.

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## Changes in Internal Control over Financial Reporting

There were no changes in our internal control over financial reporting during the period covered by this Annual Report on Form 20-F that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

## ITEM 16. [RESERVED]

## ITEM 16A. AUDIT COMMITTEE FINANCIAL EXPERT

Our board of directors has determined that Ms. Anat Winner, an independent director and Ms. Orly Guy, an External Director, meet the definition of an audit committee financial expert, as defined by rules of the SEC. For a brief listing of Ms. Winner's relevant experience, see Item 6.A. "Directors, Senior Management and Employees - Directors and Senior Management."

## ITEM 16B. CODE OF ETHICS

We have adopted a code of ethics that applies to our chief executive officer and all senior financial officers of our company, including the chief financial officer, chief accounting officer or controller, or persons performing similar functions. Our code of ethics is available for viewing on our website at [www.igld.co.il](http://www.igld.co.il). Written copies are available upon request. If we make any substantive amendment to the code of ethics or grant any waivers, including any implicit waiver, from a provision of the codes of ethics, we will disclose the nature of such amendment or waiver on our website.

## ITEM 16C. PRINCIPAL ACCOUNTANT FEES AND SERVICES

## Fees Billed by Independent Public Accountants

The following table sets forth, for each of the years indicated, the aggregate fees billed to us, Bezeq, B Communications, Pelephone and Bezeq International by the independent registered public accounting firm that prepares their financial statements. All of such fees were pre-approved by the relevant committee for the examination of the financial statements.

Services Rendered	Year Ended December 31,	
	2011	2012
	NIS	
Audit and Audit-related (1) (2)	6,969,000	6,531,000
	NIS	
Tax and other (3)	712,000	599,000
	NIS	
Total	7,681,000	7130000

(1) Audit fees are for audit services for each of the years shown in the table, including fees associated with the annual audit and audit services provided in connection with other statutory and regulatory filings.

(2) Audit related fees are the aggregate fees billed for assurance and related services that are not reported under audit fees.

- (3) Tax fees are the aggregate fees billed for professional services rendered for tax compliance and tax advice.

#### Pre-Approval Policies and Procedures

Our audit committee has adopted a policy and procedures for the pre-approval of audit and non-audit services rendered by our independent registered public accounting firm, Somekh Chaikin, a member firm of KPMG International. Somekh Chaikin also acts as Bezeq's independent registered public accounting firm. Pre-approval of an audit or non-audit service may be given as a general pre-approval, as part of the audit committee's approval of the scope of the engagement of our independent auditor, or on an individual basis. Any proposed services exceeding general pre-approved levels also require specific pre-approval by our audit committee. The policy prohibits retention of the independent registered public accountants to perform the prohibited non-audit functions defined in Section 201 of the Sarbanes-Oxley Act or the rules of the SEC, and also requires the audit committee to consider whether proposed services are compatible with the independence of the registered public accounting firm.

ITEM 16D. EXEMPTIONS FROM THE LISTING STANDARDS FOR AUDIT COMMITTEES

Not applicable.

ITEM 16E. PURCHASE OF EQUITY SECURITIES BY THE ISSUER AND AFFILIATED PURCHASERS

In 2010, our Board of Directors authorized a repurchase program, for the repurchase of up to NIS 44 million (approximately \$11.5 million) of our ordinary shares in the open market from time to time at prevailing market prices of our ordinary shares under the third program. As of December 31, 2012, we had repurchased 330,759 ordinary shares under this program at a total purchase price of approximately NIS 30.55 million (approximately \$7.96 million), or an average price of NIS 92.39 (\$24.14) per share. There were no ordinary shares of our company purchased by us or on our behalf or by any affiliated purchaser during 2012.

5,862,615 ordinary shares are held as treasury shares as of April 22, 2013, as a result of repurchases prior to 2010 and the above mentioned program.

ITEM 16F. CHANGES IN REGISTRANT'S CERTIFYING ACCOUNTANT

Not applicable.

ITEM 16G. CORPORATE GOVERNANCE

NASDAQ Exemptions for a Controlled Company

We are a controlled company within the meaning of NASDAQ Stock Market Rule 5615(c)(1), since Eurocom Communications holds more than 50% of our voting power. Under NASDAQ Stock Market Rule 5615(c)(2), a controlled company is exempt from the following requirements of NASDAQ Stock Market Rule 5605:

- The requirement that the majority of the company's board of directors qualify as independent directors, as defined under NASDAQ Stock Market Rules. Instead, we follow Israeli law and practice which requires that we appoint at least two outside directors, within the meaning of the Israeli Companies Law, to our board of directors. In addition, we have the mandated three independent directors, within the meaning of the rules of the SEC and NASDAQ, on our audit committee. See Item 6C. "Directors, Senior Management and Employees - Board Practices - Outside and Independent Directors."
- The requirement that the compensation of the chief executive officer and all other executive officers be determined, or recommended to the board of directors for determination, either by (i) a majority of the independent directors or (ii) a compensation committee comprised solely of independent directors. Under the Israeli Companies Law, any compensation arrangement with an office holder (including an exemption from liability and the insurance and indemnification of an office holder), require the approval of the compensation committee, the board of directors and in certain circumstances, shareholders.
- The requirement that director nominees either be selected or recommended for the board of directors' selection, either by (a) a majority of independent directors or (b) a nominations committee comprised solely of independent directors. Instead, we follow Israeli law and practice, in accordance with which directors may be recommended by our board of directors for election by our shareholders.

If the "controlled company" exemptions cease to be available to us under NASDAQ Stock Market Rules, we may instead elect to follow Israeli law instead of the foregoing NASDAQ requirements, as described below.

### NASDAQ Stock Market Rules and Home Country Practice

Under NASDAQ Stock Market Rule 5615(a)(3), foreign private issuers, such as our company, are permitted to follow certain home country corporate governance practices instead of certain provisions of the NASDAQ Stock Market Rules. As a foreign private issuer listed on the NASDAQ Global Select Market, we may follow home country practice with regard to, among other things, the composition of the board of directors, compensation of officers, director nomination process and quorum at shareholders' meetings. In addition, we may follow home country practice instead of the NASDAQ requirement to obtain shareholder approval for certain dilutive events (such as for the establishment or amendment of certain equity-based compensation plans, an issuance that will result in a change of control of the company, certain transactions other than a public offering involving issuances of a 20% or more interest in the company and certain acquisitions of the stock or assets of another company). A foreign private issuer that elects to follow a home country practice instead of NASDAQ requirements must submit to NASDAQ in advance a written statement from an independent counsel in such issuer's home country certifying that the issuer's practices are not prohibited by the home country's laws. In addition, a foreign private issuer must disclose in its annual reports filed with the SEC each such requirement that it does not follow and describe the home country practice followed by the issuer instead of any such requirement. Accordingly, our shareholders may not be afforded the same protection as provided under NASDAQ's corporate governance rules.

ITEM 16H. MINE SAFETY DISCLOSURE

Not applicable.

PART III

ITEM 17. FINANCIAL STATEMENTS

We have elected to furnish financial statements and related information specified in Item 18.

ITEM 18. FINANCIAL STATEMENTS

Consolidated Financial Statements of Internet Gold-Golden Lines Ltd.

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Consolidated Financial Statements of DBS Satellite Service (1998) Ltd.

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ITEM 19. EXHIBITS

Index to Exhibits

Exhibit	Description
1.1	Memorandum of Association of the Registrant (1)
1.2	Amended and Restated Articles of Association of the Registrant
2.1	Specimen of Share Certificate (1)
2.2	Terms of Convertible Debentures Traded on Tel Aviv Stock Exchange (2)
2.3	Form of B Communications Ltd. Series A Debenture Certificate for Notes issued in March 2007 and May 2007 (3)





- 4.1 Registration Rights Agreement, dated July 30, 1999, among the Registrant, Euronet Communications Ltd., Shaul Elovitch and Eli Holtzman (1)
- 4.2 Share Purchase Agreement dated October 25, 2009, between B Communications Ltd. (formerly 012 Smile. Communications Ltd.) and Ap.Sb.Ar. Holdings Ltd. (4)
- 4.3 First Amendment to the Share Purchase Agreement dated as of March 28, 2010, between B Communications (SP2) Ltd. and Ap.Sb.Ar. Holdings Ltd. (5)
- 4.4 Asset Purchase Agreement dated November 16, 2009, between Ampal Communication 2010 Ltd., B Communications Ltd. (formerly 012 Smile. Communications Ltd.) and Merhav Ampal Energy Ltd., as Guarantor (4)
- 4.5 English translation of Bezeq Control Permit issued by the Prime Minister of Israel and Israeli Minister of Communication to members of the Eurocom Group on April 13, 2010 (5)
- 4.6 English translation of Credit Agreement dated February 11, 2010 between B Communications (SP2) Ltd. and Bank Hapoalim Ltd. (as Lender, Facility Agent and Security Trustee), Bank Leumi le-Israel BM, Amitim (Senior Pension Funds), Israel Discount Bank Ltd., Mizrahi Tefahot Bank Ltd., HSBC Bank PLC, First International Bank of Israel Ltd. and Union Bank of Israel (as Lenders) (5)
- 4.7 English translation of Loan Agreement dated February 18, 2010, between B Communications (SP1) Ltd. and entities within the Migdal Insurance and Financial Holdings Ltd. group (5)
- 4.8 English translation of Addendum and Amendment No. 1 the Credit Agreement dated February 11, 2010, dated April 14, 2010, between B Communications (SP2) Ltd. and Bank Hapoalim Ltd. (as Lender, Facility Agent and Security Trustee), Bank Leumi le-Israel BM, Israel Discount Bank Ltd., Mizrahi Tefahot Bank Ltd., HSBC Bank PLC, First International Bank of Israel Ltd., Union Bank of Israel, Central Benefits Fund of Histadrut Employees Ltd. (under special management), Makefet Fund Pension and Provident Center - AS Ltd. Pension Fund, Makefet Fund Pension and Provident Center - AS Ltd. (under special management) – Other-Purpose Funds, Mivtachim The Workers Social Insurance Fund Ltd. (under special management) - Pension Fund, Mivtachim The Workers Social Insurance Fund Ltd. (under special management) Illness and Accident Provident Fund, Hadassa Employees Pension Fund Ltd. (under special management), “Egged” Members Pension Fund Ltd. (under special management) – Pension Track and “Egged” Members Pension Fund Ltd. (under special management) – Full Pension Track (as Lenders) (5)
- 4.9 English translation of Addendum and Amendment No. 2 the Credit Agreement dated February 11, 2010, dated June 26, 2011, between B Communications (SP2) Ltd. and Bank Hapoalim Ltd. (as Lender, Facility Agent and Security Trustee) and the other Lenders (6)
- 4.10 English translation of Addendum and Amendment No. 1 the Loan Agreement dated February 18, 2010, dated April 14, 2010, between B Communications (SP1) Ltd. and entities within the Migdal Insurance and Financial Holdings Ltd. Group (5)
- 4.11 English translation of Deed of Trust dated August 31, 2010 between the Registrant and Reznik, Paz, Nevo Trustees Ltd. (6)

- 4.12 English translation of Addendum to the Deed of Trust of August 31, 2010 dated September 26, 2010 between the Registrant and Reznik, Paz, Nevo Trustees Ltd. (6)
- 8 List of Subsidiaries of the Registrant
- 12.1 Certification of Chief Executive Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act, as amended
- 12.2 Certification of Chief Financial Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act, as amended
- 13.1 Certification of Chief Executive Officer pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- 13.2 Certification of Chief Financial Officer pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

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- (1) Previously filed as an exhibit to the Registrant's Registration Statement on Form F-1 (Registration No. 333-10576), and incorporated herein by reference.
  - (2) Previously filed as an exhibit to the Registrant's Report on Form 6-K for the month of April 2005 submitted to Securities and Exchange Commission on April 11, 2005, and incorporated herein by reference.
  - (3) Previously filed as an exhibit to the Registrant's Annual Report on Form 20-F for the year ended December 31, 2006, and incorporated herein by reference.
  - (4) Previously filed as Exhibit 99.1 to the Registrant's Report on Form 6-K for the month of June 2010 submitted to Securities and Exchange Commission on June 23, 2010, and incorporated herein by reference.
  - (5) Previously filed as an exhibit to the Registrant's Annual Report on Form 20-F for the year ended December 31, 2009, and incorporated herein by reference.
  - (6) Previously filed as an exhibit to the Registrant's Annual Report on Form 20-F for the year ended December 31, 2010, and incorporated herein by reference.

Internet Gold – Golden Lines Ltd.

Consolidated Financial Statements

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Report of Independent Registered Public Accounting Firm

To the Board of Directors and Shareholders of  
Internet Gold – Golden Lines Ltd.:

We have audited the accompanying consolidated statements of financial position of Internet Gold- Golden Lines Ltd. and its subsidiaries (hereinafter - “the Company”) as at December 31, 2011 and 2012 and the related consolidated statements of income, comprehensive income, changes in equity, and cash flows for each of the years in the three-year period ended December 31, 2012. The Company’s management is responsible for these consolidated financial statements. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. Our audits of the consolidated financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of the Company as of December 31, 2011 and 2012, and the results of its operations and its cash flows for each of the years in the three-year period ended December 31, 2012 in conformity with International Financial Reporting Standards (“IFRS”) as issued by the International Accounting Standards Board (“IASB”).

The accompanying consolidated financial statements as at and for the year ended December 31, 2012 have been translated into United States dollars (“dollars”) solely for the convenience of the reader. We have audited the translation and, in our opinion, the consolidated financial statements expressed in New Israeli Shekels have been translated into dollars on the basis set forth in Note 2D to the consolidated financial statements.

/s/ Somekh Chaikin  
Somekh Chaikin  
Certified Public Accountants (Isr.)  
Member Firm of KPMG International

Tel Aviv, Israel

April 24, 2013

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## Consolidated Statements of Financial Position as at

(In millions)

		December 31		Convenience translation into U.S. dollars (Note 2D) 2012 US\$
	Note	2011 NIS	2012 NIS	
<b>Assets</b>				
Cash and cash equivalents	7	1,447	764	205
Investments, including derivative financial instruments	8	1,548	1,655	443
Trade receivables, net	9	3,059	2,927	784
Other receivables	9	294	329	88
Inventory		204	123	33
Assets classified as held-for-sale		167	164	44
<b>Total current assets</b>		<b>6,719</b>	<b>5,962</b>	<b>1,597</b>
Investments including derivative financial instruments	8	119	90	24
Long-term trade receivables	9	1,499	1,074	289
Property, plant and equipment	10	7,143	6,911	1,852
Intangible assets	11	8,085	7,252	1,943
Deferred and other expenses	12	412	384	101
Investments in equity-accounted investee (mainly loans)	13	1,059	1,005	269
Deferred tax assets	20	223	126	34
<b>Total non-current assets</b>		<b>18,540</b>	<b>16,842</b>	<b>4,512</b>
<b>Total assets</b>		<b>25,259</b>	<b>22,804</b>	<b>6,109</b>

The accompanying notes are an integral part of these consolidated financial statements.

## Consolidated Statements of Financial Position as at (cont'd)

(In millions)

		December 31		Convenience translation into U.S. dollars (Note 2D) 2012 US\$
	Note	2011 NIS	2012 NIS	
<b>Liabilities</b>				
Short-term bank credit, current maturities of long term liabilities and debentures	14	1,306	1,707	457
Trade payables	15	892	793	212
Other payables, including derivative financial instruments	15	846	746	200
Dividend payable	13	669	669	179
Current tax liabilities		499	588	158
Provisions	16	186	145	39
Employee benefits	19	389	258	69
<b>Total current liabilities</b>		<b>4,787</b>	<b>4,906</b>	<b>1,314</b>
Debtors	14	6,388	5,913	1,584
Bank loans	14	6,843	6,422	1,720
Loans from institutions and others	14	544	540	145
Dividend payable	13	636	-	-
Employee benefits	19	229	246	66
Other liabilities		96	67	18
Provisions	16	69	66	18
Deferred tax liabilities	20	1,426	1,159	310
<b>Total non-current liabilities</b>		<b>16,231</b>	<b>14,413</b>	<b>3,861</b>
<b>Total liabilities</b>		<b>21,018</b>	<b>19,319</b>	<b>5,175</b>
<b>Equity</b>				
Share capital	24	*	*	**
Share premium		658	658	176
Treasury shares		(169)	(169)	(45)
Other reserves		(156)	(177)	(48)
Accumulated deficit		(360)	(403)	(107)
<b>Total equity attributable to equity holders of the Company</b>		<b>(27)</b>	<b>(91)</b>	<b>(24)</b>
Non-controlling interests		4,268	3,576	958
<b>Total Equity</b>		<b>4,241</b>	<b>3,485</b>	<b>934</b>
<b>Total liabilities and equity</b>		<b>25,259</b>	<b>22,804</b>	<b>6,109</b>

\* Represent an amount less than NIS 1.

\*\* represent an amount less than US\$ 1.



Date of approval of the financial statements: April 24, 2013

The accompanying notes are an integral part of these consolidated financial statements.

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## Consolidated Statements of Income for the Year Ended December 31

(In millions, except per share data)

	Note	2010 NIS	2011 NIS	2012 NIS	Convenience translation into U.S. dollars (Note 2D) 2012 US\$
Revenues	25	8,732	11,376	10,278	2,753
Cost and expenses					
Depreciation and amortization		2,295	2,984	2,367	634
Salaries	26	1,500	2,122	1,986	532
General and operating expenses	27	3,711	4,468	3,997	1,070
Other operating expenses (income), net	28	(3 )	323	(1 )	-
		7,503	9,897	8,349	2,236
Operating income		1,229	1,479	1,929	517
Financing (income) expenses					
Finance expenses	29	716	1,077	995	266
Finance income		(327 )	(497 )	(582 )	(156 )
Financing expense, net		389	580	413	110
Income after financing expenses, net		840	899	1,516	407
Share of losses in equity- accounted investees	13	235	216	245	66
Income before income tax		605	683	1,271	341
Income tax	20	385	653	555	149
Net income for the year		220	30	716	192
Income (loss) attributable to:					
Owners of the Company		(209 )	(266 )	(38 )	(10 )
Non-controlling interests		429	296	754	202
Net income for the year		220	30	716	192
Earnings (loss) per share	31				
Basic loss per share		(11.11 )	(13.56 )	(1.97 )	(0.53 )

Diluted loss per share	(11.23 )	(13.60 )	(2.01 )	(0.54 )
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The accompanying notes are an integral part of these consolidated financial statements.

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## Consolidated Statements of Comprehensive Income for the year ended December 31

(In millions)

	Note	2010 NIS	2011 NIS	2012 NIS	Convenience translation into U.S. dollars (Note 2D) 2012 US\$
Net income (loss) for the year		220	30	716	192
Other comprehensive income					
available-for-sale financial assets transferred to profit or loss		(1 )	-	-	-
Defined benefit plan actuarial gain (losses), net	19	15	37	(25 )	(7 )
Other items of comprehensive income		-	10	(8 )	(2 )
Income tax on other comprehensive income	20	(2 )	(12 )	6	2
Other comprehensive income for the year, net of tax		12	35	(27 )	(7 )
Total comprehensive income for the year		232	65	689	185
Attributable to:					
Owners of the Company		(208 )	(256 )	(45 )	(12 )
Non-controlling interest		440	321	734	197
Total comprehensive income for the year		232	65	689	185

The accompanying notes are an integral part of these consolidated financial statements.

Internet Gold - Golden Lines Ltd.

## Consolidated Statements of Changes in Equity

(in millions except share data)

	Attributable to equity holders of the Company								
	Share capital			Treasury shares	Other Reserves	Retained earnings (Accumulated deficit)	Non-controlling		Total equity
	Number of Shares	Amount	Share premium				Total	interest	
	(1) Shares NIS 0.01 par value	NIS	NIS	NIS	NIS	NIS	NIS	NIS	
Balance as at January 1, 2010	17,991,902	*	490	(139 )	3	106	460	233	693
Changes during 2010:									
Treasury shares at cost	(330,759 )	*	-	(30 )	-	-	(30 )	-	(30 )
Conversion of convertible debentures	1,518,008	*	167	-	-	-	167	-	167
Issuance of share in subsidiary	-	-	-	-	(1 )	-	(1 )	100	99
Exercise of options in subsidiary	-	-	-	-	(20 )	-	(20 )	70	50
Acquisition of non-controlling interest	-	-	-	-	(73 )	-	(73 )	(76 )	(149 )
Share-based compensation in subsidiaries	-	-	-	-	-	-	-	63	63
Non-controlling interests with respect to the acquisition of Bezeq	-	-	-	-	-	-	-	9,118	9,118
Non-controlling interests with respect to other business combination	-	-	-	-	-	-	-	63	63
Transfer by non-controlling interests ,net	-	-	-	-	-	-	-	2	2

Dividends to non-controlling interests	-	-	-	-	-	-	-	(2,597)	(2,597)
Other comprehensive income	-	-	-	-	(1 )	2	1	11	12
Net income (loss) for the year	-	-	-	-	-	(209 )	(209 )	429	220
Comprehensive income (loss) for the year	-	-	-	-	(1 )	(207 )	(208 )	440	232
Balance as at December 31, 2010	19,179,151	*	657	(169 )	(92 )	(101 )	295	7,416	7,711

(\*) Represent an amount less than NIS 1.

(1) Net of treasury shares.

(2) Including reserve from available-for-sale assets and reserve from transaction with non-controlling interest.

The accompanying notes are an integral part of these consolidated financial statements.

Internet Gold - Golden Lines Ltd.

## Consolidated Statements of Changes in Equity (cont'd)

(in millions except share data)

	Attributable to equity holders of the Company								Total equity NIS
	Share capital					Accumulated deficit NIS	Non-controlling interest NIS	Total NIS	
	Number of Shares (1) NIS 0.01 par value	Amount NIS	Share premium NIS	Treasury shares NIS	Other Reserves (2) NIS				
Balance as at January 1, 2011	19,179,151	*	657	(169 )	(92 )	(101 )	295	7,416	7,711
Changes during 2011:									
Share-based compensation in subsidiary	-	-	-	-	-	-	-	176	176
Exercise of options in subsidiary	-	-	-	-	4	-	4	17	21
Conversion of convertible debentures	23,927	*	1	-	-	-	1	-	1
Transactions with non-controlling interest	-	-	-	-	(71 )	-	(71 )	(277 )	(348 )
Dividends to non-controlling interests	-	-	-	-	-	-	-	(3,385 )	(3,385 )
Other comprehensive income	-	-	-	-	3	7	10	25	35
Net income (loss) for the year	-	-	-	-	-	(266 )	(266 )	296	30
Comprehensive income (loss) for the year	-	-	-	-	3	(259 )	(256 )	321	65
Balance as at December 31, 2011	19,203,078	*	658	(169 )	(156 )	(360 )	(27 )	4,268	4,241

(\*) Represent an amount less than NIS 1.

(\*\*) Represent an amount less than US\$ 1.

- (1) Net of treasury shares.
- (2) Including reserve from available-for-sale assets and reserve from transaction with non-controlling interest.

The accompanying notes are an integral part of these consolidated financial statements.

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Internet Gold - Golden Lines Ltd.

## Consolidated Statements of Changes in Equity (cont'd)

(In millions except share data)

	Attributable to equity holders of the Company							Non-controlling interest	Convenience translation into US\$ (Note 2D)	
	Share capital		Treasury shares	Other reserves	Accumulated deficit	Total	Total equity		Total equity	US\$
	Number of Shares (1)	Amount premium								
	(100 par value)	NIS	NIS	NIS	NIS	NIS	NIS		US\$	
Balance as at January 1, 2012	19,203,078	*	658	(169 )	(156 )	(360 )	(27 )	4,268	4,241	1,136
Changes during 2012:										
Share-based compensation in subsidiary	-	-	-	-	-	-	-	72	72	19
Exercise of options in subsidiary	-	-	-	-	*	-	*	8	8	2
Conversion of convertible debentures	108	*	*	-	-	-	*	*	*	**
Acquisitions non-controlling interest	-	-	-	-	(15 )	-	(15 )	(82 )	(97 )	(26 )
Transactions with non-controlling interest	-	-	-	-	(4 )	-	(4 )	11	7	2
Dividends to non-controlling interests	-	-	-	-	-	-	-	(1,431)	(1,431)	(383 )
Distribution to non-controlling interests less their investment	-	-	-	-	-	-	-	(4 )	(4 )	(1 )

in a subsidiary										
Other comprehensive income	-	-	-	-	(2 )	(5 )	(7 )	(20 )	(27 )	(7 )
Net income (loss) for the year	-	-	-	-	-	(38 )	(38 )	754	716	192
Comprehensive income (loss) for the year	-	*	*	-	(2 )	(43 )	(45 )	734	689	185
Balance as at December 31, 2012	19,203,186	*	658	(169 )	(177 )	(403 )	(91 )	3,576	3,485	934

(\*) Represent an amount less than NIS 1.

(\*\*) Represent an amount less than US\$ 1.

(1) Net of treasury shares.

(2) Including reserve from available-for-sale assets and reserve from transaction with non-controlling interest.

The accompanying notes are an integral part of these consolidated financial statements.

## Consolidated Statements of Cash Flows for the Year Ended December 31

(In millions)

	2010 NIS	2011 NIS	2012 NIS	Convenience translation into U.S. dollars (Note 2D) 2012 US\$
<b>Cash flows from operating activities</b>				
Net income for the year	220	30	716	192
<b>Adjustments:</b>				
Depreciation and amortization	2,295	2,984	2,367	634
Share of losses of equity accounted investees	235	216	245	66
Finance expenses (income), net	415	662	552	148
Capital gain, net	(37 )	2	(17 )	(4 )
Expenses (income) for derivative financial instruments, net	10	(19 )	-	-
Share-based compensation in subsidiaries	63	176	72	19
Income tax expenses	385	653	555	149
Change in inventory	5	(33 )	74	20
Change in trade and other receivables	(124 )	(755 )	506	134
Change in trade and other payables	72	(163 )	(199 )	(53 )
Changes in provisions	(207 )	(64 )	(41 )	(11 )
Changes in employee benefits	(193 )	82	(140 )	(38 )
Change in deferred income	-	50	(31 )	(8 )
Net income tax paid, net	(558 )	(649 )	(662 )	(177 )
<b>Net cash provided by operating activities</b>	<b>2,581</b>	<b>3,172</b>	<b>3,997</b>	<b>1,071</b>
<b>Cash flows from investing activities</b>				
Bezeq acquisition net of cash acquired	(5,344 )	-	-	-
Acquisition of other subsidiaries net of cash acquired	(144 )	-	-	-
Investment in intangible assets and deferred expenses	(255 )	(355 )	(269 )	(72 )
Proceeds from the sale of property, plant and equipment and refund from Ministry of Communications	125	266	305	82
Change in investments, net	(910 )	(500 )	(80 )	(22 )
Purchase of property, plant and equipment	(998 )	(1,548 )	(1,271 )	(340 )
Proceeds from sale of a subsidiary legacy communication business	1,196	-	-	-
Acquisition of investments and long term loans	8	11	100	27
Other	40	51	55	14

Net cash used in investing activities (6,282 ) (2,075 ) (1,160 ) (311 )

The accompanying notes are an integral part of these consolidated financial statements.

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## Consolidated Statements of Cash Flows for the Year Ended December 31 (cont'd)

(In millions)

	2010	2011	2012	Convenience translation into U.S. dollars (Note 2D) 2012 US\$
	NIS	NIS	NIS	
<b>Cash flows from financing activities</b>				
Loans received	7,725	2,200	650	174
Proceeds from issuance of debentures, net	564	3,410	135	36
Repayment of debentures and loans	(2,057 )	(2,462 )	(1,347 )	(361 )
Net short-term borrowing	(462 )	(3 )	-	-
Interest paid	(390 )	(700 )	(751 )	(201 )
Dividends paid by Bezeq to non- controlling interests	(2,597 )	(2,171 )	(2,119 )	(568 )
Transactions with non-controlling interest	(149 )	(348 )	(97 )	(26 )
Proceeds from issuance of shares in Subsidiaries, net	99	-	-	-
Purchase of treasury shares	(30 )	-	-	-
Other	52	20	9	3
<b>Net cash provided by (used in) financing activities</b>	<b>2,755</b>	<b>(54 )</b>	<b>(3,520 )</b>	<b>(943 )</b>
<b>Net increase (decrease) in cash and cash equivalents</b>	<b>(946 )</b>	<b>1,043</b>	<b>(683 )</b>	<b>(183 )</b>
Cash and cash equivalents as at the beginning of the year	1,350	404	1,447	388
Cash and cash equivalents as at the end of the year	404	1,447	764	205

The accompanying notes are an integral part of these consolidated financial statements.

Notes to the Consolidated Financial Statements

(All amounts are in millions except where otherwise stated)

Note 1 - Reporting Entity

Internet Gold–Golden Lines Ltd. (“the Company”) is an Israeli resident company incorporated in Israel. The address of the Company’s registered office is: 2 Dov Friedman Street, Ramat-Gan, Israel. The consolidated financial statements of the Company as at and for the year ended December 31, 2012, comprise the Company and its subsidiaries (together referred to as the Group). The Company is a subsidiary of Eurocom Communications Ltd. (“Eurocom” or “the Parent Company”) and its ultimate parent is Eurocom Holdings (1979) Ltd.

On April 14, 2010, B Communications Ltd. ("B Communications") completed the acquisition of 30.44% of the outstanding shares of Bezeq The Israel Telecommunications Corp. Limited. (“Bezeq”) and became the controlling shareholder of Bezeq. Bezeq’s ordinary shares are registered for trade on the Tel-Aviv stock exchange. For more details see Note 5.

The ordinary shares of the Company are registered for trade on the NASDAQ Global Select Market and on the Tel Aviv Stock Exchange.

Note 2 - Basis of Preparation

A. Statement of compliance

The consolidated financial statements have been prepared in accordance with International Financial Reporting Standards, as issued by the International Accounting Standards Board.

The consolidated financial statements were authorized for to be issued by the Company’s Board of Directors on April 24, 2013.

B. Definitions

In these financial statements -

- (1) International Financial Reporting Standards (“IFRS”) – Standards and interpretations that were issued by the International Accounting Standards Board (“IASB”) and which include international financial reporting standards and international accounting standards (“IAS”), along with the interpretations to these standards of the International Financial Reporting Interpretations Committee (“IFRIC”) or interpretations of the Standing Interpretations Committee (“SIC”), respectively.
- (2) The Company: Internet Gold – Golden lines Ltd.
- (3) The Group: Internet Gold – Golden lines Ltd. and its subsidiaries, as listed in Note 13 - Investees.
- (4) B Communications: B Communications Ltd. and its subsidiaries, as listed in Note 13 - Investees.
- (5) Bezeq: Bezeq The Israel Telecommunication Corporation Limited.



## Notes to the Consolidated Financial Statements

(All amounts are in millions except where otherwise stated)

## Note 2 - Basis of Preparation (cont'd)

## B. Definitions (cont'd)

(6) Bezeq Group: Bezeq The Israel Telecommunication Corporation Limited and its subsidiaries, as listed in Note 13 - Investees.

(7) Telephone: Telephone Communications Ltd.

(8) Subsidiaries: Companies including a partnership, whose financial statements are fully consolidated, directly or indirectly, with the financial statements of the Company.

(9) Jointly-controlled companies: Companies owned by various entities that have a contractual agreement for common control, and whose financial statements are consolidated with those of the Company using the proportionate consolidation method.

(10) Associates: Companies in which the Group's investment is included, directly or indirectly, in the consolidated financial statements on the equity basis, including DBS Satellite Services (1998) Ltd ("DBS"). and other associates that are immaterial.

(11) Investees: Subsidiaries, Jointly-controlled companies or associates.

(12) Related party: As defined in IAS 24 (2009), Related Party Disclosures.

(13) Israeli CPI: The consumer price index as published by the Israeli Central Bureau of Statistics.

## C. Functional currency and presentation currency

The consolidated financial statements are presented in NIS, which is the Group's functional currency, and have been rounded to the nearest million. The NIS is the currency that represents the principal economic environment in which the Group operates.

## D. Convenience translation into U.S. dollars ("dollars" or "\$")

For the convenience of the reader, the reported NIS figures as at December 31, 2012, have been presented in dollars, translated at the representative rate of exchange as at December 31, 2012 (NIS 3.733 = US\$ 1.00). The dollar amounts presented in these financial statements are merely supplementary information and should not be construed as complying with IFRS translation method or as representing amounts that are receivable or payable in dollars or convertible into dollars, unless otherwise indicated.



## Notes to the Consolidated Financial Statements

(All amounts are in millions except where otherwise stated)

## Note 2 - Basis of Preparation (cont'd)

## E. Basis of measurement

The consolidated financial statements have been prepared on the historical cost basis except for the following items:

- Financial instruments, including financial derivative instruments, at fair value recognized through profit or loss.
  - Financial assets classified as available-for-sale at fair value.
  - Inventory that is measured at the lower of cost or net realizable value.
    - Equity accounted investments.
    - Deferred tax assets and liabilities.
    - Provisions.
    - Liabilities for employee benefits.
  - Liabilities for cash-settled share-based payment arrangements.

For further information regarding the measurement of these assets and liabilities see Note 3 regarding significant accounting policies. The methods used to measure fair value are specified in Note 4.

## F. Operating cycle

The Group's operating cycle is up to one year. As a result, the current assets and current liabilities include items the realization of which is intended and anticipated to take place within one year from the date of the financial statements.

## G. Classification of expenses recognized in the statement of income

The classification of costs and expenses recognized in the statement of income is based on the nature of the expenses. Classification is compatible with the understanding of the Group's businesses, which address a wide range of services using common infrastructure. All of the costs and expenses are used to provide services.

## H. Use of estimates and judgment

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

The preparation of accounting estimates used in the preparation of the Group's financial statements requires management to make assumptions regarding circumstances and events that involve considerable uncertainty. Management of the Company prepares the estimates on the basis of past experience. In exercising its judgment when making the estimates, management relies on past experience, various facts, external circumstances, and reasonable assumptions according to the pertinent circumstances of each estimate.



## Notes to the Consolidated Financial Statements

(All amounts are in millions except where otherwise stated)

## Note 2 - Basis of Preparation (cont'd)

## H. Use of estimates and judgment (cont'd)

Estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are recognized in the period in which the estimates are revised and in any future periods affected.

Significant estimates and judgments made when applying accounting policies and changes in these estimates and assumptions that could potentially have a material effect on the financial statements are as follows:

Subject	Main assumptions	Possible implications	Reference
Useful life of property, plant and equipment	Useful life of property, plant and equipment groups	Change in the value of property, plant and equipment and depreciation expenses	Note 10
Residual value of property, plant and equipment	Residual value of copper cables	Change in the value of property, plant and equipment and depreciation expenses	Note 10
Deferred taxes	Assumption of projected future realization of the tax asset	Recognition or reversal of deferred tax asset in profit or loss	Note 20
Uncertain tax positions	The extent of the certainty that the Group's tax positions will be accepted (uncertain tax positions) and the risk of it incurring any additional tax and interest expense. This is based on an analysis of a number of matters including interpretations of tax law and the Group's past experience	Recognition of additional income tax expenses	Note 20
Provisions and contingent liabilities	Assessment of the likelihood of claims against Group companies and measuring potential liabilities attributable to claims	Reversal or creation of a provision for a claim and recognition of income/expense, respectively	Note 16 and Note 21

Measurement of recoverable amounts of cash-generating units (including those with goodwill)	Assumption of expected cash flows from cash generating units	Recognition of impairment loss	Note 11
Provision for doubtful debts	Assessment of the risk of non-collection of trade receivables	Recognition or reversal of doubtful debt expense and recognition of lost debt expense	Note 18

## Notes to the Consolidated Financial Statements

(All amounts are in millions except where otherwise stated)

## Note 2 - Basis of Preparation (cont'd)

H.		Use of estimates and judgment (cont'd)	
Subject	Main assumptions	Possible implications	Reference
Post-employment employee benefits	Actuarial assumptions such as discount rate, future salary increases and churn rate	Increase or decrease in the post-employment defined benefit obligation	Note 19
Indications of investment impairment in an equity-accounted investee	There are no indications of impairment.	Recognition of loss from investment impairment in an investee	Note 13

I. Certain insignificant comparative amounts were reclassified to the relevant line items in the financial statements for the current year.

## Note 3 - Significant Accounting Policies

The accounting policies set out below have been applied consistently by Group entities for all periods presented in these consolidated financial statements.

A.	Consolidation of the financial statements and investments in associates
	(1) Business combinations

Business combinations are accounted for by applying the acquisition method. According to this method, the identifiable assets and liabilities of the acquired business are recognized and recorded at fair value on the acquisition date.

The acquisition date is the date on which the acquirer obtains control over the acquiree. Control exists when the Company is able to govern the financial and operating policies of the entity so as to obtain benefits from its activities. In assessing control, potential voting rights were taken into account if they confer effective control. The acquisition date is the date on which the acquirer obtains control over the acquiree. Control exists when the Company is able to govern the financial and operating policies of the entity so as to obtain benefits from its activities. In assessing control, potential voting rights were taken into account if they confer de facto control.

The cost of the acquisition is the aggregate fair value of the assets transferred, liabilities incurred and equity interests issued by the acquirer on the date of acquisition. In addition, the consideration transferred includes the fair value of any contingent consideration. After the acquisition date, the Group recognizes changes in fair value of the contingent consideration in the statement of income. Contingent consideration is stated as a financial liability in the statement of financial position.

On the acquisition date the acquirer recognizes a contingent liability assumed in a business combination if there is a present obligation resulting from past events and its fair value can be reliably measured.

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## Notes to the Consolidated Financial Statements

(All amounts are in millions except where otherwise stated)

## Note 3 - Significant Accounting Policies (cont'd)

## A. Consolidation of the financial statements and investments in associates (cont'd)

## (1) Business combinations (cont'd)

In a step acquisition, the difference between the fair value at the acquisition date of the Group's pre-existing equity rights in the acquiree and the carrying amount at that date is recognized in the statement of income under other operating income.

The Group recognizes goodwill at acquisition according to the fair value of the consideration transferred, including the fair value at the acquisition date of any pre-existing equity right of the acquirer in the acquiree, less the net amount of the identifiable assets acquired and the liabilities assumed. After initial recognition, goodwill is measured at cost less any accumulated impairment losses and is not systematically amortized. For assessment of impairment of goodwill, see section I below.

Costs associated with the acquisition that were incurred by the acquirer in the business combination such as finder's fees, advisory, legal, valuation and other professional or consulting fees, other than those associated with an issue of debt or equity instruments connected to the business combination, are recognized as expenses in the period the services are received.

## (2) Transactions eliminated on consolidation

Intra-group net balances and income and expense arising from intra-group transactions are eliminated in the preparation of the consolidated financial statements.

## (3) Non-controlling interests

Transactions with non-controlling interests, while retaining control, are accounted for as equity transactions. Any difference between the consideration paid or received for change in non-controlling interests is recognized in capital reserve for transactions with non-controlling interests.

## (4) Put option granted to non-controlling shareholders

A put option issued by the Group to non-controlling interests that is settled in cash or another financial instrument is recognized as a financial liability. The Group measures, at each reporting date, the financial liability based on the estimated present value of the consideration that will be transferred when exercising the put option.

## Notes to the Consolidated Financial Statements

(All amounts are in millions except where otherwise stated)

## Note 3 - Significant Accounting Policies (cont'd)

## A. Consolidation of the financial statements and investments in associates (cont'd)

## (5) Associates (accounted for by the equity method)

Associates are those entities in which the Group has significant influence, but not control, over financial and operating policy. In respect of equity-accounted investments, goodwill is included in the carrying amount of the investment. For further information about recognition of impairment loss for these investments, see note 3.J below.

When the Group holds additional long-term interests in the associate (such as loans), which are a part of the Group's net investment in the associate, and when the Group's proportionate share in the additional interests is different from the Group's share in the equity of the associate, the Group recognizes its share in the additional losses of the associate at its proportionate share in the additional interests according to the percentage of the Group's participation in all the levels of the additional interests and according to the order of priority of the additional levels of interests. If, subsequently, the Group recognizes its share in the profits of the associate, the Group will recognize its share in the profits up to the amount of the cumulative losses previously recognized.

Bezeq's investment in long-term loans of DBS is recognized as described above. See Note 13.A below.

## B. Foreign currency transactions

Transactions in foreign currency are translated into the functional currency of the Group at the exchange rate on the dates of the transactions. Monetary assets and liabilities denominated in foreign currencies on the reporting date are retranslated to the functional currency at the exchange rate at that date.

## C. Financial instruments

## (1) Non-derivative financial assets

Non-derivative financial assets include mainly investments in exchange traded notes, financial funds, ETF's, debt instruments, shares, trade and other receivables, and cash and cash equivalents.

## a. Initial recognition of financial assets

The Group initially recognizes financial assets at the date that the Group becomes a party to contractual provisions of the instrument, meaning the date that the Group fulfills its obligations under the contract.



## Notes to the Consolidated Financial Statements

(All amounts are in millions except where otherwise stated)

## Note 3 - Significant Accounting Policies (cont'd)

- |     |  |
|-----|--|
| C.  | Financial instruments (cont'd)           |
| (1) | Non-derivative financial assets (cont'd) |
| b.  | Derecognition of financial assets        |

Financial assets are derecognized when the contractual rights of the Group to the cash flows from the asset expire, or the Group transfers the rights to receive the contractual cash flows from the financial asset in a transaction in which substantially all the risks and rewards of ownership of the financial asset are transferred.

Regular way sales of financial assets are recognized on the trade date, meaning on the date the Group undertook to sell the asset.

- |    |   |
|----|---|
| c. | Classification of financial assets and the accounting treatment in each group |
|----|---|

The Group classifies its financial assets as follows:

## Cash and cash equivalents

Cash comprises cash balances available for immediate use and call deposits. Cash equivalents comprise short-term highly liquid investments (with original maturities of three months or less) that are readily convertible into known amounts of cash and are exposed to insignificant risks of change in value.

## Financial assets at fair value through profit or loss

A financial asset is classified at fair value through profit or loss if it is held for trading or is designated as such upon initial recognition. Upon initial recognition, attributable transaction costs are recognized in the statement of income as incurred. These financial assets are measured at fair value and changes therein are recognized in the statement of income.

## Available-for-sale financial assets

The Group's investments in shares (through a venture capital fund) are classified as available-for-sale financial assets. These investments are measured at fair value and changes therein, other than impairment losses, are recognized directly in other comprehensive income. At the date of derecognition of the investment, profits from realization of the investment and profits that were recognized in capital reserve, are recognized in profit or loss. The Group elected to recognize profits or losses from disposal of available-for-sale financial assets under financing income or expenses.

## Loans and receivables

Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market. Such assets are recognized initially at fair value plus attributable transaction costs. Subsequent to initial recognition, loans and receivables are measured at amortized cost using the effective interest method, net of impairment losses.



## Notes to the Consolidated Financial Statements

(All amounts are in millions except where otherwise stated)

## Note 3 - Significant Accounting Policies (cont'd)

- C. Financial instruments (cont'd)
- (2) Non-derivative financial liabilities

Non-derivative financial liabilities include debentures issued by the Group, loans and borrowings from banks and other credit providers, and trade and other payables.

- a. Initial recognition of financial liabilities

The Group initially recognizes debt instruments as they are incurred.

Financial liabilities are initially recognized at fair value plus any attributable transaction costs. Subsequent to initial recognition, these financial liabilities are measured at amortized cost using the effective interest method.

- b. Derecognition of financial liabilities

Financial liabilities are derecognized when the obligation of the Group, as specified in the agreement, expires or when it is discharged or canceled.

- (3) Offsetting financial instruments

Financial assets and liabilities are offset and the net amount presented in the statement of financial position when, and only when, the Group currently has a legal right to offset the amounts and intends either to settle on a net basis or to realize the asset and settle the liability simultaneously.

- (4) CPI-linked assets and liabilities that are not measured at fair value

The value of CPI-linked financial assets and liabilities, which are not measured at fair value, is revaluated in each period according to the actual increase in the CPI.

- (5) Derivative financial instruments including hedge accounting

- a. Hedge accounting

CPI forward contracts, which Bezeq entered into in 2012 to hedge exposure to changes in the CPI for debentures issued by Bezeq, were initially accounted for by application of cash flow accounting hedges as follows:

## Notes to the Consolidated Financial Statements

(All amounts are in millions except where otherwise stated)

## Note 3 - Significant Accounting Policies (cont'd)

## C. Financial instruments (cont'd)

## (5) Derivative financial instruments including hedge accounting (cont'd)

## a. Hedge accounting (cont'd)

Forward contracts are measured at fair value. Attributable transaction costs are recognized in profit or loss as incurred. Subsequent to initial recognition, changes in the fair value of the derivative hedging instrument designated as a cash flow hedge are recognized through other comprehensive income, in a hedging reserve under capital, 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 removed and included in profit or loss in the same period as the hedged cash flows affect profit or loss under the same line item in the statement of income as the hedged item.

On initial designation of the hedge, Bezeq formally documents 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.

Bezeq makes an assessment, at the inception of the hedge, whether the hedging instruments are expected to be highly effective in offsetting the changes in the fair value or cash flows of the respective hedged items during the period for which the hedge is designated.

## b. Economic hedges

The Group holds other derivative financial instruments to economically hedge its exposure to foreign currency, the CPI and copper prices. Hedge accounting is not applied to derivative instruments that economically hedge financial assets and liabilities. Derivative instruments are recognized initially at fair value and attributable transaction costs are recognized in the statement of income as incurred. Subsequent to initial recognition, derivative financial instruments are measured at fair value and the changes in fair value are recognized in the statement of income as incurred.

The Group elected to present the changes under financing expenses/income or under operating income, based on the nature of the hedged item.

## (6) Share capital

## a. Ordinary shares

Incremental costs directly attributable to the issue of ordinary shares are recognized as a deduction from equity.

## Notes to the Consolidated Financial Statements

(All amounts are in millions except where otherwise stated)

## Note 3 - Significant Accounting Policies (cont'd)

(6) Share capital (cont'd)

## b. Treasury shares

When share capital recognized as equity is repurchased, the amount of the consideration paid, which includes directly attributable costs, net of any tax effects, is recognized as a deduction from equity. Repurchased shares are classified as treasury shares and are presented as a deduction from total equity. When treasury shares are sold or reissued subsequently, the amount received is recognized as an increase in equity, and the resulting surplus or deficit on the transaction is carried to share premium.

D. Property, plant and equipment

(1) Recognition and measurement

Items of property, plant and equipment are measured at cost less accumulated depreciation and accumulated impairment losses.

Cost includes expenditures that are directly attributable to acquisition of the asset. The cost of self-constructed assets includes the cost of materials, direct labor and financing costs as well as any other cost directly attributable to bringing the asset to the condition for its use intended by the management, and the costs of dismantling and removing the items and restoring the site on which they are located when the Group has an obligation to vacate and restore the site. The cost of purchased software that is integral to the functionality of the related equipment is recognized as part of the cost of the equipment.

When major parts of the property, plant and equipment have different useful lives, they are accounted for as separate items (major components) of the property, plant and equipment.

Gains or losses on disposal of property, plant and equipment are determined by comparing the proceeds from disposal with the carrying amount of the asset, and are recognized net under “other operating income” in the statement of income.

(2) Subsequent expenditure

The cost of replacing part of an item of property, plant and equipment is recognized in the carrying amount of the item if it is probable that the future economic benefit embodied in the replaced item will flow to the Group and its cost can be measured reliably. The costs of day-to-day servicing are recognized in the statement of income as incurred.

(3) Capitalization of borrowing costs

Borrowing costs were capitalized to qualifying assets throughout the period required for completion and construction until they are ready for their intended use. Borrowing costs are capitalized using a rate which is the weighted-average cost of the Bezeq Group credit sources. Other borrowing costs are recognized in the statement of income as incurred.



## Notes to the Consolidated Financial Statements

(All amounts are in millions except where otherwise stated)

## Note 3 - Significant Accounting Policies (cont'd)

## D. Property, plant and equipment (cont'd)

## (4) Depreciation

Depreciation is recognized in the statement of income on a straight-line basis over the estimated useful life of each part of an item of property, plant and equipment, since this most closely reflects the expected pattern of consumption of the future economic benefits embodied in the asset. Leased assets under finance lease agreements are depreciated over the shorter of the lease term and their useful lives. An asset is depreciated when it is ready for use, meaning when it reaches the location and condition necessary for it to be capable of operating in the manner intended by management.

Leasehold improvements are depreciated over the shorter of the lease term, including the extension option held by the Group and expected to be exercised and the expected life of the improvement.

The estimated useful lives for the current and comparative periods are as follows:

	Years	Principal depreciation rate (%)
NGN equipment	8	13
Transmission and power equipment	5-10	10
Network equipment	8-25	4
Subscriber equipment and installations	3-7	25
Motor vehicles	6-7	17
Internet equipment	4	25
Office equipment	5-14	10
Electronic equipment, computers and internal communication systems	3-7	20
Cellular network	4-10	14
Buildings	25	4
Submarine communications cable	4-25	4

Depreciation methods, useful lives and residual values are reviewed at least at each reporting year and adjusted as required.

## E. Non-current assets held for sale

Non-current assets which are expected to be realized by way of sale rather than ongoing use are classified as assets held for sale. These assets are presented at the lower of the carrying amount and fair value, less selling costs.





## Notes to the Consolidated Financial Statements

(All amounts are in millions except where otherwise stated)

## Note 3 - Significant Accounting Policies (cont'd)

## F. Intangible assets

## (1) Goodwill and brand name

Goodwill and brand names that arise upon the acquisition of subsidiaries are included in intangible assets. Subsequent to initial recognition, goodwill and brand names are measured at cost less accumulated impairment losses. Goodwill and brand names are measured at least once a year to assess impairment as described in section J(2) below.

## (2) Software development costs

Software development costs are recognized as an intangible asset only if the development costs can be measured reliably; the software is technically and commercially feasible; and the Group has sufficient resources to complete the development and intends to use the software. The costs recognized as an intangible asset include the cost of the materials, direct labor and overhead expenses directly attributable to preparation of the asset for its intended use. Other development costs are recognized in the statement of income as incurred.

Capitalized development costs are measured at cost less amortization and accumulated impairment losses.

## (3) Software

The Group's assets include computer systems consisting of hardware and software. Software that is an integral part of the hardware, which cannot function without the programs installed on it, is classified as property, plant and equipment. However, licenses for stand-alone software, which adds functionality to the hardware, is classified (mainly) as intangible assets. Software depreciation is recognized in the statement of income using the straight-line method over the estimated useful life of the asset.

## (4) Rights to frequencies

Rights to frequencies refer to Pelephone's rights to cellular communication frequencies according to a Ministry of Communications tender. Depreciation of the asset is recognized in the statement of income using the straight line method over the license term, which is 13 years and 7 months starting from the use of the frequencies.

## (5) Other intangible assets

Other intangible assets acquired by the Group, which have a definite useful life, are measured at cost less amortization and accumulated impairment losses.

## (6) Subsequent expenditure

Subsequent expenditure is recognized as an intangible asset only when it increases the future economic benefits embodied in the specific asset to which it relates. All other expenditures, including expenditures relating to generated goodwill and brands, are recognized in the statement of income as incurred.



## Notes to the Consolidated Financial Statements

(All amounts are in millions except where otherwise stated)

## Note 3 - Significant Accounting Policies (cont'd)

F.	Intangible assets (cont'd)
(7)	Amortization

Amortization, except for goodwill, brand name and customer relationships, is recognized in the statement of income on a straight-line basis over the estimated useful life of the intangible assets, from the date on which the assets are available for use. Goodwill and brand name are not systematically amortized but are tested for impairment at least once a year.

Customer relationships are amortized according to the economic benefit expected from those customers each period, which results in accelerated amortization during the early years of the relationship.

Estimated useful lives for the current and comparative periods are as follows:

Type of asset	Amortization period
Development expenses	4 - 7 years
Other rights	3 - 10 years, depending on the useful life
Frequency usage right	Over the term of the license for 13 years starting from the use of the frequencies
Computer programs and software licenses	Over the term of the license or the estimated time of use of the program
Customer relationships	10 years

Amortization methods and useful lives are reviewed at least at each reporting year and adjusted if appropriate.

G.	Leased assets
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Leases, including leases of land from the Israel Land Administration, where the Group assumes substantially all the risks and rewards of ownership are classified as finance leases. Upon initial recognition, the leased asset is measured at an amount equal to the lower of its fair value and the present value of the minimum lease payments. Subsequent to initial recognition, the asset is accounted for in accordance with the accounting policy applicable to the asset. Other leases are classified as operating leases and the leased assets are not recognized in the Group's statement of financial position. Payments made under operating leases are recognized in profit or loss on a straight-line basis over the term of the lease.

## Notes to the Consolidated Financial Statements

(All amounts are in millions except where otherwise stated)

## Note 3 - Significant Accounting Policies (cont'd)

## G. Leased assets (cont'd)

At inception or upon reassessment of an arrangement, the Group determines whether such an arrangement is or contains a lease. A specific asset is the subject of a lease if fulfillment of the arrangement is dependent on the use of that specified asset or assets. An arrangement conveys the right to use the asset if the arrangement conveys to the Group the right to control the use of the asset. At inception or upon reassessment of the arrangement, the Group separates payments and other consideration required by such an arrangement into those for the lease and those for other elements on the basis of their relative fair values.

## H. Right of use of capacities

Transactions for acquiring an infeasible right of use (IRU) of submarine communication cable capacities are mostly accounted for as service transactions. The prepaid expense is amortized on a straight-line basis as stated in the agreement, but for no longer than the expected estimated useful life of those capacities.

Identifiable capacities which serve Bezeq exclusively meet the definition of a finance lease and are recognized in property, plant and equipment. The asset is depreciated on a straight-line basis as stated in the agreement, but for no longer than the expected estimated useful life of those capacities.

## I. Inventory

Inventories are measured at the lower of cost and net realizable value. The cost of inventories is based on the moving average principle. Slow-moving inventory of terminal equipment, accessories and spare parts are stated net of the provision for impairment.

The inventory of a subsidiary includes terminal equipment and accessories intended for sale and service, as well as spare parts used for repairs in the repair service it provides to its customers.

## J. Impairment

## (1) Non-derivative financial assets

The Group tests a financial asset for impairment when objective evidence indicates that one or more loss events have had a negative effect on the estimated future cash flows of that asset.

Significant financial assets are tested for impairment on an individual basis. The remaining financial assets are assessed for impairment collectively, in groups that share similar credit risk characteristics. The financial statements include specific provisions and Group provisions for doubtful debts, which properly reflect, in the estimation of the management, the loss inherent in debts for which collection is in doubt.

## Notes to the Consolidated Financial Statements

(All amounts are in millions except where otherwise stated)

## Note 3 - Significant Accounting Policies (cont'd)

J.	Impairment (cont'd)
(2)	Non-financial assets

## Timing of impairment testing

The carrying amounts of the Group's non-financial assets, other than inventory and deferred tax assets are reviewed at each reporting date to determine whether there is any indication of impairment. If any such indication exists, then the recoverable amount of the asset is estimated.

The Group assesses the recoverable amount of goodwill and brand name once a year, or more frequently if there are indications of impairment.

## Measurement of recoverable amount

The recoverable amount of an asset or cash-generating unit is the greater of its value in use and fair value less costs to sell. In assessing value in use, the estimated future cash flows are discounted to their present value using a pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the asset.

## Determining cash-generating units

For the purpose of impairment testing, the assets are grouped together into the smallest group of assets that generates cash from continuing use that are largely independent of other assets or groups of assets ("cash-generating unit").

## Allocation of goodwill to cash-generating units

For purposes of goodwill impairment testing, cash-generating units to which goodwill has been allocated are aggregated so that the level at which impairment testing is performed reflects the lowest level at which goodwill is monitored for internal reporting purposes, but in any event is not larger than an operating segment. Goodwill acquired in a business combination is allocated to cash-generating units that are expected to generate benefits from the synergies of the combination.

For purposes of goodwill impairment testing, when the non-controlling interests are initially measured according to their relative share of the acquiree's net identifiable assets, the carrying amount of the goodwill is adjusted according to the share which the Group holds in the cash-generating unit to which the goodwill is allocated.

Notes to the Consolidated Financial Statements

(All amounts are in millions except where otherwise stated)

Note 3 - Significant Accounting Policies (cont'd)

J. Impairment (cont'd)

(3) Investments in equity-accounted investees

An investment in an associate is tested for impairment when objective evidence indicates that there has been impairment.

Goodwill that forms part of the carrying amount of an investment in an associate is not recognized separately, and therefore is not tested for impairment separately. If objective evidence indicates that the value of the investment may have been impaired, the investment is tested for impairment.

K. Employee benefits

(1) Post-employment benefits

The Group has a number of post-employment benefit plans. The plans are usually financed by deposits with insurance companies and they are classified as defined contribution plans and defined benefit plans.