

MATAV CABLE SYSTEMS MEDIA LTD  
Form 20-F  
June 30, 2005

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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**  
Washington, D.C. 20549

**FORM 20-F**

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

For the fiscal year ended December 31, 2004  
Commission file number: 0-28556

**MATAV CABLE SYSTEMS MEDIA LTD.**

(Exact name of Registrant as specified in its charter)

**Israel**

(Jurisdiction of incorporation or organization)

**42 Pinkas Street  
North Industrial Park  
P.O. Box 13600  
Netanya 42134**

**Israel**

(Address of principal executive offices)

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

**None**

Securities registered pursuant to Section 12(g) of the Act:

**Title of Each Class**

American Depositary Shares  
Ordinary Shares\*

\* Not for trading, but only in connection with the registration of American Depositary Shares representing such ordinary shares, pursuant to the requirements of the Securities and Exchange Commission.

Securities for which there is a reporting obligation pursuant to Section 15(d) of the Act:

**None**

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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 of NIS 1.00 each **30,220,476**

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 which financial statement item the Registrant has elected to follow:

Item 17  Item 18

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## INTRODUCTION

As used herein, references to we, our, us, Matav or the Company are references to Matav-Cable Systems Media Ltd., Matav Investment Ltd., Cable Systems Media Haifa-Hadera Ltd., Nonstop Internet (1999) Ltd., Matav Assets Ltd., Matav Infrastructure Ltd. and Matav Infrastructure 2001, L.P., all of which are wholly owned subsidiaries, and Nonstop Ventures, Ltd., except as the context otherwise requires

In this document, references to \$, US\$, US dollars and dollars are to United States dollars and references to NIS and shekels are to Israeli Shekels. This annual report contains translations of NIS amounts into US dollars at specified rates solely for the convenience of the reader. No representation is made that the amounts referred to in this annual report as convenience translations could have been or could be converted from NIS into US dollars at these rates, at any particular rate or at all. The translations of NIS amounts into US dollars appearing throughout this annual report have been made at the representative exchange rate on December 31, 2004 of NIS 4.308= US\$ 1.00 as published by the Bank of Israel, unless otherwise specified. See Item 3A. Key Information Selected Financial Data Exchange Rate Data.

We maintain our financial books and records in shekels and present our financial statements in conformity with generally accepted accounting principles in Israel, or Israeli GAAP. As applicable to our financial statements, Israeli GAAP and U.S. GAAP vary in certain respects, as described in Note 26 to the financial statements. We present our historical statements in shekels that have been adjusted to reflect changes in purchasing power due to changes in the Israeli consumer price index. Unless otherwise specified in this annual report, all financial data relating to us are presented in shekels adjusted to December 31, 2004 purchasing power ( adjusted NIS ). See Item 5B. Liquidity and Capital Resources - Impact of Inflation and Exchange Rate Fluctuations and Note 23 to the financial statements.

## FORWARD-LOOKING STATEMENTS

This annual report includes forward-looking statements within the meaning of Section 27A of the US Securities Act of 1933, as amended, Section 21E of the US Securities Exchange Act of 1934, as amended, and the safe harbor provisions of the US Private Securities Litigation Reform Act of 1995. We have based these forward-looking statements on our current expectations and projections about future events. These forward-looking statements are subject to risks, uncertainties and assumptions about us.

Words such as believe, anticipate, expect, intend, seek, will, plan, could, may, project, goal, target and similar expressions are forward-looking statements but are not the only way we identify these statements. All statements other than statements of historical fact included in this annual report, including the statements in the sections of this annual report entitled Item 3D. Key Information Risk Factors, Item 4. Information on the Company and Item 5. Operating and Financial Review and Prospects and located elsewhere in the annual report regarding our future performance, plans to increase revenues or margins or preserve or expand market share in existing or new markets, reduce expenses and any statements regarding other future events or our future prospects, are forward-looking statements.

We undertake no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise. Our actual results could differ materially from those anticipated in these forward-looking statements as a result of various factors, including all the risks discussed in Item 3D. Key Information Risk Factors, Item 4. Information on the Company and Item 5. Operating and Financial Review and Prospects. In light of these risks, uncertainties and assumptions, the forward-looking events discussed in this annual report might not occur.

**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**

**3A. SELECTED FINANCIAL DATA**

The following table sets forth our selected consolidated financial data as at and for each of the years in the five-year period ended December 31, 2004. The selected consolidated financial data for the years ended December 31, 2000, 2001, 2002, 2003 and 2004 are based on consolidated financial statements that have been prepared in accordance with Israeli generally accepted accounting principles, or GAAP. As applied to our consolidated financial statements, Israeli GAAP and U.S. GAAP vary in certain respects, as described in Note 26 to the financial statements.

We were incorporated on June 28, 1987. The selected consolidated financial data set forth below should be read in conjunction with Item 5. Operating and Financial Review and Prospects, and the financial statements and notes thereto included elsewhere in this report on Form 20-F. The financial data for the year ended at December 31, 2004 have been translated into US dollars using the representative rate of exchange of the US dollar to the New Israeli Shekel, as published by the Bank of Israel, at December 31, 2004 (NIS4.308 = US\$ 1.00). The translation is solely for convenience and should not be construed as a representation that Israeli currency amounts actually represent, or could be converted into US dollars.

Significant changes in accounting

The financial statements as of December 31, 2003 and for reported periods through that date were presented on the basis of the historical cost convention adjusted for the changes in the general purchasing power of the Israeli currency ( New Israeli Shekel or NIS ). The Company and its subsidiaries maintain their accounts in nominal NIS. The nominal figures were adjusted to NIS of equivalent purchasing power (NIS of December 2003) in conformity with principles prescribed by Statements of the Institute of Certified Public Accountants in Israel, on the basis of changes in the Consumer Price Index ( CPI ).

During the reported period, we recorded equity in losses of HOT Telecom L.P., which commenced its operations during 2004.

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	2000	2001	2002	2003	2004	2004
(adjusted NIS)	NIS (in thousands)*	NIS (in thousands)*	NIS (in thousands)*	NIS (in thousands)*	NIS (in thousands)*	\$ (in thousands)*
Revenues	474,670	469,389	495,536	545,480	584,564	135,693
Operating income (loss)	(61,612)	(129,851)	(98,681)	(7,819)	3,009	698
Financial expenses, net	34,324	52,088	48,089	83,958	50,333	11,684
Other income (expenses), net	1,007	3,053	278,535	80,996	(42,680)	(9,907)
Income (loss) before taxes on income	(94,930)	(178,886)	131,765	(10,781)	(90,004)	(20,893)
Equity in earnings (losses) of affiliated companies, net	(128,554)	(78,822)	10,910	40,907	14,301	3,320
Net income (loss), under Israeli GAAP	(223,654)	(257,274)	33,824	(5,450)	(82,984)	(19,263)
Net income (loss) per ordinary share, under Israeli GAAP	(7.7)	(8.9)	1.2	(0.2)	(2.74)	(0.64)
Net income (loss) per ADS, under Israeli GAAP	(15.4)	(17.8)	2.4	(0.4)	(5.48)	(1.28)
Weighted average number of shares outstanding in thousands, basic, under Israeli GAAP	28,914	28,834	28,860	29,347	30,217	30,217
ADS shares outstanding in thousands, basic, under Israeli GAAP	14,457	14,417	14,430	14,674	15,108	15,108
Net income (loss), under US GAAP	(219,400)	(215,639)	27,451	(38,093)	(98,434)	(22,849)
Net income (loss) per ordinary share, under US GAAP	(7.7)	(7.4)	1.0	(1.3)	(3.26)	(0.76)
Net income (loss) per ADS, under US GAAP	(15.4)	(14.8)	2.0	(2.6)	(6.52)	(1.52)
Weighted average number of shares outstanding in thousands, basic, under US GAAP	28,604	29,286	28,860	29,347	30,217	30,217
ADS shares outstanding in thousands, basic, under US GAAP	14,302	14,643	14,430	14,674	15,108	15,108
Capital expenditures	394,206	272,817	116,841	55,655	95,428	22,151
<b>Balance Sheet Data:</b>						
Fixed assets, net	912,346	1,038,087	991,998	876,825	825,511	191,623
Total assets, net	1,163,059	1,183,732	1,132,626	1,142,552	1,078,882	250,437
Short-term credit (including current maturities of bank loans and debentures)	249,657	561,365	547,853	469,104	499,344	115,911
Long-term bank loans	233,300	186,154	142,085	127,403	101,457	23,551
Debentures	142,479	132,457	99,462	66,145	33,201	7,707
Shareholders equity under Israeli GAAP	367,694	112,273	147,072	180,748	97,781	22,698
Shareholders equity under US GAAP	299,831	102,552	281,409	352,601	273,549	63,498
Accumulated other comprehensive income under US GAAP			150,376	220,338	237,212	55,063
Total assets, net under US GAAP	1,103,642	1,186,468	1,353,161	1,425,233	1,363,356	316,471
EBITDA**	44,504	256	56,735	146,992	139,644***	32,415

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\* The data set forth in the table above is expressed in NIS or US dollars, as applicable, except for data set forth in the table regarding numbers of shares and ADSs, as applicable.

\*\* EBITDA is presented because it is a measure commonly used in the telecommunications industry and is presented solely in order to improve the understanding of the Company's operating results and to provide perspective regarding these results. EBITDA, however, should not be considered as an alternative to operating income or income for the period or as an alternative to cash flow from operating activities or as a measure of liquidity. EBITDA is not a measure of financial performance under generally accepted accounting principles and may not be comparable to other similarly titled measures for other companies.

EBITDA may not be indicative of the historic operating results of the Company nor is it meant to be predictive of potential future results. Reconciliation between the operating profit in the financial statements and EBITDA is presented in Item 5A. Operating and Financial Review and Prospects Operating Results.

\*\*\* Since the results for the year 2003 do not include proportional consolidation with HOT Vision Ltd., for comparison purposes, the EBITDA is presented assuming no consolidation with HOT Vision Ltd. For information regarding HOT Vision Ltd., see also Item 4B. Business Overview.

### Exchange Rate Data

The following table sets forth, for the years indicated, exchange rates between the shekel and the US dollar, expressed as shekels per US dollar and based upon the daily representative rate of exchange on the last day of each year as published by the Bank of Israel.

	2000	2001	2002	2003	2004	2005(2)
Average(1)	4.077	4.214	4.736	4.512	4.483	4.364
High	4.198	4.416	4.994	4.924	4.634	4.416
Low	3.967	4.041	4.437	4.283	4.308	4.299
End of period	4.041	4.416	4.737	4.379	4.308	4.416

(1) Calculated based on the average of the exchange rates on the last day of each month during the relevant period.

(2) Through May 31, 2005.

	December	January	February	March	April	May
	2004	2005	2005	2005	2005	2005
High	4.374	4.414	4.392	4.379	4.395	4.416
Low	4.308	4.352	4.357	4.299	4.360	4.348

At May 31, 2005, the representative rate of exchange was NIS 4.416 per US dollar, as published by the Bank of Israel. Changes in the exchange rate between the shekel and the US dollar could affect our financial results.

### Payment of Dividends to Shareholders

Our board of directors decided, on December 27, 1999, to distribute an interim cash dividend to our shareholders who held shares on January 11, 2000, in the nominal amount of NIS 7.576 (approximately US\$ 1.82) per ordinary share, for a total nominal amount of approximately NIS 222.0 million paid to the shareholders on January 26, 2000. Distribution of this dividend was approved as a final dividend for the year 1999 at our annual general meeting of shareholders held on December 31, 2000. No dividends were declared in 2000, 2001, 2002, 2003 or 2004.

### 3B. CAPITALIZATION AND INDEBTEDNESS.

Not applicable.



**3C. REASONS FOR THE OFFER AND USE OF PROCEEDS.**

Not applicable.

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### 3D. RISK FACTORS

#### *Risks relating to our business and our industry*

##### **In order to operate our business, we must have and maintain valid licenses.**

We conduct our operations pursuant to two general non-exclusive cable broadcast licenses, referred to as the Cable Broadcasting Licenses, granted by the Council of Cable and Satellite Broadcasting, or the Council, on April 30, 2002, and a special broadcasting HeadEnd license, referred to as the Broadcasting HeadEnd License, granted by the Israeli Minister of Communications on May 2, 2002. In addition, we received a non-exclusive telecommunications infrastructure license, referred to as the Telecommunications Infrastructure License, from the Minister of Communications in March 27, 2002. On November 2003, the Minister of Communications granted to HOT Telecom L.P., or HOT Telecom, a limited partnership owned approximately 26.6% by us, with the remainder owned by the other two Israeli cable television operators, Tevel Israel International Ltd. Group, or Tevel, and Golden Channels & Co. Group, or Golden Channels, an infrastructure license, referred to as the HOT Telecom Infrastructure License, covering the same services covered by the Telecommunications Infrastructure License and also including the provision of domestic fixed communications services over cable networks including basic telephony services, to subscribers. The HOT Telecom Infrastructure License replaced and cancelled the Telecommunications Infrastructure License granted to us in 2002.

The Cable Broadcast Licenses are effective for a period of fifteen years, and the HOT Telecom Infrastructure License is effective for a period of twenty years, and each can be extended by additional ten-year periods if the Council, in respect of the Cable Broadcast Licenses, or the Minister of Communications, or the Minister, in respect of the HOT Telecom Infrastructure License, determine that we, or HOT Telecom, as applicable, have:

complied with the terms and conditions of the licenses and the applicable law and regulations;

complied with the instructions of the Council and the Minister;

continuously acted in a manner to improve our broadcasts, the technology of the broadcasts and the scope, availability and quality of our telecommunications services and our network technology;

the ability to continue to provide the broadcasts and to invest in improvements of the broadcasts in the future, and the ability to continue to provide the telecommunications services and make necessary investments in order to update our technology and the scope, availability and quality of our telecommunications services; and

continued to comply with the conditions upon which our licenses were granted.

Our Broadcasting HeadEnd License is valid for so long as our Cable Broadcast Licenses remain in force, but in any event no later than May 30, 2017, although we may apply for an extension of the Broadcasting HeadEnd License beyond this date.

In order to ensure compliance with our obligations pursuant to our Cable Broadcast Licenses, applicable law and regulatory bodies, we have provided a bank guarantee in the amount of NIS 9.3 million to the Council. In order to ensure compliance with the HOT Telecom Infrastructure License, we and the other two Israeli cable television operators provided bank guarantees in the aggregate amount of US\$ 14 million to the Minister. The bank guarantee provided by us was in the total amount of US\$ 3.72 million.

Each of the Minister and the Council has the authority to exercise the guarantees in the event that the licensee does not fulfill its obligations, and to cover any damage, loss or cost that the Council, the Minister or the government may incur as a result of any breach of obligations under the licenses, and to ensure any payments by the licensee, including royalty payments and payments of fines imposed by the Council or the Minister. The exercise of the guarantee does not derogate from the authority of the Council or the Minister to cancel the licenses, to amend the terms and conditions of the licenses or to impose other sanctions, including fines for certain stipulated breaches or actions.

The Council or the Minister, as applicable, have the authority to amend the terms of our licenses or the HOT Telecom Infrastructure License, at any time, and, in relation to the Cable Broadcast Licenses, the Council must take into account any prejudice to the licensee that would result from such amendment. Further, the licenses may be cancelled for material breach of their provisions, or non-compliance with legal requirements, or the failure to remedy of an immaterial breach. The HOT Telecom Infrastructure License can further be cancelled by the Minister for non-supply of services, non-fulfillment of the conditions of receipt of the license, breach of the restrictions upon the means of control of HOT Telecom, breach of cross ownership restrictions or breach of obligations to provide information to the Minister. HOT Telecom is also required to meet certain requirements pursuant to the HOT Telecom Infrastructure License regarding the laying down of network infrastructure.

Although we believe that we are currently in compliance with all material requirements of our licenses, the interpretation and application of the standards used to measure these requirements are not certain, and disagreements may arise in the future between us and the Minister or the Council.

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**We are subject to special regulatory restrictions applicable to monopolies, which limit our ability to control the conduct of our business.**

On November 8, 1999, the Controller of Restrictive Business Practices, or the Controller, declared that we, and all the other cable television operators in Israel, constitute a monopoly in the provision of multi-channel cable television services in our then respective franchise areas (which are the same areas in which we operate pursuant to our current licenses). On December 28, 1999, we filed an appeal of this declaration in the Restrictive Business Practices Court, which was dismissed in October 2004. As a result, we are and will continue to be subject to the supervision of the Restrictive Business Practices Authority, in addition to the existing supervision of the Minister and the Council, including in the areas of pricing, quality of broadcasting services, agreements with our subscribers, agreements with content providers and the use of our cable television network.

**There can be no assurance that the operational merger will result in a successful integration of the operations of us, Tevel and Golden Channels, or whether the operational merger will enhance our profits and competitiveness.**

As of 2001, the cable television operators are acting in order to merge their activities. The purpose of the merger, among other things, is to enable us to provide additional telecommunications services, to increase our ability to compete successfully with Bezeq in the field of domestic fixed line services, including telephony, and, to cooperate in various areas, including purchase of content, marketing, sales and unified networks and effect substantial cost savings. In order to strengthen the cooperation of the three Israeli cable television operators, we, Tevel and Golden Channels agreed to perform an operational merger in June 2004. To this effect, a joint management was appointed to oversee the joint operation of the marketing, sales, engineering, customer service, operations and information systems activities of the three cable television operators. The joint management conducts and manages the Company's activities in the ordinary course of business in the areas of the joint activities. Material decisions applicable to the operational merger require our approval as well as the approval of Tevel and Golden Channels. Our approval is subject to the decision of our board of directors and other corporate bodies, as required by law. Since the appointment of the joint management and the commencement of the operational merger, we, Tevel and Golden Channels have operated jointly on a regular basis. The three cable television operators have agreed in principle that the allocation of the expenses deriving from the joint activity among themselves shall be proportional to the number of subscribers of each party. The operational merger does not include transfer of assets from any of the three cable television operators to a merged entity or from any of the three cable television operators to another cable operator. Each of the three cable television operators remains the sole owner of its assets and is entitled to the revenue generated from its own subscribers. Furthermore, the joint activity does not include transfer of liabilities owed to third parties, including, inter alia, banks or other creditors. There can be no assurance that the operational merger will result in a successful integration of the operations of us, Tevel and Golden Channels, or whether the operational merger will enhance our profits and competitiveness or whether it will result in a legal merger among the parties, as described in the annual report. In addition, should the operational merger not be successful, our overall expenses may increase, since we may no longer benefit from reduced costs, which result from our joint activities with the other two cable television operators, and we may need to incur additional capital expenditures in order to operate our business as a separate entity, independent from the other two cable television operators.

**We and the other cable television operators have agreed on the terms of a merger. The legal merger might not be consummated, and if it is, we might not be able to realize any anticipated benefits from the merger.**

In February 2003, we and the other Israeli cable television operators agreed on a final version of an agreement outlining the structure and conditions of a merger among us. To date, the final merger agreement has not been signed, and we cannot predict when and if it will be signed.

Prior to the merger we will need to reach an agreement with the major Israeli banks, which are creditors of the parties to the merger, addressing among other things, the assignment of certain of the current debts and securities to the merged entity, and its future financing. The merger must also receive approvals under applicable law, including the approvals of the Council, the Income Tax Commission, the Controller, and by an Israeli court, after receiving the approvals of certain creditors and the relevant corporate bodies of the relevant parties. To date, approvals have been granted, subject to terms and conditions, from the Council, the Controller and the Income Tax Commission. Subject to the final terms of the merger, further approval of the Income Tax Commission to the merger may be required. The Supervisor of Banks of the Bank of Israel, or the Supervisor of Banks, has yet to agree that the proposed merger is not in breach of certain limitations under Israeli banking laws applicable to the Israeli banks, which are creditors of the merged entity.

According to the position of the Supervisor of Banks, the merger of the cable television operators and the formation of a merged cable entity would constitute a deviation from the directives of the Bank of Israel and of Proper Bank Management Directives of the Supervisor of Banks regarding, among other things, restriction on debt amounts to a Group of Borrowers as such term is defined in the Proper Bank Management Directives. The relevant directives deal with certain limits applicable to loan amounts given by banking corporations to Sole

Borrower and/or Group of Borrowers and as a result, attribution of the merged company's debts, among other things, to an indirect controlling shareholder of us and the other cable television operators.

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In November 2004, we concluded preliminary discussions with Tevel and its shareholders regarding the purchase by us of all of Tevel's assets, including Tevel's holdings in Golden Channels. If we were to acquire Tevel's assets, we would have over 560,000 cable subscribers, representing approximately 60% of the Israeli cable television market, and we would hold 35% of Golden Channels, subject to certain terms. We have not signed a binding agreement with Tevel, and cannot be certain that this transaction will be completed, or if completed, on what timeframe or on what terms and conditions, including price. If this transaction were to take place, we would likely incur or assume substantial additional indebtedness. If we were to acquire all of Tevel's assets as aforesaid, there is no assurance that the proposed merger of the three Israeli cable television operators will be completed in its current proposed form.

In the event that the merger is not consummated, it will be more difficult for us to realize our objectives and to compete effectively. In addition, should the merger not be consummated, our overall expenses may increase, since we may no longer benefit from reduced costs, which result from our joint activities with the other two Israeli cable television operators.

If the merger is consummated, there can be no assurance whether: (i) the conditions of the merger will enable the merged entity to successfully compete; (ii) there will be a successful integration between the merged entities; and (iii) the combined entity will be able to compete effectively against current or future competitors and will realize the anticipated benefits of the merger.

If the merger is consummated, we face the following risks:

- q As a result of the merger, we may be characterized as a passive foreign investment company, and as a result our U.S. shareholders may suffer adverse tax consequences. Generally, if for any taxable year 75% or more of our gross income is passive income, or at least 50% of our assets are held for the production of, or produce, passive income, we may be characterized as a passive foreign investment company for U.S. federal income tax purposes. This characterization could result in adverse U.S. tax consequences to our shareholders, including having gain realized on the sale of our shares be treated as ordinary income, as opposed to capital gain income, and having potentially punitive interest charges apply to such sales proceeds. U.S. shareholders should consult with their own U.S. tax advisors with respect to the U.S. tax consequences of investing in our ordinary shares.
- q As a result of the merger, we may be deemed to be an investment company under the Investment Companies Act of 1940. A significant part of our assets may constitute investment securities as defined in the Investment Company Act. If we were deemed to be an investment company, then we would be required to be registered as such. In that case there would be a substantial risk that we would be in violation of the Investment Company Act because of the practical inability of a non-U.S. company to register under the Investment Company Act. If we were deemed to be an unregistered investment company under the Investment Company Act, our contracts may be voidable, we might not be allowed to offer securities in the United States, and we may also be subject to other materially adverse consequences.
- q The sums that will be deemed to have been borrowed by the merged entity may exceed the maximum borrowing limit of a single borrower under Israeli banking laws, which might materially restrict the ability of the merged entity to receive loans from Israeli banks. In addition, we, the merged entity and the other parties to the merger may be subject to additional limitations in connection with the receipt of loans from Israeli banks due to restrictions under Israeli Banking laws pertaining to the maximum borrowing by a group of borrowers.
- q The goodwill contributed to the merged entity by the merging entities could result in accounting expenses under Israeli GAAP in the years following the consummation of the merger that would reduce our shareholders' equity and would have an adverse effect on the public market for our shares and ADS's, and may negatively affect our ability to pay dividends to our shareholders. A material reduction in our shareholders' equity could cause our shares to be delisted from the Tel Aviv Stock Exchange and Nasdaq National Market.
- q For the merger, including certain ancillary actions performed in the framework of the merger, to qualify, pursuant to the approval of the Israeli Income Tax Commission, as a tax-free transaction under Sections 103, 104 and 105 of the Israeli Income Tax Ordinance, the merging entities and their respective shareholders (including us) are required to comply with certain restrictions, including restrictions on certain issuances of shares of the merged entity and restrictions on the number of shares that may be sold by the shareholders of the merged entity. In addition, the merged entity may not sell a majority of the assets (as defined in the Income Tax Ordinance) transferred to it by the merging entities during this restricted period, and no actions, transfers, provision of guarantees or any other activities may be performed between the merged entity and the other entities that participated in the merger, including their respective shareholders. In the event that any of these conditions or restrictions are not complied with, the tax exemption may be retroactively cancelled and the merger may be subject to tax, plus a consumer price index linkage adjustment and interest. These restrictions may deter an acquisition of the

merged entity, and prevent us from selling or disposing of our shares in the merged entity. Additionally, subject to the final terms of the merger, further approval of the Income Tax Commission to the merger may be required and additional conditions or restrictions may be imposed on the merged entity, the merging entities and their respective shareholders.

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- q The terms and conditions of the approvals that we have received to date to the merger affect the ability of the merged entity to manage its business, and restrict the ability of the merged entity to utilize some of the potential competitive advantage it may otherwise have.
  - q In the event that the Controller considers there to be a material decline in the multi-channel television market as a result of the consummation of the merger, he has the power to oblige the merged entity to allow other broadcast license holders (including D.B.S. Satellite Services (1998) Ltd., commonly known as YES, the Israeli satellite multi-channel television operator) usage of the network infrastructure to access all potential subscribers, and not only to the subscribers of the merged entity.
  - q A condition of the approval of the Controller to the merger is an obligation upon the merged entity to begin to supply fixed line telephony services over cable infrastructure to the Israeli public not later than November 20, 2004. As of the end of November 2004, HOT Telecom has gradually commenced to provide commercial domestic fixed telephony services. The merged infrastructure entity is obligated to invest in fixed line telephony cable infrastructure an aggregate of not less than NIS 350 million, that shall be invested as follows: not less than NIS 190 million until June 30, 2005, not less than NIS 160 million until June 30, 2006 and any other amount as shall be required for the fulfillment of its business plan for the provision of telephony services which fully compete with those of Bezeq. The Company's portion of the infrastructure investment commitments (NIS 350 million), pro rata to its proportionate share in HOT Telecom is estimated to be approximately NIS 93 million. In addition, according to the amendment to the Controller's approval, the Controller increased the minimum number of subscribers to whom the merged entity is obliged to provide telephony services by the end of the consecutive years 2005, 2006 and 2007. The approval of the Controller to the merger is conditional upon the provision of a bank guarantee in the amount of US\$ 15 million to ensure compliance with the terms of the approval. In the event that the Controller decides, in his discretion, that there has been a material breach of the terms of the approval, he may fully or partially exercise the guarantee. We have provided our pro rata portion of this amount, by giving a guarantee in the amount of US\$ 3.75 million.

**Our joint activities with the other two Israeli cable television operators is subject to regulation and antitrust review, which limits the joint activities, causes us significant expenses and makes the future of these joint activities uncertain.**

On April 22, 2002, the Controller granted an approval to the merger the cable television operators. The Controller's approval to the merger is subject to terms and conditions. The Controller's approval to the merger was extended and amended from time to time.

On December 15, 2004, the Controller granted us and the other cable television operators an additional extension of the merger approval from April 2002 until January 29, 2005, which was further amended on January 30, 2005 until the earlier of January 29, 2006 or the consummation of the merger. There can be no assurance that the Controller will agree to further extend the approval. If the approval will not be further extended upon its expiration, we may be required to cease our joint activities with the other two cable television operators. The approval of the Council to the merger was granted on March 7, 2002 and amended on February 13, 2003. For more information on the terms and conditions of the approvals of the Council and Controller, see Item 4B. Business Overview .

On January 30, 2005, the Controller granted us and the other cable television operators an exemption from the requirement to receive an approval of a restrictive arrangement in relation to the ongoing cooperation between the cable television operators. The exemption was granted for a period of one year, until January 30, 2006. Pursuant to the exemption, the cable television operators may continue their cooperation in the multi-channel TV broadcasting operations, including marketing, content acquisition and content production, and in building infrastructure and providing fixed line telecommunication services, including access to High Speed Internet and telephony. This exemption is conditional upon, among other things, the cable television operators' compliance with the terms of the Controller's approval to the merger and all of the cable television operators refraining from taking any irreversible actions which would prevent them from being able to undertake separate and independent activities in the event that the merger will not be completed. If the merger is not consummated, it will be necessary for us to receive an extension of this exemption. There can be no assurance that the Controller will continue to grant us this exemption. If this exemption will not be extended, we may be required to cease our joint activities with the other two cable television operators.

The terms and conditions of the approvals of the Council and the Controller to the proposed merger also impose significant restrictions on the activity of the merged entity in relation to all areas of our business, including programming, marketing and broadcasting. We currently have the obligation to fulfill most of the conditions of the Controller's approval of the proposed merger.

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**The telecommunications industry in Israel is highly regulated which limits our flexibility to manage our business.**

Our business is subject to regulation under the Israeli Telecommunications Law as amended, or the Telecommunications Law, regarding, among other things:

- q licenses;
- q royalties and other payments to be paid by licensees to the government;
- q content and scope of programming;
- q the subscriber charges set by cable television operators for their cable television services;
- q our cable infrastructure that will become a public telecommunications network; and
- q the nature of telecommunications services.

Changes in laws, regulations or government policy affecting our business activities could adversely affect our business and operations. We cannot make any assurance that the Minister will not intervene in relation to the amounts we charge our subscribers.

**As a result of the changing regulatory environment we have lost the competitive advantage we previously enjoyed as a holder of exclusive franchises, and we face competition from a variety of sources. This has lowered the entry barriers for potential new competitors and may affect our ability to compete in the market.**

The Israeli telecommunications market has been transformed, moving to a more liberalized environment in which various markets are being gradually opened to competition. Amendments to the Telecommunications Law, which replaced the previous system of exclusive franchises by general non-exclusive licenses, have significantly reduced the barriers to entry into our market and imposed conditions upon us, thereby increasing competition.

In January 1999, the Ministry of Communications granted a license for the provision of television broadcasts to subscribers in Israel via satellite to YES. YES began to operate and market its broadcasts in July 2000. Bezeq Israel Telecommunications Corporation Ltd., or Bezeq, is a principal shareholder of YES. Bezeq was declared as a monopoly by the Controller over the provision of basic telephony services, telecommunications infrastructure services, data transmission services and ancillary services and access to High Speed Internet. Bezeq has great financial resources, which it may place at the disposal of YES, thereby allowing YES to offer its services at low prices and use aggressive marketing strategies, including providing set-top boxes free of charge. For these reasons, we may not be able to successfully compete with YES. We also have an obligation to lease our inside wiring to YES, and YES is under a reciprocal obligation to us, pursuant to directives issued by the Minister of Communications. Such competition from YES has affected our income, reduced the number of our subscribers and caused us increased expenses, mainly in marketing and programming. In particular, the purchasing power of YES has raised the cost of content purchasing from the major production companies.

The Telecommunications Law, our licenses and the terms of the approvals we have received to date from the regulatory authorities with regard to the proposed merger of the Israeli cable television operators, also may impose upon us an unbundling obligation, the purpose of which is to encourage competition in accordance with, and subject to the conditions of our licenses and applicable law. The obligation allows other broadcasting licensees access to our subscribers through our network infrastructure on terms that are not inferior to the terms that will be provided by HOT Telecom under the HOT Telecom Infrastructure Licensee, to our Cable Broadcast Licensees; and also allows other telecommunications licensees (who may therefore be providers of, among other things, other value added services) to have access to our infrastructure. Furthermore, pursuant to the terms of the approvals we have received in relation to the proposed merger between the Israeli cable television operators, in the event that the Controller considers there to be a material decline in competition in the multi-channel television market we may be instructed to allow YES, or other broadcast licensees, usage of our network infrastructure to all potential subscribers, and not only to our subscribers, so long as our cable network infrastructure reaches their premises. If YES ceases to operate due to insolvency, this will be deemed to be a material decline in competition in the multi-channel television market and we may be instructed to allow YES or its successor usage of our network infrastructure as mentioned above.

Pursuant to our licenses and the Telecommunications Law, we are obliged to reserve and allow one sixth of our broadcasting network capacity for broadcasts of channels produced by special cable broadcast licensees to our subscribers. According to the Telecommunications Law, without derogating from the general unbundling obligation referred to above, and taking into account the obligation to reserve one sixth of our network capacity, the Minister has the authority to direct HOT Telecom to designate network capacity for the transmission of broadcast and other telecommunications services of a third party.

We cannot anticipate how and to what extent these obligations may affect our income and expenses, or our subscriber base in the future.

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**The provision of access to High Speed Internet over cable services in Israel is characterized by significant competition.**

In April 2002, we commenced to provide access to High Speed Internet over cable services. In November 2003, HOT Telecom was granted a license to supply these services instead of us and the other cable television operators. As of June 2004, HOT Telecom provides such services to the business sector, itself, and to the residential sector through the former infrastructure licensees of the cable television operators. We have incurred considerable capital expenditure preparing for the provision of this service and in various telecommunication services, and anticipate that we and HOT Telecom shall continue to invest in the improvement and maintenance of these services in the future. However, we and HOT Telecom face significant competition in the access to High Speed Internet market from Bezeq and may face competition in the future from other well placed competitors. Furthermore, we face competition in the domestic telecommunication transmission services market and may face additional competition in this market from new competitors in the future. We can make no assurance that we will be able to compete effectively with such competitors, or that we will be successful in realizing a significant return on our investments with respect to such service.

**The provision of domestic fixed communications services in Israel is characterized by significant competition.**

As of the end of November 2004, HOT Telecom has gradually commenced to provide commercial domestic fixed telephony services. Pursuant to the approval of the Controller to the proposed merger of the cable operations, as amended, the merged infrastructure entity is to invest in fixed line telephony cable infrastructure an aggregate of not less than NIS 350 million, that shall be invested as follows: not less than NIS 190 million until June 30, 2005, not less than NIS 160 million until June 30, 2006 and any other amount as shall be required for the fulfillment of its business plan for the provision of telephony services which fully compete with those of Bezeq. The Company's portion of the infrastructure investment commitments (NIS 350 million), pro rata to its proportionate share in HOT Telecom of 26.6% is estimated to be approximately NIS 93 million.

On September 17, 2002, the Minister of Communications adopted, with certain changes, the recommendations of a committee formed by the Ministry of Communications for the establishment of policies and rules for the opening of competition in the field of domestic fixed communications services, as the guiding principles in this field. In order to implement the committee's recommendations, the Israeli parliament approved an amendment to the Telecommunications Law at the end of May 2003. Under this amendment, as of September 1, 2004, the Minister may grant a special general license for domestic fixed telecommunications services without imposing on the holders of such licenses the obligation to provide their services to the entire public throughout the entire country or in any specifically defined area in Israel. The Ministry of Communications published the language of the special general license. In June 2004, the Ministry published new regulations setting forth the conditions and procedures for obtaining a special general license for domestic fixed telecommunications services. Under the said regulations, any applicant may be granted with such a license, provided it is able to comply with several basic conditions which are listed in the said regulations.

On November 30, 2004, the Ministry of Communications issued policy principles to license the provision of telephony services by broadband access, known as Voice-Over Broadband access, or VoB. The VoB services that new competitors shall be entitled to provide may compete with the telephony services already provided by HOT Telecom. HOT Telecom filed a detailed status paper in which it demanded to revoke the policy principles. As a result of these new competitors, HOT Telecom may not be able to compete effectively, and it may not recover its significant investments in telephony services.

Pursuant to the abovementioned regulations and policy principles, the Ministry has granted several special marketing licenses for experimental provision of fixed line telephony services by broadband access (VoB), inter alia, to ISP, cellular and international communications licensees.

In addition, new technologies are being developed, such as VoIP, voice-on-data lines, wireless technologies and broadband infrastructure, which will enable current telecommunication providers and/or new competitors to implement rapid deployment of relatively low-cost technologies. This could place HOT Telecom in an inferior status in competing with them.

In March 2004, the Minister announced its new policy with respect to Bezeq's general license. Specifically, the policy provides that Bezeq may offer discounts for size at a rate of up to 10% and may request to amend its license in a manner that it will be able to market bundled services when its market share of the fixed domestic telephony industry (residential or business customers) decreases below 85% or if the competitive status of Bezeq's subsidiary, YES, has significantly deteriorated. With regard to YES, the Minister determined that a significant deterioration in the competitive status shall be a situation in which its market segment in the industry of multi channel-broadcast to subscribers decreased below 25% of all subscribers in that market. On January 9, 2005, the Minister resolved to raise the deterioration threshold in the competitive status of YES from 25% to 29%. This policy enables Bezeq to provide services jointly with its affiliates, which it was not allowed to do in the past, including among other things, telephony services (local and international), multi-channel television services, cellular services and access to High Speed Internet services. As a result of this policy, HOT Telecom may not be able to compete effectively with Bezeq and others, and it may not recover its significant investments in telephony services. In addition, the offering by Bezeq of bundled services, including multi-channel television services through YES, may have a material effect on our ability to supply telephony services to our subscribers and could cause us to lose multi-channel television subscribers. Accordingly, we may suffer losses as the result of our holdings in HOT Telecom, which would affect our results of operations.

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**Due to the prospective investment in Bezeq, Bezeq may no longer be regarded as a government company and therefore, shall cease to be subject to the limitations imposed on a government company. As a result, our ability to compete in the access to High Speed Internet, telephony services and multi-channel services markets could suffer.**

On May 2005, the State of Israel selected the offer made by F.S.B.R Holdings Ltd. ( FSBR ) as the winning bid for the purchase of approximately 30% of the shares of Bezeq, which are currently held by the State of Israel. In addition FSBR will have an option to purchase an additional 10.66% of the shares of Bezeq. The consummation of such transactions is subject to the receipt of certain approvals, including the approval of the Prime Minister and the Minister of Communications and the consent of the Controller. If these transactions are consummated, Bezeq will no longer be a government company and will, therefore, no longer be subject to government involvement and certain obligations as a government company. Bezeq will continue to be subject to other limitations imposed on it, including, inter alia, obligations imposed on it according to its license and its declaration as a monopoly. Further, Bezeq has great financial resources, which it may place at the disposal of YES, without the restrictions that have in the past been imposed on it as a government company, thereby allowing YES to offer its services at lower prices and use more aggressive marketing strategies. If this occurs, our ability to compete in the multi-channel services market could be harmed. The business activities of the controlling shareholder of FSBR are focused on media and television productions. This controlling shareholder also has significant holdings in broadcasting and communication entities both within and outside of Israel. As a result, this could provide Bezeq and YES with a great competitive advantage to our detriment. This could have a negative effect on our ability to compete in the access to High Speed Internet, telephony services and multi-channel television markets.

**We have recently been the victim of industrial espionage in Israel, which could have an adverse effect on our operations, on our financial condition and on our ability to compete in the market.**

We were notified in May 2005 that the Israeli police were conducting an investigation of industrial espionage against certain companies in Israel, including against our competitor YES. On June 2, 2005, we along with other cable television operators filed a statement of claim in the District Court of Tel Aviv asking for certain relief against YES's alleged actions, inter alia, requesting to appoint a receiver in order to seize all documents taken from us by YES. YES has responded to our claims stating that it did, in fact, receive documents of the cable television operators through civil intelligence but also indicated that these documents have since been confiscated by the police. We have filed our response to YES's response. We are examining what additional procedures we may pursue. As the entire scope of our confidential information that was improperly disclosed to YES is still unknown, it is difficult for us to assess the risk involved and the exact implications it will have on our business, including the scope of damages to our business. The disclosure of our confidential information could have an adverse effect on our operations, our financial condition and on our ability to compete in the multi-channel television, access to High Speed Internet and telephony services markets.

**We could lose our competitive advantage of being the exclusive provider of Video on Demand services if YES were to receive an approval from the Ministry of Communications to provide alternative services.**

We, along with the other cable television operators, gradually commenced in January 2005 providing Video on Demand, or VOD, services in our operating areas on a commercial basis. We, along with the other cable television operators, are currently the only companies to offer VOD services. VOD is a service that allows television viewers to instantaneously select and view various contents (such as library movies, current movies, series, contents for children, contents for adults, sports content, entertainment and leisure contents) at any time they choose. VOD services also allow the viewer to stop, pause, fast-forward, rewind and restart the viewing, in a similar manner to the operation of a video tape recorder. We have incurred considerable capital expenditure preparing for the provision of this service. According to publication, YES requested permission from the Ministry of Communications to provide VOD services deployed over DSL. If YES were to receive such an approval from the Ministry, we would lose our competitive advantage of being the exclusive provider of such services in Israel. This could have a material



adverse effect on our financial condition.

**We may face competition from other existing technologies in broadcasting and infrastructure that may be implemented in Israel, or new technologies that could reduce the appeal of our services.**

While we believe that our existing technologies allow us to effectively compete with other existing technologies implemented in Israel, we may face competition from new technologies that may be implemented in Israel. We cannot anticipate whether, and to what extent if at all, future changes in technology will materially affect the continued use of fiber optic and coaxial cabling technologies that we employ. We may also face competition from technologies in development or that may be implemented in the future, such as LMDS and other wireless technologies in the fields of data over cable and telephony, video on demand or VOD, services that may be deployed over DSL, and satellite platforms. We cannot predict the effect of existing, emerging and future technological changes on the viability or competitiveness of our system. Accordingly, we cannot make any assurance that the technologies we currently employ, or shall employ in the future, will not become obsolete or subject to competition from new technologies in the future.

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**One party controls a large block of our shares.**

As of December 2004, Delek Investments and Properties Ltd., or Delek, holds approximately 40% of our outstanding shares. Delek is a wholly-owned subsidiary of Delek Group Ltd., a public company whose shares are listed on the Tel Aviv Stock Exchange. As of May 2005, Delek Group Ltd. is controlled by Mr. Yitzchak Sharon ( Tshuva ). Mr. Tshuva holds indirectly approximately 78.64% of the shares of Delek Group Ltd. Accordingly, Delek Group Ltd. and Tshuva, as the single largest beneficial shareholder, may have the ability to determine the election of a majority of our directors, and to direct our policies, including the payment of dividends, and may control the outcome of substantially all matters that may be brought before our shareholders.

**We may not be able to obtain additional capital in order to implement our business plans on favorable terms.**

Although our management currently believes that our existing capital resources, including our credit lines, are adequate to satisfy our financial needs in order to implement our business plans for the next 12 months, as of December 31, 2004, we may in fact require additional capital. Our financial needs in that period will be subject to, among other things: our ability to successfully provide our services; the need to upgrade our network to provide added value services; the need to acquire additional equipment; the need to implement the buildout of our infrastructure in peripheral areas; and the needs of companies in which we have significant investments, such as Barak and, if the proposed merger shall be consummated, the merged entity.

Any future equity or debt financing, if available, may be on terms that are not favorable to us, and in the event of equity financing, could result in dilution of our shareholders' interests. Our principal shareholders are not contractually obligated to make loans or contribute equity to us.

We commenced negotiations with the banks regarding an increase of our credit lines. These negotiations were ceased due to the proceedings in connection with the proposed merger of the Israeli cable television operators. In the event that we are granted increased credit lines to meet our financial needs, there can be no assurance that we would be able to obtain terms which are favorable to us, or which are not significantly expensive, in light of current market conditions. Further, one of our main credit lines is based on an unwritten agreement with the bank. Due to its oral nature, the terms and conditions of this credit line are at risk and we could be required to accelerate payment of all amounts owing to this bank. In addition, our agreement with another bank supplying one of our credit lines contains a number of covenants relating to, among other things, our debt to equity ratio and the maintenance of a minimum number of subscribers. In the event we breach any of these covenants, we could be required to accelerate payment of all amounts owing to this bank. For further details regarding this credit arrangement, please see Item 5B. Operating and Financial Review and Prospects - Liquidity and Capital Resources .

**We have been notified by one of our banks that we did not comply with two of our covenants under our credit agreement, which if not remedied, could result in an event of default under the agreement, which may have an effect on our liquidity in the future.**

As of December 31, 2004, we did not comply with two covenants to maintain the financial ratios, as defined in the agreement, as follows: (i) the number of broadcast subscribers and (ii) Operating surplus.

In March 2005, we received a letter from our bank according to which the bank does not deem the non-compliance, described above, to be a violation by the company to maintain such financial ratios for a period of one year, commencing on March 24, 2005 (the Waiver Period ). We anticipate that additional negotiations will take place with the bank at the end of the Waiver Period. If we fail to comply with the covenants at that time or fail to reach an agreement with the bank, it could result in an event of default under the credit agreement, in which case amounts

One party controls a large block of our shares.

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under the agreement would become due. For further details regarding this credit arrangement, please see Item 5B. Operating and Financial Review and Prospects Liquidity and Capital Resources .

**Our substantial leverage could adversely affect our financial health.**

In recent years, we incurred intensive capital expenditures related to the continued construction of our cable television network and other technological projects, and operating losses, which have increased our indebtedness, resulting in our becoming highly leveraged.

Our ability to meet our debt obligations will depend on whether we can successfully implement our strategy, as well as on financial, competitive, regulatory and technical factors, including some factors that are beyond our control. If we are unable to generate sufficient cash flow from operations to meet principal and interest payments on our debt, we may have to refinance all or part of our indebtedness.

We cannot assure you that any such refinancing would be possible on terms that we could accept or that we could obtain additional financing. If refinancing were not possible or if additional financing were not available, we may have to sell our assets under circumstances that might not yield the highest prices, or default on our debt obligations.

**Due to the fact that we have a significant amount of short-term loans bearing variable interest rates, we are vulnerable to interest rate increases.**

Because we have a significant amount of short-term loans bearing variable interest rates, we are vulnerable to interest rate increases. In the event that the interest rates applicable to our short-term loans should increase significantly, this would increase our expenses. Any significant increase in our expenses will harm our results of operations.

**Our industry is subject to rapid technological changes that will cause us to incur capital expenditures to remain competitive.**

In order to provide advanced communication services, we have incurred significant capital expenditures expanding our cable network bandwidth from 550 MHz to 860 MHz. We have a technological advancement plan for deployment of additional two-way services, expansion of fiber optic cable networks and a digital broadcasting system or advanced data over cable/IP platform. We also aim to improve the network in terms of redundancy and manageability, by closing fiber rings, enhancing the powering and telemetry measures, and downsizing the fiber nodes. Such enhancements are necessary to allow us to provide telecommunication services at a Telco-Grade quality of service, which is the standard commonly used by telephone companies to grade availability and quality of services. We may not have sufficient capital resources to finance the expenditures required to remain competitive, which could adversely affect our results of operations.

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**Our business may be impacted by shekel exchange rate fluctuations and inflation.**

Since we may be unable, or not permitted to raise our rates and fees pursuant to our licenses in a manner that would fully compensate for any increase in the Israeli consumer price index, inflation in Israel, which may impact our borrowing costs with respect to shekel amounts linked to the Israeli consumer price index and may cause an interest increase in Israel, may have a material adverse effect on us.

Substantially all of our revenues and a portion of our operating expenses are denominated in shekels, and on the other hand, substantially all of our programming expenses and certain other expenses are denominated or linked to foreign currency. Thus, any devaluation of the shekel against the US dollar (or other foreign currencies), will also increase the shekel cost of our non-shekel denominated or linked expenses. Such increase may have an adverse impact upon our operating results, which may be material. Our borrowings are mostly in Israeli shekels. We enter into option contracts to protect ourselves from the risk of the possible fluctuations in exchange rates. There can be no assurance that we adequately protect ourselves from exchange rate fluctuations.

**The financial situation of the other Israeli cable television operators has an impact upon our business.**

Due to the fact that we cooperate closely with the other two Israeli cable television operators, Tevel and Golden Channels, and during 2004 have decided to merge our operations with those of Tevel and Golden Channels, the financial situation of these companies has an impact on our business.

Any future deterioration of Tevel or Golden Channels, which result in a delay or omission of such party to provide its relative portion of the joint activity's costs, could have an impact upon our business and our day to day operations, including causing an increase in our respective pro rata portion of joint costs, including, among others, content costs which may have a material adverse affect upon our financial statements.

Furthermore, it may affect the possibility of the consummation of the proposed merger between the Israeli cable television operators, and the conditions that the creditors of the companies that are parties to the merger may impose.

We have concluded preliminary discussions with Tevel and its shareholders for the purchase by us of all of Tevel's assets. Please see the discussion of this proposed transaction in Item 4B. Business Overview Agreement for a Merger of the Cable Television Operators.

**Our previous franchises required us to meet certain milestones with respect to cable access to potential customers in the areas covered by our licenses, which if not met, could expose us to litigation or administrative actions.**

Our previous exclusive franchises contained specific construction milestones with respect to regions within a franchise area that must be passed by the cable television network by specified dates. We substantially completed the installation of the regional cable transmission network in all our operating areas, and believe that completing portions of the buildout requirements in peripheral regions in the operating areas would be substantially more expensive, on a per-subscriber basis than in the metropolitan areas. Therefore we did not fully complete build-out requirements in certain peripheral regions. Our current licenses require us to connect any applicant to purchase cable television broadcasts within a specified period of time. The Ministry of Communications or the exceptions committee thereof may allow an exception regarding the time schedule to connect applicants, or the obligation to connect every applicant.

We are subject to a lawsuit and have been subject to other lawsuits in the past, and may be exposed to additional lawsuits in the future, by residents of communities that are not, or were not, connected to our cable television network, seeking to force us to implement the build-out of our network in their communities, or compensation for being prevented from receiving cable television services. See Item 8A. Consolidated Statements and Other Financial Information Legal and Arbitration Proceedings.

**We may be required to pay royalties to, and could be subject to lawsuits by, owners of copyrights in connection with particular programs.**

We re-transmit certain foreign channels which are broadcast by third parties. These foreign channels may purchase rights from third parties to broadcast particular programs. According to a recent final ruling of the Israeli Supreme Court in a further hearing, the re-transmission by us of programs broadcast by the foreign channels may constitute an infringement of the rights of the copyright owners of such programs if they did not consent to the re-transmission of their programs into Israel. As a result of this ruling, we may be required to reach royalty arrangements with the owners of the copyrights of such programs prior to their re-transmission, in addition to the arrangements we reach with the foreign channels. This could increase our programming costs. In addition, we could be subject to lawsuits by the owners of copyrights in programs broadcast by the foreign channels. If we are found to have violated the copyrights of third parties, we could also be subject to regulatory sanctions. In the ruling, the Supreme Court called upon the Israeli legislators to amend the Copyrights Law to address this issue. We have been informed that the legislature has published a draft amendment to the Copyrights Law to address certain aspects of the foregoing issues; however, we cannot predict if and when the legislators will complete this process and what shall be the final version of such amendment, nor can we currently predict the magnitude of our exposure to increased royalty obligations and lawsuits relating to programs broadcast by the foreign channels we offer.

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**The proposed reduction in royalties by the Ministry of Communications and the Ministry of Finance could have an adverse effect on our ability and HOT Telecom's ability to compete in the market.**

According to a letter dated April 20, 2005, which was sent by the Ministry of Finance and the Ministry of Communications to the Manager of the Government Companies Authority in Israel, the Ministries intend to reduce the percentage of royalties paid to the State of Israel by the holders of the international communication licenses and the holders of domestic fixed communication services licenses. The amount of the reduction is 0.5% per year commencing on January 1, 2006 up to a percentage of royalties of 1% in the year 2010. The execution of this reduction is conditioned on the amendment of the Communication Regulations (Royalties), the approval of the Minister of Communications and the Minister of Finance, and the approval of the Finance Committee of the Knesset. This intended reduction will supplement an additional reduction already made with regard to holders of cellular telecommunication licenses.

The said position does not include the field of multi-channel broadcasting. Therefore, in the event the reduction will be implemented as detailed above, we will not be able to benefit from it. In addition, although HOT Telecom may benefit from the intended reduction in its activity as a provider of infrastructure services, this reduction will not be significant due to the fact that HOT Telecom is a new operator with relatively low revenues. Furthermore, such a reduction in the percentage of royalties may be of more significance to HOT Telecom's competitor. As such, the reduction in royalties, as proposed, could have an adverse effect on our ability as well as HOT Telecom's ability to compete in the market.

**Pursuant to tax assessments made by the Israeli Income Tax Authority, we may be required to pay significant additional taxes in respect of past years.**

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We received tax assessments from the Israeli Income Tax Authority. For details, please see Item 8A. Financial Information Consolidated Statements and Other Financial Information Legal and Arbitration Proceedings . If, as a result of any of these tax assessments, we are required to pay significant additional amounts of taxes to the Israeli Income Tax Authority, our results of operations would be materially affected.

### **We may be required to pay stamp duty on agreements executed by us on or after June 1, 2003, which would increase our taxes.**

The Israeli Stamp Duty on Documents Law, 1961 (the Stamp Duty Law ), provides that most documents signed by Israeli companies are subject to a stamp duty, generally at a rate of between 0.4% and 1% of the value of the subject matter of such document. De facto, it has been common practice in Israel not to pay such stamp duty unless a document is filed with a governmental authority or with the courts. As a result of an amendment to the Stamp Duty Law that came into effect on June 1, 2003, the Israeli tax authorities have approached many companies in Israel and requested the disclosure of all agreements signed by such companies after June 1, 2003 with the aim of collecting stamp duty on such agreements. The legitimacy of the aforementioned amendment to the Stamp Duty Law and of said actions by the Israeli tax authorities are currently under review by the Israeli High Court of Justice. Based on advice from our Israeli counsel, we believe that we may only be required to pay stamp duty on documents signed on or after August 2004. However, we cannot assure you that the tax authorities or the courts will accept such view. Although at this stage it is not yet possible to evaluate the effect, if any, on us of the amendment to the Stamp Duty Law, the same could adversely affect our results of operations.

In January 2005, an order was signed in accordance with which the said requirement to pay stamp duty is cancelled with effect from January 1, 2008.

### *Risks relating to the market for our shares*

#### **Our ordinary shares and ADSs are listed for trading on different markets and this may result in price variations.**

Our ordinary shares are listed for trading on the Tel Aviv Stock Exchange, or TASE, and our ADSs are listed for trading on the Nasdaq Stock Market, or Nasdaq. Each ADS represents two ordinary shares. Trading in our ordinary shares and ADSs on these markets is made in different currencies (NIS on TASE and US dollars on Nasdaq), and at different times (resulting from different time zones, different trading days and different public holidays in the United States and Israel). Actual trading volume on Nasdaq or the TASE could be insignificant and as such could be subject to volatility. The trading prices of our ordinary shares and ADSs on these two markets often differ, resulting from the factors described above, as well as differences in exchange rates. Any decrease in the trading price of our ordinary shares on the TASE could cause a decrease in the trading price of our ADSs on Nasdaq, and any decrease in the trading price of our ADSs on Nasdaq could cause a decrease in the trading price of our ordinary shares on the TASE.

#### **If our ADSs are delisted from Nasdaq, the liquidity and price of our securities and our ability to issue additional securities may be significantly reduced.**

We intend to delist voluntarily from the Nasdaq National Market and to terminate our American Depositary Receipt (ADR) program in the future. Our board of directors will examine the timing of such termination in the next few months. We intend to file a Form 15 with the SEC to terminate the registration of the ADRs and ordinary shares, thereby suspending our obligation to file annual and other reports with the SEC. After the delisting, our shares will continue to trade in the TASE and we will continue to make public reports in accordance with the Israeli securities laws and regulations. Although we only have a limited number of record holders of our ADSs, delisting could diminish investors interest in our securities as well as significantly reduce the liquidity and price of our securities. Delisting may also make it more difficult for us to issue additional securities or secure additional financing.

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### *Risks relating to operations in Israel*

#### **We are subject to the political, economic and military conditions in Israel.**

We are incorporated and based in, and currently derive all our revenues in Israel. As a result, the political, economic and military conditions in Israel directly influence us. Hostilities involving Israel, the interruption or curtailment of trade between Israel and its trading partners, political instability within Israel or its neighboring countries, a significant downturn in the economic or financial condition of Israel and changes in Israeli laws and regulations, including taxation, are likely to cause our revenues to fall and harm our business.

A state of hostility, varying from time to time in intensity and degree, has led to security and economic problems for Israel. Since October 2000, there has been an increased level of hostilities and violence between Israel and the Palestinians, which has adversely affected the peace process and has negatively influenced our relationship with several Arab countries. The future effect of this deterioration and violence on the

One party controls a large block of our shares.

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Israeli economy and our operations is unclear. From time to time Israeli companies or companies doing business with Israeli companies have been subject to an economic boycott initiated by several Arab countries. This boycott or similar restrictive laws or policies directed towards Israel or Israeli business could adversely affect us.

Due to a continuing budget deficit of the Israeli government and the slow down of the Israeli economy in recent years, the Israeli parliament approved, on May 29, 2003, an economic plan that entails, among other things, budget cuts in various sources of government spending, the increase of various tax liabilities and cuts in various social benefits. It is not known at this stage what impact the implementation of the approved economic plan would have on the Israeli economy. Since we are located in, and currently derive all of our revenues in Israel, economic events in Israel, or uncertainties associated with such events, could adversely affect our operations and financial results.

**Our results of operations could be negatively affected by the obligations of our personnel to perform military service.**

Certain of our male employees are obligated to perform annual military reserve duty in Israel. In addition, in the event of a military conflict or other attack on Israel, including the ongoing conflict with the Palestinians, these persons could be required to serve in the military for extended periods of time. The absence of a number of our officers and employees for significant periods could disrupt our operations and harm our business.

**Provisions of our licenses and Israeli law could delay, prevent or make difficult a merger or acquisition or a change of control of us and therefore depress the market price of our shares.**

Our Cable Broadcast Licenses and HeadEnd License, and the HOT Telecom Infrastructure License, include restrictions regarding changes of means of control of the licensees.

In addition, provisions of Israeli corporate law may have the effect of delaying, preventing or making more difficult a merger with, or acquisition of us. The Israeli Companies Law generally requires that a merger be approved by a company's board of directors and by a majority of the shares present and voting on the proposed merger at a meeting called on at least 21 days' notice. For purposes of the shareholder vote, unless a court rules otherwise, the merger will not be deemed approved if a majority of the voting rights held by parties other than the other party to the merger (or by any person who holds 25% or more of the shares or the right to appoint 25% or more of the directors of the other party or its general manager) have voted against the merger. Upon the request of any creditor of a party to the proposed merger, a court may delay or prevent the merger if it concludes that there is a reasonable concern that, as a result of the merger, the surviving company will be unable to satisfy the obligations of the surviving company. In addition, a merger may not be completed unless 30 days have passed from the time in which each of the merged companies' shareholders have resolved to merge, and at least 50 days have passed since the filing of the merger proposal signed by both parties with the Israeli Registrar of Companies.

The Israeli Companies Law also 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, a person would become a holder of 25% or more of the company. This rule does not apply if there is already another 25% shareholder of the company. Similarly, the Israeli Companies Act 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 become a holder of 45% or more of the company, unless there is already another 45% shareholder of the company. This requirement does not apply if the acquisition is made in a private placement provided that the company's shareholders approve such private placement as a private placement which is intended to grant the placee a holding of either (a) 25% or more of the company, if there is not already another 25% shareholder of the company, or (b) 45% or more of the company, if there is not already another 45% shareholder of the company. In addition, this requirement will not apply upon the purchase of shares from either (i) a holder of 25% or more of the company which results in a person becoming a holder of 25% or more of the company or (ii) a holder of 45% or more of the company which results in the purchaser holding more than 45% of the company. The tender offer must be extended to all shareholders, but the offeror is not required to purchase more than 5% of the company's outstanding shares, regardless of how many shares are tendered by shareholders. The tender offer may be consummated only if (i) at least 5% of the company's outstanding shares will be acquired by the offeror and (ii) the number of shares tendered in the offer exceeds the number of shares whose holders objected to the offer. Shares that are acquired in violation of this requirement to make a tender offer will be deemed treasury shares and will have no rights whatsoever for so long as they are held by the acquirer. If, as a result of an acquisition of shares, the acquirer will hold more than 90% of a company's outstanding shares, the Israeli Companies Law requires that the acquisition be made by means of a tender offer for all of the outstanding shares. If less than 5% of the outstanding shares are not tendered in the tender offer, all the shares that the acquirer offered to purchase will be transferred to it. The Israeli Companies Law provides for appraisal rights if any shareholder files a request in court within three months following the consummation of a full tender offer. If more than 5% of the outstanding shares are not tendered in the tender offer, then the acquirer may not acquire the shares in the tender offer that will cause his shareholding to exceed 90% of the outstanding shares.

Finally, Israeli tax law treats some acquisitions, such as stock-for-stock exchanges between an Israeli company and a foreign company less favorably than U.S. tax laws. For example, Israeli tax law may, under certain circumstances, subject a shareholder who exchanges his ordinary shares for shares in another corporation to taxation prior to the sale of the shares received in such stock-for-stock swap.

These provisions of our licenses and of the Israeli corporate and tax law (and the uncertainties surrounding such laws) may have the effect of delaying, preventing or making more difficult a merger or acquisition or change of control of us, and depress the market price of our ordinary shares which otherwise might rise as a result of such a change of control.

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**It may be difficult to (i) enforce a U.S. judgment against us, our officers and directors and our Israeli auditors, (ii) assert U.S. securities laws claims in Israel, and (iii) serve process on substantially all of our officers and directors and these accountants.**

We are incorporated in Israel. Substantially all of our executive officers and directors and our Israeli auditors are nonresidents of the United States, and a substantial portion of our assets and the assets of these persons are located outside the United States. Therefore, service of process upon our directors and officers named herein may be difficult to effect within the United States because some of these people reside outside the United States. Any judgment obtained in the United States against us or these individuals or entities may not be enforceable within the United States.

There is doubt as to the enforceability of civil liabilities under the Securities Act and the Securities Exchange Act in original actions instituted in Israel. However, subject to specified time limitations, Israeli courts may enforce a U.S. final executory judgment in a civil matter, provided, inter alia, that:

adequate service of process has been effected and the defendant has had a reasonable opportunity to be heard;

the judgment and its enforcement are not contrary to the law, public policy, security or sovereignty of the State of Israel;

the judgment was obtained after due process before a court of competent jurisdiction according to the rules of private international law prevailing in Israel;

the judgment was not obtained by fraudulent means and does not conflict with any other valid judgment in the same matter between the same parties;

an action between the same parties in the same matter is not pending in any Israeli court at the time the lawsuit is instituted in the U.S. court; and

the U.S. court is not prohibited from enforcing the judgments of Israeli courts.

If a foreign judgment is enforced by an Israeli court, it generally will be payable in new Israeli shekels, which can then be converted into non-Israeli currency and transferred out of Israel. The usual practice in an action to recover an amount in non-Israeli currency is for the Israeli court to render judgment for the equivalent amount in new Israeli shekels at the rate of exchange on the date of payment, but the judgment debtor also may make payment in non-Israeli currency. Pending collection, the amount of the judgment of an Israeli court stated in new Israeli shekels ordinarily will be linked to the Israel Consumer Price Index plus interest at the annual rate (set by Israeli law) prevailing at that time. Judgment creditors bear the risk of unfavorable exchange rates.

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**ITEM 4. INFORMATION ON THE COMPANY**

**4A. HISTORY AND DEVELOPMENT OF THE COMPANY**

We were incorporated as Matav-Cable Systems Media Ltd. under the laws of the State of Israel on June 28, 1987. Our principal executive offices are located at 42 Pinkas Street, North Industrial Area, Netanya 42134, Israel (telephone: +972-9-860-2160). Our website address is [www.hot.net.il](http://www.hot.net.il). Our agent for service of process in the United States is Puglisi & Associates, 850 Library Avenue, Suite 204, P.O. Box 885, Newark, Delaware 19715.

We are one of three operators and providers of broadband cable television services in Israel. The other two cable television operators are Tevel Israel International Communications Ltd. Group, or Tevel, and Golden Channels & Co. Group, or Golden Channels. We market our cable

One party controls a large block of our shares.

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television services and engage in content-related activities and other telecommunication activities together with Tevel and Golden Channels under the brand name HOT .

In order to strengthen the cooperation of the three Israeli cable television operators, we, Tevel and Golden Channels agreed to perform an operational merger in June 2004. To this effect, a joint management was appointed to oversee the joint operation of the marketing, sales, engineering, customer service, operations and information systems activities of the three cable television operators. The joint management conducts and manages the Company's activities in the ordinary course of business in the areas of the joint activities. Material decisions applicable to the operational merger require our approval as well as the approval of Tevel and Golden Channels. Our approval is subject to the decision of our board of directors and other corporate bodies, as required by law. Since the appointment of the joint management and the commencement of the operational merger, we, Tevel and Golden Channels have operated jointly on a regular basis. The three cable television operators have agreed in principle that the allocation of the expenses deriving from the joint activity among themselves shall be proportional to the number of subscribers of each party. The operational merger does not include transfer of assets from any of the three cable television operators to a merged entity or from any of the three cable television operators to another cable operator. Each of the three cable television operators remains the sole owner of its assets and is entitled to the revenue generated from its own subscribers. Furthermore, the joint activity does not include transfer of liabilities owed to third parties, including, inter alia, banks or other creditors.

Prior to the grant of our licenses in 2002, we operated pursuant to five exclusive franchises granted to us by the Israeli Ministry of Communications to provide cable television services in franchise areas, which covered approximately 25% of Israel's households. As of December 31, 2004, we provided cable television services to approximately 26.7% of all cable television subscribers in Israel. We own substantially all of our cable television network infrastructure. Our exclusive franchises covered four operating areas, three of which included the major metropolitan areas of Bat-Yam, Holon, Haifa, and Netanya, Hadera, and one of which served the less densely populated area of the Galilee. Our exclusive franchises were subsequently cancelled and replaced by general non-exclusive long term broadcast licenses covering the same geographical areas. Our subscriber penetration is highest in the metropolitan operating areas.

We operate both directly and through subsidiaries in various fields of communications. We began serving cable television subscribers in 1990. We have adopted a growth strategy that combines core activities in the multi-channel television market, based on state-of-the-art technology, with the use of cable television infrastructure. The total number of our cable television subscribers was approximately 257,344 as of December 31, 2004, compared to approximately 266,700 as of December 31, 2003 and approximately 275,000 as of December 31, 2002. Cable television subscriber penetration has decreased by approximately 4% during the same period. In April 2002, we started to offer a commercial service of access to High Speed Internet over cable.

Our aggregate revenues (including revenues from cable television and access to High Speed Internet residential subscribers) have increased from approximately NIS 495.5 million as of December 31, 2002 to approximately NIS 545.5 million as of December 31, 2003 and approximately NIS 584.6 million as of December 31, 2004. During the same period, our operating loss and net income was approximately NIS 98.7 million and approximately NIS 33.8 million, respectively, for the year ended December 31, 2002, and an operating loss and net loss of approximately NIS 7.8 million and approximately NIS 5.5 million, respectively, for the year ended December 31, 2003, and an operating income and net loss of approximately NIS 3 million and approximately NIS 83 million, respectively, for the year ended December 31, 2004. EBITDA has increased from approximately NIS 56.7 million for the year ended December 31, 2002 to approximately NIS 147.0 million for the year ended December 31, 2003 and decreased to approximately NIS 139.6 million for the year ended December 31, 2004. (Since the results for the year 2003 do not include proportional consolidation with HOT Vision, for comparison purposes, the EBITDA is presented assuming no consolidation with HOT Vision.)

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Through December 31, 2004, we have invested approximately NIS 2,119 million (approximately US\$ 491.9 million) in the build-out of our cable television network within our license areas and in other fixed assets. In July 2002, we and the other two Israeli cable television operators, Tevel and Golden Channels, submitted a request to receive a license to provide domestic fixed communications services. In October 2003, we and the other two Israeli cable television operators, acting through affiliates, entered into an agreement, as amended in November 2003, for the establishment of AMAT Telecom L.P., now known as HOT Telecom L.P., which would engage in the establishment and operation of a public telecommunications network based on the cable network of the cable television operators by which it will supply domestic-fixed telecommunications services.

In November 2003, the Ministry of Communications granted HOT Telecom the HOT Telecom Infrastructure License covering the same services covered by our Telecommunications Infrastructure License (to be supplied within the time frames set forth in the Telecommunications Infrastructure License), and also including the requirement to start to provide other services over cable networks including basic telephony services to subscribers by no later than November 25, 2004. The HOT Telecom Infrastructure License replaced and cancelled our Telecommunications Infrastructure License. HOT Telecom provides the following services: access to High Speed Internet over cable services, various data telecommunications services and various data transmission services and Infrastructure services. As of the end of November 2004, HOT Telecom has gradually commenced to provide commercial domestic fixed telephony services.

In November 2004, we concluded preliminary discussions to acquire the cable and communications assets of Tevel. If this transaction is completed, we would have over 560,000 cable subscribers, representing approximately 60% of the Israeli cable market, and we would hold 35% of Golden Channels, subject to certain terms. We have not signed a binding agreement with Tevel, and cannot be certain that this transaction will be completed, or if completed, on what timeframe or on what terms and conditions, including price. If this transaction were to take place, we would likely incur or assume substantial additional indebtedness.

We have expanded our telecommunications activities by investing in Barak I.T.C. (1995) The International Telecommunications Services Corp. Ltd., or Barak, an international telephony service provider in Israel, and in Partner Communications Company Ltd., or Partner, one of four licensed providers of mobile cellular telephone services in Israel, and one of the two providers using the global system for mobile telecommunications, a comprehensive digital standard for the operation of all elements of a cellular telephone system, known as GSM. For more information on Barak and the recent settlement with Barak's creditors, see Item 4B. Business Overview International Telecommunication Services.

As of April 2002, we beneficially held, through Matav Investments Ltd., approximately 15.2% of Partner's issued and outstanding shares. Following the sale of shares in Partner in April 2002, November 2003 and April 2005, we beneficially own approximately 1.2% of Partner's issued and outstanding shares.

We intend to delist voluntarily from the Nasdaq National Market and to terminate our American Depositary Receipt (ADR) program in the future. Our board of directors will examine the timing of such termination in the next few months. We intend to file a Form 15 with the SEC to terminate the registration of the ADRs and ordinary shares, thereby suspending our obligation to file annual and other reports with the SEC. After the delisting, our shares will continue to trade in the TASE and we will continue to make public reports in accordance with the Israeli securities laws and regulations.

### **Important events in the development of the cable television and telecommunications industry and our business**

#### Overview

Television broadcasting in Israel began in 1967 through one off-air government controlled channel, known as Channel 1. In 1993, private operators commenced regular commercial broadcasts of a second off-air channel, known as Channel 2, and later, an additional channel, the Israeli Knesset Channel. In April 2000, the Ministry of Communications approved the establishment of a second commercial channel (Channel 10), which began broadcasting at the beginning of 2002.



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In 1989, we, together with the other cable television operators, formed I.C.P. Israel Cable Programming Company Ltd., or ICP, for the purpose of jointly purchasing and producing our local cable channels, which then consisted of four channels: family, now known as HOT 3, movies, now known as HOT Movies, sport, and children's. The culture & science channel was later added. In January 2004, ICP changed its legal name to HOT Vision Ltd. Today, HOT Vision Ltd., or HOT Vision, creates, produces and acquires content for only two channels (HOT 3 and HOT Movies), and independent producers produce the other three channels. For a discussion regarding HOT Vision, please see Item 4B. Business Overview - HOT Vision and Cooperation of Cable Television Operators in Production of Broadcasting.

In 1990, the Ministry of Communications began issuing exclusive franchises to operate cable television systems in various geographical areas in Israel. Pursuant to amendments to the Telecommunications Law in 2001 the exclusive franchises were replaced by a system of general non-exclusive long term broadcast licenses, broadcasting HeadEnd licenses, and general non-exclusive telecommunications infrastructure licenses, all of which we have been granted. In November 2003, our Telecommunications Infrastructure License was replaced and cancelled by the HOT Telecom Infrastructure License. Please see the discussion regarding the HOT Telecom Infrastructure License in Item 4B. Business Overview - Domestic Fixed Communications.

### Direct Broadcasting by Satellite and Developments regarding YES

On January 5, 1998, the Israeli parliament approved an amendment to the Telecommunications Law, which allows the Ministry of Communications to grant licenses for distribution of direct broadcast by satellite (DBS) services to subscribers. The Ministry of Communications granted D.B.S. Satellite Services (1998) Ltd., or YES, a license for the provision of television broadcasts to subscribers via satellite, and YES commenced DBS broadcasting in July 2000. The development of competition to cable television services by the commencement of DBS broadcasting has adversely affected our business. Following a dispute arising out of the grant of the license to YES, and in consideration for the recognition by the government of our ownership of the cable television network infrastructure, in July 2001, the cable television operators entered into an agreement with the State of Israel pursuant to which the cable television operators, including us, undertook not to bring any claim in the future regarding the grant of a license to YES, and to make certain payments to the government over a 12 year period, commencing January 1, 2003.

On September 13, 2000, we, together with the other Israeli cable television operators, entered into an agreement with YES, under which we and the other cable television operators granted YES a non-exclusive permit to use our Inside Wiring for the transfer of satellite broadcasts (multi-channel television and interactive channels only); and YES granted the cable television operators a non-exclusive permit to use its Inside Wiring for the transfer of cable television broadcasts (including any other service provided by the cable television operators). This agreement has since been terminated by YES, and in place of that agreement, in September 2001 the Minister of Communications issued administration directives, which were amended effective as of February 3, 2002, governing the reciprocal use of Inside Wiring between the cable television operators and YES. The directives establish instructions regarding the procedures of transition for cable television subscribers to become subscribers to YES and vice versa. These directives also provide that YES shall pay fees to the relevant cable television operators for the use of their Inside Wiring, and that the cable television operators shall pay fees to YES for the use of its Inside Wiring. The directives stipulate what such amounts should be. In addition, the Minister of Communications has the authority to issue directives regarding the common use of the Inside Wiring by both YES and by the cable television operators, with regard to the provision of different services by each party. The Ministry of Communications conducted a hearing regarding the common use of Inside Wiring. To date, the Ministry has not issued directives regarding this matter. In January 2004, we and the other cable television operators reached an agreement with YES according to which YES will pay the aggregate amount of NIS 7.3 million (not including VAT) in consideration for the use of Inside Wiring for the period from January 2002 through December 2004. We are entitled to 26.6% of that amount. We, the other cable television operators and YES attempted to reach an understanding regarding the terms for YES's use of our Inside Wiring during 2005 and thereafter; however, this attempt was unsuccessful. On May 30, 2005, the cable television operators sent a letter to YES requesting that YES pay for the months of January to May 2005 in an amount equal to NIS 1.5 million, including interest and linkage differentials. On June 7, 2005, YES responded to the request, refusing to pay such amount and instead, suggesting to continue in negotiations in order to resolve the dispute. We are examining what additional procedures we may pursue.

In addition, the Telecommunications Law permits a person in residential premises to purchase from the service provider the Inside Wiring installed in the person's premises.

Digital Broadcasting

We commenced digital broadcasting in July 2001, pursuant to approvals from the Council for Cable and Satellite Broadcasting, or the Council, and the Ministry of Communications. These approvals allow us to broadcast in a digital format our analog basic package channels and Pay-Per-View services, as well as other channels that have been subsequently approved for digital broadcast. These approvals include authorization to provide electronic program guide services, commonly referred to as EPG services.

We informed the Ministry of Communications that we would provide digital set-top boxes to our subscribers principal connection according to actual demand as follows: up to 100,000 set-top boxes will be provided in 2001; 70,000 in 2002, and 60,000 in 2003. The remainder is to be provided during the year 2004. As of May 31, 2005, we have provided approximately 258,000 set-top boxes to our subscribers. We have already purchased approximately 280,000 set-top boxes. We have entered into various agreements to purchase additional set-top boxes.

Additional Packages and Services

As of March 1, 2005, we market to our digital subscribers, a new marketing method based on various combinations we offer our customers. According to the new marketing method, our digital subscribers, in addition to the basic package offered to them, may receive, at their choice, for additional consideration, content-products that include a variety of additional channels, channel packages and additional content products and services. In addition, as of March 1, 2005, we offer all of our subscribers a bundled package of our cable television offerings, access to High Speed Internet and telephony services (available only to subscribers in the areas where HOT Telecom has commenced providing telephony services) into a Triple Play offer. For more information about these services, see Item 4B Business Overview Additional Packages and Services.

Pay-Per-View, Video On Demand and Personal Video Recorder

We began offering Pay-Per-View services in October 2000. Pay-Per-View services are governed by our Cable Broadcast Licenses. As of January 2005, we have gradually provided Video on Demand, or VOD, services on a commercial basis. We intend to commence providing Personal Video Recorder, or PVR, services in July 2005. For more information about these services, see Item 4B Business Overview Products and Services.

High Definition Services

We recently commenced offering our subscribers an additional unique channel based upon high definition technology. For more information about these services, see Item 4B Business Overview Products and Services.

Internet Services

We received a license to provide ordinary dial-up Internet services in February 2000, and we commenced such services in April 2000. In parallel, we began to offer our subscribers access to High Speed Internet over cable on a trial basis, pursuant to a trial license.

According to the HOT Telecom Infrastructure License granted in November 2003 and amended on March 16, 2005, access to High Speed Internet services shall be provided through HOT Telecom. Specifically, pursuant to the March 2005 amendment, from the date of the grant of the HOT Telecom Infrastructure License and until the consummation of the merger amongst the cable television operators, HOT Telecom shall be entitled to contact with subscribers, including subscribers of the former infrastructure licensees of the cable television operators for the provision of access to High Speed Internet services through the former infrastructure licenses of the cable television operators, including our subsidiary Matav Infrastructure 2001 L.P., and the provision of the said service shall be deemed as a service rendered by HOT Telecom and the HOT Telecom Infrastructure License provisions shall apply. Please see the discussion regarding the HOT Telecom Infrastructure License in

Item 4B. Business Overview Domestic Fixed Communications Services . As of December 31, 2004, we provide access to High Speed Internet over cable services to 88,324 residential subscribers.

Ownership of Cable Infrastructure and Payments to the State of Israel

In light of the contention of the Ministry of Finance according to which, following the expiration of the cable television operators franchises, the cable television operators should pay the State of Israel appropriate consideration for the grant of a right to continue to provide multi-channel television services to subscribers, as well as other telecommunications services over the cable network, the cable television operators, including ourselves, came to an agreement with the State of Israel dated July 2001, in which we undertook, among other things, to make certain payments to the government over a 12-year period, and in consideration, each cable television operator received recognition by the government of its ownership of its respective cable television network infrastructure. Subsequent amendments to the Telecommunications Law adopted that agreement. The material terms of the agreement provide that:

- q Each cable television operator shall make payments to the government over a period of 12 years commencing on January 1, 2003, equal to its pro rata portion of a sum determined by multiplying certain accumulated income of all the cable television operators, including certain income derived from the use of cable infrastructure, by a percentage which is between 0% and 4%, increasing gradually according to the amount of such income. In the July 2001 agreement, it was agreed that our pro rata portion would be 24.1%, until agreed differently by all of the cable television operators.
- q Each cable television operator shall pay the State of Israel in the 12-year period up to 12% of its income from the sale of any activity related to the cable infrastructure or a right related to such activity, and the sale of certain assets as set forth in the agreement.
- q The Israeli government (subject to payment of payments by the cable television operators) undertook to waive any of its rights or claims regarding the ownership of the cable infrastructure.

As a result, each cable television operator is deemed to own all the rights to the cable network infrastructure in its license areas, and the right to operate it is subject to applicable law, following the expiration of the previous franchises.

In March 2003, the cable television operators approached the Israeli Ministry of Finance with a request to defer for one year the commencement of payments due under the July 2001 agreement. In April 2004, this request was rejected by the Accountant General of the State of Israel, and the Accountant General of the Ministry of Communications demanded that we pay all amounts outstanding in respect of 2003 and the first quarter of 2004 by May 31, 2004. On June 6, 2004, we reached an agreement with the Accountant General of the State of Israel regarding the terms of payment of our obligations in respect of 2003. We agreed to pay the amount owed in seven equal quarterly installments, beginning on July 21, 2004, and ending on January 21, 2006. The amounts outstanding with respect to 2003 are linked to the Israeli Consumer Price Index, and will bear annual interest at the rate of 5.9%. As of the date of this annual report, we have already paid 4 installments.

The July 2001 agreement, and its codification into law by way of amendments made to the Telecommunications Law, will continue to be in effect if the cable television operators consummate their proposed merger. Please see the discussion of the proposed merger below.

Proposed Merger of the Israeli Cable Television Operators

As of 2001, the cable television operators are acting in order to merge their activities. The purpose of the merger, among other things, is to enable us to provide additional telecommunications services, to increase our ability to compete successfully with Bezeq in the field of domestic fixed line services, including telephony, and, to cooperate in various areas, including purchase of content, marketing, sales and unified networks and effect substantial cost savings. The consummation of the merger is subject to reaching an agreement with the major Israeli banks and the other creditors of the merging entities addressing among other things, the assignment of certain of the current debts and securities to the merged entity, and its future financing, and receipt of approvals required under applicable law, including the approvals of the Income Tax Commission, the Council, the Controller of Restrictive Business Practices, or the Controller, and the Israeli court. To date, we have received approvals, subject to certain terms and conditions, from the Council, the Controller and the Income Tax Commission. Subject to the final terms of the merger, further approval of the Income Tax Commission to the merger may be required. See Item 4B. Business Overview Arrangement for a Merger of the Cable Television Operators .

In February 2003, we and the other Israeli cable television operators agreed on a final version of an agreement outlining the structure and conditions of a merger between us, including, inter alia, the terms of the agreement between the shareholders. The merger agreement, if, and when, it will be signed, will add to and broaden the terms of the previous arrangement between the parties executed on December 31, 2001, which cancelled and replaced previous arrangements between the parties. The parties have agreed that if the final version of the merger agreement has not been signed by July 31, 2003, or a later date agreed upon by the parties, the provisions of the agreement will not apply, the parties shall not have any claim or suit towards another party with respect to the proposed merger agreement and/or the shareholders agreement, and shall be free to act independently or together with others, without any limitation. To date, the agreement has not been signed.



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According to the position of the Supervisor of Banks, the merger of the cable television operators and the formation of a merged cable entity would constitute a deviation from the directives of the Bank of Israel and of Proper Bank Management Directives of the Supervisor of Banks regarding, among other things, restriction on debt amounts to a Group of Borrowers as such term is defined in the Proper Bank Management Directives. The relevant directives deal with certain limits applicable to loan amounts given by banking corporations to Sole Borrower and/or Group of Borrowers and as a result, attribution of the merged company's debts, among other things, to an indirect controlling shareholder of us and the other cable television operators.

Since the date of the approval of the Controller to the merger on April 22, 2002, we, Tevel and Golden Channels cooperate in most of our areas of activities, including but not limited to marketing and content related activities, and since the end of 2003 we carry out these activities under the brand name HOT.

In order to strengthen the cooperation of the three Israeli cable television operators, we, Tevel and Golden Channels agreed to perform an operational merger in June 2004. To this effect, a joint management was appointed to oversee the joint operation of the marketing, sales, engineering, customer service, operations and information systems activities of the three cable television operators. The joint management conducts and manages the Company's activities in the ordinary course of business in the areas of the joint activities. Material decisions applicable to the operational merger require our approval as well as the approval of Tevel and Golden Channels. Our approval is subject to the decision of our board of directors and other corporate bodies, as required by law. Since the appointment of the joint management and the commencement of the operational merger, we, Tevel and Golden Channels have operated jointly on a regular basis. The three cable television operators have agreed in principle that the allocation of the expenses deriving from the joint activity among themselves shall be proportional to the number of subscribers of each party. The operational merger does not include transfer of assets from any of the three cable television operators to a merged entity or from any of the three cable television operators to another cable operator. Each of the three cable television operators remains the sole owner of its assets and is entitled to the revenue generated from its own subscribers. Furthermore, the joint activity does not include transfer of liabilities owed to third parties, including, inter alia, banks or other creditors.

### Domestic Fixed Communications Services

We beneficially own approximately 26.6% of the rights in HOT Telecom. We and the other two cable television operators committed to provide access to our cable networks to HOT Telecom on terms and conditions to be determined. Furthermore, we agreed that if, during the 36 months following the date of signature of the partnership agreement our cable broadcasting and communications operations would be merged, the holdings of the parties in HOT Telecom, including the operations of HOT Telecom would be transferred to the merged entity for no consideration. HOT Telecom is obligated to invest in fixed line telephony cable infrastructure an aggregate of not less than NIS 350 million, that shall be invested as follows: not less than NIS 190 million until June 30, 2005, not less than NIS 160 million until June 30, 2006 and any other amount as shall be required for the fulfillment of its business plan for the provision of telephony services which fully compete with those of Bezeq. The Company's portion of the said investment (NIS 350 million), pro rata to its proportionate share in HOT Telecom, is estimated to be approximately NIS 93 million.

In October 2003, the limited partners of HOT Telecom also entered into an agreement to establish AMAT Telecom Ltd. to serve as general partner of HOT Telecom (with a 1% interest). On April 14, 2004, AMAT Telecom Ltd.'s name was changed to HOT Telecom Ltd. We beneficially own approximately 26.6% of HOT Telecom Ltd., and have the right to appoint two out of six directors to HOT Telecom Ltd.'s board of directors. This agreement includes provisions relating to the taking of decisions, distribution of profits and income, limitations on the transfer of rights in HOT Telecom Ltd. and the obligations of the three cable television operators to afford access to their cable networks to HOT Telecom and HOT Telecom Ltd.

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The abovementioned two agreements were made conditional upon the Israeli court overseeing Tevel's insolvency proceedings approving the entrance into such agreements by Tevel. On November 24, 2003, Tevel's trustee notified the court of, among other things, these agreements. To date, no decision, response or instruction has been received from the Court with respect to the approval of Tevel's entrance into these agreements. As of January 8, 2004, all of the approvals that were required in order for the arrangement of creditors of Tevel to become effective had been obtained, and accordingly the arrangement of creditors entered into effect. According to this arrangement, Tevel has reached agreement with its unsecured creditors, which has resulted in the settlement of all of the debts. According to the agreement reached with the secured creditors, Tevel's shares and remaining assets are subject to the right of Tevel's secured creditors which are banks to realize these shares and assets to cover Tevel's debts to these secured creditors.

On September 17, 2002, the Minister of Communications adopted, with certain changes, the recommendations of a committee formed by the Ministry of Communications for the establishment of policies and rules for the opening of competition in the field of domestic fixed communications services, as the guiding principles in this field. In order to implement the committee's recommendations, the Israeli parliament approved an amendment to the Telecommunications Law at the end of May 2003. Under this amendment, as of September 1, 2004, the Minister may grant a special general license for domestic fixed telecommunications services without imposing on the holders of such licenses the obligation to provide their services to the entire public throughout the entire country or in any specifically defined area in Israel. The Ministry of Communications published the language of the special general license. In June 2004, the Ministry published new regulations setting forth the conditions and procedures for obtaining a special general license for domestic fixed telecommunications services. Under the said regulations, any applicant may be granted with such a license, provided it is able to comply with several basic conditions which are listed in the said regulations.

On November 30, 2004, the Ministry of Communications issued policy principles to license the provision of telephony services by Voice-Over Broadband access (VoB) (the policy principles). Pursuant to the policy principles, the provision of fixed-domestic VoB services shall be organized in the context of a unique domestic operator license, according to which the provision of telephony services is to be performed by VoP technology while using the broadband access of a domestic operator (currently Bezeq or HOT Telecom). According to the policy principles, licenses to provide VoB services shall be granted in 2005 in a manner that the commencement of operations by virtue of the licenses shall be feasible on May 1, 2005. It was further determined that for the time being, an owner of VoB license shall not be charged to pay the domestic operator for using the domestic operator's network. The Ministry, in its policy principles, noted that it intends to complete soon the policy on the provision of VoB services by broadband access network of cellular operators. In addition, the policy principles indicated that Bezeq shall be entitled to provide VoB services at the earlier of May 1, 2007 or after its customer segment in the area of the fixed-domestic telephony (business or private segments) shall decrease below 85%, and a subsidiary of Bezeq shall be able to provide VoB services subject to restrictions stipulated in the unique domestic operator's regulations.

Following the policy principles and as a result of applications by Bezeq and HOT Telecom, the Ministry of Communications, on December 29, 2004, sent a letter to various parties including Bezeq and HOT Telecom thereby enabling them to present their position with respect to the ramifications of the policy principles on them and with respect to the manner and the timing of Bezeq's participation in the provision of VoB services, directly or through a subsidiary. In a reply to the Ministry of Communications, HOT Telecom filed a detailed status paper in which it demanded to revoke the policy principles alleging that they constitute a deviation from the policy to organize the communications market in Israel on a facilities based competition and that the resolution of the Ministry of Communications to enable the provision of VoB services while using the domestic operator infrastructures constitutes an illegal impairment of the proprietary right of the infrastructure's owner. In addition, it was alleged that the resolution pursuant to which the VoB operator shall not be charged with a payment for using the domestic operator's infrastructure lacks authority and is devoid of reasonableness and results in economic distortions and the ministry is required to enable the payment of access fees to the domestic operator for using its infrastructures for providing the VoB service. Alternatively, HOT Telecom requested to adjourn the date for granting the VoB licenses until after HOT Telecom shall reach a market segment of 5% of the fixed-domestic telephony industry. In addition, HOT Telecom claims that the resolution of the Ministry of Communications to enable the use in the domestic operator's infrastructures to provide cellular VoB service without, at the same time, enabling HOT Telecom to provide VoB service over the cellular infrastructures, is unreasonable and discriminatory amongst the operators.

Following a hearing held by the Ministry of Communications regarding its policy principles, on April 20, 2005, the Ministry of Communications notified HOT Telecom, in writing, that it is considering to amend its policy principles, thus, enabling Bezeq or a subsidiary on its behalf to provide VoB services in the event that Bezeq's share of the fixed domestic telephony market, in the business or private segments, shall decrease below 85%. In addition, the Ministry of Communications notified HOT Telecom of its intention to establish two testing points, the first to be established in November 2006 and the second to be established in November 2007, in which, the possibility to allow Bezeq or a subsidiary on its behalf to provide VOB services shall be examined, even if Bezeq's share market has not decreased below 85%. In its response to the letter, HOT Telecom, has repeated its previous position, according to which, Bezeq or a subsidiary on its behalf should not be allowed to provide VOB services, as long as Bezeq constitutes a monopoly in the fixed domestic telephony market, that is, so long as Bezeq holds 50% of the fixed domestic telephony market. In addition, HOT Telecom expressed its rejection to the establishment of the testing stations.

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Pursuant to the abovementioned regulations and policy principles, the Ministry has granted several special marketing licenses for experimental provision of fixed line telephony services by broadband access (VoB), inter alia, to ISP, cellular and international communications licensees.

In March 2004, the Minister announced its new policy with respect to Bezeq's general license. Specifically, the policy provides that Bezeq may offer discounts for size at a rate of up to 10% and may request to amend its license in a manner that it will be able to market bundled services when its market share of the fixed domestic telephony industry (residential or business customers) decreases below 85% or if the competitive status of Bezeq's subsidiary, YES, has significantly deteriorated. With regard to YES, the Minister determined that a significant deterioration in the competitive status shall be a situation in which its market segment in the industry of multi channel-broadcast to subscribers decreased below 25% of all subscribers in that market. On January 9, 2005, the Minister resolved to raise the deterioration threshold in the competitive status of YES from 25% to 29%. This policy enables Bezeq to provide services jointly with its affiliates, which it was not allowed to do in the past, including among other things, telephony services (local and international), multi-channel television services, cellular services and access to High Speed Internet services. As a result of this policy, HOT Telecom may not be able to compete effectively with Bezeq and others, and it may not recover its significant investments in telephony services. In addition, the offering by Bezeq of bundled services, including multi-channel television services through YES, may have a material effect on our ability to supply telephony services to our subscribers and could cause us to lose multi-channel television subscribers. Accordingly, we may suffer losses as the result of our holdings in HOT Telecom, which would affect our results of operations.

According to a recent amendment to the Communications Regulations (Bezeq and Broadcasting) (Payments for Interconnection), which, inter alia, set the Bill and Keep arrangement, which applies between Bezeq and HOT Telecom, as follows: Bezeq and the domestic operator (except for a unique domestic operator and Bezeq) will not make payments to each other for interconnection as stated in the aforesaid regulation, and each of them will bear their costs in this respect, subject to the fulfillment of the following cumulative conditions: (i) two years have not yet elapsed from the date on which the domestic operator commenced providing telephony services on a commercial basis, as the Minister of Communications informed the concerned license holders (according to the Minister of Communications the date applicable with respect to HOT Telecom is November 25, 2004); and (ii) the difference between the total minutes of traffic originating in the domestic operator's aforesaid network and their destination being the domestic operator network of Bezeq and the total minutes of traffic originating in the domestic operator's network of Bezeq and their destination being domestic operator's aforesaid network does not exceed 1,050,000,000 minutes of traffic.

Bezeq has withdrawn a petition it submitted to the Supreme Court with respect to the recent amendment at the recommendation of the court.

**4B. BUSINESS OVERVIEW**

We operate digital and analog cable television systems and provide a variety of channels and programs as one of three cable television operators in Israel. We believe that Israel is and will continue to be an attractive environment in which to provide cable television services for the following reasons:

*Multi-Channel Cable Television Market.* As of December 31, 2004, there were approximately 1.84 million homes covered by cable networks in Israel, with a penetration rate of approximately 52.5%. The high penetration rate for multi-channel cable television services in Israel is attributable to the high penetration of televisions, multiple televisions in homes, and the fact that we provide various programs and services.

*Subscriber Base.* Between 2001 and 2004, the population of Israel grew at an average rate of approximately 1.8% per year. In 2004, our number of cable television subscribers decreased. Of our cable television subscribers, our number of digital subscribers increased, and our number of subscribers for other services provided over cable increased. During the same period, our number of access to High Speed Internet subscribers increased.

*Diverse Population.* The cultural and linguistic diversity of Israel's population has created a large pool of potential cable television subscribers with different viewing needs. From 1991 through the end of 2004, approximately 938,000 new immigrants arrived in Israel, representing approximately 52% of the increase in Israel's population during that period. In addition, a substantial portion of Israel's population consists of first or second-generation immigrants, many of which we believe continue to speak the language of their country of origin and maintain strong cultural ties to that country.

*Digital Broadcasting Services.* In July 2001, we began to provide digital broadcasting services, in addition to the analog broadcasting services which we provided all along. We offer our digital subscribers the digital Basic Package. In addition, digital subscribers may receive, at their choice, for additional consideration, content-products that include a variety of additional channels, channel packages and additional content products and services. For additional information on the Basic Package, please see Item 4B. Products and Services.

*Growth in the Number of Channels and Diversity of Content.* We provide our subscribers with the most widely viewed cable television broadcasts in Israel. We continually aim to increase the number of channels we provide and improve the diversity of content, including channels in various languages for a large spectrum of viewers, in accordance with the perceived requirements of our subscriber base. The following are the new channels that we provide since January 1, 2001, most of which are subtitled or dubbed in Hebrew or Russian, which we believe promote viewer interest in cable television in Israel. The list is up to date as of May 31, 2005.

- q Added during 2001: the children's channel ( Fox Kids ); the Indian entertainment channel ( Zee TV ); the Romanian entertainment channel ( Pro TV ); the youth channel ( BIP ); the 40 audio music channels; the European culture channel, ( ARTE ); the action channel ( Reality ); the Arabic family, sport, children movie and music channels ( ART 1, 2, 3, 4 and 5); the entertainment channel ( E! ); the History Channel; the movie channels ( HOT Drama , HOT Action , and HOT Fun ); the movie channel ( MGM ); the Adventure channel ( Adventure 1 ); the lifestyle channel, ( The Good Life ); the telenovella channel ( Viva Platina ); the sports channels ( Sport 5+ ); and ( NBA ).
- q Added during 2002: the life style channel ( The Mens Channel ); the movie channel ( HOT Prime ), and four music channels ( MTV Base , MTV 2 , MTV Hits , and VH1 Classic ); the Russian movie channel ( MF ); the news channel ( Fox News ); the sports channel ( Eurosport ); the economics channel ( CNBC ); the sports channel ( Fox Sport ); and 4 regional radio channels.
- q Added during 2003: the Russian channel ( NTV Mir ); the sports channel (the Teams channel ); the Russian History channel ( History Russian ); the Judaism channel ( Techelet ); the Playboy channel (reinstated); the children's knowledge channel ( Logi ); and the Russian Telenovela channel ( Romantica ).
- q Added during 2004 : the Academic channel; the General Russian channel ( Moscow Open World ); the Extreme sports channel; Home+ channel; Karma channel; the Parents channel; the Campus channel;; Nickelodeon channel; the TVR channel; Inter Plus channel; the Baby channel ( Luli ); and the Private Blue channel.
- q Added through May 2005: the premium series channel ( X-tra HOT ) and the High Definition channel.



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For more information on the channels, see Item 4B. Business Overview Programming.

*High Definition.* We have recently commenced offering our subscribers a channel transmitted in High Definition technology. For more information about this channel, see Item 4B. Business Overview Products and Services.

*Additional Services.* We began offering Pay-Per-View services in October 2000, which are commenced by digital and analog HeadEnd equipment and received at the subscribers premises by analog and digital set-top boxes. As of January 2005, we have gradually provided Video on Demand services on a commercial basis to our subscribers. We also intend to commence providing Personal Video Recorder services to our subscribers in July 2005. For more information about these services, see Item 4B. Business Overview Products and Services.

*Interactive Services.* Since the end of 2001, we have provided interactive services to our digital subscribers. For more information about these services, see Item 4B. Business Overview Products and Services.

*Access to High Speed Internet Over Cable Services.* On April 8, 2002, as part of our competitive activity in the telecommunications market, we began to provide access to High Speed Internet over cable services through our infrastructure.

*Services to the Business Sector.* HOT Telecom has commenced the marketing of additional communication services designed for businesses, such as Internet for businesses, various data transmission services and network services at different bit rates, including Internet Protocol Virtual Private Network, or IP VPN, Synchronous Digital Hierarchy, or SDH, services, and IP services . Please see the tables relating to our services to the business sector under Item 4B. Business Overview Services for the Business Sector .

*Domestic Fixed Line Telephony Services.* As of the end of November 2004, HOT Telecom has gradually commenced to provide commercial domestic fixed telephony services. For more information on HOT Telecom s domestic fixed line telephony services, see Item 4B. Business Overview Domestic Fixed Line Telephony Services.

*Technologically Advanced Infrastructure.* Due to the relatively recent buildout of the cable television industry in Israel, operators utilize advanced technologies, such as broadband, hybrid fiber optic/coaxial, or HFC, cable networks and digital video broadcasting, or DVB, platforms. The main benefits of using such technologies are the potential for greater capacity, increased functionality, improved broadcasting quality, and development of two-way communication based services. We installed and utilize a DVB platform, and previously upgraded our HFC network into a full two-way expanded bandwidth plant. We successfully employ access to High Speed Internet over our cable platform. We have upgraded our infrastructure to allow us to provide data over cable services. The technology upgrade is compliant with the technologies of the other parties to the proposed merger of the Israeli cable television operators. Based on our infrastructure, we plan to gradually implement more service layers, such as enhanced television interactive applications and other services, which utilize the cable television platform advantages over other alternative platforms.

*Integrated Fiber-Optic Network.* The broadband networks of the three cable television operators in Israel are connected through nationwide fiber optic cable links. This interconnection is currently being used for sharing resources, for mutual back up measures and in order to create a uniform platform for new access to High Speed Internet services provided by us, Tevel and Golden Channels. That network also creates an opportunity, subject to regulatory approvals, to develop and provide subscribers throughout Israel with services such as telecommunications using the already installed cable television infrastructure networks.

### Strategy

Our mission is to leverage our cable television infrastructure and market share to be a leader in the Israeli telecommunications and entertainment industry. In order to achieve our mission, we are implementing strategies designed to:

- q increase our range of video on demand and interactive value-added services offerings to our subscribers;
- q enhance our broadband internet services, complete the rollout of our new domestic fixed line telephony services and gain significant market share in this area;

- q combine our cable television offerings, access to High Speed Internet and telephony into a triple play offer, with a view to increase revenues, reduce costs by lowering churn while increasing customer loyalty, and increase profitability of our operations; and
- q focus on our customer relations, inter alia, by improving the efficiency and responsiveness of our customer service.

#### **Competitive Strengths**

We believe that the following competitive strengths differentiate us from our competitors and will assist us in achieving our mission and implementing our strategies:

- q state-of-the-art technology and an advanced network and infrastructure which we own entirely, including two-way broadband transmission, HFC cables, a fully developed IP network for the supply of broadband internet access and near completion of a brand new state-of-the-art telephony over cable IP network, and a fully digitalized broadcasting system;
- q a diversified and rich selection of programming content, including the supply of unique VOD services;
- q high quality of broadcasting service and support for subscribers;
- q bundle packages of our cable television offerings, access to High Speed Internet and telephony into a triple play offer;
- q as of December 31, 2004, a large subscriber base which contains approximately 257,344 subscribers, constituting a penetration rate of approximately 52% in our license areas ;
- q a highly experienced and dedicated management team and staff;
- q technological unique advantages comprised of wide bandwidth, 2-way communication, one pipe for various multiple services ( triple play i.e., voice, data, TV, VOD, PVR, access to High Speed Internet, etc.), and segmented network (which allows reuse of bandwidth and implementation of narrowcast and Unicast service).;
- q reasonable fees for our cable television broadcast offerings and access to High Speed Internet over cable services, telephony services, and for other services; and
- q offering various value-added services to our subscribers, including services targeted to the business sector.

#### **Availability and Sources of Programming**

The increasing availability of cable television in Israel has provided an attractive alternative to the limited off-air television programming and the use of video cassette recorders and DVDs. We offer cable television analog and digital subscribers a single tier of basic service within the framework of the analog and digital Basic Packages. We offer our digital subscribers the possibility for additional channels and packages within the framework of our Premium Broadcastings and services and various marketing combinations that include the Basic Package and additional products, according to the subscriber's choosing. Two of the most popular channels available to cable television operators in Israel are provided by HOT Vision. The three cable television operators in Israel currently provide the same program scheduling on all of the channels in each of their license areas, enabling subscribers throughout Israel to watch the same program at the same time under the brand name HOT. For information regarding the channels and packages included in the Basic Packages and the Premium Broadcastings, see Item 4B. Products and Services - Basic Packages and Item 4B: Products and Services Additional Packages and Services .

We aim to diversify and improve the content quality we provide to our subscribers. We do so by adding new broadcasting channels and enriching the existing ones, including the VOD services, which offer a wide range of programming, and new interactive channels and applications. See the discussion in Item 4B. Business Overview Growth in the Number of Channels and Diversity of Content .

## Products and Services

### *Overview of our Cable Television Services*

We offer cable television analog and digital Basic Packages, and we offer our digital subscribers Premium Broadcastings and a variety of channel packages and combinations.

Subscribers are offered access to a variety of Hebrew language programming (including original, subtitled and dubbed), a home shopping channel, off-air channels originating in Israel and other selected countries, and satellite television channels. We charge subscribers an initial installation fee of NIS 99 including VAT, and a monthly subscription fee for the analog and the digital Basic Packages of approximately NIS 170.9-176.5 including VAT and 186.5 including VAT, respectively. We also require a deposit of approximately NIS 99 including VAT, for the regular analog set-top box (for those subscribers without cable-ready televisions), or NIS 198 including VAT, for the addressable analog set-top box, and a deposit of approximately NIS 399 including VAT, for the digital set top box. We partially refund the deposit when the set-top box is returned. The refund amount (which is linked to the Israeli consumer price index) is reduced by 10% of the value of the set-top box for depreciation each year or each partial year commencing from the date of installation of the set-top box and until the date we cease to provide services to such subscriber. Alternatively, our subscribers may elect to lease the set-top box for a monthly fee that ranges between NIS 9 and NIS 11 including VAT. We are allowed to sell the set-top box to a subscriber, at the subscriber's option, in consideration for an amount not exceeding the value of the set-top box. In certain marketing campaigns, we fully refund the first set-top box given to our new customers in return for certain obligations to the company. We also charge subscribers fees for reconnection, installation of additional outlets in subscribers households, and provision of cable television services on the additional outlets. The fees set forth above include value added tax at a rate of 17%.

### *Programming*

We currently transmit programming on varying numbers of channels in our operating areas, which consists of off-air channels, local channels, satellite channels, dedicated channels, and other channels. The tables set forth below present our analog and digital Basic Packages and those additional channels and packages that are included within the Premium Broadcastings, which we provide to digital subscribers in the tiering system. For a discussion of the risks related to programming, see Item 3. Risk Factors, and for a discussion of certain of our costs associated with programming, see Item 5. Operating Results Results of Operations Operating Expenses.

We and the other cable television operators have agreed, to pay royalties to certain organizations representing Israeli performing artists with respect to copyrighted materials broadcasted by the cable television operators. For the years ended December 31, 2002, 2003 and 2004, we recorded royalties expenses with respect to such organizations of approximately NIS 2.9 million, NIS 2.8 million and NIS 3.6 million, respectively.

*Off-Air Channels.* The off-air channels we transmit to our subscribers are the Israel Broadcast Authority channels (Channel 1, Channel 33) and Channel 2. Although subscribers can receive transmission of these off-air channels through a household antenna or a satellite dish, the antennae located on our HeadEnds enable subscribers to obtain superior picture and sound quality.

*Satellite Channels.* We transmit to our subscribers broadcasts of foreign and Israeli television channels which we receive at our HeadEnds via satellite. We pay fees for the right to transmit certain of these broadcasts. We have not received permission to transmit the respective broadcasts from all foreign satellite television operators whose broadcasts we transmit. However, pursuant to our Licenses, and subject to the permission of the Council, our freedom to remove channels from the Basic Packages is limited. The telecommunications rules prohibit the broadcasting of channels or programs without the consent of the original broadcaster. Furthermore, there can be no assurance that the satellite television operators to whom we do not currently make payments will not request payments from us in the future. In addition, a lawsuit was filed against us in connection with these matters. See Item 8A. Consolidated Statements and Other Financial Information - Legal and Arbitration Proceedings.

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*Special Cable Television Licenses.* Under the Telecommunications Law, we are required to provide up to one-sixth of our network capacity for broadcasting to holders of special cable television licenses for specific channels. In addition, we have allocated programming time to broadcasting by local community organizations and the public educational channel, which we are obliged to broadcast according to the Telecommunications Law. With the exception of the broadcasts by local community organizations and the public educational channel, all such special cable television licensees are required to pay for the use of our network capacity. We are under an obligation to allow other broadcast license holders to have access to our network infrastructure, within three months from the date requested by the other licensee or producer. According to the approval of the Controller to the proposed merger, if we are unable to reach a commercial agreement with such broadcast licensee or producer within 60 days, the matter must be referred to arbitration and the arbitrator must act in accordance with the instructions of the Controller.

*Shopping Channel.* In late 1995, we began transmitting a home-shopping channel, which offers products directly to cable television subscribers, known as the Shopping Channel. The Shopping Channel is broadcast pursuant to a special broadcast license and is provided to our subscribers as part of the digital and analog Basic Packages.

*Commercial Advertising and Dedicated Channels.* According to the Telecommunications Law, the Council may grant special licenses to independent producers of specific dedicated cable television channels, and such channels may be entitled to offer commercial advertising. The Economic Committee of the Israeli Parliament, or Knesset, decided on January 27, 1998, that such dedicated channels will be: an Arabic channel, a Jewish traditional channel, two news channels, an Israeli music channel and one channel or more in foreign languages for new immigrants arriving to Israel. In 2001 and 2002, the Council selected winning bids for the tender for a News Channel, a general Russian Channel and an Israeli music channel, all of which are permitted to broadcast commercials. The general Russian Channel commenced broadcasts as of November 2002. The Israeli music channel commenced broadcasts as of June 2003. The Council decided to cancel the license granted by it to the News Channel as a result of the News Channel's failure to timely commence broadcasting. To date, the Arabic channel has not commenced broadcasts. A bid for the Jewish traditional channel was published by the Council. As of the date of this annual report, a bidder has not been selected.

Currently Channel 2, Channel 10, the general Russian Channel and the Israeli music channel are the only locally produced channels (which have commenced broadcasting) that have permits to air commercials. Some foreign satellite channels also air commercials. In addition to the prohibition on broadcasting commercials on our local channels, the Telecommunications Law, as amended, prohibits the broadcasting of commercials on channels that the Council has decided are targeted mainly to the Israeli public, without the prior approval of the Council. The Council has set certain criteria regarding these stipulations.

The approval of the Controller to the merger of the Israeli cable television operators provides, among other things, that if the merged broadcasting entity receives approval to air advertisements on its channels, then the Controller shall have the power to impose additional restrictions upon the entity. We have no assurance that the merged entity shall receive any such approval to air commercials.

*Locally Produced Programming.* In 1989, together with the other Israeli cable television operators, we established a company named ICP Israel Cable Television Programming Company Ltd., which is now known as HOT Vision Ltd., for the purpose of jointly purchasing and producing content for our local channels. Today, HOT Vision creates, produces and acquires content for two channels (HOT 3 and HOT Movies). We own approximately 26% of HOT Vision and make payments to it based on the number of our subscribers. For the years ended December 31, 2002, 2003 and 2004, we paid HOT Vision approximately NIS 62.0 million, NIS 54.0 million and NIS 50 million, respectively.

*Local News Broadcasts.* Our licenses also require that we provide periodic local news broadcasts in our license area. The content of our local news and local community programs varies in our operating areas. In accordance with the Council's decisions of December 2002, February 2003 and June 2005, Cable Broadcasting Licensees are required to produce local news broadcast for five license areas through an external producer, subject to the Council's approval. We and the other two Israeli cable television operators entered into an agreement dated January 5, 2003, as amended on March 5, 2003, with Today's Cable News—the Local News Company Ltd., commonly referred to as JCS, whereby JCS shall produce local news for the cable television operators for their respective areas.

### **Basic Packages**

In accordance with Israeli law and our Broadcasting License, we must provide each of our subscribers (analog and digital) basic broadcasts that include:

- q Channels 1 and 33 of the Israeli Broadcasting Authority;
- q the commercial channels (Channels 2 and 10);
- q the Knesset channel;

q the Israeli educational channel;

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- q channels of special cable licensees according to the Council's instructions, on the digital service only - we currently broadcast Tourism, Health and Leisure from the Teva Hadvarim Group;
- q dedicated channels pursuant to the Telecommunications Law (which currently only include the Shopping Channel, Russian Channel and Music Channel,);
- q regional news and community broadcastings; and
- q the EPG service, on the digital service only.

Our Cable Broadcast Licenses stipulate that, in the event that we wish to reduce the scope of the basic broadcasts, we must request the Council's approval. In the event that the scope of the analog basic broadcasts has been reduced, the Council may instruct us (subject to the approval of the Minister) to reduce the price for such reduced package to an amount determined by the Council. In such case, we would be entitled to present our position to the Council prior to it rendering its decision.

Our Cable Broadcast Licenses stipulate that we may not charge our analog subscribers for the basic broadcasts more than approximately NIS 148 plus VAT in the Holon/Bat Yam and Haifa/Hadera regions, approximately NIS 140 plus VAT, in the Sea of Galilee/Netanya region, and approximately NIS 141 plus VAT, in the Golan/Safed and Kiryat Shemoneh region. Additionally, we may not charge our analog subscribers for a movie provided on Pay-Per-View basis more than approximately NIS 15 plus VAT, per broadcast. We may link our fees to the Israeli consumer price index from February 2002 (subject to regulations and the provisions of our licenses). Our Cable Broadcast Licenses do not stipulate fees for digital subscribers. Under regulations promulgated pursuant to the Telecommunications Law, we may determine our subscriber fees for digital subscribers (including the basic broadcasts package). The fees that we set for our digital subscribers must be reasonable, and the Minister may direct us to adjust such fees if he finds, among other things, that they are harmful to competition, discriminatory or misleading. The Council's approval to the proposed merger of the Israeli cable television operators (as amended) stipulates, as a condition to the merger, that we, or the merged entity, will be subject to a maximum subscriber fee for both the digital and analog basic broadcasts packages of NIS 156 including VAT once the merger will be consummated. The subscriber fee will be linked to an index which includes the Israeli consumer price index of December 2001 (published January 15, 2002) and the US dollar exchange rate as published by the Bank of Israel, or any other index as shall be determined in regulations. The effectiveness of the Council's condition regarding the linkage to the combined index is subject to the amendment of the applicable regulations promulgated under the Telecommunications Law. To date, the Ministry has not adopted such an amendment. For more information on fees we charge our subscribers, see Item 4B Business Overview Overview of our Cable Television Services.

The Council has determined that all channels in the Basic Package on our digital platform must be included in the Basic Package on our analog platform, unless otherwise authorized by the Council.

### Digital Basic Package

The following table lists information regarding the Basic Package that we offer to our digital subscribers as of April 30, 2005.

Channel	Description	Language <sup>(1)</sup>
HOT 3	Entertainment	Hebrew
HOT Movies	Cinema Movies	Hebrew
Sport	Local and intentional games & Competition	Hebrew
Children	Cartoons, movies & other children entertainment	Hebrew
MTV	Europe video music	English
Channel 8	Culture, Science & Education	Hebrew and Russian
Local Channel	Local news & others-general	Hebrew
Channel 9	Russian channel	Russian
Channel 10	Third national channel	Hebrew
Israel 1	First national channel	Hebrew
Israel 33	General Channel of the Israel Broadcasting Authority	Arabic/Hebrew/English



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<b>Channel</b>	<b>Description</b>	<b>Language <sup>(1)</sup></b>
CNN	World news	English
Sky news	World news	English
BBC World	Collection of BBC best programs	English
Fox News	World News	English
Channel One-Russia	Russian channel	Russian
RTR Planeta	Russian channel	Russian
NASHA KINO	Russian Channel	Russian
RTV Int	Russian Channel	Russian
NTV MIR	Russian Channel	Russian
Moscow Open World	Russian Channel	Russian
National Geographic	Localized channel of NGC	Hebrew
Academic Channel	Academic Lectures	Hebrew
Star World	Entertainment	English
Shopping	Israeli shopping channel	Hebrew
Israel 2	Second national channel	Hebrew
Education	Israeli educational channel	Hebrew
Music 24	Israeli Music	Hebrew
Knesset	Israeli parliament channel	Hebrew
Nickelodeon	Children s channel	Hebrew/English
SAT 3	German channel	German
RTL	German channel	German
TV5	French channel	French
France 2	French channel	French
Arte	Culture	French
Euro sport	European sport broadcasting	English
VH-1	Video Music	English
TVE	Spanish channel	Spanish
RETE 4	Italian channel	Italian
TRT 1	Turkey 1	Turkish
TRT 2	Turkey 2	Turkish
INTERSTAR	Turkish channel	Turkish
DUNA TV	Hungarian channel	Hungarian
Emergency (2)	Emergency communications	Hebrew
SAT 1	German channel	German
LBC	Arabic channel	Arabic
Viva	Teledrama Channel	Hebrew
Fashion TV	Fashion TV	French
MEZZO	Classic Music Channel	French
Hop	Children Channel	Hebrew
Hallmark	Series and Movies	Hebrew/Russian
HOT Time	Pay-Per-View Portal	English/Hebrew
BBC Prime	English channel	English/ Hebrew
AXN	Action	Hebrew
TCM	Movies	English/Hebrew
ESPN	Sport	English
CARTOON	Cartoons, movies & other Children entertainment	English
TV 7-TUNIS	Tunisian channel	Arabic
Jordan	Jordanian channel	Arabic
Jordan	Jordanian channel	English
Morocco	Moroccan national channel	Arabic
Egypt	Egyptian national channel	Arabic
METV	Free Lebanon television	Arabic/English
MBC	Arabic channel	Arabic
Almustakbal	Entertainment	Arabic
Saudia	National	Arabic
Syria	National	Arabic
Aljazeera	News	Arabic
Dubai	National	Arabic
EPG	User Guide	Hebrew/English /Russian



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User Guidance Channel  
Radio Channels

User Guidance Channel  
Music, News General

Hebrew /Russian  
Hebrew /Russian

- (1) Originated, subtitled or dubbed, as indicated.
- (2) Operates only during emergencies.

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Analog Basic Package

The following table lists information regarding the Basic Package that we offer to our analog subscribers as of April 30, 2005.

Channel	Description	Language <sup>(1)</sup>	Bat-Yam/ Holon	Haifa	Netanya/ Hadera	Golan	Arab section	Galilee
HOT 3	Entertainment	Hebrew	ü	ü	ü	ü	ü	ü
HOT Movies	Cinema Movies	Hebrew	ü	ü	ü	ü	ü	ü
Sport	Local and intentional games & Competition	Hebrew	ü	ü	ü	ü	ü	ü
Children	Cartoons, movies & other Children entertainment	Hebrew	ü	ü	ü	ü	ü	ü
MTV	Europe video music	English	ü	ü	ü	ü	ü	ü
Channel 8	Culture, Science & Education	Hebrew/Russian	ü	ü	ü	ü	ü	ü
Channel 9	Russian channel	Russian	ü	ü	ü	ü	ü	ü
Local channel	Local news & others	Hebrew	ü	ü	ü	ü	ü	ü
TVE	Spanish channel	Spanish	ü	ü	ü	ü		ü
Channel 10	Third national channel	Hebrew	ü	ü	ü	ü	ü	ü
Israel 1	First national channel	Hebrew	ü	ü	ü	ü	ü	ü
CNN	World news	English	ü	ü	ü	ü	ü	ü
Sky news	World news	English	ü	ü	ü	ü	ü	ü
ORT Russia	Russian channel	Russian	ü	ü	ü	ü	ü	ü
RTR Planeta	Russian channel	Russian	ü	ü	ü	ü		ü
National Geographic	Localized channel of NGC	Hebrew	ü	ü	ü	ü	ü	ü
Star World	Entertainment	English	ü	ü	ü	ü		ü
RETE 4	Italian channel	Italian	ü	ü	ü	ü	ü	ü
Shopping	Israeli shopping channel	Hebrew	ü	ü	ü	ü	ü	ü
Israel 2	Second national channel	Hebrew	ü	ü	ü	ü	ü	ü
Education	Israeli educational channel	Hebrew	ü	ü	ü	ü	ü	ü
SAT 3	German channel	German		ü		ü	ü	ü
RTL	German channel	German	ü	ü	ü			ü
Jordan	Jordanian channel	Arabic				ü	ü	
TV Guide	TV broadcasting programs	Hebrew	ü	ü	ü	ü		ü
Morocco	Moroccan national channel	Arabic	ü	ü	ü	ü		ü

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Channel	Description	Language <sup>(1)</sup>	Bat-Yam/ Holon	Haifa	Netanya/ Hadera	Golan	Arab section	Galilee
Egypt	Egyptian national channel	Arabic	ü	ü	ü	ü	ü	ü
METV	Free Lebanon television	Arabic/English	ü	ü	ü	ü	ü	ü
MBC	Arabic channel	Arabic	ü	ü	ü	ü	ü	ü
Israel 33	General channel of the Israeli Broadcasting Authority	Hebrew	ü	ü	ü	ü	ü	ü
Knesset	Israeli Parliament channel	Hebrew	ü	ü	ü	ü	ü	ü
TV5	French channel	French	ü	ü	ü			ü
France 2	French channel	French	ü	ü	ü	ü		ü
Euro sport	European sport broadcasting	English	ü	ü	ü		ü	ü
VH-1	Video Music	English	ü	ü	ü	ü	ü	ü
TRT1	Turkey 1	Turkish	ü		ü			
TRT2	Turkey 2	Turkish	ü					
DUNA TV	Hungarian channel	Hungarian	ü	ü	ü	ü		ü
Emergency (2)	Emergency communications	Hebrew				ü		ü
TV 7 -TUNIS	Tunisian channel	Arabic			ü	ü		ü
LBC	Arabic channel	Arabic		ü		ü	ü	
Viva	Teledrama Channel	English / Hebrew	ü	ü	ü	ü	ü	ü
Fashion TV	Fashion TV	French	ü	ü	ü	ü		ü
MEZZO	Classic Music Channel	French	ü	ü	ü	ü	ü	ü
Hop	Children Channel	Hebrew	ü	ü	ü	ü	ü	ü
RTV Int.	Russian Channel	Russian	ü	ü	ü	ü		ü
Hallmark	Series and Movies	English/ Hebrew	ü	ü	ü	ü	ü	ü
BBC Prime	English channel	English/ Hebrew	ü	ü	ü	ü	ü	ü
AXN	Action	English/ Hebrew	ü	ü	ü	ü	ü	ü
TCM	Movies	English/ Hebrew	ü	ü	ü	ü	ü	ü
ESPN	Action	English	ü	ü	ü	ü	ü	ü
CARTOON	Cartoons, movies & other Children entertainment	English	ü	ü	ü	ü	ü	ü
NASHA KINO	Russian Channel	Russian	ü	ü	ü	ü	ü	ü
Almustakbal	Entertainment	Arabic					ü	
Saudia	National	Arabic					ü	
ART 1	Family	Arabic					ü	
ART 2	Sport	Arabic					ü	
ART 3	Children	Arabic					ü	
ART 4	Movies	Arabic					ü	
ART 5	Music	Arabic					ü	
Syria	National	Arabic					ü	
Aljazeera	News	Arabic					ü	
Dubai	National	Arabic					ü	
Music Channel	Israeli Music	Hebrew	ü	ü	ü	ü	ü	ü

(1) Originated, subtitled or dubbed as indicated.

(2) Operates only during emergencies.

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### *Additional Packages and Services*

As of March 1, 2005, we market to our digital subscribers, a new marketing method based on various combinations we offer our customers. According to the new method, our digital subscribers, in addition to the basic package offered to them, may receive, at their choice, for additional consideration, products that include a variety of Premium channels, channel packages, and a la carte channels.

In addition, as of March 1, 2005, we offer all of our subscribers a bundled package of our cable television offerings, access to High Speed Internet and telephony services (available only to subscribers in the areas where HOT Telecom has commenced providing telephony services) into a Triple Play offer. Under the Triple Play offer, analog subscribers may receive, in addition to the basic analog cable television package, access to High Speed Internet and telephony services. Digital subscribers may receive under the Triple Play offering, the digital basic package, additional channel packages and a la carte channels, plus access to High Speed Internet and telephony services. The fees associated with the content are fixed. Further, the subscriber is permitted to change channel packages once a month without incurring an additional fee.

### Product Choices

#### *One Package Choice.*

Below please find the list of packages available to our digital subscribers.

<b>Name of Package</b>	<b>Channels Included</b>
Movies	HOT Drama HOT Fun HOT Action HOT Prime Games and Content about Movies MGM
Children	HOT Fun Parents Channel Logi Jetix Games Channel
Parents and Babies	Parents Channel HOT Luli
Enrichment for Children	HOP Lomdim Gordy's Friends
Music	VH-1 Classic MTV Hits MTV 2 MTV Base
24 Music Choice	Variety of Music Channels
Entertainment and Leisure	Bip- the laughter channel Xtra Hot - the series channel The Good Life E! Leisure and Entertainment History channel Adventure 1
Men and Sport	Reality TV  Ego Sport 5+ Eurosport News Fox Sports Extreme Sports

One party controls a large block of our shares.

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CNBC

Russian

Reality TV  
HOT DJ  
History Channel  
Romantica  
E!

Karma and Home+

Home+  
Karma

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*A Product of Two Channels.*

Below please find the list of channels available to our subscribers under our Product of Two Channels.

<b>Channels Included</b>
Bip- the laughter channel
Xtra Hot - the series channel
The Good Life
E!
Home+
Reality TV
Ego
Karaoke
Parents Channel
History Channel
Adventure 1
Eurosport News
Fox Sports
Extreme Sports
CNBC
HOT Luli
Logi
Jetix
VH-1 Classic
MTV Hits
MTV 2
MTV Base
Mega Film
Romantica
Ukranian Channel Inter+
MGM

*A La Carte Channels.*

Below please find a list of our channels that are offered a la carte.

Channels Included
Viva Platina
The Nature and Things
Tchelet Channel
Pro-TV
Romanian Channel TVR
HOT Time
Playboy Channel
Private Blue
Campus
Viva Espanola
Entertainment and Leisure
Vegas (Games for adults)
Double Click
Gogo Club
The Green Point (in the Children s Channel)
Jetix Channel
Karaoke Channel
Gogo
Klick
The Hot Game
Weather- Daily and Weekly forecast in Israel and Abroad
Horoscope, Forecast and Matches
Personal Horoscope
HOT Talk

We intend to provide an additional package in the future called VOD For Choice.

***Pay-Per-View***

Pay-Per-View services are covered by our Cable Broadcast Licenses. We are subject to maximum price restrictions for analog Pay-Per-View services, of approximately NIS 15 plus VAT, per broadcast. We are also subject to restrictions regarding payment for specific broadcasts, the time duration of a single broadcast and certain restrictions regarding the cancellation of a Pay-Per-View order by a subscriber. We are authorized to offer live broadcasting by Pay-Per-View. We began providing Pay-Per-View services to our subscribers in October 2000. We currently broadcast 10 Pay-Per-View channels on the digital platform. Pursuant to our request, on June 24, 2004, the Council resolved to allow us to cease to provide Pay-Per-View services on our analog platform, subject to our commitment, with respect to subscribers that received such service commencing from January 1, 2003, to provide to such subscribers who approach us, the option to use such service upon their request, on terms determined in the Council's decision. Beginning in March 2005 and ending in April 2005, we gradually ceased to provide Pay-Per-View services on our analog platform in all of our operating areas.

***Video On Demand***

In January 2005, we gradually commenced providing Video on Demand services on a commercial basis. Currently, VoD services are provided in the majority of our operating areas. Video on Demand, or VOD, is a service that allows television viewers to instantaneously select and view various contents (such as library movies, current movies, series, contents for children, contents for adults, sports content, entertainment and leisure contents) at any time they choose. VOD services also allow the viewer to stop, pause, fast-forward, rewind and restart the viewing, in a similar manner to the operation of a video tape recorder, thereby allowing the viewer to determine and control exclusively the timing and the speed in which he would like to watch the selected content. The VOD service gives the subscriber direct and instant access to a variety of content-libraries via a friendly access portal for the user. We provide VOD services to our digital subscribers in accordance with the approval rendered to us by the Council. We currently charge a fixed subscription fee for our VOD services. In addition, while various contents are not subject to additional payment, certain contents are subject to additional fees on a pay-per-use basis or a subscription VOD basis. On June 9, 2005, the Council published a hearing regarding the limitation on ownership with respect to the provision of VOD services.

***Personal Video Recorder***

We intend to begin providing Personal Video Recorder, or PVR, services in July 2005 under the brand name HOT Magic. PVR is a device, based on large storage (hard-drive) and an easy-to-use user interface. PVR services allow the viewer to decide what content to record along with providing them with the convenience of being able to watch them whenever they want. PVR services also allow the viewer to stop, pause, fast-forward, rewind and restart the viewing, in a similar manner to the operation of a video tape recorder.

***High Definition***

In May 2005, we gradually commenced providing a high definition channel. As of June 2005, this channel is available to all of our subscribers. The high definition channel broadcasts contents using a high definition system. The high definition technology enables the subscriber to enjoy a sharp quality picture and peripheral sound in the dolby digital system. The high definition channel's contents are diversified, and include sports, music, lifestyle and travel.

***Interactive Services.***

Since the end of 2001, we have provided interactive services such as Horoscopes and Weather to our digital subscribers. In June 2002, we added to our interactive services to include Games Channels. Since February 2002, we provide an entertainment programming guide service. Various interactive applications have been integrated into different channels since July 2002. Since August 2002 we provide an interactive invoice service. In December 2002, we began to implement an interactive voting application, which allows our subscribers to participate in television votes conducted on certain programs through the use of the subscriber set-top box. In January 2003, we began to implement an interactive commercial application. Since the end of the fiscal year 2003 and through to June 2005, we have commenced providing the following interactive services to our digital subscribers: two children's channels (HOP Lomdim and Gordy's friends); Vegas Channel; Karaoke Channel (in Hebrew and Russian); Net Action; and TV Mall Channel. We currently offer our digital subscribers Games Channels also on a pay-per-play basis (pay per game) or pay-per-use basis (pay per defined duration of time played), the use of which may be limited by the subscriber (for the purpose of parental control), on the basis of a predetermined maximum monthly fee. Subject to the receipt of the relevant regulatory approvals, we intend to provide additional interactive services in the future, including interactive channels, games channels and integration of interactive applications into additional channels.



**Internet Services**

On April 8, 2002, we launched a service of access to High Speed Internet over cable. Initially we offered promotional packages to the subscribers to the trial services and other initial subscribers to the service. We currently offer access to High Speed Internet over cable services in all of our license areas, and at December 31 2004, we had 88,324 access to High Speed Internet over cable subscribers. As of May 31, 2005, we had approximately 96,000 access to High Speed Internet subscribers. The table below sets forth the products we offer to our residential subscribers of access to High Speed Internet over cable services.

<u>Upload Speed</u>	<u>Download Speed</u>
64Kbps	0.256Mbps
96Kbps	0.75Mbps
128Kbps	1.5Mbps
150 Kbps	3.0Mbps

In addition, we offer our Internet subscribers the option to upgrade the Upload Speed of our access to High Speed Internet over cable products, by 64Kbps ( Extra ) and 128Kbps ( Extra Plus ).

HOT Telecom s access to High Speed Internet over cable service, which is provided to the residential subscribers in the former Infrastructure License areas by us, allows the user to directly access the Internet over cable broadband infrastructure, through the use of a cable modem and personal computer, and there is no need for dial-up activity

**Services for the Business Sector**

In March 2004, HOT Telecom commenced the marketing of additional communication services designed for businesses, including access to High Speed Internet for businesses, Internet Protocol Virtual Private Network, or IP VPN, and data transmission services and network services at different bit rates.

HOT Telecom markets packages with the following various broadband widths:

**Broadband Cable Internet for Businesses**

<u>Name of Package</u>	<u>Upload Speed</u>	<u>Download speed</u>
HOT Business 750K	150 Kbps	750 Kbps
HOT Business 1.5M	150 Kbps	1.5 Mbps
HOT Business 3M	150 Kbps	3 Mbps

In addition, HOT Telecom offers its subscribers the option to upgrade the upload speed of these products by 64Kbps and 128 Kbps.

**Access to High Speed Cable Internet for Businesses**

<u>Name of Package</u>	<u>Upload Speed</u>	<u>Download speed</u>
HOT Business 2M/512K	512 Kbps	2 Mbps
HOT Business 3M/512K	512 Kbps	3 Mbps
HOT Business 3M/1M	1 Mbps	3 Mbps
HOT Business 4M/1M	1 Mbps	4 Mbps

**Data Transmission Services and Network Services at Different Bit Rates**

HOT Telecom provides broadband connections which allows for the transmission of data at different speeds over a fiber optic and coax cable in a variety of technologies.

**SDH Services**

The following diverse services are provided on the (SDH) transmission backbone:

	Transmission rate
E1	2Mbps
E3	34Mbps
DS3	45Mbps
STM-1	155Mbps
STM-4	622Mbps
STM-16	2.5Gbps
F.C	1.06Gbps
Escon	200Mbps
Fecon	1.06Gbps
G.E	1Gbps

**IP Services**

The following diverse services are provided on the IP backbone:

Type of infrastructure	Interface
Optic/copper	10BaseT
	100BaseT
	1000BaseT
	1000BaseFX
Coax	10BaseT

*Domestic Fixed Line Telephony Services.*

In November 2004, HOT Telecom commenced providing domestic fixed line telephony services to residential and business subscribers. A subscriber may subscribe only to the telephony services without having to subscribe to our broadcasting or access to High Speed Internet services. HOT Telecom also provides ancillary services, such as: voicemail services, caller ID, last-call service, and call blocking options. As of June 2005, HOT Telecom provides such services gradually throughout its license areas, including provision of the ancillary services in stages. By using HOT Telecom's telephony services, a subscriber can call and receive phone calls from the Bezeq network, from all of the cellular networks, and from abroad through the Israeli international telephony operators. The payment for HOT Telecom's telephony services is based on a fixed monthly fee for the basic package, which includes up to 2,000 minutes per month (to the Bezeq network and to the HOT Telecom network) plus caller ID, last-call service, and call blocking services, without additional fees. HOT Telecom offers its subscribers 24-hour customer service and maintenance. HOT Telecom commenced supplying telephony services to small offices and big businesses via PRI channels. HOT Telecom has an interconnection agreement with all of the cellular suppliers and with the major international telecommunication companies, including Barak, Golden Lines and Bezeq International.

On July 9, 2004, Hot Telecom, signed an agreement with an Israeli entity in the global Lucent Int. Group for the establishment of a telephony network based on the cable infrastructure. The agreement is a framework agreement for 100,000 subscribers and, in the first stage, orders have been issued for the establishment of a network for approximately 60,000 telephony subscribers in consideration for an estimated amount of US\$ 19 million. As of May 31, 2005, to secure the payments to Lucent, we provided a bank guarantee in the amount of approximately NIS 7.7 million. In addition, Tevel and we, guarantee, jointly and severally, in a total aggregate amount of US\$ 4.5 million to secure the payments of HOT Telecom to Cisco. The cable television operators signed an indemnification agreement with respect to this guarantee.

**Sales, Marketing and Customer Service**

*Sales and Marketing.* Our marketing strategy is to increase the subscriber penetration within our license areas and maintain subscriber satisfaction in order to preserve low subscriber churn rate and to increase the average revenues per user, or ARPU. We market and sell our services through the combined efforts of integrated sales, marketing, technical and customer service groups. We train our personnel to provide information concerning technological advances and to address the specific requirements of existing and potential subscribers. We monitor the performance of these personnel through a variety of supervising methods. In addition, HOT Vision participates in rating surveys conducted by independent organizations, and we also use training programs and surveys prepared by independent professional marketing consultants to help increase the effectiveness and efficiency of its sales and marketing groups.

During the initial phase of the buildout of our network, we sought to create awareness of our cable television services and stimulate subscriber demand. In an effort to increase subscriber penetration, we initially relied on door-to-door visits by sales personnel who introduced our products and services by offering on-location demonstrations. We also utilized billboards, direct mail and mass marketing programs, including radio advertising, print media and shopping mall demonstrations to further marketing efforts. As the buildout of our cable television network continued and subscriber penetration rates increased in the license areas, we placed greater emphasis on telemarketing and direct mail efforts to target those groups that had not subscribed for our services, tailoring the campaign to the specific requirements of such potential subscribers. This targeted marketing had the effect of reducing the marketing costs incurred in attracting new subscribers. We have further refined our focus to preserve our existing subscriber base and, in this context, we have established marketing locations in centrally located consumer malls within our license areas.

As part of our effort to attract and maintain subscribers, we market our services, inter alia, by advertising on television and through print media, direct mail, and telemarketing. In addition, as part of our effort to maintain subscribers, we broadcast channels and programs that we broadcast for promotion and cross promotions. We also invest in promotions specifically aimed at the Russian sector in Israel due to the potential of this market.

We also contact subscribers who request to be disconnected and attempt to rectify any perceived or actual problem promptly. Under the Telecommunications Law and the subscriber agreement, we are required to disconnect an analog subscriber within 14 days of receipt of a written disconnection request, or such later date as the subscriber may request. According to our Cable Broadcast Licenses, we are required to disconnect a digital services subscriber within 2 business days of receipt of a written disconnection request or such later date as the subscriber may request, and we must not charge the subscriber any fees from the date of the disconnection. According to the HOT Telecom Infrastructure License, HOT Telecom is required to disconnect services provided under our Cable Broadcast Licenses and the HOT Telecom Infrastructure License (including access to High Speed Internet over cable services) within 2 business days of receipt of a written disconnection request or such later date as the subscriber may request. During those periods, the marketing and sales groups contact the subscriber in an effort to retain the subscriber.

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Although we seek to limit disconnections initiated by subscribers, a certain amount of such disconnections is inevitable, either because a subscriber has moved outside of our license areas or has decided that it no longer wishes to receive our services. We make marketing efforts towards such homes that have disconnected cable services in order to get cable television subscriptions reinstalled by new subscribers who have moved into such locations or by subscribers who made a decision to no longer receive cable television services. We believe that satisfaction with our services is essential to reaching and maintaining high levels of penetration. We have combined our cable television offerings, internet access and telephony into a Triple Play offer, with a view to increase revenues, reduce costs by lowering churn while increasing customer loyalty, and increase profitability of our operations. An integral part of our efforts has been to create for ourselves a positive image among our potential and existing subscriber base. To foster such image, we have been involved, and intend to continue to be involved, with various communities within our license areas by participating in public campaigns with local authorities.

*Customer Service.* We believe that highly efficient, responsive and prompt customer service is a significant factor in our marketing efforts to build and retain subscriber satisfaction. Since 1999, we operated a service number for the convenience of our subscribers. We currently operate a toll free number for our cable television subscribers. As of December 31, 2004, we had a staff of 246 customer service personnel on a full-time or full-time equivalent basis. Our subscriber service personnel provide information regarding, among other things, subscriber bills, special offers, channels, packages and available services. Our customer service personnel also provide technical support via telephone so that, to the extent possible, subscribers will not have to wait for on-site service. However, if a problem cannot be resolved over the telephone, a service technician is dispatched to the location, usually at no cost to the subscriber, depending on the circumstances and pursuant to the terms of the license. The customer support staff routinely provides feedback to the marketing and research and development groups. Our customer service personnel also engage in sales activities.

### *Operating Areas.*

During 2003, we unified the 4 operational areas into 2 operational areas- Netanya and Haifa. Since the last quarter of 2004, the activity of the cable television operators, within the framework of the operational merger, is conducted in four operating areas, which include the Northern area (includes Haifa and Galilee); the Sharon area (includes Netanya and Hadera), the Shfela area (includes Bat-Yam and Holon) and the Southern part of Israel. We do not operate in the Southern part of Israel.

### *A Description of the Geographical Areas according to our Broadcast Licenses Areas.*

In the fiscal year 2004, we conducted our operations in the following geographical areas.

*Haifa:* The Haifa operating area includes the city of Haifa and the surrounding communities. We substantially completed the installation of a regional cable transmission network in this operating area in 1995. As of December 31, 2004, the area included approximately 138,650 households, and our network in the Haifa area passed 136,238 homes and had approximately 74,609 cable television subscribers.

*Galilee:* The Galilee operating area includes the city of Tiberias, along the Sea of Galilee, Safed and Kiryat Shemona, in Israel's north, as well as the surrounding small towns and agricultural communities, and the Golan Heights. As of December 31, 2004, the area included approximately 58,002 households, and our network in the Galilee operating area passed 54,986 homes and had approximately 26,878 cable television subscribers. We have not completed the buildout of the cable network in this operating area.

*Bat-Yam/Holon:* The Bat-Yam/Holon operating area includes the cities of Bat-Yam and Holon (which border Tel Aviv to the south) and neighboring areas. We completed installation of most of the cable transmission network in this operating area by the end of 1991. As of December 31, 2004, the area included approximately 118,806 households, and our network in the Bat-Yam/Holon area passed 118,806 homes and had approximately 68,742 cable television subscribers.

*Netanya/Hadera:* The Netanya/Hadera operating area includes the coastal cities of Netanya, approximately 30 kilometers north of Tel Aviv, and Hadera, located between Haifa and Tel Aviv, and adjacent communities to these cities. We substantially completed the installation of a regional cable transmission network in this operating area in 1995. As of December 31, 2004, the area included approximately 210,036 households, and our network in the Netanya/Hadera area passed 188,722 homes and had approximately 87,115 cable television subscribers.

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### *Description of our Subscriber Penetration on a Geographical Basis According to our Broadcast Licenses*

The table below contains information on subscriber penetration on a geographical basis as of December 31, 2004 according to our broadcast licenses.

Area	Date Commenced Cable Television Operations	Approx No. of Households	Plant Length (km)	Homes Covered	Cable Television Subscribers	Penetration Rate of Homes Passed <sup>(1)</sup>	Penetration Rate of Households <sup>(2)</sup>	Internet Subscribers
Bat-Yam								
Holon	March 1990	118,806	596	118,806	68,742	57.9%	57.9%	20,731
Haifa	September 1991	138,650	1,160	136,238	74,609	54.8%	53.8%	25,956
Netanya								
Hadera	January 1993	210,036	3,344	188,722	87,115	46.2%	41.5%	32,838
Galilee	December 1990	58,002	1,225	54,986	26,878	48.9%	46.3%	8,799
<b>Total</b>		<b>525,494</b>	<b>6,325</b>	<b>498,752</b>	<b>257,344</b>	<b>51.6%</b>	<b>49.0%</b>	<b>88,324</b>

(1) Cable television penetration of homes covered is calculated by dividing the total number of cable television subscribers at applicable date by the total number of homes covered.

(2) Cable television penetration of households is calculated by dividing the total number of cable television subscribers at the applicable date by the total number of households.

For information on our HeadEnd Agreements, see Item 4B. Business Overview Technological Preparations for Competition in the Telecommunications Market.

### **Technological Preparations for Competition in the Telecommunications Market**

As part of our preparation for competition in the telecommunications market, we have defined, performed and completed a network upgrade project, for segmentation and bandwidth expansion.

In order to enable fast two-way communication via cable modems, a split of the HFC network into smaller sub-networks, known as Segmentation, is necessary. The Segmentation project involves significant installation of new fibers and optical equipment. We completed the Segmentation process by the end of 2000 to the extent actually required to reflect our subscriber demand.

Our original network bandwidth was 50-550MHz, and fully occupied 45-48 analog television channels. Full utilization of our network capacity is not possible due to regulatory restrictions. We have upgraded our network in order to expand the network capacity to 860MHz. The upgrade project included bandwidth expansion of both the downstream and the upstream paths. The network's old equipment has been replaced, in all of our operational areas, by a new uniform type of equipment. The bandwidth expansion increased the network capacity by approximately 25 analog channels, which is equivalent to more than 400 digital channels, and enabled bandwidth allocation for new added value services.

The network Segmentation and bandwidth expansion projects are part of our technological enhancement plan, which enables us to offer subscribers a new variety of interactive services, access to High Speed Internet over cable using, alternatively, the television screen or a personal computer, Pay-Per-View services, VOD, and may enable us in the future to offer other bandwidth consumer services.

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We have completed a substantial portion of the construction of our cable television broadcast and transmission system, including technologically advanced HeadEnds and a broadband, hybrid optical fiber/coaxial cable television network. Our cable network consists almost entirely of underground plants. Our cable transmission network is capable of supporting both broadcast transmission and two-way data transmissions for various telecommunications applications.

As part of our technological preparations toward becoming a multi-service operator for multi-channel television broadcasting and interactive television, access to High Speed Internet over cable, telephony and data over cable services, we have completed the installation of an addressable analog broadcast system; a digital broadcast system and a data-over-cable platform. During the first quarter of 2005, we phased out the addressable analog system and introduced a new state of the art VOD (Video On Demand) Platform, as well as a VoIP landline telephony service. The VOD platform will enhance our ability to launch new services, which are not possible, as of today, by YES, our main competitor in the television services.

The digital system enables us to provide our subscribers with dozens of broadcasting channels, channel packages according to choice, Telephony, access to High Speed Internet and data services, interactive services, and added value services, including Pay-Per-View, Video on Demand and High Definition. During the last year we also introduced an array of Interactive applications and services including e-commerce, chat and messaging services, multi-user games etc. Overall, we provide more than 100 Interactive applications to our subscribers.

We are currently in the final stages of introducing our PVR platform (an XTV Set-Top-Box), which will complement our VOD Platform and will enable us to offer our subscribers the most comprehensive user experience available today.

### **HeadEnds**

A cable television system begins with a HeadEnd, which transmits signals obtained from the following three main sources: satellite broadcasts received by dish antennae; local broadcasts received off-air or via optical transmission; and programs played back from videocassette recorders and/or video servers. A fiber optic cable network transmits signals carrying all the system's channels from the main HeadEnd to secondary HeadEnds and distribution hubs, which cover the different areas of the licenses and service zones. From the secondary HeadEnds/hubs, the services are distributed to subscriber homes via an HFC network. The drop cable terminates at a wall outlet installed in the subscriber household; a cable from the wall outlet passes through a channel converter or a Digital Set-Top-Box to the subscriber's television set. A wireless remote unit enables the viewer to select a channel from among the broadcasted channels. Subscribers who own cable-ready television sets and prefer the analog services only, may connect their sets directly to the wall outlet and select the viewing channel via the television set's control panel/remote control.

In November 1989, pursuant to a special permit issued by the Ministry of Communications prior to our receiving a franchise, we became the first cable television operator in Israel to supply cable television services when we commenced operation of our HeadEnd in Bat-Yam. This HeadEnd is operated as a secondary Headend serving the Bat-Yam/Holon operating area. Currently, this HeadEnd is in the process of shut down and unification with Tevel's Rishon Lezion HeadEnd.

The subscribers in the Galilee license area are served by a HeadEnd located at Ramot Naftali (completed in December 1990), which includes, among other things, a back-up play-back system and satellite dish antennas, cable-television programming is transmitted by microwave from the HeadEnd to two unattended sites, located in the Galilee license area, which in turn is transmitted by underground cable to subscribers. As of the second quarter of 2005, those microwave links have been replaced by modern two-way fiber optics links to enable the full range of digital services to all the subscriber population.

In September 1991, we completed construction of a HeadEnd located in Haifa. This HeadEnd operates as a master HeadEnd and includes, among other things, a playback system, satellite dish antennas and a production studio that generates original programming. A fiber-optic network carries the services from the Haifa HeadEnd to the Netanya operating area and the secondary Headends at Bat-Yam and Ramot Naftali.

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We acquired the HeadEnd equipment primarily from suppliers in the United States. Construction of the HeadEnds was for the most part carried out by sub-contractors supervised by a technical team we provided. The HeadEnds are located on land that we either purchased or lease under a long-term lease.

The cable installation includes several stages, such as: preparation of an engineering plan and receipt of permits from local authorities, excavation, laying the cable and network installation (including connecting cables that have been laid and installation of network components); and repaving the area where the work was conducted.

The network installation for a given geographic area is deemed to have been completed when the infrastructure necessary to connect a building to the network has been installed adjacent to each of the buildings in the area. After completion of the network installation, network equipment is installed in the buildings in the relevant area and subscribers are connected to the system. As of March 31, 2005, we completed the installation of approximately 3,931 miles of underground Coax and Fiber Optic cables.

We supervise the various stages of network installation, which are performed by design, infrastructure and network contractors. We are not dependent on the services of any one of those contractors. In addition, we purchase equipment, including cable, from a number of foreign suppliers and are not dependent on any particular supplier. In building the network, we have left additional conduit space for future uses.

In April 2005, we and the other two Israeli cable television operators entered into an agreement (the HeadEnd Agreement) in order to cooperate for the purpose of improving the efficiency of the transmissions of the multi-channel television broadcasts for subscribers, by way of a joint use of the cable television operators HeadEnds including the unification of the operational systems which are connected to the HeadEnds, according to the following terms: (1) the distribution of the multi-channel television broadcasts for subscribers of the cable television operators shall be carried out jointly by the HeadEnds of the cable television operators as one system; (2) the cable television operators shall bear the cost of the HeadEnds system, including depreciation, according to the proportional number of subscribers of each cable operator as shall be updated each quarter; (3) each cable operator, if required, shall enable the use of its HeadEnd system for the purpose of the exercise of the joint cooperation under the HeadEnd Agreement. The HeadEnd Agreement pertains only to the right of use of the HeadEnds, and does not address any transfer of assets. In addition, the cable television operators shall consider the need to unify HeadEnds or the need to partially shut down part of the HeadEnds or the need for a cessation of certain HeadEnds activities. As of the date of the signing of the agreement, the cable television operators resolved to take the following actions effective on April 1, 2005: (i) the shut down of part of Tevel's broadcasting HeadEnd activities in Tel Aviv, which will be performed instead at our broadcasting HeadEnd in Haifa, and as a result, Tevel's broadcasting HeadEnd in Tel Aviv will become an unmanned broadcasting HeadEnd; and (ii) the shut down of part of our broadcasting HeadEnd activities in Bat-Yam, which shall be unified with Tevel's broadcasting HeadEnd in Rishon-lezion. The finance of the HeadEnds activities, including future investments, shall be performed pursuant to a budget as shall be agreed upon and approved by the cable television operators, according to the proportional number of subscribers of each cable television operator.

### Cellular Telecommunication Services

We became a shareholder in Partner Communications Company Ltd., or Partner, one of four providers of mobile cellular telephone services in Israel, and one of the two operators which use the GSM technology on a fully commercial basis in Israel.

In April 1998, Partner received its license to establish and operate a mobile telephone network in Israel. In October 1999, Partner completed an offering of its shares to the public, raising a gross sum of US\$ 525 million. Partner's shares are traded on the Tel Aviv Stock Exchange, and its American Depositary Shares, or ADSs, each representing one of Partner's ordinary shares, are quoted on the Nasdaq National Market and are traded on the London Stock Exchange. As a result of Partner's initial public offering we recorded capital gains in the amount of approximately NIS 447 million. In addition, Partner repaid its shareholder loans which it owed to us. In April 2002, we sold approximately 50% of our holdings in Partner to a subsidiary of Hutchison Whampoa Ltd., in consideration for approximately NIS 305 million. In November 2003, we sold shares of Partner representing approximately 2.1% of Partner's issued and outstanding share capital in market transactions. In April 2005, we sold to Partner 7,783,444 ordinary shares, or approximately 4%, of its issued and outstanding shares, for total consideration of approximately NIS 250 million. Currently, through Matav Investments Ltd., we beneficially own approximately 1.2% of Partner's issued and outstanding share capital.

### International Telecommunication Services

Barak I.T.C. (1995) The International Telecommunications Services Corp. Ltd. ( Barak ), an Israeli company, provides international telecommunications services, which include voice, data, Internet to the business and residential markets in Israel. Barak was one of the three companies originally licensed by the Ministry of Communications of the State of Israel to provide international telecommunications services. Barak commenced providing international voice services on July 4, 1997.

We indirectly hold a 10% share ownership interest in Barak. The other major beneficial shareholders in Barak are Clalcom Ltd. ( Clalcom ), and indirectly, Sprint International, Inc., Deutsche Telekom AG and France Cables et Radio SA. We have the right to appoint one director to the board of directors of Barak (which is comprised of 10 directors), pursuant to a shareholders' agreement.

Since we have a 10% interest in Barak, our holdings in Barak are reflected in our financial statements on a cost basis. Barak's financial results do not affect our financial statements.

In December 2001, the Minister of Communications published its policy to work towards opening the international telecommunications market in Israel to additional competition. In April 2004, the Minister published regulations in order to achieve this. The regulations provide that companies that meet the required preconditions to serve as an international telecommunications operator may receive licenses, except for domestic operators, cellular operators or material operators in the field of international transmission services. Accordingly, during the second half of 2004, the Ministry of Communications has granted three additional licenses for the establishment and operation of international telecommunications systems in Israel, of which two were given to large providers of access to High Speed Internet.

On November 28, 1997, Barak issued notes in an aggregate principal amount of US\$ 183 million, due 2007. The notes were issued at a discount on their aggregate principal amount at maturity and generated gross proceeds of US\$ 100.2 million.

As at December 31, 2004 the principal amount of the notes outstanding totaled US\$ 122.4 million. The notes bear interest payable semi-annually, commencing May 15, 2003. Until the payment was due on November 15, 2004, Barak had met its interest payment obligations. However, Barak has decided to defer payments of interest to the noteholders in the amount of US\$ 7.6 million each, which were due in installments on November 15, 2004 and May 15, 2005.

Since Barak did not pay the interest payment within the 30-day period, the noteholders may have the right to request for the immediate acceleration of the bonds, subject to certain limitations. Barak does not currently have the financial ability to repay these notes in full. As of December 31, 2004, Barak had a capital deficiency in the amount of NIS 527 million and a working capital deficit in the amount of NIS 704 million. During 2002, we wrote-off approximately NIS 8.8 million of our investment in Barak. During 2004, we wrote off the remaining portion of our investment in Barak in the amount of approximately NIS 16 million. These decisions were based on a company valuation of Barak, the deterioration in Barak's financial position, the opening of the international communications segment to new competitors and the granting of licenses to three additional operators, as described above.

During 2004, Barak increased the total volume of voice traffic by approximately 14%. Barak reported revenues of NIS 704.4 million in 2004 as compared to NIS 711.4 million and NIS 694.7 million in 2003 and 2002, respectively, and net loss of NIS 53.4 million in 2004 as compared to net income of NIS 55.9 million in 2003 and NIS 62.6 million in 2002.

On June 15, 2005, Barak, Clalcom and Clal Industries and Investments Ltd. (together: Clal ), Dial-the Israeli Company for International Communications Ltd. and we, entered into a Non-Binding Term Sheet in order to set out the terms for a proposed reconstruction (the

Reconstruction ) of Barak's capital and debt (the Term-Sheet ), subject, inter alia, to the entry by Barak, certain holders of Senior Subordinated Discount Notes due 2007 of Barak (the Existing Notes ) (the Note Holders or the Ad Hoc Committee ), Clalcom and Clal Industries and the current (pre-restructuring) shareholders of Barak, into a definitive Restructuring Agreement. The Restructuring Agreement shall be effected through, amongst other things, a plan under Section 350 of the Companies Law (the Plan ).



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Pursuant to the terms agreed in the Term Sheet, upon the Plan becoming effective in accordance with Israeli law and, unless otherwise agreed between Barak, the Ad Hoc Committee and Clal, in the U.S. (the Closing ), Barak shall pay the Note Holders, a cash sum (the Cash Payment ) of US\$ 32.35 million in exchange for the full and final compromise of: (a) US\$ 57.4 million of the principal face value of the Existing Notes; (b) default interest on the interest coupon due on the outstanding Existing Notes on November 15, 2004 (the November Coupon ), but excluding the November Coupon itself, the amount of which is US\$7.65 million; and (c) all interest accrued on the outstanding Existing Notes, including the interest coupon due on the outstanding Existing Notes on May 15, 2005 and all default interest thereon, but excluding (i) the November Coupon, and (ii) the interest due on the Residual Notes, as defined below, accruing from March 1, 2005 (The Debt Compromise ).

The Term Sheet provides that the Cash Payment shall be funded by Clal in exchange for ordinary shares that will be issued to Clal by Barak, on terms to be agreed between Clal, Barak and the other current shareholders of Barak, subject to the prior approval by the Ad Hoc Committee with regard to the pro forma post-Restructuring balance sheet. Following Closing, Clal will own at least 95% of the share capital of the Barak, subject to any participation by the current shareholders of Barak in the funding of the Cash Payment.

On June 28, 2005, our board of directors resolved to participate in the funding of the Cash Payment in the amount of approximately US\$ 6 million, in accordance with our proportional holdings in Barak. As required by a letter agreement that we entered into with Clal, we notified Clal on June 29, 2005 of such decision by our board of directors. As a result of such participation, our holdings in Barak will be increased upon the Cash Payment to approximately 18.5% (on a non-diluted basis). As long as we hold at least 12.5% of Barak, we will be entitled to appoint one director to the board of directors of Barak (which then, will be comprised of five directors).

Following the Debt Compromise, the principal amount of the Existing Notes shall be reduced to US\$ 65 million (the Residual Notes ). The Residual Notes shall bear interest at the rate of 10% per annum (compared to 12.5% according to the current terms of the notes), accruing from March 1, 2005. Payments of interest on the Residual Notes shall be made on May 15 and November 15 each year. The maturity date of the Residual Notes will be extended to November 15, 2010 (compared to 2007 according to the current terms of the notes) at which time the entire principal amount of the Residual Notes shall be repaid in one payment. The first interest payment on the Residual Notes will be paid when due on November 15, 2005.

In addition, within 3 business days of the date of the Restructuring Agreement, Barak shall pay to the Note holders, US\$ 7.65 million (being the November Coupon) out of its cash funds. The payment of the November Coupon shall be in addition to the payment of the Cash Payment.

Referring to our participation right, as described above, we reached a written understanding with Clal according to which we, together with Clal, will be granted, among others, preemptive rights, a put option to sell all of our shares in Barak to Clal, subject to certain conditions, and a call option for Clal to purchase all of our shares in Barak, all subject to certain conditions.

### **Investments in Technological Companies**

In May 2000, we and some of our shareholders at that time decided to invest in start-up companies which engage in fields of Internet, cable television, data telecommunications, applications, content, infrastructure and Internet Protocol telephony. To this end, Nonstop Ventures Ltd. was formed by several of our former shareholders, in which we hold, since November 2002, 50% of the issued share capital. As of December 31, 2004, we and the other shareholders have invested through Nonstop Ventures Ltd. in seven start-up companies an aggregate amount of approximately US\$ 5.8 million. Of the aggregate investment, we invested approximately US\$ 2.9 million. Due to, among other things, market factors, the financial situation of these companies and our accounting policies, these investment amounts were reduced in our financial records, and were recorded in our financial statements for the year ended December 31, 2004 at a value of approximately US\$ 0.3 million.

## Government Regulation

### *General*

The operation of cable television systems and other telecommunication services relating to our business is regulated in Israel by the Telecommunications Law, the Ministry of Communications, and the Council for Cable and Satellite Broadcasting.

The Council is established pursuant to the Telecommunications Law and is comprised of 13 members (including 6 representatives of the government and 7 representatives of the public) appointed by the Israeli Government upon the recommendation of the Ministry of Communications. The Council is authorized, among other things, to:

- q grant cable broadcast licenses;
- q establish policies and adopt rules concerning the type, subject and content of cable television programming;
- q supervise the provision of broadcasting services by cable television and satellite operators; and
- q advise the Ministry of Communications.

### *The Telecommunications Law and Our Licenses*

Until we received our licenses, we operated under five exclusive franchises in central and northern Israel. In July 2001, the Israeli parliament approved amendments to the Telecommunications Law, under which terms were set for the granting of licenses for the provision of telecommunication services via cable television networks, in place of the exclusive franchises. The amendments also set new regulatory standards with respect to television broadcasting services provided to subscribers in a highly competitive environment.

We now operate under non-exclusive long-term licenses pursuant to the provisions of the amended law. On March 27, 2002, we were granted a Telecommunications Infrastructure License by the Minister of Communications for the provision of infrastructure services for the distribution of cable broadcasts and access to High Speed Internet providers. On April 30, 2002, we were granted two Cable Broadcast Licenses by the Council. On May 2, 2002, we were granted a special license to hold a Broadcasting HeadEnd by the Minister of Communications. These licenses cover the same geographical areas as our previous five exclusive franchises. In November 2002, our Telecommunications Infrastructure License was amended by the Minister of Communications, pursuant to which we were allowed to provide additional infrastructure services of data communications, digital transmission and optic transmission services. In November 2003, the Ministry of Communications granted to HOT Telecom, a limited partnership owned by the three Israeli cable television operators (of which we beneficially own approximately 26.6%), a license covering the same services covered by our Telecommunications Infrastructure License (to be supplied within the time frames set forth in the Telecommunications Infrastructure License), and also including the requirement to start to provide other services over cable networks including basic telephony services to subscribers by no later than November 25, 2004. As of the end of November 2004, HOT Telecom has gradually commenced to provide commercial domestic fixed telephony services. HOT Telecom Infrastructure License replaced and cancelled the Telecommunications Infrastructure License granted to us in 2002. According to a recent amendment to the HOT Telecom Infrastructure License, dated March 16, 2005, from the date of the grant of the HOT Telecom Infrastructure License and until the consummation of the merger amongst the cable television operators, HOT Telecom shall be entitled to contact with subscribers, including subscribers of the former infrastructure licensees of the cable television operators for the provision of access to High Speed Internet services through the former infrastructure licenses of the cable television operators, including our subsidiary Matav Infrastructure 2001 L.P., and the provision of the said service shall be deemed as a service rendered by HOT Telecom and the HOT Telecom Infrastructure License provisions shall apply. The terms and conditions of the various regulatory approvals we have received to the proposed merger between the Israeli cable television operators also affect the regulation of our current business in certain respects. See Item 4B. Business Overview Arrangement for a Merger of the Cable Television Operators .

Pursuant to the terms of the Telecommunications Law, as amended, and the terms of our licenses and HOT Telecom's license, we are now subject, among other things, to the terms, conditions and restrictions set forth below.

*Our Licenses*

*Corporate Separation of Cable Broadcast and Telecommunications Infrastructure Licensees and Ownership of Network*

We must operate through separate entities, namely the broadcast entities, on the one hand, and an infrastructure entity, on the other hand, which must each hold a Cable Broadcast License or Telecommunications Infrastructure License, as appropriate. Pursuant to the Telecommunications Law, the licensee under the Telecommunications Infrastructure License, or the Telecommunications Infrastructure Licensee, must own the cable network infrastructure as a condition to the receipt of the license. However, according to an agreement with the Ministry of Communications incorporated in our Telecommunications Infrastructure License, and subsequently, in the HOT Telecom Infrastructure License, our Cable Broadcast Licensees are allowed to continue to own the cable network infrastructure and to provide infrastructure services for an additional interim period of the earlier of two years following the date of the grant of the HOT Telecom Infrastructure License, which was November 25, 2003, or the date of the consummation of the merger of the Israeli cable television operators.

During such interim period, the necessary arrangements must be made regarding the transfer of the ownership of the cable network infrastructure to the Telecommunications Infrastructure Licensee. Accordingly, and as a condition for the receipt of our original Telecommunications Infrastructure License, our Cable Broadcast Licensees and the Telecommunications Infrastructure Licensee entered into an agreement dated March 5, 2002, whereby our Cable Broadcast Licensees granted an exclusive lease to the Telecommunications Infrastructure Licensee to operate the cable network infrastructure. In October 2002, our Cable Broadcast Licensees and the Telecommunications Infrastructure Licensee entered into an agreement, whereby the Telecommunications Infrastructure Licensee shall provide the Cable Broadcast Licensees infrastructure services for the broadcast of cable broadcasts in the areas covered by their respective license, including installment, maintenance and disconnection of terminal equipment. Since November 2003, HOT Telecom is our Telecommunications Infrastructure Licensee and the prior agreements are no longer in effect. Agreements in this regard will be signed between HOT Telecom and us in the future. The Cable Broadcast Licenses, the original Telecommunications Infrastructure License and the HOT Telecom Infrastructure License all contain restrictions limiting the number and identity of directors that are permitted to serve in both the infrastructure entity (and its general partner), and the Cable Broadcast companies.

According to our Broadcasting Licenses, as amended January 6, 2005, in the earlier event of the following, that either another entity is granted a general license to broadcast through the cable network, or in the event that HOT Telecom reaches a number of subscribers to access to High Speed Internet over cable services equal to 450,000, or the number of the telephony lines operated by HOT Telecom pursuant to the HOT Telecom Infrastructure License reaches 250,000 or on January 5, 2006, the separation rules set forth below shall apply.

According to the HOT Telecom Infrastructure license, in the event that either another entity is granted a general license to broadcast through the cable network, or in the event that HOT Telecom reaches a number of subscribers to access to High Speed Internet over cable services equal to 450,000, or if the number of the telephony lines operated by HOT Telecom pursuant to the HOT Telecom Infrastructure License reaches 250,000, the separation rules set forth below shall apply.

Subject to the aforesaid, the Council with respect to us, and the Minister with respect to HOT Telecom, also have the authority to impose conditions in addition to those set forth below, regarding the relationship between the Cable Broadcast Licensees or the Telecommunications Infrastructure Licensee and their connected companies, including the identity of the officers of each company, the transfer of information, the separation of entities between broadcast and infrastructure, the accounting systems, and technological, geographical or commercial restrictions regarding the laying down of infrastructure or regarding the provision of services or broadcasts.

Separation rules:

- i. A separation must be effected between the management of the Cable Broadcast Licensees, on the one hand, and the management of the Telecommunications Infrastructure Licensee and its general partner (but not including the board of directors), on the other hand, including in relation to the business, financial and marketing systems;
- ii. subject to the interim period mentioned above, a division of the assets of both Cable Broadcast Licensees and the Telecommunications Infrastructure Licensee must be effected;

- iii. the Telecommunications Infrastructure Licensee and its general partner shall not be permitted to employ the employees of the Cable Broadcast Licensees and vice versa; and
- iv. no employee of both the Telecommunications Infrastructure Licensee and its general partner can also be a director of either Cable Broadcast Licensee, if pursuant to such employee's duties he has access to commercial information regarding any other general broadcast licensee that competes with our Cable Broadcast Licensees.

In the event that a company connected to the Telecommunications Infrastructure Licensee is an Internet service provider, then there will be an immediate obligation of structural separation between the Telecommunications Infrastructure Licensee and the Internet service provider, in accordance with the above restrictions. If the Minister finds that special circumstances exist, after he is convinced that competition in the field of telecommunications broadcasting will not be harmed, he is entitled, upon a written request by a license holder, to amend the license to include exceptions to the separation obligation subject to conditions that the Minister may set.

q *Term of our Licenses*

Our Cable Broadcast Licenses are each valid for initial periods of 15 years. The HOT Telecom Infrastructure License is valid for a period of 20 years. The Cable Broadcast Licenses and the HOT Telecom Infrastructure License may be extended for additional 10-year periods, by the Council and the Minister respectively, upon the request of the licensees. Our Broadcasting HeadEnd License is valid for as long as our Cable Broadcast Licenses are valid, but not later than May 30, 2017. It may be extended upon request to the Ministry of Communications.

In order to have our licenses extended, we are obliged to, among other things, prove, during the terms of the licenses, that we have met with their terms and conditions. To this end, we are required to deliver detailed reports to the Council as to our compliance with our Cable Broadcast Licenses and applicable law, and evidence of acts that we have taken to improve the quality and technology of the broadcasts. We are similarly required to deliver detailed reports to the Minister in respect of telecommunications services that we provide.

q *Guarantees*

In order to ensure compliance with our obligations pursuant to the licenses, applicable law and regulatory bodies, and to ensure payment of fines that may be imposed by the Council and the Ministry of Communications, the following guarantees have been provided:

- q bank guarantees by the three cable television operators in the aggregate amount of US\$ 14 million to the Ministry of Communications pursuant to the HOT Telecom Infrastructure License, of which we provided a bank guarantee in the amount of US\$ 3.72 million; and
- q a guarantee of NIS 9.3 million to the Council pursuant to the Cable Broadcast Licenses provided by us.

Each of the Minister and the Council has the authority to exercise the applicable guarantees in the event that we or HOT Telecom, as the case may be, do not fulfill our or its obligations, and to cover any damage, loss or cost that the Council, the Minister, or the government may incur as a result of any breach of our obligations under the licenses, and to ensure all payments by the licensee, including royalty payments and payments of fines imposed by the Council or the Minister. The exercise of the guarantee does not derogate from the authority of the Council or the Minister to cancel the licenses, to amend the terms and conditions of the licenses or to impose other sanctions including fines for certain stipulated breaches or actions.

*Subscriber Services*

Infrastructure services must be provided to all applicants in our service areas, upon non-discriminatory terms. A licensee is obliged to connect anyone wishing to be a subscriber of cable broadcast services or infrastructure services according to the terms of the relevant license, within stipulated time periods.

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Our standard cable broadcasting subscriber agreements are subject to the approvals of the Council and the Court for Standard Contracts. We may be directed to amend the terms of our standard cable broadcasting subscriber contracts. The standard subscriber agreement with respect to the services granted pursuant to the HOT Telecom Infrastructure License must be submitted to the General Manager of the Ministry of Communications for approval if so requested.

HOT Telecom is obliged to offer its services to all applicants, regardless of whether or not they may be a subscriber of another licensee (including a broadcast licensee). HOT Telecom is prohibited from discriminating, and will refrain from giving a preference to a licensee that is related to it, in the provision of services, including with respect to payment for services, conditions of the services, availability of the services, providing information regarding the services, or in any other manner. HOT Telecom is prohibited from making the provision of the infrastructure services dependant upon the purchase of its own or another party's services, or dependant upon refraining from receiving services from another party, unless authorized by the Minister.

We are prohibited from making the supply of broadcasts dependant upon unreasonable, discriminatory or unfair terms, such as: minimum periods; the receipt of other services; or the obligation to obtain equipment from another party or us. We are prohibited from discriminating between subscribers. We are also subject to rules concerning the time limits allowed for connection and disconnection of subscribers, after such subscriber has given us notice.

We or HOT Telecom, as the case may be, must continue to operate a customer service call center and office, for technical and general customer support, and appoint a complaints officer. Minimum standards are set in our licenses as to the operation of such services and the management of customer complaints.

Under our Cable Broadcast Licenses and under the HOT Telecom Infrastructure License, we or HOT Telecom, as the case may be, do not have the right to disconnect or discontinue the broadcast and infrastructure services except: upon the subscribers request, for a material breach of the subscriber agreement, for the purpose of maintenance, or due to risk, or as further set forth in our Cable Broadcast Licenses and the HOT Telecom Infrastructure License.

### *Restrictions upon Transfer of Assets*

According to the Telecommunications Law, the licenses themselves and the rights granted thereunder may not be charged, transferred, or made subject to a lien, with the exception of transfers within the framework of structural reorganizations. Both our Cable Broadcast Licenses and the HOT Telecom Infrastructure License also stipulate that the assets of the licensees pertaining to the licenses (including terminal equipment of the Cable Broadcast Licensees) may not be transferred, assigned, charged or otherwise pledged in any way, other than in accordance with the provisions of the Telecommunications Law (in respect of the Cable Broadcast Licenses), and only upon the advanced written consent of the Minister (in respect of the HOT Telecom Infrastructure License). However, according to the Telecommunications Law, it is possible to create a charge upon the assets of a cable broadcast licensee in favor of a bank legally operating in Israel.

In addition, under the HOT Telecom Infrastructure License, HOT Telecom is allowed to create a charge in favor of a bank legally operating in Israel in order to receive financial credit, provided that prior notice is given to the Minister of Communications, and so long as the charge agreement includes a provision according to which the exercise of rights pursuant to the charge shall not be harmful to the provision of services by HOT Telecom.

### *Restrictions upon Ownership and a Change of Means of Control.*

According to the Telecommunications Law, a cable television operator must be a citizen and a resident of Israel, or an entity incorporated in Israel, and at least 26% of any means of control of such entity must be held by Israeli citizens and residents.

According to our Cable Broadcast Licenses, the Council's authorization is necessary for any of the following changes of means of control in a Cable Broadcast Licensee, and any such change effected without the Council's authorization shall be void:

- (i) a change of identity of the controlling entity of the Cable Broadcast Licensees;
- (ii) an increase in shareholding by over 10% in the Cable Broadcast Licensees; or
- (iii) a change in the holdings in the Cable Broadcast Licensees following which any party becomes an interested party (a holding of 5% or greater), or has a material influence (a holding of 25% or more); or if such party has ceased to be an interested party or holder of material influence.



A change in the holdings in Cable Broadcast Licensees of up to 15% of the means of control (but which does not result in a change of control in the Cable Broadcast Licensee) which result from transactions performed on a stock exchange require notification to the Council, rather than authorization, as well as to the Senior Vice President of Engineering and Licensing of the Ministry of Communications.

In addition, any agreement pledging the controlling shareholding must be made conditional upon the Council's approval if the exercise of such pledge would cause a change in the means of control of the Cable Broadcast Licensees.

The restrictions outlined above must also be included in the articles of association of the Cable Broadcast Licensees. These provisions appear in our amended articles of association.

According to the HOT Telecom Infrastructure License, the authorization of the Minister is necessary for any of the following changes of means of control in HOT Telecom:

- (i) if any party becomes an interested party (a holding of 5% or greater of any means of control);
- (ii) if any party gains a material influence (inter alia, a holding of 25% or more of any means of control);
- (iii) if any party becomes a controlling shareholder (inter alia, a holding of 50% or more of any means of control); or
- (iv) transfer of means of control which would result in any party becoming an interested party, holder of material influence, or controlling shareholder.

Furthermore, in the event that a charge is placed over the means of control of HOT Telecom or over the means of control of an interested party of HOT Telecom, which, if exercised will make the grantee a holder of means of control in HOT Telecom which vest the grantee with material influence over HOT Telecom, or as a result of which the grantee shall become a controlling shareholder of HOT Telecom, then such charge must include a provision stating that the exercise of the charge is conditional upon receipt of advanced written consent from the Minister of Communications. Due to restrictions regarding cross ownership interests, certain entities or individuals are prohibited from becoming an interested party in HOT Telecom. According to our HeadEnd License, the prior written approval of the General Manager of the Ministry of Communications is necessary for the transfer of the license, directly or indirectly, to another party. For this purpose, transfer includes a change in the holdings of the means of control of the licensee, even if this does not include a change of identity of the controlling entity of the licensee.

#### *Specific Terms and Conditions of our Cable Broadcast Licenses*

In addition to those mentioned above, our Cable Broadcast Licenses also include, among others, the following specific terms and conditions.

##### q Subscription fees

The subscription fees that we charge our analog subscribers for cable television services are regulated under the terms of our Cable Broadcast Licenses and by regulations promulgated under the Telecommunications Law. Pursuant to such regulations, the fees are linked to the Israeli consumer price index. If the consumer price index increases between 4% and 10% after the date of a previous increase of the fees and rates we charge, then we can increase fees and rates once every 3 months. However, if the consumer price index increases in excess of 10% after the previous increase of our fees and rate charges, then we may increase fees and rates regardless of whether three months have passed since the previous increase of such fees and rates. We are authorized to charge subscribers a monthly subscription fee, fees for the Premium Broadcastings, fees for Pay-Per-View services, an installation fee, lease payments or a deposit for the set-top boxes, an additional outlet fee and fees for certain ancillary services.

We have the right to offer discounts and make special offers for limited periods, subject to giving prior notice to the Chairman of the Council and a Senior Manager of the Ministry of Communications. They have the combined authority to disallow and to direct us to take actions with regard to any offers that we wish to make, upon specific considerations set forth in our Cable Broadcast Licenses. In the event that such offers last for longer than the limited period allowed, the Chairman of the Council and a Senior Manager of the Ministry of Communications have the authority to deem the sale prices to be a request to amend our price list accordingly.

*Broadcasts and Programming*

Pursuant to the terms of our Cable Broadcast Licenses, the Cable Broadcast Licensees shall air only the broadcasts that have been authorized by the Council, according to the terms of such approval. Such broadcasts shall be both digital and analog, or any other system authorized in advance by the Council. We may request permission to reduce the scope of the analog broadcasts, and in such event, we may be instructed to charge lower subscription fees. We are prohibited from ceasing the supply of approved programs or packages without the Council's prior approval. The Council has the authority to change the terms of its approval of broadcasts, and has the authority to cancel the approval for the broadcast of any channel following breach of the terms of the approval, or in the case of a material change in the content of the channel.

We are required to provide a stipulated amount of independent and local original programming, including information and broadcasts/programs exclusively regarding events in local areas, as well as a variety of films, and entertainment, music, arts, education, science, culture and sport programming material, all in accordance with quantity and content criteria established by the Telecommunications Law, Council Regulations and our Cable Broadcast Licenses. We are also required to provide real-time, unedited transmission of radio and television programming broadcasts to the public in Israel, receivable from the open airwaves, including those of foreign television stations and educational television broadcasts. We must provide an electronic programming guide. On July 31, 2003, the Council amended the telecommunications rules and our Cable Broadcast Licenses, according to which, obligations of the Cable Broadcast Licensees in respect of the content and scope of broadcasts that the licensees are required to provide were reduced.

On December 31, 2003, the Council resolved that prior to determining the final version of new broadcast rules, it will conduct a procedure according to which individuals and companies which have interests in the subject matter will be able to present their positions to the Council regarding the proposed version of the new rules. On April 25, 2004, the cable television operators presented their position regarding the proposed new rules. To date, such rules have not yet been adopted. Nevertheless, the Council amends the regulations relating to specific issues from time to time.

On October 14, 2004, the Council resolved to allow the cable television operators, including us, to broadcast, under certain conditions, local original programming, that we purchased exclusively, for infants or for children and youth.

Our Cable Broadcast Licenses prohibit us from conditioning (directly or indirectly) the provision of any broadcasts to a subscriber upon the purchase of other broadcasts, including by means of pricing that is unreasonable in the opinion of the Council and which was not approved in advance by the Council. However, this does not affect our ability to condition the receipt of additional digital broadcasts upon the purchase of the digital basic broadcasts package. The Council may, for special reasons, direct us to alter the composition of the tiering packages, or to separate a channel from the basic packages. We are obliged to allow subscribers the right to purchase individual channels separately, although if the Council is convinced that we are offering our subscribers a broad choice at reasonable prices, it has the authority to exempt us from this latter requirement.

We are prohibited from advertising new broadcasts, channels, or packages before we have served the Council with a request to broadcast such broadcasts, channels or packages. The Council has the authority to prohibit such advertisements until such request is granted. Furthermore, any offering of free broadcasts to subscribers must include an express clarification, to be approved by the Council in advance, as to our plans to charge subscribers for such broadcasts in the future.

We are entitled to broadcast notices regarding sponsorships during certain sports and culture broadcasts, subject to certain conditions, in accordance with and as set forth in the Council's decisions of September 3, 2002 and November 23, 2004. Under the Telecommunications Law and in accordance with the resolution of the Council of June 2002 as amended in September 2002 and in May 2003, each Cable Broadcast Licensee is required to allocate to local production or purchase of locally produced programs in initially broadcasting in Israel, a percentage of its annual income derived from subscriber fees for the year preceding the year of the investment, as follows: (i) commencing April 30, 2002 (the date of grant of the Cable Broadcast License) and until the end of 2005, at least 8% of such income; and commencing 2006 and thereafter, as to be determined by the Council prior to the end of June 2005; and (ii) in the event a Cable Broadcast License is granted to the merged entity of the Israeli cable television operators, the Council shall determine, prior to the end of June 2005, the rate of the amounts that shall be allocated to local productions by the Cable Broadcast Licensees as of 2006 and thereafter. For this latter purpose, the Council shall consider, among other things, the financial condition of the licensees in connection with their broadcast activities and the contribution of the proposed merger of the cable television operators to the improvement of the financial condition of the licensees. According to the valuation of our management, the investment amount made by us for local production in initial broadcasting in 2002, 2003 and 2004 is higher than 8% of our annual revenues from the subscription fees for the same years.



*Obligation to Broadcast Specific Channels of Special Broadcast License Holders*

Our Cable Broadcast Licenses stipulate that we must allow any holder of a special broadcast license to broadcast a specific channel to have access to our subscribers. Restrictions apply to the terms of any agreement with the holder of the special broadcast license, to the effect that such terms cannot be inferior to the terms on which we broadcast our own channels. The obligation to allow such access does not apply to analogical broadcasts, with the exception of dedicated channels or channels that were broadcast on the analogical system before the granting of the general non-exclusive license (such as the Shopping Channel). We are required to commence the broadcasts of such special broadcast license holder at any time, or upon such date that the Council shall direct, even if no agreement has been reached with such special broadcast license holder, and even if we have been unable to reach agreement as to the price, provided that such special broadcast license holder will provide guarantees.

In any advertisement of the broadcast schedule of the independent channels, a special broadcast license holder may not be discriminated against by the Cable Broadcast Licensee. The fee that we are permitted to charge for such broadcasts may include costs in addition to reasonable profit for such inclusion of information in such advertisement. We must include broadcasts of a special broadcast license holder on the electronic programming guide, and we must air trailers for such broadcasts for a period of six months following the date the channel started its broadcasts. We shall also be responsible for taking any specific actions necessary to enable broadcasts of the special broadcast license holder, including the provision of technical services upon terms equal to those provided to independent channels. The price for such services must be included in the general fee for the broadcast. We are obliged to connect subscriber(s) to channels of a special broadcast license holder within 3 working days of notification by the special broadcast license holder and the special broadcast license holder is entitled to elect whether to offer its broadcasts to subscribers as part of a package of channels of such special broadcast license holder or of other special broadcast license holders, in addition to the offer of its broadcasts to subscribers as a single channel. We are prohibited from preventing such choice from being effected.

*Outstanding Obligations from the Previous Franchises*

Our Cable Broadcast Licenses, as amended by the Council's decisions dated April 10, 2003, list all of the following unfulfilled obligations on behalf of all of the previous franchise holders in Israel, which are still outstanding under the terms of the previous exclusive franchises. Based upon the number of subscribers, our pro rata portion of the cost of such common obligations would be approximately 25%. During a period of 8 years commencing two years from the date of our Cable Broadcast Licenses, we and the other cable television operators are obliged to fulfill these obligations. According to the Council's decision, the total outstanding obligations include:

- i. 398 total hours of original locally produced broadcasts;
- ii. US\$ 6,466,178 worth of total investments in original locally produced broadcasts;
- iii. 3,890 total hours in total of original programming on HOT 3, the Children's channel and Channel 8;
- iv. 342 total movies on HOT Movies;
- v. 5,483 total regional news broadcasts of at least 15 minutes each; and
- vi. 1,350 total hours of translated programs with subtitles and 118 total new broadcasts with translation into sign language for the hearing impaired.

The cable television operators have addressed the Council asking for relief with respect to their outstanding obligations and the Council has responded by granting the cable television operators extensions with regard to certain of the individual obligations mentioned above, although not extending further the original 8-year period. The parties are still in correspondence with regard to this matter.

*The status of our Cable Broadcast Licenses in the event that the merger between the Israeli cable television operators is consummated*

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The terms of the approval of the Council to the merger (dated March 7, 2002, as amended on February 13, 2003) shall be incorporated into any new broadcast license that will be granted to the merged entity and that will replace our current Cable Broadcast License. Pursuant to the Council's amended approval, an application for a general broadcast license was filed with the Council on behalf of the merged entity on March 5, 2003.

### *Specific terms and conditions of the HOT Telecom Infrastructure License*

In addition to the above, the HOT Telecom Infrastructure License also includes, among other things, the following terms and conditions.

#### q *Services*

HOT Telecom has the right to grant general cable broadcast license holders services, and to provide services of access to High Speed Internet over cable, messaging services, data communications services, and other ancillary telephony services.

The provision of our service to a broadcast licensee shall be effected in such a manner that the broadcast licensee shall be able to provide its services to the subscribers in accordance with the terms and conditions of its license. HOT Telecom is prohibited from discriminating, and will refrain from giving a preference to a licensee that is related to it, in the provision of services, including with respect to payment for services, conditions of the services, availability of the services, providing information regarding the services, or in any other manner.

#### q *Fees*

The fees that are permitted to be charged to subscribers by HOT Telecom and by us (with respect to the services provided by us), include, among other things: payment of installation fee for connection; payment for terminal equipment and installation thereof; payment for installation of extensions; relocation fees; payment for the sale, loan or lease of terminal equipment; regular periodic payments; varying payments for use of the service according to time or traffic volume; and payment for conversion of services and any other payment approved by the Minister or the General Manager of the Ministry of Communications. In addition, with respect to cable modems, we may not charge subscribers for a deposit in excess of the cost of the cable modem, for cable modem leased to the subscriber, and we may reduce the amount by 10% of the value of the cable modems each year or partial year.

We have the right to determine service packages of telecommunications services that we provide, at an overall price per package of services, or at a price for each service. We are obliged to offer, without discrimination, every service and every service package on equal terms and at a uniform fee, according to the type of subscribers all over the service area. We must make information with respect to fees fully available to every applicant, including on the Internet.

We are obliged to notify the Ministry in advance of any intended changes in fees. The Minister has the right to alter the fee if he finds that it contravenes the provisions of the license or might compromise competition or the rights of subscribers.

When collecting payment from a subscriber for another service provider, no additional amount may be charged to the other entity's fee.

#### q *Frequencies*

Certain frequency bands are forbidden, including between 806MHz and 862 MHz. We are prohibited from causing interference to other systems and shall cooperate in preventing interference.

#### q *Termination*

Upon termination of the HOT Telecom Infrastructure License, in the event that HOT Telecom is unable to reach an agreement with a potential purchaser of its infrastructure within 6 months, then an arbitrator shall be appointed who shall impose a valuation calculated according to the value of the infrastructure, on a going concern basis and according to its economic value.

***Our Broadcasting HeadEnd License***

This license allows us to among other things; construct, maintain and operate broadcasting HeadEnds, for the purpose of maintaining the cable services provided by the Cable Broadcast Licensees; to connect our telecommunication system to the public telecommunications network operated by HOT Telecom or another entity licensed for transmission; to connect our telecommunications system to the system of another special licensee for operating a HeadEnd, to enable broadcasting reception via our telecommunications system and to construct and operate monitoring mechanisms needed to ensure the orderly operation of our telecommunications system. In October 2002, two of our Cable Broadcast Licensees entered into an agreement, pursuant to which one Licensee will provide the other HeadEnd services for the purpose of transmission of cable broadcasts. The General Manager of the Ministry of Communications has the authority to conduct inspections to ensure that the terms of our Broadcast HeadEnd License have been complied with.

In April 2005, we and the other two Israeli cable television operators entered into the HeadEnd Agreement in order to cooperate for the purpose of improving the efficiency of the transmissions of the multi-channel television broadcasts for subscribers, by way of a joint use of the cable television operators HeadEnds including the unification of the operational systems which are connected to the HeadEnds. For additional information on the HeadEnd Agreement, see Item 4B. Business Overview--Technological Preparations for Competition in the Telecommunications Market.

***Special Licenses***

In July 2002, the Ministry of Communications granted us special licenses to provide messaging services, which were subsequently extended to July 2008. Under these special licenses, as subsequently amended in October 2002, March 2004 and May 2004, we may provide the following services:

SMS services (between our subscribers and subscribers of mobile cellular telephone service providers);

T-Mail services (from television to television, between our subscribers and between our subscribers and subscribers of Internet service providers);

chat services (between our subscribers of this service, and between our subscribers and subscribers of chat services of other cable television operators);

instant messaging (between our subscribers of this service, and between our subscribers and subscribers of instant messaging services of other cable television operators); and

interactive games (between our subscribers of this service or between our subscribers of other cable television operators), including multi-player messaging between these subscribers, and personal data information services (allows a subscriber to connect to databases through the cable network, which includes information on the subscriber, and for the purpose of receiving and inputting personal information and data, and connection of the licensee's network to databases).

***Agreements with Subscribers.***

When we started to provide our subscribers with digital broadcasting services we began signing new subscribers and those subscribers electing to purchase such digital services, on a new subscriber agreement. This agreement was approved by the Council in January 2001, together with the Council's approval of our digital broadcasting services. This agreement was submitted to the Standard Contract Court in Israel for its approval, which has not yet been received.

When we started to provide our subscribers with access to High Speed Internet over cable services we began signing such subscribers on an access to High Speed Internet over cable agreement. This agreement was submitted to the General Manager of the Ministry of Communications for its approval. This agreement was submitted to the Standard Contract Court for its approval as required by our Telecommunications Infrastructure License in effect at such time. The review of our application was later joined with similar applications submitted by the other cable television operators. To date, comments or amendments to this agreement by the General Manager have not been received. We are currently working towards receiving the Court's approval.

HOT Telecom has entered into an agreement with its subscribers for the provision of telephony services. According to the HOT Telecom License, HOT Telecom is not required to receive the approval of the Standard Contract Court with regard to this agreement.

**Royalties and Payments to the State of Israel**

Under our Cable Broadcast Licenses, we are required to pay the Ministry of Communications an annual license fee and variable royalties. The variable royalties are payable annually in an amount equal to a certain percentage of our annual gross revenues (not including VAT) from the provision of certain broadcast services, which include, among other things, certain installation and subscribers fees. For purposes of payment of these royalties, revenues derived from subscriber fees for tiering and pay-per-view broadcasts are to be calculated net of payments that the licensee is contractually obligated to pay to the holder of the rights to such broadcasts. Under amendments to regulations promulgated under the Telecommunications Law proposed by the Minister of Communications and approved by the Economic Committee of the Israeli parliament on June 16, 2003, royalties payable by Cable Broadcast Licensees have been reduced, effective retroactively, from 5% of annual gross revenues (not including VAT), to 4% of such revenues in 2002 and 2003, and 3.5% of such revenues in 2004 and 2005. Payments are made on a quarterly basis.

In addition, regulations promulgated under the Telecommunications Law provide for royalties payable by general telecommunications licensees (which includes HOT Telecom) for the right to provide local fixed line communication services (including access to High Speed Internet and others), as follows: until December 31, 2003, 4% of certain income, and from January 1, 2004, 3.5% of certain income. Certain income for these purposes includes all income of the general telecommunications licensee that is derived from the provision of telecommunications services pursuant to its license, excluding:

- i. income collected by the licensee on behalf of another licensee (general or special) and transferred to the other licensee; or payments made to a different general license holder for the completion of calls, or the transfer of such calls in the telecommunications network of such other license holder, including payments made for interconnection;
- ii. income of the licensee from the provision of transmission services to other license holders;
- iii. income of the licensee from segments of transmission services by way of satellite;
- iv. income of the licensee from selling terminal equipment; and
- v. bad debts that are related to income from the provision of services in relation to which the licensee pays royalties.

Our Broadcasting HeadEnd License provides that we must pay fees in consideration for the license as determined by the Ministry of Communications pursuant to the Telecommunications Law and the Telegraph Ordinance [New Version], 1972.

In December 2003, the Minister of Communications announced his intention to amend the regulations in several aspects, and among them, in a way that will exclude from the royalties payment obligation, income from certain data communication and transmission services that are supplied by special licensees, which are not obliged to pay royalties.

HOT Telecom asked for certain amendments to the Minister of Communications proposal. The proposed amendment to the regulation has not been executed yet.

According to a letter dated April 20, 2005, which was sent by the Ministry of Finance and the Ministry of Communications to the Manager of the Government Companies Authority in Israel, the Ministries intend to reduce the percentage of royalties paid to the State of Israel by the holders of the international communication licenses and the holders of domestic fixed communication services licenses. The amount of the reduction is 0.5% per year commencing on January 1, 2006 up to a percentage of royalties of 1% in the year 2010. The execution of this reduction is conditioned on the amendment of the Communication Regulations (Royalties), the approval of the Minister of Communications and the Minister of Finance, and the approval of the Finance Committee of the Knesset. This intended reduction will supplement an additional reduction already made with regard to holders of cellular telecommunication licenses.

The said position does not include the field of multi-channel broadcasting. Therefore, in the event the reduction will be implemented as detailed above, we will not be able to benefit from it.

In addition, although HOT Telecom may benefit from the intended reduction in its activity as a provider of infrastructure services, this reduction will not be significant due to the fact that HOT Telecom is a new operator with relatively low revenues. Furthermore, such a reduction in the percentage of royalties may be of more significance to HOT Telecom's competitor.

#### **HOT Vision and Cooperation of Cable Television Operators in Production of Broadcasting**

In 1989, we, together with the other Israeli cable television operators, formed I.C.P. Israel Cable Programming Company Ltd., or ICP, for the purpose of jointly purchasing and producing our local cable channels, which then consisted of four channels: family, movies, sport and children. The culture and science channel was later added. In January 2004, ICP changed its legal name to HOT Vision Ltd. We currently hold approximately 26.2% of Hot Vision ordinary shares and 28.6% of Hot Vision preferred shares. In January 1995, the cable television operators and ICP (as it was known at such time) reached an agreement for the approval of unified channels with the Controller of Restrictive Business Practices, or the Controller, regarding its operations, according to which, among other things, it would produce, create or acquire at least 15% of its programming from local agents and suppliers. This agreement was extended from time to time by the Restrictive Business Practices Court.

HOT Vision executed agreements with certain shareholders in connection with the provision of contents purchased by it from the owners of the said contents. The initial term of the agreements was until December 31, 2000, and the shareholders are entitled to extend them for additional periods of 12 months each, on terms to be determined by the parties. The shareholders have exercised the extension option for an additional year in 2005.

For information regarding certain guarantees we have provided to two banks in order to secure certain liabilities of HOT Vision, see Item 5B. Operating and Financial Review and Prospects - Liquidity and Capital Resources .

For information regarding two lawsuits filed in the District Court of Los Angeles, California, United States, by Warner Bros. International Television Distribution, a provider of movie and series content broadcasted on HOT 3 and HOT Movies of the Israeli cable television operators, including ours, against the two other Israeli cable television operators, Tevel and Golden Channels, alleging that they are in breach of their respective license agreements with Warner Bros., see Item 8A. Consolidated Statements and Other Financial Information - Legal and Arbitration Proceedings . As a result of these lawsuits, we now provide content purchased from alternative studios and content providers in place of the programs we previously purchased from Warner Bros.

On June 30, 2003, HOT Vision and the cable television operators signed an agreement for the indemnification of HOT Vision relating to all of the amounts that it shall bear in connection with the debt to major studios and expenses associated with the management of the above legal procedures. According to the indemnification agreement, the cable television operators are committed, one towards the other, to jointly finance through HOT Vision the debt to the major studios and expenses associated with the management of these legal procedures which were implemented against certain of the cable television operators as well as any other procedure between Tevel and/or Golden Channels and the major studios in connection with agreements which were signed and/or terminated with the major studios - regarding content which was provided to HOT 3 and HOT Movies. As for the pay channels (HOT Drama, HOT Action, HOT Fun and HOT Prime), it was agreed that the amounts will be paid directly to Tevel. According to the indemnification agreement, the debt to the major studios contains amounts that Tevel and/or Golden Channels have to pay, as the case may be, to the major studios in connection with the legal proceedings associated with these agreements, including the amounts of new guarantees provided to the major studios, if so provided, and which the major studios will forfeit and legal fees that Tevel and/or Golden Channels will have to pay to the major studios, all by virtue of a judgment or a decree rendered in the context of the proceedings. The indemnification agreement stipulates, inter alia, that each of the cable television operators shall pay HOT Vision sums, according to its relative share in the market, of the amounts that shall be actually paid by Tevel or Golden Channels with respect to the debt to the major studios and expenses associated with the management of the legal procedures in connection with HOT Movies and/or HOT 3. The indemnification does not include amounts that are payable by the cable television operators to Tevel and/or Golden Channels through HOT Vision and Avdar for purchase of content to channels 3 and 4 and to the pay channels (HOT Drama, HOT Action, HOT Fun and HOT Prime).

The indemnification agreement further stipulates that the commitments of the cable television operators shall be revoked in the following cases: (1) if the cable television operators release HOT Vision in writing from its obligations under this agreement (2) if Tevel, Golden Channels and we were to merge into another cable company and the merged entity assumes, in writing and without any condition, the commitments of all of the cable television operators towards Hot Vision under this agreement even if HOT Vision is not released from all of its said obligations given that the merged cable company holds all of the issued share capital of HOT Vision and that its commitments cover all of HOT Vision's obligations under the indemnification agreement.

**Cooperation Among the Cable television operators**

*Agreement for a Merger of the Cable Television Operators*

As of 2001, the cable television operators are acting in order to merge their activities. The purpose of the merger, among other things, is to enable us to provide additional telecommunications services, to increase our ability to compete successfully with Bezeq in the field of domestic fixed line services, including telephony, and, to cooperate in various areas, including purchase of content, marketing, sales and unified networks and effect substantial cost savings. Prior to the merger we will need to reach an agreement with the major Israeli banks, which are creditors of the parties to the merger, addressing among other things, the assignment of certain of the current debts and securities to the merged entity, and its future financing. The merger must also receive approvals under applicable law, including the approvals of the Council, the Income Tax Commission, the Controller, and by an Israeli court, after receiving the approvals of certain creditors and the relevant corporate bodies of the relevant parties.

To date, approvals have been granted, subject to terms and conditions, from the Council, the Controller and the Income Tax Commission. Subject to the final terms of the merger, further approval of the Income Tax Commission to the merger may be required. The Supervisor of Banks of the Bank of Israel, or the Supervisor of Banks, has yet to agree that the proposed merger is not in breach of certain limitations under Israeli banking laws applicable to the Israeli banks, which are creditors of the merged entity.

In February 2003, we and the other Israeli cable television operators and us agreed on a final version of an agreement, which sets forth the structure and conditions of a merger among us, including, inter alia, the terms of the agreement between the shareholders. The parties have agreed that this merger agreement, if, and when, it is signed, will add to and broaden the terms of the previous arrangement between these parties executed on December 31, 2001, which cancelled and replaced previous arrangements between the parties dated December 29, 1999 and April 30, 2001. In the event any terms of these agreements shall conflict, the terms of the latter agreement of February 2003 shall prevail. Under the terms of this merger agreement, on the date of the consummation of the merger, all of our cable broadcast operations will be transferred to our subsidiary, Cable Systems Media Haifa-Hadera Ltd., immediately following which all of the cable broadcast operations of the cable television operators shall be merged into and together with Gvanim Cable TV Ltd., such that Gvanim Cable TV Ltd. shall become the merged broadcasting entity. Likewise, all of the infrastructure operations of the subsidiaries of the cable television operators shall be merged into and together with a wholly owned subsidiary of Gvanim Cable TV Ltd., such that this subsidiary shall become the merged infrastructure entity. The parties have agreed that if the final version of the merger agreement has not been signed by July 31, 2003, or a later date agreed upon by the parties, the provisions of the agreement will not apply, the parties shall not have any claim or suit towards another party with respect to the proposed merger agreement and/or the shareholders agreement, and shall be free to act independently or together with others, without any limitation.

According to the position of the Supervisor of Banks, the merger of the cable television operators and the formation of a merged cable entity would constitute a deviation from the directives of the Bank of Israel and of Proper Bank Management Directives of the Supervisor of Banks regarding, among other things, restriction on debt amounts to a Group of Borrowers as such term is defined in the Proper Bank Management Directives. The relevant directives deal with certain limits applicable to loan amounts given by banking corporations to Sole Borrower and/or Group of Borrowers and as a result, attribution of the merged company's debts, among other things, to an indirect controlling shareholder of us and the other cable television operators.

Based on the aforesaid, and due to the difficulties arising from the position of the Supervisor of the Banks and the provisions of Proper Bank Management Directives there is no certainty whether the merger will be actually completed and if it will be completed when it will actually occur and what will be its structure.

Since April 2002, in accordance with the approval of the Controller of Restrictive Business Practices to the proposed merger, we cooperate with the other two Israeli cable television operators in order to strengthen our competitive position in the telecommunications market and to achieve maximum operating efficiency in a broad range of activities, including, among others, our marketing and content related activities.

On January 30, 2005, the Controller granted us and the other cable television operators an exemption from the requirement to receive an approval of a restrictive arrangement for a period of one year, until January 30, 2006. On December 15, 2004, the Controller granted us and the other cable television operators an additional extension of the merger approval from April 2002 until January 29, 2005, which was further amended on January 30, 2005 until the earlier of January 29, 2006 or the consummation of the merger.

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Tevel filed a motion for stay of proceedings on April 22, 2002. The stay of proceedings was granted by the Court on April 22, 2002. In September 2003, the meeting of creditors of the shareholders of Tevel approved the creditors arrangement proposed by Tevel's trustee. Following the approval of the creditors arrangement by the meetings of creditors, the Court approved the arrangement. As of January 8, 2004, all of the approvals that were required in order for the arrangement of creditors to become effective had been obtained, and accordingly the arrangement of creditors entered into effect. According to this arrangement, Tevel has reached agreement with its unsecured creditors, which has resulted in the settlement of all of the debts. According to the agreement reached with the secured creditors, Tevel's shares and remaining assets are subject to the right of Tevel's secured creditors which are banks to realize these shares and assets to cover Tevel's debts to these secured creditors.

We have concluded preliminary discussions with Tevel and its shareholders regarding the purchase by us of all Tevel's assets including Tevel's holdings in Golden Channels. If we were to acquire Tevel's assets, we would have over 560,000 cable subscribers, representing approximately 60% of the Israeli cable television market, and we would hold 35% of Golden Channels, subject to certain terms. We have not signed a binding agreement with Tevel, and cannot be certain that this transaction will be completed, or if completed, on what timeframe or on what terms and conditions, including price. If this transaction were to take place, we would likely incur or assume substantial additional indebtedness.

However, we believe that an acquisition by us of Tevel's assets, might facilitate the consummation of a merger among the cable television operators.

In order to strengthen the cooperation of the three Israeli cable television operators, we, Tevel and Golden Channels agreed to perform an operational merger in June 2004. To this effect, a joint management was appointed to oversee the joint operation of the marketing, sales, engineering, customer service, operations and information systems activities of the three cable television operators. The joint management conducts and manages the Company's activities in the ordinary course of business in the areas of the joint activities. Material decisions applicable to the operational merger require our approval as well as the approval of Tevel and Golden Channels. Our approval is subject to the decision of our board of directors and other corporate bodies, as required by law. Since the appointment of the joint management and the commencement of the operational merger, we, Tevel and Golden Channels have operated jointly on a regular basis. The three cable television operators have agreed in principle that the allocation of the expenses deriving from the joint activity among themselves shall be proportional to the number of subscribers of each party. The operational merger does not include transfer of assets from any of the three cable television operators to a merged entity or from any of the three cable television operators to another cable operator. Each of the three cable television operators remains the sole owner of its assets and is entitled to the revenue generated from its own subscribers. Furthermore, the joint activity does not include transfer of liabilities owed to third parties, including, inter alia, banks or other creditors. .

### *The Approval of The Council for Cable and Satellite Broadcasting*

The approval of the Council to the merger of March 7, 2002, as amended on February 13, 2003, and that shall be effective only upon the consummation of the merger, is subject to a number of conditions, including:

- q an obligation upon the cable television operators, which has since expired, to allow direct broadcasting by YES, to broadcast the HOT 3, HOT Movies, sports and childrens channels, for consideration;
- q an obligation of unbundling, requiring the merged entity to grant special broadcast license holders which broadcast on a digital platform a non-exclusive permit, for consideration, to use its network in order to transfer their broadcasts (which will be up to a maximum of the higher of either: (i) one sixth of our broadcasting network capacity; or (ii) 75 Mhz from the date of the approval of the merger, including the capacity required for dedicated channels and special cable broadcasting licensees (one sixth of the broadcasting network capacity); and 150Mhz after 2005);

- q a maximum subscriber fee for the basic packages (digital or analog) of NIS 156 including VAT, linked to the combined index, that includes the Israeli consumer price index of December 2001 (published January 15, 2002) and the US dollar exchange rate as published by the Bank of Israel, or any other index as shall be determined in regulations. The effectiveness of the Council's approval regarding the said linkage to the combined index is subject to the amendment of the applicable regulations promulgated under the Telecommunications Law. To date, the Ministry has not adopted such an amendment;
- q an obligation to sell 20% of the entity that shall control broadcasting content (as opposed to infrastructure) to third parties, within four years from the date of the decision (in relation to which a public offering will be considered such a sale) unless certain conditions stipulated in the decision shall occur;
- q a limitation upon the number of channels which the cable television operators shall be allowed to produce (not including up to 16 optional channels on a pay-per-view and Near Video on Demand basis); and
- q the provision by all of the cable television operators of a guarantee of NIS 45 million to cover the obligations of the merged entity under the Council's approval, and all the Cable Broadcast Licensees (taking into account any amount already provided by way of guarantee pursuant to all the Cable Broadcast Licenses). Our pro rata portion of the NIS 45 million amounts to approximately NIS 11 million.

In addition, in accordance with the approval of the Council, in the event that the Council is convinced that there is a material decline in competition in the multi-channel television market, the Council is entitled to instruct the cable television operators to allow each special and general cable broadcast license holder that broadcasts in a digital format use of our infrastructure in order to access all potential subscribers, even if they are not our subscribers, so long as our cable network infrastructure reaches their premises. According to the Council's decision, a material decline will be deemed to occur, among other things, in the event that YES shall cease its operation or the merged entity shall provide services to more than 80% of multi-channel television subscribers in Israel.

Pursuant to the Council's amended approval, an application for a general broadcast license was filed with the Council on behalf of the merged entity on March 5, 2003.

In accordance with the Council's approvals to the merger, upon the merger, the terms of the Council's approvals to the merger will be an integral part of the terms of the Cable Broadcast License of the cable television operator or any merged entity in place of the cable television operators.

The eventual application of the above terms and other provisions are subject to interpretation and clarification.

***The Approval of the Controller of Restrictive Business Practices to the Merger and Exemption from the Requirement to Receive an Approval of a Restrictive Arrangement***

The approval of the Controller to the merger, granted in April 2002, is also subject to a number of terms and conditions, set forth below. On April 14, 2003, the Controller extended the validity of his approval to the merger until the earlier of June 6, 2003 or the consummation of the merger. In June, November and December 2003, the Controller further extended the validity of his approval to the merger until the earlier of December 15, 2004 or the consummation of the merger. On December 15, 2004, the Controller granted us and the other cable television operators an additional extension of the merger approval from April 2002 until January 29, 2005, which was further amended on January 30, 2005 until the earlier of January 29, 2006 or the consummation of the merger. The eventual application of the terms and conditions of the Controller's approval to the merger, as amended from time to time, and the way in which they will be implemented together with the terms of the Council's approval may be subject to interpretation and further clarification.

*Separation of activities:* the merged entity shall conduct its activities through a broadcasting entity and a cable infrastructure entity, whose activities must be completely separated.

*Unbundling:* the merged infrastructure entity must allow other cable broadcast license holders to use its cable infrastructure on terms that are not inferior to those offered to the merged broadcasting entity, up to the same maximum commitment as provided by the terms of the approval of the Council, with the additional stipulation of not less than 75 Mhz from the date of the consummation of the merger, and not less than 100Mhz after January 2005 for third parties who are not dedicated channels. This obligation shall not apply to any broadcaster of multi-channel national television broadcasts, on a national infrastructure network in its control, unless there is a material decline in the multi-channel television market. In the event that the Controller considers there to be a material regression in the multi channel television market for subscribers, he shall have the authority to instruct the merged infrastructure entity (and if necessary, the merged broadcast entity) to provide any cable broadcast license holder the telecommunications infrastructure services needed to supply the package of channels of such licensee to any person whose premises is reached by the cable network even if such person is not a subscriber of the merged broadcast entity; however, such



instruction shall not oblige the merged infrastructure entity to lay down additional telecommunications infrastructure for such a cable broadcast license holder, to a person who is not a subscriber of the merged broadcast entity. Without derogating from the above, in the event that YES ceases to operate, it will be deemed to be such a material decline in competition. Regarding these conditions, YES or its successor shall be deemed to be such a cable broadcast license holder if it ceases its operation due to insolvency.

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*Restrictions upon the corporate structure:* within 48 months of the Controller's approval, at least 20% of the controlling entities of the merged broadcasting entity must be owned by an entity that does not hold, directly or indirectly, any means of control in any other cable or infrastructure entity. This restriction may be amended or waived at the discretion of the Controller, or will be deemed inapplicable, if either at the end of 48 months there are at least two other holders of a general cable broadcasting license in Israel that are not linked to either the merged broadcasting entity or the merged infrastructure entity; or, if the Minister of Communications has set rates for usage of the merged entity's infrastructure by third parties within 30 months of the date of the approval (and the Controller finds that such rates encourage competition significantly). According to clarifications provided by the Controller in relation to this obligation, in the event that 20% of the means of control of the merged infrastructure entity is purchased by a third party and 20% of the means of control of the merged broadcast entity is purchased by a different third party, neither of whom have a connection to the existing cable television operators, it will not be necessary to meet this requirement.

*Restrictions upon the ownership and purchase of broadcasting material:*

(i) The merged broadcasting entity and the merged infrastructure entity shall be prohibited from holding means of control of a producer of a channel, except HOT 3 and (HOT Movies in the basic packages, and shall be prohibited from owning or having any interest in any other producer of a channel, unless it has received authorization to the contrary from the Controller by way of amendment of the terms of the Controller's approval to the merger. Subsequent to the approval and pursuant to the said restriction, we sold and transferred an option that we held to purchase certain interests in the Hop channel, we and the other cable television operators sold and transferred options we held to purchase certain interests in the sports channels (Channel 5 and the Sport 5+ channel), and we and the other cable television operators relinquished our interests in the children's channel and the culture and science channel. Pursuant to the recent amendment to the merger approval granted to us by the Controller in January 2005, the merged broadcasting entity is permitted to hold means of control in four additional channels (channels that were not broadcasted on the cable infrastructure as of January 1, 2005 and which will not substitute a channel that is being broadcasted by a producer of a channel that was broadcasted on the cable infrastructure on January 1, 2005).

(ii) The merged broadcasting entity and the merged infrastructure entity are permitted to use the content of another producer, but shall be prohibited from owning the content of another producer, and further, these entities shall be prohibited from determining to whom content shall be sold or transferred to third parties for use (with the exception of agreements with the major production companies, namely Warner Bros., Universal, Buena Vista (Walt Disney), Paramount, MGM, Columbia, and Twentieth Century Fox, which were signed prior to the date of the Controller's merger approval and received prior regulatory approvals).

(iii) The merged broadcasting entity shall only be allowed to purchase content for HOT 3 and HOT Movies and for Pay-Per-View and Near Video On Demand, and the additional channels purchased shall be in accordance with restrictions concerning, among other things, the purchase of exclusive content. In addition, the merged broadcasting entity shall have a must sell requirement to YES or any other general license holder regarding certain material content broadcast on HOT 3 and the HOT Movies channel stipulated in the Controller's approval. Further, all content purchased, by any party to the merger or any person related to such parties, from the major production companies within 24 months following the Controller's approval to the merger (April 2002), shall be subject to the must sell requirement to YES or any other general license holder, provided that any person who receives content pursuant to this must sell requirement shall also be subject to the must sell requirement with respect to contents purchased or that may be purchased from the major production companies during such period.

*Obligation to supply multi-channel television broadcasts to the entire population of Israel:* subject to price restrictions, and existence of appropriate infrastructure.

*Infrastructure:*

The merged infrastructure entity shall be prohibited from preventing the development of competing infrastructures, and shall be prohibited from using its control over the merged infrastructure to prevent or hinder competition. Unless prior written consent has been received from the Controller, both the merged broadcasting entity and the merged infrastructure entity shall be prohibited from holding any interest, directly or indirectly, in any person or entity that holds an interest greater than 10% in any other company that owns infrastructure for cable television or any other infrastructure for telecommunications services.

The merged infrastructure entity shall be prohibited from preventing any registered building contractor from laying down infrastructure, regardless of the presence of infrastructure belonging to the merged entity already in such area. Without derogating from the above, the infrastructure entity shall be prohibited from preventing a building contractor from laying down infrastructure in places where it has laid its own infrastructure, subject to the receipt of an indemnity for any damages to its infrastructure caused thereby.

The merged infrastructure entity and the merged broadcasting entity shall be separated entirely from Internet service providers. In addition, companies such as Barak I.T.C. (1995) The International Telecommunications Services Corp. Ltd., and other Internet service providers connected to the cable television operators or their shareholders, are also prohibited from transferring Internet service provider activities to the merged entities.

The merged infrastructure entity and the merged broadcasting entity shall be prohibited from preventing any end user which has Inside Wiring on his property from: (i) connecting with any other provider of multi-channel television; (ii) the common use of Inside Wiring by such user to connect to another provider in addition to the merged entities; and (iii) gaining access to Internet infrastructure, or access by such end user to Internet services, which are marketed either by the merged infrastructure entity or by the merged broadcasting entity, even in the event that such end user purchases multi-channel television from a competitor. The merged entities shall still be subject to the administrative directives published by the Minister of Communications governing the reciprocal obligation to lease Inside Wiring between the cable television operators and YES.

*Restrictions upon connected persons or entities:*

The terms of the Controller's approval shall equally apply to any person or entity connected to the cable television operators, the infrastructure entity, or the broadcast entity whose action is needed in order to fully and exactly comply with all or part of such terms. Any restriction or condition applying under the terms of the Controller's approval upon a party to the merger, on the infrastructure entity, or on the broadcast entity, shall also equally apply to any person or entity connected to them, and non-compliance with such restriction or condition by a connected person or entity, or together with such connected person or entity, shall be deemed to be non-compliance with the terms of the Controller's approval on the part of the party to the merger to which such person is connected, and by non-compliance by the broadcast entity and the infrastructure entity to which such person or entity is connected.

Restrictions shall also apply upon the activities of the officers or owners of the groups of the controlling shareholders of the merged entities, including, among others, as follows:

prohibition upon such officers having activities in businesses that compete, directly or indirectly, with the business of the merged broadcasting entity and/or the merged infrastructure entity, without the written approval of the Controller;

prohibition upon such owners from sharing information related to the business of the merged broadcasting entity and/or the merged infrastructure entity;

an enforced total separation between specific named Israeli corporate entities such as cellular telecommunications companies and newspapers, on the one hand, and the merged broadcasting entity and the merged infrastructure entity, on the other hand; and

if the merged broadcasting entity shall be allowed to air commercials in multi channel television channels, then the Controller shall have the authority to impose further restrictions stemming from concerns arising from the cross interests of the controlling shareholders of the parties to the merger in other entities that sell commercial time to the public.

*Interests in telephony services:* According to the terms of the approval to the merger, HOT Telecom is required to provide telephony services, which compete with those of Bezeq, to a minimum number of subscribers as follows: by November 20, 2005, 24,000 residential subscribers and 1,500 business subscribers; by November 20, 2006, 50,000 residential subscribers and 4,700 business subscribers; and by November 20, 2007, 98,500 residential subscribers and 10,000 business subscribers. As of the end of November 2004, HOT Telecom has gradually commenced to provide commercial domestic fixed telephony services. The merged infrastructure entity is bound by minimal infrastructure investment commitments of not less than NIS 350 million, to be completed in stages as follows: not less than NIS 190 million until June 30, 2005, not less than NIS 160 million until June 30, 2006 and any other amount as shall be required for the fulfillment of its business plan for the provision of telephony services which fully compete with the telephony services of Bezeq. The Company's portion of the infrastructure investment commitments (NIS 350 million), pro rata to its proportionate share in HOT Telecom is estimated to be approximately NIS 93 million.

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In accordance with the terms of the approval of the Controller to the merger, in July 2002, the Israeli cable television operators filed an application for the merged infrastructure entity for an infrastructure license, which includes the provision of fixed line telephony services. This license was granted in November 2003 to HOT Telecom. HOT Telecom has undertaken actions to meet the conditions and timetable set in the HOT Telecom Infrastructure License and the approval of the Controller to the merger with respect to the provision of telephony services. For more information on HOT Telecom's domestic fixed line telephony services, see Item 4B. Business Overview Domestic Fixed Line Telephony Services.

*Bank Guarantee:* The approval of the Controller to the merger is also conditional upon the provision of a bank guarantee in the amount of US\$ 15 million to ensure compliance with the terms of the approval of the Controller. In the event that the Controller decides, in his discretion, that there has been a material breach of the terms of the approval, he may fully exercise the guarantee. We have provided our pro rata portion of this guarantee in the amount of US\$ 3.75 million.

In the event of a non-material breach, the Controller may exercise US\$ 500,000 of the bank guarantee in relation to each breach, and an additional US\$ 500,000 per month, until such breach is remedied. Such amounts are non-refundable and the guarantee must be maintained at US\$ 15 million at all times, including in the event of breach. The provision and usage of the guarantee does not derogate from the Controller's ability to take any other remedy according to the provisions of the Restrictive Business Practices Law against the merged entities in the event of breach.

On January 30, 2005, the Controller granted us and the other cable television operators an exemption from the requirement to receive an approval of a restrictive arrangement in relation to the ongoing cooperation between the cable television operators. The exemption was granted for a period of one year, until January 30, 2006. Pursuant to the exemption, the cable television operators may continue their cooperation in the multi-channel TV broadcasting operations, including marketing, content acquisition and content production, and in building infrastructure and providing fixed line telecommunication services, including access to High Speed Internet and telephony. This exemption is conditional upon, among other things, the cable television operators' compliance with the terms of the Controller's approval to the merger and all of the cable television operators refraining from taking any irreversible actions which would prevent them from being able to undertake separate and independent activities in the event that the merger will not be completed. If the merger is not consummated, it will be necessary for us to receive an extension of this exemption.

**4C. ORGANIZATIONAL STRUCTURE**

We have three significant subsidiaries, all of which are Israeli entities, which we control directly or indirectly, as described below.

- q *Matav Investments Ltd.* is a company wholly owned by us and it owns 100% of the share capital of Matav Assets Ltd. Through Matav Investments Ltd. we are the beneficial owners of:
  - q 10% of the share capital of Barak I.T.C. (1995) The International Telecommunications Services Corp. Ltd., an international telephony service provider in Israel;
  - q approximately 1.2% of the share capital of Partner Communications Company Ltd., the third of four licensed providers of mobile cellular telephone services in Israel, and one of the two operators which use GSM; and
  - q approximately 26.6% of HOT Telecom L.P., Limited Partnership owned by the three cable television operators.
  
- q *Cable Systems Media Haifa-Hadera Ltd.* is a company wholly owned by us, and holds the Cable Broadcast License for the Haifa-Hadera area.
  
- q *Matav Infrastructure 2001 L.P.*, is a limited partnership, of which we own approximately 72% of the rights, with the remainder being held by our wholly owned subsidiary Cable Systems Media Haifa-Hadera Ltd. Matav Infrastructure 2001 L.P. was the holder of the previous infrastructure license.

We were formerly part of the Dankner Group. As of June 20, 2003, Dankner Investments Ltd., or Dankner Investments, held approximately 47.74% of our outstanding ordinary shares and 49.70% of the voting rights. In November and December of 2003, and in January of 2004, Dankner Investments sold approximately 7.7% of our outstanding shares in private transactions. In February 2004, Dankner Investments sold approximately 18% of our outstanding shares to Delek Investments and Properties Ltd., or Delek, and granted to Delek an option exercisable for two years to purchase an additional 2% of our outstanding shares. The option was exercised by Delek in September 2004. In May 2004, the controlling shareholders of Dankner Investments signed an agreement with Delek Real Estate Ltd., an affiliate of Delek, for the purchase of 87.5% of the issued share capital of Dankner Investments. This transaction was completed in August 2004. In November 2004, Delek Real Estate Ltd. commenced a tender offer in Israel to purchase all of the shares not already owned by it. As a result of this transaction, which was completed on November 25, 2004, Dankner Investments is a private company, wholly owned by Delek Real Estate Ltd. In December 2004, Dankner Investments sold approximately 20% of our outstanding shares to Delek. As a result of this transaction, Dankner Investments does not own any shares in Matav. The Delek group holds directly approximately 40% of our outstanding shares.

Delek is a wholly-owned subsidiary of Delek Group Ltd., a public company whose shares are traded on the Tel Aviv Stock Exchange. The Council approved the change of means of control resulting from the sale of Matav shares to Delek by Dankner Investments. Delek Group Ltd. is currently controlled by Mr. Yitzhak Sharon ( Tshuva ). Mr. Tshuva holds indirectly approximately 78.64% of the shares of Delek Group Ltd.

**4D. PROPERTY, PLANTS AND EQUIPMENT**

We own our telecommunications network infrastructure and related equipment. Our network infrastructure covers covers 498,752 homes and is approximately 3,931 miles of underground cable.

Our principal executive offices are in Netanya, Israel in a building purchased by us in 1992 for approximately NIS 3.0 million, which currently has 1,528 square meters of built space.

Our HeadEnd, studio and regional administrative offices in Haifa are situated in a 1,700 square meter building on 6,690 square meters of land leased from the Israel Lands Authority pursuant to a lease which will expire in 2040. In July 1991, we paid approximately NIS 1.5 million, constituting the entire amount due under such lease in advance as well as approximately NIS 3.8 million to the City of Haifa for the buildings on the plot. We have an option to renew the lease for 49 additional years.

Our HeadEnd in Bat-Yam is situated on a 200 square meter property, which we lease under a lease agreement providing for a monthly rent of NIS 12,000. The lease is scheduled to expire in August 31, 2005. We are currently in the process of relocating the HeadEnd in Bat-Yam to the HeadEnd in Rishon-lezion.

Our HeadEnd and microwave broadcast tower in Ramot-Naftali is situated on 520 square meters of land, owned by the Israel Lands Authority, which is subleased to us by the Mevot Hermon Local Council under a lease agreement expiring in October 2006, of which 160 square meters is the HeadEnd and 77 square meters is a basement. Pursuant to the terms of the lease agreement, we are obligated to pay the Mevot Hermon Local Council an annual fee of NIS 1 and to provide cable television services to the residents of Moshav Kadesh Naftali free of charge. Upon termination of the lease agreement, our interest in the property will pass to the Mevot Hermon Local Council, although we will be entitled to remove all of our transmission equipment.

We also hold real property in Bat-Yam of 2,500 square meters, under a lease from the Israel Lands Authority which is scheduled to expire in 2038. In 1989, we paid approximately NIS 1.8 million for this lease, constituting the entire amount due under the lease, in advance, and approximately an additional NIS 1.28 million in order to extend the deadline under the lease for completion of a building on the property to January 1, 1997. In March 2004, the Israel Lands Authority notified us that its management agreed to extend our lease agreement for this property, subject to the payment of property value differentials amounting to approximately NIS 1.3 million, plus VAT. This amount was based on the valuation of a land appraiser. In April 2004, we paid approximately NIS 1 million. We have submitted an appeal on the valuation of the land appraiser, and we provided a bank guarantee in the amount of approximately NIS 320,000. In April 2004, we received a supplement to the lease agreement from the Israel Lands Authority, according to which, the lease agreement shall be extended to August 1, 2006. This supplement has not yet been signed. In our appeal of the valuation, the property was re-appraised for less than the prior valuation. The amount of such re-appraisal was equivalent to the amount that had already been paid to the Israel Lands Authority by us up until June 8, 2003. As a result, we addressed the Israel Land Authority on March 30, 2005, with a request to repay the sums that were overpaid by us, cancel the bank guarantee provided by us to the Israel Land Authority and amend the supplement to the lease agreement according to the new valuation.

In Pardess Hanna, we lease a 1,009 square meter plot of land from the Israel Lands Authority. Two structures which contain a HeadEnd for the Hadera license area are located on this property.

In 1999, we purchased 1,927 square meters in a building near our headquarters in Netanya, for approximately NIS 8.4 million. We use this property, among other things, for our Netanya Hadera cable operations and for our access to High Speed Internet over cable activities.

In addition to the foregoing, we lease several other small properties totaling approximately 2,200 square meters throughout our operating areas, which we use for office space, storage, and microwave reception towers. Altogether with the leased properties described above, the aggregate monthly rental payments made by us are approximately NIS 75,000.

**ITEM 5. OPERATING AND FINANCIAL REVIEW AND PROSPECTS**

The following operating and financial review and prospects are based upon and should be read in conjunction with our financial statements and selected financial data, which appear elsewhere in this annual report. You should also read the risk factors appearing elsewhere in this annual report for a discussion of a number of factors that affect or could affect our financial condition and results of operations.

The financial statements have been prepared in conformity with accounting principles generally accepted in Israel, which differ in certain respects from the U.S. generally accepted accounting principles (as restated, see Note 26 to the financial statements) followed in the United States. The financial information in this section is presented in adjusted NIS, unless stated otherwise.

We reported certain amounts in adjusted NIS, which have been translated for convenience into US dollars using the representative exchange rate of the US dollar as published by the Bank of Israel on December 31, 2004 (US\$ 1.00 = NIS 4.308). Except where otherwise stated, amounts appearing in dollars have been translated from NIS at this exchange rate.

**Critical Accounting Policies**

In order to improve understanding of the discussions below, it is important to obtain some degree of familiarity with our principal or significant accounting policies. These policies are described in Note 2 to the Consolidated Financial Statements listed in Item 18. We review our financial reporting, disclosure practices and accounting policies annually to ensure that the financial statements developed, in part, on the basis of these accounting policies provide complete, accurate and transparent information concerning the financial condition of our company. As part of this process, we reviewed the selection and application of our critical accounting policies and financial disclosures as of December 31, 2004.

In preparing our financial statements in accordance with generally accepted accounting policies, our management must often make estimates and assumptions which may affect the reported amounts of assets, liabilities, revenues, expenses and related disclosures as of the date of the financial statements and during the reporting period. These estimates and judgments are reviewed by management on an ongoing basis, and by our Audit Committee at the end of each quarter prior to the public release of our financial results. Some of those judgments can be subjective and complex, and consequently actual results may differ from those estimates. For any given individual estimate or assumption made by our management, there may be alternative estimates or assumptions which are also reasonable. We consider our most significant accounting policies to be those relating to depreciation of fixed assets, allowance for doubtful accounts, income taxes and contingent liabilities, which are discussed below.

*Depreciation of fixed assets:*

Our fixed assets are depreciated by the straight-line method over their estimated useful life. A significant portion of our operating expenses results from depreciation of fixed assets. The vast majority of our fixed assets are composed of cable network, equipment in the broadcasting centers, studios, converters and modems. If rapid technological changes are to occur in our industry, the estimated useful life of some of our fixed assets could be shortened and consequently lead to an increase in annual depreciation costs and operating expenses.

*Allowance for doubtful accounts:*

The allowance is principally determined with respect to specific debts that are doubtful of collection based on the age of the customer's debt. Our revenues are derived from a large number of subscribers in the license areas. We perform ongoing credit evaluations of our subscribers for the purpose of determining the appropriate allowance for doubtful accounts, by taking into account variables such as disconnection, past experience, age of the receivable balance and current economic conditions that may affect a subscriber's ability to pay. The use of different estimates or assumptions could produce different allowance balances. If the financial condition in Israel were to deteriorate, resulting in an impairment of our subscribers' ability to make monthly payments, additional allowance for doubtful accounts may be required. If we were to face stronger competition, we might experience a higher rate of disconnections and hence additional allowance for doubtful accounts may be required.

*Contingent liabilities:*

We are party to certain legal actions as described in Item 8A. Consolidated Statements and Other Financial Information Legal and Arbitration Proceedings and described in Note 15 in the financial statements.

With regard to claims and petitions for certification of some of these actions as class actions, we believe, based on the opinion of our legal counsel, that since the claims and petitions for certification of them as class actions, and our response to the claims and petitions raise complex legal and factual questions, which have not yet been resolved in Israeli case law and for which there are no precedents based on similar facts, we cannot currently evaluate the likelihood of success of such claims, and therefore, no provision has been included in our financial statements with respect to such claims. With regard to other claims in which the proceedings are in early stages, the prospects of the claims cannot be estimated and no provision has been included in our financial statements with respect to such other claims. As to the remaining claims, we believe, based on the opinion of our legal counsel, that we have good defensive arguments against these claims, and therefore, no provision has been included in our financial statements with respect to such claims. However, as detailed in our financial statements, we recorded provisions in the financial statements with respect to certain claims.

As additional information becomes available, we will assess our potential liability related to our pending litigation and revise our estimates if needed. Such revisions of our estimates of our potential liability under legal claims could materially impact our results of operation and financial position.

*Impairments of assets:*

The vast majority of our fixed assets are composed of cable network, equipment in the broadcasting centers, studios, converters and modems. If rapid technological changes or other changes which may cause a rapid churn of our subscribers were to occur in our industry, the estimated fair value of some of our fixed assets could consequently be subjected to impairment.

*Accounting for income taxes:*

At the end of each reported period, we are required to estimate our provision for income taxes. This process requires us to estimate our actual current tax liabilities and make an assessment of the amount of our tax operating carry forward losses. We must then assess the likelihood that our deferred tax assets resulting from the carry forward losses will be realized through future taxable income and, to the extent we believe that realization is not likely, we must establish a valuation allowance. Management judgment is required in determining our provision for income taxes, our deferred tax assets and any valuation allowance recorded against our net deferred tax assets. Our judgment as to the probability to realize our net deferred tax assets is largely based upon our estimate of future taxable income. Since we do not believe it is more likely than not that our deferred tax assets will be realized, we recorded a valuation allowance for the full amount of the deferred tax asset. Our estimates of our tax provision is based on our assessment as to the outcome of our dispute with the tax authorities. Actual outcome might differ from our current estimates and require us to record an additional loss.

**New accounting standards in the United States:**

On December 16, 2004, the Financial Accounting Standards Board (FASB) issued SFAS No. 123 (revised 2004), Share-Based Payment ( SFAS 123(R) ), which is a revision of SFAS 123. Generally, the approach in SFAS 123(R) is similar to the approach described in SFAS 123. However, SFAS 123 permitted, but did not require share-based payments to employees to be recognized based on their fair values while SFAS 123(R) requires all share-based payments to employees to be recognized based on their fair values. SFAS 123(R) also revises, clarifies and expands guidance in several areas, including measuring fair value, classifying an award as equity or as a liability and attributing compensation cost to reporting periods. The Company expects to adopt SFAS 123(R) on January 1, 2006.

SFAS 123(R) permits companies to adopt its requirements using one of the following two methods:

1. The modified prospective method, in which compensation cost is recognized commencing with the effective date (i) based on the requirements of SFAS 123(R) for all share-based payments granted after the effective date and (ii) based on the requirements of SFAS 123 for all awards granted to employees prior to the effective date of SFAS 123(R) that remain unvested at the effective date.



2. The modified retrospective method, which includes the requirements of the modified prospective method described above, but also permits entities to restate based on the amounts previously recognized under SFAS 123, for purposes of pro forma disclosures, all prior periods presented.

The adoption of the SFAS 123(R) fair value method will have significant impact on the Company's results of operations, although it will have no impact on the Company's overall financial position. The impact of the adoption of SFAS 123(R) cannot be predicted at this time, as it depends on levels of share-based payments for future grant. However, had the Company adopted SFAS 123(R) in prior periods, the impact of that standard would have approximated the impact of SFAS 123.

In March 2005, the SEC Staff issued Staff Accounting Bulletin No. 107 (SAB 107) to give guidance on implementation of SFAS 123(R), which the Company considers implementing.

**New accounting standards in Israel:**

In July 2004, Accounting Standard No. 19 Taxes on Income (the Standard) was approved by the Israel Accounting Standards Board. The Standard prescribes the principles for recognition, measurement, presentation and disclosure of taxes on income in the financial statements.

The principal change pursuant to the Standard in relation to the principles presently applied are the recognition of deferred taxes in respect of temporary differences arising when there is recognition of deferred taxes in respect of temporary differences relating to land.

The Standard is effective in respect of financial statements relating to periods beginning on or after January 1, 2005. Changes resulting from adoption of the Standard should be recorded by including the cumulative effect in the statement of operations as of the beginning of the period in which the Standard is adopted.

The Company estimates that the effect of the new Standard on the financial position, operating results and cash flows of the Company is not expected to be material.

**5A. OPERATING RESULTS**

We were formed in June 1987. We began building out our cable television network and offering cable television services on a trial basis in November 1989. In March 1990, we began providing full cable television services. Between 1990 and 2002, we operated pursuant to five exclusive franchises granted to us by the Ministry of Communications covering the following areas: Bat-Yam and Kiryat Shemona, Holon, Safed and the Golan Heights, Haifa, Hadera, and Netanya and the Sea of Galilee. During 2002, these franchises were replaced by two general non-exclusive Cable Broadcast Licenses, a Telecommunications Infrastructure License and a Broadcasting HeadEnd License. The Telecommunications Infrastructure License was subsequently replaced and cancelled by the HOT Telecom Infrastructure License. Under the terms of our previous franchises and current licenses, we pay the Ministry of Communications variable and fixed franchise/license royalties. For the years ended December 31, 2002, 2003 and 2004, we recorded aggregate expenses for royalties to the Ministry of Communications of NIS 20.6 million, NIS 17.6 million and NIS 15.9 million, respectively.

As of December 31, 2004, we provided cable television services to 257,344 subscribers, representing approximately 26.7% of all cable television subscribers in Israel, and have achieved an average subscriber penetration rate of approximately 52% for all of our license areas. (The number of subscribers is calculated based on the number of connected customers indicated in our billing system records.) For the years ended December 31, 2002, 2003 and 2004, we generated revenues of NIS 495.5 million, NIS 545.5 million and NIS 584.6 million, respectively. Our operating loss for the years ending December 31, 2002 and 2003, was NIS 98.7 million, NIS 7.8 million, respectively, and an operating income for the year ended December 31, 2004 was NIS 3 million.

Our net income for the year ended December 31, 2002 was NIS 33.8 million. Our net loss for the years ended December 31, 2003 and 2004 was NIS 5.5 million and NIS 83 million, respectively. During the years 2002, 2003 and 2004, we achieved EBITDA (Earnings Before Interest Taxation Depreciation and Amortization) of NIS 56.7 million, NIS 147.0 million and NIS 139.6 million, respectively. The EBITDA excludes other income or expenses and equity in earnings of affiliates, net. Since the results for the year 2003 do not include proportional consolidation with HOT Vision, for comparison purposes, the EBITDA is presented assuming no consolidation with HOT Vision.

Through December 31, 2004, we invested approximately NIS 2,119 million (US\$ 491.9 million) in building out our cable television network and in other fixed assets within our license areas. As of December 31, 2004, our cable television network extended 3,931 miles and covered approximately 500,000 homes, or approximately 95% of the households in the areas in which we operate.

With our transition to digital cable television services, we increased our revenues, while, at the same time, we also increased our expenses by investments in digital set top boxes, program content purchasing and providing other services to our subscribers. Each digital set-top box costs us between approximately US\$ 130 to US\$ 200. Due to marketing considerations, we do not charge the customer the full cost of the digital set-top box, and we subsidize this cost. As of May 31, 2005, we have already purchased approximately 258,000 digital set top boxes, and approximately 68% of our subscribers were equipped with digital set-top boxes. In April 2002, we commenced providing access to High Speed Internet over cable services. As of December 31, 2004, we had 88,324 subscribers with access to High Speed Internet.

**Revenues**

We derive a substantial amount of our revenues from the cable television services monthly subscription fee for the analog and the digital Basic Packages of approximately NIS 170.9 including VAT and 176.5 including VAT and 186.5 including VAT, respectively. We also collect a one-time deposit of NIS 99 (including VAT), for the regular analog set-top box (for those subscribers without cable-ready televisions), or NIS 198 (including VAT), for the addressable analog set-top box. With respect to digital set-top boxes, we collect a one-time deposit of NIS 399 (including VAT). We partially refund these deposits when the set-top boxes are returned. The refund amount, linked to the Israeli consumer price index, is reduced to reflect depreciation of 10% of the value of the set-top box to us for each year or each partial year (until September 2003 the refund amount was reduced to reflect a depreciation of 10% of the deposits for each year or each partial year), commencing from the date of installation of the set-top box and until the earlier of the date we cease to provide services to such subscriber, or until the removal of a set-top box. Such depreciation is included in our revenues, exclusive of VAT. Instead of paying the deposits referred to above, our subscribers may elect to lease the set-top box for a monthly fee that ranges between NIS 9 and NIS 11 including VAT, but in any event, not more than the value of the set-top box. We are allowed to sell the set-top box to a subscriber, at the subscriber's option, in consideration for an amount not exceeding the value of the set-top box. We also charge subscribers fees for reconnection, installation of additional outlets in subscribers' households, and provision of cable television services on the additional outlets. The fees set forth above include value added tax at a rate of 17%. In certain marketing campaigns, we fully refund the first set-top box given to our new customers, in return for certain obligations to the company. Additional revenues are derived from our tiering services, Pay-Per-View services, interactive services, access to High Speed Internet over cable services and other services.

Our revenues per subscriber, penetration rate and churn rate may vary in the future from historical levels depending upon numerous factors, which are mostly beyond our control. These factors include amongst others, the nature of our future cable television and telecommunications services, the development of competition for revenues per subscriber and the success of our marketing strategies as well as market acceptance of our services by subscribers.

#### **Cost of Revenues and Other Operating Expenses**

Our principal operating expenditures are:

- q programming costs;
- q depreciation and amortization of fixed assets;
- q payroll and related expenses;
- q license (previously franchise) royalties and payments to the government of Israel; and
- q maintenance.

#### **Churn**

Churn refers to subscriber disconnection from network services, either involuntary, due to non-payment of bills or suspected fraudulent use, or voluntary, due to subscribers terminating their use of our services.

We recognize that managing subscriber churn is an important factor in maximizing revenues and cash flow. In order to control churn caused by subscribers voluntarily terminating our services, we attempt to ensure that our services are of high quality and are competitive. We use our advanced information technology systems as a tool to understand, monitor and control voluntary churn. We have a retention team within our customer services group that makes follow-up phone calls to subscribers who call us with complaints or problems in order to resolve any problems and to retain the subscribers. We also host exclusive subscriber events, such as shows and parties for subscribers, in order to encourage subscriber loyalty. Following the launch of our high-speed Internet access services, we offered our subscribers a television and Internet bundled package on attractive terms so as to reduce churn and increase loyalty. Our competitors have introduced similar approaches. In March 2005, we launched our brand new telephony over cable service using the IP technology, and started to offer our subscribers with a bundled package of television, Internet access and voice services ( Triple Play ). Our competitors cannot offer such triple play offer until certain milestones in the progress of our voice services are met. We expect that the Triple-Play offering will reduce churn and increase customer loyalty. For the year ended December 31, 2004, our churn rate for our operating areas averaged approximately 24%.

**Results of Operations**

The following table sets forth certain items from our results of operations for the periods indicated:

<b>In adjusted NIS (in millions)</b>	<b>Years ended December 31,</b>		
	<b>2002</b>	<b>2003</b>	<b>2004</b>
Revenues	495.5	545.5	584.6
Operating expenses	507.4	466.7	472.5
Gross profit (loss)	(11.9)	78.8	112.1
Selling and marketing expenses	40.7	44.0	63.7
General and administrative expenses	46.1	42.6	45.4
Operating income (loss)	(98.7)	(7.8)	3
Financial expenses, net	48.1	84.0	50.3
Loss after financial expenses	(146.8)	(91.8)	(47.3)
Other income (expenses), net	278.6	81.0	(42.7)
Income (loss) before taxes on income	131.8	(10.8)	(90)
Taxes on income	108.9	35.6	7.3
Income (loss) after taxes on income	22.9	(46.4)	(97.3)
Equity in earnings of affiliated companies, net	10.9	40.9	14.3
Net income (loss)	33.8	(5.5)	(83)
EBITDA *	56.7	147.0	139.6

**Comparison of Years Ended December 31, 2002, 2003 and 2004****Operating results according to business segments**

The following table sets forth our consolidated statement of operation according to our various business segments:

<b>In adjusted NIS (in millions)</b>	<b>2002</b>		<b>2003</b>		<b>2004</b>	
	<b>Cable TV</b>	<b>Internet</b>	<b>Cable TV</b>	<b>Internet</b>	<b>Cable TV</b>	<b>Internet</b>
Revenues	486.4	9.1	511.1	34.4	518.9	65.7
Operating expenses	494.7	12.7	449.3	17.4	446.4	26.1
Gross profit (loss)	(8.3)	(3.6)	61.8	17.0	72.5	39.6
Selling and marketing expenses	37.5	3.2	38.3	5.7	53.7	10
General and administrative expenses	45.1	1.0	41.7	0.9	44.3	1.1

One party controls a large block of our shares.

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Operating income (loss)	(90.9)	(7.8)	(18.2)	10.4	(25.5)	28.5
Financial expenses, net	48.1		84.0		50.3	
Income (loss) after financial expenses	(139.0)	(7.8)	(102.2)	10.4	(75.8)	28.5
Other income (expenses), net	278.6		81.0		(42.5)	(0.2)
Income (loss) before taxes on income	139.6	(7.8)	(21.2)	10.4	(118.3)	28.3
Taxes on income	108.9		35.6		7.3	
Income (loss) after taxes on income	30.7	(7.8)	(56.8)	10.4	(125.6)	28.3
Equity in earnings (losses) of affiliated companies, net	10.9		40.9		17.5	(3.2)
Net income (loss)	41.6	(7.8)	(15.9)	10.4	(108.1)	25.1
EBITDA*	58.5	(1.8)	129.8	17.2	104.3	35.3

\*Since the results for the year 2003 do not include proportional consolidation with HOT Vision, for comparison purposes, the EBITDA is presented assuming no consolidation with HOT Vision.

**Revenues**

	Years ended December 31,			% Change 2002 vs. 2003	% Change 2003 vs. 2004
	2002	2003	2004		
	in adjusted NIS in millions				
Cable TV	486.4	511.1	518.9	5.1	1.5
Internet	9.1	34.4	65.7	278.0	91.0
<b>Total revenues</b>	<b>495.5</b>	<b>545.5</b>	<b>584.6</b>	<b>10.1</b>	<b>7.2</b>

Of our total revenues, approximately 88.8% can be attributed to cable TV activities in 2004, in comparison to 93.7% in 2003 and 98.2% in 2002. Our revenues from cable TV activities increased by NIS 7.8 million in 2004 and NIS 24.7 million in 2003. Our revenues from cable TV activities are derived from monthly subscription fees, Pay-Per-View services, interactive services, depreciation of subscribers' deposits for set-top boxes, installation fees, payments from the Shopping Channel and other minor sources.

The following table sets forth the distribution of our subscribers for the periods covered:

	2002	2003	2004	% Change 2002 vs. 2003	% Change 2003 vs. 2004
Average of total number of subscribers for cable TV services*	281,241	270,570	262,462	(3.8)	(3.0)
Average of total digital subscribers*	137,811	151,059	158,753	9.6	5.1
Average of total number of subscribers with access to High Speed Internet services*	10,395	37,954	75,622	265.1	99.2
Average monthly revenue per subscriber (ARPU) in NIS	147.1	166.3	177.5	13.1	6.7

\*The average number of subscribers is calculated based on the number of connected customers indicated in our billing system records.

The increase in revenues from cable TV services is mainly attributed to the fact that in 2004, our financial results are proportionally consolidated with HOT Vision Ltd. for the first time. Furthermore, despite a decline in the number of subscribers, there is an increase in the rate of digital subscribers out of total subscribers from 55.8% in 2003 up to 60.5% in 2004. Our revenues from High Speed Internet services are derived mainly from monthly subscription fees, and increased by NIS 31.3 million in 2004, compared to an increase of NIS 25.3 million in 2003, and NIS 3.5 million in 2002. The sharp increase in revenues from High Speed Internet services in 2004 is due to an increase in the number of subscribers. We anticipate that in spite of our continuing marketing efforts to increase our subscriber base for High Speed Internet services, subscription fees might be eroded as a result of the intensive competition in this field.

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Average monthly revenue per subscriber (ARPU) for 2004 was NIS 177.5 compared to NIS 166.3 in 2003 and 147.1 in 2002. The increase in ARPU is derived from a sharp increase in revenues from access to high speed internet (NIS 65.7 million in 2004 compared to NIS 34.4 million in 2003) and an increase in the number of digital subscribers as described above.

### *Operating expenses*

	Years ended December 31,			% Change 2002 vs. 2003	% Change 2003 vs. 2004
	2002	2003	2004		
	in adjusted NIS in millions				
Cable TV	494.7	449.3	446.4	(9.2)	*
Access to High Speed Internet	12.7	17.4	26.1	37.0	50
<b>Total operating expenses</b>	<b>507.4</b>	<b>466.7</b>	<b>472.5</b>	<b>(8.0)</b>	<b>1.2</b>

\*Percentages not provided where negative number became a positive number, or where resulting calculation is in thousands of percentage points due to inability to provide a meaningful mathematical number.

Of our total operating expenses, approximately 94.5% can be attributed to cable TV only activities in 2004, in comparison to 96.3% in 2003 and 97.5% in 2002. As a percentage of revenues from cable TV only activities, operating expenses from cable TV only activities decreased from 101.7% in 2002 to 87.9% in 2003, and to 86% in 2004.

The decrease in operating expenses in cable TV only activities in 2004 is derived mainly from a decrease in depreciation of fixed assets which was partially offset by an increase in the cable TV programming expenses. The decrease in operating expenses (excluding depreciation and amortization) in 2003 is derived mainly from a decrease in programming expenses.

The access to high speed internet operating expenses include direct expenses only and do not include expenses for the usage, services and the depreciation of the cable infrastructure (which are fully recorded as part of the cable television operating expenses)

Cable TV operating expenses are comprised of:

	Years ended December 31,			% Change 2002 vs. 2003	% Change 2003 vs. 2004
	2002	2003	2004		
	in adjusted NIS in millions				
Cable TV programming expenses	242.8	194.4	198.0	(19.9)	1.8
Depreciation and amortization of fixed assets	156.0	153.7	138.4	(1.5)	(10)
Other operating expenses from Cable TV activities	95.9	101.2	110	5.5	8.7
<b>Total</b>	<b>494.7</b>	<b>449.3</b>	<b>446.4</b>	<b>(9.2)</b>	<b>*</b>

\*Percentages not provided where negative number became a positive number, or where resulting calculation is in thousands of percentage points due to inability to provide a meaningful mathematical number.

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As a percentage of total revenues from cable TV activities, our programming expenses remained at the same level in 2003 and 2004 (38.0% compared to 38.2%) and decreased from 49.9% in 2002. The decrease in programming expenses in 2003 reflects lower costs for most of the channels in spite of an increase in tiering services, which generates additional expenses as a result of additional purchases of content.

Since all of our programming expenses are either paid in US dollars or linked to US dollars, any substantial devaluation of the shekel against the US dollar will increase the shekel cost of our US dollar denominated expenses. The gradual decrease in depreciation of fixed assets and amortization in 2004 and 2003 is mainly due to the fact that some of our fixed assets are terminating their accounting life.

The increase in other operating expenses in 2004 and 2003 is primarily due to an increase in maintenance costs, mainly those which related to digital set-top-boxes.

### *Selling and marketing expenses*

	Years ended December 31,			% Change 2002 vs. 2003	% Change 2003 vs. 2004
	2002	2003	2004		
	in adjusted NIS in millions				
Cable TV	37.5	38.3	53.7	2.1	40.2
Access to High Speed Internet	3.2	5.7	10	78.1	75.4
<b>Total selling and marketing expenses</b>	<b>40.7</b>	<b>44.0</b>	<b>63.7</b>	<b>8.1</b>	<b>44.8</b>

Of our total selling and marketing expenses, approximately 84.3% can be attributed to cable TV only activities in 2004, in comparison to 87% in 2003, and 92.1% in 2002.

As a percentage of total revenues from cable TV only activities, our selling and marketing expenses decreased from 7.7% in 2002 to 7.5% in 2003, and increased to 10.3% in 2004. The increase in selling and marketing expenses in 2004 compared to 2003 is mainly due to an increase in our advertising expenditures in connection with the launch of the HOT brand name, which occurred in the fourth quarter of 2003, and campaigns for the launches of new channels.

As a percentage of total revenues from access to high speed internet only activities, our selling and marketing expenses decreased from 35.16% in 2002 to 16.6% in 2003 and to 15.2% in 2004. The high level of selling and marketing expenses in 2002 is attributed to the launch of the internet activity.

### *General and administrative expenses*

	Years ended December 31,			% Change 2002 vs. 2003	% Change 2003 vs. 2004
	2002	2003	2004		
	in adjusted NIS in millions				
Cable TV	45.1	41.7	44.3	(7.5)	6.2
Access to High Speed Internet	1.0	0.9	1.1	(10.0)	22.2
<b>Total general and administrative expenses</b>	<b>46.1</b>	<b>42.6</b>	<b>45.4</b>	<b>(7.6)</b>	<b>6.6</b>

Of our total general and administrative expenses, approximately 97.6% can be attributed to cable TV activities in 2004, in comparison to 97.9% in 2003 and 97.8% in 2002.

As a percentage of total revenues from cable TV activities, our general and administrative expenses from cable activities decreased from 9.3 % in 2002 to 8.2% in 2003, and increased to 8.5% in 2004. Our payroll and related expenses increased in 2004 compared to 2003 due to non-recurring expenses provided with respect to senior employees as part of their retirement benefits, which were offset by a decrease in the provision for doubtful accounts and bad debts. Our payroll and related expenses decreased significantly in 2003 compared to 2002 due to a one-time reduction.





*Operating income (loss) and total EBITDA (\*\*)*

	Years ended December 31,			% Change 2002 vs. 2003	% Change 2003 vs. 2004
	2002	2003	2004		
	In adjusted NIS in millions				
Cable TV	(90.9)	(18.2)	(25.5)	(79.9)	40.1
Access to High Speed Internet	(7.8)	10.4	28.5	*	174
Total operating income (loss)	(98.7)	(7.8)	3	(92.1)	*
EBITDA from Cable TV	58.5	129.8	104.3	121.9	(19.6)
Total EBITDA	56.7	147.0	139.6	159.3	(5)

\*Percentages not provided where negative number became a positive number, or where resulting calculation is in thousands of percentage points due to inability to provide a meaningful mathematical number.

\*\* Since the results for the year 2003 do not include proportional consolidation with HOT Vision, for comparison purposes the EBITDA is presented assuming no consolidation with HOT Vision.

As a percentage of total revenues from cable TV activities, EBITDA represented 20.1% in 2004 as compared to 25.4% in 2003, and 12.0% in 2002.

Total EBITDA is comprised of the following:

In adjusted NIS in millions	Years ended December 31,		
	2002	2003	2004
Net income (loss)	33.8	(5.5)	(83)
Financial expenses, net	48.1	84	48.5*
Taxes on income	108.9	35.6	7.3
Depreciation and amortization, including deduction of income from amortization of set-top boxes deposits	155.4	154.8	138.9*
Other income (expenses), net	278.6	81	(42.2)*
Equity in earnings of affiliates, net	10.9	40.9	14.3
Total EBITDA	56.7	147.0	139.6

\* Since the results for the year 2003 do not include proportional consolidation with HOT Vision, for comparison purposes, the EBITDA is presented assuming no consolidation with HOT Vision.

*Net financial expenses*

	Years ended December 31,			% Change 2002 vs. 2003	% Change 2003 vs. 2004
	2002	2003	2004		
	in adjusted NIS in millions				
Total net financial expenses	48.1	84.0	50.3	74.6	(40.1)

Net financial expenses include interest on our borrowings in Israel and linkage payments related to the fluctuations in the Israeli inflation rate (with respect to our borrowings in shekels) and the US dollar exchange rate (with respect to our borrowings in US dollars). Accordingly, our net financial expenses are affected by the level of our borrowings, from time to time, by changes in the interest rates announced by the Governor of the Bank of Israel and as determined by our creditors, and by changes in the Israeli inflation rate and the exchange rate of the US dollar against the shekel. The decrease in our net financial expenses in 2004 compared to 2003 is principally attributable to a lower debt level and the decrease in interest rates during 2004. The increase in our net financial expenses in 2003 compared to 2002, despite a reduction in our bank credit, is principally attributable to fluctuations in the rate of inflation from +6.5% in 2002 to 1.9% in 2003. The reduction in the rate of inflation in 2003 caused an increase in the real interest on unlinked NIS credit, which is a principal component of our credit portfolio. In addition, our net financial expenses increased in 2003 as a result of losses derived from exchange rate hedging transactions we performed.

**Other income (expenses).** This item includes non-recurring sources of income (expenses) or other income (expenses) not derived from our ordinary operations.

In 2004, other expenses in the amount of NIS 42.7 million were mainly composed as follows:

- A. During 2004, we wrote off the remaining portion of our investment in Barak I.T.C. (1995) The International Telecommunications Services Corp. Ltd. ( Barak ) in the amount of approximately NIS 16 million, based on a valuation implemented by an independent appraiser. See Item 4B. Information on the Company Business Overview International Telecommunication Services and Note 5c in our financial statements.
- B. During 2004, we recorded a provision of NIS 23.4 million with respect to our indemnification to Golden Channels (through HOT Vision) for approximately 26.5% of the damages awarded to Columbia, Fox and Warner Bros. International Television Distribution ( Warner ). See also Note 15b3 in our financial statements.

In 2003 and 2002, other income is primarily derived from the sale of 3,826,169 shares in Partner in November 2003 (in the amount of approximately NIS 97 million) and 13,778,668 shares in Partner in April 2002 (in the amount of approximately NIS 296 million, approximately 50% of our holdings at such time), respectively. See Item 4B Information on the Company Business Overview Cellular Telecommunication Services and Note 19d in our financial statements.

**Taxes on income.** Costs related to taxes on income decreased by NIS 28.3 million, or 79.5%, from NIS 35.6 million in 2003 to NIS 7.3 million in 2004. Costs related to taxes on income decreased by NIS 73.3 million, or 67.3%, from NIS 108.9 million in 2002 to NIS 35.6 million in 2003. In 2003 and 2002, we recorded costs related to taxes on income with respect to capital gains derived from our sales of shares in Partner. See the discussion regarding our sales of shares in Partner in Item 5B. Operating and Financial Review and Prospects Liquidity and Capital Resources . For more information regarding our taxes on income, see Note 17 in our financial statements.

**Equity in earnings of affiliated companies, net.** Our share in the earnings of affiliated companies decreased by NIS 26.6 million, from NIS 40.9 million in 2003 to NIS 14.3 million in 2004, mainly due to the decrease in our share in Partner s profits (totaling NIS 17.5 million in 2004 compared to NIS 40.9 million in 2003) which was offset by our share in HOT Telecom s losses (totaling NIS 3.2 million in 2004). Our share in the earnings of affiliated companies increased by NIS 30.0 million, from NIS 10.9 million in 2002 to NIS 40.9 million in 2003. The increase is attributed to our share in Partner s profits.

**5B. LIQUIDITY AND CAPITAL RESOURCES**

We have financed our operations through cash we generated from our operations, equity contributions and loans from our former principal shareholders, loans and credit lines from banks and others, sale of financial assets (including 4.45% of our shares that were held by Cable Systems Media Haifa-Hadera Ltd., a wholly owned subsidiary of ours, for aggregate consideration of approximately NIS 40.1 million), and from the public offerings, in Israel of our ordinary shares on the Tel Aviv Stock Exchange in October 1993 and of debentures and warrants in August 1997, and in the United States of our American Depository Shares in June 1996. For details regarding the terms of the debentures, including outstanding amounts, please see Note 14 of our financial statements.

In April 2002, we sold 13,778,668 shares of Partner Communications Company Ltd., or Partner, to a subsidiary of Hutchison Whampoa Ltd., representing approximately 50% of our holdings in Partner at that time. The gross consideration we received was approximately US\$ 62.4 million. In November 2003 we sold 3,826,169 shares of Partner. The gross consideration we received was approximately US\$ 25.5 million. In April 2005, we exercised our option to participate in the share buyback of Partner together with Elbit Ltd., Eurocom Communications Limited and Polar Communications Limited. At the closing of the transaction, we sold to Partner 7,783,444 ordinary shares of Partner for total consideration of approximately US\$ 57 million. We currently hold 1,884,926 ordinary shares of Partner, almost all of which are subject to transfer restrictions under Partner's communications license. The gain received from the sales of our shares in Partner is subject to income tax (the taxation of these sales is under dispute with the tax authorities). We have paid approximately NIS 70 million as an advance payment on account of this income tax. See Note 17 of our financial statements. We currently own indirectly, approximately 1.2% of the outstanding share capital of Partner.

During the past several years, we made use of external funds to finance our operating activities, capital expenditures associated with building-out our network and investments in associated companies. We have relied on internal cash flows, equity investments and loans from our principal shareholders, together with loans from banks and the proceeds from the issuance of our ordinary shares, American Depository Shares, debentures and warrants, and credit arrangements with suppliers to provide us with the necessary funding for building-out of our cable television network operating and investing activities. Our net capital expenditures, as determined on a cash basis, were NIS 77.3 million for the year ended December 31, 2002, NIS 56.6 million for the year ended December 31, 2003, and NIS 107.4 million (including an investment in HOT Telecom in the amount of approximately NIS 12 million) for the year ended December 31, 2004. In 2002 and 2003, there is a decrease in capital expenditures compared to the years 2000 and 2001 due to the fact that large projects relating to infrastructure (such as upgrading the network and the digital infrastructure), which required intensive capital expenditures, were completed in 2001. The increase in our capital expenditures in 2004, is due to large investments in converters and modems as a result of our market share strategy, our efforts to reduce churn and the investment in HOT Telecom. We did not invest in affiliated or other companies in 2002 and 2003. See Note 5 in our financial statements.

In 2002, we sold in private transactions in Israel an aggregate amount of 26,651 of our ordinary shares held by our subsidiary Cable Systems Media Haifa-Hadera Ltd., in consideration for an aggregate gross amount of approximately NIS 1.0 million. In 2003, we sold the remaining 1,343,497 of our ordinary shares held by Cable Systems Media Haifa-Hadera Ltd. in private transactions in Israel, in consideration for an aggregate amount of approximately NIS 39.1 million.

In 2002, we wrote-off approximately NIS 8.8 million of our investment in Barak. During 2004, we wrote off the remaining portion of our investment in Barak in the amount of approximately NIS 16 million, based on a valuation implemented by an independent appraiser. We may be required to make additional capital contributions in proportion to our relative holdings in Barak in the foreseeable future because Barak may not have readily available financing resources, including from its shareholders. We provided a guarantee on behalf of Barak to a bank in the amount of US\$ 200,000. See Item 4B. Information on the Company Business Overview International Telecommunication Services and Note 5c in our financial statements.

As of December 31, 2004, the principal amount of the bonds outstanding in Barak's financial statements totaled US\$ 122.4 million. The bonds bear interest payable semi-annually, commencing May 15, 2003. Until the payment which was due on November 15, 2004, Barak had met its interest payment obligations. Barak has decided to defer payment of interest to bondholders in the amount of US\$ 7.6 million due on November 15, 2004.

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Since Barak did not pay the interest payment within the 30-day period, the bondholders may have the right to request for the immediate acceleration of the bonds, subject to certain limitations. Barak does not have the financial ability to repay currently these bonds in full. As of December 31, 2004, Barak had a capital deficiency in the amount of NIS 527 million and a working capital deficit in the amount of NIS 704 million. For information regarding a non-binding term sheet entered into on June 15, 2005, by Barak, Clalcom, Clal Industries and Investments Ltd, Dial-the Israeli Company for International Communications Ltd. and we, which sets out the terms of a proposed reconstructing of Barak's capital and debt, see Item 4B. Business Overview International Telecommunication Services.

We hold approximately 26.6% of the outstanding shares of HOT Vision Ltd. The results of HOT Vision were recorded based on the equity method until December 31, 2003. On December 31, 2003, the accounts of HOT Vision were consolidated for the first time by the proportionate consolidation method on the basis of our proportionate share in the issued share capital of HOT Vision. We provided an unlimited guarantee to Bank Leumi L. Israel B.M., or Bank Leumi, for purposes of securing up to 24.6% of the credit the Bank Leumi will provide to HOT Vision. The board of directors of HOT Vision determined that the line of credit of HOT Vision from Bank Leumi would be limited to approximately US\$ 35 million, unless otherwise determined. As of December 31, 2004, we guaranteed to Bank Leumi US\$ 4.6 million on this line of credit. In addition, we provided a guarantee in an amount of up to US\$ 16 million to Bank Hapoalim B.M., or Bank Hapoalim, to secure approximately 25% of the credit provided by Bank Hapoalim to HOT Vision, and upon the fulfillment of certain conditions, up to 44% of the total credit. As of December 31, 2004, we guaranteed to Bank Hapoalim between US\$ 4.4 million to US\$ 7 million. In January 2005, Bank Hapoalim demanded from HOT Vision to repay all of its outstanding borrowings in the amount of approximately US \$16 million. HOT Vision had some discussions with the bank to extend the credit period See Note 15c to the financial statements.

Since March 26, 2002, Bank Leumi, Bank Igud, Bank Mizrahi, Israel Mercantile Discount Bank and Investec Trust Company have floating charges over all of our current and future assets, and specific fixed charges for an unlimited sum over our unpaid share capital and goodwill. According to the charge documents, any exercise of the charges shall be subject to the restrictions contained in our licenses, including the right of the licensee to use its assets to continue to supply services to its subscribers for so long as such license is valid. Furthermore, any terminal equipment situated in the subscribers' premises is exempted from the application of the charge. The provisions of the Telecommunications Law prohibit the grant of a charge over our licenses.

As of December 31, 2004, our borrowings consist of short and long-term loans from Israeli banks and other sources and debentures issued to the public, part of which are linked to the Israeli consumer price index or the US dollar. Below is a tabular summary of our outstanding indebtedness:

In adjusted NIS in millions	Total	Up to one year	Two to three years	Four to five years
Short-term bank credit (1)	437	437		
Debentures (Series A) (2)	67.2	34	33.2	
Long-term bank loans and other (3)	129.8	28.3	27.9	73.6
Total	634	499.3	61.1	73.6

(1) In NIS (not linked to the Israeli consumer price index), and as of December 31, 2004, bears average annual interest of approximately 5.4%.

(2) Linked to the Israeli consumer price index, and bears annual interest of 3.7%. See Note 14 of our financial statements for the terms of these debentures.

(3) In NIS (linked to the Israeli consumer price index and to the US dollar), and bears annual interest at rates ranging from 5.5% to 6.2%, or in US dollars and bearing average annual interest of LIBOR + 1.5-1.75%.

We commenced negotiations regarding an increase of our present credit lines with our banks, in order to have, together with our internal cash flow, sufficient funds to finance the investment in the continued network build-out and development, acquisition of additional digital set-top boxes, extension of our cable television and IP networks, and loans granted to HOT Telecom to finance its telephony project. In the framework of our negotiations with the banks regarding the extension of our credit lines, we agreed to enhance the security granted to the banks as collateral for our credit lines by granting a floating charge in their favor, subject to the terms of our licenses. These negotiations were ceased due to the proceedings in connection with the proposed merger of the Israeli cable television operators. Thereafter, as the merger was not consummated, these negotiations were recommenced. There is no assurance that we shall reach an agreement with the banks and receive such increased credit lines.



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In the event that we shall increase our present credit lines, we expect that the amount and cost of the additional bank credit as well as the security we will be obligated to make available to the banks will be influenced by many factors, including: the volatility of private and public markets in debt and equity, our financial results, the effect of competition and regulatory uncertainty. Therefore, we cannot assure you that the additional financing, if any, will be on the same terms as our current financing from the banks, or on terms which are favorable to us or which are not significantly expensive.

Under our credit agreements with the banks that finance our operations, we are subject to conditions and limitations on our business activities, including limitations on our ability to obtain additional credit, sell or purchase assets and distribute dividends. One of our credit agreements with a bank in Israel includes certain covenants according to which, until the date of consummation of the merger of the three Israeli cable television operators, we are required to maintain certain financial ratios, such as, with respect to our level of equity, total financial credit, operational costs and financing expenses. We are also required to maintain a certain number of subscribers. If we fail to fulfill any of our covenants we could be deemed to be in breach of our loan agreements with the bank. In such event, the bank will be entitled to demand immediate payment of all amounts owing to it under the line of credit, loans, banking services and any other obligation we have to such bank. The balance of credit taken from this bank as of December 31, 2004 was approximately NIS 60 million. As of December 31, 2004, we did not comply with two covenants to maintain the financial ratios, as defined in the agreement, as follows:

1. The number of broadcast subscribers.

2. Operating surplus.

During March 2005, we received a letter from this bank according to which the bank does not deem the non-compliance, described above, to be a violation by the company to maintain the financial ratios for a period of one year, commencing from the date of the letter (the waiver period).

Further to the non-compliance of the financial covenants in 2004 and with regard to the dictated increase in the required operating surplus, as defined in the covenants, in 2005, the company's management anticipates that additional negotiations shall take place with the bank, at the end of the waiver period (March 2006).

### ***Cash Flow (Cable TV and Internet activities together)***

Below is a condensed presentation of certain aspects of our cash flow during 2003 and 2004. For our full cash flow statements, please see the financial statements attached at Item 18. Financial Statements .

	<b>Years ended December 31,</b>	
	<b>2003</b>	<b>2004</b>
	<b>in adjusted NIS in millions</b>	
Net cash provided by (used in) operating activities	96.0	121.3
Net cash provided by (used in) investing activities	60.4	(106)
Net cash used in finance activities	(126.1)	(29)
Increase (decrease) in cash and cash equivalents	30.3	(13.7)
Cash and cash equivalents at beginning of year	7.6	37.9
Cash and cash equivalents at end of year	37.9	24.2

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The increase in net cash provided by our operating activities in 2004 compared to 2003 derives from an increase in our revenues and a decrease in our financing costs, which is partly offset by an increase in operating expenses.

Net cash used in investment activities in 2004 in the amount of approximately NIS 106 million is primarily used for purchasing of property, plant and equipment and investment in HOT Telecom. In 2003 net cash provided by investment activities in the amount of approximately NIS 60.4 million, is primarily derived from the proceeds of the sale of a portion of our shares in Partner in the amount of NIS 114.4 million, which was offset by investments in fixed assets in the amount of NIS 56.6 million.

Net cash used in financing activities in 2004 in the amount of approximately NIS 29 million mainly represent redemption of debentures. Net cash used in financing activities in 2003 is comprised of NIS 131.5 million used for repayment of bank loans, NIS 33.7 million used for redemption of debentures, and NIS 39.1 million provided by sales of our shares held by a subsidiary.

We paid a dividend on January 26, 2000 of approximately NIS 222.0 million. We did not pay a dividend in 2001, 2002, 2003 and 2004. We have not adopted any dividend distribution policy, and we cannot assure you that we would pay additional dividends in the future.

Our management believes that our cash and cash equivalents reserve, as well as cash flow from our operations and available credit lines, will be sufficient to meet our anticipated cash needs for a period of at least twelve months commencing on December 31, 2004.

### **Impact of Inflation and Exchange Rate Fluctuations**

Since we may be unable or not permitted to raise our rates and fees pursuant to our licenses in a manner that would fully compensate for any increase in the Israeli consumer price index, inflation in Israel, which may impact our borrowing costs with respect to Shekel amounts linked to the Israeli consumer price index and may cause an interest increase in Israel, may have a material adverse effect on us.

Substantially all of our revenues and a majority of our operating expenses are denominated in shekels. However, through December 31, 2004, a substantial amount of our operating expenses were linked to non-shekel currencies. These expenses related mainly to programming where the price paid by us is based on the US dollar. Some of our capital expenditures are incurred in, or linked to, non-shekel currencies, mainly US dollars. Thus, any devaluation of the shekel against the US dollar, will also increase the shekel cost of our non-shekel denominated or linked expenses. Such increase may have an adverse impact upon our operating results, which may be material. Our borrowings are mostly in Israeli shekels with the remainder in US dollars.

### **Differences Between Israeli GAAP and U.S. GAAP**

Israeli GAAP varies in certain respects from U.S. GAAP. The application of U.S. GAAP to our financial statements would have affected the determination of net loss, determination of capital deficiency, comprehensive income, investment in affiliates and marketable securities available for sale, debentures and deferred taxes as of December 31, 2004 to the extent summarized in Note 26 to the financial statements.

### **5C. RESEARCH AND DEVELOPMENT, PATENTS AND LICENSES**

Not applicable.

### **5D. TREND INFORMATION**

1. During 2004, our number of cable television subscribers declined, mainly due to increased competition from YES, the Israeli satellite television broadcaster. However, during the same period, our number of access to High Speed Internet subscribers increased. This trend has continued in 2005 so far.

2. In the second half of 2004, we experienced a decrease in our total revenues and our monthly average revenues per subscriber. The decrease in our revenues and our monthly average revenues per subscriber has continued in the first quarter of 2005, but at a more moderate pace. We believe that the decrease in our revenues and our monthly average revenues per subscriber was a result of the intensified market share strategy undertaken by the three cable television operators in Israel. Such strategy has been replaced in the second quarter of 2005 with a retention strategy, as the three cable television operators are moving into the era of marketing bundled television, high speed access internet and telephony in one package known as the Triple Play .



3. In recent years our results, such as gross profits, profit from operations and EBITDA, have improved. There is a deterioration in the parameters mentioned above as a result of the ongoing intensified competition over the market share strategy in the Israeli multi-channel television market .

4. In 2000 and 2001, we made significant capital expenditures to upgrade our network. In 2002 and 2003, we significantly reduced our capital expenditures. In 2004, our capital expenditures increased due to large investments in converters and modems as a result of our market share strategy, and our efforts to reduce churn. We also made capital investment in the telephony project through the investment in HOT Telecom. For more information about other factors that may affect our results of operations, see Item 3D. Key Information — Risk Factors.

**5E. OFF-BALANCE SHEET ARRANGEMENTS**

We hold approximately 26.6% of the outstanding shares of HOT Vision Ltd. The results of HOT Vision were recorded based on the equity method until December 31, 2003. On December 31, 2003, the accounts of HOT Vision were consolidated for the first time by the proportionate consolidation method on the basis of our proportionate share in the issued share capital of HOT Vision. We provided an unlimited guarantee to Bank Leumi L. Israel B.M., or Bank Leumi, for purposes of securing up to 24.6% of the credit the Bank Leumi will provide to HOT Vision. The board of directors of HOT Vision determined that the line of credit of HOT Vision from Bank Leumi would be limited to approximately US\$ 35 million, unless otherwise determined. As of December 31, 2004, we guaranteed to Bank Leumi US\$ 4.6 million on this line of credit.

We hold approximately 26.6% of the outstanding shares of HOT Telecom. The results of HOT Telecom are recorded based on the equity method. As of May 31, 2005, we provided a bank guarantee of approximately NIS 7.7 million to secure the payments of HOT Telecom to Lucent. In addition, we and Tevel guarantee, jointly and severally, in a total aggregate amount of US\$ 4.5 million to secure the payments of HOT Telecom to Cisco. The cable television operators signed an indemnification agreement with respect to the Cisco guarantee.

In addition, we provided a guarantee in an amount of up to US\$ 16 million to Bank Hapoalim B.M., or Bank Hapoalim, to secure approximately 25% of the credit provided by Bank Hapoalim to HOT Vision, and upon the fulfillment of certain conditions, up to 44% of the total credit. As of December 31, 2004, we guaranteed to Bank Hapoalim between US\$ 4.4 million to US\$ 7 million. In January 2005, Bank Hapoalim requested to exercise the guarantee. HOT Vision has discussed with the bank to extend the credit period.

In order to ensure compliance with our obligations pursuant to our licenses, applicable law and regulatory bodies, and to ensure payment of fines that may be imposed by the Council and the Ministry of Communications, we have provided a guarantee of US\$ 3.72 million pursuant to the HOT Telecom Infrastructure License along with the other two cable television operators in an aggregate amount of US\$ 14 million. For more information on this guarantee, see Item 4B. Information on the Company Business Overview Our Licenses.

**5F. TABULAR DISCLOSURE OF CONTRACTUAL OBLIGATIONS**

The following table sets forth, as of December 31, 2004, our known contractual obligations by type of obligation and for the periods indicated:

In thousands of NIS adjusted as of December 31, 2004	Payment due by period				more than 5 years
	Total	Less than 1 year	1-3 years	3-5 years	
Long-term debt obligations (banks and others)	129,767	28,310	86,769	14,688	
Operating lease obligations	15,221	6,736	7,851	634	
Debentures	67,206	34,005	33,201		
Accrued severance pay*	20,394				20,394
<b>Total</b>	<b>232,588</b>	<b>69,051</b>	<b>127,821</b>	<b>15,322</b>	<b>20,394</b>

\*As of December 31, 2004, we had NIS 17,911 in a severance pay fund to cover such liability.

*Contingent Obligations*

In order to ensure compliance with our obligations pursuant to our licenses, applicable law and regulatory bodies, and to ensure payment of fines that may be imposed by the Council and the Ministry of Communications, we have provided a guarantee of NIS 9.3 million to the Council pursuant to the Cable Broadcast Licenses.

The approval of the Controller to the merger is also conditional upon the provision of a bank guarantee in the amount of US\$ 15 million to ensure compliance with the terms of the approval of the Controller. In the event that the Controller decides, in his discretion, that there has been a material breach of the terms of the approval, he may fully exercise the guarantee. We have provided our pro rata portion of this guarantee in the amount of US\$ 3.75 million.

For more information on these guarantees, see [Item 4B. Information on the Company](#) [Business Overview](#) [Our Licenses](#).

Pursuant to the proposed reconstruction of Barak's capital and debt, we are entitled to participate in the funding of a cash payment in the amount of US\$ 6 million in accordance with our proportional holdings in Barak. Our board of directors has recently decided to participate in the funding. We will be required to provide additional guarantees in the future of unknown amounts pursuant to the proposed reconstruction. For more information on the cash payment, see [Item 4B. Information on the Company](#) -- [Business Overview](#) [International Telecommunication Services](#).

**ITEM 6. DIRECTORS, SENIOR MANAGEMENT AND EMPLOYEES****6A. DIRECTORS AND SENIOR MANAGEMENT****Directors**

Set forth below is certain information about our officers and directors as of June 25, 2005.

Directors

<u>Name</u>	<u>Age</u>	<u>Position</u>
Meir Srebernik	46	Chairman of the Board of Directors
Asaf Bartfeld	53	Director
Shimon Cheifetz (1)	62	Director
Moshe Amit (1) (2)	70	Director
Gabriel Last	58	Director
Menashe Raz	58	Director
Hanania Gibstein	72	Director
Yair Keusch (1) (2) (3)	65	Director
Yeshayahu Drori (1) (2) (3)	67	Director
Yehoshua Gibstein (1)	45	Alternate Director

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Officers

<u>Name</u>	<u>Age</u>	<u>Position</u>
Amit Levin	42	Chief Executive Officer
Ori Gur Arieh	48	Counsel and Company Secretary
Tal Peres	39	Chief Financial Officer
Shlomi Ashkenazi	39	Vice President, Sales, Marketing and Operational Areas

- (1) Member of the Finance Committee.
- (2) Member of the Audit Committee.
- (3) Independent Director.

**Meir Srebernik** has been a director of Matav since March 2002 and its Chairman since September 2004. Mr. Srebernik was the Chief Executive Officer of Dankner Investments Ltd., from February 2002 to August 2004. Mr. Srebernik served as a director of various other companies, including Matav Investments Ltd., Cable Systems Media Haifa-Hadera Ltd., Matav Assets Ltd., Matav Infrastructure Ltd., HOT Telecom Ltd., Nonstop Ventures Ltd, and HOT Vision. Between 1995 and 2000, he was the president and Chief Executive Officer of Netia Holding SA, a leading Polish alternative fixed line telecommunications company. He has also served as the head of the cable television division of the Israeli Ministry of Communications from 1987 to 1993, as Vice President of Telecommunications of Dankner Investments Ltd. from 1993 to 1994 and as a director of Pelephone Communications Ltd., one of the four mobile phone service providers in Israel, in 2001. Mr. Srebernik has a B.A. degree in economics and business administration from the Hebrew University, Jerusalem.

**Asaf Bartfeld** has been a director of Matav since June 2004. Mr. Bartfeld is currently the President and CEO of Delek Group Ltd., and the CEO of Delek Investments and Properties Ltd. Prior to holding his current positions in the Delek Group he was CFO of Delek Group Ltd. Mr. Bartfeld serves as the chairman of the board of directors of Delek Real Estate Ltd., Gadot Biochemical Industries Ltd., Delek Belron International Ltd., and is a member of the board of directors of several other entities within the Delek Group. Mr. Bartfeld has a B.A. degree in economics from Tel Aviv University.

**Shimon Cheifetz** has been a director of Matav since January 20, 1989. Mr. Cheifetz is also a director of various companies in Israel: Matav Investments Ltd., Cable Systems Media Haifa-Hadera Ltd., Matav Assets Ltd. and Barak I.T.C.- The International Telecommunications Services Ltd. Mr. Cheifetz served as the general manager of Maariv-Modiin Publishing House Ltd. until April 1992. Since April 1992 Mr. Cheifetz has been the chairman of the board of directors and a director in various other companies including, Mifratz Flour Mills Ltd., Man Haifa Bay Flour Mills (1999) Ltd., Grand Moulins D Israel Ltd., Ugda Investment Ltd., Synet Industries Ltd., El-Mul Technologies Ltd., and Yeda Research and Development Co. Ltd.

**Moshe Amit** has been a director of Matav since August 2004. He serves as the Chairman of Continental Bank and as a director of several banks and companies, including Bank Hapoalim (Swiss), Signature Bank (New York), and the Delek Group. Mr. Amit served between 1980 to 2003 as member of the board of management of Bank Hapoalim and his latest position was deputy CEO of Bank Hapoalim. Mr. Amit has a B.A. degree in political science from Bar-Ilan University and has a diploma in bank management.

**Gabriel Last** has been a director of Matav since August 2004. Mr. Last served as the CEO of Delek Group Ltd. from 2001 to 2003. In 2003 he was appointed as Chairman of the board of directors of Delek Group and is a director in many subsidiaries of the Delek Group. From 1998 to 2001 he served as CEO of the Israeli Society of Insurance Companies and of the Israeli Association of Life Insurance Companies Ltd. From 1985 to 1998, Mr. Last served in various command positions in the Israeli police force, including as the Vice Inspector General from 1996 to 1998. Mr. Last has a L.L.B. degree from Tel Aviv University and a M.A. degree in political science from Haifa University. He is a graduate of A.M.P Harvard Business School.

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**Menashe Raz** has been a director of Matav since August 2004. For over 30 years, Mr. Raz has been engaged in the electronic media in various positions, including as editor, television and public radio reporter, T.V. show host and documentary films maker. He serves as a news reporter, anchor and show host in the News Company. Channel 10 since April 2002. From 1972 to 1999, Mr. Raz served in various positions in Channel 1, the Israeli public television channel, including as editor and anchor of *Mabat Lachadashot*, the main news edition of Channel 1. He was the CEO of the Schruver Fund, a non-profit organization engaged mainly in funding of development projects in Israel. Mr. Raz is a graduate of the Hebrew University in political science and international relations.

**Hanania Gibstein** has been a director of Matav since August 14, 1987. Mr. Gibstein also serves as a director of Cable Systems Media Haifa Hadera Ltd. and Matav Investments Ltd. Mr. Gibstein was a member of the Municipal Council of the city of Rishon Le-Zion, and was the mayor of that city from 1969 to 1983. Mr. Gibstein is the chairman of the Society of Friends of The Beer Yaacob Mental Health Center. Since 1991 Mr. Gibstein has been the vice-chairman of the Association for Welfare of the Soldiers of Israel, and has managed private businesses, primarily in real estate.

**Yair Keusch** has been an external director of Matav since June 3, 2004. Mr. Keusch has served as an economic and financial advisor to various companies since 2001. From 1972 to 2000, Mr. Keusch served as the Vice President of Finance of Delek The Israel Fuel Corporation Ltd., an energy company publicly traded on the Tel-Aviv Stock Exchange. Mr. Keusch also served as a director in many companies. In the past, Mr. Keusch lectured in the Department of Economics of Tel-Aviv University and at other institutions of higher education in Israel. Mr. Keusch previously served as the Manager of the Economics Department of the Institute for Productivity of Labor and Manufacture. Mr. Keusch has a B.A. in economics and an MBA from the Hebrew University in Jerusalem.

**Yeshayahu Drori** has been an external director of Matav since June 3, 2004. Mr. Drori held various positions with the *Dan* bus cooperative from 1978 to 2000, including heading the inspection, planning/development and finance divisions, and served as the Chairman of the cooperative's Secretariat from 1997 to 2000. From 1992 to 2000, Mr. Drori served as the Chairman of *AVIS* *Dan* Rent a Car. Mr. Drori has served as a member of the Tel Aviv municipal council since 1999, Mr. Drori serves as a member of various municipal councils and committees, environmental bodies and is a member of the board of directors of *Netivey Ayalon* Ltd.

**Yehoshua Gibstein** has been an alternate director of Matav for Mr. Hanania Gibstein since May 24, 1998. Mr. Yehoshua Gibstein was a director of Matav between 1992 and May 1998. Mr. Gibstein is also a director in *Pikom* Ltd., *Exent Technologies* Ltd., *Cabletek* Ltd. and *Noa* (G.P.A) Investment Company Ltd., which specializes in investment and project development. Mr. Gibstein is the son of Hanania Gibstein.

**Amit Levin** has been our Chief Executive Officer since October 7, 1999. In addition, Mr. Levin currently serves as Vice President of Service and Logistics of the merged operations of the three cable television operators. Mr. Levin served as Vice President of Marketing and Programming of the merged operations of the three cable television operators from June 2004 to June 2005. Before that and since September 1998, he served as our interim Chief Executive Officer. Between October 1994 and September 1998, he was Matav's Vice President of Israeli Operations. Mr. Levin is a director of *Nonstop Internet* (1999) Ltd., *Matav Assets* Ltd. and *Matav Infrastructure* Ltd. Between 1991 and 1994, Mr. Levin was Matav's area manager for *Netanya*.

**Ori Gur Arieh** has been Matav's Counsel and Company Secretary since November 2000. Mr. Gur Arieh also serves as General Counsel to *HOT* Telecom and General Counsel to the merged operations of the three cable television operators, referred to as *HOT*. Prior to his employment with Matav, Mr. Gur Arieh was a partner in the private law practice of *Avital, Dromi & Co.*

**Tal Peres** has been our Chief Financial Officer since May 2005. Prior to joining the Company and since 2003, Mr. Peres served as chief financial officer and a member of the executive committee of *Hashmira* Group. Mr. Peres has served as chief financial officer and a member of the executive committee of the *DBM* Group from 2001 to 2002 and of the *Career* Group, a subsidiary of *Manpower International*, from 1996 to 2001. Mr. Peres is a certified public accountant.

**Shlomi Ashkenazi** has been Matav's Vice President of sales, marketing and operational areas since August 2002. Mr. Ashkenazi also serves as Vice President of Sales of the merged operations of the three cable television operators, referred to as *HOT*. Between February 2002 and August 2002 he served as Matav's Vice President of Marketing and Sales. Before that and since 1998, he served as Matav's Vice President and Chief Operating Officer. Between 1995 and 1998 he served as an operating area manager for our *Bat-Yam*, *Holon* and the *Galilee* franchise areas.

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Except as disclosed above, none of the above directors or members of senior management has any family relationship with any other director or senior manager of Matav.

### **6B. COMPENSATION**

The aggregate net compensation paid, and benefits in kind granted to or accrued on behalf of all of our directors, officers and members of our extended management, as a group, for their services in all capacities during the year ended December 31, 2004 was approximately NIS 8.1 million. This amount includes pension, retirement and similar benefits in the aggregate amount of NIS 1.5 million. This amount excludes amounts we expended for vehicles we made available to our officers and members of extended management and expenses (including business travel, professional and business association dues and expenses) with which we reimbursed our officers and members of extended management.

During 2001, we granted 770,500 options to purchase ordinary shares of the company to 45 employees under our 2001 Employee and Officers Option Plan, or the 2001 Plan. As of December 31, 2004, 608,300 options were cancelled, 90,732 options were forfeited, 37,235 options were exercised and 34,233 options expired.

In addition, as of December 31, 2003, options were granted to approximately 46 members of our senior management under our 2003 Employee and Officers Option Plan, or the 2003 Plan, to purchase up to 770,000 of our ordinary shares. The options under the 2003 Plan vest in three equal portions. The first portion vested on January 31, 2004 and has an exercise price of 85% of the average 30 day trading price on the Tel Aviv Stock Exchange, or TASE prior to November 17, 2003. The second portion vested on January 31, 2005 and has an exercise price of 90% of the average 30 day trading price on TASE prior to the vesting date. The third portion vests on January 31, 2006 and has an exercise price of 90% of the average 30 day trading price on TASE prior to the vesting date. In addition, all of the employees that were entitled to receive options under the 2003 Plan that received options under the 2001 Plan were required to waive their vested options under the 2001 Plan as a condition to receiving options under the 2003 Plan.

On November 29, 2004, a special meeting of the Company's shareholders approved the grant of 302,205 stock options of the 2003 Plan at no consideration to a member of the Company's board of directors. The exercise price of the options is NIS 38 per share.

As of December 31, 2004, under the 2003 Plan, 1,072,205 options were issued to 46 employees, 36,483 options were exercised, and 11,000 options were forfeited.

For more information see Item 6E. Share Ownership.

### **6C. BOARD PRACTICES Israeli Companies Law**

We are subject to the provisions of the Israeli Companies Law, 5759-1999, which became effective on February 1, 2000 and regulations adopted thereunder, or the Companies Law, which supersedes most of the provisions of the Israeli Companies Ordinance (New Version), 5743-1983.

#### **Terms of Directors**

Generally, each director is elected at the annual general meeting of shareholders and holds office until the election of his/her successor at the next annual general meeting, except for external directors, who hold office for three-year terms and may be re-elected by the shareholders for an additional three-year term. Currently, our articles of association provide that our board of directors consists of at least 4 directors but not more than 15. Our articles of association provide that a majority of our board of directors, entitled to participate, may appoint additional directors, up to the maximum number permitted. Our articles of association also provide that our board of directors may delegate all of its powers to committees of the board of directors, as it deems appropriate, subject to the provisions of the Companies Law. No director has a service contract with our company or its subsidiary providing for benefits upon termination of employment. Our officers serve at the discretion of our board of directors or until their successors are appointed.

### **Alternate Directors**

Our articles of association provide that a director may at any time, appoint any individual as an alternate director. In addition, no person who already serves as a director or alternate director of Matav may serve as the alternate director of another director of Matav. An alternate director may not serve as such unless such person is qualified to serve as a director. Under the Companies Law, an alternate director shall have all of the rights and obligations of the director appointing him or her. The alternate director may not act at any meeting at which the director appointing him or her is present. Unless the time period or scope of any such appointment is limited by the appointing director, such appointment is effective for all purposes and for an indefinite time, but will expire upon the expiration of the appointing director's term. Mr. Yehoshua Gibstein is alternate director for Mr. Hanania Gibstein, in his absence.

### **Independent Directors and External Directors**

Pursuant to the current listing requirements of the Nasdaq National Market, as a foreign private issuer which was already publicly traded in December 1999, we are required to have at least two independent directors on our board of directors and to establish an audit committee, a majority of whose members must be independent.

The Companies Law requires that we have two external directors. The election of an external director under the Companies Law must be approved by a general meeting of shareholders provided that either: (a) the majority of shares voted at the meeting, including at least one third of the shares of non-controlling shareholders voted at the meeting, vote in favor of such election; or (b) the total number of shares voted against such election does not exceed one percent of the aggregate voting rights in the company.

On June 3, 2004, Mr. Yair Keusch and Mr. Yeshayahu Drori were appointed as external directors to replace Mr. David Harnik and Mr. Michael Goldschmidt whose terms expired on June 4, 2004. Our current external directors satisfy the provisions of the Companies Law pursuant to which they were appointed, and also satisfy the requirements of the Nasdaq National Market regarding independent directors.

### **Audit Committee**

As a foreign private issuer, we received an automatic exemption from the listing requirements of Nasdaq relating to audit committees that were adopted in 2000. Accordingly, we are required to have at least two, rather than three, independent directors on our audit committee. The responsibilities of the audit committee under the Nasdaq requirements include, among other things, evaluating the independence of our directors. In addition, we are not required to adopt a formal audit committee charter.

The Companies Law requires public companies, including us, to appoint an audit committee. The responsibilities of the audit committee include reviewing our financial statements, identifying irregularities in the management of the company's business (including in consultation with the internal auditor and the company's independent accountants) and to suggest an appropriate course of action to amend such irregularities, and approving certain related party transactions as required by law. An audit committee must consist of at least 3 members, and include all of the company's external directors. However, the chairman of the board, any director employed by the company or providing services to the company on an ongoing basis, any controlling shareholder or any relative of a controlling shareholder, may not be a member of the audit committee. The current members of our audit committee are: Mr. Moshe Amit, Mr. Yair Keusch and Mr. Yeshayahu Drori.

### **Internal Auditor**

The Companies Law requires the board of directors of a public company to appoint an internal auditor proposed by the audit committee. A person who does not satisfy certain independence requirements may not be appointed as an internal auditor. The role of the internal auditor is to examine, among other things, the compliance of the company's conduct with applicable law and orderly business procedures. The accounting firm Elan Katz Nagor was appointed as our internal auditor in November 17, 2003.

### **Fiduciary Duties of an Office Holder**

The Companies Law imposes fiduciary duties on an office holder of a company, which consist of a duty of loyalty and a duty of care. An office holder is defined in the Companies Law as a director, general manager, chief executive officer, executive vice president, vice president, other manager directly subordinate to the any other person assuming the responsibilities of any of the foregoing positions regardless of that person's title and other managers directly subordinate to the general manager. The duty of loyalty requires the office holder to avoid any conflict of interest between the office holder's duties for the company and other duty or personal affairs, and proscribes any competition with the company or the exploitation of any business opportunity of the company in order to receive personal advantages for himself or herself, or for others. This duty also requires him or her to reveal to the company any information or documents relating to the company's affairs that the office holder has received due to his or her position as an office holder. The duty of care requires an office holder to act with the level of care which a reasonable office holder in the same position would employ under the same circumstances. This includes the duty to utilize reasonable means to obtain information regarding the advisability of a given action submitted for his or her approval or performed by virtue of his or her position, and all other relevant information pertaining to such action.

### **Approval of Related Party Transactions**

Generally, under the Companies Law the compensation of office holders who are directors requires the approval of the audit committee, the board of directors and the general meeting of the shareholders of the company (in that order). The Companies Law also requires that arrangements as to the compensation of office holders who hold a controlling interest in the company must be approved by the audit committee, the board of directors and a meeting of the shareholders (in that order) provided that either: (a) the majority of shares voted at the meeting, including at least one third of the shares of shareholders not having a personal interest in the matter voted at the meeting, vote in favor of such arrangement; or (b) the total number of shares voted against such arrangement does not exceed one percent of the aggregate voting rights in the company.

The Companies Law requires that an office holder promptly disclose any direct or indirect personal interest that he or his affiliates may have, and all related material information known to him, in connection with any existing or proposed transaction by the company. The office holder must make his disclosure orally or in writing no later than the first meeting of the company's board of directors meeting which discusses the particular transaction. The company may approve the transaction in accordance with the provisions of its articles of association and the Companies Law. Under the Companies Law, if the office holder has a personal interest, the company may approve the transaction provided that the transaction is not adverse to the company's interest. In addition, if the transaction is an extraordinary transaction, then in addition to any approval required by the articles of association, it also must be approved by the company's audit committee, its board of directors (in that order) and, in certain circumstances, the shareholders of the company at a general meeting. Generally, a director who has a personal interest in a matter that is considered at a meeting of the board of directors or the audit committee may not attend that meeting or vote on the matter, unless a majority of the board of directors or the audit committee also has a personal interest in the matter.

For information concerning the direct and indirect personal interests of certain of our office holders and principal shareholders in certain transactions, see Item 7. Major Shareholders and Related Party Transactions.

Under the Companies Law, the disclosure requirements which apply to an office holder also apply to a controlling shareholder of a public company. Moreover, under the Companies Law, extraordinary transactions between a public company and a controlling shareholder of the company or with a third party in which a controlling shareholder has a personal interest, in addition to any approvals stipulated by the articles of association, require the approval of the audit committee, the board of directors and of the shareholders with the same majority requirement as required for the approval of compensation arrangements of office holders who hold a controlling interest in the company.

### **Duty of a Shareholder**

Under the Companies Law, a shareholder has a duty to act in good faith towards the company and other shareholders, and refrain from improperly exploiting his power in the company, including when voting in the general meeting of shareholders on (a) any amendment to the articles of association, (b) an increase of the company's authorized share capital, (c) a merger or (d) approval of transactions with interested parties which require shareholder approval. In addition, any controlling shareholder, any shareholder who knows that it possesses the power to determine the outcome of a shareholder vote and any shareholder that, pursuant to the provisions of the articles of association, has the power to appoint or prevent the appointment of an office holder in the company or any other power towards the company, is under a duty to act in fairness towards the company. The Companies Law does not detail the substance of this duty.



### Exculpation of Office Holders

Under the Companies Law, an Israeli company may not exempt an office holder from liability with respect to a breach of his duty of loyalty, but may exempt in advance an office holder from his liability to the company, in whole or in part, with respect to a breach of his duty of care, provided that the articles of association of the company permit it to do so. Our articles of association allow us to exempt our office holders to the fullest extent permitted by law.

### Indemnification of Office Holders

Our articles of association permit us to undertake in advance to indemnify our officers and directors, provided that the undertaking is restricted to the events of a kind which the board of directors may anticipate at the time it makes such undertaking and limited to an amount which the board of directors determines is reasonable under the circumstances. In addition, we can indemnify an officer or director for specific occurrences retroactively.

Our articles of association further provide that the total amount as to which we may indemnify our officers and directors under these provisions shall not exceed 25% of our equity according to the last financial statements that were published.

Our articles of association also provide that we may indemnify an officer or director for liability or expense imposed on him as a result of an action performed by him in his capacity as our officer or director as follows:

- (1) Any financial liability imposed on the officer or director in favor of a third party in accordance with a judgment, including a judgment given in a settlement or a judgment of an arbitrator, approved by the court.
- (2) Reasonable litigation expenses, including legal fees, incurred by the officer or director or which he was ordered to pay by the court:
  - (a) within the framework of proceedings filed against him by Matav or on Matav's behalf or by a third party,
  - (b) in a criminal proceeding in which he was acquitted,
  - (c) in a criminal proceeding in which he was convicted of a felony which does not require a finding of criminal intent.

In November 2004, our shareholders approved and ratified our authority to indemnify our officers and directors to the fullest extent permitted by law and to provide each of them with an Indemnification Letter providing for the same. Our officers and directors are also exempted from any liability for damages caused as a result of a breach of duty of care to the Company, to the fullest extent permitted by law.

### Insurance of Office Holders

Our articles of association provide that, subject to the provisions of the Companies Law, we may enter into a contract for the insurance of the liability of any of our office holders with respect to an act performed by such individual in his or her capacity as an office holder, for:

- (1) a breach of an office holder's duty of care to us or to another person; or
- (2) a breach of an office holder's duty of loyalty to us, provided that the office holder acted in good faith and had reasonable cause to assume that his or her act would not prejudice our interests; or
- (3) a financial liability imposed upon an office holder in favor of another person.

We have obtained a directors and officers insurance policy, currently valid until August 31, 2005.

**Limitations on Exculpation, Indemnification and Insurance**

Under the Companies Law, in no event may we enter into a contract for the insurance of our office holders, indemnify an office holder or exempt an officer from responsibility toward the company, for:

- (1) breach of the duty of loyalty toward Matav, unless, with respect to insurance coverage, the officer or director acted in good faith and had reasonable grounds to assume that the action would not harm us;
- (2) breach of the duty of care if it was committed intentionally or recklessly;
- (3) an act or omission committed with the intent to yield a personal profit; or
- (4) any fine or penalty imposed on the office holder.

**6D. EMPLOYEES**

As of December 31, 2004, we had 826 employees on a full-time or full-time equivalent basis. Of these employees, 128 were in engineering and technical support, 246 were in customer service and support, 166 were in marketing, 106 were in Internet activities, and the remainder in administration and management.

As at December 31, 2004, all of our employees are located in Israel. Substantially all of our employees have entered into employment contracts with us, terminable at will by either party. The majority of our employees is managed by the joint management of the three cable television operators, which oversees the operational merger. The payroll expenses related to these employees are divided among the three cable television operators pursuant to the operational merger. For more information on the operational merger, see Item 4. Information on the Company.

Our employees are not covered by any specific collective bargaining agreement. However, we are subject to various Israeli labor laws and practices, as well as orders extending certain provisions of collective bargaining agreements between the Histadrut, currently the largest labor organization in Israel, and the Coordination Bureau of Economic Organizations, the federation of employers organizations. Such laws, agreements and orders cover a wide range of areas and impose minimum employment standards including, working hours, minimum wages, vacation and severance pay, and special issues, such as equal opportunity in employment, and employment of women, youth, disabled persons and army veterans.

We generally contribute funds on behalf of our employees to a fund known as Managers Insurance. This fund provides a combination of savings plan, insurance and severance pay benefits to the employees, giving the employees a lump sum payment upon retirement or a pension upon retirement and securing some of the severance pay, if legally entitled, upon termination of employment. Most of our employees are entitled to participate in the plan upon the start of employment or after an initial period. Each employee contributes an amount equal to 5% of his salary and we contribute between 13.3% and 15% of such employee's salary.

We also offer some of our employees the opportunity to participate in a Continuing Education Fund, which functions also as a savings plan. Each of the participating employees contributes an amount equal to 2.5% of his salary and we contribute 7.5% of such employee's salary.

According to the National Insurance Law, Israeli employers and employees are required to pay predetermined sums to the National Insurance Institute. These contributions entitle the employees to health insurance and benefits in periods of unemployment, work injury, maternity leave, disability, reserve military service and bankruptcy or winding-up of the employer. We have never experienced a strike or work stoppage.

Except for one action pending against us, by a former service provider, claiming an employer-employee relationship existed at the time he provided his services, no material labor-related claims are pending. For more information on this claim, also see Item 8A. Financial Information Consolidated Statements and Other Financial Information Legal and Arbitration Proceedings.

**6E. SHARE OWNERSHIP**

As of April 30, 2005, our directors and executive officers owned an aggregate of 2,737,653 or approximately 9% of our outstanding ordinary shares. Except for Shimon Cheifetz and Hanania Gibstein, no individual director or senior manager listed in Item 6A Directors and Senior Management , owns directly (or through fully owned companies) 1% or more of our outstanding ordinary shares.

As of April 30, 2005, our senior managers and directors, held, in the aggregate, options to purchase up to 1,072,205 of our ordinary shares under the 2003 Plan, out of which 302,205 stock options granted on November 2004 vest in 36 equal monthly installments at an exercise price of NIS 38 per share. The remaining portion of the options which were granted in 2003 (in the amount of 770,000) vest in three equal annual installments as follows: the first portion vested on January 31, 2004, and has an exercise price of NIS 26.82, which was determined based on the average 30 day trading price on the Tel Aviv Stock Exchange, or TASE, prior to November 17, 2003. The second portion vested on January 31, 2005 and has an exercise price of NIS 30.43, which was determined based on the average 30 day trading price on TASE prior to the vesting date. The third portion vests on January 31, 2006 and has an exercise price of 90% of the average 30 day trading price on TASE prior to the vesting date.

As of April 30, 2005, Mr. Hanania Gibstein owned 262,939 ordinary shares, or approximately 0.87% of our outstanding ordinary shares directly, and an additional 1,147,426 ordinary shares, or approximately 3.8% of our outstanding ordinary shares indirectly, through his holdings in Gibstein Holdings Ltd., Gibstein Financial Holdings (1998) Ltd. and Gibstein Investments (1997) Ltd.

As of April 30, 2005, Messrs. Shimon Cheifetz and Eli Cheifetz owned 616,896 ordinary shares or 2.04% of our outstanding ordinary shares directly, and 710,392 ordinary shares or 2.35% of our outstanding ordinary shares, indirectly through their holdings in Cheifetz Holdings Ltd.

*2001 Senior Employee Share Option Plan*

On January 30, 2001, our board of directors adopted the 2001 Employee Share Option Plan, or the 2001 Plan, to promote the interests of our company and its shareholders by providing our senior management and other key employees with appropriate incentives and rewards to encourage them to enter into and continue in the employ of Matav and to acquire a proprietary interest in our long-term success.

The 2001 Plan authorized the issuance of options to purchase up to 864,000 of our ordinary shares, or 432,000 ADSs. Each option represents the right to receive, upon exercise, our ordinary shares or ADSs in the value of the appreciation, if any, of the price of our ordinary shares on the Tel Aviv Stock Exchange, on the day of exercise, over the exercise price for each ordinary share subject to the option.

As of April 30, 2005, under the 2001 Plan, 770,500 options were issued to 45 employees, 608,300 options were cancelled, 90,732 options were forfeited, 37,235 options were exercised and 34,233 options expired.

The ordinary shares which were issuable upon exercise of the options covered by the 2001 Plan, are registered for sale on both Nasdaq and the Tel Aviv Stock Exchange.

*2003 Employee and Officers Option Plan*

In November and December 2003, our board of directors adopted a new Employee and Officers Option Plan, or the 2003 Plan, which provides for the grant of up to 770,500 (of which, 770,000 were issued until that date) options to purchase our ordinary shares to 46 of our employees. In addition, on November 2004, our board of directors approved the grant of 302,205 stock options to a senior employee. The 2003 Plan was approved by our shareholders in December 2003. All of the employees that were entitled to receive options under the 2003 Plan and who received options under the 2001 Plan were required to waive their vested options under the 2001 Plan as a condition to receiving options under the 2003 Plan. The options that were granted under the 2001 Plan that were not yet vested were cancelled with the agreement of the grantees. As of December 31, 2004, under the 2003 Plan, 1,072,205 options were issued to 46 employees, 36,483 options were exercised and 11,000 options were forfeited.

For an English summary of the principal terms of the 2003 Plan, please see Exhibit 4(c)(ii).

**Item 7. MAJOR SHAREHOLDERS AND RELATED PARTY TRANSACTIONS****7A. MAJOR SHAREHOLDERS**

The following table sets forth certain information with respect to the beneficial ownership of our ordinary shares as of April 30, 2005 with respect to each person or entity that we believe to be the beneficial owner of 5% or more of our outstanding ordinary shares. Except where otherwise indicated, we believe, based on information furnished to us by the principal shareholders, that the beneficial owners of the ordinary shares listed below have sole investment and voting power with respect to such ordinary shares.

Name	Number of Ordinary Shares Beneficial Owned	Percentage of Outstanding Ordinary Shares Beneficially Owned	Percentage of Voting Securities
Delek Investments and Properties Ltd.(1)	12,088,618	40%	40%
Bank Leumi L Israel B.M. (2)	2,566,844	8.49%	8.49%

(1) In February 2004, Dankner Investments sold approximately 18% of our outstanding shares to Delek Investments and Properties Ltd., or Delek, and granted to Delek an option exercisable for two years to purchase an additional 2% of our outstanding shares. The option was exercised by Delek in September 2004. In May 2004, the controlling shareholders of Dankner Investments signed an agreement with Delek Real Estate Ltd., an affiliate of Delek, for the purchase of 87.5% of the issued share capital of Dankner Investments. This transaction was completed in August 2004. In November 2004, Delek Real Estate Ltd. commenced a tender offer in Israel to purchase all of the shares of Dankner Investments not already owned by it. As a result of this transaction, which was completed on November 25, 2004, Dankner Investments is a private company, wholly owned by Delek Real Estate Ltd. In December 2004, Dankner Investments sold approximately 20% of our outstanding shares to Delek. As a result of this transaction, Dankner Investments does not own any shares in Matav. Delek holds approximately 40% of our outstanding shares. Delek is a wholly-owned subsidiary of Delek Group Ltd., a public company whose shares are traded on the Tel Aviv Stock Exchange. As of May 2005, Delek Group Ltd. is controlled by Mr. Yitzhak Sharon ( Tshuva ). Mr. Tshuva holds indirectly approximately 78.64% of the shares of Delek Group Ltd. .

(2) Bank Leumi L Israel Ltd., or BLL, is one of the two largest commercial banks in Israel. The shares beneficially owned by BLL are held by various of its affiliated mutual funds and provident funds.

Dankner Investments Ltd., Bank Hapoalim B.M. and Ma ariv Modi in Publishing House Ltd. ceased to own 5% or more of Matav during 2004.

**Significant Changes in the Ownership of Major Shareholders**

Set forth below is a list of significant changes in the ownership of major shareholders for the years ended 2002, 2003 and 2004, as applicable.

*Transactions by Dankner Investments Ltd., a former major shareholder, and Delek Investments and Properties Ltd.*

- On November 23, 2003, Dankner Investments Ltd. sold 1,270,000 ordinary shares on the Tel Aviv Stock Exchange at a price per share of NIS 35.50 and at an aggregate price of NIS 45,085,000.
- On December 16, 2003, Dankner Investments Ltd. sold 460,300 ordinary shares on the Tel Aviv Stock Exchange at a price per share of NIS 34.50 NIS and at an aggregate price of NIS 15,880,350.

3. On December 31, 2003, Dankner Investments Ltd. sold 400,000 ordinary shares on the Tel Aviv Stock Exchange at a price per share of NIS 34.50 and at an aggregate price of NIS 13,800,000.
4. On January 5, 2004, Dankner Investments Ltd. sold 200,000 ordinary shares on the Tel Aviv Stock Exchange at a price per share of NIS 35 and at an aggregate price of NIS 7,000,000.
5. On February 22, 2004, Dankner Investments sold 5,433,685 ordinary shares to Delek Investments and Properties Ltd. at a price per share of US\$8.00, and at an aggregate price of US\$43,500,000, and granted to Delek Investments and Properties Ltd. an option, exercisable for a period of two years, to purchase an additional 604,078 ordinary shares, which constitutes approximately 2% of our outstanding ordinary shares. The option was exercised by Delek Investments and Properties Ltd. in September 2004.
6. On December 30, 2004, Dankner Investments sold 6,050,855 ordinary shares, the remainder of its shares, to Delek Investments and Properties Ltd., at a price per share of NIS \$35.28 (approximately US\$8.10), and at an aggregate price of NIS 213.5 million (approximately US\$49.1 million).

*Transactions by us*

In 2002, we sold in private transactions in Israel an aggregate amount of 26,651 of our ordinary shares held by our subsidiary Cable Systems Media Haifa-Hadera Ltd., in consideration for an aggregate gross amount of approximately NIS 1.0 million. In 2003, we sold the remaining 1,343,497 of our ordinary shares held by Cable Systems Media Haifa-Hadera Ltd. in private transactions in Israel, in consideration for an aggregate amount of approximately NIS 39.1 million.

Our major shareholders do not have different voting rights.

For information on a proposed merger of the Israeli cable television operators, see Item 4A. History and Development of the Company -- Proposed Merger of the Israeli Cable Television Operators.

*Number of Record Holders in the United States*

On April 30, 2005, 66,210 ADSs were held of record in the United States. These ADSs were held by 9 record holders. The number of record holders in the United States is not representative of the number of beneficial holders, nor is it representative of where such beneficial holders are resident, since many of these ADSs were held of record by brokers or other nominees.

We intend to delist voluntarily from the Nasdaq National Market and to terminate our American Depositary Receipt (ADR) program in the future. Our board of directors will examine the timing of such termination in the next few months. We intend to file a Form 15 with the SEC to terminate the registration of the ADRs and ordinary shares, thereby suspending our obligation to file annual and other reports with the SEC. After the delisting, our shares will continue to trade in the TASE and we will continue to make public reports in accordance with the Israeli securities laws and regulations.

**7B. RELATED PARTY TRANSACTIONS**

*Subcontractor Agreement*

Mr. Yehoshua Gibstein, an alternate director for Mr. Hanania Gibstein, indirectly owns 57% of Geyser Communication Services Ltd. Geyser Communication Services Ltd. owns 79% of the shares of Cabletek Ltd. In 1995, we entered into a subcontractor agreement with Cabletek Ltd. Under this agreement Cabletek Ltd. served as our subcontractor for building our network and operating our cable television services in certain communities within our franchises. As of the years ended December 31, 2002, 2003 and 2004, we paid Cabletek Ltd. a total of approximately NIS 2.9 million, NIS 2.4 million and NIS 1.5 million, respectively. As of the period beginning January 1, 2005 and ended May 31, 2005, we paid Cabletek Ltd. a total of approximately NIS 0.8 million.

*Gavish Agreement*

On October 30, 2000, our audit committee and board of directors approved a bonus incentive agreement with Mr. Moshe Gavish, who served as vice chairman of our board of directors from December 31, 2000 until September 30, 2001. This agreement and amendment thereto were approved by our shareholders in its general meetings on December 31, 2000 and December 27, 2001, respectively. According to this agreement, Mr. Gavish served as active vice-chairman of our board of directors. Pursuant to this agreement, Mr. Gavish was entitled to receive a bonus that was calculated according to the value of our ordinary shares on the Tel-Aviv Stock Exchange. Under this agreement, during the period Mr. Gavish served as vice chairman of our company, Mr. Gavish was entitled to gradually accumulate a bonus, in an amount equal to a total number of our ordinary shares constituting 1% of our outstanding ordinary shares, in three equal portions at the end of 6 months, 18 months and 30 months following the beginning of his service with our company. Under the agreement, Mr. Gavish was entitled to exercise such rights during a period of 36 months following the accumulation of his rights under each portion. The exercise price for each ordinary share underlying the first portion of his right shall be an amount equal to a 17.5% discount on the difference between the closing price of our ordinary shares on the Tel-Aviv Stock Exchange on the day of the exercise, and the average price of our ordinary share on the Tel-Aviv Stock Exchange during the 30 days period prior to the approval of his agreement by our board of directors. The exercise price for each ordinary share underlying the second and third portions of his right shall be an amount equal to a 17.5% discount on the average price of our ordinary shares on the Tel-Aviv Stock Exchange during the 30 days period prior to the accumulation by Mr. Gavish of each such portion of the right. The exercise price of each ordinary share under the second and third portions of his right shall be linked to the consumer price index. The ordinary shares underlying Mr. Gavish's bonus are subject to adjustments following any distribution of bonus shares, dividend and other rights.

Upon Mr. Gavish's retirement, pursuant to the amendment to the agreement approved by the shareholders on December 27, 2001, he is entitled to receive the rights accumulated in relation to the first portion of his right (in respect of which a payment demand was to be provided to us until March 15, 2004), and half of the rights in relation to the second portion of his right (in respect of which a payment demand may be provided to us until September 30, 2004). Under the amendment, the exercise price for each ordinary share underlying the rights to which he is entitled in relation to the second portion of his right shall be an amount equal to the average price of our ordinary shares on the Tel Aviv Stock Exchange during the 30 days period prior to March 15, 2002. On April 13, 2004, we paid Mr. Gavish approximately NIS 1 million as payment in full for all of his rights.

*Investments With Shareholders*

In May 2000, we decided that together with other of our former shareholders, we will invest in start-up companies which engage in the fields of Internet, cable television, data communications, applications, content, infrastructure and Internet Protocol telephony.

To this end, Nonstop Ventures Ltd. was formed by several of our shareholders, in which we hold, as of November 2002, 50% of the issued share capital, following the exercise of an option granted to us under a memorandum of understanding dated December 31, 2000, as amended. Pursuant to the exercise of the said option, 50% of certain amounts we invested and loans we made on behalf of Nonstop Ventures Ltd. are deemed to be provided by us to Nonstop Ventures Ltd., in consideration of the issuance to us of a non-convertible promissory note by Nonstop Ventures Ltd., and the transfer and assignment to Nonstop Ventures Ltd. of our rights and obligations towards third parties in connection with such investments and loans. The shareholders of Nonstop Ventures Ltd. have agreed to finance its operations in proportion to their respective holdings in the share capital of Nonstop Ventures Ltd. up to a total sum of US\$ 15 million. Investments made by the respective shareholders in Nonstop Ventures Ltd. prior to October 30, 2002, are in consideration of the issuance to such shareholders of non-convertible promissory notes by Nonstop Ventures Ltd.

As of December 31, 2004, we and the other shareholders invested through Nonstop Ventures Ltd. in a few start-up companies an amount of approximately US\$ 5.8 million. Of the aggregate investment, we invested approximately US\$ 2.9 million. This amount does not include costs related to such investments such as wages, consultant fees, legal fees, etc. Due to, among other things, market factors, the financial situation of these companies and our accounting policies, these investment amounts were reduced in our financial records, and were set in our financial statements for the year ended December 31, 2004, at a value of approximately US\$ 0.3 million.

*B-Point Agreement*

On May 5, 1997 we entered into two agreements with B-Point Systems Ltd., a company owned by Mr. David Binmovitch, who is the son-in-law of Mr. Shmuel Dankner, the former Chairman of our board of directors. Under these agreements, B-Point Systems Ltd. provides us with cable television installation services, and sets up and maintains our cable television networks. For the years ended December 31, 2002, 2003 and 2004, we paid B-Point an amount of approximately NIS 12.5 million, approximately NIS 11.5 million and approximately NIS 11.7 million, respectively.

*Delek Agreement*

On April 17, 2005, our board of directors approved an agreement, dated March 1, 2005, between us and Delek, our principal shareholder, according to which Delek shall provide us with automatic fueling services through computer systems, which is known as Dalkan Delek, for our vehicles at a discounted rate.

*Negotiations with Cabletek Ltd.*

Mr. Yehoshua Gibstein, an alternate director for Mr. Hanania Gibstein, indirectly owns 57% of Geysler Communication Services Ltd. Geysler Communication Services Ltd. owns 79% of the shares of Cabletek Ltd. Cabletek Ltd. operates our cable television services in Judea and Samaria. We are in negotiations with Cabletek Ltd. for the purchase of assets (including equipment) and rights and obligations of Cabletek with respect to its activities in the field of providing cable broadcasting services.

See also Note 22 to the financials statements attached in Item 18 for details of additional related party transactions.

**7C. INTERESTS OF EXPERTS AND COUNSEL**

Not applicable.

**ITEM 8. FINANCIAL INFORMATION**

**8A. CONSOLIDATED STATEMENTS AND OTHER FINANCIAL INFORMATION**

Audited financial statements for the three fiscal years ended December 31, 2004 are included at Item 18. Financial Statements .

**Legal and Arbitration Proceedings**

In addition to the legal proceedings discussed below, we are a party to a number of legal and administrative proceedings arising in the ordinary course of our business. We do not expect the outcome of such matters in the aggregate to have a material adverse effect upon our business and financial condition, results of operations and cash flows.

(a) On April 22, 1999, a lawsuit and application to recognize the suit as a class action were filed in the Tel-Aviv-Jaffa District Court against us. The suit alleges that we constitute a monopoly, and that we adversely exploit our position in the market, in a manner which is, or may be, damaging to the general public, among other things, by setting and collecting an unreasonable and unfair price for the services we provide. The plaintiff is seeking, among other things, that we be required to reduce the subscriber fees we collect and to pay our subscribers compensation in connection with the subscriber fees we collected from May 10, 1996 through April 1, 1999. In this context, the plaintiff claims he has sustained damages in an amount of reported NIS 1,387 and the sum of compensation due to all of the members of the class in the action, if certified as a class action, amounts to reported NIS 360 million. The plaintiff is further claiming compensation for alleged damages caused to all of the members of the class in the action, if certified as a class action, from the date of filing the lawsuit up to the date judgment is rendered. In addition, the plaintiff is claiming a mandatory injunction, according to which we will be obliged to reduce the service fees which we charge from our subscribers. We opposed the action being certified as a class action, claiming that the motion lacks any material substance, inter alia, on grounds that the plaintiff disregarded the high investments we made in infrastructure and equipment, that the franchise we were granted for cable television broadcasts is limited in time, the comparisons made by the plaintiff between our company and foreign companies dealing in cable television broadcasts in countries where the situation is very different are not relevant to our modus operandi, and finally because the subscriber fees we charge are subject to supervision and highly regulated.





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At the beginning of the hearing of the request, it was stated that the clarification of the request will be joint with similar requests that were filed against the cable television operators Tevel, Golden Channels and Idan (however, in the meantime, this condition changed, see below). After the unification of proceedings and pursuant to the arrangement reached by the parties and which was validated as a court decision, it was agreed that the Court will preliminarily decide with respect to the legal threshold claims that were raised by the Company (and other cable television operators).

On August 21, 2003, the Court dismissed our claims and determined that the expenses of the proceeding would be determined at the conclusion of the proceeding. The Court found, among other things, that the cable television operators are not entitled to benefit from the immunity provided under Section 6 of the Torts Ordinance and the decision of the Restrictive Business Practices Court in a similar matter that was granted in the past did not constitute binding precedent on us. According to the procedural settlement reached by the parties, the Court must still hear the remaining claims set forth in the application to recognize the suit as a class action, and the responses of the cable television operators to the action. In a pre-trial hearing held on November 26, 2003, the Court determined that the proceedings against the various cable television operators would be separated and first the application to recognize the suit as a class action against us would be heard.

The parties reached a procedural arrangement concerning the hearing proceeding according to which no examinations shall be conducted and each party shall submit its summations. According to the said agreement, the summations on behalf of the petitioner were submitted on April 1, 2005 and the summations on our behalf were submitted on June 22, 2005. The petitioner is entitled to submit a response to our summations by August 14, 2005.

(b) On November 8, 1999, the Controller of Restrictive Business Practices, declared us to be a monopoly in the field of providing multi-channel television broadcasts for payment, in the regions in which we operate. On December 28, 1999, we filed an appeal against this determination with the Restrictive Business Practices Court. In our appeal, we claim, among other things, that the Controller's declaration should be revoked (i) due to lack of due process, including, among other things, that the declaration lacks an appropriate factual foundation, and (ii) on merit, due to the fact that in the relevant market we do not provide over 50% of the services in our license areas in which we operate and therefore we are not a monopoly in this market. The Controller counter-claimed our appeal, requesting that it be dismissed, together with appeals filed by the other cable television operators on the same issues. The Restrictive Trade Practices Court concluded the deposition stage of the appeal on October 30, 2001, and the parties have submitted their summaries to the Court. In October 2004, the Restrictive Business Practices Court dismissed our appeal.

(c) On March 28, 2000, a claim was filed in the Tel-Aviv-Jaffa District Court against the cable television operators, including our company, by the Association for the International Collective Management of Audiovisual Works – AGICOA, or AGICOA, an international association of producers of cinema and television works. The aggregate sum of the claim is not less than approximately US\$ 171 million and for the purpose of court fees was limited to an initial sum of US\$ 20 million. AGICOA is an organization that represents numerous producers in a suit against the cable television operators for the alleged breach of copyrights of the represented producers due to the re-transmission of programs by the cable television operators. AGICOA is also claiming unjust enrichment on the part of the cable television operators and that they be ordered to submit their accounts. In our statement of defense, filed on July 9, 2000, we claim, among other things, that AGICOA have no right to file this claim in light of the restrictive business practices laws in Israel. The dispute was transferred by the Court to mediation in the second quarter of 2001. The mediation was not successful and the matter was returned to the Court. At a preliminary hearing held on June 18, 2002, the Court ruled to delay its decision in this matter pending resolution of the Israeli Supreme Court in a further hearing in another matter, which the Court believes will have material implications on all or part of this dispute. However, the Court determined that the preliminary proceedings in this dispute may be commenced and completed. On November 26, 2003, another preliminary hearing was held in which it was agreed that the date for completion of preliminary proceedings would be postponed until after the delivery of the judgment of the Supreme Court in the further hearing mentioned above.

The further hearing referred to by the Court was filed with respect to the ruling of the Supreme Court (presiding as an appellate court), which determined that the re-transmission of broadcasts as secondary broadcasts may also constitute an infringement of copyrights, if such broadcasts include copyrights owned by third parties who have not consented to their broadcast in Israel. AGICOA's motion to be included as a party to the proceedings was denied by the Supreme Court. On November 4, 2003, a hearing before the Supreme Court was held to complete oral arguments. On June 16, 2004, the Supreme Court presiding over the further hearing confirmed the earlier determination of the Supreme Court.

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In January 2005, the parties completed the discovery proceedings and therefore in the context of the preliminary proceedings, disclosing additional information and questionnaires remain to be completed.

On July 27, 2004, Tevel's trustee notified the Court (with the consent of the plaintiff) of the cessation of these proceedings with respect to Tevel and Gvanim Cable Television Company Ltd., or Gvanim, in light of the entrance into effect of the arrangement of creditors of these companies. On July 28, 2004, the Court approved this notification.

(d) In September 2000, a claim was filed in the Tel-Aviv-Jaffa Labor Court against our company by a plaintiff who claims that an employer-employee relationship existed between him and our company and that as a consequence, our company is required to pay him the amount of an adjusted NIS 2.6 million in respect of severance pay and other salary components. In parallel, in September 2000, our company and its subsidiary, Cable Systems Media Haifa-Hadera Ltd., filed a monetary claim with the Netanya Magistrates Court in an amount of at least NIS 786 thousand (subject to adjustment) contending that the plaintiff violated, in a basic and severe manner, undertakings to deliver an advanced telemarketing system to our company and its subsidiary. This claim was transferred to mediation by the Netanya Magistrates Court, which was not successful. On November 15, 2001, the Netanya Magistrates Court issued a resolution joining the above two claims to be heard in the Tel-Aviv Jaffa District Labor Court. The parties' affidavits have been submitted to the Court and a preliminary hearing was held.

(e) On December 3, 2002, a lawsuit and application to recognize the suit as a class action were filed in the Tel Aviv-Jaffa District Court against us, the other Israeli cable television operators, the Council and the Ministry. The suit, filed by seven plaintiffs, alleges that we and the other cable television operators violated the terms of the approval of the Council for the transmission of the pay sport channel (offered to subscribers through the tiering services) since we and the other cable television operators did not maintain certain programs in the original sport channel which is part of the basic packages offered to subscribers. The plaintiff seeks to represent a group of 1,050,000 subscribers. The plaintiffs requested that we and the other cable television operators pay compensation to all of the members of the class in the action, if certified as a class action, in a total amount of approximately NIS 302 million as of the date of the motion, plus NIS 25.2 million for each additional month from the date the suit was filed up to the date judgment is rendered by the Court. Our proportionate share based on the ratio of number of subscribers as of May 31, 2005, is approximately NIS 80 million, in addition to a monthly amount of approximately NIS 6.7 million accumulating from the date the claim was filed until a ruling is rendered. A response to the application was submitted to the Court on behalf of all of the respondents. In our response, we opposed the action being certified as a class action on grounds that the class of persons of the claim fail to meet the legal requirements of such an action due to differences between the claimants that exist on the level of the content of the broadcasts (program preference), as well as on the level of the damages being claimed, and that the cable television operators and the original cable sport channel producer have complied with most of the terms of the Council's approval. On May 27, 2004, the application to recognize the suit as a class action against us was denied. On July 5, 2004, the petitioners submitted an appeal to the Supreme Court seeking to overturn the ruling of the District Court. The parties submitted their summations. The date for a hearing of the appeal in the Supreme Court is set for January 9, 2006.

(f) On August 28, 2002, a lawsuit and application to recognize the suit as a class action were filed in the Tel Aviv-Jaffa District Court against us and the other Israeli cable television operators. The suit, filed by three plaintiffs, alleges that we and the other cable television operators did not connect residents of peripheral settlements who are the members of the class in the action. The claim is for indemnification of residents in settlements for not being connected to the cable networks within 6 years of the date on which the cable franchises were granted. The plaintiffs are seeking that we and the other cable television operators pay compensation to all of the members of the class in the action, if certified as a class action. In accordance with the suit, our portion of the claimed compensation is approximately NIS 139 million. We and one of the other cable television operators, Golden Channels & Co., or Golden Channels, filed a motion to dismiss the suit without prejudice, due to the dismissal of a lawsuit identical in substance to this suit. The Court determined that the motion for dismissal of the suit without prejudice will be heard together with the application to recognize the suit as a class action. We and Golden Channels filed a response to the application to recognize the suit as a class action. The plaintiffs submitted their reply regarding the request to dismiss the claim without prejudice, and we and Golden Channels filed a response to the plaintiff's response. The plaintiffs' request to join the hearing as creditors of Tevel was dismissed by the court. No date was scheduled for a hearing.

(g)

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(1) On November 27, 2002, Warner Bros. International Television Distribution ( Warner ) filed a lawsuit against Tevel in a court in California seeking, inter alia, a monetary compensation of US\$ 17 million ( Warner lawsuit in California ), on the grounds that the agreement from July 13, 1999, pursuant to which, Tevel (through which all the cable television operators) acquired from Warner the rights to broadcast films, was breached and consequently was rescinded by Warner.

Following the Warner lawsuit in California and other actions taken by Warner, on December 5, 2002, the trustee for Tevel group filed with the District Court in Tel Aviv a motion to instruct, among others, that Warner should take any measure necessary to discontinue the lawsuit in California and this in view, among others, of the stay of proceedings order that was granted with respect to Tevel, which prohibits the institution of new proceedings against Tevel without the approval of the District Court in Tel Aviv) and based on the proof of debt submitted by Warner to the trustee under the same cause of action.

On February 10, 2003, the court rendered its ruling on the trustee's motion. Pursuant to the ruling, the court dismissed Warner's position and accepted the motion. The court, inter alia, ruled that Warner instituted unlawful proceeding in the United States and under circumstances substantiating doubts as to its good faith, and such a proceeding cannot be materialized or enforced in the boundaries of the state of Israel. On March 25, 2003, the trustee rendered its decision of Warner's proof of debt, in which the majority of the proof was rejected. On April 24, 2003, Warner appealed to the district court on the issue of proof of debt and following decisions rendered on the appeal, on June 24, 2003, Warner filed an amended appeal on the trustee's decision in the matter of the proof of debt.

On October 21, 2003, the Supreme Court rejected Warner's appeal on the court's ruling of February 10, 2003, subject to the rights of Warner and the trustee to argue on the issue of the applicable law on the proof of debt and this is in the context of Warner's appeal on the trustee's decision on the proof of debt and instructed Warner to file an amended appeal in order to include the argument that Warner's lawsuit should be litigated under California law.

The amended appeal was filed, in the context of which, Warner seeks the reversal of the trustee's decision on the proof of debt (which approved the debt for Warner in the amount of US\$ 182 thousand only) and approve Warner a debt in the aggregate of US\$ 17 million and alternatively US\$ 12 million.

On September 1, 2004, the Court dismissed the amended appeal with respect to the proof of debt determining that the Warner's appeal contradicts the law and its entire substance is nothing but an attempt to generate high profit in an unjust and extraordinary manner at the expense of the ordinary creditors of Tevel. In view of the extraordinary circumstances and the scope of litigation, the Court ruled that Warner shall pay Tevel expenses and legal fees.

On October 5, 2004, Warner filed an appeal with the Supreme Court. Simultaneously, Warner filed, on that very day a motion for stay of performance with respect to the ruling dated September 1, 2004, with the Court and an urgent motion for hearing of the said motion. On October 5, 2004, the Court rendered a ruling according to which, the facts referred to in the motion for stay of performance were not supported by an affidavit and it was further determined that the motion is inappropriate to be heard ex parte and the case shall be scheduled for hearing. In addition, the court instructed the trustee to take into consideration the fact that a motion for the stay of performance proceeding was filed. On November 24, 2004, a reply to the motion for stay of performance was filed on behalf of the trustee and on January 17, 2005, a reply on behalf of the Official Receiver was filed.

On February 9, 2005, the Court rendered its ruling in the matter of the motion for stay of performance. The court indicated that it is of the opinion that the prospects of Warner's appeal to prevail are remote. However, due to the concern that if the stay of performance is not granted the factual situation shall be irreversible (in the event that a decision in the appeal shall be rendered in favor of Warner) and in order not to completely nullify the appeal, the court instructed that until a ruling in the appeal is rendered the trustee shall withhold an amount of US\$ 4 million, which would be necessary for dividend distribution to Warner if the Court shall render a judgment in favor of Warner in the appeal. The stay of performance is contingent upon a deposit of a bank guarantee by Warner in the amount of NIS 2 million to secure the creditors' damages. The said amount was imposed in addition to the guarantees that may be determined by the Supreme Court as a prerequisite for hearing the appeal. The hearing of the appeal in the Supreme Court is scheduled for September 19, 2005.

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(2) On December 9, 2002, Warner filed a lawsuit against Golden Channels with the district court in Los Angeles, California in the U.S. The lawsuit is seeking, inter alia, monetary compensation on the grounds of breach of contract with Golden Channels dated July 13, 1999 and a lawsuit for declaratory remedies, as detailed in the complaint. On January 17, 2003, an amended complaint was filed in context of which, Warner was seeking, inter alia, to compel Golden Channels to pay compensation of at least US\$ 16 million in addition to expenses. In addition, among other things, declaratory remedies and an injunction were requested. On February 14, 2003, Golden Channels filed its answer and a counterclaim. In the context of the lawsuit, the parties also filed motions for preliminary injunctions. A hearing for the preliminary injunctions was held on March 31, 2003. The court rejected all of the motions for preliminary injunctions. The evidential hearing for the complaint and the counterclaim was held during January 2004 and on February 2004 the parties filed their summaries. In Warner's post trial brief it requested compensation in the amount of approximately US\$ 25 million. Golden Channels requested compensation in the amount of approximately US\$ 3.8 million.

On September 29, 2004, the district court in Los Angeles, California, ruled in favor of Warner. The district court awarded Warner damages in the amount of approximately US\$ 19.3 million (excluding attorney fees) and rejected Golden Channels' counterclaims in the matter. The Court originally entered judgment for Warner in the amount of US\$ 19 million. The Court subsequently granted Golden's motion to amend the judgment to deduct US\$ 0.6 million in tax certificate damages, and Warner's motion to add US\$ 0.65 million in prejudgment interest. Following an amendment, the judgment awarded Warner damages of US\$ 19.4 million, US\$ 0.2 million in costs, and US\$ 2.3 million in attorney's fees and other costs, for a total judgment amount of US\$ 21.7 million (the Final Amended Judgment).

On March 7, 2005, Golden Channels filed a notice of appeal, pursuant to which, it appeals to the United States Court of Appeals for the Ninth Circuit from the Final Amended Judgment, including other prior orders and decisions granted by the Court.

On March 21, 2005, Warner filed a notice of cross appeal pursuant to which it appeals to the United States Court of Appeals for the Ninth Circuit from the order of the District Court denying Warner's motion to amend the judgment to add prejudgment interest, as reflected in the Final Amended Judgment, including all orders and decisions pertaining thereto that are or may be merged into the Final Amended Judgment.

Pursuant to an agreement among the Israeli cable television operators (including Golden Channels, Tevel and us) and Hot Vision, we are required to indemnify Golden Channels (through HOT Vision) for approximately 26.6% of the damages awarded to Warner, which will actually be paid by Golden Channels amounting to a maximum of approximately US\$ 5.8 million.

(3) On or about the filing date of the above lawsuits, Warner drew-down letters of credit it was granted by Golden Channels and Tevel in the amount of US\$ 5 million each. Further to the above lawsuits and a demand made by Tevel and Golden Channels, Hot Vision board of directors resolved that, in principle, Hot Vision shall bear the amounts borne or to be borne by Tevel and Golden Channels with respect of the forfeiture of letters of credit, as detailed above, and in respect of the aforesaid agreements with the major studios, including their termination and related expenses and/or in respect of legal proceedings taken as above, subject to indemnification by its shareholders to cover these amounts.

For information on an indemnification agreement entered into between the cable television operators and HOT Vision, see Item 4B. Business Overview -- HOT Vision and Cooperation of Cable Television Operators in Production of Broadcasting.

(h) In December 31, 2003, Eshkolot - The Israeli Artists Society for Performers Rights Ltd., or Eshkolot, filed an action in the District Court of Tel Aviv-Jaffa against us and the other two cable television operators for certain payments, for temporary and permanent injunctions, and to give instructions to Tevel's trustee. Eshkolot claims that, since January 1, 2003, the cable television operators broadcast programs in violation of the rights of Israeli performers held by Eshkolot in that such broadcasts were made without Eshkolot's consent and without the payment of royalties. In the context of the claim, the Court was requested to instruct and affirm that Eshkolot is entitled to receive a usage payment of NIS 8.5 million as compensation for 2003 royalties (net of payments already transferred to Eshkolot), and that, from now on in each year the cable television operators will have to pay this amount including linkage differentials and to update such royalties relative to increases in the number of broadcasting minutes of protected performances. Additionally, Eshkolot requested to obligate the cable television operators to pay the maximum statutory compensation, as set in the Copyrights Law, in the total amount of NIS 24.3 million. Eshkolot also requested a permanent injunction order against the cable television operators that will prohibit the broadcast of protected performances employing performers' rights held by Eshkolot, unless expressly authorized by Eshkolot. Further, the Court was requested to give a temporary injunction to prohibit the cable television operators from broadcasting performances employing performers' rights held by Eshkolot, if an advance express written authorization from Eshkolot does not exist, until the hearing and the decision in Eshkolot's primary claim for compensation for violating performers' rights and in the request for the permanent injunction against the cable television operators.

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On May 13, 2004, the court approved the parties notice of arbitration and the case was forwarded to arbitration with instructions to strike the suit with no order for expenses. The statement of complaint on behalf of Eshkolot, in the arbitration, was filed on June 25, 2004. The amount of the claim, which significantly exceeds the amounts that were paid previously to Eshkolot by the cable television operators pursuant to the agreement that was valid until 2002, is NIS 8.5 million for 2003 and a similar amount plus 10% for each of the years 2004-2006. Eshkolot argues that this is the appropriate royalty as implied in the Performers and Broadcasters Rights Law 1984, which is to be paid each year.

The statement of defense on behalf of the cable television operators was filed on August 3, 2004. In the statement of defense, the cable television operators refute Eshkolot's arguments, inter alia, concerning the scope of the use of its repertoire and claim that in view of the various developments in the communications market in Israel, and particularly in view of entering of competitors to the market such as Yes, the amount of the royalties paid to Eshkolot should be decreased. It is further argued that Eshkolot is not the owner of rights in certain musical works, which it refers to within its claim, since the performing artists exclusively assigned their rights to production companies. The Company also claims that Eshkolot misused its monopolistic powers in the market in order to impose unreasonable prices on its consumers.

On January 30, 2005, Eshkolot requested the arbitrator, due to the prolongation of the arbitration proceedings, to order the cable television operators to pay Eshkolot an intermediate payment in the amount of NIS 11.5 million for the years 2003-2005, in addition to the sum of NIS 3.5 million, which the cable television operators already paid to Eshkolot prior to the commencement of the arbitration proceedings.

On February 15, 2005, the cables companies filed their response, claiming that: (i) the request has no legal grounds based on the arbitration agreement; (ii) the arbitrator has no authority to rule in this matter; (iii) the causes for this request have not occurred; and (iv) the request was filed in bad faith and abuses the court proceedings.

On February 25, 2005, the parties filed a request to postpone all legal procedures (including the request for the intermediate payment) in order to try to enable them to conduct negotiations. The negotiations between the parties have not yet been concluded. cable television operators

(i) On April 11, 2005, the Israeli Records and Cassettes Federation (the Federation) filed in the District Court of Haifa a claim against the Company and the other cable television operators as well as a request for payment of temporary royalties. The Federation seeks to represent the Israeli record companies as well as foreign record companies that impressed musical compositions on records and compact disks, which the cable television operators broadcast.

The Federation seeks a permanent injunction that shall prohibit the cable television operators to use the compositions, which are included in the Federation's repertoire. The Federation further notified the Court that it shall be willing to withdraw the claim for permanent injunction subject to payment by the cable television operators of the license fees in the amount demanded by the Federation or determined by the Court.

The Federation contemplated that since March 15, 2004 the cable television operators broadcast programs in violation of the rights held by the Federation, due to the fact that the agreement between the cable television operators and the Federation terminated on December 31, 2002 as well as the temporary license rendered by the Federation to the cable television operators in order to negotiate and execute a new agreement. The Federation claims that although the cable television operators acknowledge its rights they continue to use the compositions included in the Federation's repertoire and violate the law.

The Federation noted that it reserves the right to request a preliminary injunction. The Federation further noted its consent that the Court shall render a judgment in way of granting the operative legal ruling without furnishing any reasoning. In addition the Federation informed the Court of its consent to arbitration proceedings. The Court is further requested to instruct the cable television operators to pay the Federation interim royalties until a judgment is rendered. The Federation presented two main models in respect of a calculation of the royalties as follows: (a) payment in the amount of 0.26% - 0.3% of the income of the cable television operators (plus VAT); (b) payment of yearly royalties in a fixed sum per subscriber (plus VAT).

The Federation requested the Court to oblige the cable television operators to pay permanent royalties in the sum of US\$ 2 per each subscriber that does not receive the audio channels or US\$ 5 per each subscriber that receives the audio channels.

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The cable television operators submitted the response to the request for payment of temporary royalties and the statement of defense on June 6, 2005. In the response, the cable television operators claimed, inter alia, that the request made by the Federation for the payment of temporary royalties was not timely and was not submitted in good faith. In addition, the cable television operators claimed that the amount of the request was extremely unreasonable in that it exceeded 11 times the amount of the highest royalty amount paid to the Federation during the term of the agreement. In that matter, the cable television operators claimed that the request for payment of temporary royalties can be in an amount up to US\$ 200,000, which is the contractual amount that was paid to the Federation during the term of the agreement. The date of the hearing was set for July 6, 2005.

(j) We currently have the following tax matters pending:

- (1) In light of a disagreement with the Tax Authorities, the Company and Cable Systems Media Haifa-Hadera Ltd., a wholly owned subsidiary of ours, received in 2002 and 2004, tax orders for tax years 1997 - 2001. Under these orders, the Company and Matav Haifa are required to pay additional aggregate amount of NIS 52 million (not including interest and CPI linkage) and to decrease their carry forward loss for the years 2000-2001 by NIS 96 million. The Company and Matav Haifa disagree with those mentioned tax orders. Management's opinion, based on the evaluation of its external advisers, has well founded arguments against all the claims included in these tax orders and therefore the Company intends to appeal against these tax orders. In light of previously non-concluded discussions and an unwritten understanding with the Tax Authorities, the Company recorded in the financial statements as of December 31, 2004, a provision of approximately NIS 6.5 million with respect to the aforementioned tax orders.
- (2) In May 2004, a subsidiary of ours, Matav Investments Ltd., received assessments for tax years 1998-2001 and a tax order for 2002. The tax order for 2002 included a requirement to pay a tax amount of NIS 114 million. In addition, with respect to 2002 tax order, a deficit penalty was imposed on the Company in the amount of NIS 18 million (including interest and CPI linkage). According to the opinion of the Company's management, based on the evaluation of its external advisers, the Company has well founded arguments against these assessments and the mentioned penalty and therefore no provision has been made in the Company's accounts for the above-mentioned deficit penalty claim and the assessments for tax years 1998-2001. During 2005, Matav Investments signed an agreement with the tax authorities regarding the tax assessment for the years 1998-2001. The agreement does not have an effect on the financial statements.

### Dividend Distribution Policy

We have not adopted any dividend distribution policy and we cannot assure that we would pay additional dividends in the future. In the past we have distributed cash dividends. See Item 3A. Key Information - Selected Financial Data - Payment of Dividends to Shareholders .

### 8B. SIGNIFICANT CHANGES

For information on Barak and the recent settlement with Barak's creditors, see Item 4B. Business Overview - International Telecommunication Services.

For information on our recent sale of shares in Partner, see Item 4B. Business Overview -- Cellular Telecommunication Services.

Other than the matters mentioned above, no other significant change has occurred since the date of our financial statements.

**ITEM 9. THE OFFER AND LISTING**

**9A. OFFER AND LISTING DETAILS**

Our share capital consists of ordinary shares, which have been listed for trading on the Tel Aviv Stock Exchange since October 1993 and ADSs, which have been listed for quotation on the Nasdaq National Market since June 12, 1996, under the symbol MATV . Each ADS represents two ordinary shares.

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The tables below set forth, for the periods indicated, the high and low closing market prices for our ordinary shares and ADSs, as reported by the Tel Aviv Stock Exchange and the Nasdaq National Market, respectively.

	Nasdaq (\$ per ADS)		Nasdaq (NIS per ADS)		Tel Aviv Stock Exchange (\$ per ordinary share)		Tel Aviv Stock Exchange (NIS per ordinary share)	
	High	Low	High	Low	High	Low	High	Low
<b><u>Most recent five full financial years</u></b>								
2000	69.25	32.81	281.57	132.63	34.59	15.70	141.20	64.69
2001	34.25	9.74	140.70	38.45	17.02	5.22	69.90	22.75
2002	18.58	8.34	83.11	42.19	9.20	4.27	40.82	20.58
2003	16.59	9.91	74.26	48.43	8.13	4.96	36.31	24.22
2004	20.39	15.0	92.88	66.08	10.21	7.07	46.16	31.55
<b><u>Most recent two full financial years</u></b>								
<b>2003</b>								
First Quarter	12.0	9.91	56.24	48.43	5.87	4.96	28.51	24.22
Second Quarter	15.70	11.76	71.65	54.78	7.65	6.22	35.02	27.60
Third Quarter	13.50	11.44	58.68	50.69	6.95	5.85	29.87	25.92
Fourth Quarter	16.59	12.77	74.26	57.30	8.13	6.63	36.31	29.28
<b>2004</b>								
First Quarter	20.25	15.0	90.78	66.08	10.0	7.68	44.98	33.82
Second Quarter	20.39	17.0	92.88	78.17	10.21	9.02	46.16	40.47
Third Quarter	19.39	15.01	87.02	67.64	9.63	7.59	43.21	34.45
Fourth Quarter	16.79	14.1	74.43	62.46	8.59	7.07	37.90	31.55
<b><u>Most recent six months</u></b>								
December 2004	16.33	14.3	71.31	62.39	8.01	7.36	34.97	31.89
January 2005	16.69	15.18	72.7	66.32	8.12	7.32	35.49	32.29
February 2005	15.9	14.64	69.64	63.86	8.31	7.51	36.37	32.79
March 2005	16.75	15.21	72.33	65.92	8.94	7.69	38.56	33.44
April 2005	16.00	15.34	69.82	66.51	8.23	7.78	35.93	34.0
May 2005	18.45	15.39	80.45	67.96	9.36	7.87	40.82	34.74

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**9B. PLAN OF DISTRIBUTION**

Not applicable.

**9C. MARKETS**

Our ADSs are quoted on the Nasdaq National Market under the symbol **MATV** and our ordinary shares are traded on the Tel Aviv Stock Exchange.

We intend to delist voluntarily from the Nasdaq National Market and to terminate our American Depositary Receipt (ADR) program in the future. Our board of directors will examine the timing of such termination in the next few months. We intend to file a Form 15 with the SEC to terminate the registration of the ADRs and ordinary shares, thereby suspending our obligation to file annual and other reports with the SEC. After the delisting, our shares will continue to trade in the TASE and we will continue to make public reports in accordance with the Israeli securities laws and regulations.

**9D. SELLING SHAREHOLDERS**

Not applicable.

**9E. DILUTION**

Not applicable.

**9F. EXPENSES OF THE ISSUE**

Not applicable.

**ITEM 10. ADDITIONAL INFORMATION**

**10A. SHARE CAPITAL**

Not applicable.

**10B. MEMORANDUM AND ARTICLES OF ASSOCIATION**

**Purposes and Objects of the Company**

We are a public company registered under the Israeli Companies Law as Matav Cable Systems Media Ltd., registration number 52-004007-2.

Pursuant to our memorandum of association, we were formed mainly for the purpose of establishing television and cable television networks, broadcasting and to provide such services and related and ancillary services in Israel and without derogating from the above, we are also empowered to hold any right, obligation or legal action and to operate in any business or matter approved by our company.

Pursuant to our articles of association, our board of directors is entitled to donate reasonable amounts to worthy causes, up to a limited sum.

**The Powers of the Directors**

The power of our directors to vote on a proposal, arrangement or contract in which the director is materially interested is limited by the relevant provisions of the Companies Law. In addition, the power of our directors to vote compensation to themselves or any members of their body requires the approval of the audit committee and the shareholders at a general meeting. For information regarding approval of related party transactions and fiduciary duties of directors, see Item 6C. Directors, Senior Management and Employees Board Practices Approval of Related Party Transactions.

Subject to applicable laws, the powers of our directors to borrow are not limited, except in the same manner as any other transaction by the company.

Our articles do not limit the age of retirement of our directors.

Directors in our company are not required to hold shares for director qualification.

**Rights Attached to Shares**

Our registered share capital consists of a single class of 100 million ordinary shares, par value NIS 1.00 per share, of which 30,220,476 ordinary shares were issued and outstanding as of December 31, 2004, and 30,222,774 ordinary shares were issued and outstanding as of May 31, 2005. All outstanding ordinary shares are validly issued, fully paid and non-assessable. The rights attached to the ordinary shares are as follows:

***Dividend rights***

Under our articles of association, holders of our ordinary shares are entitled to the full amount of any cash or share dividend subsequently declared. Our board of directors may propose a dividend with respect to any fiscal year out of profits in accordance with the provisions of the Companies Law. For additional information regarding Israeli tax consequences, see Item 10E. Additional Information Taxation.

Seven years after a dividend has been declared and is still unclaimed, the person so entitled to it is deemed to have waived his or her right to receive such dividend and such amount is returned to the company. We are not obligated to pay interest or linkage on an unclaimed dividend.

***Voting rights***

Holders of our ordinary shares have one vote for each ordinary share held on all matters submitted to a vote of shareholders. Such voting rights may be affected by the grant of special voting rights to the holders of a class of shares with preferential rights that may be authorized in the future. The quorum required for an ordinary meeting of shareholders consists of at least two shareholders present or by proxies who hold or represent, in the aggregate, at least 40% of the voting rights of the issued share capital. In the event that a quorum is not present within 30 minutes of the scheduled time, the shareholders' meeting will be adjourned to the same day of the following week, at the same time and place, or such time and place as the board of directors may determine. If at such reconvened meeting a quorum is not present within half an hour of the time fixed for the meeting any two shareholders present in person or by proxy or in any other manner permitted by the Companies Law will constitute a quorum.

Under the Companies Law, unless otherwise provided in the articles of association or applicable law, all resolutions of the shareholders require approval by the holders, in a general meeting, of a majority of the voting rights represented at the meeting, in person or by proxy, and voting on the matter. Under our articles of association, a special majority is required to approve a change of rights attached to a certain class of shares or to cancel a class of shares. See Item 10B. Additional Information Memorandum and Articles of Association Changing Rights Attached to Shares .

Under our articles of association, our directors are appointed by a simple majority of our shareholders at a general meeting, duly convened, and they serve until the next annual meeting or until earlier termination of their office pursuant to our articles of association, provided that, external directors shall be elected in accordance with applicable law and/or relevant stock exchange rules applicable to us. For information regarding the appointment of external directors, see Item 6C. Directors, Senior Management and Employees Board Practices Independent Directors and External Directors. In each annual general meeting the directors that were elected at the previous annual general meeting are deemed to have resigned from their office. A resigning director may be reelected.

According to our articles of association each ordinary share represents one vote. The ordinary shares do not have cumulative voting rights in the election of directors.

Currently, our articles of association provide that a majority of our board of directors, entitled to participate, may appoint additional directors, up to the maximum number permitted.

***Rights in the Company's profits***

Our shareholders have the rights to share in our profits distributed as a dividend and any other permitted distribution. See Item 10B. Additional Information Rights Attached to Shares Dividend Rights.

***Rights in the event of liquidation***

All of our ordinary shares confer equal rights among them with respect to amounts distributed to shareholders in case of liquidation.

**Changing Rights Attached to Shares**

In order to change the rights attached to our shares, the general meeting of the shareholders must adopt a resolution to change such rights by a majority of the votes of shareholders participating in the meeting and voting on the matter. However, if our share capital is divided into different classes of shares, in order to change the rights attached to a certain class of shares or cancel a certain class of shares, our articles of association require the approval of a special majority representing at least 75% of the votes of the shareholders participating in the general meeting and voting on the matter, provided that the holders of such class of shares have consented to such action by unanimous written consent or by a special majority representing at least 75% of the holders of such class of shares participating in a class meeting and voting on the matter (unless the terms of such class of shares provide otherwise).

## Annual and Special Meetings

According to the Israeli Companies law, our board of directors must convene an annual meeting of shareholders at least once every calendar year, within 15 months of the last annual meeting. Notice of at least 21 days prior to the date of the annual meeting is required. A special meeting may be convened by the board of directors, as it decides or upon a demand of any two directors or 25% of the presiding directors, or of one or more shareholders holding in the aggregate at least 5% of our issued capital and 1% of our voting rights, or of one or more shareholders holding in the aggregate at least 5% of our voting rights. A special meeting must be held not more than 35 days from the publication date of the announcement of the meeting.

## Anti-Takeover Provisions; Mergers and Acquisitions

Our Cable Broadcast Licenses and HeadEnd License, and the HOT Telecom Infrastructure License include restrictions regarding changes of means of control of the Licensees. See Item 4B. Information on the Company Business Overview Our Licenses Restrictions Upon Changes of Means of Control . In accordance with the Cable Broadcast Licenses, the restrictions set forth in these licenses regarding changes of means of control of the licensees have been entrenched in our articles of association, as approved by our shareholders at the annual general meeting of October 31, 2002.

The Israeli Companies Law allows for mergers, provided that each party to the transaction obtains the approval of its board of directors and subject to certain exceptions, a vote of the majority of its shares, at a shareholders meeting called on at least 21 days prior notice. For the purpose of the shareholder vote, unless a court rules otherwise, a merger will not be deemed approved if a majority of the voting rights held by parties other than the other party to the merger, or by any person who holds 25% or more of the shares or the right to appoint 25% or more of the directors of the other party, have voted against the merger. Upon the request of a creditor of either party to the proposed merger, the court may delay or prevent the merger if the court 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. Finally, a merger may not be completed unless 30 days have passed from the time in which each of the merged companies shareholders have resolved to merger, and, at least 50 days have passed from the time that the requisite proposals for approval of the merger were filed with the Israeli Registrar of Companies by each merging company.

The Companies Law also provides, subject to several exceptions, that an acquisition of shares in a public company must be made by means of a tender offer if, as a result of such acquisition, the purchaser would hold 25% or more of the voting rights of the company and there is no existing shareholder of the company who holds 25% or more of the voting rights of the company. Similarly, the 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 and there is no existing shareholder of the company who holds more than 45% of the voting rights of the company. In any event, if as a result of an acquisition of shares a purchaser would hold more than 90% of a company s shares, the acquisition must be made by means of a tender offer for all of the shares of such class. If more than 95% of the outstanding shares are tendered in the tender offer, all shares that the purchaser offered to acquire are transferred to such purchaser. However, the remaining minority shareholders may seek to alter the consideration by court order.

Israeli tax law treats stock-for-stock acquisitions between an Israeli company and another company less favorably than does U.S. tax law. For example, Israeli tax law may, under certain circumstances, subject a shareholder who exchanges his ordinary shares for shares of another corporation to taxation prior to the sale of the shares received in such stock-for-stock swap.

## Changes in Our Capital

Changes in our capital are subject to the approval of the shareholders at a general meeting by a majority of the votes of shareholders participating in the general meeting and voting on the matter.

## 10C. MATERIAL CONTRACTS

Except for agreements listed below, we are not a party to any material contracts other than those entered into in the ordinary course of business.

Arrangements in connection with the proposed merger of the Israeli cable television operators. For information, see Item 4B. Information on the Company Business Overview Agreement for a Merger of the Cable Television Operators .

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Limited Partnership Agreement among the three cable television relating to HOT Telecom L.P., dated October 2003.

Agreement relating to the establishment of HOT Telecom Ltd., dated October 2003.

### **10D. EXCHANGE CONTROLS**

There are currently no currency control restrictions on payments of dividends or other distributions with respect to our ordinary shares or the proceeds from the sale of shares, except for the obligations of Israeli residents to file reports with the Bank of Israel regarding such transactions. However, legislation remains in effect under which currency controls can be imposed by administrative action at any time. Under Israeli law, persons who are neither residents nor nationals of Israel may freely hold, vote and transfer ordinary shares in the same manner as Israeli residents or nationals.

Neither our articles of association nor our memorandum of association contain any restrictions on non-residents or non-nationals of Israel concerning the holding, voting or transfer of our ordinary shares.

### **10E. TAXATION**

Holders of our ordinary shares should consult their own tax advisors as to the United States, Israeli or other tax consequences of the purchase, ownership and disposition of ordinary shares, including, in particular, the effect of any foreign, state or local taxes.

### **ISRAELI TAX**

The following is a summary of the current tax laws of the State of Israel as they relate to us. The following also includes a discussion of the material Israeli tax consequences to persons purchasing our ordinary shares. To the extent that the discussion is based on legislation yet to be subject to judicial or administrative interpretation, there can be no assurance that the views expressed herein will accord with any such interpretation in the future of the appropriate tax authorities or the courts. This discussion is not intended and should not be construed as legal or professional tax advice, may not apply to all shareholders, and does not cover all possible tax considerations.

#### **General Corporate Tax Structure**

Israeli companies are generally subject to income tax on their taxable income at the corporate tax rate of 35% for the 2004 tax year, 34% for the 2005 tax year, 32% for the 2006 tax year and 30% for the 2007 tax year and thereafter, and are generally subject to capital gains tax at a rate of 25% for capital gains (other than gains deriving from the sale of listed securities) derived after January 1, 2003.

Recently, the Israeli Ministry of Finance has published a memorandum proposing an amendment to the Israeli Tax Ordinance [New Version], 1961 ( ITO ) under which the corporate tax rate will be reduced gradually to 25%, as follows: 31% for the 2006 tax year; 29% for the 2007 tax year; 27% for the 2008 tax year; 26% for the 209 tax year; and 25% for the 2010 tax year and thereafter. In order to enact such proposal as legislation, it must be approved by the Israeli parliament and published. Because we cannot predict whether, and to what extent, such proposal will eventually be enacted into law, we face uncertainties as to the potential consequences of such proposal.

#### **Taxation Under Inflationary Conditions**

The Income Tax (Inflationary Adjustment) Law 1985 (the Inflationary Adjustments Law ), attempts to overcome some of the problems presented to a traditional tax system by rapid inflation. Generally, the Inflationary Adjustments Law provides tax deductions and adjustments to depreciation deductions and tax loss carry forwards to mitigate the effects resulting from an inflationary economy. Our taxable income is determined under this law.

## Stamp Duty

The Israeli Stamp Duty on Documents Law, 1961 (the Stamp Duty Law), provides that any document (or part thereof) that is signed in Israel or that is signed outside of Israel and refers to an asset or other thing in Israel or to an action that is executed or will be executed in Israel, is subject to a stamp duty, generally at a rate of between 0.4% and 1% of the value of the subject matter of such document. De facto, it has been common practice in Israel not to pay such stamp duty unless a document is filed with a governmental authority. An amendment to the Stamp Duty Law that came into effect on June 1, 2003, determines, among other things, that stamp duty on most agreements shall be paid by the parties that signed such agreement, jointly or severally, or by the party that undertook under such agreement to pay the stamp duty. As a result of the aforementioned amendment to the Stamp Duty Law, the Israeli tax authorities have approached many companies in Israel and requested disclosure of all agreements signed by such companies after June 1, 2003, with the aim of collecting stamp duty on such agreements. The legitimacy of the aforementioned amendment to the Stamp Duty Law and of said actions by the Israeli tax authorities are currently under review by the Israeli High Court of Justice.

Based on advice from our Israeli counsel, we believe that we may only be required to pay stamp duty on documents signed on or after August 2004. However, we cannot assure you that the tax authorities or the courts will accept such view. Although at this stage it is not yet possible to evaluate the effect, if any, on us of the amendment to the Stamp Duty Law, the same could adversely affect our results of operations.

In January 2005, an order was signed in accordance with which the said requirement to pay stamp duty is cancelled with effect from January 1, 2008. Furthermore, pursuant to such order, as of January 1, 2005, stamp duty is no longer chargeable on, among others, loan agreements.

## Dividends

We currently do not intend to pay dividends for the foreseeable future. See Item 8A. Financial Information Consolidated Statements and Other Financial Information Dividend Distribution Policy. However, the following Israeli tax consequences would apply in the event we actually pay any dividends in respect of ordinary shares.

### *Taxation of Israeli Residents*

The distributions of dividends, other than bonus shares (stock dividends), are generally subject to income tax at a rate of 25% (that is withheld at source) for individuals. Distribution of dividends, other than bonus shares, to Israeli corporations are subject to a tax at a rate of 25% (that is withheld at source) if the source of such dividends is income derived outside of Israel and are exempt from tax if the source of such dividends is income derived in Israel. See Item 10E. Additional Information—Taxation—Capital Gains Tax Taxation of Israeli Residents.

The aforementioned memorandum proposing an amendment of the ITO, which is intended to come into effect on January 1, 2006, proposes to reduce the tax rate applicable to distributions of dividends to a rate of 20% for individuals, excluding a shareholder holding a controlling interest who shall continue to be subject to a 25% tax rate on such distributions. As aforesaid, such proposal has yet to be enacted as legislation, and we cannot predict whether, and to what extent, such proposal will eventually be enacted into law.

### *Taxation of Non-Israeli Residents*

Non-residents of Israel are subject to income tax on income accrued or derived from sources in Israel, including dividends from Israeli corporations. Distributions of dividends other than bonus shares or stock dividends are subject to income tax at a rate of 25% that is withheld at source, unless a different rate is provided in an applicable treaty between Israel and the shareholder's country of residence.

## Capital Gains Tax

### *General*

Israeli law generally imposes a capital gains tax on the sale of any capital assets by residents of Israel, as defined for Israeli tax purposes, and on the sale of assets located in Israel or the sale of direct or indirect rights to assets located in Israel, including on the sale of shares in Israeli companies, by both residents and non-residents of Israel, unless a specific exemption is available or unless a tax treaty between Israel and the shareholder country of residence provides otherwise. The law 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 Israeli consumer price index or, in certain circumstances, a foreign currency exchange rate, between the date of purchase and the date of sale. Real Gains (other than gains deriving from the sale of listed securities) derived after January 1, 2003 are taxed at a rate of 25% for both individuals and corporations. According to the aforementioned memorandum proposing an amendment of the ITO, it is proposed to reduce the aforementioned tax rate for individuals to 20%, excluding with respect to a shareholder holding a controlling interest who shall continue to be subject to a 25% tax rate.

### *Taxation of Israeli Residents*

Generally, capital gains tax is imposed at a rate of 15% on real gains derived on or after January 1, 2003, from the sale of shares in (i) companies publicly traded on the Tel Aviv Stock Exchange ( TASE ) or; (ii) Israeli companies publicly traded on Nasdaq or on a recognized stock exchange or regulated market in a country that has a treaty for the prevention of double taxation with Israel, or (iii) companies dually traded on both the TASE and Nasdaq or a recognized stock exchange or regulated market outside (such as us). This tax rate is contingent upon the shareholder not claiming a deduction for financing expenses in connection with such shares (in which case the capital gain will be taxed at a rate of 25%) and does not apply to: (i) the sale of shares to a relative (as defined in Israeli Income Tax Ordinance); (ii) the sale of shares by dealers in securities (who will be taxed at corporate tax rates for corporations and at marginal tax rates of up to 49% for individuals); (iii) the sale of shares by shareholders that report in accordance with the Inflationary Adjustments Law (who will be taxed at corporate tax rates for corporations and at marginal tax rates of up to 49% for individuals); or (iv) the sale of shares by shareholders who acquired their shares prior to our initial public offering (that may be subject to a different tax arrangement). The tax basis of shares acquired prior to January 1, 2003 will be determined in accordance with the average closing share price in the three trading days preceding January 1, 2003. However, a request may be made to the tax authorities to consider the actual adjusted cost of the shares as the tax basis if it is higher than such average price.

According to the memorandum proposing an amendment of the ITO, the tax rate applicable to capital gains from the sale of traded securities will be generally be increased to 20% for individuals (instead of 15%) and unified with the tax rate applicable to capital gains from the sale of non-traded assets. Israeli corporations will be subject to corporate tax rates on such gains and the applicable provisions of the the Inflationary Adjustments Law will be cancelled.

### *Taxation of Non-Israeli Residents*

Pursuant to a specific exemption, non-Israeli residents are exempt from Israeli capital gains tax on any gains derived from the sale of shares publicly traded on the TASE, and are exempt from Israeli capital gains tax on any gains derived from the sale of shares of Israeli companies publicly traded on a recognized stock exchange or regulated market outside of Israel, provided that such capital gains are not derived from a permanent establishment in Israel and that such shareholders are not subject to the Inflationary Adjustment Law and did not acquire their shares prior to our initial public offering. However, non-Israeli corporations will not be entitled to such exemption if an Israeli resident (i) has a controlling interest of 25% or more in such non-Israeli corporation, or (ii) is the beneficiary of or is entitled to 25% or more of the revenues or profits of such non-Israeli corporation, whether directly or indirectly.

In some instances where our shareholders may be liable to Israeli tax on the sale of their ordinary shares, the payment of the consideration may be subject to the withholding of Israeli tax at the source.

### **Taxation of Residents of the United States under the U.S. Treaty**

Residents of the United States generally will be subject to withholding tax in Israel deducted from dividends paid, if any, on our ordinary shares. Generally, under the Convention between the Government of the United States and the Government of the State of Israel with respect to Taxes on Income (referred to as the US Treaty ), the maximum Israeli withholding tax on dividends paid to a holder of ordinary shares or ADSs who is a resident of the United States (as defined in the US Treaty) will be 25% (and if such shareholder is a U.S. corporation holding at least 10% of the issued voting power throughout the tax year in which the dividend is distributed as well as the previous tax year then, the maximum Israeli withholding tax on dividends is 12.5%).

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The US Treaty exempts from taxation in Israel any capital gain realized on the sale, exchange or other disposition of ordinary shares or ADSs by a holder that is a resident of the United States for purposes of the US Treaty, and that owns directly or indirectly, less than 10% of our voting power at all times during the 12-month period preceding such sale, exchange or other disposition, provided such capital gain cannot be allocated to a permanent establishment of the such holder in Israel.

Sellers of ordinary shares, who are residents of the United States and who hold 10% or more of the outstanding ordinary shares at any time during such 12-month period will be subject to Israeli Capital Gains Tax. However, under the US treaty, residents of the United States (as defined in the US Treaty) would be permitted to claim a credit for this tax against U.S. federal income tax imposed on the sale, exchange or other disposition, subject to the limitations in U.S. laws applicable to foreign tax credits. The US treaty does not relate to U.S. state or local taxes.

### **Repatriation**

Non residents of Israel who acquire any of our ADSs using non Israeli currencies will be able to repatriate dividends, liquidation distributions and the proceeds from the sale of such ADSs, into non-Israeli currencies at the rate of exchange prevailing at the time of repatriation provided that any applicable Israeli income tax has been paid, or withheld, on such amounts if applicable.

### **U.S. TAX**

#### **United States Federal Income Tax Considerations**

Subject to the limitations described below, the following discussion describes the material United States federal income tax consequences to a holder of ordinary shares, referred to for purposes of this discussion as a U.S. holder, that is:

a citizen or resident of the United States;

a corporation created or organized in the United States or under the laws of the United States or of any state;

an estate, the income of which is includible in gross income for United States federal income tax purposes regardless of its source; or

a trust, if a court within the United States is able to exercise primary supervision over the administration of the trust and one or more U.S. persons have the authority to control all substantial decisions of the trust.

In addition, certain material aspects of United States federal income tax relevant to a holder other than a U.S. holder, referred to as a Non-U.S. holder, are discussed below.

This summary is for general information purposes only. It does not purport to be a comprehensive description of all of the tax considerations that may be relevant to each person's decision to purchase ordinary shares.

This discussion is based on current provisions of the Internal Revenue Code of 1986, as amended (the Code), United States Treasury Regulations promulgated there under and administrative and judicial interpretations thereof, all as in effect as of the date of this Annual Report on Form 20-F, all of which are subject to change, possibly on a retroactive basis. This discussion does not address all aspects of United States federal income taxation that may be relevant to any particular shareholder based on such shareholder's individual circumstances. In particular, this discussion considers only U.S. holders that will own ordinary shares as capital assets and does not address the potential application of the alternative minimum tax or United States federal income tax consequences to U.S. holders that are subject to special treatment, including U.S. holders that:

are broker-dealers or insurance companies;

have elected mark-to-marketing accounting;

are tax-exempt organizations;



are financial institutions or financial services entities ;

hold ADSs or ordinary shares as part of a straddle, hedge or conversion transaction with other investments;

own directly, indirectly or by attribution at least 10% of the Company's outstanding voting shares;

acquire their shares in a compensatory transaction; or

have a functional currency that is not the dollar.

In addition, this discussion does not address any aspect of state, local or non-United States tax laws.

Additionally, the discussion does not consider the tax treatment of persons who hold ADSs or ordinary shares through a partnership or other pass-through entity or the possible application of United States federal gift or estate tax. Material aspects of United States federal income tax relevant to a holder other than a U.S. holder are also discussed below.

**Each holder of ADSs or ordinary shares is advised to consult such person's own tax advisor with respect to the specific tax consequences to such person of purchasing, holding or disposing of the Company's ADSs or ordinary shares.**

**Dividends Paid on the Ordinary Shares**

A U.S. Shareholder generally will be required to include in gross income the amount of any distributions paid in respect of the ordinary shares (including the amount of any Israeli taxes withheld therefrom) to the extent that such distributions are paid out of the Company's current or accumulated earnings and profits as determined for U.S. federal income tax purposes. Under U.S. legislation enacted in 2003, which is generally effective for tax years beginning after December 31, 2002 and before January 1, 2009, a maximum U.S. federal income tax rate of 15% (rather than the higher rates of tax generally applicable to items of ordinary income) will apply to qualified dividend income received by an individual (as well as certain trusts and estates) provided certain holding period requirements are met. Qualified dividend income generally includes dividends paid by a U.S. corporation or a qualified foreign corporation. A non-U.S. corporation (other than a foreign personal holding corporation, foreign investment company, or passive foreign investment company) generally will be considered to be a qualified foreign corporation if (i) the shares of the non-U.S. corporation are readily tradable on an established securities market in the United States, or (ii) the non-U.S. corporation is eligible for the benefits of a comprehensive U.S. income tax treaty determined to be satisfactory to the United States Department of the Treasury. The United States Department of the Treasury and the Internal Revenue Service have determined that the United States-Israel Tax Treaty is satisfactory for this purpose. In addition, the United States Department of the Treasury and the Internal Revenue Service have determined that ordinary shares are considered readily tradable on an established securities market if such shares are listed on an established securities market in the United States such as the NASDAQ National Market. Information returns reporting dividends paid to U.S. Shareholders will identify the amount of dividends eligible for the reduced rates. Distributions in excess of such earnings and profits will be treated first as non-taxable return of capital reducing the U.S. Shareholder's tax basis in the ordinary shares to the extent of the distributions, and then as capital gain from a sale or exchange of such ordinary shares. Such dividends will generally not qualify for the dividends received deduction available to corporations. The amount of any cash distribution paid in Israeli shekels will equal the U.S. dollar value of the distribution, calculated by reference to the spot exchange rate in effect on the date of the distribution.

***Credit for Israeli Taxes Withheld***

Subject to certain conditions and limitations, U.S. holders will have the option of claiming the amount of any Israeli income taxes withheld at source either as a deduction from gross income or as a dollar-for-dollar credit against their United States federal income tax liability. Individuals who do not claim itemized deductions, but instead utilize the standard deduction, may not claim a deduction for the amount of the Israeli income taxes withheld, but such amount may be claimed as a credit against the individual's United States federal income tax liability. The amount of foreign income taxes which may be claimed as a credit in any year is subject to complex limitations and restrictions, which must generally be determined on an individual basis by each shareholder. The limitations set out in the Code include, among others, rules which limit foreign tax credits allowable with respect to specific classes of income to the United States federal income taxes otherwise payable with respect to each such class of income. Distributions of current or accumulated earnings and profits will be foreign source passive income for United States foreign tax credit purposes and will not qualify for the dividends received deduction available to corporations. The total amount of allowable foreign tax credits in any year cannot exceed regular U.S. tax liability for the year attributable to foreign source taxable income. However, a U.S. holder who is a natural person may elect not to be subject to the foreign tax credit limitation rules if all of that U.S. holder's foreign source income is qualified passive income and his or her creditable foreign taxes do not exceed US\$ 300, or US\$ 600 for joint returns, in a taxable year. Qualified passive income includes dividends and other amounts, but only to the extent the U.S. holder receives a Form 1099 or similar payee statement with respect to that qualified passive income. 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 30-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. Special rules apply in determining the foreign tax credit limitation with respect to qualified dividend income that is subject to the maximum 15% tax rate.

***Taxation of the Disposition of Ordinary Shares***

Upon the sale, exchange or other disposition of ordinary shares, a U.S. holder will generally recognize capital gain or loss in an amount equal to the difference between such U.S. holder's basis in the ordinary shares, which is usually the cost of such shares, and the amount realized on the disposition. Capital gain from the sale, exchange or other disposition of ordinary shares held more than one year is generally long-term capital gain and, if recognized on or after May 6, 2003 and before January 1, 2009, is generally taxed to individual U.S. holders at a maximum rate of 15% (reduced from the 20% maximum rate that applied to long-term capital gain recognized before May 6, 2003). Gains and losses recognized by a U.S. holder on a sale, exchange or other disposition of ordinary shares will generally be treated as United States source income or loss for United States foreign tax credit purposes. The deductibility of a capital loss recognized on the sale, exchange or other disposition of ordinary shares is subject to limitations.

***Tax Consequences if the Company is a Passive Foreign Investment Company***

The Company will be a passive foreign investment company, or PFIC, if 75% or more of its gross income in a taxable year, including the pro rata share of the gross income of any company, U.S. or foreign, in which the Company is considered to own 25% or more of the shares by value, is passive income. Alternatively, the Company will be considered to be a PFIC if at least 50% of the average value of its gross assets in a taxable year—calculated quarterly and ordinarily determined based on fair market value, including the pro rata share of the assets of any company in which the Company is considered to own 25% or more of the shares by value—are held for the production of, or produce, passive income. For this purpose, passive income includes dividends, interest, royalties, rents, annuities and the excess of gain over losses from the disposition of assets which produced passive income. If the Company were a PFIC, and a U.S. holder did not make an election to treat the Company as a qualified electing fund (as described below), then:

excess distributions by the Company to a U.S. holder would be taxed in a special way. Excess distributions are amounts received by a U.S. holder with respect to the Company's shares or ADSs in any taxable year that exceed 125% of the average distributions received by that U.S. holder from the Company in (i) the three previous years or (ii) the U.S. holder's holding period for ordinary shares before the present taxable year, if shorter. Excess distributions must be allocated ratably to each day that a U.S. holder has held the Company's securities. A U.S. holder must include amounts allocated to the current taxable year, and any taxable year prior to the first taxable year in which the Company is a PFIC, in its gross income as ordinary income for that year. A U.S. holder must pay tax on amounts allocated to each prior taxable year during which the Company was a PFIC at the highest rate in effect for that year on ordinary income and the tax is subject to an interest charge at the rate applicable to deficiencies for income tax.

the entire amount of gain that was realized by a U.S. holder upon the sale or other disposition of ordinary shares will also be treated as an excess distribution and will be subject to tax as described above.

a U.S. holder's tax basis in the Company's shares that were acquired from a decedent would not receive a step-up to fair market value as of the date of the decedent's death but would instead be equal to the decedent's basis, if lower.



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The special PFIC rules described above will not apply to a U.S. holder if the U.S. holder makes an election to treat the Company as a qualified electing fund, or QEF, in the first taxable year in which the U.S. holder owns ordinary shares and the Company is a PFIC. Instead, a shareholder of a qualified electing fund is required for each taxable year to include in income a pro rata share of the ordinary earnings of the qualified electing fund as ordinary income and a pro rata share of the net capital gain of the qualified electing fund as long-term capital gain, subject to a separate election to defer payment of taxes, which deferral is subject to an interest charge. A U.S. holder may make a QEF election only if the Company agrees to furnish the U.S. holder annually with certain tax information on a PFIC annual information statement. The Company does not presently prepare or provide such information, and such information may not be available to U.S. holders if the Company is subsequently determined to be a PFIC.

A U.S. holder of PFIC stock which is publicly traded could elect to make an election to mark-to-market the ordinary shares annually, rather than be subject to the above-described rules. Under such election, the U.S. holder will include as ordinary income or loss each year an amount equal to the difference as of the close of the taxable year between the fair market value of the PFIC stock and the holder's adjusted basis in the PFIC stock. Losses would be allowed only to the extent of net mark-to-market gain previously included by the U.S. holder under the election for prior taxable years. If the mark-to-market election were made, then the rules set forth above would not apply for periods covered by the election.

The Company believes that it was not a PFIC in 2004. However, the tests for determining PFIC status are applied annually and it is difficult to make accurate predictions of future income and assets, which are relevant to this determination. Accordingly, there can be no assurance that the Company will not become a PFIC.

U.S. holders who hold ordinary shares or ADSs during a period when the Company is a PFIC will be subject to the foregoing rules, even if the Company ceases to be a PFIC, subject to certain exceptions for U.S. holders who made a QEF or mark-to-market election. A U.S. holder who beneficially owns shares in a PFIC must file an annual return with the IRS on IRS Form 8621 that describes any distributions received with respect to such shares and any gain realized on the disposition of such shares.

U.S. holders are urged to consult their tax advisors about the PFIC rules, including the consequences to them of making a mark-to-market or QEF election with respect to the Company's ordinary shares and ADSs in the event that the Company qualifies as a PFIC.

### ***Tax Consequences for Non-U.S. Holders of Ordinary Shares***

Except as described in Information Reporting and Back-up Withholding below, a Non-U.S. holder of ADSs or ordinary shares will not be subject to U.S. federal income or withholding tax on the payment of dividends on, and the proceeds from the disposition of, ordinary shares, unless:

such item is effectively connected with the conduct by the Non-U.S. holder of a trade or business in the United States and, in the case of a resident of a country which has a treaty with the United States, such item is attributable to a permanent establishment or, in the case of an individual, a fixed place of business in the United States;

the Non-U.S. holder is an individual who holds ADSs or the ordinary shares as a capital asset and is present in the United States for 183 days or more in the taxable year of the disposition and does not qualify for an exemption; or

the Non-U.S. holder is subject to tax pursuant to the provisions of United States tax law applicable to U.S. expatriates.

### ***Information Reporting and Backup Withholding***

U.S. holders generally are subject to information reporting requirements with respect to dividends paid on, or proceeds from the disposition of, ADSs or ordinary shares. U.S. holders are also generally subject to back-up withholding on such dividends or sales proceeds at a rate of up to 28% unless the U.S. holder provides IRS Form W-9 or otherwise establishes an exemption.

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Non-U.S. holders generally are not subject to information reporting or back-up withholding with respect to dividends paid on, or upon the disposition of, ADSs or ordinary shares, provided that the non-U.S. holder provides a taxpayer identification number, certifies to its foreign status, or otherwise establishes an exemption.

The amount of any back-up withholding will be allowed as a credit against a U.S. or Non-U.S. holder's United States federal income tax liability and may entitle such holder to a refund, provided that certain required information is furnished to the IRS.

### **10F. DIVIDENDS AND PAYING AGENTS**

Not applicable.

### **10G. STATEMENT BY EXPERTS**

Not applicable.

### **10H. DOCUMENTS ON DISPLAY**

Reports and other information of ours filed with the Securities and Exchange Commission can be inspected without charge and copied at prescribed rates at the public reference facilities maintained by the Securities and Exchange Commission at 450 Fifth Avenue, N.W., Washington, D.C. 20549, and at the regional offices of the Securities and Exchange Commission located at Seven World Trade Center, Suite 1300, New York, New York 10048 and the Northwest Atrium Center, 500 West Madison Street, Suite 1400, Chicago, Illinois 60661-2511. Copies of this material are also available by mail from the Public Reference Branch of the Securities and Exchange Commission, at 450 Fifth Street, N.W., Washington, D.C. 20549, at prescribed rates.

### **10I. SUBSIDIARY INFORMATION**

Not applicable.

**ITEM 11. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

**General**

We are exposed to risks deriving from changes in the exchange rate of the shekel against foreign currencies, to risks deriving from changes in the interest rates and inflation rates, and to other market risks. From time to time, we examine the exposure and the risks that such exposures create, and take hedging measures, while taking market conditions into consideration. However, there is no assurance that our hedging measures will offset, either in whole or in part, if at all, the financial effects deriving from adverse changes in exchange rates, interest rates, inflation rates or other market risks. We do not hold or issue hedging instruments for the purpose of trading in them. See Note 18 of our financial statements.

***Risks Deriving from Exchange Rates***

As of December 31, 2004, we had liabilities denominated or linked to foreign currency in an aggregate amount of approximately NIS 58.6 million, and assets denominated or linked to foreign currency in an aggregate amount of approximately NIS 2.4 million. All of our programming expenses and a portion of our other expenses are denominated or linked to foreign currency (which, for the year ended December 31, 2004 was NIS 198.0 million). On the other hand, all of our revenues (which, for the year ended December 31, 2004, were NIS 584.6 million) are wholly denominated in shekels.

During the years 2002, 2003 and 2004, in light of the fluctuation in the exchange rate of the U.S. dollar in relation to the NIS, we entered into derivative transactions to purchase U.S. dollars at predetermined exchange rates. As of December 2004, we had a call option to buy US\$ 24 million. As a result of the above, we recorded a financial loss in our financial statements for the years ended December 31, 2002, 2003 and 2004, in the amount of about NIS 0.4 million, NIS 11.2 million and NIS 3.8 million, respectively.

***Risks Deriving from Inflation***

Our financial expenses are affected by, among other things, the inflation rate in Israel. High rates of inflation cause a decrease in the real value of our unlinked assets, which in turn, causes an increase in our financial expenses. Likewise, high rates of inflation cause a decrease in the real value of our unlinked liabilities, which in turn, causes a decrease in our financial expenses.

Regarding our assets and liabilities that are linked to the Israeli consumer price index and unlinked, see Note 18 of our financial statements.

Further, we may be unable to update the fees we collect from our subscribers in order to keep pace with inflation, due to regulatory restrictions and/or market factors. This may cause a decrease of our income in real terms.

The financial statements as of the dates and for the reported periods subsequent to December 31, 2003 are presented in reported amounts, in conformity with accounting standards of the Israel Accounting Standards Board. The financial statements as of the dates and for the reported periods until the aforementioned date are presented in values that were adjusted until that date according to the changes in the general purchasing power of the Israeli currency, in accordance with pronouncements of the Institute of Public Accounting in Israel.

The effect of the adoption of Accounting Standard No. 12 is dependent on the inflation rate in Israel, on the composition of the Company's assets and its sources of financing at that time.

***Risks Deriving from Interest Rates***

In addition to the exchange rate exposure, as described above, we have short term loans bearing variable interest rates, which are linked to the prime interest rate, determined by the Bank of Israel which is the standard interest rate for inter-bank loans. Since we present our financial statements in real terms, we are exposed to the change in the Israeli consumer price index on our interest expenses of short-term bank loans. The long-term loans, including debentures which we have issued, are mainly linked to the Israeli consumer price index plus a fixed interest percentage above the Israeli consumer price index, and some are linked to the US dollar plus a fixed interest percentage above the LIBOR. See, Item 18. Financial Statements Notes to Consolidated Financial Statements . We do not hedge any of our risks deriving from interest rates.

**Other Market Risks**

Our operations may be affected, among other things, by legislative and regulatory changes, regulatory policy, technological changes and changes in the behavior of our customers, particularly as a result of competition in the telecommunications services market, in general, and the multi-channel television market, in particular.

**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**

None

**ITEM 15. CONTROLS AND PROCEDURES**

In June 2003, we established a Disclosure Controls Procedure Committee and adopted Disclosure Controls and Procedures.

We carried out an evaluation, under the supervision and with the participation of our chief financial officer, of the effectiveness of the design and operation of our disclosure controls and procedures as of the end of the period covered by the report. Based on this evaluation, our principal executive officer and principal financial officer have concluded that, as of the end of such period, our disclosure controls and procedures are effective to ensure that information required to be included in our periodic reports to the Securities and Exchange Commission is recorded, processed, summarized and reported in a timely manner. In addition, there have been no significant changes in our internal controls or in other factors that could significantly affect those controls subsequent to the date of their last evaluation.

Although we believe our pre-existing disclosure controls and procedures and internal controls were adequate to enable us to comply with our disclosure obligations, as a result of such review we intend to implement changes, primarily to formalize and document procedures already in place.

**ITEM 16. [RESERVED]**

**ITEM 16A. AUDIT COMMITTEE FINANCIAL EXPERT**

Our board of directors has determined that Yair Keusch, one of the members of our audit committee, qualifies as a financial expert under the applicable regulations.

**ITEM 16B. CODE OF ETHICS**

On April 29, 2004, we adopted a code of ethics that applies to all of the Company's directors, officers and employees, including our principal executive officer, principal financial officer, principal accounting officer or controller and persons performing similar functions. We undertake to provide to any person without charge, upon request, a copy of our code of ethics, which you may request from Matav's legal department, tel: +972-9-860-2261.

**ITEM 16C. PRINCIPAL ACCOUNTANT FEES AND SERVICES**

*Audit Fees*

For 2003 and 2004, we paid audit fees in the aggregate amount of approximately US\$ 84,000 and US\$ 120,000, respectively. Out of the total amounts paid for audit fees, we paid our principal accountant, Kost Forer Gabbay & Kasierer, a member of Ernst & Young Global, aggregate amounts of approximately US\$ 60,000 and US\$ 120,000 for 2003 and 2004, respectively. Out of the total amounts paid for audit fees, we paid Kesselman & Kesselman, a member of PriceWaterhouse Coopers, aggregate amount of approximately US\$ 24,000 for 2003. Audit fees consist of fees billed for the annual audit services engagements and other audit services which are those services that only the external auditor can reasonably provide, and include the group audit; statutory audit; consents; and assistance with review of documents filed with the SEC.

*Audit Related Fees*

We paid audit related fees in the aggregate amount of approximately US\$ 75,000 to Kost Forer Gabbay & Kasierer in 2003 and US\$ 115,700 in 2004. Audit related services fees consist of fees billed for assurance and related services that are reasonably related to the performance of the audit or review of our financial statements or that are traditionally performed by the external auditor, and include consultations concerning financial accounting, reporting standards and internal control reviews.

*Tax Fees*

For 2003 and 2004, we paid tax fees in the aggregate amounts of approximately US\$ 119,000 and US\$ 134,700, respectively. Out of the total amounts paid for tax fees, we paid approximately US\$ 19,000 to Kesselman and Kesselman in 2003. Out of the total amounts paid for tax fees, we paid approximately US\$ 100,000 and US\$ 134,700 to Kost Forer Gabbay & Kasierer in 2003 and 2004, respectively. Tax fees include fees billed for tax compliance services, including the preparation of original and amended tax returns and claims for tax refunds; tax consultations such as assistance and representation in connection with tax audits and appeals and tax planning services.

*All Other Fees*

We did not pay any other fees in 2003 and 2004.

*Pre-approval Policies and Procedures*

Our audit committee will approve each audit and non-audit service to be performed by our independent accountant before the accountant is engaged.



**ITEM 16D. EXEMPTIONS FROM LISTING STANDARDS FOR AUDIT COMMITTEES**

Not applicable.

**ITEM 16E. PURCHASES OF EQUITY SECURITIES BY THE ISSUER AND AFFILIATED PURCHASERS**

None.

**PART III**

**ITEM 17. FINANCIAL STATEMENTS**

We have responded to Item 18. Financial Statements in lieu of responding to this Item.

**ITEM 18. FINANCIAL STATEMENTS**

The following financial statements are filed as part of this annual report.

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### ITEM 19. EXHIBITS

The exhibits filed with or incorporated by reference into this annual report are listed on the index of exhibits below.

<u>Exhibit Number</u>	<u>Description</u>
***1.1	Matav s Articles of Association, as adopted on December 31, 2000 and amended on October 31, 2002
*1.2	English translation of Matav s Memorandum of Association
*2(a)	Specimen Certificate for American Depository Shares
**4(a)(i)-A	English summary of Merger Arrangement dated December 31, 2001
***4(a)(i)-B	English summary of final version of Merger Agreement dated February 2003
****4(a)(i)-C	English summary of Limited Partnership Agreement for HOT Telecom L.P., dated October 2003, as amended in November 2003.
****4(a)(i)-D	English summary of Agreement relating to the establishment of HOT Telecom Ltd., dated October 2003.
4 (b)(ii)(b)-A	English translation of Cable Broadcast License dated April 30, 2002, as amended, granted to Matav- Cable Systems Media Ltd., and Cable Broadcast License dated April 30 2002, as amended, granted to Cable Systems Media Haifa Hadera Ltd.
**4(b)(ii)(b)-C	English summary of Broadcasting HeadEnd License dated May 2, 2002 granted to Cable Systems Media Haifa Hadera Ltd.
****4(b)(ii)(b)-D	English translation of Telecommunications Infrastructure License dated November 25, 2003 granted to HOT Telecom L.P.
***4(c)(1)	English translation of 2001 Senior Employee Option Plan
****4(c)(2)	English summary of principal terms of 2003 Option Plan
6	See Note 2(q) to our financial statements for information explaining how net loss per share information was calculated
8	List of Subsidiaries
10.1	Consent of Independent Auditors
12.1	Certification by CEO pursuant to 17 CFR 240.13a-14(a), as adopted pursuant to §302 of the Sarbanes-Oxley Act of 2002.
12.2	Certification by CFO pursuant to 17 CFR 240.13a-14(a), as adopted pursuant to §302 of the Sarbanes-Oxley Act of 2002.
13.1	Certification of CEO pursuant to 18 U.S.C. §1350, as adopted pursuant to §906 of the Sarbanes-Oxley Act of 2002.
13.2	Certification of CFO pursuant to 18 U.S.C. §1350, as adopted pursuant to §906 of the Sarbanes-Oxley Act of 2002.

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\* Incorporated herein by reference to our registration statement on Form F-1 (No. 333-4822).

\*\* Incorporated herein by reference to Matav's Annual Report on Form 20-F for the fiscal year ending December 31, 2001.  
\*\*\* Incorporated herein by reference to Matav's Annual Report on Form 20-F for the fiscal year ending December 31, 2002.  
\*\*\*\* Incorporated herein by reference to Matav's Annual Report on Form 20-F for the fiscal year ending December 31, 2003.  
The terms of the Cable Broadcast License granted to Cable Systems Media Haifa - Hadera Ltd. are substantially identical to the terms of the Cable Broadcast License granted to Cable Systems Media Ltd. In accordance with Rule 12b-31, only the latter is exhibited hereto (Exhibit 4 (b)(ii)(b)-A). The only substantial differences between the two licenses are in relation to fees and license areas. An English translation of the annexes of the licenses relating to these issues is exhibited hereto separately for each license.

## GLOSSARY OF SELECTED TERMS

The following explanations are not intended as technical definitions, but to assist the reader to understand certain terms as used in this annual report.

### *GLOSSARY*

**ADSL:** asymmetric digital subscriber line, refers to a modem technology that provides enhanced and affordable access to the Internet, video streaming, and a wide variety of other multimedia broadband services over existing copper twisted-pair wire-lines. The ADSL is the basic and most commonly used technology (of the DSL family) offered by telecommunication companies.

**Broadband:** a general term used to describe wide bandwidth equipment or networks which carry large amounts of analog and digital information over a frequency spectrum. A broadband cable television and telecommunications network can deliver multiple channels and other services.

**Buildout:** refers to the process of digging, laying cable, filling, and covering underground trenches in the streets which pass by the homes and installing and connecting the necessary electronic equipment in a license area.

**Cable television:** refers to a cable television network which employs transmission over coaxial and/or fiber-optic cable to transmit multiple channels carrying images, sound and data, between a central facility and an individual subscriber's television set. Networks may allow one-way or two-way transmission from a HeadEnd to a subscriber with a return path to the HeadEnd.

**Cable television operator:** refers to the entity which has been granted a Cable Broadcast License, by the Ministry of Communications pursuant to its authority under regulations promulgated within the scope of the Telecommunications Law, for the purpose of providing cable television services for a specific license area, building and operating a cable television network. The current cable television operators previously operated under exclusive franchises granted by the Ministry of Communications.

**Churn:** refers to the discontinuance of cable television services to a subscriber either, voluntarily or involuntarily, and commonly measured as a rate from period to period. Subscribers who disconnect and simultaneously reconnect are not included as having disconnected for purposes of calculating the churn rate.

**Churn rate:** refers to cable television subscriber termination rates expressed by calculating the total number of disconnected cable television subscribers during the relevant period as a percentage of the average number of cable television subscribers during that period.

**Coaxial cable:** refers to a cable consisting of a central conductor surrounded by and insulated from another conductor. It is the standard material used in traditional cable television networks. Signals are transmitted through this cable at different frequencies, giving a channel capacity greater than the capacity of a twisted pair cable, but smaller than the capacity of a fiber-optic cable.

**Council:** refers to the Israeli Council for Cable and Satellite Broadcasting.

**Dish:** refers to an antenna shaped like a dish used to receive television signals from a satellite.

**DBS:** refers to direct broadcasting satellite services.

**Download:** refers to the transfer of information from the network to a computer, such as games or music files.

**Downstream Path:** refers to a broad-band (85-860MHz), One-to-Many HFC network segment, which carries RF signals (TV Channels) from the network HeadEnd, Down to all the subscribers homes. (Very basic, One-Way Cable services utilize the downstream path only).

**DSL:** digital subscriber line, refers to a modem technology that provides enhanced and affordable access to the Internet, video streaming, and a wide variety of other multimedia broadband services over existing copper twisted-pair wire-lines; DSL operates with different data rates in the two directions. The ADSL is part of the DSL technology family.

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**EPG Services:** refers to electronic program guide services and broadcasting.

**Fiber-optic cable:** refers to a cable made of glass fibers through which signals are transmitted as a light energy. This cable is capable of carrying a large number of channels and other data and telecommunications information.

**GSM:** refers to the global system for mobile communications. This system is a comprehensive digital standard for the operation of all elements of a cellular telephone system. GSM originated in Europe, but is now the most popular digital mobile telephone standard used worldwide.

**HeadEnd:** refers to a collection of hardware, typically including, satellite dishes, satellite receivers, modulators, amplifiers and videocassette playback machines. After being processed, signals are then combined for distribution within the cable television network.

**High Speed Internet over cable:** refers to High Speed Internet access over cable broadband infrastructure, through the use of a cable modem and personal computer.

**Homes passed:** is an expression in common usage and referring to the measurement of the size of a cabled area, meaning the total number of premises which have the potential of becoming connected to a cable television network. A home is deemed passed if it can be connected to the cable television distribution network without further extension of trunk transmission lines.

**Inside Wiring:** refers to a part of the public telecommunications network that is located in the premises of the subscriber, and is designed to serve the premises of only such subscriber

**Interactive services:** refers to different services by way of interactive applications that are provided to our digital subscribers through the use of the subscriber's digital set-top box.

**LMDS:** refers to local multipoint distribution system, which is a point to multipoint service with a two-way capability to transmit voice, data and video information. LMDS offers innovative consumer services such as two way interactive video, advanced teleconferencing, telemedicine, telecommuting and high-speed data services.

**Minister:** refers to the Israeli Minister of Communications

**Off-air TV:** refers to over-the-air broadcast television channels that are available to viewers in Israel free of charge.

**Pay-Per-View:** refers to the payment made for individual cable television films or events on per program basis.

**Penetration:** refers to the measurement of the take-up of cable television services. Penetration is calculated by dividing the total number of subscribers by the total number of homes passed.

**PVR:** refers to personal video recorder. Refers to a device, based on large storage (hard-drive) and an easy-to-use user interface. PVR services allow the viewer to decide what content to record along with providing them with the convenience of being able to watch them whenever they want. PVR services also allow the viewer to stop, pause, fast-forward, rewind and restart the viewing, in a similar manner to the operation of a video tape recorder.

**SDH:** refers to Synchronous Digital Hierarchy. SDH is the international standard for transmitting digital information over optical networks. It is a synchronous digital transport system with a built-in management channel for remote management of complex topologies.

**Set-top box:** refers to an auxiliary device that usually rests on top of or adjacent to a television receiver. The set-top box is used to receive analog or digital transmissions and digital television to be viewed on an ordinary television set. The set-top device may convert television or signals to a form or format that allows end-user channel selection or interaction. It may tune channels that the television does not tune and may include descrambling circuitry. It may also include an electronic program guide.

**Subscriber:** refers to a subscriber to a cable television distribution system for cable television services.

**Telecommunications Law:** refers to the Israeli Telecommunications Law (Telecommunications and Broadcasting), 1982, as amended, and the rules and regulations promulgated thereunder by the Ministry of Communications and the Council for Cable and Satellite Broadcasting. The Telecommunications Law governs the licensing and operation of the telecommunications industry in the State of Israel.



**Telephony:** refers to the provision of telephone services.

**Terminal equipment:** refers to telecommunications equipment for use by a subscriber, which is or is intended to be connected from the subscriber's premises to the public telecommunications network by means of an interface intended for this purpose

**Two-way network:** refers to a network which allows the sending and receiving of signals (as opposed to a one-way network).

**Upload:** refers to the transfer of information from a computer to the network, such as sending an e-mail.

**Upstream Path:** refers to a broad-band (5-65MHz), Many-to-One HFC network segment, which carries RF signals back from all the subscribers homes UP to the network HeadEnd. Together with the downstream path, the Upstream creates BI-Directional network, which enables the deployment of advanced, Two-Way services (such as Fast-Internet-Access, Interactive TV and cable telephony).

**VOD:** refers to video on demand, a service that allows television viewers to instantaneously select and view a wide range of contents at any time they choose. VOD services also allow the viewer to stop, pause, fast-forward, rewind and restart the viewing, in a similar manner to the operation of a video tape recorder.

**SIGNATURES**

The Company hereby certifies that it meets all of the requirements for filing on Form 20-F and that it has duly caused and authorized the undersigned to sign this annual report on its behalf.

MATAV CABLE SYSTEMS MEDIA LTD.

/s/ Tal Peres

\_\_\_\_\_  
Name: Tal Peres  
Title: Chief Financial Officer

Date: June 30, 2005

/s/ Amit Levin

\_\_\_\_\_  
Name: Amit Levin  
Title: Chief Executive Officer

Date: June 30, 2005

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MATAV - CABLE SYSTEMS MEDIA LTD.

FINANCIAL STATEMENTS

AS OF DECEMBER 31, 2004

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**Kost Forer Gabbay & Kasierer** ¾ Phone: 972-3-6232525  
¾ 3 Aminadav St. Fax: 972-3-5622555  
Tel-Aviv 67067, Israel

**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

**To the shareholders of**

**MATAV - CABLE SYSTEMS MEDIA LTD.**

We have audited the accompanying balance sheets of Matav Cable Systems Media Ltd. ( the Company ) as of December 31, 2004 and 2003 and the consolidated balance sheets as of such dates and the related statements of operations, changes in shareholders equity and cash flows Company and consolidated for each of the three years in the period ended December 31, 2004. These financial statements are the responsibility of the Company s board of directors and management. Our responsibility is to express an opinion on these financial statements based on our audits.

We did not audit the financial statements of a jointly controlled (proportionately consolidated) company whose assets included in consolidation constitute approximately 4.9% and 5.7% of total consolidated assets as of December 31, 2004 and 2003, respectively, and whose revenues constitute approximately 1% of total consolidated revenues for the year ended December 31, 2004. Also, we did not audit the financial statements of an affiliate (an available for sale investment under US GAAP), the investment in which, at equity, amounted to NIS 91,334 thousand and NIS 65,373 thousand as of December 31, 2004 and 2003, respectively, and the Company s equity in its earnings amounted to NIS 25,961 thousand, NIS 64,038 thousand and NIS 11,119 thousand for the years ended December 31, 2004, 2003 and 2002, respectively, in financial statements prepared under Israeli GAAP. Those financial statements were audited by other auditors, whose reports have been furnished to us, and our opinion, insofar as it relates to the amounts included for those companies, is based solely on the reports of the other auditors.

We conducted our audits in accordance with the Standards of Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. We were not engaged to perform an audit of the Company s internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company s internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes 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, as well as evaluating the overall financial statement presentation. We believe that our audits and the reports of other auditors provide a reasonable basis for our opinion.

In our opinion, based on our audits and the reports of other auditors, the financial statements referred to above present fairly, in all material respects, the financial position of the Company and consolidated as of December 31, 2004 and 2003 and the results of operations and cash flows of the Company and consolidated for each of the three years in the period ended December 31, 2004, in conformity with accounting principles generally accepted in Israel, which differ in certain respects from U.S. generally accepted accounting principles (see Note 26 to the consolidated financial statements).

Without qualifying our opinion, we draw attention to the matters described in Note 15 to the financial statements regarding contingent liabilities and claims filed against the Company and its subsidiaries.

Tel-Aviv, Israel

March 20, 2005, except as to notes 24 and 26 which are dated June 30, 2005.

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/s/ KOST FORER GABBAY & KASIERER  
KOST FORER GABBAY & KASIERER  
A Member of Ernst & Young Global

## MATAV - CABLE SYSTEMS MEDIA LTD.

## CONSOLIDATED BALANCE SHEETS

	Note	December 31,		Convenience translation (Note 2(b)3)
		2003	2004	December 31, 2004 U.S. dollars
		NIS		
		Adjusted <sup>(2)</sup>	Reported <sup>(1)</sup>	
(In thousands)				
<b>ASSETS</b>				
<b>CURRENT ASSETS:</b>				
Cash and cash equivalents	3	37,948	24,250	5,629
Short-term deposit			50	12
Trade receivables	4a	83,151	75,458	17,515
Other accounts receivable	4b	19,765	20,010	4,645
		140,864	119,768	27,801
<b>INVESTMENTS AND LONG-TERM RECEIVABLES:</b>				
Investments in affiliates	5b	66,807	101,736	23,616
Investment in non-marketable equity securities	5c	16,241		
Investment in limited partnerships	6	2,057	1,656	384
Rights to broadcast films and programs	7	34,927	26,509	6,153
Other receivables		885	601	140
		120,917	130,502	30,293
<b>PROPERTY, PLANT AND EQUIPMENT:</b>				
Cost	8	2,028,447	2,119,060	491,890
Less accumulated depreciation		1,151,622	1,293,549	300,267
		876,825	825,511	191,623
<b>INTANGIBLE ASSETS AND DEFERRED CHARGES, NET</b>				
	9	3,946	3,101	720
		1,142,552	1,078,882	250,437

(1) See Note 2.

(2) Adjusted to the NIS of December 2003.

The accompanying notes are an integral part of the financial statements.

One party controls a large block of our shares.



## CONSOLIDATED BALANCE SHEETS

	Note	December 31,		Convenience translation (Note 2(b)3)
		2003	2004	December 31, 2004
		NIS		U.S. dollars
		Adjusted <sup>(2)</sup>	Reported <sup>(1)</sup>	
(In thousands)				
<b>LIABILITIES AND SHAREHOLDERS EQUITY</b>				
<b>CURRENT LIABILITIES:</b>				
Bank credit	10	435,403	465,339	108,018
Current maturities of debentures	14	33,701	34,005	7,893
Trade payables	11a	94,699	104,282	24,207
Jointly controlled entity current account		17,690	18,112	4,204
Other accounts payable	11b	158,982	201,943	46,876
		740,475	823,681	191,198
<b>LONG-TERM LIABILITIES:</b>				
Loans and debentures (net of current maturities):				
Loans from bank and others	13	127,403	101,457	23,551
Debentures	14	66,145	33,201	7,707
Customers deposits for converters, net of accumulated amortization	21	25,675	20,279	4,707
Accrued severance pay, net	12	2,106	2,483	576
		221,329	157,420	36,541
COMMITMENTS, CONTINGENT LIABILITIES AND LIENS	15			
<b>SHAREHOLDERS EQUITY:</b>				
Share capital:	16			
Ordinary shares of NIS 1.00 par value authorized: 100,000,000 shares as of December 31, 2004 and 2003; issued and outstanding: 30,220,477 shares and 30,203,918 shares as of December 31, 2004 and 2003, respectively		48,882	48,899	11,351
Additional paid-in capital		375,538	375,538	87,172
Accumulated deficit		(243,672)	(326,656)	(75,825)
		180,748	97,781	22,698
		1,142,552	1,078,882	250,437

- (1) See Note 2.
- (2) Adjusted to the NIS of December 2003.

The accompanying notes are an integral part of the financial statements.

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## MATAV - CABLE SYSTEMS MEDIA LTD.

## BALANCE SHEETS - THE COMPANY

	Note	December 31,		Convenience translation (Note 2(b)3)
		2003	2004	December 31, 2004
		NIS		U.S. dollars
		Adjusted <sup>(2)</sup>	Reported <sup>(1)</sup>	
(In thousands)				
<b>ASSETS</b>				
<b>CURRENT ASSETS:</b>				
Cash and cash equivalents	3	35,879	21,602	5,014
Trade receivables	4a	45,400	37,398	8,682
Other accounts receivable	4b	19,431	15,321	3,556
		100,710	74,321	17,252
<b>INVESTMENTS AND LONG-TERM RECEIVABLES:</b>				
Investments in subsidiaries and long-term accounts	5a	247,348	254,100	58,983
Investments in affiliates	5b	75,992	114,230	26,516
Investment in non-marketable equity securities	5c	16,227		
Other receivables		885	601	140
		340,452	368,931	85,639
<b>PROPERTY, PLANT AND EQUIPMENT:</b>				
Cost	8	1,429,183	1,473,217	341,972
Less accumulated depreciation		816,948	915,730	212,565
		612,235	557,487	129,407
<b>INTANGIBLE ASSETS AND DEFERRED CHARGES, NET</b>				
	9	1,330	616	143
		1,054,727	1,001,355	232,441

(1) See Note 2.

(2) Adjusted to the NIS of December 2003.

The accompanying notes are an integral part of the financial statements.

One party controls a large block of our shares.





## MATAV - CABLE SYSTEMS MEDIA LTD.

## BALANCE SHEETS THE COMPANY

	Note	December 31,		Convenience translation (Note 2(b)3)
		2003	2004	December 31, 2004
		NIS		U.S. dollars
		Adjusted <sup>(2)</sup>	Reported <sup>(1)</sup>	
(In thousands)				
<b>LIABILITIES AND SHAREHOLDERS EQUITY</b>				
<b>CURRENT LIABILITIES:</b>				
Bank credit	10	394,896	424,992	98,652
Current maturities of debentures	14	33,701	34,005	7,893
Trade payables	11a	63,617	74,917	17,390
Subsidiaries' current account		15,988	18,619	4,322
Other accounts payable	11b	140,608	184,498	42,827
		648,810	737,031	171,084
<b>LONG-TERM LIABILITIES:</b>				
Loans and debentures (net of current maturities):				
Loans from bank and others	13	127,403	101,457	23,552
Debentures	14	67,402	34,005	7,893
Losses over investment in subsidiaries	5a	10,778	15,157	3,518
Customers' deposits for converters, net of accumulated amortization	21	18,882	14,901	3,459
Accrued severance pay liability, net	12	704	1,023	237
		225,169	166,543	38,659
<b>COMMITMENTS, CONTINGENT LIABILITIES AND LIENS</b>	15			
<b>SHAREHOLDERS' EQUITY:</b>				
Share capital:	16			
Ordinary shares of NIS 1.00 par value authorized: 100,000,000 shares as of December 31, 2004 and 2003; issued and outstanding: 30,220,477 shares and 30,203,918 shares as of December 31, 2004 and 2003, respectively		48,882	48,899	11,351
Additional paid-in capital		375,538	375,538	87,172
Accumulated deficit		(243,672)	(326,656)	(75,825)
		180,748	97,781	22,698
		1,054,727	1,001,355	232,441

One party controls a large block of our shares.



(1) See Note 2.

(2) Adjusted to the NIS of December 2003.

The accompanying notes are an integral part of the financial statements.

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## MATAV - CABLE SYSTEMS MEDIA LTD.

## CONSOLIDATED STATEMENTS OF OPERATIONS

	Note	Year ended December 31,			Convenience translation (Note 2(b)3)
		2002	2003	2004	Year ended December 31, 2004
		NIS			U.S. dollars
		Adjusted <sup>(2)</sup>	Reported <sup>(1)</sup>		
(In thousands, except per share amounts)					
Revenues	2j	495,536	545,480	584,564	135,693
Operating expenses:					
Depreciation		161,996	160,521	144,902	33,636
Other operating expenses	19a	345,441	306,165	327,586	76,041
<b>Total operating expenses</b>		<b>507,437</b>	<b>466,686</b>	<b>472,488</b>	<b>109,677</b>
Gross profit (loss)		(11,901)	78,794	112,076	26,016
Selling, marketing, general and administrative expenses:	19b				
Selling and marketing		40,643	43,954	63,676	14,782
General and administrative		46,137	42,659	45,391	10,536
		86,780	86,613	109,067	25,318
Operating income (loss)		(98,681)	(7,819)	3,009	698
Financial expenses, net	19c	(48,089)	(83,958)	(50,333)	(11,684)
Other income (expenses), net	19d	278,535	80,996	(42,680)	(9,907)
Income (loss) before taxes on income		131,765	(10,781)	(90,004)	(20,893)
Taxes on income	17	108,851	35,576	7,281	1,690
Income (loss) after taxes on income		22,914	(46,357)	(97,285)	(22,583)
Equity in earnings of affiliates, net	5	10,910	40,907	14,301	3,320
Net income (loss)		33,824	(5,450)	(82,984)	(19,263)

One party controls a large block of our shares.

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Basic and diluted net earnings (loss) per Ordinary share NIS	2q	1.17	(0.19)	(2.74)	(0.64)
Basic and diluted net earnings (loss) per ADS NIS	2q	2.34	(0.38)	(5.48)	(1.28)
Weighted average number of shares outstanding during the year (in thousands)	2q	28,860	29,347	30,217	30,217
Weighted average number of ADS outstanding during the year (in thousands)	2q	14,430	14,674	15,108	15,108

- (1) See Note 2.  
 (2) Adjusted to the NIS of December 2003.  
 The accompanying notes are an integral part of the financial statements.

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## STATEMENTS OF OPERATIONS - THE COMPANY

	Note	Year ended December 31,			Convenience translation (Note 2(b)3)
		2002	2003	2004	Year ended December 31, 2004
		NIS			U.S. dollars
		Adjusted <sup>(2)</sup>	Reported <sup>(1)</sup>		
(In thousands, except per share amounts)					
Revenues	2j	347,890	367,326	370,275	85,951
Operating expenses:					
Depreciation		116,151	116,878	103,715	24,075
Other operating expenses	19a	229,917	207,205	223,632	51,911
<b>Total operating expenses</b>		<b>346,068</b>	<b>324,083</b>	<b>327,347</b>	<b>75,986</b>
Gross profit		1,822	43,243	42,928	9,965
Selling, marketing, general and administrative expenses:	19b				
Selling and marketing		29,124	26,878	34,988	8,122
General and administrative		29,899	28,288	30,340	7,043
		59,023	55,166	65,328	15,165
Operating loss		(57,201)	(11,923)	(22,400)	(5,200)
Financial expenses, net	19c	(44,125)	(79,387)	(45,961)	(10,669)
Other income (expenses), net	19d	286,574	84,941	(41,976)	(9,744)
Income (loss) before taxes on income		185,248	(6,369)	(110,337)	(25,613)
Taxes on income	17	108,851	35,496	4,516	1,048
Income (loss) after taxes on income		76,397	(41,865)	(114,853)	(26,661)
Equity in earnings (losses) of affiliates and subsidiaries, net	5	(42,573)	36,415	31,869	7,398
Net income (loss)		33,824	(5,450)	(82,984)	(19,263)

One party controls a large block of our shares.

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Basic and diluted net earnings (loss) per Ordinary share	NIS	2q	1.17	(0.19)	(2.74)	(0.64)
Basic and diluted net earnings (loss) per ADS	NIS	2q	2.34	(0.38)	(5.48)	(1.28)
Weighted average number of shares outstanding during the year (in thousands)		2q	28,860	29,347	30,217	30,217
Weighted average number of ADS outstanding during the year (in thousands)		2q	14,430	14,674	15,108	15,108

(1) See Note 2.

(2) Adjusted to the NIS of December 2003.

The accompanying notes are an integral part of the financial statements.

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## MATAV - CABLE SYSTEMS MEDIA LTD.

## STATEMENTS OF CHANGES IN SHAREHOLDERS EQUITY

	Share capital		Additional paid-in capital	Accumulated deficit	Cost of Company shares held by subsidiary	Total
	Number of shares	Amount				
<b>Adjusted NIS in thousands (2)</b>						
Balance at January 1, 2002	30,204	48,882	401,654	(272,046)	(66,205)	112,285
Sale of Company shares held by subsidiary			(325)		1,288	963
Net income for the year				33,824		33,824
Balance at December 31, 2002	30,204	48,882	401,329	(238,222)	(64,917)	147,072
Sale of Company shares held by subsidiary			(25,791)		64,917	39,126
Loss for the year				(5,450)		(5,450)
Balance at December 31, 2003	30,204	48,882	375,538	(243,672)		180,748
<b>Reported NIS in thousands (1)</b>						
Balance at January 1, 2004	30,204	48,882	375,538	(243,672)		180,748
Exercise of stock options by employees	17	17				17
Loss for the year				(82,984)		(82,984)
Balance at December 31, 2004	30,221	48,899	375,538	(326,656)		97,781
<b>Convenience translation (Note 2(b)3)</b>						
<b>U.S. dollars in thousands</b>						
Balance at January 1, 2004	30,204	11,347	87,172	(56,562)		41,957
Exercise of stock options by employees	17	4				4
Loss for the year				(19,263)		(19,263)
Balance at December 31, 2004	30,221	11,351	87,172	(75,825)		22,698

One party controls a large block of our shares.



(1) See Note 2.

(2) Adjusted to the NIS of December 2003.

The accompanying notes are an integral part of the financial statements.

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## MATAV - CABLE SYSTEMS MEDIA LTD.

## CONSOLIDATED STATEMENTS OF CASH FLOWS

	Year ended December 31,			Convenience translation (Note 2(b)3)
	2002	2003	2004	Year ended December 31, 2004
	NIS			U.S. dollars
	Adjusted <sup>(2)</sup>	Reported <sup>(1)</sup>		
	(In thousands)			
<b>Cash flows from operating activities:</b>				
Net income (loss) for the year	33,824	(5,450)	(82,984)	(19,263)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities (a)	(123,249)	101,503	204,244	47,410
Net cash provided by (used in) operating activities	(89,425)	96,053	121,260	28,147
<b>Cash flows from investing activities:</b>				
Short-term deposit			(50)	(12)
Investment in Hot Telecom			(12,209)	(2,834)
Investment in limited partnerships			(88)	(20)
Newly consolidated jointly controlled company (proportionate consolidation) (b)		1,980		
Purchase of property, plant and equipment	(77,296)	(56,642)	(95,217)	(22,102)
Repayment of long-term loans to affiliate	461	292		
Deposit in trust, net	1,838			
Investment in intangible assets	(2,924)			
Proceeds from sale of investment in affiliate	305,088	114,440		
Proceeds from sale of property, plant and equipment	1,243	1,700	1,393	323
Grant of long-term loan for the purchase of fixed assets		(1,394)		
Collection of long-term loans granted for the purchase of property, plant and equipment			278	65
Grant of capital note to affiliate			(68)	(16)
Net cash provided by (used in) investing activities	228,410	60,376	(105,961)	(24,596)
<b>Cash flows from financing activities:</b>				
Exercise of stock options by employees			17	4
Sale of Company shares held by subsidiary	963	39,126		
Receipt of long-term loans from banks and others	6,508	31,676	3,759	873
Repayment of long-term loans from banks and others	(129,430)	(73,522)	(45,965)	(10,670)
Redemption of debentures	(33,637)	(33,701)	(34,107)	(7,917)
Short-term bank credit, net	23,721	(89,664)	47,299	10,979
Net cash used in financing activities	(131,875)	(126,085)	(28,997)	(6,731)

One party controls a large block of our shares.

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Increase (decrease) in cash and cash equivalents	7,110	30,344	(13,698)	(3,180)
Cash and cash equivalents at beginning of year	494	7,604	37,948	8,809
Cash and cash equivalents at end of year	7,604	37,948	24,250	5,629

(1) See Note 2.

(2) Adjusted to the NIS of December 2003.

The accompanying notes are an integral part of the financial statements.

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## CONSOLIDATED STATEMENTS OF CASH FLOWS

	Year ended December 31,			Convenience translation (Note 2(b)3)
	2002	2003	2004	Year ended December 31, 2004
	NIS			U.S. dollars
	Adjusted <sup>(2)</sup>	Reported <sup>(1)</sup>		
	(In thousands)			
(a) <u>Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:</u>				
Income and expenses not involving cash flows:				
Equity in earnings of affiliates, net	(10,910)	(62,840)*	(22,652)	(5,258)
Depreciation and amortization	165,745	171,820	146,488	34,004
Deferred income taxes, net		15,630*	8,351	1,938
Severance pay, net	(424)	1,685	377	88
Loss (gain) from:				
Changes in shareholding in affiliate (including from sale of shares of affiliates)	(295,933)	(96,662)		
Write-off of investment in non-marketable equity securities	8,962		16,241	3,770
Sale of property, plant and equipment	44	1,428	197	46
Linkage differences on principal of debentures	692	355	1,467	340
Linkage and exchange differences in respect of long-term loans from banks and loans granted to others	(390)	(3,647)	(1,097)	(255)
Purchasing power loss on deposit in trust	(1,838)			
	(134,052)	27,769*	149,372	34,673
Changes in operating assets and liabilities:				
Decrease in rights to broadcast movies and programs			8,418	1,954
Decrease in trade receivables	3,642	9,718	7,693	1,786
Decrease (increase) in affiliate current accounts	(5,194)	15,008	422	98
Increase in other accounts receivable	(743)	(29)	(245)	(57)
Increase (decrease) in trade payables	(24,382)	(1,832)	9,717	2,256
Increase in other accounts payable	31,903	50,003*	34,263	7,953
Increase (decrease) in customers deposits for converters, net	5,577	866	(5,396)	(1,253)
	10,803	73,734*	54,872	12,737
	(123,249)	101,503	204,244	47,410

- \*) Reclassified.
- (1) See Note 2.
- (2) Adjusted to the NIS of December 2003.

The accompanying notes are an integral part of the financial statements.

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## CONSOLIDATED STATEMENTS OF CASH FLOWS

	Year ended December 31,			Convenience translation (Note 2(b)3)
	2002	2003	2004	Year ended December 31, 2004
	NIS			U.S. dollars
	Adjusted <sup>(2)</sup>		Reported <sup>(1)</sup>	
(In thousands)				
<b>(b) Newly consolidated jointly controlled company:</b>				
Net working capital (except for cash and cash equivalents)		38,745		
Property, plant and equipment, net		(1,142)		
Investment in limited partnerships		(2,057)		
Rights to broadcast movies and programs		(34,927)		
Long-term liabilities		737		
Investment in affiliate (prior to consolidation)		624		
		1,980		
<b>(c) Supplementary cash flow information:</b>				
Cash paid during the year for:				
Interest	50,894	56,239	29,877	6,935
Taxes on income	70,612	80		
<b>(d) Non-cash activities:</b>				
Purchase of property, plant and equipment on credit	57,656	35,512	16,833	3,907

(1) See Note 2.

(2) Adjusted to the NIS of December 2003.

The accompanying notes are an integral part of the financial statements.

## STATEMENTS OF CASH FLOWS - THE COMPANY

	Year ended December 31,			Convenience translation (Note 2(b)3)
	2002	2003	2004	Year ended December 31, 2004
	NIS			U.S. dollars
	Adjusted <sup>(2)</sup>	Reported <sup>(1)</sup>		
	(In thousands)			
<b>Cash flows from operating activities:</b>				
Net income (loss) for the year	33,824	(5,450)	(82,984)	(19,263)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities (a)	(121,495)	42,870	147,052	34,135
Net cash provided by (used in) operating activities	(87,671)	37,420	64,068	14,872
<b>Cash flows from investing activities:</b>				
Investment in Hot Telecom			(12,209)	(2,834)
Purchase of property, plant and equipment	(32,324)	(12,311)	(50,511)	(11,725)
Investment in subsidiaries and affiliate (long-term accounts and capital notes), net	(67,287)			
Collection of long-term loans granted to subsidiaries, net		54,396	11,817	2,743
Investment in intangible assets	(186)			
Proceeds from sale of investment in affiliate, net	302,418	113,709		
Proceeds from sale of fixed assets	1,036	1,077	1,117	259
Grant of long-term loan for the purchase of property, plant and equipment		(1,394)		
Collection of long-term loans granted for the purchase of property, plant and equipment			278	65
Net cash provided by (used in) investing activities	203,657	155,477	(49,508)	(11,492)
<b>Cash flows from financing activities:</b>				
Exercise of stock options by employees			17	4
Receipt of long-term loans from banks and others	6,508	31,676	3,759	873
Repayment of long-term loans from banks and others	(120,974)	(73,522)	(45,965)	(10,670)
Redemption of debentures	(33,637)	(33,701)	(34,107)	(7,917)
Short-term bank credit, net	36,718	(89,646)	47,459	11,016
Receipt of long-term loans from subsidiary	2,669	731		
Net cash used in financing activities	(108,716)	(164,462)	(28,837)	(6,694)
Increase (decrease) in cash and cash equivalents	7,270	28,435	(14,277)	(3,314)

One party controls a large block of our shares.

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Cash and cash equivalents at beginning of year	174	7,444	35,879	8,328
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Cash and cash equivalents at end of year	7,444	35,879	21,602	5,014
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>

(1) See Note 2.

(2) Adjusted to the NIS of December 2003.

The accompanying notes are an integral part of the financial statements.

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## STATEMENTS OF CASH FLOWS - THE COMPANY

	Year ended December 31,			Convenience translation (Note 2(b)3)
	2002	2003	2004	Year ended December 31, 2004
	NIS			U.S. dollars
	Adjusted <sup>(2)</sup>	Reported <sup>(1)</sup>		
(In thousands)				
(a) <u>Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:</u>				
Income and expenses not involving cash flows:				
Equity in losses (earnings) of affiliates and subsidiaries, net	42,573	(58,348)*	(40,219)	(9,336)
Depreciation and amortization	118,480	126,350	102,098	23,700
Deferred income taxes, net		15,630*	8,351	1,938
Severance pay, net	(126)	1,109	319	74
Loss (gain) from:				
Changes in shareholding in subsidiary affiliates (including proceeds from realization of affiliate shares)	(302,418)	(97,876)		
Write-off of investment in non-marketable equity securities	8,830		16,227	3,767
Sale of property, plant and equipment	92	938	81	19
Linkage differences on principal of debentures	220	(116)	1,014	236
Linkage and exchange differences in respect of long-term loans from banks and loans granted to others	(225)	(3,386)	(1,097)	(255)
Purchasing power loss on long-term accounts and capital note	294	82		
	<u>(132,280)</u>	<u>(15,617)*</u>	<u>86,774</u>	<u>20,143</u>
Changes in operating assets and liabilities:				
Decrease in trade receivables	3,541	2,235	8,002	1,857
Decrease (increase) in affiliate current accounts	(950)	13,973	2,631	611
Decrease (increase) in other accounts receivable	1,917	(5,781)	4,110	954
Increase (decrease) in trade payables	(23,115)	(4,268)	14,160	3,287
Increase in other accounts payable	25,436	51,793*	35,356	8,207
Increase (decrease) in customers deposits for converters, net	3,956	535	(3,981)	(924)
	<u>10,785</u>	<u>58,487*</u>	<u>60,278</u>	<u>13,992</u>
	<u>(121,495)</u>	<u>42,870</u>	<u>147,052</u>	<u>34,135</u>
(b) <u>Supplementary cash flow information:</u>				
Cash paid during the year for:				

One party controls a large block of our shares.



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Interest	50,894	56,239	29,769	6,446
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Taxes on income	70,612			
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
 (c) <u>Non-cash activities:</u>				
Purchase of property, plant and equipment against credit from suppliers	40,316	28,602	6,798	1,578
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>

\*) Reclassified.

(1) See Note 2.

(2) Adjusted to the NIS of December 2003.

The accompanying notes are an integral part of the financial statements.

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NOTES TO FINANCIAL STATEMENTS

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## NOTE 1: GENERAL

## a. Operations:

## 1. The Licenses

Matav - Cable Systems Media Ltd. (the **Company**) and its wholly owned subsidiary, Cable Systems Media Haifa-Hadera Ltd. (**Matav Haifa**), operate in the field of cable television (**CATV**) broadcasting. As detailed below, in the past the Company and Matav Haifa operated pursuant to five exclusive franchises granted to them by the Ministry of Communications to provide cable television services in the franchises areas. The franchises covered the following operational areas as follows: Bat-Yam, Holon, Haifa, Netanya Hadera, and the Galilee. The Company commenced commercial broadcasts in March 1990.

The franchises were granted to the Company and Matav Haifa under the Israeli Telecommunications Law, 1982, and the rules and regulations promulgated hereunder (the **Telecommunications Law**), which determine the regulatory framework in which the Company operates and the obligations imposed upon it. The Telecommunications Law determines, among other things, maximum subscription fees, milestones and restrictions on transfer and allotment of shares among the license holders.

On July 25, 2001, the Knesset (the **Israeli Parliament**) approved an amendment (No. 25) to the Telecommunications Law (**Amendment 25**). Amendment 25 settled the licensing of CATV broadcasting by establishing a policy of general, long-term, non-exclusive licenses, as opposed to the exclusive regional CATV broadcasting franchises granted to the Company and Matav Haifa, for limited periods, prior to the said amendment. As a result of the approval of Amendment 25, licenses conferring exclusive rights in certain areas cannot be granted. Pursuant to Amendment 25, the CATV operators are entitled to apply for a license to provide non-exclusive cable broadcast licenses for CATV broadcasting (the **Broadcast Licenses**) and a non-exclusive special license to hold a broadcasting headend (the **Headend License**). Under the said amendment, all the CATV operators can also apply for an approval to operate jointly once they have received their licenses. On April 30, 2002, the Council for Cable and Broadcasting (the **Council**) granted the Company and Matav Haifa general, long-term non-exclusive Broadcast Licenses for the same areas that are mentioned above. In addition, on May 2, 2002, the Ministry of Communications granted the Company a Headend License. These licenses replaced the franchises pursuant to which, the Company operated prior to the above mentioned dates. The Broadcast Licenses are effective for a period of 15 years, however, they may be extended for additional periods of ten years each. The Headend License is valid for so long as the Broadcast Licenses remain in force, but in no event, no later than May 30, 2017, although it may be extended upon request to the Ministry of Communications.

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NOTES TO FINANCIAL STATEMENTS

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## NOTE 1: GENERAL (Cont.)

2. **The Broadcasts**

On May 10, 2001, the Company received from the Council the approval to provide digital broadcasting services in a tiering system. The tiering technique enables the Company to provide to its digital services subscribers a basic broadcasting package in consideration of fixed subscription fees and additional single channels as well as packages of channels for additional payment. The Company began to market tiering broadcasting packages to its subscribers in July 2001.

According to the terms of the Broadcast Licenses, the Company shall air only the broadcasts that have been authorized by the Council, according to the terms of such approvals. Such broadcasts shall be both analog and digital or any other system authorized in advance by the Council. The Company may request permission to reduce the scope of the analog broadcasts and in such event, the Company may be instructed to charge lower subscription fees. As of today, the broadcast package, for which a maximum tariff was set in the licenses is the basic analog package. According to the Telecommunications Law, the Company has the right to determine the tariffs for the digital broadcasts. The Company is obliged to notify the Ministry of Communications in advance, of any intended change in fees. The Minister has the right to alter the fees, including inter alia, in the following cases: if he finds that such fees are discriminatory, misleading or harm the competition. In the approval of the Council to the merger of the Israeli cable companies, which will come into effect only after the consummation of the merger, it was determined that the Council is authorized to direct the Cable Companies a maximum subscription fee for the analog and digital basic packages.

3. **The Infrastructure License and Hot telecom**

In addition to the aforesaid, on March 27, 2002 Matav Infrastructures 2001 LP ( **Matav Infrastructures** ) a subsidiary of the Company was granted a Telecommunications Infrastructure License by the Minister of Communications for the provision of infrastructure services for the distribution of cable broadcasts and access to High Speed Internet providers (the **Infrastructure License** ). Matav Infrastructures commenced providing services pursuant to the said license in April 2002.

In August 2002, the Ministry of Communications granted the Company special licenses to provide additional Bezeq services on the cable network infrastructure to its subscribers in digital format including, inter alia, SMS services and T-mail services over the cable network among TV subscribers.

In November 2002, the Minister of the Communication amended the Telecommunications Infrastructure License thereby allowing Matav Infrastructure to provide additional infrastructure services of data communication, digital transmission and optical transmission services.

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NOTES TO FINANCIAL STATEMENTS

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## NOTE 1: GENERAL (Cont.)

In July 2002, the Company together with certain other Cable Companies (the Cable companies ) submitted a request to receive a license to provide domestic fixed communications services. In October 2003, the Cable Companies entered into an agreement, as amended from time to time, for the establishment of a limited partnership -HOT Telecom L.P. ( **HOT Telecom** ) which would engage in the establishment and operation of a public telecommunications network by which it will supply domestic-fixed telecommunications services, including, fixed telephony services, access to High Speed Internet over cable, infrastructure services, messaging and data telecommunications services.. The partnership agreement includes, among other things, provisions relating to the management of HOT Telecom and its general partner, HOT Telecom Ltd., the distribution of its profits and income and limitations on the transfer of rights by the partners of HOT Telecom.

In the context of the said agreement, the Company (through its subsidiary), based on its proportionate share in the total number of subscribers of the Cable Companies (the subscribers of multi channel TV broadcast and the subscribers of access to High Speed internet services) as of October 31, 2003, owns, directly and indirectly, approximately 26.5% of the Partnership rights as well as approximately 26.5% of the general partner rights in the Hot Telecom.

In November 2003, the Ministry of Communications granted HOT Telecom a license covering the same services covered by the Infrastructure Licensees of the Cable Companies (to be supplied within the time frame set forth in the Infrastructure License) and also including the requirement to start to provide other domestic fixed communication services over cable network including basic telephony services to subscribers ( **Hot Telecom Infrastructure License** ). The said license canceled and terminated the Infrastructure License, which was granted to Matav Infrastructures in March 2002.

On March 16, 2005, the Minister of the Communications amended Hot Telecom Infrastructure License thereby allowing Hot Telecom to provide access to High Speed Internet services, by the former infrastructure licensees of the Cable Companies, including inter alia, Matav Infrastructures, (whilst the said services shall be deemed to have been provided by Hot Telecom) during an interim period commencing on November 2003 until the consummation of the merger of the Cable Companies.

Hot Telecom Infrastructure License is effective for a period of 20 years and it may be extended by the Minister of Communications for additional periods of 10 years each.

Hot Telecom is obliged to offer its services to all applicants without discrimination, regardless of whether or not they may be a subscriber of another licensee (including a broadcast licensee).

According to the approval of the Controller of Restrictive Business Practices (the **Controller** ), in connection with the proposed merger of the Cable Companies (see section 7 below), Hot Telecom is required to make a comprehensive investment in telephony services in an amount of not less than NIS 350 million.

The Company's portion of the said investment, pro rata to its proportionate share in Hot Telecom is estimated to be approximately NIS 93 million.

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NOTES TO FINANCIAL STATEMENTS

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**NOTE 1: GENERAL (Cont.)**

As of the date of the balance sheet, domestic-fixed telecommunications services to the business sector are provided by Hot Telecom and access to High Speed Internet services to the private sector are provided by the consolidated partnership Matav Infrastructure.

In view of the above, the consolidated financial statements of the Company as of December 31, 2004, include part of the access to High Speed Internet activity that is provided by Matav infrastructure.

As of the end of November 2004, Hot Telecom has gradually commenced to provide commercial telephony services, where in the first stage, the service is rendered in the Tel Aviv, Hasharon and Beer Sheva Regions.

**4. Ownership of the cable network**

The Group must operate through separate entities, namely the broadcast entities, on the one hand, and an infrastructure entity, on the other hand, which must each hold a Cable Broadcast License or Telecommunications Infrastructure License, as appropriate. Pursuant to the Telecommunications Law, the licensee under the Telecommunications Infrastructure License, or the Telecommunications Infrastructure Licensee, must own the cable network infrastructure as a condition to the receipt of the license. However, according to the terms of the Telecommunications Infrastructure License, and subsequently, in the HOT Telecom Infrastructure License, the Cable Broadcast Licensees are allowed to continue to own the cable network infrastructure and to provide infrastructure services for an additional interim period of the earlier of two years following the date of the grant of the HOT Telecom Infrastructure License, which was November 25, 2003, or the date of the consummation of the merger of the Israeli cable television operators.

During such interim period, the necessary arrangements must be made regarding the transfer of the ownership of the cable network infrastructure to the Telecommunications Infrastructure Licensee. Accordingly, and as a condition for the receipt of the original Telecommunications Infrastructure License, the Group's Cable Broadcast Licensees and Matav Infrastructure Telecommunications Infrastructure Licensee entered into an agreement dated March 5, 2002, whereby the Group's Cable Broadcast Licensees granted an exclusive lease to the Telecommunications Infrastructure Licensee to operate the cable network infrastructure. In October 2002, the Group's Cable Broadcast Licensees and the Group's Telecommunications Infrastructure Licensee entered into an agreement, whereby Matav Infrastructure shall provide the Cable Broadcast Licensees infrastructure services for the broadcast of cable broadcasts in the areas covered by their respective license, including installment, maintenance and disconnection of terminal equipment. Since November 2003, HOT Telecom is the Group's Telecommunications Infrastructure Licensee and the prior agreements are no longer in effect. Agreements in this regard will be signed between HOT Telecom and the Company in the near future.

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## NOTES TO FINANCIAL STATEMENTS

**NOTE 1: GENERAL (Cont.)**

The Cable Companies have not yet established a mechanism to charge Hot Telecom for usage and maintenance fees of the network. Therefore, Hot Telecom's management cannot assess at this stage the scope and date of the said charge. Hot Telecom's financial statements do not include usage fees costs and network maintenance fees. Since Hot Telecom will be charged with usage fees by the cable companies, the aforementioned will not affect the Company's net results of operations.

**5. Structural Separation between broadcasts and infrastructure**

The Broadcast Licenses, and HOT Telecom Infrastructure License all contain restrictions limiting the number and identity of directors that are permitted to serve in both the infrastructure entity (and its general partner), and the Cable Broadcast companies.

In the event that either another entity is granted a general license to broadcast through the cable network, or in the event that HOT Telecom reaches a number of subscribers to the service of access to High Speed Internet over cable equals to 450,000, or if the number of the telephony lines operated by HOT Telecom pursuant to the HOT Telecom Infrastructure License reaches 250,000, a much broader structural separation (as detailed in the said licenses) shall apply. Subject to the aforesaid, the Council with respect to the Broadcast Licensee, and the Minister with respect to HOT Telecom, also have the authority to impose additional conditions, regarding the relationship between the Broadcast Licensees or the Infrastructure Licensee and their connected companies, including the identity of the officers of each company, the transfer of information, the separation of entities between broadcast and infrastructure, the accounting systems, and technological, geographical or commercial restrictions regarding the laying down of infrastructure or regarding the provision of services or broadcasts. In the event that the Minister finds that special circumstances exist, after he is convinced that competition in the field of the Telecommunication broadcasting will not be harmed, he is entitled, upon a written request by Hot Telecom to amend the license to include exceptions to the separation obligation, subject to conditions that the Minister may impose.

The licenses of the Group also include certain provisions relating to approvals required for change of means of control in the owners of such licenses.

**6. D.B.S. Satellite Services (1998) Ltd.**

On January 5, 1999, the Knesset approved an amendment to the Telecommunications Law, according to which the Ministry of Communications may grant a license for direct broadcasting via satellite. On January 21, 1999, the Ministry of Communications granted D.B.S. Satellite Services (1998) Ltd. (known as: **Yes**) a license for providing television broadcasts to subscribers in Israel via satellite. YES commenced DBS broadcasting in July 2000.

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NOTES TO FINANCIAL STATEMENTS

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## NOTE 1: GENERAL (Cont.)

In September 2001, the Minister of Communications issued administrative directives which were amended effective as of February 3, 2002, governing the reciprocal use of inside wiring between the Cable Companies and Yes (the **Administrative Directives** ). The Administrative Directives stipulate, inter alia, that the Company would be obligated to allow Yes to utilize the inside wiring, which is a part of the public telecommunications network that is located in the premises of the subscribers and is designed to serve the premises of such subscribers (the **Inside Wiring** ) of the subscribers of the Company, and that Yes would be obligated to allow the Company to utilize the Inside Wiring of the subscribers of Yes.

The Administrative Directives establish instructions regarding the procedures of transition for cable television subscribers to become subscribers to Yes and vice versa. These directives also provide that Yes shall pay fees to the relevant cable television operators for the use of their Inside Wiring, and that the cable television operators shall pay fees to YES for the use of its Inside Wiring. The Administrative Directives stipulate what such amount should be. In addition, the Minister of Communications has the authority to issue directives regarding the common use of the Inside Wiring by both Yes and by the cable television operators, with regard to the provision of different services by each party. The Ministry of Communications conducted a hearing regarding the common use of Inside Wiring. To date, the Ministry has not issued directives regarding this matter.

7. **The proposed Merger between the Israeli Cable Companies**

In February 2003 the company and the other Cable Companies agreed on a final version of an agreement outlining the structure and conditions of the merger of the Cable Companies. To date, the final merger agreement has not yet been signed.

Prior to the merger, the Cable Companies shall need to reach an understanding with the major Israeli banks which are creditors of the parties to the merger. The merger must also receive approvals under applicable law, including the approvals of the Council, the Income Tax Commission, the Controller and by an Israeli court, after receiving the approvals of certain creditors and the relevant corporate bodies of the relevant parties. To date, approvals have been granted, subject to terms and conditions, from the Council, the Controller and the Income Tax Commission. Subject to the final terms of the merger, further approval of the Income Tax Commission to the merger may be required.

In March 2002, the Council granted an approval for the merger of the Cable Companies. The said approval was amended in February 2003.

The approval of the Controller to the merger was granted in April 2002. The said approval is subject to a number of terms and conditions.

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NOTES TO FINANCIAL STATEMENTS

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## NOTE 1: GENERAL (Cont.)

The Controller's conditions to the merger (most of which already apply in light of the cooperation between the Cable Companies as described below and defined as the Operational Merger), include, inter alia, conditions concerning: (1) separation between the cable infrastructure and the broadcasting activity of the merged companies; (2) allowing access to and use of cable broadcasting infrastructure to owners of licenses to operate CATV systems; (3) the ownership structures of the merged companies; (4) restrictions as to the purchase of content and interest in the channels; (5) provisions concerning non prevention of competitive infrastructures development; (6) restrictions on parties that are related to the merged companies, including in connection with acting as officers in the merged company and the transfer of business information; (7) the commitment to supply fixed telephony services to the public in Israel over the cable infrastructure that compete with those of Bezeq as detailed in the approval; (8) the provision of a bank guarantee (by all the Cable Companies) in the amount of 15 million dollars for the fulfillment of the Controller's conditions.

On January 30, 2005, the Controller has issued an amendment to its previous approval to the merger of the Cable Companies from April 2002, as amended from time to time. According to the amendment, the Controller extended the validity of the approval to the merger until the earlier of January 29, 2006 or the date of the consummation of the merger. As part of the amendment, the controller revised some of the conditions to the approval, including, allowing the merged entity to hold means of control in four additional channels and amending the schedule set for the investment of NIS 350 million required by the merged entity as follows: not less than NIS 190 million until June 30, 2005, not less than NIS 160 million until June 30, 2006 and any other amount that shall be required for the fulfillment of the business plan for the provision of telephony services, which fully compete with the telephony services of Bezeq. In addition, according to the amendment, the Controller enlarged the minimum number of subscribers to whom the merged entity is obliged to provide telephony services by the end of the consecutive years 2005, 2006 and 2007.

On January 30, 2005, the Controller also granted the three Israeli Cable Companies an exemption from the requirement to receive an approval of a Restrictive Arrangement as such term is defined under section 14 of the Restrictive Business Practice Law, in relation to the ongoing cooperation between the Cable Companies. Pursuant to the exemption, the Cable Companies may continue their cooperation in the multi-channel TV broadcasting operations, including marketing, content acquisition and content production, and in building infrastructure and providing fix line telecommunication services including access to High Speed Internet and telephony. The exemption is granted for a period of one year, until January 30, 2006.

The Supervisor of the Banks at the Bank of Israel (the **Supervisor**) has not yet approved the merger and has expressed reservations due to certain limitations under Israeli Banking Laws. According to the position of the Supervisor, the merger of the Cable Companies and the formation of a merged cable entity constitutes a deviation from the directives of the Bank of Israel and of Proper Bank Management Directives of the Supervisor of the Banks, regarding inter alia, the restriction on Group of Borrowers, as such term is defined in the Proper Bank Management Directives.

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NOTES TO FINANCIAL STATEMENTS

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## NOTE 1: GENERAL (Cont.)

The above position of the Supervisor has an impact as to the issue of giving loans by banking corporations and as to the issue of allocation of the merged company debts, inter alia, to the major shareholder (directly and indirectly) of the Company.

Based on the aforesaid, and due to the difficulties arising from the position of the Supervisor of the Banks and the provisions of Proper Bank Management Directives there is no certainty whether the merger will be actually consummated and, if consummated, when it will actually occur and what will be its structure. The Company's management is examining any and all alternatives in order to continue to preserve the existing cooperation between the Cable Companies, including the examination of possible acquisition of Tevel's subscribers and assets in the multi channel television and access to High Speed Internet as detailed below.

The Operational Merger

Since April 2002, and in accordance with the approval of the Controller to the proposed merger, the Cable Companies have strengthened cooperation between themselves and have gradually cooperated in most areas of their activities. Since October, 2003 the joint activity is carried out under the brand name HOT.

In order to strengthen the cooperation of the Cable Companies, the Group, Tevel group and Golden Channels group agreed in June 2004 to perform an operational merger (the **Operational Merger**). To this effect, a joint management was appointed to oversee the Operational Merger of the marketing, sales, engineering, customer service, operations and information systems activities of the three Cable Companies (including those of Hot Telecom). The Company's activity in the ordinary course of business in areas of the joint activities is being held by the joint management of the Operational Merger although material decisions are subject to the approval of the Board of Directors of the Company. The Cable Companies have agreed upon the allocation of the expenses deriving from the joint activity.

The joint activity of the Operational Merger as detailed above, does not include transfer of assets from any of the Cable Companies to a merged entity or from any of the Cable Companies to another cable company and each of the Cable Companies, including the Company, remains the sole owner of its assets. Furthermore, the joint activity does not include transfer of liabilities towards third parties including, inter alia, banks and creditors.

Negotiations for the acquisition of the cable operations and assets of Tevel

In light of the above, the Company's management examined the options available in order to continue and maintain the existing cooperation among the Cable Companies, including the possibility of purchasing the cable operations and assets of Tevel Israel International Communications Ltd. (**Tevel**). On November 11, 2004 and on November 23, 2004 the Company announced that it has concluded preliminary discussions regarding the acquisition by the Company of the assets of Tevel.

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NOTES TO FINANCIAL STATEMENTS

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**NOTE 1: GENERAL (Cont.)**

As of the date of the approval of the financial statements the Company has not signed a binding agreement with Tevel, and cannot be certain that this transaction will be completed, or if completed, on what timeframe or on what terms and conditions, including price.

**8. Hot Vision Ltd. (Formerly: I.C.P - Israel Cable Programming Company Ltd. ( Hot Vision ))**

- a) The Company owns, as of December 31, 2004 and December 31, 2003, 26.6% of Hot Vision ordinary shares (see section b. below). In addition, the Company owns 28.6% of Hot vision preferred shares. Since December 31, 2003, the Company consolidated the accounts of Hot Vision by the proportionate consolidation method.
- b) Hot Vision is owned by the three Cable Companies (including the Company). It was formed in order to jointly acquire rights to broadcast movies and television programs and to grant those rights to its shareholders for the purpose of television broadcast.

As of December 31, 2004, the Company holds, directly and indirectly, approximately 26.6% of the issued ordinary share capital of Hot Vision and this is according to an agreement between the Cable Companies, the owners of interests in Hot Vision, according to which, each of them shall retain holding in ordinary share capital and in voting rights according to the relative share of the shareholders in the weighted number of active subscribers in each year. In addition, the Preferred shares confer upon their holders an exclusive right in the distribution of earnings upon liquidation up to the amount of approximately NIS 12 million. Other earnings will be distributed to the ordinary shareholders pro rata to their holdings. In addition, Hot Vision is jointly controlled by the Cable Companies.

According to the opinion of the Company's management, which is based on the opinion of its legal counsel, in light of the Controller's approval to the proposed merger of the Israeli cable television operators, and the exemption provided by the Controller from the requirement to receive approval of a restrictive arrangement in connection with joint activities of the cable television operators, there is no longer a need for the separate approval of the Restrictive Trade Practices Court for the said cooperation through Hot Vision.

In the past, Hot Vision executed agreements with certain shareholders in connection with the provision of contents purchased by it from the owners of the said contents. The initial term of the agreements was until December 31, 2000, and the shareholders are entitled to extend them for additional periods of 12 months each, on terms to be determined by the parties. The shareholders have not yet exercised the extension option for an additional year in 2005.

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## NOTES TO FINANCIAL STATEMENTS

## NOTE 1: GENERAL (Cont.)

The scope of investments made by the Company and Haifa Hadera with respect to purchase of contents for channels HOT 3 and HOT Movies during 2004 and 2003 was NIS 68 million and NIS 66 million, respectively.

9. As of December 31, 2004 and 2003, the Company through its wholly owned subsidiary Matav Investments, holds approximately 5.25% (5.01% on a fully diluted basis) of the shares of the affiliate, Partner Communications Company Ltd. ( **Partner** ). Partner operates a mobile telecommunications network based upon the Global System for Mobile Communications ( **GSM** ) Standard in Israel, see also Notes 5b(2).

Matav Group has significant influence over the financial and operating policies of Partner, as defined in Statement 68, by virtue of an agreement, entered into by and among the shareholders of Partner, according to which, Matav has the right to appoint two directors to serve on its behalf on Partner's board of directors.

In April 2002, the Group sold approximately 7.7% of the Ordinary shares of Partner, in consideration for approximately adjusted NIS 306 million. The capital gain, net of taxes, from the above transaction amounted to adjusted NIS 197 million. As a result of this sale, the interest held in Partner was reduced to 7.4%.

In November 2003, the Group sold approximately 2.1% Ordinary shares of Partner in consideration for approximately adjusted NIS 114 million. The capital gain from the above sale, net of the taxes, totaled approximately adjusted NIS 62 million. Subsequent to the above sale, the Company held approximately 5.25% of Partner shares.

As for the sale of Partner shares held by the company during May 2005, see Note 24a.

10. In addition, the Group invested in ventures relating to the Internet and interactive communications through the associated company Nonstop Ventures Ltd. ( **Nonstop Ventures** ) (see Note 5b(3)).
11. The Company intended to delist voluntarily from the Nasdaq National Market and to terminate its American Depositary Receipt (ADR) program, both expected to take effect in a few months. Concurrently with delisting from Nasdaq, The Company intends to file a Form 15 with the U.S. Securities and Exchange Commission (SEC) to terminate the registration of its ADRs and Ordinary Shares, thereby suspending its obligation to file annual and other reports with the SEC.

In such case, the Company's shares will continue to trade in the TASE and the Company shall continue to make public reports in accordance with the Israeli securities laws and regulations.

See Note 24c for the delay in implementation of the aforementioned delisting.

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## NOTES TO FINANCIAL STATEMENTS

**NOTE 1: GENERAL (Cont.)**

12. The Company has financed its operations using, inter alia, short-term bank borrowings due to the present credit market conditions and other circumstances. Consequently, the Company had a working capital deficit at December 31, 2004 of approximately NIS 703 million. The Company believes that it will be able to repay or renew its obligations as they become due, including through receipt of long-term borrowings as the market conditions permit. Alternatively, the Company can liquidate its investment in Partner shares, if necessary, in order to repay the short-term obligations. See Note 24(a).

**b. Definitions:**

In these financial statements:

Wholly owned and controlled companies	companies or limited partnerships in which more than 50% of the voting equity is owned or controlled by the Company (as defined in Opinion 57 of the Institute of Certified Public Accountants in Israel) and whose accounts are consolidated with those of the Company
Jointly controlled company	a company owned by various entities that have a contractual consent for joint control, which is not of a temporary nature and whose accounts are consolidated with those of the Company using the proportionate consolidation method.
Subsidiaries	Jointly controlled company and wholly owned and controlled companies.
Affiliates	companies and partnership that are not subsidiaries, and over which the Company has significant influence. The Company's investment therein is included using the equity method of accounting
The Group	the Company and its subsidiaries.
Interested Parties	as defined in the Securities Regulations (Preparation of Annual Financial Statements) 1993.
Related parties	as defined in the opinions of the Institute of Certified Public Accountants in Israel.
Cable Companies	Tevel International Communications Ltd. Group, Golden Channels and Co. and the Group.

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**NOTES TO FINANCIAL STATEMENTS**

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**NOTE 2: SIGNIFICANT ACCOUNTING POLICIES**

The consolidated financial statements presented herein are prepared in accordance with generally accepted accounting principles ( GAAP ) in Israel, which differ in certain respects from those followed in the United States, as described in Note 26.

The significant accounting policies applied in the preparation of the financial statements are as follows:

a. Use of estimates:

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

b. Discontinuance of the adjustment of financial statements and financial reporting in Reported amounts as of December 31, 2004 and for the year then ended:

In 2001, the Israel Accounting Standards Board published Accounting Standard No. 12 with respect to the discontinuance of the adjustment of financial statements. According to this Standard (as amended by Accounting Standard No. 17), the adjustment of financial statements for the effects of inflation should be discontinued beginning January 1, 2004. The Company applied the provisions of the Standard and, accordingly, the adjustment for the effects of inflation was discontinued as from January 1, 2004.

1. Basis of presentation:

- a) In the past, the Company prepared its financial statements based on the historical cost convention, adjusted for the changes in the general purchasing power of the Israeli currency based on the changes in the Israeli Consumer Price Index ( Israeli CPI ). These adjusted amounts, as included in the financial statements as of December 31, 2003 (the transition date), served as a basis for nominal financial reporting beginning January 1, 2004. Additions made after the transition date are included at nominal values.
- b) The amounts for non-monetary assets do not necessarily represent realizable value or current economic value, but only the Reported amounts (see 2. below) for those assets.
- c) In the financial statements cost represents cost in the Reported amount (see 2 below).
- d) All comparative data for previous periods are presented after adjustment for the Israeli CPI as of the transition date (the Israeli CPI for December 2003).

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NOTES TO FINANCIAL STATEMENTS

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**NOTE 2: SIGNIFICANT ACCOUNTING POLICIES (Cont.)**

## 2. Financial statements in reported amounts:

## a) Definitions:

*Adjusted amount* historical nominal amount adjusted for the Israeli CPI as of December 2003, according to the provisions of Opinions No. 23 and No. 36 of the Institute of Certified Public Accountants in Israel.

*Reported amount* adjusted amount as of the transition date (December 31, 2003), plus additions in nominal values after the transition date and less amounts deducted after the transition date.

## b) Balance sheet:

- 1) Non-monetary items are presented in reported amounts.
- 2) Monetary items are presented in nominal values as of the balance sheet date.
- 3) The carrying value of investments accounted for under the equity method is determined based on the financial statements of these companies in reported amounts.

## c) Statement of operations:

- 1) Income and expenses relating to non-monetary items are derived from the change in the reported amounts between the opening balance and the closing balance.
- 2) Other items in the statement of operations are presented in nominal values.
- 3) The equity in the results of operations of investees accounted for under the equity method is determined based on the financial statements of these companies in reported amounts.

## 3. Convenience translation into U.S. dollars:

The financial statements as of December 31, 2004 and for the year then ended, have been translated into U.S. dollars using the representative exchange rate of the U.S. dollars as of such date (U.S.\$ 1 = NIS 4.308). The translation was made solely for the convenience of the readers. The U.S. dollar amounts presented in the financial statements should not be construed to represent amounts receivable or payable in dollars, or convertible into dollars, unless otherwise indicated in these statements.

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NOTES TO FINANCIAL STATEMENTS

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**NOTE 2: SIGNIFICANT ACCOUNTING POLICIES (Cont.)**

## c. Adjusted financial statements:

## General:

The financial statements as of December 31, 2003 and for reported periods through that date were presented on the basis of the historical cost convention adjusted for the changes in the general purchasing power of the Israeli currency ( New Israeli Shekel or NIS ). The Company and its subsidiaries maintain their accounts in nominal NIS. The nominal figures were adjusted to NIS of equivalent purchasing power (NIS of December 2003) in conformity with principles prescribed by Statements of the Institute of Certified Public Accountants in Israel, on the basis of changes in the Consumer Price Index ( Israeli CPI ).

## Balance sheet:

Nonmonetary items were adjusted in accordance with the changes in the Israeli CPI from the date of acquisition (transaction) to December 31, 2003 (as published on January 15, 2004).

Monetary items are presented in the adjusted balance sheet at their nominal value.

Investments accounted for by the equity method are based on the adjusted financial statements of the investees.

The adjusted values of nonmonetary items should not be construed as a presentation of realizable values or real economic values, but merely as the original values adjusted for the changes in the general purchasing power of the currency.

## Statement of income:

Revenues were adjusted in accordance with the change in the Israeli CPI from transaction date to December 31, 2003.

Expenses, other than financing expenses and those deriving from nonmonetary items, were adjusted for the changes in the index from transaction date to December 31, 2003. Expenses deriving from nonmonetary items were adjusted in correspondence with the adjusted balance sheet item.

Group equity in the results of investees accounted for under the equity method is based on their adjusted financial statements.

The balance of the inflationary adjustment, not attributed to revenues or expenses as referred to above, was included in net financing income or expenses.

## 4. Data regarding Israeli CPI and exchange rates of foreign currency:

1. Assets and liabilities in or linked to foreign currency are included in the financial statements according to the representative exchange rate as published by the Bank of Israel on December 31, 2003.

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## NOTES TO FINANCIAL STATEMENTS

## NOTE 2: SIGNIFICANT ACCOUNTING POLICIES (Cont.)

2. Assets and liabilities linked to the Israeli CPI are included in the financial statements according to the relevant index for each asset or liability.

The following are details of the Israeli CPI and the exchange rate of the U.S. dollar:

At December 31,:	Israeli CPI points *)	Exchange rate of U.S. dollar NIS
2004	180.7	4.308
2003	178.6	4.379
2002	182.0	4.737
Changes during the year:	%	%
2004	1.2	(1.6)
2003	(1.9)	(7.6)
2002	6.5	7.3

- \*) According to the Israeli CPI for the month ending on the balance sheet date on an average basis of 1993 = 100.

## d. Principles of consolidation:

1. The consolidated financial statements include the accounts of the Company and its subsidiaries.
2. The significant consolidated subsidiaries are as follows:

## Wholly-owned:

Matav Haifa;  
 Matav Investments;  
 Matav Infrastructure Ltd. (the general partner in Matav Infrastructure partnership)  
 Matav Infrastructure 2001 limited partnership (28% held by Matav Haifa)

## Wholly-owned subsidiaries of Matav Investments:

Matav Properties Ltd;  
 Nonstop Internet 1999 Ltd. (ceased its operations in 2001)

## Jointly controlled entity:

Hot Vision Ltd.

3. Intercompany balances and transactions have been eliminated in consolidation.

## e. Investments:

1. Affiliates and subsidiaries:

The investment in affiliates and subsidiaries, as it relates to the Company's financial statements, is accounted for under the equity method.



2. Non-marketable equity securities:

The investment in non-marketable equity securities is stated at cost, net of impairment losses for decline in value that is other than temporary.

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## NOTES TO FINANCIAL STATEMENTS

**NOTE 2: SIGNIFICANT ACCOUNTING POLICIES (Cont.)**

## f. Investments in limited partnerships:

The investment in limited partnerships producing films, in which the Company is a limited partner, is presented at cost. The investment in the partnerships is written down when actual broadcast takes place.

## g. Rights to broadcast films and programs:

The cost includes the cost to purchase rights to broadcast films and TV programs with the addition of direct costs in order to adjust the films and programs for broadcasting in Israel.

The rights to use content by the jointly controlled entity which was made available by its shareholders, is also included as part of this asset.

Cost of rights are amortized when actual broadcasting takes place, while giving a relatively greater weight to primary broadcasting.

## h. Property, plan and equipment:

1. Property, plan and equipment is stated at cost.

2. The assets are depreciated by the straight-line method over their estimated useful lives (other than leasehold improvements, see below). The Company evaluates in each reporting period the necessity to record an impairment loss, in accordance with the provisions of Accounting Standard No. 15 (see k below). The annual depreciation rates are as follows:

	%
Buildings	2 4 (mainly 2)
Cable network	8.33;10
Equipment in the broadcasting center and studio (primarily electronic equipment)	15 20 (mainly 15)
Converters and modems	10
Computers and peripheral equipment	20 33
Office furniture and equipment	6 10
Development costs of internet site	33
Vehicles	15

3. Assets leased under a capital lease are presented in fixed assets based on the present value of the future lease payments. Lease payments due in the future, net of the implicit interest component, are included in long-term liabilities.

4. Leasehold improvements are amortized by the straight-line method over the term of the lease or the estimated useful life of the improvements, whichever is shorter.

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## NOTES TO FINANCIAL STATEMENTS

**NOTE 2: SIGNIFICANT ACCOUNTING POLICIES (Cont.)**

- i. Intangible assets, long-term receivables and deferred charges:
1. Deferred charges in respect of issuance of debentures are amortized, using the interest method, over the life of the debentures, in proportion to the balance of debentures outstanding. The amortization is recorded under the financial expenses, net.
  2. Intangible assets include payment made in respect of a non-exclusive license to provide stationary communications services within Israel. The license charges are amortized by the straight-line method over the period of the license (15 years).
  3. Assets leased by the Company in capital lease arrangements were derecognized and a long term receivable was recorded in respect of the lease arrangement.
- j. Revenue recognition:
1. Revenue from subscription fees is recognized on a monthly basis as the service is provided.
  2. See also 1 below (amortization of customers' deposits for converters).
  3. Initial hook up revenues, obtained from connecting subscribers to the Company's cables infrastructure, are less than related direct selling costs as defined under SFAS 51 (Financial Reporting by Cable Television Companies). Therefore, such revenues, together with the selling costs, are recognized as the hook up is completed.
- k. Impairment of assets:
1. Impairment of fixed assets:
 

On January 1, 2003, the Company adopted Accounting Standard No. 15, Impairment of Assets. This Standard prescribes the accounting treatment and disclosures required in the event of impairment of assets. The Standard applies to all assets recognized in the balance sheet other than inventories, assets generated by construction contracts, assets generated by employee benefits, deferred tax assets and financial assets (except investments in investees that are not subsidiaries). According to the new Standard, whenever there is an indication that an asset may be impaired, the Company should determine if there has been an impairment of the asset by comparing the carrying amount of the asset to its recoverable amount. The recoverable amount is the higher of an asset's net selling price or value in use, which is determined based on the present value of estimated future cash flows expected to be generated by the continuing use of an asset and by its disposal at the end of its useful life. If the carrying amount of an asset exceeds its recoverable amount, the impairment to be recognized is measured by the amount by which the carrying amount of the asset exceeds its fair value. An impairment loss recognized should be reversed only if there have been changes in the estimates used to determine the asset's recoverable amount since the impairment loss was recognized.

The adoption of this Standard did not have a material effect on the Company's financial position and results of operations.

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NOTES TO FINANCIAL STATEMENTS

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**NOTE 2: SIGNIFICANT ACCOUNTING POLICIES (Cont.)**

## 2. Impairment of investment in non-marketable equity securities:

The Company generally evaluates the fair value of its investments in each reporting period and whenever changes in circumstances or occurrence of other events indicate a decline in value that is other than temporary.

The evaluation of the fair value takes into consideration, among others, valuations of the investments, the conditions of the industry in which the investee company is operating, the investee company's business condition, prices of equity transactions in the investee company and additional information that the investee company presents to its board of directors (if the Company is represented on the board) or to its shareholders.

Based on the results of the above evaluation, the Company, if necessary, recognizes an impairment loss that is other than temporary in the statement of operations.

## 1. Customers' deposits for converters:

The Company and Matav Haifa collect deposits from their subscribers in respect of converters installed by them, in an amount not exceeding their cost. The Company and Matav Haifa partially refund the deposit when the converter is returned. The refund amount (which is linked to the Israeli CPI) is reduced to reflect 10% amortization for each year or portion of a year in which the subscriber used the converter.

In July 2003, the financial committee of the Knesset approved amendment No. 5 of the Bezeq regulations (Licenses) that enables the Company to amortize deposits that were collected from the date of approval at an annual rate of 10% of their cost to the Company, rather than 10% of the deposit amount.

The amortization of the deposits is included in revenue.

## m. Income taxes:

## 1. Deferred taxes are computed in respect of temporary differences between the amounts included in the financials statements and the tax basis of assets and liabilities and in respect of carryforward tax losses. As to the main factors in respect of which deferred taxes have been included see Note 17c.

Deferred tax balances are measured using the enacted tax rate expected to be in effect at time when the differences are expected to reverse, based on the applicable tax laws at balance sheet date. The amounts of deferred taxes presented in the statements of operations reflect changes in the above balances during the reported years.

## 2. Taxes which would apply in the event of disposal of the investments in the subsidiaries and the affiliates (except for Partner) have not been taken into account in computing the deferred taxes, as long as it is probable that the sale of the investment is not expected in the foreseeable future.

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## NOTES TO FINANCIAL STATEMENTS

**NOTE 2: SIGNIFICANT ACCOUNTING POLICIES (Cont.)**

As to Partner: During 2003, the Company's management revised its plans as to the investment in the shares of Partner such that the realization of Partner shares in the foreseeable future is no more unlikely. In view of the change in Company's management's plans as to the realization of the investment in the shares of Partner, in accordance with the provisions of Opinion 68 of the Institute of Certified Public Accountants in Israel, the Company recorded a deferred tax liability (see also Note 5b(2)(d)).

3. Due to the uncertainty whether or not the Company shall incur taxable income in the future and since the Company accumulated tax loss carryforwards, no deferred tax assets have been recorded in the financial statements.
4. As to the effect of the adoption of Accounting Standard No. 19 with respect to taxes on income, see Note t. below.

n. Allowance for doubtful accounts:

The allowance is principally determined in respect of specific debts that are doubtful of collection, based on the age of the customers' debt.

o. Cash equivalents:

The Group considers all highly liquid investments, which include unrestricted short-term bank deposits with original maturities of three months or less), to be cash equivalents.

p. Long term liabilities to banks in respect of borrowed debt securities

Debt to banks that represents borrowing of debt securities (i.e. short sale of debt securities), for which the Company has an intent and it is probable that the Company will repay only at maturity of these debt securities, is accreted to the redemption value based on the effective interest method.

q. Net earnings (loss) per Ordinary share and per American Depository Shares ( ADS )::

Basic earnings (loss) per share and per ADS are computed based on the weighted average number of shares outstanding during the year, assuming the conversion of convertible securities at the later of either the beginning of the year or the date of their issuance, if conversion is likely.

Diluted earnings (loss) per share and per ADS are computed as above, with the addition of the effect of shares deriving from the conversion of convertible securities which were not included in the computation of basic earnings per share. If the effect of the conversion of convertible securities is antidilutive, it is not included in the computation.

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NOTES TO FINANCIAL STATEMENTS

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**NOTE 2: SIGNIFICANT ACCOUNTING POLICIES (Cont.)**

r. Linkage basis:

Balances whose contractual linkage terms stipulate linkage to the latest index published prior to the date of payment are stated on basis of the latest index published prior to balance sheet date.

s. Advertising expenses:

Advertising expenses are charged to income as incurred, see also Note 19b.

t. Derivatives:

The Company purchased options (call options combined in certain cases with put options) to offset the effect of possible fluctuation in the NIS/dollar exchange rate on the NIS amount of certain dollar cash outflows. The Company does not hold or issue derivative financial instruments for trading purposes.

The options are stated at fair value. Gains and losses on the options are included in financial expenses.

u. Implementation of new accounting standards and their impact on the financial statements:

In July 2004, Accounting Standard No. 19 - Taxes on Income ( the Standard ) was approved by the Israel Accounting Standards Board. The Standard prescribes the principles for recognition, measurement, presentation and disclosure of taxes on income in the financial statements.

The principal change pursuant to the Standard in relation to the principles presently applied is the recognition of deferred taxes in respect of temporary differences relating to land.

The Standard is effective in respect of financial statements relating to periods beginning on or after January 1, 2005. Changes resulting from adoption of the Standard should be recorded by including the cumulative effect in the statement of operations as of the beginning of the period in which the Standard is adopted.

The Company estimates that, the effect of the new Standard on its financial statements is not expected to be material.

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## NOTES TO FINANCIAL STATEMENTS

## NOTE 3: CASH AND CASH EQUIVALENTS

	Consolidated		The Company	
	December 31,		December 31,	
	2003	2004	2003	2004
NIS in thousands				
	Adjusted	Reported	Adjusted	Reported
Cash	2,724	4,155	655	1,507
Short-term bank deposits	35,224	20,095	35,224	20,095
	37,948	24,250	35,879	21,602

## NOTE 4: ACCOUNTS RECEIVABLE

## a. Trade receivables:

	Consolidated		The Company	
	December 31,		December 31,	
	2003	2004	2003	2004
NIS in thousands				
	Adjusted	Reported	Adjusted	Reported
Open accounts (1) (2)	82,772	75,030	45,054	37,074
Notes and checks	379	428	346	324
	83,151	75,458	45,400	37,398
(1) Net of allowance for doubtful accounts *)	3,250	3,238	2,495	2,546
(2) Includes credit card receivables in the amount of	21,551	19,576	13,442	13,084



(\*) For changes in the allowance for doubtful accounts See Note 19b.

b. Other accounts receivable:

Cable Companies	1,203*)	4,180	1,151*)	2,999
Prepaid expenses	10,851	6,424	12,422	7,010
Income receivable	3,953	3,136	3,238	2,267
Advances to suppliers	692*)	5,236	370*)	2,473
Other	3,066*)	1,034	2,250*)	572
	<u>19,765</u>	<u>20,010</u>	<u>19,431</u>	<u>15,321</u>

\*) Reclassified.

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## NOTES TO FINANCIAL STATEMENTS

**NOTE 5: INVESTMENTS IN SUBSIDIARIES AFFILIATES AND OTHER COMPANY**

a. Investments in subsidiaries (losses over the investments in subsidiaries):

1. The investment is comprised as follows:

	<b>The Company</b>			
	<b>December 31,</b>			
	<b>2003</b>	<b>2004</b>		
	<b>Total</b>	<b>Included in investments and long- term receivables</b>	<b>Included in long-term liabilities</b>	<b>Total</b>
<b>NIS in thousands</b>				
<b>Adjusted</b>	<b>Reported</b>			
Cost of shares	8,362	8,362		8,362
Equity in post acquisition losses	(127,755)	(106,862)	(11,806)	(118,668)
<b>Equity value</b>	<b>(119,393)</b>	<b>(98,500)</b>	<b>(11,806)</b>	<b>(110,306)</b>
Long-term loan (1)	36,903	37,346		37,346
Long-term accounts (2)	322,661	315,254		315,254
Capital notes (3)	(3,601)		(3,351)	(3,351)
	<b>236,570</b>	<b>254,100</b>	<b>(15,157)</b>	<b>238,943</b>

(1) The CPI linked loan does not bear interest and its repayment date had not yet been determined.

(2) Long term accounts are linked to the CPI and their repayment date had not yet been determined.

(3) Capital notes are unlinked to the CPI and bear no interest and their repayment date had not yet been determined.

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## NOTES TO FINANCIAL STATEMENTS

**NOTE 5: INVESTMENTS IN SUBSIDIARIES AFFILIATES AND OTHER COMPANY (Cont.)**

2. The changes in the investments during 2004 and 2003 are as follows:

	<b>The Company</b>	
	<b>December 31,</b>	
	<b>2003</b>	<b>2004</b>
	<b>NIS in thousands</b>	
	<b>Adjusted</b>	<b>Reported</b>
Balance at the beginning of the year	258,022	236,570
Changes during the year:		
Equity in earnings (losses)	(31,485)	14,258
Liquidation of an investment in a subsidiary (MIS)	(1,062)	
Sale of the Company's shares held by a subsidiary	64,917	
Newly consolidated jointly controlled company (by proportionate consolidation)	624	
Repayment of long term accounts	(54,396)	(11,885)
Purchasing power loss of capital note	(50)	
	<u>236,570</u>	<u>238,943</u>

- b. Investments in affiliates:

1. The investment is comprised as follows:

	<b>Consolidated</b>		<b>The Company</b>	
	<b>December 31,</b>		<b>December 31,</b>	
	<b>2003</b>	<b>2004</b>	<b>2003</b>	<b>2004</b>
	<b>NIS in thousands</b>			
	<b>Adjusted</b>	<b>Reported</b>	<b>Adjusted</b>	<b>Reported</b>
Partner, see (2) below	65,373	91,334	62,369	88,330
Nonstop Ventures, see (3) below	1,434	1,402	13,623	13,691

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Hot Telecom, see (4) below	9,000	12,209
	66,807	101,736
	75,992	114,230

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## NOTES TO FINANCIAL STATEMENTS

**NOTE 5: INVESTMENTS IN SUBSIDIARIES AFFILIATES AND OTHER COMPANY (Cont.)**

The changes in the investments during 2004 and 2003 are as follows:

	Consolidated		The Company	
	December 31,		December 31,	
	2003	2004	2003	2004
NIS in thousands				
	Adjusted	Reported	Adjusted	Reported
Balance at the beginning of the year	22,400	66,807	29,168	75,992
Changes during the year:				
Investment in Hot Telecom		12,209		12,209
Newly proportionately consolidated Company	(624)		(624)	
Purchasing power loss on capital note (see Note 5(3))	(31)		(31)	
Sale of investments	(17,508)		(16,293)	
Equity in earnings	62,840	22,616	64,042	25,925
Grant of capital note		68		68
Provision for expected loss upon exercise of options	(270)	36	(270)	36
Balance at the end of the year	66,807	101,736	75,992	114,230

## 2. Partner:

a) The investment in Partner is composed as follows:

Shares:				
Cost of shares		2,437	2,437	
Equity in accumulated earnings		63,206	89,131	62,639
Provision for expected loss upon exercise of options		(270)	(234)	(270)
		65,373	91,334	62,369
				88,330

- b) Partner operates a mobile telecommunications networks based upon the Global System for mobile Communications ( GSM ) Standard in Israel.

On November 1, 1999, Partner in which the Group held by the Company and Matav Investments 20.326% of its issued capital offered to the public abroad in an initial public offering ( IPO ) 38,888,999 ADS, each ADS representing one Ordinary share of NIS 0.01 par value of Partner, at a price of \$13.50 per ADS.

Since the IPO, Partner s ADS are listed on the NASDAQ National Market in the United States ( NASDAQ ) and on the London Stock Exchange. Since July 2001, Partner s shares are also listed for trading on the Tel-Aviv Stock Exchange ( TASE ).

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NOTES TO FINANCIAL STATEMENTS

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**NOTE 5: INVESTMENTS IN SUBSIDIARIES AFFILIATES AND OTHER COMPANY (Cont.)**

The Group owns as of December 31, 2004 and 2003, 5.25% in Partner.

The market value of Partner's shares owned by the Group is NIS 358 million and NIS 332 million as of December 31, 2004 and 2003, respectively.

The market value of the shares at the date of approximating the issuances of the financial statements is NIS 393 million.

Under the terms of Partner's License, certain shareholders of Partner, among them the Company, are subjected to certain obligations such as compliance with the Required Israeli Percentage (minimum percentage of shares to be held by Israeli persons or entities as determined in the License) and the Required Founders Percentage (minimum holding of means of control by Founders' Group as determined in the License) (see also Note 24a.).

As to collateral on Partner's shares, see Note 15c(2).

c) Realizations of Partner's shares:

In April 2002, the Group entered into agreements according to which it sold to a subsidiary of Hutchison Whampoa Ltd. (Hutchison) 13,778,668 shares of Partner, which constituted 7.7% of Partner's issued and outstanding share capital. The proceeds from the sale amounted to adjusted NIS 306 million. The gain (net of taxes) resulting to the Group from the above transaction amounted to NIS 197 million.

On November 3, 2003, the Group sold 3,826,169 Ordinary shares of Partner in consideration for approximately adjusted NIS 114.4 million. The gain resulting from the above sale, net of tax effect, amounted to approximately NIS 62 million. Subsequent to the sale, the interest held in Partner is 5.25%.

As for the sale of the shares of Partner held by the Company during May 2005, see Note 24a.

d) During 2003, the Company's management revised its plans as to the realization of the investment in Partner such that the realization of the Partner's share in the foreseeable future is no more unlikely. The revision of the plans of Company's management, as aforesaid, included the sale of Partner's unrestricted shares, as described above.

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NOTES TO FINANCIAL STATEMENTS

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**NOTE 5: INVESTMENTS IN SUBSIDIARIES AFFILIATES AND OTHER COMPANY (Cont.)**

Consequently, in accordance with the provisions of Opinion 68 of the Institute of Certified Public Accountants in Israel, the financial statements as of December 31, 2004 include a deferred tax liability of approximately NIS 24 million for the difference between the tax base of the investment in Partner and the carrying value of the investment as of December 31, 2004. The tax expense in respect of the Partner investment amounted to NIS 8.3 million and NIS 15.6 million in 2004 and 2003, respectively. Such tax expense was included as an offset to equity in earnings of affiliates.

## e) Partner's contingent liabilities:

- 1) On October 28, 1999, an Israeli consumer organization lodged a claim against Partner, alleging a variety of consumer complaints and requested that this claim be approved as a class action.

On March 20, 2002, the Haifa District Court decided to strike the claim, because the consumer organization lost, on December 31, 2001, a special status required under Israeli law for consumer organizations, to file class action claims.

Another claim, involving a substantial amount, which was filed by a private consumer who had previously requested to join the above class action, has been brought again before the court. The court had previously stayed the proceedings of the private consumer's claim, until a decision was made in the case that was filed by the consumer organization.

On May 25, 2003, the private consumer filed a request to amend his motion to file a class action claim and the proposed claim itself, and also a draft of the proposed amended motion and claim. The motion to amend was granted and on January 21, 2004, Partner has submitted its response to the motion.

On November 24, 2004, the court decided to strike the motion to recognize the claim as a class action.

- 2) On April 8, 2002, a claim was filed against Partner, together with a motion to approve this claim as a class action, alleging a variety of consumer complaints. The amount of the claim against Partner is estimated at approximately NIS 545 million plus additional significant amounts relating to other alleged damages. Only preliminary hearings have taken place and the parties await a decision by the court with regard to a preliminary motion to dismiss the claim, which was submitted by partner.

At this stage, and until the claim is approved as a class action, Partner and its legal counsel are unable to evaluate the probability of success of such claim, and therefore no provision has been made in Partner's accounts.

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NOTES TO FINANCIAL STATEMENTS

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**NOTE 5: INVESTMENTS IN SUBSIDIARIES AFFILIATES AND OTHER COMPANY (Cont.)**

In addition, Partner and its legal counsel are of the opinion that even if the request to approve this claim as a class action is granted, and even if the plaintiff's arguments are accepted, the outcome of the claim will be significantly lower than the abovementioned amount.

- 3) On April 13, 2003 a claim was filed against Partner and other cellular telecommunication companies, together with a request to recognize this claim as a class action, for alleged violation of antitrust law, alleging that no fee should have been collected for incoming SMS messages or alternatively, that the fee collected is excessive and that it is a result of illegal co-operation between the defendants. The amount of the claim against all the defendants is estimated at approximately NIS 90 million. Partner has filed its response on October 1, 2003.

At this stage, no hearings have taken place and unless and until the claim is approved as a class action, Partner and its legal counsel are unable to evaluate the probability of success of such claim, and therefore no provision has been made in Partner's accounts.

- 4) On September 14, 2004, a claim was filed against Partner, together with a motion to recognize this claim as a class action, alleging errors in client accounts, including charges in respect of Internet access after the client requested to block the service, and in the recording of credit balances as charges. The plaintiff claims that Partner clients have suffered damages of approximately NIS 173 million over a period of two years and that Partner is in violation of the Consumer Protection Law. Partner has not yet filed a response. At this stage, no hearings have taken place and unless and until the claim is recognized as a class action, Partner and its legal counsel are unable to evaluate the probability of success of such claim, and therefore no provision has been made in Partner's accounts.

- 5) Partner does not have building permits for many of its cell sites and as a result is involved in numerous legal actions (including criminal proceedings against officers and directors) relating to this issue.

Most of these proceedings have been settled under plea bargain arrangements, whereby Partner has paid fines of insignificant amounts.

Management, based upon current experience and the opinion of legal counsel, does not believe that these legal actions will result in significant costs to Partner. The accounts of Partner do not include a provision in respect thereof.

- 6) Partner is a party to various claims arising in the ordinary course of its operations. Management of Partner, based upon the opinion of its legal counsel, is of the opinion that the ultimate resolution of these claims will not have a material effect on the financial position of Partner. The accounts do not include a provision in respect thereof in Partner's accounts.

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## MATAV - CABLE SYSTEMS MEDIA LTD.

## NOTES TO FINANCIAL STATEMENTS

## NOTE 5: INVESTMENTS IN SUBSIDIARIES AFFILIATES AND OTHER COMPANY (Cont.)

## 3. Nonstop Ventures:

- a) The Group owns, as of December 31, 2004 and 2003, 50% of Nonstop Ventures (see b) below). The Group's investment in Nonstop ventures is comprised as follows:

	Consolidated		The Company	
	December 31,		December 31,	
	2003	2004	2003	2004
NIS in thousands				
	Adjusted	Reported	Adjusted	Reported
Shares:				
Cost of shares	5	5		
Equity in accumulated losses	(12,194)	(12,294)		
Long-term loans and capital note *)	13,623	13,691	13,623	13,691
	1,434	1,402	13,623	13,691

\*) Includes long-term loans bearing interest at the Prime rate and capital notes that bear no interest and are unlinked, effective from January 2002. The date of repayment of the above capital notes and long-term loans, has not yet been determined.

- b) Nonstop ventures is 50% owned by the Group and 50% by shareholders of the Company.

Nonstop Ventures is engaged in the investments in companies and entrepreneurs whose main activities are in the area of Internet, cable and data Communications.

## 4. Hot Telecom:

- a) The Group owns, at December 31, 2004, 26.5% of Hot Telecom.

The Company's investment in Hot Telecom is comprised as follows:

Consolidated	The Company
December 31, 2004 *)	
Reported NIS in thousands	

Equity in accumulated losses	(3,209)	
Long-term debt (1)	12,209	12,209
	<u>          </u>	<u>          </u>
	9,000	12,209
	<u>          </u>	<u>          </u>

\*) Hot Telecom was established by the Cable Companies in November 2003. See Note 1a(4,5,6).

(1) Long-term debt is unlinked to CPI and bears no interest. Its repayment date had not yet been determined.

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NOTES TO FINANCIAL STATEMENTS

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**NOTE 5: INVESTMENTS IN SUBSIDIARIES AFFILIATES AND OTHER COMPANY (Cont.)**

- b) According to the license, which was granted to Hot Telecom, the Partnership has to pay royalties at a rate of 3.5% to the Government of Israel, based on the gross income from telecommunication services according to the license conditions.
- c) Hot Telecom, together with the Cable Companies are obliged to make payments to the government, see Note 15(a)(1)(b).
- d) On July 9, 2004, Hot Telecom, signed an agreement with an Israeli entity in the global Lucent Int. Group for the establishment of a telephony network based on the cable infrastructure. The agreement is a framework agreement for 100,000 subscribers and, in the first stage, orders will be issued for the establishment of a network for 24,000 telephony subscribers in consideration for an estimated amount of \$16 million. To secure the payments to Lucent, the partnership provided a guarantee in amount of \$4 million through its partners including the company (see also Note 15c(9)).
- e) On July 29, 2004, Bezeq, the Israel Telecommunication Corp. Ltd. ( Bezeq ) submitted a petition for the granting of orders nisi and for the granting of an interim order, against the Government of Israel, the Minister of Communications and the Minister of Finance ( the Respondents ) and against Hot Telecom as a formal respondent.

The petition was based on an amendment to the Communications Regulations (Bezeq and Broadcasting) (Payments for Interconnection), 2000 (the Interconnection Regulations ), specifically on interim Regulation No. 10. This regulation sets a Bill and Keep arrangement which applies between Bezeq and Hot Telecom as follows:

In regulation 10 to the interconnection regulations, Bezeq and the internal operator (except for a unique internal operator and Bezeq) will not make payments to each other for reciprocal communication links as stated in the aforesaid regulation, and each of them will bear their costs in this respect, all of which is if the following cumulative conditions are met:

1. Two years have not yet elapsed from the date on which the internal operator commenced providing telephony services on a commercial basis, as the Minister of Communications informed the concerned license holders (November 25, 2004).
2. The difference between the total minutes of traffic originating in the internal operator's aforesaid network and their destination being the internal operator network of Bezeq and the total minutes of traffic originating in the internal operator's network of Bezeq and their destination being internal operator's aforesaid network does not exceed 1,050,000,000 minutes of traffic.

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NOTES TO FINANCIAL STATEMENTS

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**NOTE 5: INVESTMENTS IN SUBSIDIARIES AFFILIATES AND OTHER COMPANY (Cont.)**

The petitioner requested interim orders to delay the effective date of the arrangement until compensation to the petitioner is ensured in respect of loss of income, through amendment of the Bezeq (Royalties) Regulations, 2001, to enable the petitioner to set off the loss of income incurred and to cancel Regulation 10 that was enacted without authority and with discrimination against the petitioner.

In addition, an interim order was requested to maintain the current status until a decision is rendered with respect to the petition or until the petitioner's right to receive compensation for loss of income is determined fully and completely.

On August 11, 2004, the request for an interim order was rejected.

Subsequent to a preliminary hearing of the petition, and after the Bezeq (Royalties) Regulations, 2001 was amended in a way that ensured that Bezeq may set off the loss of income, the petitioner filed an amended petition. A hearing for the amended petition was scheduled on April 14, 2005. The date set for submission of a response on behalf of Hot Telecom to the amended petition is no later than 5 days before the date set for the hearing (see also Note 24e in respect of the withdrawal of the petition).

- f) On November 30, 2004, the Ministry of Communications issued policy principles to license the provision of telephony services by broadband access (VoB) (The policy principles). Pursuant to the policy principles, the provision of stationary domestic VoB services shall be organized in the context of a unique domestic operator license, according to which the provision of telephony services is to be performed by VoIP technology while using the broadband access of a domestic operator (currently Bezeq or Hot Telecom). The policy principles determine that licenses to provide VoB services shall be granted in 2005 in a manner that the commencement of operations by virtue of the licenses shall be feasible on May 1, 2005. It was further determined that for the time being, an owner of VoB license shall not be charged to pay the domestic operator for using the domestic operator's network. The ministry, in its policy principles, noted that it intends to complete soon the policy on the provision of VoB services by broadband access network of cellular operator. In addition, pursuant to the policy principles, Bezeq shall be entitled to provide VoB services at the earlier of May 1, 2007 or after its customer segment in the area of the stationary telephony (business or private segments) shall decrease below 85%, and a subsidiary of Bezeq shall be able to provide VoB services subject to restrictions stipulated in the unique domestic operator's regulations. The ministry indicated that a hearing proceeding regarding the same matter with the relevant parties shall be conducted in the coming weeks.

Concurrently with promulgating the policy principles, the ministry commenced to grant licenses for marketing experiment for a payment to provide VoB services to several internet suppliers, among which are 012 Golden Lines, Barak, Bezeq International and Gold internet.

NOTES TO FINANCIAL STATEMENTS

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**NOTE 5: INVESTMENTS IN SUBSIDIARIES AFFILIATES AND OTHER COMPANY (Cont.)**

As a result of applications by Bezeq and Hot Telecom the Ministry of Communications, on December 29, 2004, sent a letter to various parties including Bezeq and Hot Telecom thereby enabling them to present their position with respect to the ramifications of the policy principles on them. In a reply to the Ministry of Communications, Hot Telecom filed a detailed status paper in which it demanded to revoke the policy principles alleging that they constitute a deviation from the policy having a basis to organize the communications market in Israel on a facilities based competition and that the resolution of the Ministry of Communications to enable the provision of VoB services while using the domestic operator infrastructures constitutes an illegal impairment of the proprietary right of the infrastructures owner. In addition, it was alleged that the resolution pursuant to which the VoB operator shall not be charged with a payment for using the internal operator's infrastructure lacks authority and is devoid of reasonableness and results in economic distortions and the ministry is required to enable the payment of access fees to the internal operator for using its infrastructures for providing the VoB service. Alternatively, Hot Telecom requested to adjourn the date for granting the VoB licenses until after Hot Telecom shall reach a market segment of 5% of the stationary telephony industry. In addition, Hot Telecom claims that the resolution of the Ministry of Communications to enable the use in the domestic operator's infrastructures to provide cellular VoB service without, at the same time, enabling Hot Telecom to provide VoB service over the cellular infrastructures, is unreasonable and creates discrimination between the operators.

As to the matter of providing VoB services by Bezeq, Hot Telecom demands that Bezeq shall not be entitled to provide directly and/or by its subsidiary, VoB services as long as it is a monopoly in the stationary telephony industry, to wit, as long as it holds in 50% of stationary telephony market.

As of the date of filing the report, a new resolution of the ministry of communications has not yet been issued.

- g) On March 31, 2004, the Ministry of Communications issued policy principles on Bezeq license-discounts for size and marketing bundled services according to which: (a) Bezeq may offer discounts for size at a rate of up to 10%, effective with the commencement date of providing commercial telephony services by a domestic operator, and (b) Bezeq may request to amend its license in a manner that it will be able to market bundled services including telephony services and multi-channel TV that are provided by a subsidiary when its market segment of the stationary telephony industry (private or business sectors) shall decrease below 85% and this is in relation to the same customers segment. In addition, it was determined that if it is found that even before the market segment of Bezeq decreased below 85%, as above, that the competitive status of Bezeq's subsidiary deteriorated significantly resulting, among others, from marketing service bundles that include telephony by a competitor, the minister shall consider to amend Bezeq's license according to the above.

## NOTES TO FINANCIAL STATEMENTS

**NOTE 5: INVESTMENTS IN SUBSIDIARIES AFFILIATES AND OTHER COMPANY (Cont.)**

As to this matter, the ministry determined that in relation to Yes a determination of a significant deterioration in the competitive status shall be a situation in which its market segment in the industry of multi channel-broadcast to subscribers decreased below 25% of all subscribers.

Following additional hearing procedures held by the Ministry of Communications in this matter, the ministry resolved on January 9, 2005, to raise the significant deterioration threshold in the competitive status of Yes from 25% to 29%.

## c. Non-marketable equity securities:

	Consolidated		The Company	
	December 31,		December 31,	
	2003	2004	2003	2004
	NIS in thousands			
Adjusted	Reported	Adjusted	Reported	
Cost of shares of Barak I.T.C. (1995) International Telecommunications Services Corp. Ltd. ( Barak )*)	16,241		16,227	

\*) Barak, 10% held by the Group, won a tender of the Israeli Ministry of Communications for the provision of international telephony services. The operating license was granted to Barak in February 1997 for a period of ten years and the provision of services commenced in July 1997.

1. During 2002, the Company wrote-off a part of its investment in Barak, which amounted to NIS 8.8 million, based on a valuation of Barak. This amount was presented in other expenses, net.
2. As of December 31, 2004 Barak had shareholders' deficiency of NIS 527 million and a working capital deficiency of NIS 704 million, derived mainly from classification of long-term bank liabilities as current liabilities as a result of Barak's noncompliance with part of its financial covenants.

In the opinion of Barak's management, in light of its positive cash flows from operating activities and the advanced negotiations with banks in connection with refinancing of Barak's debt, Barak will continue to operate as a going concern in the foreseeable future. Nonetheless, management of Barak is in the opinion that absent a financing arrangement with the banks, Barak will encounter difficulties in paying interest to debentures holders and the principal of the loan to banks that are repayable in November and December 2005.

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## NOTES TO FINANCIAL STATEMENTS

**NOTE 5: INVESTMENTS IN SUBSIDIARIES AFFILIATES AND OTHER COMPANY (Cont.)**

In light of the deterioration in Barak's financial position, as stated above, and in light of the opening of the international communications segment to new competitors, and the granting of licenses to three additional operators, the Company's management decided to reexamine the value of its investment in shares of Barak.

The value of the investment in Barak was determined by the work of a valuation expert, based on the discounted cash flows method, discounted at a capitalization rate of 12.5% per annum. The valuation was performed under the assumption that Barak will arrange the abovementioned refinancing for purposes of repayment of the debentures issued and, accordingly, will continue to operate as a going concern. According to the valuation implemented by the appraiser, the estimated fair value of the interest in Barak is between zero and \$1 million only. Management of the Company chose to present the investment according to the low range of the valuation and, therefore wrote down the entire amount of the investment in Barak, in the amount of approximately NIS 16 million (see also Note 24d). The loss amounting from the aforementioned write-down was included as part of other expenses.

- d. Company's share of assets, liabilities, revenues and expenses and cash flows of a jointly controlled company that is consolidated by the proportionate consolidation method (26.6%):

	<b>December 31</b>	
	<b>2003</b>	<b>2004</b>
	<b>NIS in thousands</b>	
	<b>Adjusted</b>	<b>Reported</b>
Current assets	20,520	24,044
Non-current assets	38,125	29,202
Current liabilities	61,913	57,594
Non-current liabilities	737	605
		<b>Year ended December 31, 2004</b>
		<b>NIS in thousands</b>
		<b>Reported</b>
Net revenues		5,852
Expenses		1,291

Gross profit	4,119
Loss from continuing operations and net loss	
Cash flows from operating activities	1,104
Cash flows from investing activities	(493)
Cash flows from financing activities	(195)

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## NOTES TO FINANCIAL STATEMENTS

**NOTE 6: INVESTMENT IN LIMITED PARTNERSHIPS**

The jointly controlled entity invests in limited partnerships that are engaged in the production of films in Israel. The limited partnerships received an approval from a committee at the Ministry of Industry and Trade which deals with withholding tax of films under the Income Tax Regulations (Withholding of Investors Income from Israeli Films), 1990.

The jointly controlled entity is a limited partner in these partnerships.

As of December 31, 2004 Hot Vision has an obligation to perform additional investments in these partnerships of NIS 190 thousand.

**NOTE 7: RIGHTS TO BROADCAST MOVIES AND PROGRAMS FILM COSTS**

	<b>December 31, 2004</b>
	<b>NIS in thousands</b>
	<b>Reported</b>
Balance at the beginning of the year *)	34,927
Additions during the year	26,936
Amortization during the year	(35,354)
Balance at the end of the year	26,509

\*) The accounts of Hot Vision were consolidated for the first time on December 31, 2003.

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## NOTES TO FINANCIAL STATEMENTS

**NOTE 8: PROPERTY, PLANT AND EQUIPMENT**

Composition of assets and accumulated depreciation and amortization, grouped by major classifications, and changes during 2004, are as follows:

Consolidated										
Cost			Accumulated depreciation				Depreciated balance			
Balance at beginning of year	Changes during the year		Balance at end of year	Balance at beginning of year	Changes during the year		Balance at end of year	December 31,		
	Additions	Disposals			Additions	Disposals		2003	2004	
NIS in thousands										
Adjusted	Reported		Adjusted	Reported		Adjusted	Reported			
Leasehold land (including construction plans) (1)	4,319		4,319				4,319	4,319		
Buildings (including land) (2)	53,699	1,163	54,862	11,660	1,046	12,706	42,039	42,156		
Cable network	1,342,613	24,138	1,366,751	820,540	89,941	910,481	522,073	456,270		
Broadcasting center (primarily electronic equipment)	136,940	18,488	155,428	101,478	12,314	113,792	35,462	41,636		
Studio equipment	12,294	3,037	15,331	12,294	653	12,947		2,384		
Converters and modems	390,242	45,245	434,161	136,105	34,113	169,688	254,137	264,473		
Computers and peripheral equipment	62,049	2,885	64,934	51,147	5,704	56,851	10,902	8,083		
Office furniture and equipment	14,507	308	14,815	9,934	656	10,590	4,573	4,225		
Leasehold improvements	6,364	30	6,394	4,620	287	4,907	1,744	1,487		
Development costs of internet site	1,099		1,099	972	31	1,003	127	96		
Vehicle	4,282		793	2,872	406	2,695	583	1,410	210	
Telephone equipment	39	134	173		1	1	39	172		
	2,028,447	95,428	4,815	2,119,060	1,151,622	145,152	3,225	1,293,549	876,825	825,511

- (1) The land is leased for a 49 year period ending in 2038. The lease fees have been capitalized. Registration of the lease with the Land Registry has not yet been completed.
- (2) The cost of the buildings includes an amount of NIS 21,907 thousand at December 31, 2004 and 2003 representing cost of buildings on leased land. The lease in respect of most of the land is for a 49 year period ending in 2040, with an option to renew the lease for an additional 49 years. Registration of the leases with the Land Registry has not yet been completed.

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## NOTES TO FINANCIAL STATEMENTS

## NOTE 8: PROPERTY, PLANT AND EQUIPMENT (Cont.)

The Company									
Cost			Accumulated depreciation				Depreciated balance		
Changes during the year			Changes during the year				December 31,		
Balance at beginning of year	Additions	Disposals	Balance at end of year	Balance at beginning of year	Additions	Disposals	Balance at end of year	2003	2004
NIS in thousands									
Adjusted	Reported		Adjusted	Reported		Adjusted	Reported		
Leasehold land (including construction plans) (1)	4,319		4,319				4,319	4,319	4,319
Buildings (including land) (2)	18,875	1,141	20,016	5,532	389		5,921	13,343	14,095
Cable network	990,398	65	990,463	596,222	67,894		664,116	394,176	326,347
Broadcasting center (primarily electronic equipment)	65,085	8,632	73,717	55,700	3,387		59,087	9,385	14,630
Studio equipment	3,561		3,561	3,561			3,561		
Converters and modems	272,762	35,122	915	306,969	97,259	23,915	389	120,785	175,503
Computers and peripheral equipment	55,160	2,784	57,944	45,530	4,852		50,382	9,630	7,562
Office furniture and equipment	8,704	80	8,784	5,706	342		6,048	2,998	2,736
Leasehold improvements	5,921	8	5,929	4,267	271		4,538	1,654	1,391
Development costs of internet site	1,095		1,095	994	31		1,025	101	70
Vehicle	3,303	2,883	420	2,177	301	2,211	267	1,126	153
	1,429,183	47,832	3,798	1,473,217	816,948	101,382	2,600	915,730	612,235
								557,487	

(1) The land is leased for a 49 year period ending in 2038. The lease fees have been capitalized. Registration of the lease with the Land Registry has not yet been completed.

(2) The cost of the buildings, includes mostly an amount which represents cost of buildings on leased land. The lease in respect of most of the land is for a 49 year period ending in 2040, with an option to renew the lease for an additional 49 years. Registration of the leases with the Land Registry has not yet been completed.

As to the pledges on property, plant and equipment see Note 15c(1).



## NOTES TO FINANCIAL STATEMENTS

## NOTE 9: INTANGIBLE ASSETS AND DEFERED CHARGES, NET

	Consolidated				The Company	
	Original amount		Unamortized balance		Unamortized balance	
	December 31,				December 31,	
	2003	2004	2003	2004	2003	2004
	NIS in thousands					
	Adjusted	Reported	Adjusted	Reported	Adjusted	Reported
Debentures issuance expenses, see Note 14	11,393	11,393	1,330	616	1,330	616
Non-exclusive license, see Note 2(i)	3,972	3,972	2,616	2,485		
	15,365	15,365	3,946	3,101	1,330	616

## NOTE 10: BANK CREDIT

	Weighted average interest rate	Consolidated		The Company	
		December 31,		December 31,	
	December 31, 2004	2003	2004	2003	2004
	%	NIS in thousands			
		Adjusted	Reported	Adjusted	Reported
Short-term credit, see Note 19	5.3	389,730	437,029	349,223	396,682
Current maturities of long-term loans, see Note 13		45,673	28,310	45,673	28,310
		435,403	465,339	394,896	424,992

The total unused credit lines out of the authorized credit lines as of December 31, 2004, amounted to approximately NIS 157 million.

Financial covenants and arrangements:

- a. According to a credit arrangement from September 2003, the Company received a credit line from a bank in the amount of approximately NIS 87 million (of which approximately NIS 47 millions have been used as of December 31, 2004). The use of credit, which is collateralized by a floating charge, proportionately with other banks, is conditional upon the Company's fulfillment of certain financial and non-financial covenants determined under the aforesaid agreement.

As of December 31, 2004, the company did not comply with two covenants to maintain the financial ratios, as defined in the agreement, as follows:

1. The number of broadcast subscribers.
2. Operating surplus.

During March 2005, the company received a letter from the bank according to which the bank does not deem the non-compliance, as above, a violation of the company to maintain the financial ratios for a period of one year from the date of the letter (the waiver period).

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## NOTES TO FINANCIAL STATEMENTS

**NOTE 10: BANK CREDIT (Cont.)**

In view of the dictated increase in the required operating surplus, as defined in the covenants agreement, in 2005, the Company's management anticipates that additional negotiations shall take place with the bank at the end of the waiver period.

- b. An amount of approximately NIS 31 million was classified as long-term liabilities since the bank committed to renew such debt at its repayment date (which is less than 12 months from balance sheet date) for a period longer than a year.
- c. Bank Hapoalim Ltd. demands that Hot Vision repays its outstanding borrowings amounting to NIS 71 million. Hot Vision had some discussions with the bank to extend the credit period.

**NOTE 11: ACCOUNTS PAYABLE**

	Consolidated		The Company	
	December 31,		December 31,	
	2003	2004	2003	2004
	NIS in thousands			
	Adjusted	Reported	Adjusted	Reported
<b>a. Trade payables:</b>				
Open accounts	63,499	66,255	43,983	45,681
Checks payable	31,200	38,027	19,634	29,236
	<u>94,699</u>	<u>104,282</u>	<u>63,617</u>	<u>74,917</u>
<b>b. Other accounts payable:</b>				
Payroll and related expenses	6,912	6,754	4,757	4,710
Provision for vacation pay	4,473	5,114	3,438	3,761
Government authorities (1)	96,416	103,779	89,391	97,448
Advances from Cable Companies	5,004	2,738		
Royalties to the Government of Israel	11,225	11,069	11,225	11,069
Accrued interest	1,846	1,381	1,846	1,381
Accrued expenses (2)(3)	16,623	22,695	13,844	18,153
Provision due to lawsuit (see Note 15(b)(3))		23,400		23,400
Deferred taxes	15,630	23,981	15,630	23,981
Others	853	1,032	477	595
	<u>158,982</u>	<u>201,943</u>	<u>140,608</u>	<u>184,498</u>



- (1) Mainly includes a provision for taxes in respect of the sale of Partner shares during 2002 and 2003 (see Note 5b(2)(c)).

The Company paid an amount of NIS 71 million as an advance on account of capital gains tax in respect of the sale of Partner shares in 2002. As of December 31, 2004 and 2003, the accumulated tax accrual in respect of the above sale and the sale in 2003 amounted to a total consideration of NIS 83 million (not including interest and CPI linkage). This amount was not yet paid due to a continuing dispute with the tax authorities.

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## NOTES TO FINANCIAL STATEMENTS

**NOTE 11: ACCOUNTS PAYABLE (Cont.)**

The financial statements contain a provision for the full tax liability (including interest and CPI linkage) relating to the sale of Partner shares in 2003 and 2002.

- (2) Consolidated and the Company includes balance with former related party in an amount of adjusted NIS 128 thousand as of December 31, 2003.
- (3) Includes, as of December 31, 2004, a provision relating to expenses to be paid to an interested party in the amount of NIS 1,300 thousand.

**NOTE 12: ACCRUED SEVERANCE PAY (SEVERANCE PAY FUND)**

Labor laws and agreements require the Group companies to pay severance pay to employees dismissed or leaving their employment under certain other circumstances.

The companies' severance pay liability to their employees, is computed based on the number of years of employment multiplied by the most recent salary and, is covered primarily by purchase of insurance policies and by an accrual. The companies records the obligation as if it was payable at each balance sheet date on an undiscounted basis. The balance of the severance pay liability and the amounts funded for such liability as above are as follows:

	Consolidated		The Company	
	December 31,		December 31,	
	2003	2004	2003	2004
	NIS in thousands			
	Adjusted	Reported	Adjusted	Reported
Amount of severance pay liability	17,272	19,477	12,878	14,368
Amount funded	(15,166)	(16,994)	(12,174)	(13,345)
Unfunded balance, net	2,106	2,483	704	1,023

The companies may make withdrawals from the funds only for the purpose of disbursement of severance pay.

The amounts accumulated in insurance companies in connection with deposits made by a jointly controlled entity in order to cover its liabilities for severance pay are not under its control and management and, therefore, neither these amounts nor the corresponding accrual for severance pay are included in the balance sheet.

Severance pay expense totaled NIS 5,278 thousand, adjusted NIS 5,748 thousand and adjusted NIS 4,470 thousand in 2004, 2003 and 2003, respectively.

## NOTES TO FINANCIAL STATEMENTS

**NOTE 13: LONG-TERM LOANS FROM BANKS AND OTHERS**

- a. Comprised as follows:

<b>Consolidated and The Company</b>				
		<b>Weighted average interest rate</b>	<b>December 31,</b>	
		<b>31.12.2004</b>	<b>2003</b>	<b>2004</b>
		<b>%</b>	<b>NIS in thousands</b>	
			<b>Adjusted</b>	<b>Reported</b>
From banks	linked to the dollar	Libor+1.5	3,678	1,206
From banks	linked to the Israeli CPI	5.65	147,862	125,937
From others	linked to the dollar	Libor+1.75	21,536	1,140
From others	unlinked (*)			1,484
			<b>173,076</b>	<b>129,767</b>
Less	current maturities		45,673	28,310
			<b>127,403</b>	<b>101,457</b>

(\*) Amounts received from sale of credit card receivables with recourse.

The Libor rate as of December 31, 2004 was 3.10%.

- b. The loans (net of current maturities) are repayable in the following years subsequent to the balance sheet dates:

<b>Consolidated and The Company</b>		
<b>December 31,</b>		
	<b>2003</b>	<b>2004</b>
	<b>NIS in thousands</b>	
	<b>Adjusted</b>	<b>Reported</b>
Second year	28,310*)	27,922
Third year	26,698	58,847
Forth year	57,832*)	14,688
Fifth year	14,563	

127,403

101,457

As to collateral to secure the loans see Note 15c.

\*) Reclassified.

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## NOTES TO FINANCIAL STATEMENTS

**NOTE 14: DEBENTURES**

- a. According to a prospectus dated August 28, 1997, the Company issued NIS 200 million par value of registered debentures (series A), for redemption in seven equal annual installments on August 20 in each of the years 2000 to 2006, and 2,850,000 warrants (series 1), see Note 16c. The debentures (principal and interest) are linked to the Israeli CPI and bear annual interest at the rate of 3.7% (as determined in the tender). Debentures with a par value of NIS 30,700 thousand were purchased by a wholly-owned subsidiary, upon issuance. In August 2001, the subsidiary sold the remaining debentures held by it at that date for NIS 23,268 thousand. The debentures are traded on the TASE. Debenture issuance expenses are presented in the balance sheets as deferred charges. See Notes 2i and 9.
- b. The debentures are presented in the balance sheets as follows:

	Consolidated		The Company	
	December 31,		December 31,	
	2003	2004	2003	2004
NIS in thousands				
	Adjusted	Reported	Adjusted	Reported
Debentures outstanding	101,103	68,010	101,103	68,010
Less discount in respect of sale of debentures by subsidiary	1,257	804		
	99,846	67,206	101,103	68,010
Less current maturities	33,701	34,005	33,701	34,005
	66,145	33,201	67,402	34,005

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NOTES TO FINANCIAL STATEMENTS

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**NOTE 15: COMMITMENTS, CONTINGENT LIABILITIES AND LIENS**

a. Commitments:

1. Royalties and other payments to the Government:

- a) The Company and Matav Haifa were required to pay royalties at the rate of 5% to the Government of Israel, based on the gross income from operating CATV broadcasts.

On June 16, 2003, the finance committee of the Knesset approved amendment No. 2 of the Bezeq Regulations (Franchises 1987) which retroactively reduces the royalties payable by the holder of a license to operate CATV systems from 5% of gross annual revenues from providing broadcasting services to 4% in 2002 and 2003 and to 3.5% in 2004 and thereafter.

As to the revenues from the Internet activities, the Company is obligated to a payment at a rate of 4% in 2002 and 2003 and at a rate of 3.5% in 2004 and thereafter to the Government of Israel.

- b) In light of the contention of the Ministry of Finance according to which, following the expiration of the cable television operators franchises, the cable television operators should pay the State of Israel appropriate consideration for the grant of a right to continue to provide multi-channel television services to subscribers, as well as other telecommunications services over the cable network, the cable television operators, including the Company, came to an agreement with the State of Israel dated July 2001 according to which the Company undertook, among other things, to make certain payments to the government over a 12 year period, and in consideration, each cable television operator received recognition by the government of its ownership of its respective cable television network infrastructure. Subsequent amendments to the Telecommunications Law adopted that agreement. The material terms of the agreement provide that:

Each cable television operator shall make payments to the government over a period of 12 years commencing on January 1, 2003, equal to its pro rata portion of a sum determined by multiplying certain accumulated income of all the cable television operators, including certain income derived from the use of cable infrastructure, by a percentage which is between 0% and 4%, increasing gradually according to the amount of such income. In the July 2001 agreement, it was agreed that the Company's pro rata portion would be 24.1%, until agreed differently by all of the cable television operators; and

Each cable television operator shall pay the State of Israel in the 12-year period up to 12% of its income from the sale of any activity related to the cable infrastructure or a right related to such activity, and the sale of certain assets as set forth in the agreement.

NOTES TO FINANCIAL STATEMENTS

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**NOTE 15: COMMITMENTS, CONTINGENT LIABILITIES AND LIENS (Cont.)**

The Israeli government (subject to payment of payments by the cable television operators) undertook not to assert any rights or claims regarding the ownership of the cable infrastructure.

As a result, each cable television operator is deemed to own all the rights to the cable network infrastructure in its license areas, and the right to operate it is subject to applicable law, following the expiration of the previous franchises. The July 2001 agreement, and its codification into law by way of amendments made to the Telecommunications Law, will continue to be in effect if the cable television operators consummate their proposed merger. As to Royalties and other payments to the Government, see Note 19a.

2. Royalties:

The Company and Matav Haifa have undertaken to pay royalties to various entities in respect of copyrights on programs transmitted or broadcasted on cable television, as stipulated in the agreements with the said entities. The annual amounts of royalties in 2004, 2003 and 2002 were approximately adjusted NIS 3.6 million, NIS 2.7 million and adjusted NIS 2.9 million, respectively.

3. As to commitments to purchase rights, liabilities and licenses relating to the productions of certain channels, see Note 1a(8).

4. Under the Telecommunications Law and in accordance with the Council's resolution of June 2002 as amended in September 2002 and in May 2003, each Cable Broadcast Licensee is required to invest or allocate in production or purchase of locally produced programs, a percentage of its annual income derived from subscriber fees for the year preceding the year of the investment, as follows: (i) commencing April 30, 2002 (the date of the grant of the Broadcast License) and until the end of 2005, at least 8% of such income; and commencing 2006 and thereafter, as to be determined by the Council prior to the end of June 2005; and (ii) in the event a Cable Broadcast License is granted to the merged entity of the Israeli cable television operators, the Council shall determine, prior to the end of June 2005, the rate of the amounts that shall be allocated to locally produced programs by the Broadcast Licensee as of 2006 and thereafter. For this latter purpose, the Council shall consider, among other things, the financial condition of the Licensees in connection with their broadcast activities and the contribution of the said merger to the improvement of the financial condition of the Licensees.

According to the evaluation of the Company's management, the amounts that were invested by the Company in respect of locally produced programs in 2002, 2003 and 2004 is higher than 8% of its annual revenues from the subscription fees for these years.

## NOTES TO FINANCIAL STATEMENTS

**NOTE 15: COMMITMENTS, CONTINGENT LIABILITIES AND LIENS (Cont.)**

## 5. Lease commitments:

The Company and its subsidiaries lease offices and motor vehicles under various operating lease agreements, which expire on various dates, the latest of which is in 2008.

Future minimum lease payments under non-cancelable lease agreements as of December 31, are as follows:

	<u>NIS in thousands</u>
2005	6,736
2006	5,478
2007	2,372
2008	634
	<u>15,220</u>

## b. Contingent liabilities:

## 1. Claims and petitions for approval of class actions:

- a) On April 22, 1999, a lawsuit and motion to approve the claim as a class action were filed against the Company with the Tel-Aviv-Jaffa District Court pursuant to Article 46a of the Restrictive Business Practices Law, 1988 by a subscriber of the Company who seeks approval as class action, thereby representing all of the members of the class allegedly included in such action.

In the claim, it is alleged that the Company constitutes a monopoly, and that it adversely exploits its position in the market, in a manner which is, or may be, damaging to the general public, inter alia, by setting and collecting unreasonable and unfair prices for the services it provides.

If the class action is approved, the court will be requested to require the Company to reduce the subscriber fees that it collects and to pay its subscribers compensation in connection with the subscriber fees collected from May 10, 1996 to April 1, 1999. In this context, the petitioner claims that he has sustained damages in a sum of reported NIS 1,387 and further claims that the sum of compensation due to all of the members of the class included in the class action, if approved, amounts to reported NIS 360 million. In addition, the subscriber is also claiming compensation with respect to the damages caused to all of the members included in the class action, if approved, from the date of filing the lawsuit to the date judgment is rendered. In addition, the petitioner is claiming for a mandatory injunction according to which the Company will be obliged to reduce the service fee, which it charges from its subscribers.

NOTES TO FINANCIAL STATEMENTS

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**NOTE 15: COMMITMENTS, CONTINGENT LIABILITIES AND LIENS (Cont.)**

The Company filed an objection to the motion to approve the claim as a class action inter alia, on the grounds that the claim and the motion lack any merits, because of the fact that the petitioner has disregarded the high investments made in infrastructure and equipment, because of the fact that the franchise granted to the Company for CATV broadcasts, is limited in time, because of the fact that the comparisons made by the petitioner between the Company and foreign companies dealing in CATV broadcasts in countries where the situation is very different, are not relevant to the Company's modus operandi, and because of the fact that the subscriber fees are subject to supervision and are highly regulated.

At the beginning of the hearing on the request, it was stated that the hearing of the request will be joined with similar requests that were filed against the Cable Companies Tevel, Golden Channels and Idan (however, in the meantime, this condition changed, as detailed below).

After the unification of proceedings and pursuant to the arrangement reached by the parties and which was validated by the court, it was agreed that the Court will preliminarily decide with respect to the legal threshold claims that were raised by the Company (and other Cable Companies).

On August 21, 2003, the Court rendered its decision thereby rejecting the arguments of the Company (and of the other Cable Companies) and determined that the expenses with respect to the proceedings will be taken into account at the end of the proceedings.

In that decision the Court has determined, among other things, that the immunity stated in article 6 to Torts Ordinance is not granted to the Cable Companies and that the decision of the Restrictive Trade Practices Court that was granted in the past does not constitute a binding precedent or Court's ruling toward the petitioners in the said procedure. Nevertheless, according to a procedural settlement reached by the parties, the Court will have to rule on other issues and parties arguments which were detailed in the request to approve the claim as a class action and the responses of the Cable Companies in that issue.

In a pre-trial hearing held on November 26, 2003, it was determined that the hearing of the proceedings against the various Cable Companies will be separated and that the first to be heard is the request to approve a class action which was filed against the Company. The parties reached a procedural arrangement concerning the hearing according to which no examinations shall be conducted and each party shall submit its summations. According to the said agreement, the summations on behalf of the petitioner were submitted on April 1, 2005 and the summations on behalf of the Company shall be submitted by June 22, 2005. The petitioner is entitled to submit a response to the Company's summations by August 14, 2005.



NOTES TO FINANCIAL STATEMENTS

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**NOTE 15: COMMITMENTS, CONTINGENT LIABILITIES AND LIENS (Cont.)**

According to the opinion of the Company's management, based on the opinion of its legal counsels, since the claim and the motion to approve it as a class action, and the Company's response to the claim and the motion, raise complex, factual and legal questions that have not yet been resolved in Israeli case law, and for which there are no precedents that are based on similar facts, it is not possible to estimate the outcome of the claim. Therefore, no provision was recorded in respect to the aforesaid claim in the Company's financial statements.

- b) On August 28, 2002, a lawsuit and motion to approve the claim as a class action were filed against the Cable Companies on behalf of the residents of peripheral settlements. The claim is for indemnification in respect to these settlements not being connected to the cable networks with the elapse of six years from the date on which the franchises were granted. The compensation requested from the Company amounts to about NIS 139 million, as of the date the claim was filed.

In view of a rejection of a claim identical in substance to this claim, the Company and Golden Channels have presented a request to dismiss the claim without prejudice. The petitioners presented a reply to the request to dismiss the claim without prejudice and the Company and Golden Channels presented their reply to the petitioners' reply. In addition, the Company and Golden Channels presented a reply to the request to approve the Claim as a Class Action. The petitioner's request to join the hearing as creditors of Tevel was dismissed by the court. No date was scheduled for a hearing.

According to the opinion of the Company's management, based on the opinion of its legal counsels, it is not possible to estimate the chances of the claim. Therefore, no provision was recorded in respect to the aforesaid claim in the Company's financial statements.

- c) On December 3, 2002 a lawsuit and motion to approve the claim as a class action were filed by seven Israeli residents, who requested recognition of their action as representing 1,050,000 subscribers of the Cable Companies. According to the claim, the Cable Companies violated the terms of the approval given to them by the Council for the transmission of the pay sport channel, since they did not maintain certain programs in the original sport channel, which is part of the basic package, offered to subscribers. The petitioners requested the Court to instruct all three Cable Companies to compensate the subscribers by a total sum of NIS 302 million as of the date of the motion and by an additional sum of NIS 25 million for each month from the date the claim was filed up to the date judgment is rendered by the Court. The Company's proportionate share based on the subscribers ratio as of the balance sheet date, is NIS 80 million, in addition to a monthly amount of NIS 6.7 million accumulating from the date the claim was filed until a ruling is rendered (the **Original Lawsuit**).

## NOTES TO FINANCIAL STATEMENTS

**NOTE 15: COMMITMENTS, CONTINGENT LIABILITIES AND LIENS (Cont.)**

On May 27, 2004, the Court denied the motion to approve the claim as a class action. On July 5, 2004, the petitioners submitted an appeal to the Supreme Court. The parties submitted their summations. The date for a hearing of the appeal in the Supreme Court of the appeal in the Supreme Court is set to January 9, 2006.

According to the opinion of the Company's management, based on the opinion of its legal counsels, it is not possible to estimate the chances of the claim. Therefore, no provision was recorded in respect to the aforesaid claim in the Company's financial statements. The amount of the Original Lawsuit was calculated by the petitioners based on the number of subscribers of each of the Cable Companies at the date the claim was filed.

- d) On February 8, 2005, the Company received notice of a lawsuit and motion to approve the claim as a class action (the lawsuit and the motion accordingly). The lawsuit and the motion were filed against the Company by an Israeli resident in the Tel Aviv-Jaffa District Court. The motion alleges, among other things, that the Company has misled consumers within the framework of a certain sales promotion campaign in 2001, thereby violating the Israeli Consumers Protection Law. According to the motion, the damages owed to the petitioner are in the amount of NIS 1,574 (equates to approximately \$357) and the aggregate damages to the class are indeterminable at this stage, because the number of other potential petitioners is not known to the petitioner.

The Company noted that the motion relates to the same subject matter of an indictment that was filed in March 2003 in the Netanya Magistrate Court against the Company and certain of its officers for violation of the Israeli Consumers Protection Law. The officers were dropped from the indictment and in November 2003, the court approved a plea bargain, pursuant to which the Company admitted the facts in an amended indictment and paid an insignificant fine.

The Company has to submit its response until April 22, 2005. According to the opinion of the Company's management, based on the opinion of its legal counsels and in view of the preliminary stage of the motion, it is not possible, at this stage, to estimate the chances of the claim and therefore no provision was recorded in respect of the aforesaid claim in the Company's financial statements. See also Note 24(e).

2. Other claims:

- a) On March 28, 2000, a claim was filed in the Tel-Aviv-Jaffa District Court against the Cable Companies, including the Company, by the Association for the International Collective Management of Audiovisual Works AGICOA, an international association of producers of cinema and television works.

The aggregate sum of the claim is not less than approximately \$170.2 million and for the purpose of court fees was limited to a sum of \$20 million.

NOTES TO FINANCIAL STATEMENTS

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**NOTE 15: COMMITMENTS, CONTINGENT LIABILITIES AND LIENS (Cont.)**

AGICOA is an organization that represents numerous producers in a claim against the Cable Companies for the alleged breach of copyrights of the represented producers due to the re-transmission of programs by the cable television operators. AGICOA is also claiming unjust enrichment on the part of the cable television operators and that they be ordered to submit their accounts.

In the opinion of the Companies' management, as was expressed in the statement of defense filed with the court on July 9, 2000, the claimant has no right to file a claim in Israel, which is in light of the Anti-Trust Laws in Israel. In addition, the period of time on which the claim relies exceeds, at least partially, what is prescribed by law, due to the fact that the claimant did not properly prove the legitimacy of its rights claimed in the works and that the amount of the claim appears to be apparently groundless and exaggerated.

At a preliminary hearing held on June 18, 2002, the Court ruled to delay its decision in this matter pending resolution of the Israeli Supreme Court in a further hearing in another matter, the Tele Event case, which the Court believes will have material implication on all or part of this dispute. The further hearing referred to by the Court was filed with respect to the ruling of the Supreme Court (presiding as an appellate court), which determined that the re-transmission of broadcasts as secondary broadcasts may also constitute an infringement of copyrights, if such broadcasts include copyrights owned by third parties who have not consented to their broadcast in Israel.

In January 2005, the parties completed the discovery proceedings and therefore in the context of the preliminary proceedings, disclosing additional information and questionnaires remain to be completed.

According to the opinion of the Company's management, based on the opinion of its legal counsels it is impossible, at this stage, to estimate the chances of the claim. Therefore no provision was recorded in respect of the aforesaid claim in the Company's financial statements. In addition, in the opinion of the Company's management based on the opinion of its legal counsel and despite the ruling in the matter of Tele Event, the Company has additional solid and well founded defense arguments.

NOTES TO FINANCIAL STATEMENTS

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**NOTE 15: COMMITMENTS, CONTINGENT LIABILITIES AND LIENS (Cont.)**

- b) In December 31, 2003, Eshkolot The Israeli Artists Society for Performers Rights Ltd., or Eshkolot, filed a lawsuit in the District Court of Tel Aviv-Jaffa against the Company and the other Cable Companies for certain payments, for temporary and permanent injunctions, and to give instructions to Tevel's trustee. Eshkolot claims that, since January 1, 2003, the cable television operators broadcast programs in violation of the rights of Israeli performers held by Eshkolot since such broadcasts were made without Eshkolot's consent and without payment of royalties. In the context of the claim, the Court was requested to instruct and affirm that Eshkolot is entitled to receive a usage payment of NIS 8.5 million as compensation for 2003 royalties (net of payments already transferred to Eshkolot), and that, from now on in each year the cable companies will have to pay this amount including linkage differentials and to update such royalties relative to increases in the number of broadcasting minutes of protected performances. Additionally, Eshkolot requested to oblige the Cable Companies to pay the maximum statutory compensation, as set in the Copyrights Law, in the total amount of NIS 24.3 million. Eshkolot also requested a permanent injunction order against the cable companies that will prohibit the broadcast of protected performances employing performers' rights held by Eshkolot, unless expressly authorized by Eshkolot.

Further, the Court was requested to give a temporary injunction to prohibit the Cable Companies from broadcasting performances employing performers' rights held by Eshkolot, unless an advance express written authorization from Eshkolot is received, until the hearing and the decision in Eshkolot's primary claim for compensation for violating performers' rights and in the request for the permanent injunction against the Cable Companies.

On May 13, 2004, the court approved the parties' notice of arbitration and the case was forwarded to arbitration with instructions to strike the lawsuit with no order for expenses.

The statement of complaint on behalf of Eshkolot, in the arbitration, was filed on June 25, 2004. The amount of the claim, which significantly exceeds the amounts that were paid previously to Eshkolot by the Cable Companies pursuant to the agreement that was valid until 2002, is NIS 8.5 million for 2003 and a similar amount plus 10% for each of the years 2004-2006. Eshkolot argues that this is the appropriate royalty as implied in the Performers and Broadcasters Rights Law 1984, which is to be paid each year.

NOTES TO FINANCIAL STATEMENTS

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**NOTE 15: COMMITMENTS, CONTINGENT LIABILITIES AND LIENS (Cont.)**

The statement of defense on behalf of the Cable Companies was filed on August 3, 2004. In the statement of defense, the Cable Companies refute Eshkolot's arguments, inter alia, concerning the scope of the use of its repertoire and claim that in view of the various developments in the communications market in Israel, and particularly in view of entering of competitors to the market such as Yes the amount of the royalties paid to Eshkolot should be decreased. It is further argued that Eshkolot is not the owner of rights in certain musical works, which it refers to within its claim, since the performing artists exclusively assigned their rights to production companies. The Company also claims that Eshkolot misused its monopolistic powers in the market, in order to impose unreasonable prices on its consumers.

On January 30, 2005 Eshkolot requested the Cable Companies to pay an interim payment in the amount of NIS 11.5 million for the years 2003-2005 (in addition to the payment in the amount of NIS 3.5 million). On February 15, 2005 the Cable companies replied Eshkolot and declined the said request. On February 25, 2005 the parties submitted a request to delay the arbitration proceedings including, inter alia, the decision regarding the said request, in order to enable them to conduct negotiations. The negotiations between the parties have not yet been concluded.

According to the opinion of the Company's management, based on the opinion of its legal counsels and in view of the preliminary stage of the proceedings, it is impossible, at this stage, to estimate the chances of the claim. Nevertheless, the Company's management included in the financial statements a provision, which in its opinion reflects adequately the Company's exposure in respect of this claim.

- c) The license agreement between the Cable Companies and the Israel Records and Cassette Federation (the **Record Federation**) (the **Agreement**) terminated in the end of 2002. Upon the termination of the Agreement, the parties negotiated in order to renew or extend the Agreement for an additional period. Under these negotiations, the parties agreed, inter alia, that as an interim arrangement, the Cable Companies shall pay the Records Federation for the year 2003 75% of the amount which was paid to the Federation in the year 2002. This amount was to be paid until the execution of a new agreement between the parties. It was further agreed that the Cable Companies shall be granted a license to broadcast the repertoire of the Record Federation until the execution of a new agreement.

In 2004, the parties conducted mediation proceedings in an effort to reach a new agreement, hence such agreement was not reached.

NOTES TO FINANCIAL STATEMENTS

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**NOTE 15: COMMITMENTS, CONTINGENT LIABILITIES AND LIENS (Cont.)**

On December 13, 2004, the Records Federation informed the Cable Companies that since an agreement was not yet executed, it regards the usage of its repertoire as a violation of its rights and hence announced that it contemplates to pursue legal actions in order to avoid such alleged violation and receive a monetary compensation.

On December 27, 2004, the Records Federation sent a letter demanding from the Cable Companies a payment of NIS 24 million (plus VAT) (for the years 2003 - 2005). The relative part of the company is NIS 6.2 million (plus VAT).

On January 23, 2005, the Cable Companies sent a response to the abovementioned demand. The Cable Companies stated that the demand is unreasonable. Without derogating from any allegation or right, the Cable Companies proposed to pay the Record Federation the entire amount that was paid in 2002 until a ruling is rendered in respect of the amount of the royalties to be paid. On January 30, 2005, the Records Federation dismissed the above payment proposal.

According to the opinion of the Company's management, based on the opinion of its legal counsels, it is very likely that the Records Federation shall take legal or quasi legal proceeding against the Cable Companies in the coming few months. However, since a lawsuit has not yet been filed, it is impossible, at this stage, to estimate the prospects of the abovementioned payment demand (see also Note 24(e)).

According to the opinion of the Company's management, based on the opinion of its legal counsels, it is not possible, at this stage, to estimate the chances of the claim. Nevertheless, the Company's management included in the financial statements a provision, which in its opinion reflects adequately the Company's exposure in respect of this claim.

- d) The Company is involved in several additional claims that are not included in this section and which do not exceed the aggregate of NIS 5 million. The Company's management estimation, based on the opinion of its legal counsel, is that no provision should be included in the financial statements in respect of such claims.
- e) In light of disagreement with the Tax Authorities, the Company and its subsidiary, Matav Haifa, received in 2002 and 2004, tax orders for tax years 1997 - 2001. Under these orders, the Company and Matav Haifa are required to pay an additional aggregate amount of NIS 52 million (not including interest and CPI linkage) and to decrease their carry forward losses for the years 2000 - 2001 by NIS 96 million. The Company and Matav Haifa disagree with the aforementioned Tax orders. Management's opinion, based on the opinion of its tax advisers, is that the Company has well founded arguments against all the claims included in these tax orders and therefore the Company intends to appeal against these tax orders.

## NOTES TO FINANCIAL STATEMENTS

## NOTE 15: COMMITMENTS, CONTINGENT LIABILITIES AND LIENS (Cont.)

In light of previously non-concluded discussions and unwritten understandings with the Tax Authorities, the Company recorded in the financial statements as of December 31, 2004, a provision of approximately NIS 6.5 million with respect to the aforementioned tax orders.

- f) In May 2004, a subsidiary of the company, Matav Investments, received assessments for tax years 1998-2001 and a tax order for 2002.

The tax order for 2002 included a requirement to pay a tax amount of NIS 114 million (due to a dispute with the tax authorities - see also Note 11b(1)) which was fully provided for in the financial statement.

In addition, with respect to a 2002 tax order a deficit penalty was imposed on the Company in the amount of NIS 18 million (including interest and CPI linkage), which was delayed until the date of approval of the financial statements. See also Note 24e.

According to the opinion of the Company's management, based on the opinion of its tax advisers, the Company has well founded arguments against the assessments and the mentioned penalty and therefore no provision has been made in the Company's accounts for the above-mentioned deficit penalty claim and the assessments for tax years 1998-2001.

3. Hot Vision's contingent liabilities:

In July-September 1999, Tevel and Golden Channels and Co. (**Golden Channels**) entered into license agreements with the major studios (Columbia, Fox and Warner Bros. International Television Distribution (**Warner**)) to purchase contents (the **Agreements**). The contents were broadcast, inter alia, in channels HOT 3 and HOT Movies, which are produced by Hot Vision for the Cable Companies, and for the pay channels- HOT Drama, Hot Action, Hot Fun and Cinema Prime, which are produced by Avdar Silver Industries Ltd. (**Avdar**) for the Cable Companies.

Agreements were entered into by and between Tevel, Golden Channels and Hot Vision, according to which, broadcasting rights for the above contents, were provided to Hot Vision. In addition, agreements were entered between Avdar and the Cable Companies, pursuant to which the broadcast rights for the above pay channels were placed with Avdar.

- 1) On November 27, 2002, Warner filed a lawsuit against Tevel in the District Court in California seeking, inter alia, a monetary compensation of \$17 million (**Warner Lawsuit**). Warner contends that the agreement between Warner and Tevel dated July 13, 1999, pursuant to which Tevel acquired from Warner the rights to broadcast films, was breached and consequently terminated by Warner.

NOTES TO FINANCIAL STATEMENTS

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**NOTE 15: COMMITMENTS, CONTINGENT LIABILITIES AND LIENS (Cont.)**

Following the Warner Lawsuit and other actions taken by Warner, on December 5, 2002, the trustee for Tevel group filed with the District Court in Tel Aviv (the **Court**) a motion to instruct Warner, inter alia, to take any measure necessary to discontinue the Warner Lawsuit (in view, among others, of the stay of proceedings order that was granted with respect to Tevel, which prohibits the institution of new proceedings against Tevel without the approval of the Court and based on the proof of debt submitted by Warner to the trustee under the same cause of action ( **the Trustee's Motion** )).

On February 10, 2003, the Court rendered its ruling in favor of the Trustee's motion and dismissed Warner's position (although a Blocking Order as this term is defined in the Civil Procedure Regulations 1984, was not granted). The Court determined, inter alia, that Warner instituted unlawful proceeding in the United States under circumstances substantiating doubts as to its good faith, and such a proceeding cannot be materialized or enforced in the boundaries of the state of Israel. On March 25, 2003, the trustee rendered its decision of Warner's proof of debt, according to which, it rejected the majority of the said proof. On April 24, 2003, Warner appealed to the district court on the issue of proof of debt and following decisions rendered on the appeal, on June 24, 2003, Warner filed an amended appeal on the trustee's decision relating to the matter of the proof of debt.

On October 21, 2003, the Supreme Court dismissed Warner's appeal with respect to the Court's ruling dated February 10, 2003, subject to the rights of Warner and the Trustee to raise arguments as to the issue of the applicable law with respect to the proceeding of the proof of debt within Warner's appeal on the trustee's decision. In addition, the Court instructed Warner to file an amended appeal in order to include the argument with respect to the applicable law.

The amended appeal was filed, in the context of which, Warner seeks the reversal of the trustee's decision on the proof of debt (which proved the debt for Warner in the amount of \$182 thousand only) and proved Warner a debt in the aggregate of \$17 million and alternatively \$12 million.

On September 1, 2004, the Court dismissed the amended appeal with respect to the proof of debt determining that the Warner's appeal contradicts the law and its entire substance is nothing but an attempt to generate high profit in an unjust and extraordinary manner at the expense of the ordinary creditors of Tevel. In view of the extraordinary circumstances and the scope of litigation, the Court ruled that Warner shall pay Tevel expenses and legal fees.



NOTES TO FINANCIAL STATEMENTS

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**NOTE 15: COMMITMENTS, CONTINGENT LIABILITIES AND LIENS (Cont.)**

On October 5, 2004, Warner filed an appeal with the Supreme Court. Simultaneously, Warner filed, on that very day a motion for stay of performance with respect to the ruling dated September 1, 2004, with the Court and an urgent motion for hearing the said motion. On October 5, 2004, the Court rendered a ruling according to which, the facts referred to in the motion for stay of performance were not supported by an affidavit and it was further determined that the motion is inappropriate to be heard ex parte and the case shall be scheduled for hearing. In addition, the court, instructed that the trustee shall take into consideration the fact that a motion for the stay of performance proceeding was filed. On November 24, 2004, a reply to the motion for stay of performance was filed on behalf of the Trustee and on January 17, 2005 a reply on behalf of the Official Receiver was filed.

On February 9, 2005, the Court rendered its ruling in the matter of the motion for stay of performance. The court indicated that it is in the opinion that the prospects of Warner's appeal to prevail are remote, however, due to the concern that if the stay of performance is not granted the factual situation shall be irreversible (in the event that a decision in the appeal shall be rendered in favor of Warner) and in order not to completely nullify the appeal, the court instructed that until a ruling in the appeal is rendered the trustee shall hold up an amount of \$4 million, which is necessary for dividend distribution to Warner, if the Court shall render a judgment in favor of Warner in the appeal. The stay of performance is contingent upon a deposit of a bank guarantee by Warner in the amount of NIS 2 million to secure the creditors damages. The said amount was imposed in addition to the guarantees that may be determined by the Supreme Court as a prerequisite for hearing the appeal.

The hearing of the appeal in the Supreme Court is scheduled to September 19, 2005.

In the opinion of Tevel's management, based on the opinion of its legal advisors, the prospects of Warner's appeal on the ruling of the district court, are remote.

- 2) On December 9, 2002, Warner filed a lawsuit against Golden Channels with the district court in Los Angeles, California in the U.S. The lawsuit is seeking, inter alia, a monetary compensation on the grounds of breach of contract with Golden Channels dated July 13, 1999 and a lawsuit for declaratory remedies, as detailed in the complaint. On January 17, 2003, an amended complaint was filed in context of which, Warner was seeking, inter alia, to compel Golden Channels to pay compensation of at least \$16 million in addition to expenses. In addition, among others, declaratory remedies and an injunction were requested. On February 14, 2003, Golden Channels filed its answer and a counterclaim. In the context of the lawsuit, the parties also filed motions for preliminary injunctions. A hearing for the preliminary injunctions was held in March 2003. The court rejected all of the motions for preliminary injunctions. The evidential hearing for the complaint and the counterclaim was held during January 2004 and in February 2004 the parties filed their summaries. In Warner's post trial brief it requested compensation in the amount of approximately \$25 million. Golden channels requested compensation in the amount of approximately \$3.8 million.

NOTES TO FINANCIAL STATEMENTS

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**NOTE 15: COMMITMENTS, CONTINGENT LIABILITIES AND LIENS (Cont.)**

On September 29, 2004, the district court in Los Angeles, California, ruled in favour of Warner. The district court awarded Warner damages in the amount of approximately \$19.3 million (excluding attorney fees) and rejected Golden Channels' counterclaims in the matter. The Court originally entered judgment for Warner in the amount of \$19 million. It subsequently granted Golden's motion to amend the judgment to deduct \$0.6 million in tax certificate damages, and Warner's motion to add \$0.65 million in prejudgment interest. Following amendment, the judgment awarded Warner damages of \$19.4 million, \$0.2 million in costs, and \$2.3 million in attorney's fees and other costs, for a total judgment amount of \$21.7 million (the **Final Amended Judgment**).

On March 7, 2005, Golden Channels filed a notice of appeal, pursuant to which, it appeals to the United States Court of Appeals for the Ninth Circuit from the Final Amended Judgment, including other prior orders and decisions granted by the Court.

On March 21, 2005 Warner filed a notice of cross appeal pursuant to which, it appeals to the United States Court of Appeals for the Ninth Circuit from the order of the District Court denying Warner's motion to amend the judgment to add prejudgment interest, as reflected in the Final Amended Judgment, including all orders and decisions pertaining thereto that are or may be merged into the Final Amended Judgment.

Pursuant to an agreement among the Israeli cable television operators (including Golden Channels, Tevel and the Company) and Hot Vision (see below), the Company is required to indemnify Golden Channels (through Hot Vision) for approximately 26.5% of the damages awarded to Warner, which will actually be paid by Golden Channels amounting at the maximum to approximately \$5.755 million.

In light of the abovementioned and taking into consideration the additional interest and legal costs that may be incurred by Golden channels, the financial statements of Hot Vision as of December 31, 2004, include a provision of NIS 92.8 million (see below).

- 3) On or about the filing date of the lawsuits detailed in sections 1 and 2 above, Warner forfeited letters of credit it was granted by Golden Channels and Tevel in the amount of \$5 million each.

Further to the above lawsuits and a demand made by Tevel and Golden Channels, Hot Vision's board of directors resolved that, in principle, Hot Vision shall bear the amounts borne or to be borne by Tevel and Golden Channels with respect of the forfeiture of letters of credit, as detailed above, and in respect of the aforesaid agreements with the major studios, including their termination and related expenses and/or in respect of legal proceedings taken, subject to indemnification by its shareholders to cover these amounts.

NOTES TO FINANCIAL STATEMENTS

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**NOTE 15: COMMITMENTS, CONTINGENT LIABILITIES AND LIENS (Cont.)**

On June 30, 2003, Hot Vision and the Cable Companies signed an agreement for the indemnification of Hot Vision relating to all of the amounts that it shall bear in connection with the debt to the major studios and expenses associated with the management of the above legal procedures (the **Indemnification Agreement** ). According to the Indemnification Agreement, the Cable Companies are committed, one towards the other, to jointly finance through Hot Vision the debt to the major studios and expenses associated with the management of these legal procedures which were implemented until the date of the financial statements against certain of the Cable Companies as well as any other procedure between Tevel and/or Golden Channels and the major studios in connection with agreements which were signed and/or terminated with the major studios - regarding content which was provided to channels HOT 3 and HOT Movies . As for the pay channels ( Hot Drama , HOT Action , Hot Fun and Cinema Prime ), it was agreed that the amounts shall be paid directly to Tevel.

According to the Indemnification Agreement, the debt to the major studios contains amounts that Tevel and/or Golden Channels have to pay, as the case may be, to the major studios in connection with the legal proceedings associated with these agreements, including the amounts of new guarantees provided to the major studios, if so provided, and which the major studios will forfeit and legal fees that Tevel and/or Golden Channels will have to pay to the major studios, all by virtue of a judgment or a decree rendered in the context of the legal proceedings. The Indemnification Agreement stipulates, inter alia, that each of the Cable Companies shall pay Hot Vision sums, according to its relative share in the market, of the amounts that shall be actually paid by Tevel and/or Golden Channels with respect to their debt to the major studios and expenses associated with the management of the legal procedures in connection to Hot Movies and/or HOT 3 .

The indemnification does not include amounts that are payable by the Cable Companies to Tevel and/or Golden Channels through Hot Vision and Avdar for purchase of content to channels HOT 3 and HOT Movies and to the pay channels ( Hot Drama , HOT Action , Hot Fun and Cinema Prime ).

The indemnification Agreement further stipulates that the commitments of the Cable Companies shall be revoked in the following cases: (1) if the Cable Companies release Hot Vision in writing from its obligations under this agreement (2) if Tevel, Golden Channel and the Company merge into another cable company (the **Merged Company** ) and the Merged Company assumes, in writing and without any condition, the commitments of all of the Cable Companies towards Hot Vision under this agreement even if Hot Vision is not released from all of its said obligations given that the Merged Company holds all of the issued share capital of Hot Vision and that its commitments cover all of Hot Vision 's obligations under the Indemnification Agreement.

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## NOTES TO FINANCIAL STATEMENTS

**NOTE 15: COMMITMENTS, CONTINGENT LIABILITIES AND LIENS (Cont.)**

In light of the abovementioned, the Company included in the financial statements as of December 31, 2004 its relative share in the provision recorded by Hot Vision in the amount of NIS 24.7 million (including additional amounts as mentioned above).

4. There is no mechanism of the Cable Companies to charge the partnership for usage and maintenance fees of the network. See Note 1(a)(4).
- c. Guarantees and charges:
1. In order to secure its liabilities to banks and holders of debentures, the Company placed a first ranking floating charge on its assets and rights in favor of the banks and the debenture holders. The total secured liabilities at December 31, 2004 amounted to approximately NIS 634 million.
  2. Under some credit facility agreements of Partner, its principal shareholders were required to pledge, in favor of the participating banks in the aforesaid agreements, a part of their shares in Partner.
- The Company, as one of Partner's principal shareholders, registered a pledge, unlimited in amount, on its shares in Partner (5.25%) and all the rights attached thereto as security for the balance of Partner's bank loans.
- See Note 24(a) with respect to the removal of the pledge (as described above) as a result of the buy back transaction of Partner shares subsequent to the balance sheet.
3. In order to ensure compliance with the obligations pursuant to the Licenses, applicable law and regulatory bodies, and to ensure payment of fines that may be imposed by the Council and the Ministry of Communications the following guarantees have been provided:

Bank guarantees by the three Cable Companies in the aggregate amount of \$14 million to the Ministry of Communications pursuant to Hot Telecom Infrastructure License, of which the Company provided a bank guarantee in the amount of NIS 16.3 million (valid until December 2025 (see note 1(a)(8))).

A guarantee of NIS 9.3 million to the Council pursuant to the Broadcast Licenses (valid until April 2005).

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NOTES TO FINANCIAL STATEMENTS

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**NOTE 15: COMMITMENTS, CONTINGENT LIABILITIES AND LIENS (Cont.)**

Each of the Minister and the Council has the authority to exercise the applicable guarantees in the event that the Company or HOT Telecom, as the case may be, do not fulfill their obligations, and to cover any damage, loss or cost that the Council, the Minister, or the government may incur as a result of any breach of the Company's obligations under the licenses, and to ensure all payments by the licensee, including royalty payments and payments of fines imposed by the Council or the Minister. The exercise of the guarantee does not derogate from the authority of the Council or the Minister to cancel the licenses, to amend the terms and conditions of the licenses or to impose other sanctions including fines for certain stipulated breaches or actions.

4. The Company provided Hot Vision with unlimited guarantees on amounts due to a bank at a rate of approximately 25% of the total bank debt. In accordance with the resolution of Hot Vision's board of directors, it was determined that the total credit to be extended to Hot Vision by the bank shall not exceed the amount of \$35 million. Any excess amount shall be approved in writing by the Company's board of directors. This resolution was forwarded to the bank that provides the credit. As of December 31, 2004, the Company's share in those guarantees amounted to \$4.6 million.

In addition, the Company is a guarantor to another bank to secure Hot Vision's liabilities in the amount, which varies between \$4.4 - \$7 million (the Company's share).

5. The Company recorded a charge on equipment purchased from a supplier to secure its liabilities toward the supplier in a total amount of NIS 0.6 million.
6. The Company guarantees an amount of \$200 thousand to Barak (non-marketable equitable securities).
7. The Company provided a bank guarantee of NIS 16.5 million to the Controller, which is valid through December 2007, to ensure compliance with the terms of the approval of the Controller to the merger. In the event that the Controller decides, in his discretion, that there has been a breach of the terms of the approval, he may fully exercise the guarantee. (see Note 1(a)(4)).
8. The Company provided a bank guarantee in the amount of NIS 4.7 million to secure the payments of the affiliate partnership Hot Telecom to Lucent (see Note 5(b)(4)(c)).
9. The Company and Tevel guarantee jointly and severally in a total aggregate amount of \$4.5 million to secure the payments of Hot Telecom to Cisco. The Cable Companies signed an indemnification agreement in respect of the mentioned guarantee.

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## NOTES TO FINANCIAL STATEMENTS

**NOTE 15: COMMITMENTS, CONTINGENT LIABILITIES AND LIENS (Cont.)**

- d. In 2000, the Company was granted a call option for the purchase of 50% of the shares in the company which produces the Hop channel Hop Ltd. ( Hop ) from its shareholders in consideration for \$50 thousand. Due to the terms of the Controller's approval to the merger of the Cable Companies, the Company was required to transfer the option to the full and exclusive ownership of a third party so that the Company does not have any interest in Hop. In the context of the agreement with the third party, it was determined that, in consideration for the transfer of the rights in the option to a third party, the third party shall pay the Company an amount equivalent to 95% of the amount actually received upon the exercise of the option and the actual purchase of ownership in 50% of the shares in Hop. In August 2003, the third party entered into an agreement with United King (1999) Ltd. ( **United King** ) for the sale of the option in consideration for the total amount of approximately \$1.8 million. The Company's share amounts to approximately \$1.7 million.

As of December 31, 2004, the Company did not recognize as income the expected gain, which amounts to \$1.1 million, net of tax effect, from the sale of the option, since the material conditions, as stipulated in the sale agreement, were not fulfilled. The Company notes that a legal proceeding in this respect is currently pending in the Tel- Aviv - Jaffa District Court.

**NOTE 16: SHAREHOLDERS EQUITY**

- a. Share capital:
1. Composition of share capital:

	December 31, 2003		December 31, 2004	
	Authorized	Issued and outstanding	Authorized	Issued and outstanding
	Number of shares			
Ordinary shares 1 NIS par value each	100,000,000	30,203,918	100,000,000	30,220,477

2. The Company's shares are traded on the Tel-Aviv Stock Exchange ( TASE ).

The Company's ADS are listed on the NASDAQ under the symbol MATV. Each ADS represents two of the Company's Ordinary shares of NIS 1 par value.

- b. Option plan for senior employees:
1. On January 30, 2001, the Company's Board of Directors approved an option plan for the Company's senior employees ( the 2001 Plan ). Under the 2001 plan, senior employees are to be allotted, without consideration, up to 864,000 options to purchase 864,000 Ordinary shares of NIS 1 par value of the company.

## NOTES TO FINANCIAL STATEMENTS

**NOTE 16: SHAREHOLDERS EQUITY (Cont.)**

Notwithstanding the above, employees who exercise options will not be allotted shares in the full amount of the options exercised, but instead the employees will be allotted shares in consideration for their par value only, in the amount which fair value reflects the element of the benefit embodied in the options as calculated at the time of exercise.

Under the plan, options become exercisable from the following dates: 1/3 of the options 12 months after the decision was taken to make the allotment; 1/3 of the options 24 months after the allotment; and, 1/3 of the options 36 months after the allotment. These options are exercisable (in whole or in part) for a period of 24 months from the end each of the above periods (the exercise period).

Options not exercised will expire after the exercise period. The exercise price of the options is NIS 49 per share, linked to the Israeli CPI for December 2000 (based on 85% of the price of the Company's Ordinary shares on the date of the decision of the Board of Directors) (NIS 52 as of December 31, 2004).

The Ordinary shares under the 2001 plan were issued in accordance with the provisions of Section 102 of the Israeli Income Tax Ordinance which stipulate, inter-alia, that the Company shall be able to claim as a tax deduction the amounts credited to senior employees as benefit in respect of sale of the shares so issued at a price in excess of the exercise price, when such benefit is considered as taxable income.

On August 28, 2001, the Company's Board of Directors approved to reprice the exercise price of the first allotted portion to NIS 39.60 (based on 90% of the price of the Company's Ordinary shares on August 15, 2001) (NIS 41 as of December 31, 2004) and the earliest date on which the first portion of the options may be exercised was postponed for three months from the original date.

As of December 31, 2004, under the 2001 Plan, 770,500 options were issued to 45 employees, out of which 608,300 options were cancelled, 90,732 options were forfeited, 37,235 options were exercised and 34,233 options expired. See also 2 below.

2. In November and December 2003, the Company's Board approved a stock option plan for 50 of the Company's employees (the 2003 Plan), according to which such employees will be granted a total of 770,500 options that are exercisable into 770,500 Ordinary shares of NIS 1 par value of the Company (including 85,000 options granted to an interested party).

Notwithstanding the above, employees who exercise options will not be allotted shares in the full amount of the options exercised, but instead the employees will be allotted shares in consideration for their par value only, in the amount which fair value reflects the element of the benefit embodied in the options as calculated at the time of exercise.

The options become exercisable from the following dates: 1/3 of the options January 31, 2004; 1/3 of the options January 31, 2005; and 1/3 of the options January 31, 2006 (the vesting period). The options are exercisable for a period of 36 months from the end of each of the above periods (the exercise period).

NOTES TO FINANCIAL STATEMENTS

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**NOTE 16: SHAREHOLDERS EQUITY (Cont.)**

Any option that is not exercised during the exercise period expires. In the first tranche, the exercise price of the options is NIS 26.816 per share (on the basis of 85% of the average price of the Company's share during 30 trading days on the Tel Aviv Stock Exchange before the date of the Board's decision - November 17, 2003). In the second and third tranches, the exercise price of the options is determined as 90% of the average price of the Company's share during 30 trading days on the Tel Aviv Stock Exchange before the end of vesting period of each of the tranches. Accordingly, the exercise price of the second tranche of the options is NIS 30.43 per share.

According to the 2003 plan, options may be issued provided that the employee waives his rights to options, which matured in the first and second tranches of the 2001 plan and that the Company's Board of Directors approved the cancellation of the third tranche of the 2001 Plan, subject to the employees' agreement (see 1 above).

The issuance of options is managed under the principles which were determined for that purpose in section 102 of the Income Tax Ordinance which stipulate, inter-alia, that the Company shall not be able to claim as a tax deduction the amounts credited to senior employees as benefit (in respect of sale of the issued shares at a price in excess of the exercise price), if that benefit is subject to capital gains tax in a reduced tax rate and will be able to claim as a tax deduction the amounts credited, as mentioned if that benefit is considered as regular taxable income.

On November 29, 2004, a special meeting of the Company's shareholders approved the grant of 302,205 additional stock options under the 2003 plan at no consideration to the chairman of the Company's board of directors. The exercise price of the options is NIS 38 per share.

As of December 31, 2004, under the 2003 plan, all 1,072,205 options were issued to 46 employees, out of which 36,483 options were exercised and 11,000 options were forfeited.

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## NOTES TO FINANCIAL STATEMENTS

## NOTE 17: TAXES ON INCOME

- a. Tax laws applicable to the companies:

The provisions of the Income Tax (Inflationary Adjustments) Law, 1985 apply to the Company and its Israeli investees. According to the law, the results for tax purposes are measured based on the changes in the Israeli CPI.

- b. Tax rates applicable to the income of the Group companies:

Until December 31, 2003, the regular tax rate applicable to income of companies was 36%. In July 2004, an amendment to the Income Tax Ordinance (No. 140 and Temporary Provision), 2004 was approved by the Knesset (Israeli parliament), which determines, among other things, that the corporate tax rate is to be gradually reduced to the following tax rates: 2004 35%, 2005 34%, 2006 32% and 2007 and thereafter 30%. The effect of the aforementioned change in tax rate on the results of operations in 2004 amounted to NIS 868 thousand.

- c. Deferred income taxes:

The composition of the deferred tax assets and liabilities, related valuation allowance and the changes therein during the reported years and the related valuation allowance as of December 31, 2004 and 2003, are as follows:

<b>Consolidated</b>					
	<b>Temporary differences related to investment in affiliate</b>	<b>Provisions for employees rights (severance pay and vacation pay) and for allowance for doubtful accounts</b>	<b>Carryforward tax losses</b>	<b>Valuation allowance</b>	<b>Total</b>
<b>Adjusted NIS in thousands</b>					
Balance at January 1, 2003		1,656	153,360	(155,016)	
Change during 2003 recorded in net loss	(15,630)	712	36,685	(37,397)	(15,630)
Balance at December 31, 2003	(15,630)	2,368	190,045	(192,413)	(15,630)
<b>Reported NIS in thousands</b>					
Balance at January 1, 2004	(15,630)	2,368	190,045	(192,413)	(15,630)
Adjustment due to tax rate change	868	(171)	(34,935)	35,106	868
Change during 2004 recorded in net loss	(9,219)	356	24,759	(25,115)	(9,219)

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Balance at December 31, 2004	(23,981)	2,553	179,869	(182,422)	(23,981)
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## NOTES TO FINANCIAL STATEMENTS

## NOTE 17: TAXES ON INCOME (Cont.)

	The Company				Total
	Temporary differences of investment in affiliate company	Provisions for employees rights (severance pay and vacation pay) and for allowance for doubtful accounts	Carryforward tax losses	Valuation allowance	
Adjusted NIS in thousands					
Balance at January 1, 2003		1,249	122,585	(123,834)	
Change during 2003 recorded in net loss	(15,630)	242	36,175	(36,417)	(15,630)
Balance at December 31, 2003	(15,630)	1,491	158,760	(160,251)	(15,630)
Reported NIS in thousands					
Balance at January 1, 2004	(15,630)	1,491	158,760	(160,251)	(15,630)
Adjustment due to tax rate change	868	(77)	(30,792)	30,869	868
Change during 2004 recorded in net loss	(9,219)	209	30,326	(30,535)	(9,219)
Balance at December 31, 2004	(23,981)	1,623	158,294	(159,917)	(23,981)

Deferred taxes are calculated using a 34% tax rate.

- d. Taxes on income included in the statements of operations:
1. Composition:

Consolidated

Year ended December 31,

	2002	2003	2004
NIS in thousands			
	Adjusted		Reported
Current	108,851	41,799	
Deferred taxes		(6,303)	
For previous years			7,281
	<u>108,851</u>	<u>35,576</u>	<u>7,281</u>

The Company			
Year ended December 31,			
	2002	2003	2004
NIS in thousands			
	Adjusted		Reported
Current	108,851	41,799	
Deferred taxes		(6,303)	
For previous years			4,516
	<u>108,851</u>	<u>35,496</u>	<u>4,516</u>

Current taxes are computed at the tax rate of 35% (previous years 36%).

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## NOTES TO FINANCIAL STATEMENTS

**NOTE 17: TAXES ON INCOME (Cont.)**

2. Below is a reconciliation between the theoretical tax expense (benefit), assuming all of the Group's income is taxed at the regular tax rates applicable to companies in Israel (see (1) above), and the actual tax expense as reported in the statements of operations.

	Consolidated		
	Year ended December 31,		
	2002	2003	2004
	NIS in thousands		
	Adjusted	Reported	
Income (loss) before taxes on income, as reported in the statement of operations	131,765	(10,781)	(90,004)
Theoretical tax rate	36%	36%	35%
Theoretical tax expenses (benefit)	47,435	(3,881)	(31,501)
Increase (decrease) in taxes resulting from:			
Non-deductible expenses	4,115	1,980	6,386
Tax losses for which deferred taxes were not provided	55,424*	36,685*	24,759
Temporary differences for which deferred taxes were not provided	(242)*	712*	356
Difference in definition of capital and assets for tax purposes	2,059		
Taxes in respect of prior years		80	7,281
	108,851	35,576	7,281
	The Company		
	Year ended December 31,		
	2002	2003	2004
	NIS in thousands		

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	Adjusted		Reported
Income (loss) before taxes on income, as reported in the statement of operations	185,248	(6,369)	(105,163)
Theoretical tax rate	36%	36%	35%
Theoretical tax expenses (benefit)	66,689	(2,293)	(36,807)
Increase (decrease) in taxes resulting from:			
Non-deductible expenses	3,639	1,372	6,272
Tax losses for which deferred taxes were not provided	38,723*)	33,805*)	23,407
Taxes in respect of equity earnings of partnership		2,370*)	6,919
Temporary differences for which deferred taxes were not provided	(200)*)	242*)	209
Taxes in respect of prior years			4,516
	108,851	35,496	4,516

\*) Reclassified.

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NOTES TO FINANCIAL STATEMENTS

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**NOTE 17: TAXES ON INCOME (Cont.)**

e. Carryforward tax losses:

At December 31, 2004 and 2003, the Group had carryforward tax losses (include capital losses) of adjusted NIS 600 million and NIS 527 million, respectively. As of December 31, 2004 and 2003, the Company had carryforward of tax losses (including capital losses) of adjusted NIS 528 million and NIS 441 million, respectively. The amounts of carryforward tax losses are linked to the Israeli CPI and can be utilized indefinitely. The amounts of carryforward tax losses is subject to adjustments depending on the results of the dispute with the tax authorities (Note 11b(1)) and the tax assessments and orders received (Note 15b(e) and 15b(f)).

f. Tax assessments:

The Company has received final assessments through 1996, and the other Group companies have received final assessments and orders through 1997.

Regarding tax assessments which were received by the Company and its subsidiaries for years 1997 - 2002 (see Note 15b(e) and 15b(f)).

## NOTES TO FINANCIAL STATEMENTS

## NOTE 18: LINKAGE TERMS OF MONETARY ITEMS

	Consolidated							
	December 31, 2003				December 31, 2004			
	In or linked to foreign currency *)	Linked to the Israeli CPI	Unlinked	Total	In or linked to foreign currency *)	Linked to the Israeli CPI	Unlinked	Total
	NIS in thousands							
	Adjusted				Reported			
<b>Assets:</b>								
Cash and cash equivalents	80		37,868	37,948	70	20,095	4,085	24,250
Short-term deposit							50	50
Trade receivables			83,151	83,151	2,060		73,398	75,458
Other accounts receivable			8,592	8,592	320		12,210	12,530
Loan, long-term debt and capital note to affiliates			13,623	13,623			25,900	25,900
Other receivables			885	885			601	601
	80		144,119	144,199	2,450	20,095	116,244	138,789
<b>Liabilities:</b>								
Short-term credit	19,005	163	370,562	389,730	20,115		416,914	437,029
Trade payables	7,331		87,368	94,699	28,362		75,920	104,282
Affiliate current accounts			17,690	17,690			18,112	18,112
Other accounts payable		83,418	54,930	138,348	27,936	94,758	52,531	175,225
Loans from banks and other (including current maturities)	25,214	147,862		173,076	2,346	125,937	1,484	129,767
Debentures (including current maturities)		99,846		99,846		67,206		67,206
Customers deposits for converters, net of accumulated amortization		25,675		25,675		20,279		20,279
	51,550	356,964	530,550	939,064	78,759	308,180	564,961	951,900

\*) Mainly in U.S. dollar.



## NOTES TO FINANCIAL STATEMENTS

## NOTE 18: LINKAGE TERMS OF MONETARY ITEMS (Cont.)

	The Company							
	December 31, 2003				December 31, 2004			
	In or linked to foreign currency**)	Linked to the Israeli CPI	Unlinked	Total	In or linked to foreign currency**)	Linked to the Israeli CPI	Unlinked	Total
	NIS in thousands							
	Adjusted				Reported			
Assets:								
Cash and cash equivalents	80		35,799	35,879	70	20,095	1,437	21,602
Trade receivables			45,400	45,400			37,398	37,398
Other accounts receivable		359,562*)	7,009	366,571*)	320	352,600	5,518	358,438
Loan, long-term debt and capital note to affiliates			13,623	13,623			25,900	25,900
Other receivables			885	885			601	601
	80	359,562*)	102,716	462,358	390	372,695	70,854	443,939
Liabilities:								
Short-term credit			349,223	349,223	1,245		395,437	396,682
Trade payables	7,331		56,286	63,617	22,490		52,427	74,917
Affiliate current accounts			15,988	15,988			18,619	18,619
Other accounts payable		43,418	81,560	124,978	26,771	92,043	38,965	157,779
Loans from banks and other (including current maturities)	25,214	147,862		173,076	2,346	125,937	1,484	129,767
Debentures (including current maturities)		101,103		101,103		68,010		68,010
Customers deposits for converters, net of accumulated amortization		18,882		18,882		14,901		14,901
Capital notes to subsidiaries			3,601*)	3,601*)			3,351*)	3,351*)
	32,545	311,265	506,658	850,468	52,852	300,891	510,283	864,026

\*) Reclassified.

\*\*) Mainly in U.S. dollar.

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## NOTES TO FINANCIAL STATEMENTS

## NOTE 19: SUPPLEMENTARY INFORMATION OF THE STATEMENTS OF OPERATIONS

## a. Other operating expenses:

	Consolidated			The Company		
	Year ended December 31,			Year ended December 31,		
	2002	2003	2004	2002	2003	2004
	NIS in thousands					
	Adjusted	Reported	Adjusted	Reported		
Payroll and related expenses	31,763	32,131	34,550	19,203	18,840	18,894
Royalties and other payments to the Government	20,631	24,242	22,879	14,450	15,925	14,659
Royalties in respect of films and programs paid to Hot Vision	61,763	53,994	51,647	44,981	38,129	37,759
Costs in respect of programs and other services provided	181,172	141,500*)	157,104	121,885	98,957	107,987
Subscribers maintenance	17,619	22,845	27,589	11,590	14,380	19,369
Other	32,493	31,453*)	33,817	17,808	20,974	24,964
	<u>345,441</u>	<u>306,165</u>	<u>327,586</u>	<u>229,917</u>	<u>207,205</u>	<u>223,632</u>

## b. Selling, marketing, general and administrative expenses:

Selling and marketing:						
Payroll and related expenses	15,832	15,539	19,121	11,191	10,446	9,631
Advertising	10,218	14,698	32,791	8,952	8,457	19,444
Sales promotion	14,593	13,717	11,764	8,981	7,975	5,913
	<u>40,643</u>	<u>43,954</u>	<u>63,676</u>	<u>29,124</u>	<u>26,878</u>	<u>34,988</u>
General and administrative:						
Payroll and related expenses	20,777	16,596	19,309	10,735	12,718	13,792
Office rent and maintenance	9,687	7,894	9,635	7,687	4,692	5,318
Professional fees	4,600	5,445*)	6,418	3,100	5,445*)	6,235
Legal fees	2,383	1,547	2,144	2,383	1,182	1,539
Amortization of intangible asset	1,420	894				
Doubtful accounts and bad debts*)	2,065	5,300	1,928	1,452	3,590	1,256

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Other	5,205	4,983*)	5,957	4,542	661*)	2,200
	<u>46,137</u>	<u>42,659</u>	<u>45,391</u>	<u>29,899</u>	<u>28,288</u>	<u>30,340</u>
	<u>86,780</u>	<u>86,613</u>	<u>109,067</u>	<u>59,023</u>	<u>55,166</u>	<u>65,328</u>

\*) The changes in allowance for doubtful accounts are composed as follows:

Balance at beginning of year	4,575	3,887	3,250	3,633	2,898	2,495
Write-off of bad debt	(2,753)	(5,937)	(1,940)	(2,187)	(3,993)	(1,205)
Increase during the year	2,065	5,300	1,928	1,452	3,590	1,256
Balance at end of year	<u>3,887</u>	<u>3,250</u>	<u>3,238</u>	<u>2,898</u>	<u>2,495</u>	<u>2,546</u>

\*) Reclassified.

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## NOTES TO FINANCIAL STATEMENTS

## NOTE 19: SUPPLEMENTARY INFORMATION OF THE STATEMENTS OF OPERATIONS (Cont.)

c. Financial expenses (income), net:

	Consolidated			The Company		
	Year ended December 31,			Year ended December 31,		
	(* 2002)	(* 2003)	2004	(* 2002)	(* 2003)	2004
	NIS in thousands					
	Adjusted	Reported		Adjusted	Reported	
In respect of debentures and long-term loans	25,032	11,214	15,068	24,092	11,214	15,068
In respect of short-term credit	10,328	51,637	22,251	10,771	49,272	20,062
Banks and credit card companies commissions	6,595	7,473	7,394	4,732	5,296	5,609
Other, net	6,134	13,634	5,620	4,530	13,605	5,222
	48,089	83,958	50,333	44,125	79,387	45,961

\*) In 2002 and 2003, includes purchasing power gain or loss in respect of monetary items.

d. Other income (expenses), net:

Gain (losses) from:						
Gain from sale of shares of affiliate	295,933	96,662		302,418	97,876	
Write-off of investment in other company	(8,962)		(16,241)	(8,830)		(16,241)
Gain (loss) from sale, net of write-off of property, plant and equipment	(44)	(9,956)*	51	(92)	(7,638)	168
Provision for claims and settlement of claims (see Note 15(b)(3))	(235)		(24,292)	(235)		(24,751)
Merger expenses related to the Cable Companies	(2,801)	(4,487)	(812)	(2,801)	(4,487)	(812)
Adjustments of amortization of deposits for converters and other	(5,356)	(4,001)		(3,434)	(2,803)	
Retroactive refund of royalties		4,151			4,151	
Other		(1,373)	(1,386)	(452)	(2,158)	(340)
	278,535	80,996	(42,680)	286,574	84,941	(41,976)



\*) Reclassified.

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## NOTES TO FINANCIAL STATEMENTS

**NOTE 20: NET EARNING (LOSS) PER SHARE**

Number of shares and income (loss) used in the calculation of income (loss) per ordinary share:

Year ended December 31,					
2002		2003		2004	
Net income		Loss		Loss	
Adjusted NIS in thousands	Weighted average amount of shares	Adjusted NIS in thousands	Weighted average amount of shares	Reported NIS in thousands	Weighted average amount of shares
33,824	28,860*)	(5,450)	29,347*)	(82,984)	29,360

\*) Subsequent to deduction of the shares held by a subsidiary.

**NOTE 21: BUSINESS SEGMENTS**

- The group companies operate in two principal business segments: cable television and Internet.
- All income and expenses are attributed directly to business segments. No material transactions among the segments were carried out.
- Since a fee mechanism for the usage of the cable infrastructures and other services and facilities by the internet segment has not been determined yet, the Company does not charge Matav Infrastructure for these services. Accordingly, the results of the internet segment do not include any expenses for this usage and services and the depreciation of the cable infrastructure is fully recorded as part of the cable television segment results. The results of the internet segment include direct expenses only.
- Segment's assets include all operating assets used in the segment and mainly consist of trade receivables and property, plant and equipment. Most of the assets can be attributed to a certain segment. The amounts of certain assets that are used by both segments, are allocated between the segments on a reasonable basis.
- The liabilities of a segment include all operating liabilities deriving from its operating activities and consist mainly of trade payables and other accounts payable. Assets and liabilities of the segment do not include income tax assets and liabilities.

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## NOTES TO FINANCIAL STATEMENTS

## NOTE 21: BUSINESS SEGMENTS (Cont.)

	Year ended December 31, 2004		
	Internet	Cable Television	Total consolidated
	Reported NIS in thousands		
Sales to external customers	65,659	518,905	584,564
Total revenues	65,659	518,905	584,564
Segments results (operating income (loss))	28,457	(25,448)	3,009
Financial expenses, net			(50,333)
Other income, net			(42,680)
Taxes on income			7,281
Income (loss) after taxes on income			(97,285)
Equity in earnings of affiliates			14,301
Loss			(82,984)
<u>Other information</u>			
Segment assets	112,863	839,401	952,264
Unallocated assets			126,618
Total consolidated assets			1,078,882
Segment liabilities	17,445	210,916	228,361
Unallocated liabilities			752,740
Total consolidated liabilities			981,101
Capital expenditure	8,165	87,263	95,428



	<u>          </u>	<u>          </u>	<u>          </u>
Depreciation and amortization	6,871	138,412	145,283
	<u>          </u>	<u>          </u>	<u>          </u>

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## NOTES TO FINANCIAL STATEMENTS

## NOTE 21: BUSINESS SEGMENTS (Cont.)

	Year ended December 31, 2003		
	Internet	Cable Television	Total consolidated
Adjusted NIS in thousands			
Sales to external customers	34,403	511,077	545,480
Total revenues	34,403	511,077	545,480
Segment results (operating (loss) income)	10,436	(18,255)	(7,819)
Financial expenses, net			(83,958)
Other income, net			80,996
Taxes on income			(35,576)
Income (loss) after taxes on income			(46,357)
Equity in earnings (losses) of affiliates			40,907
Loss			(5,450)
<u>Other information</u>			
Segment assets	78,090	940,663*	1,018,753*
Unallocated assets			123,799*
Total consolidated assets			1,142,552
Segment liabilities	15,963	184,141	200,104
Unallocated liabilities			761,700
Total consolidated liabilities			961,804
Capital expenditure	38,131	17,524	55,655

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Depreciation and amortization	<u>6,792</u>	<u>153,729</u>	<u>160,521</u>
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\*) Reclassified

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## MATAV - CABLE SYSTEMS MEDIA LTD.

## NOTES TO FINANCIAL STATEMENTS

## NOTE 21: BUSINESS SEGMENTS (Cont.)

	Year ended December 31, 2002		
	Internet	Cable Television	Total consolidated
	Adjusted NIS in thousands		
Sales to external customers	9,124	486,412	495,536
Total revenues	9,124	486,412	495,536
Segment results (operating (loss))	(7,724)	(90,957)	(98,681)
Financial expenses, net			(48,089)
Other income, net			278,535
Taxes on income			(108,851)
Income after taxes on income			22,914
Equity in earnings of affiliates			10,910
Net income			33,824
<u>Other information</u>			
Segment assets	39,297	1,042,360*)	1,081,657*)
Unallocated assets			50,969*)
Total consolidated assets			1,132,626
Segment liabilities	10,369	145,761	156,130
Unallocated liabilities			829,424
Total consolidated liabilities			985,554
Capital expenditure	36,073	80,768	116,841

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	<u>          </u>	<u>          </u>	<u>          </u>
Depreciation and amortization	5,893	156,103	161,996
	<u>          </u>	<u>          </u>	<u>          </u>

\*) Reclassified

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## NOTES TO FINANCIAL STATEMENTS

## NOTE 22: TRANSACTIONS WITH INTERESTED PARTIES

	Consolidated and the Company		
	Year ended December 31,		
	2002	2003	2004
	NIS in thousands		
	Adjusted	Reported	
a. Salaries and profit sharing grant:			
1. To unemployed directors:			
Payments	194	142	142
Number of recipients	3	3	5
2. Employed interested parties:			
Cost of salaries (1)	1,251	1,116	2,481
Number of recipients	1	1	2
b. Expenses:			
Rental and services to shareholders affiliate	286	244	255
Payment to supplier (infrastructure and maintenance)	15,127	13,936	10,095
Operating commissions	2,902		
Professional services	295	2,728	87

(1) For the year ended December 31, 2004, includes an amount of NIS 1,300 thousand in respect of a termination charge.

NOTES TO FINANCIAL STATEMENTS

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**NOTE 23: FINANCIAL INSTRUMENTS AND RISK MANAGEMENT**

a. Foreign exchange risk management:

The Company enters into foreign exchange contracts to hedge itself against the risk of the possible fluctuation of the change in the dollar/NIS exchange rate, attributable to future dollar cash outflows.

As of December 31, 2004, the Company had call options to buy \$24 million in consideration for NIS 108 million. The options, which are due to expire on December 12, 2005, are presented in the financial statements at market value (see c below). As of December 31, 2003, the Company had call options to buy \$24 million and put options to sell \$24 million in consideration for NIS amounts.

Those hedges were not designated as hedge transactions for accounting purposes; hence all changes in fair value were recorded in 2004, 2003 and 2002 as financial expenses in the amount of NIS 3,800 thousand, NIS 11,218 thousand and NIS 365 thousand, respectively.

b. Concentrations of credit risks:

At December 31, 2004 and 2003, the Group held cash and cash equivalents which were deposited mainly with Israeli banks. The Group is of the opinion that the credit risk in respect of these balances is remote.

The Group's revenues are derived from a large number of customers in the licensed areas. Consequently, the exposure to concentration of credit risk relating to trade receivables is limited. The Group performs ongoing credit evaluations of its customers for the purpose of determining the appropriate allowance for doubtful accounts.

c. Fair value of financial instruments:

The fair value of the financial instruments included in working capital of the Group and of loans from banks is usually equal to or approximates their carrying value.

The fair value of debentures as of December 31, 2004 and 2003 amounted to adjusted NIS 67 million and adjusted NIS 99 million, respectively, which represents the market value of the debentures on the TASE.

The fair value of the derivatives mentioned in a. above as of December 31, 2004 is a net asset of adjusted NIS 320 thousand.

As to the fair value of the investment in Partner see Note 5(b)2.

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## NOTES TO FINANCIAL STATEMENTS

**NOTE 24: SUBSEQUENT EVENTS**

- a. On April 20, 2005, the Company exercised its option to participate in the share buyback of Partner Communications Company Ltd. ( **Partner** ), together with Elbit Ltd., Eurocom Communications Limited and Polar Communications Limited. At the closing of the transaction, the Company sold to Partner 7,783,444 ordinary shares of Partner for a total consideration of approximately NIS 250 million. The above mentioned transaction was subsequent to the removal of the pledge on Partner shares as described in Note 15(c)2. The Company expects to recognize on this sale in its financial statements prepared under Israeli GAAP a capital gain (net of tax effect) of approximately NIS 115 million. Subsequent to the above sale, the Company holds 1,884,926 Ordinary shares of Partner (constituting approximately 1.2% of the share capital of Partner), almost all of which are still subject to transfer restrictions under Partner's communications license (see Note 5b(2)(b)).

As a result of a decrease in the interest held in Partner, effective as of April 2005, the investment in Partner shall be accounted for in the Company's financial statements, in accordance with generally accepted accounting principles in Israel, under the cost method.

- b. The Controller approved the merger between Bezeq - Israeli Telecommunications Corporation Ltd. ( **Bezeq** ) and Yes subject to various conditions. Such merger shall increase Bezeq's holdings in Yes in excess of 50%. The Cable Companies, including the Company, filed an appeal on the Controller's decision on March 14, 2005.
- c. On May 26, 2005, the Company announced that it is delaying the implementation of its previously announced plan, as mentioned in Note 1(a)11, to terminate its SEC registration, NASDAQ listing and its American Depository Receipt (ADR) program.

The board of directors of the Company will re-examine the timing of such termination in the next few months.

- d. On June 15, 2005, Barak, Clalcom Ltd (which holds approximately 44% of the share capital of Barak and which is a subsidiary of Clal Industries and Investments Ltd.), Clal Industries and Investments Ltd. (together: **Clal** ), Dial-the Israeli Company for International Communications Ltd. ( **Dial** ), and Matav entered into a Non-Binding Term Sheet in order to set out the terms for a proposed restructuring of Barak's capital and debt (the **Term-Sheet** ), subject, inter alia, to the entry of Barak, certain holders of Senior Subordinated Discount Notes due 2007 of Barak (the **Existing Notes** ) (the **Note Holders** ), Clal and the current shareholders of Barak, into a definitive Restructuring Agreement. The Restructuring Agreement shall be effected through, amongst other, a plan under Section 350 of the Companies Law (the **Plan** ).

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NOTES TO FINANCIAL STATEMENTS

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**NOTE 24: SUBSEQUENT EVENTS (Con.)**

Pursuant to the Plan, Barak shall pay the Note Holders, upon the Plan becoming effective (the Closing ) a cash sum (the Cash Payment ) of US\$32.35 million in exchange for the full and final compromise of: (a) US\$57.4 million of the principal face value of the Existing Notes; (b) default interest on the interest coupon due on the outstanding Existing Notes on November 15, 2004 (the November Coupon ), but excluding the November Coupon itself; and (c) all interest accrued on the outstanding Existing Notes including the interest coupon due on the outstanding Existing Notes on May 15, 2005 and all default interest thereon, but excluding (i) the November Coupon, and (ii) the interest due on the Residual Notes accruing from March 1, 2005 (The Debt Compromise ).

Following the Debt Compromise, the principal amount of the Existing Notes shall be reduced to US\$65 million (the Residual Notes ). The Residual Notes shall bear interest at the rate of 10% per annum, accruing from March 1, 2005.

In addition, within 3 business days of the date of the Restructuring Agreement, Barak shall pay to the Note holders, US\$7.65 million (being the November Coupon) out of its cash funds. The payment of the November Coupon shall be in addition to the payment of the Cash Payment.

The Cash Payment shall be funded by Clal in exchange for ordinary shares that will be issued to Clal by Barak, on terms to be agreed between Clal, Barak and the other current shareholders of Barak and subject to the prior approval by the Note Holders. Following Closing, Clal will own at least 95% of the share capital of Barak, subject to any participation by the current shareholders of Barak in the funding of the Cash Payment.

The Restructuring Agreement is subject to certain conditions and approvals which have not yet been met or received.

The company is entitled, no later than June 30, 2006, to participate in the funding of the Cash Payment, in the amount of US\$6 million in accordance with its proportional holdings in Barak at that time. In the event that the company shall elect to participate in the funding of the Cash Payment, its holdings in Barak shall be increased to approximately 18.5%. If the Company shall elect not to participate in the funding of the Cash Payment, its holdings in Barak shall be reduced to approximately 1.39%.

In connection with the Company's participation right, as described above, the company entered into an agreement with Clal according to which upon its decision to participate in the cash payment together with Clal, the company will be entitled to appoint one board member out of a total five board members in Barak and will be granted, among other preemptive rights, a Put option to sell all of its shares in Barak to Clal at certain conditions as detailed in the agreement. In addition, it has been agreed by the parties that Clal will be granted, among certain rights as defined in the agreement, a Call option at certain conditions as agreed upon, to purchase all of the company's shares in Barak. According to the agreement the company had to inform Clal on its participation no later than June 30, 2005.

During June 28, 2005 the Company's Board of Directors approved the Company's participation in the funding of the Cash Payment, as described above..

NOTES TO FINANCIAL STATEMENTS

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**NOTE 24: SUBSEQUENT EVENTS (Con.)**

## e. Contingent liabilities:

1. Further to Note 5b(4) above, during a preliminary hearing of the amended petition against Hot Telecom, submitted by Bezeq, which was held on April 14, 2005, and in accordance with the Court's recommendation, Bezek withdrew the petition.
2. Further to Note 15b(2)(c), in April 11, 2005 the Israeli Records and Cassettes Federation (the **Federation**) filed in the District Court of Haifa a claim against the Company and the other Cable Companies as well as a request for payment of temporary royalties. The Federation seeks to represent the Israeli record companies as well as foreign record companies that impressed musical compositions on records and compact disks, which the Cable Companies broadcast.

The Federation noted that it reserves the right to request a preliminary injunction. The Federation further noted its consent that the Court shall render a judgment in way of granting the operative legal ruling without furnishing any reasoning. In addition the Federation informed the Court of its consent to arbitration proceedings. The Court is further requested to instruct the Cable Companies to pay the Federation interim royalties until a judgment is rendered. The Federation presented two main models in respect of the calculation of the royalties as follows: (a) payment in the amount of 0.26% - 0.3% of the income of the Cable Companies (plus VAT); (b) payment of yearly royalties in a fixed sum per subscriber (plus VAT).

The Federation requested the Court to oblige the Cable Companies to pay permanent royalties in the sum of \$2 per each subscriber that does not receive the audio channels or \$5 per each subscriber that receives the audio channels.

The Cable Companies submitted the response to the request for payment of temporary royalties and the statements of defense on June 6, 2005.

In the response, the Cable Companies claimed, inter alia, that the request made by the Federation for the payment of temporary royalties was not timely and was not submitted in good faith. In addition the Cable Companies claimed that the amount of the request was extremely unreasonable and it should be an amount of up to US\$200,000, which is the contractual amount that has already been paid to the Federation. The date of the hearing was set on July 6, 2005.

According to the opinion of the Company's management, based on the opinion of its legal counsels, it is not possible, at this stage, to estimate the chances of the claim. Nevertheless, the Company's management included in the financial statements a provision, which in its opinion reflects adequately the Company's exposure in respect of this claim.

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## NOTES TO FINANCIAL STATEMENTS

**NOTE 24: SUBSEQUENT EVENTS (Con.)**

3. The class action described in Note 15b(1)(d):  
On May 15, 2005, the Tel Aviv-Jaffa district court approved the request filed by the parties and rendered a judgment according to which the claim was stricken.
4. Further to Note 15(b)2(f) above, during June 2005 Matav Investments signed an agreement with the tax authorities regarding the tax assessments for the years 1998-2001. The agreement does not have an effect on the financial statements.

**NOTE 25: CONDENSED FINANCIAL DATA IN NOMINAL HISTORICAL VALUES FOR TAX PURPOSES**

- a. The Company provides nominal historical data for income tax purposes only.
- b. The financial statements have been prepared in accordance with generally accepted accounting principles in Israel, based on the historical cost convention, without taking into consideration the changes in the general purchasing power of the Israeli currency.
- c. Balance sheets the Company:

	December 31,	
	2003	2004
	NIS in thousands	
<b>ASSETS</b>		
<b>CURRENT ASSETS:</b>		
Cash and cash equivalents	35,879	21,602
Trade receivables	45,400	37,398
Other accounts receivable	19,431	15,321
	100,710	73,321
<b>INVESTMENTS AND LONG-TERM RECEIVABLES:</b>		
Investments in subsidiaries and long-term accounts	227,483	239,974
Investments in affiliates	72,365	111,072
Investment in non-marketable equity securities	16,536	
Other receivables	885	601
	317,269	351,647
<b>PROPERTY, PLANT AND EQUIPMENT:</b>		
Cost	1,090,654	1,134,888
Less accumulated depreciation	536,694	620,800

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	<u>553,960</u>	<u>514,088</u>
INTANGIBLE ASSETS AND DEFERRED CHARGES, NET	1,134	525
	<u>973,073</u>	<u>940,581</u>

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## NOTES TO FINANCIAL STATEMENTS

## NOTE 25: CONDENSED FINANCIAL DATA IN NOMINAL HISTORICAL VALUES FOR TAX PURPOSES (Cont.)

	December 31,	
	2003	2004
	NIS in thousands	
<b>LIABILITIES AND SHAREHOLDERS EQUITY</b>		
<b>CURRENT LIABILITIES:</b>		
Bank credit	394,896	424,992
Current maturities of debentures	33,701	34,005
Trade payables	63,617	74,917
Jointly controlled entity current account	15,988	18,619
Other accounts payable	139,027	183,167
	<u>647,229</u>	<u>735,700</u>
<b>LONG-TERM LIABILITIES:</b>		
Loans and debentures (net of current maturities):		
Loans from bank and others	127,403	101,457
Debentures	67,402	34,005
Losses over investments in subsidiaries	12,393	16,759
Customers deposits for converters, net of accumulated amortization	18,882	14,901
Accrued severance pay, net	704	1,023
	<u>226,784</u>	<u>168,145</u>
<b>SHAREHOLDERS EQUITY:</b>		
Share capital	30,204	30,220
Additional paid-in capital	295,439	295,439
Accumulated deficit	(226,583)	(288,923)
	<u>99,060</u>	<u>36,736</u>
	<u>973,073</u>	<u>940,581</u>

## NOTES TO FINANCIAL STATEMENTS

**NOTE 25: CONDENSED FINANCIAL DATA IN NOMINAL HISTORICAL VALUES FOR TAX PURPOSES (Cont.)**

d. Statements of operations the Company:

	Year ended December 31,		
	2002	2003	2004
	NIS in thousands		
Revenues	346,094	372,202	370,275
Operating expenses	323,537	304,573	312,627
Gross profit	22,557	67,629	57,648
Selling, marketing, general and administrative expenses:			
Selling and marketing	29,159	27,236	34,988
General and administrative	29,934	28,664	30,340
	59,093	55,900	65,328
Operating income (loss)	(36,536)	11,729	(7,680)
Financial expenses, net	(70,832)	(71,181)	(40,787)
Other income (expenses), net	285,130	88,516	(42,201)
Income (loss) before taxes on income	177,762	29,064	(90,668)
Taxes on income	110,720	36,530	4,516
Income (loss) after taxes on income	67,042	(7,466)	(95,184)
Equity in earnings (losses) of affiliates and subsidiaries, net	(61,228)	62,734	32,844
Net income (loss) for the year	5,814	55,268	(62,340)

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## NOTES TO FINANCIAL STATEMENTS

## NOTE 25: CONDENSED FINANCIAL DATA IN NOMINAL HISTORICAL VALUES FOR TAX PURPOSES (Cont.)

e. Statements of changes in shareholders' equity

	Share capital	Additional paid-in capital	Retained earnings (accumulated deficit)	Cost of Company shares held by subsidiary	Total
NIS in thousands					
Balance at January 1, 2002	30,204	318,727	(287,665)	(63,603)	(2,337)
Net income for the year			5,814		5,814
Sale of Company shares held by subsidiary		(377)		1,309	932
Balance at December 31, 2002	30,204	318,350	(281,851)	(62,294)	4,409
Net income for the year			55,268		55,268
Sale of Company shares held by subsidiary		(22,911)		62,294	39,383
Balance at December 31, 2003	30,204	295,439	(226,583)		99,060
Net loss for the year			(62,340)		(62,340)
Exercise of stock options by employees	16				16
Balance at December 31, 2004	30,220	295,439	(288,923)		36,736

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NOTES TO FINANCIAL STATEMENTS

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**NOTE 26: EFFECT ON THE FINANCIAL STATEMENTS OF MATERIAL DIFFERENCES BETWEEN ISRAELI AND UNITED STATES GENERALLY ACCEPTED ACCOUNTING PRINCIPLES**

The financial statements are prepared in accordance with generally accepted accounting principles in Israel ( Israeli GAAP ). Israeli GAAP vary in certain respects from generally accepted accounting principles in the U.S. ( U.S. GAAP ), as described below:

## a. Effect of inflation:

As described in Note 2b, the Company, in accordance with the Israeli GAAP, comprehensively included the effects of price level changes in the accompanying financial statement until December 31, 2003, when the adjustment of financial statements for the effects of inflation in Israel was discontinued. Such Israeli accounting principles measured the effects of the price level changes in the inflationary Israeli economy and, as such, this is considered a more meaningful presentation than financial reporting based on historical cost for Israeli and U.S. accounting purposes. As explained in Note 2b above, the amounts adjusted for the effects of inflation in Israel, presented in the financial statements as of December 31, 2003 (thereafter the transition date ), were used as the opening balances for the nominal financial reporting in the following periods. As a result, amounts reported in 2004 for non-monetary items that originated before the transition date are based on their adjusted December 2003 shekel balance. U.S. GAAP does not generally provide for the adjustment of financial statements for the impact of inflation for entities which do not operate in an hyperinflationary economy. As permitted by the United States Securities and Exchange Commission rules for foreign private issuers whose financial statements comprehensively include the effects of inflation, price level adjustments have not been reversed in the accompanying reconciliation of Israeli GAAP to U.S. GAAP.

## b. Proportionate consolidation:

Under Israeli GAAP, a jointly controlled entity is included in the Company s consolidated financial statements according to the proportionate consolidation method.

Under U.S. GAAP, investments in jointly controlled entities are accounted for by the equity method. Pursuant to the Securities and Exchange Commission requirements applicable to foreign private issuers, the Company is not required to disclose the differences in classification that result from using proportionate consolidation provided all of equity holders contractually participate in the operations of the joint venture. For the Company s share in assets, liabilities, revenues, expenses and cash flows of the jointly controlled entity consolidated by the proportionate consolidation method, see Note 5(d).

## c. Investment in Partner:

Under US GAAP, the investment in Partner s shares is accounted for as an investment in available-for-sale marketable securities pursuant to Statement of Accounting Standard No. 115, Accounting for Certain Investments in Debt and Equity Securities ( SFAS 115 ).

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NOTES TO FINANCIAL STATEMENTS

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**NOTE 26: EFFECT ON THE FINANCIAL STATEMENTS OF MATERIAL DIFFERENCES BETWEEN ISRAELI AND UNITED STATES GENERALLY ACCEPTED ACCOUNTING PRINCIPLES (Cont.)**

Accordingly, the securities are measured at fair value, with unrealized gains and losses reported net-of-tax in accumulated other comprehensive income, a separate component of shareholders' equity. Realized gains on the sale of Partner shares are included in the consolidated statement of operations. When computing realized gain or loss, cost, determined on an average basis, is based upon the carrying amount of the investment in Partner's shares, at the date on which the company ceased to account for such investment under the equity method under U.S. GAAP (April 2002), due to realization of a significant part of the investment in Partner shares and as a result loss of the ability to exercise significant influence over Partner. At that date, the carrying amount of the investment in Partner was nil.

Under Israeli GAAP, the investment in Partner's shares is accounted for under the equity method, since the Company is considered to have the ability to exercise significant influence over the financial and operating policies of Partner.

In 2002, the Company realized 7.7% of Partner's outstanding shares. Due to the difference between the carrying amount of the investment in Partner under Israeli GAAP to such amount under U.S. GAAP, the gain realized under U.S. GAAP (net of taxes) amounted to NIS 305,860 thousand, and exceeded the realized gain under Israeli GAAP by NIS 9,155 thousand (net of taxes).

On November 3, 2003, the Company realized an additional 2.15% of Partner's issued and outstanding share capital in consideration for adjusted NIS 114.4 million. As a result, the Company recognized a gain under U.S. GAAP of approximately adjusted NIS 73.2 million, net of taxes on income, which exceeded the gain, net of taxes, recognized under Israeli GAAP by adjusted NIS 10.9 million.

During the years 2004, 2003 and 2002, the Company recorded under US GAAP as other comprehensive income unrealized gains, net of tax of approximately NIS 16.9 million, adjusted NIS 143.2 million and adjusted NIS 150.4 million, respectively. As of December 31, 2004 and December 31, 2003, the accumulated other comprehensive income totaled approximately NIS 237.2 million and adjusted NIS 220.3 million, respectively.

The Company recorded under Israeli GAAP equity earnings, net of tax effect, in respect of the investment in Partner in the amount of NIS 17,610 thousand, NIS 42,270 thousand and NIS 14,181 thousand in 2004, 2003 and 2002, respectively. These equity earnings were cancelled under U.S. GAAP.

As described in Note 24a, subsequent to balance sheet date, the Company sold 7,783,444 of Partner shares. As a result, the Company expects to record in 2005 under U.S. GAAP in its statement of operations a realized gain of approximately NIS 164.3 million, net of taxes.

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## NOTES TO FINANCIAL STATEMENTS

**NOTE 26: EFFECT ON THE FINANCIAL STATEMENTS OF MATERIAL DIFFERENCES BETWEEN ISRAELI AND UNITED STATES GENERALLY ACCEPTED ACCOUNTING PRINCIPLES (Cont.)**

## d. Effect of change in tax rate:

As described in Note 17(b) in June 2004, an amendment to the Income Tax Ordinance was approved by the Israeli parliament which determined, among others, that the corporate tax rate is to be gradually reduced to 30% in 2007, beginning in 2004. According to U.S. GAAP, the effect of tax rate changes is reflected as a component of tax expense from continuing operations. Thus, the effect of the tax rate change on the deferred taxes relating to Partner shares, which were initially charged to other comprehensive income, was recognized as an adjustment to income tax expense and amounted to a tax benefit of NIS 6.1 million.

## e. Compensation expense in respect of employee stock options (see also Note 16b):

Under Israeli GAAP, no compensation expenses are recorded in respect of employee stock options.

Under U.S. GAAP as permitted by Statement of Financial Accounting Standards ( FAS ) No. 123 of the Financial Accounting Standards Board of the United States ( FASB ), Accounting for Stock-Based Compensation , the Company accounts for its employee stock option plans using the provisions prescribed by Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees ( APB 25 ). According to APB 25, compensation expense is measured under the intrinsic value method, whereby compensation expense is equal to the excess, if any, of the quoted market price of the stock over the exercise price at the grant date of the award or if applicable at a subsequent measurement date. Compensation cost is recorded over the vesting period. The Company's plans are considered to be variable plans and accordingly compensation expense is measured as the intrinsic value of the options at the end of each reporting period. The data for each employee stock option plan is as follows:

## 1.

The 2001 plan:

As of December 31, 2004, all options under this plan were cancelled, exercised or expired.

Since the exercise price of the options was higher than the fair value of the shares as of December 31, 2003 and 2002 no compensation expenses were charged to income under U.S. GAAP.

The fair value of each option at the date of grant and at the date of the repricing, computed by the Black-Scholes formula, was NIS 6.6 (as for the first tranche) and NIS 7.5 (as for the second and third tranches). The assumptions used in this calculation were: dividend yield of 0%, expected volatility at the date of grant and at the date of the repricing of 46.11% and 49.83%, respectively, risk-free U.S. dollar interest rate of 6.5% and expected average life of 1 year.

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NOTES TO FINANCIAL STATEMENTS

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**NOTE 26: EFFECT ON THE FINANCIAL STATEMENTS OF MATERIAL DIFFERENCES BETWEEN ISRAELI AND UNITED STATES GENERALLY ACCEPTED ACCOUNTING PRINCIPLES (Cont.)**

2. The 2003 plan:

- a. The difference between the fair value of the shares as of December 31, 2004 (NIS 33.2; \$ 7.7) and the exercise price of such options (adjusted NIS 26.816; \$ 6.12 for the first allotted portion, adjusted NIS 30.43; \$ 7.25 for the second allotted portion and NIS 29.9; \$ 6.9 for the third allotted portions\*) is recognized as compensation expense over the vesting period (December 29, 2003 to January 30, 2006). Expenses are recorded against additional paid-in capital.

The fair value of each option at the date of grant, computed by the Black-Scholes formula, was adjusted NIS 13.096-14.474. The assumptions used in this calculation were: dividend yield of 0%, risk-free U.S. dollar interest rate of 4%, expected average life of 3.08-5.08 years and volatility at date of grant of 33.89%.

- b. As for the options which were granted on November 29, 2004:

As of December 31, 2004, the fair value of the shares (NIS 33.2; \$ 7.7) is below the exercise price of such options (NIS 38) and, therefore, no compensation expenses have yet been recorded.

The fair value of each option at the date of grant, computed by the Black-Scholes formula, was NIS 10.77. The assumptions used in this calculation were: dividend yield of 0%, risk-free U.S. dollar interest rate of 3.5%, expected average life of 3 years and volatility at date of grant of 43.12%.

- \*) The exercise prices for the third allotted portions were calculated based on 90% of the share price as of December 31, 2004. See also Note 16b(2).

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## NOTES TO FINANCIAL STATEMENTS

**NOTE 26: EFFECT ON THE FINANCIAL STATEMENTS OF MATERIAL DIFFERENCES BETWEEN ISRAELI AND UNITED STATES GENERALLY ACCEPTED ACCOUNTING PRINCIPLES (Cont.)**

A summary of the Company's share option activity under the plans is as follows:

	Year ended December 31,					
	2002		2003		2004	
	Amount of options	Weighted average exercise price (NIS)	Amount of options	Weighted average exercise price (NIS (1))	Amount of options	Weighted average exercise price (NIS (1))
Outstanding beginning of the year	812,000	47.46	711,000	48.87	841,468	31.28
Granted			770,000	30.09	302,205	38.00
Exercised					(73,718)	39.54
Canceled or expired			(608,300)	49.26	(34,233)	52.00
Forfeited	(101,000)	37.57	(31,232)	52.00	(11,000)	30.17
Outstanding end of the year	711,000	48.87	841,468	31.28	1,024,722	32.30
Options exercisable at the end of the year	206,333	41.20	71,468	44.11	228,578	27.23

- 1) Average exercise price of the third allotted portion of the 2003 plan was calculated based on the assumption that the exercise price of the third allotted portion is 90% of the share price, as of December 31, 2004. As of December 31, 2003, the average exercise price for the second and third allotted portions of the 2003 plan were calculated based on the assumption that the exercise price of the second and third allotted portions are 90% of the share price as of December 31, 2003.

The options as of December 31, 2004 have been separated into ranges of exercise price, as follows:

Exercise price (NIS)	Options outstanding as of December 31, 2004	Weighted average remaining contractual life (Years)	Weighted average exercise price (NIS)	Options exercisable at December 31, 2004	Weighted average exercise price of exercisable options (NIS)
26.82 - 30.43	722,517	3.08	30.22	220,184	26.82
38.00	302,205	unlimited*)	38.00	8,394	38.00

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1,024,722	3.03	32.51	228,578	27.23
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\*) As long as employment is not terminated. In case of employment termination, the options expire within the timeframe set forth in the option agreement.

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## NOTES TO FINANCIAL STATEMENTS

**NOTE 26: EFFECT ON THE FINANCIAL STATEMENTS OF MATERIAL DIFFERENCES BETWEEN ISRAELI AND UNITED STATES GENERALLY ACCEPTED ACCOUNTING PRINCIPLES (Cont.)**

The weighted average values of options granted during the years ended December 31, 2002, 2003 and 2004 were:

	For exercise price on the grant date that:					
	Exceeds market price			Less than market price		
	Year ended December 31,			Year ended December 31,		
	2002	2003	2004	2002	2003	2004
Weighted average exercise prices			38.00			30.09
Weighted average fair value on grant date			10.77			13.88

Had compensation cost for the Company's plan been determined based on the fair value at the measurement date for the above awards consistent with the method of FAS 123, the Company's net income (loss) and earnings (loss) per ordinary share and per ADS would have been reduced to the pro forma amounts indicated below:

	Year ended December 31,		
	2002	2003	2004
	NIS in thousands		
Net income (loss), as reported	27,451	(38,093)	(98,434)
Add: Stock-based employee compensation expense included in reported net income (loss)	65	197	2,491
Deduct: Total stock-based employee compensation expense determined under the fair value based method for all awards	2,896	982	7,254
Pro forma net income (loss)	24,620	(38,878)	(103,197)
Earnings (loss) per Ordinary share:			
Basic and diluted as reported	0.95	(1.30)	(3.26)

	_____	_____	_____
Basic and diluted pro forma	0.85	(1.32)	(3.43)
	_____	_____	_____
Earnings (loss) per ADS:			
Basic and diluted as reported	1.90	(2.60)	(6.52)
	_____	_____	_____
Basic and diluted pro forma	1.70	(2.64)	(6.86)
	_____	_____	_____

For pro forma purposes, options issued in the 2003 plan in exchange for options from the 2001 plan were accounted for as a modification of options whereby the additional value resulting from the modification on the date of exchange is recorded as compensation expense.

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NOTES TO FINANCIAL STATEMENTS

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**NOTE 26: EFFECT ON THE FINANCIAL STATEMENTS OF MATERIAL DIFFERENCES BETWEEN ISRAELI AND UNITED STATES GENERALLY ACCEPTED ACCOUNTING PRINCIPLES (Cont.)**

f. Debentures issued with detachable warrants:

Under U.S. GAAP, the proceeds derived from issuance of debentures and detachable warrants in a public offering, were allocated between the securities based on their relative fair value. The aforementioned allocation resulted in a discount on the debentures, which is amortized over the debenture's contractual life under the effective interest method.

Under Israeli GAAP, all the proceeds were attributed to the debentures, as the warrants were issued in accordance with the prospectus for no consideration.

g. Accrued severance pay:

According to U.S. GAAP, accrued severance pay and related funded amounts are presented in the balance sheet separately as a liability and asset, respectively. Income from earnings on amounts funded is added to severance pay funds.

According to Israeli GAAP, accrued severance pay is included in the balance sheet net of any related funded amounts, including the income from earnings on amounts funded.

See Note 12 for the presentation in the Company's balance sheet prepared under Israeli GAAP.

h. Company shares held by subsidiary (treasury stock):

Under Israeli GAAP, the losses incurred during 2003 from sale of treasury stock, in the amount of adjusted NIS 25,791 thousand, were charged to additional paid in capital.

Under U.S. GAAP, such losses should be charged to additional paid in capital to the extent that previous net gains from sales of treasury stock were included therein, otherwise it should be charged to retained earnings. Since there were no gains from previous sales of such stock the aforementioned losses were charged to accumulated deficit.

i. Comprehensive income:

Under U.S. GAAP, it is required to present a statement of comprehensive income. Comprehensive income consists of net income and other gains affecting shareholders equity that under generally accepted accounting principles are excluded from the net income. For the Company, such items consist of unrealized gains on available for sale securities (see also paragraph c. above).

Under Israeli GAAP, no such statement is recognized.

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## NOTES TO FINANCIAL STATEMENTS

**NOTE 26: EFFECT ON THE FINANCIAL STATEMENTS OF MATERIAL DIFFERENCES BETWEEN ISRAELI AND UNITED STATES GENERALLY ACCEPTED ACCOUNTING PRINCIPLES (Cont.)**

## j. Classification of certain expenses and income:

1. Under Israeli GAAP, losses in respect of legal claims in the amount of NIS 24,292 thousand and adjusted NIS 235 thousand incurred in 2004 and 2002, respectively, are included as other expenses. Under U.S. GAAP, such expenses should be included among operating expenses.
2. Under Israeli GAAP adjustments of amortization of deposits for converters in the amount of adjusted NIS 4,001 thousand and adjusted NIS 5,356 thousand in 2003 and 2002, respectively, are included as other expenses. Under U.S. GAAP such expenses should be deducted from revenues.
3. Under Israeli GAAP, income from retroactive refund of royalties in the amount of adjusted NIS 4,151 thousand, recorded in 2003, is included as other income. Under U.S. GAAP, such income should be included among operating expenses.
4. Under Israeli GAAP, the gain (loss) on sales and write-off of property, plant and equipment in the amount of NIS 51 thousand, adjusted NIS (9,956) thousand and adjusted NIS (44) thousand, recorded in 2004, 2003 and 2002, respectively, are included as other expenses and income. Under U.S. GAAP, such expenses and income should be included within operating expenses.
5. Under Israeli GAAP, merger expenses related to the cable companies and other expenses in the amount of NIS 2,198 thousand, adjusted NIS 4,576 thousand and adjusted NIS 2,801, recorded in 2004, 2003 and 2002, respectively are included as other expenses. Under U.S. GAAP, such expenses should be included within operating expenses.
6. Under Israeli GAAP, the write-off of receivables related to payments made to government authorities in previous years in the amount of adjusted NIS 1,284 thousand, recorded in 2003, is included within other expenses. Under U.S. GAAP, such write-off should be included within operating expenses.

## k. Long term liabilities to banks in respect of borrowed debt securities

Under Israeli GAAP debt to banks that represents borrowing of debt securities (i.e. short sale of debt securities), for which the Company has an intent and it is probable that the Company will repay only at maturity of these debt securities, is accreted to the redemption value based on the effective interest method.

Under U.S GAAP such liabilities are recorded at fair value with changes in fair value recorded in earnings.



NOTES TO FINANCIAL STATEMENTS

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**NOTE 26: EFFECT ON THE FINANCIAL STATEMENTS OF MATERIAL DIFFERENCES BETWEEN ISRAELI AND UNITED STATES GENERALLY ACCEPTED ACCOUNTING PRINCIPLES (Cont.)**

1. Impairment of long-lived assets:

On January 1, 2003, the Company adopted Accounting Standard No. 15, Impairment of Assets . According to this Standard, if the carrying amount of an asset exceeds its recoverable amount, an impairment loss should be recognized for the amount by which the carrying amount of the asset exceeds its recoverable amount. Recoverable amount is defined as the higher of an asset 's selling price and its value in use. Value in use is the present value of estimated future cash flows expected to arise from the continuing use of an asset and from its disposal at the end of its useful life.

According to U.S. GAAP (SFAS 144 - Accounting for the Impairment or Disposal of Long-Lived Assets ) an impairment loss is recognized only if the carrying amount of an asset is not recoverable. The carrying amount is not recoverable if it exceeds the estimated undiscounted future cash flows expected to result from the use of the asset. If the carrying amount is not recoverable, an impairment loss should be recorded for the amount by which the carrying value of the asset exceeds its fair value.

Under Israeli GAAP an impairment loss previously recognized should be reversed when there has been a change in the estimates used to determine the asset 's recoverable amount since the impairment was recognized.

Under U.S. GAAP restoration of a previously recognized impairment loss is prohibited. The adjusted carrying amount of the asset impaired is its new cost basis.

The abovementioned difference between Israeli GAAP and U.S. GAAP did not have an effect on the Company 's financial statements.

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## NOTES TO FINANCIAL STATEMENTS

**NOTE 26: EFFECT ON THE FINANCIAL STATEMENTS OF MATERIAL DIFFERENCES BETWEEN ISRAELI AND UNITED STATES GENERALLY ACCEPTED ACCOUNTING PRINCIPLES (Cont.)**

m. The effects on the financial statements of the abovementioned differences between U.S. GAAP and Israeli GAAP are as follows:

1. Consolidated balance sheets:

	December 31,						Convenience translation  December 31, 2004  U.S. dollars in thousands
	2003			2004			
	As reported under Israeli GAAP	Effect of U.S. GAAP	Under U.S. GAAP	As reported under Israeli GAAP	Effect of U.S. GAAP	Under U.S. GAAP	
	Adjusted			Reported			
NIS in thousands							
Investment in affiliates (1)	66,807	(65,373)	1,434	101,736	(91,334)	10,402	2,415
Investment in available-for-sale marketable securities (1)		331,928	331,928		357,897	357,897	83,077
Severance pay fund (2)		16,126	16,126		17,911	17,911	4,158
Deferred taxes (3)	(15,630)	(95,960)	(111,590)	(23,981)	(90,637)	(114,618)	(26,605)
Accrued severance pay (2)	(2,106)	(16,126)	(18,232)	(2,483)	(17,911)	(20,394)	(4,734)
Long term loans from banks (4)				(101,457)	(741)	(102,198)	(23,723)
Debentures (including current maturities) (5)	(99,846)	1,258	(98,588)	(67,206)	583	(66,623)	(15,465)
Shareholders' equity:							
Additional paid-in capital (6)	(375,538)	(98,703)	(474,241)	(375,538)	(101,194)	(476,732)	(110,662)

One party controls a large block of our shares.

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Accumulated deficit (7)	243,672	147,188	390,860	326,656	162,638	489,294	113,578
Accumulated other comprehensive income (8)		(220,338)	(220,338)		(237,212)	(237,212)	(55,063)

- (1) Effect of differences described in c. above.
- (2) Effect of differences described in g. above.
- (3) Effect of differences described in c and d. above.
- (4) Effect of differences described in k. above.
- (5) Effect of differences described in f. above.
- (6) Effect of differences described in e, f and h. above.
- (7) Effect of differences described in c., d., e., f., h. and k. above.
- (8) Effect of differences described in c. and i. above.

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## NOTES TO FINANCIAL STATEMENTS

**NOTE 26: EFFECT ON THE FINANCIAL STATEMENTS OF MATERIAL DIFFERENCES BETWEEN ISRAELI AND UNITED STATES GENERALLY ACCEPTED ACCOUNTING PRINCIPLES (Cont.)**

## 2. Consolidated statements of operations:

	Year ended December 31,			Convenience translation
	2002	2003	2004	Year ended December 31, 2004
	Adjusted		Reported	
	NIS in thousands			U.S. dollars in thousands
Net income (loss), as reported in consolidated statements of operations under Israeli GAAP	33,824	(5,450)	(82,984)	(19,263)
Impact of applying U.S. GAAP:				
Compensation expense in respect of employee stock options (see e. above)	(65)	(197)	(2,491)	(578)
Gain from sale of shares of an affiliate, net of taxes on income (see c. above)	9,155			
Amortization of discount relating to debentures (see f. above)	(1,282)	(1,103)	(675)	(157)
Effect of recording long term liability in respect of borrowed debt securities at fair value (see k. above)			(741)	(172)
Gain from sale of investment in available for sale marketable securities, net of income taxes (see c. above)		10,927		
Cancellation of equity in earnings of affiliate, net of taxes on income (see c. above)	(14,181)	(42,270)	(17,610)	(4,088)
Effect of change in tax rate (on deferred taxes) (see d. above)			6,067	1,409
Net income (loss) under U.S. GAAP	27,451	(38,093)	(98,434)	(22,849)

## 3. Total comprehensive income (loss):

Convenience translation

	Year ended December 31,			Year ended
	2002	2003	2004	December 31,
	Adjusted		Reported	2004
	NIS in thousands			U.S. dollars
				in thousands
<b>Other comprehensive income (loss):</b>				
Unrealized gains on available for sale securities	222,612	223,756	25,969	6,028
Tax effect on unrealized gain	(72,236)	(80,552)	(9,095)	(2,111)
Reclassification adjustment for gain realized included in net income		(114,440)		
Tax effect of reclassification adjustments		41,198		
Total other comprehensive income	150,376	69,962	16,874	3,917
Net income (loss)	27,451	(38,093)	(98,434)	(22,849)
Total comprehensive income (loss)	177,827	31,869	(81,560)	(18,932)
<b>Accumulated other comprehensive income:</b>				
Balance at beginning of the year		150,376	220,338	51,146
Other comprehensive income, net of tax for the year	150,376	69,962	16,874	3,917
Balance at end of year	150,376	220,338	237,212	55,063

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## NOTES TO FINANCIAL STATEMENTS

**NOTE 26: EFFECT ON THE FINANCIAL STATEMENTS OF MATERIAL DIFFERENCES BETWEEN ISRAELI AND UNITED STATES GENERALLY ACCEPTED ACCOUNTING PRINCIPLES (Cont.)**

- n. Earnings (loss) per Ordinary share and per ADS ( EPS ):

Israeli GAAP relating to computation of EPS are described in Note 2q.

The EPS computation according to U.S. GAAP presented below is in accordance with FAS 128, Earnings per Share .

According to Israeli GAAP, the dilutive effect of convertible securities is included in the computation of basic earnings (loss) per share if their exercise or conversion is considered to be probable, even if their effect is antidilutive. According to U.S. GAAP, basic earnings (loss) per share exclude all convertible securities. In addition, the calculation of the dilutive effect of stock options under U.S. GAAP differs from such calculation under Israeli GAAP.

The above differences did not have an effect on the computation of earnings (loss) per share for the periods presented.

The calculation of EPS under U.S. GAAP is as follows:

	Year ended December 31,		
	2002	2003	2004
	Adjusted	Reported	
NIS in thousands (except per Ordinary share and per ADS data)			
Net income (loss) under U.S. GAAP (see k(2) above)	27,451	(38,093)	(98,434)
EPS under U.S. GAAP (*):			
Basic and diluted earnings (loss) per Ordinary share	0.95	(1.30)	(3.26)
Basic and diluted earnings (loss) per ADS	1.90	(2.60)	(6.52)

- (\*) Number of Ordinary shares and ADS used for computation of earnings (loss) per share under U.S. GAAP does not differ from such number used for the computation under Israeli GAAP.

- o. Impact of recently issued accounting standards:

On December 16, 2004, the Financial Accounting Standards Board (FASB) issued SFAS No. 123 (revised 2004), Share-Based Payment ( SFAS 123(R) ), which is a revision of SFAS 123. Generally, the approach in SFAS 123(R) is



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similar to the approach described in SFAS 123. However, SFAS 123 permitted, but did not require share-based payments to employees to be recognized based on their fair values while SFAS 123(R) requires all share-based payments to employees to be recognized based on their fair values. SFAS 123(R) also revises, clarifies and expands guidance in several areas, including measuring fair value, classifying an award as equity or as a liability and attributing compensation cost to reporting periods. The Company expects to adopt SFAS 123(R) on January 1, 2006.

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NOTES TO FINANCIAL STATEMENTS

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**NOTE 26: EFFECT ON THE FINANCIAL STATEMENTS OF MATERIAL DIFFERENCES BETWEEN ISRAELI AND UNITED STATES GENERALLY ACCEPTED ACCOUNTING PRINCIPLES (Cont.)**

SFAS 123(R) permits companies to adopt its requirements using one of the following two methods:

1. The modified prospective method, in which compensation cost is recognized commencing with the effective date (i) based on the requirements of SFAS 123(R) for all share-based payments granted after the effective date and (ii) based on the requirements of SFAS 123 for all awards granted to employees prior to the effective date of SFAS 123(R) that remain unvested at the effective date.
2. The modified retrospective method, which includes the requirements of the modified prospective method described above, but also permits entities to restate based on the amounts previously recognized under SFAS 123, for purposes of pro forma disclosures in all prior periods presented.

The Company is still evaluating the method of adoption of FAS 123(R).

The adoption of the SFAS 123(R) fair value method will have an impact on the Company's results of operations, although it will have no impact on the Company's overall financial position. The impact of the adoption of SFAS 123(R) cannot be predicted at this time, as it depends on levels of share-based payments for future grant. However, had the Company adopted SFAS 123(R) in prior periods, the impact of that Standard would have approximated the impact of SFAS 123, as described in the disclosure of the pro forma information above.

In March 2005, the SEC released SEC Staff Accounting Bulletin No. 107, Share-Based Payment (SAB 107). SAB 107 provides the SEC staff's position regarding the application of FAS 123(R) and contains interpretive guidance related to the interaction between FAS 123(R) and certain SEC rules and regulations, and also provides the SEC staff's views regarding the valuation of share-based payment arrangements for public companies. SAB 107 highlights the importance of disclosures made relating to the accounting for share-based payment transactions. The Company is currently reviewing the effect of SAB 107, however it does not believe that SAB 107 will have a material effect on its financial position, results of operations or cash flows.

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## APPENDIX TO FINANCIAL STATEMENTS

## SCHEDULE OF PRINCIPAL INVESTEE COMPANIES

Name of company	Ownership and control as of December 31, 2004	
Cable System Media Haifa-Hadera Ltd.	100%	Subsidiary
Matav Investments Ltd.	100%	Subsidiary
Matav Infrastructures 2001 Limited Partnership	100%	Subsidiary
Matav Properties Ltd.	100%	Subsidiary
Partner Communication Company Ltd.	5.25%*)	Affiliate
Hot Vision Ltd.	26.6%	Proportionately consolidated
Nonstop Ventures Ltd.	50%	Affiliate
Hot Telecom Limited Partnership	26.5%	Affiliate

\*) See also Note 24a.

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**Certified Public Accountants****REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM****To the Shareholders of****HOT VISION LTD.**

We have audited the balance sheets of Hot Vision Ltd. (the Company) as of December 31, 2004 and 2003 (including the Appendix), and the related statements of income, changes in shareholders' equity and cash flows for each of the three years in the period ended December 31, 2004 (not presented separately herein). These financial statements are the responsibility of the Board of Directors and management of the Company. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in Israel, including those prescribed by the Israeli Auditors Regulations (Auditors' Mode of Performance), 1973 and in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by the Board of Directors and management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements (including the Appendix) referred to above present fairly, in all material respects, the financial position of the Company as of December 31, 2004 and 2003, and the results of its operations, changes in its shareholders' equity and its cash flows for each of the three years in the period ended December 31, 2004, in conformity with accounting principles generally accepted in Israel, which differ in certain respects from accounting principles generally accepted in the United States to the extent summarized in the Appendix to the financial statements attached hereto.

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As described in Note 2, the financial statements as of the dates and for the reported periods subsequent to December 31, 2003, are presented in reported amounts, in conformity with Accounting Standards of the Israel Accounting Standards Board. The financial statements as of the dates and for the reported periods until the aforementioned date are presented in values that were adjusted until that date according to the changes in the general purchasing power of the Israeli currency, in accordance with pronouncements of the Institute of Certified Public Accountants in Israel.

/s/ Fahn Kanne & Co.  
Fahn Kanne & Co.  
Certified Public Accountants (Isr.)

Tel-Aviv, March 2, 2005

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**MATAV CABLE SYSTEMS MEDIA LTD.**

**ANNUAL REPORT ON FORM 20-F**

**FOR THE YEAR ENDED DECEMBER 31, 2004**

**EXHIBITS**

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## EXHIBITS

The exhibits filed with or incorporated by reference into this annual report are listed on the index of exhibits below.

<u>Exhibit Number</u>	<u>Description</u>
***1.1	Matav s Articles of Association, as adopted on December 31, 2000 and amended on October 31, 2002
*1.2	English translation of Matav s Memorandum of Association
*2(a)	Specimen Certificate for American Depository Shares
**4(a)(i)-A	English summary of Merger Arrangement dated December 31, 2001
***4(a)(i)-B	English summary of final version of Merger Agreement dated February 2003
****4(a)(i)-C	English summary of Limited Partnership Agreement for HOT Telecom L.P., dated October 2003, as amended in November 2003.
****4(a)(i)-D	English summary of Agreement relating to the establishment of HOT Telecom Ltd., dated October 2003.
4 (b)(ii)(b)-A	English translation of Cable Broadcast License dated April 30, 2002, as amended, granted to Matav Cable Systems Media Ltd., and Cable Broadcast License dated April 30 2002, as amended, granted to Cable Systems Media Haifa Hadera Ltd.
**4(b)(ii)(b)-C	English summary of Broadcasting HeadEnd License dated May 2, 2002 granted to Cable Systems Media Haifa Hadera Ltd.
****4(b)(ii)(b)-D	English translation of Telecommunications Infrastructure Licensed dated November 25, 2003 granted to HOT Telecom L.P.
***4(c)(1)	English translation of 2001 Senior Employee Option Plan
****4(c)(2)	English summary of principal terms of 2003 Option Plan
6	See Note 2(q) to our financial statements for information explaining how net loss per share information was calculated
8	List of Subsidiaries
10.1	Consent of Independent Auditors
12.1	Certification by CEO pursuant to 17 CFR 240.13a-14(a), as adopted pursuant to §302 of the Sarbanes-Oxley Act of 2002.
12.2	Certification by CFO pursuant to 17 CFR 240.13a-14(a), as adopted pursuant to §302 of the Sarbanes-Oxley Act of 2002.
13.1	Certification of CEO pursuant to 18 U.S.C. §1350, as adopted pursuant to §906 of the Sarbanes-Oxley Act of 2002
13.2	Certification of CFO pursuant to 18 U.S.C. §1350, as adopted pursuant to §906 of the Sarbanes-Oxley Act of 2002

\* Incorporated herein by reference to our registration statement on Form F-1 (No. 333-4822).

\*\* Incorporated herein by reference to Matav's Annual Report on Form 20-F for the fiscal year ending December 31, 2001.  
\*\*\* Incorporated herein by reference to Matav's Annual Report on Form 20-F for the fiscal year ending December 31, 2002.  
\*\*\*\* Incorporated herein by reference to Matav's Annual Report on Form 20-F for the fiscal year ending December 31, 2003.  
The terms of the Cable Broadcast License granted to Cable Systems Media Haifa Hadera Ltd. are substantially identical to the terms of the Cable Broadcast License granted to Cable Systems Media Ltd. In accordance with Rule 12b-31, only the latter is exhibited hereto (Exhibit 4 (b)(ii)(b)-A). The only substantial differences between the two licenses are in relation to fees and license areas. An English translation of the annexes of the licenses relating to these issues is exhibited hereto separately for each license.