

INTERNET GOLD GOLDEN LINES LTD  
Form 20-F  
April 26, 2017

**SECURITIES AND EXCHANGE COMMISSION  
Washington D.C. 20549**

**FORM 20-F**

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

**OR**

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

**For the fiscal year ended December 31, 2016**

**OR**

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

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

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

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

**Commission file number: 0-30198**

**INTERNET GOLD – GOLDEN LINES LTD.**

(Exact name of Registrant as specified in its charter and translation of Registrant’s name into English)

**Israel**

(Jurisdiction of incorporation or organization)

**2 Dov Friedman Street, Ramat Gan 5250301, Israel**

(Address of principal executive offices)

**Doron Turgeman, CEO, +972-3-9240000 (phone), +972-3-9399832 (fax)**

**2 Dov Friedman Street, Ramat Gan 5250301, Israel**

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

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

| Title of each class                        | Name of each exchange on which registered |
|--|---|
| <b>Ordinary Shares, NIS 0.01 Par Value</b> | <b>NASDAQ Global Select Market</b>        |

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

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

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

**Ordinary Shares, par value NIS 0.01 per share .....19,203,186**

(as of December 31, 2016)

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

Yes      No

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

Yes      No

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

Yes      No

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

Yes      No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or an emerging growth company. See the definitions of “large accelerated filer,” “accelerated filer,” and “emerging growth company” in Rule 12b-2 of the Exchange Act.

Large accelerated filer      Accelerated filer  
Emerging growth company      Non-accelerated filer

If an emerging growth company that prepares its financial statements in accordance with U.S. GAAP, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards<sup>†</sup> provided pursuant to Section 13(a) of the Exchange Act.

† The term “new or revised financial accounting standard” refers to any update issued by the Financial Accounting Standards Board to its Accounting Standards Codification after April 5, 2012.

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

Item 17      Item 18

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

Yes      No

## **INTRODUCTION**

We are a leading communications group in Israel. Our shares are listed on the NASDAQ Global Select Market and on the Tel Aviv Stock Exchange, or TASE. B Communications Ltd. (formerly known as 012 Smile.Communications Ltd.) is our subsidiary.

On April 14, 2010, our principal subsidiary, B Communications, completed the acquisition of the controlling 30.44% interest in Bezeq (TASE:BZEQ), Israel's largest telecommunications provider, from Ap.Sb.Ar. Holdings Ltd. (a consortium of Apax Partners, Saban Capital Group and Arkin Communications) for an aggregate cash purchase price of approximately NIS 6.5 billion. In accordance with the terms of the transaction, effective as of the closing of the acquisition, B Communications designated seven directors to replace the Apax-Saban-Arkin Group's representatives on Bezeq's Board of Directors, which numbers 11 directors. We began consolidating Bezeq's financial results into our financial statements effective as of the closing of the acquisition. B Communications currently owns 26.34% of Bezeq's outstanding shares. B Communications' ordinary shares are listed on the NASDAQ Global Select Market (symbol: BCOM) and on the TASE. We currently own 64.78% of the ordinary shares of B Communications.

The Bezeq Group operates the most comprehensive telecommunications infrastructure in Israel, with a broad range of telecommunications services across all of its markets. Through its wholly-owned subsidiaries, the Bezeq Group is a leading provider in Israel of fixed-line telephony services and fixed-line broadband Internet infrastructure access services, cellular telephony services, Internet service provider, or ISP, services, international telephony, or ILD, services, international and domestic data transfer and network services and information and communication technology, or ICT, services, pay television services and other communications infrastructures and services. In each of these markets, the Bezeq Group holds a significant market share, as indicated in the chart below.

As used in this annual report, the terms "we," "us" and "our" mean Internet Gold - Golden Lines Ltd. and its subsidiaries, "B Communications" means B Communications Ltd., "SP1" means B Communications (SP1) Ltd., "SP2" means B Communications (SP2) Ltd., "Eurocom Communications" means Eurocom Communications Ltd., "Bezeq" means Bezeq - The Israel Telecommunications Corp., Ltd.; "Pelephone" means Pelephone Communications Ltd., "Bezeq International" means Bezeq International Ltd. and "YES" (the trade name for DBS) and DBS mean DBS Satellite Services (1998) Ltd. Bezeq, Pelephone, Bezeq International and DBS are sometimes referred to as the Bezeq Group in this annual report.

Our consolidated financial statements appearing in this annual report are prepared in New Israeli Shekels and are translated into U.S. dollars at the representative rate of exchange at December 31, 2016 (NIS 3.845= \$1.00). The dollar amounts so presented should not be construed as representing amounts receivable, payable or incurred in dollars or convertible into dollars. All references in this annual report to "dollars" or "\$" are to U.S. dollars and all references in this annual report to "NIS" are to New Israeli Shekels.

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

## Forward Looking Statements

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



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**PART I**

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

Not applicable.

**ITEM 2. OFFER STATISTICS AND EXPECTED TIMETABLE**

Not applicable.

**ITEM 3. KEY INFORMATION**

**A. Selected Financial Data**

The tables below as of and for the five years ended December 31, 2016 set forth selected consolidated financial data, which is derived from our audited consolidated financial statements. The audited consolidated financial statements as of December 31, 2015 and 2016 and for the years ended December 31, 2014, 2015 and 2016 appear in this annual report.

**Consolidated Statement of Income Data:**

(Amounts in millions, except share and per share data)

|                               | Year Ended December 31, |       |       |       |        | 2016         |
|-------------------------------|-------------------------|-------|-------|-------|--------|--------------|
|                               | 2012                    | 2013  | 2014  | 2015  | 2016   | 2016         |
|                               | (NIS)                   |       |       |       |        | (U.S.<br>\$) |
| Revenues                      | 10,278                  | 9,563 | 9,055 | 9,985 | 10,084 | 2,623        |
| Depreciation and amortization | 2,367                   | 2,014 | 1,873 | 2,131 | 2,161  | 563          |
| Salaries                      | 1,980                   | 1,874 | 1,771 | 1,960 | 2,017  | 525          |

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|  |         |        |         |        |          |         |
|--|---------|--------|---------|--------|----------|---------|
| General and operating expenses                         | 3,997   | 3,586  | 3,371   | 3,878  | 4,024    | 1,047   |
| Other operating expenses (income)                      | (1 )    | 57     | (535 )  | 3      | 21       | 5       |
|  | 8,343   | 7,531  | 6,480   | 7,972  | 8,223    | 2,140   |
| Operating profit                                       | 1,935   | 2,032  | 2,575   | 2,013  | 1,861    | 483     |
| Finance expense  | 997     | 931    | 1,329   | 759    | 1,108    | 288     |
| Finance income   | (582 )  | (535 ) | (635 )  | (164 ) | (133 )   | (35 )   |
| Finance expense, net                                   | 415     | 396    | 694     | 595    | 975      | 253     |
| Profit after financing expenses, net                   | 1,520   | 1,636  | 1,881   | 1,418  | 886      | 230     |
| Share of losses (profit) in equity- Accounted investee | 245     | 252    | 170     | (12 )  | 5        | 1       |
| Profit before income tax                               | 1,275   | 1,384  | 1,711   | 1,430  | 881      | 229     |
| Income tax expenses                                    | 556     | 524    | 667     | 347    | 442      | 115     |
| Net profit for the year                                | 719     | 860    | 1,044   | 1,083  | 439      | 114     |
| Profit (loss) attributable to owners of the company    | (37 )   | 26     | (103 )  | 87     | (202 )   | (53 )   |
| Income attributable to non-controlling interest        | 756     | 834    | 1,147   | 996    | 641      | 167     |
| Net profit for the year                                | 719     | 860    | 1,044   | 1,083  | 439      | 114     |
| Basic earnings (loss) per share.                       | (1.94 ) | 1.33   | (5.38   | 4.54   | (10.52 ) | (2.74 ) |
| Diluted earnings (loss) per share                      | (1.97 ) | 1.26   | (5.50 ) | 4.47   | (10.52 ) | (2.74 ) |

**Statements of Financial Position:**

(Amounts in millions)

|                           | December 31, |        |        |        |        |              |
|---------------------------|--------------|--------|--------|--------|--------|--------------|
|                           | 2012         | 2013   | 2014   | 2015   | 2016   | 2016         |
|                           | (NIS)        |        |        |        |        | (U.S.<br>\$) |
| Cash and cash equivalents | 764          | 867    | 732    | 619    | 810    | 211          |
| Restricted cash           | -            | -      | 65     | 155    | -      | -            |
| Total assets              | 22,806       | 21,410 | 21,558 | 22,410 | 20,527 | 5,339        |
| Total current liabilities | 4,899        | 4,104  | 3,974  | 5,352  | 4,407  | 1,147        |
| Non-current liabilities   | 14,427       | 14,153 | 14,818 | 14,457 | 13,383 | 3,480        |

**Exchange Rate Information**

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

| Period                       | Average |
|------------------------------|---------|
| Year ended December 31, 2012 | 3.856   |
| Year ended December 31, 2013 | 3.611   |
| Year ended December 31, 2014 | 3.578   |
| Year ended December 31, 2015 | 3.887   |
| Year ended December 31, 2016 | 3.841   |

| Period                        | High  | Low   |
|-------------------------------|-------|-------|
| October 2016                  | 3.856 | 3.778 |
| November 2016                 | 3.876 | 3.799 |
| December 2016                 | 3.867 | 3.787 |
| January 2017                  | 3.860 | 3.769 |
| February 2017                 | 3.768 | 3.659 |
| March 2017                    | 3.693 | 3.614 |
| April 2017 (through April 25) | 3.681 | 3.628 |

On April 25, 2017, the representative rate of exchange was NIS 3.648 = \$1.00 as published by the Bank of Israel.

**B. Capitalization and Indebtedness**

Not applicable.

**C. Reasons for the Offer and Use of Proceeds**

Not applicable.

## **D. Risk Factors**

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

### **Risks Relating to the Bezeq's Fixed Line Business**

#### **Competition from other providers could adversely affect the Bezeq's business, results of operations and financial condition.**

The competition in the domestic fixed-line communications industry has recently intensified, both from other domestic carriers including HOT, Bezeq's principal competitor in this segment, and secondarily from other cellular operators. Competition strengthened significantly upon implementation of the wholesale market by the principal communications groups in Israel and other communications operators (holders of a special or unified licenses) who compete with Bezeq in selling end-to-end service packages based on Bezeq's infrastructures at prices prescribed by the Ministry of Communications and not pursuant to commercial terms determined by negotiation. Bezeq may also face competition in the future from potential infrastructure owners. The increased competition has led to the churn of some of Bezeq's customers and has caused Bezeq to lower its prices for certain services and to an increase in the cost of acquiring new customers and retaining existing ones. The entities competing with Bezeq at present or those that might compete with it in the future, benefit from greater business flexibility than Bezeq, including the ability to cooperate with subsidiaries and affiliates for marketing joint packages of services. The ability of HOT to offer "Triple Play" and other packages with tariff flexibility compared with the restrictions that prevent Bezeq from doing the same, has adversely impacted Bezeq's ability to compete and its cash flow from operations.

**Bezeq is subject to governmental control and regulation.**

Bezeq is subject to government control and regulation relating, among other things, to the licensing of operations, setting permitted areas of operation, setting tariffs, operation, competition, payment of royalties, providing universal service, share ownership, relations between Bezeq and its subsidiaries and a ban on ceasing or limiting its services (which could oblige Bezeq to provide services under uneconomic circumstances). The continuing governmental control and regulation has at times resulted in government intervention that Bezeq believes impedes its business activities. In this regard, Bezeq is exposed to the imposition of various sanctions by the Ministry of Communications, including fines. In addition, the Minister of Communications has the authority to change the terms of Bezeq's license, affect existing tariffs and marketing offerings, and impose directives on Bezeq. Significant changes in the regulatory principles applicable to the communications industry as a whole and to Bezeq in particular, could require Bezeq to make changes to its strategic plans and harm its ability to plan its business activities for the long term.

**Bezeq's tariffs for fixed-line services are subject to governmental control, which could have a material adverse effect on its business.**

Bezeq's tariffs for its main services (including interconnect fees) are subject to government control and intervention. The Minister of Communications is authorized to intervene in existing tariffs and marketing offers and impose directives on Bezeq. On average, controlled tariffs erode in real terms. Significant changes in Bezeq's controlled tariffs, if implemented could have a material adverse effect on Bezeq's business and results. Additionally, the restrictions applicable to Bezeq in marketing alternative payment bundles may make it difficult for Bezeq to provide an appropriate competitive solution to market changes and have placed Bezeq at a disadvantage to those competing with it in the sale of end-to-end service packages using wholesale Bitstream Access services, or BSA services, supplied by Bezeq. In the context of the implementation of a wholesale market, the Ministry of Communications has the power to set the price for which Bezeq will sell its services to license holders. The low prices set by the Ministry of Communications may adversely affect Bezeq's level of revenues and profits.

**Bezeq could be subject to labor disruptions.**

Bezeq's implementation of human resources and organization plans, including retirement and restructuring plans, involves coordination with its workers and significant costs, including compensation for early retirement. The implementation processes of such plans may cause unrest in labor relations and be damaging to Bezeq ongoing activities.

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

Bezeq's general license obligates it to ensure that its relationships with its principal subsidiaries do not result in favoring them over their competitors. Separation is required between the managements of Bezeq and those companies, as is separation between the business, financial and marketing systems, assets and employees, which causes duplication and high administration overheads. In addition, Bezeq is currently limited in its ability to offer joint service bundles with those companies. Due to the entry of companies into direct competition with Bezeq based on the provision of service bundles to customers and the option of providing wholesale services in order to offer customers end-to-end services, the risk that this factor will affect Bezeq's operations and results of operations has increased.

**Bezeq is subject to legal proceedings, which could result in its being ordered to pay significant sums.**

Bezeq is a party to legal proceedings, including class actions, which could result in it being ordered to pay significant sums, most of which cannot be estimated, and therefore, no provisions have been made in Bezeq's financial statements for most of them. In addition, Bezeq's insurance policies are limited to defined cover limits and to certain causes of action, and might not cover claims for certain types of damages. In recent years, class actions against large commercial companies have become more numerous and severe. By their very nature, class actions may result in significant judgments or settlements. In addition, since Bezeq provides communications infrastructures as well as billing services to other licensees, parties suing those licensees in other class actions are also likely to try to involve Bezeq as a party to such proceedings.

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

Bezeq measures exposure to changes in exchange rates and inflation by the surplus or deficit of assets against liabilities, based on the type of linkage. While Bezeq's exposure to changes in currency exchange rates against the shekel is low, its exposure to inflation rates is high, and therefore Bezeq takes steps to cover part of the inflation exposure. As a result, the annual rate of inflation and its distribution during the year can have a material influence on the erosion of Bezeq's tariffs and its revenues and expenses during the year, which in turn could have a material adverse impact on its operating results.



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

Negative developments in, or the general weakness of, Israel's economy, in particular increasing levels of unemployment, may have a direct negative impact on the spending patterns of retail consumers, both in terms of the products they subscribe for and usage levels. Stability in the financial market and the strength of economies in countries around the world, have recently been subjected to high volatility. While the Israeli economy has displayed economic resilience, reflected in economic expansion, low levels of unemployment and inflation rates within government targets, the continued increase in of housing prices, global economic shocks and uncertainty in the political and defense arenas may cast doubt over a continuation of these trends. In the event the local economy is negatively impacted following external or internal events, Bezeq's business results may be harmed as consequence of lower revenues (including revenues from affiliates) or due to an increase in finance costs.

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

Bezeq is subject to the Israeli Non-Ionizing Radiation Law, which regulates the emission of electromagnetic radiation from broadcast facilities. While Bezeq is working to obtain permits to set up and operate its various broadcast installations, the difficulties it faces in this area, including difficulties stemming from the change in policy by relevant entities and amendments to statutes and standards, could have an adverse impact on the infrastructure of these installations and on the continuity of services using them, and as a result, on Bezeq's revenues from these services. Bezeq's third-party liability policy does not currently cover liability for electromagnetic radiation.

**Frequent technological changes may negatively impact Bezeq's operations and the value of its assets.**

The communications sector is characterized by frequent technological changes and the shortening of the economic life of new technologies. The trend has created a need to invest significant resources in technology upgrades, has caused the lowering of barriers to entry into the sector by new competitors, increased depreciation rates, and in certain cases, resulted in the redundancy of technologies and networks owned by Bezeq (the cost of investment in which is still recorded on its balance sheets).

**Bezeq's operations are vulnerable to damage or interruption, which could expose it to material risks.**

Bezeq provides services using various infrastructure systems that include, among others, exchanges, transmission, data communication and access systems, cables, computerized systems and others. If any part of Bezeq's infrastructure becomes subject to a flood, fire, other natural disaster, terrorism, acts of war, a computer virus, a power loss, material bugs in software or other catastrophe or unauthorized access, its operations and customer relations could be materially adversely affected. In addition, disaster recovery, security and service continuity protection measures that Bezeq has made or may in the future undertake, and its monitoring of network performance, may be insufficient to prevent losses. In such event, Bezeq might incur liabilities or reputational damages.

**Risks Relating to Pelephone's Business**

**Competition from other providers has adversely affected Pelephone's business and results of operations.**

Competition in the cellular telephony industry has intensified since 2012. This has led to lower prices and higher customer churn rates, which in turn has affected the results of Pelephone. Pelephone expects competition to continue to increase amid the changing legislation in Israel and consolidation in the telecommunications industry that permits certain service providers to market a combination of fixed-line telephony, fixed-line broadband Internet infrastructure access, ISP and pay television services, or a "bundle", for an aggregate price which is lower than the price of the individual products and services in the bundle. These competitive forces may create further downward pressure on prices, which may result in a decrease in the Pelephone's average revenue per user, or ARPU, and increase churn rates. Furthermore, the costs of establishing, maintaining and operating a mobile telephony network per subscriber is expected to be higher for Pelephone if it will not be allowed to operate under some form of network sharing model.

**Pelephone is subject to governmental control and regulation**

The cellular industry in Israel is subject to legislation and standardization relating to issues such as the environment, increased competition, tariffs, product warranty and repair. Regulatory intervention in the industry may materially impact Pelephone's structure of competition and operating costs. Changes in the regulatory principles applicable to the cellular industry as a whole and to Pelephone in particular, could require Pelephone to make changes to its strategic plans and harm its ability to plan its business activities for the long term.

**Pelephone's operations are subject to market risks such as currency fluctuations.**

Pelephone is exposed to exchange rate risks as most of its terminal equipment, accessories, spare parts and infrastructure equipment are purchased in US dollars. While its revenues are in NIS. Any erosion of the NIS against the US dollar may affect Pelephone's profitability if it is unable to adjust selling prices promptly.

**Frequent technological changes may negatively impact Pelephone's operations and finances.**

The cellular market in Israel and worldwide is characterized by substantial capital investments in the deployment of infrastructure. The frequent technological changes in infrastructure and terminal equipment and the fierce competition in various market segments impose a heavy financial burden on the companies operating in the market, requiring them to update their infrastructure technology from time to time.

**Pelephone's results of operations are subject to credit risk associated with consumer credit transactions.**

Pelephone's sales of terminal equipment are mostly credit-based. Most of this credit, which is not covered by either insurance or sureties, is exposed to risk. It is noted that the credit is spread among a large number of customers and Pelephone's collection mechanisms are efficient and competent. Negative developments in, or the general weakness of, Israel's economy, in particular increasing levels of unemployment, may have a direct negative impact on consumer defaults. Therefore, a weak economy and negative economic developments may jeopardize Pelephone's growth targets and may have a material adverse effect on its business, financial condition and results of operations.

**Potential health risks related to cellular network sites and cellular telecommunication devices could have a material adverse effect on Pelephone's business, results of operations and financial condition.**

Pelephone operates hundreds of broadcast facilities and sells electromagnetic radiation emitting terminal equipment. While Pelephone is taking measures to ensure that the levels of radiation emitted by its broadcast facilities and terminal equipment do not exceed the radiation levels permitted in the Ministry of Environmental Protection guidelines (the levels adopted are based on international standards), no assurance can be given that it will be able to do so in the future. If health risks are found to exist or if the broadcast sites or terminal equipment are found to emit radiation levels exceeding the permitted radiation standards, thereby constituting a health hazard, this may have an adverse effect due to reduced consumption of Pelephone's services, difficulty in renting sites, compensation claims for physical and property damages in substantial amounts and attempts to exercise the deeds of indemnity deposited by

Pelephone with the planning authorities with respect to applicable law. Pelephone's third-party liability policies do not currently cover electromagnetic radiation and any exposure to such claims could have a material adverse impact on Pelephone's business, results of operations and financial condition.

**Pelephone may face difficulties in obtaining some of the building and environmental permits required for the establishment and operation of its cellular antennas.**

Pelephone is subject to the Israeli Radiation Law. Establishing and operating cellular antennas require building permits from various planning and building committees, a process that involves, among other things, obtaining several approvals from State entities and local regulatory bodies. The inability to obtain and retain the necessary permits may impact the quality of Pelephone's existing network and the deployment of its new network.

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

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

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

Pelephone provides services using various infrastructure systems and is spread throughout the country through core network sites, antenna sites and other systems. Pelephone's business is totally dependent upon these systems. If any part of Pelephone's infrastructure becomes subject to a flood, fire, other natural disaster, terrorism, acts of war, a computer virus, a power loss, material bugs in software or other catastrophe or unauthorized access, its operations and customer relations could be materially adversely affected. In addition, disaster recovery, security and service continuity protection measures that Pelephone has, or may in the future undertake, and its monitoring of network performance, may be insufficient to prevent losses. In such event, Pelephone might incur liabilities or reputational damages.

**Pelephone is subject to legal proceedings, which could result in its being ordered to pay significant sums.**

Pelephone is a party to legal proceedings, including class actions, which may result in it being liable for material amounts that cannot presently be estimated and no provision has been made in Pelephone's financial statements for these proceedings. In addition, Pelephone's insurance policies are limited to defined cover limits and to certain causes of action, and might not cover claims for certain types of damages. In recent years, class actions against large commercial companies have become more numerous and severe. By their very nature, class actions may result in significant judgments or settlements.

**Pelephone could be subject to labor disruptions.**

Pelephone has a collective agreement with the New General Federation of Workers and with the employees' committee which applies to most of its employees. Implementation of the collective agreement may reduce managerial flexibility and incur additional costs for Pelephone. Pelephone's implementation of human resources and organization plans, including retirement and restructuring plans, involves coordination with the New General Federation of Workers and with the employees' committee. The implementation processes of such plans may cause unrest in labor relations and be damaging to Pelephone's ongoing activities.

**Pelephone's frequencies are exposed to interference which could impair the service quality of its services.**

Under its cellular license and the Wireless Telegraph Ordinance, Pelephone has rights of use of frequencies in the 850 MHz, which and could impair the service quality of its networks. The factors that could cause interference include the fact that the 850 MHz frequency is also used for terrestrial television broadcasts by television stations in the Middle East, causing interference in Pelephone's 850 MHz UMTS/HSPA network. In addition, the Jordanian networks also use the same 2100 MHz frequency range that Pelephone uses and in view of the limited cooperation between the operators in Jordan and Pelephone, this could have an adverse effect on service quality. The Ministry of Communications is currently preparing to implement the first giga frequency program that could impact the frequency ranges allocated to Pelephone.

**Risks Relating to DBS's Business**

**Competition from other providers and content piracy has adversely affected DBS's business and results of operations.**

Competition in the broadcast sector with HOT and more recently with Cellcom, requires DBS to constantly invest in attracting and retaining customers, and dealing with high subscriber churn rates between the companies. Competition also increased due to the increasing use of pirated broadcasts. The broadcasting sector is also exposed to piracy by viewers in viewing broadcasts without paying subscription fees and is exposed to unlicensed public access to content to which the broadcast providers have rights. These competitive forces may create downward pressure on prices, which may result in a decrease in the DBS's ARPU and increase churn rates.

**DBS's operations are subject to market risks such as currency fluctuations, economic weakness and the security situation in Israel.**

A material part of DBS's expenses and investments are linked to fluctuations in the exchange rate of the US dollar (particularly content, satellite segments, purchase of decoders and additional logistics equipment). Therefore, sharp fluctuations in the exchange rate will have an effect on DBS's business results. In addition, the loans taken out by DBS are linked to the consumer price index and, therefore, sharp rises in inflation rates could have a material effect on DBS's business results. An economic recession, increase in unemployment rates and a decrease in disposable income might bring about a decrease in the number of DBS' subscribers, a decrease in DBS' revenues and harm to its business results. In addition, an ongoing unstable security situation in large areas of Israel, which disrupts the day-to-day lives of the residents, could have an adverse effect on DBS's business results.

**DBS is subject to governmental control and regulation**

DBS provides multi-channel television broadcasts under a broadcast license and other licenses. Violation of the provisions of the licenses and of the law under which the licenses are issued could, subject to the license conditions, result in the revocation, amendment or suspension of the licenses and consequently adversely affect DBS's ability to continue operating. DBS's operations and broadcasts are subject to obligations and restrictions set out in legislation and to a system of licensing, oversight and approvals from various regulatory bodies. Consequently, DBS may be affected and restricted by policy considerations dictated by these entities and by their decisions and changes in communications legislation. Regulatory changes could impact DBS operations and could have a material adverse effect on its financial results. Likewise, the entry of content providers transmitting video content without applicable regulation of their operations including licensing may significantly affect DBS's financial results. As a provider of public services, DBS operations are also subject to consumer protection regulations.

**Technological developments and improvements may negatively affect DBS and its operations.**

The development of new technologies may render existing technology inferior, forcing DBS to invest large sums to retain its competitive edge. Such technological advances and developments may also facilitate increased accessibility to video content, allowing other providers to offer content viewing services without the need for heavy investment that may make it difficult for DBS to recruit new subscribers, retain existing subscribers and offer its services. In order to compete effectively, DBS may be required to invest large amounts. Alternative multi-channel broadcasting infrastructures, such as DTT, a terrestrial implementation of digital television technology using an aerial to broadcast to a conventional television antenna (or aerial) instead of a satellite dish or cable television connections, and its expansion, may have an adverse impact on the financial results of DBS.

**The failure to comply with the covenants in DBS's credit facilities could lead to acceleration of the underlying debt under certain circumstances and such covenants may limit DBS's financial and operational flexibility.**

DBS's outstanding debt is subject to immediate repayment in the event of non-compliance with its loan agreements. DBS's failure to comply with the provisions of its financing agreements may, under certain circumstances, permit the lenders to call the loans provided to DBS for immediate repayment and acquire the shares of DBS deposited as security to some of the lenders. DBS is required to maintain sufficient cash flow from its operations in order to be in compliance with certain of its debt covenants. These covenants could restrict DBS's ability to achieve its business objectives, and therefore, could have an adverse effect on its financial condition. The absence of a sufficient cash flow may negatively impact DBS's ability to increase its rate of penetration of advanced services (such as PVR and HDPVR decoders) and to face the competitive threats arising from technological developments and consumption patterns in the market.

**DBS is subject to restrictions on intercompany relations with Bezeq and its other subsidiaries, which harms its ability to compete and adversely affects its business.**

DBS is restricted in entering into joint ventures with Bezeq with respect to offering communications service bundles. Both HOT and Cellcom, DBS's principal competitors, are able to provide service bundles to their customers, which provide them with a significant advantage. DBS's inability to ability to offer joint service bundles to customers has had a material impact on its business and competitive ability.

**There are significant risks associated with providing satellite-based broadcasting.**

DBS broadcasts its multi-channel pay television via space segments on the Amos 2 and Amos 3 satellites stationed at identical points in space. Malfunction of one of the satellites, damage to one of them or the unavailability of space segments on any of the satellites (including the unavailability of a new satellite scheduled to replace a satellite that ceased to broadcast) could disrupt and materially reduce the volume of DBS broadcasts, unless an alternative is promptly found to replace unavailable space segments. While DBS has attempted to provide for redundancy and has entered into a partial backup mechanism in its agreement with Spacecom, it may not be successful in fully replacing its broadcast capabilities and would likely not be able to provide all the channels it now offers. DBS is not insured against loss of revenues caused by satellite malfunction.

**DBS is dependent on Spacecom, as the exclusive holder of the rights and the sole provider of space segments used by DBS.**

DBS is dependent on Spacecom Communications Ltd., or Spacecom, a company controlled by our controlling shareholder, as the exclusive holder of the rights and the sole provider of space segments used by DBS in providing satellite broadcast. Spacecom is, and is also responsible for operating the space segments.

**DBS is dependent on several third-party vendors and a disruption in those services could adversely affect its business.**

DBS is dependent on certain providers of software, equipment, content and services, including broadcast encryption services in providing its satellite TV services. Failure to receive the products and services, or the failure to retain broadcast licenses and obtain access to new content from content providers services would negatively impact DBS's its business and competitive position.



**DBS depends on its broadcast centers and central computing center in Israel and is susceptible to any event that could adversely affect their condition.**

Damage to a broadcast center's operations may significantly impair DBS's ability to continue its satellite TV broadcasts. DBS operates broadcast centers in Kfar Saba and Re'em Junction in order to reduce the risks involved if one of its centers sustains damage and improve the survivability of some of its broadcast capabilities. In the event of damage to one of the broadcast centers, DBS will be able to continue broadcasting only a portion of its channels from the other broadcasting center. This is more significant in the event of damage to the Kfar Saba center, which is the only center with the capacity to broadcast certain of DBS's key channels. Both of the broadcast centers have identical encryption systems and therefore backup is also available for the encryption system in the event of damage to one of the broadcast centers. A significant malfunction in DBS's central computer systems would also severely impact its operational capability. While DBS has a remote backup site designed to be activated and provide partial computer services within a few hours in the event of malfunction, it will be extremely difficult for DBS to operate efficiently without the operation of the central computer systems. Damage to DBS's logistics center could also lead to a disruption of its operations.

**DBS's technology is inferior to that of its principal competitor.**

DBS's technology is inferior to that of HOT, its principal competitor. This technical inferiority prevents DBS from providing telephony and Internet services, and various interactive services, including VOD, via its infrastructure; and therefore DBS is dependent on third parties in order to provide such services.

**DBS is dependent on third-party encryption systems.**

DBS encrypts the broadcasts it transmits via satellite and utilizes encoded smart cards that are installed in the decoders in subscribers' homes. Defects in the encryption system or its enforcement or a breach thereof could make it possible for unauthorized persons to view broadcasts without payment to DBS, causing a reduction in revenues and a breach of the agreements between DBS and its content suppliers. A malfunction of the encryption system or its enforcement could have a material adverse impact on DBS's operations and financial results.

**DBS's frequencies are not exclusive, and are subject to interference, which could impair the service quality of its services.**

The spectrum of frequencies used by DBS to transmit its broadcasts from the broadcast satellites to the satellite dishes installed in subscribers' homes is allocated in accordance with the license from the Ministry of Communications and is defined as a frequency spectrum with a secondary allocation. An Israeli entity is allowed to make authorized primary use the frequency spectrum used by DBS. If the owner of the primary allocation uses the frequency spectrum, this may cause an adverse impact on the quality and/or availability of DBS broadcasts to its subscribers, which may adversely affect the financial results of DBS. To the best of DBS's knowledge, the primary allocation holder has not made use of such frequencies in a manner that has caused any real or lengthy disruptions to DBS's broadcasts. As DBS's broadcasts are wireless transmissions from broadcast centers to broadcast satellites and from them to the receiver dishes in subscriber homes, the broadcast of wireless signals in the same frequency spectrum, whether or not they originate in Israel, and extreme weather conditions of heavy rain, hail or snow could cause disruptions to the quality and/or availability of the broadcasts provided by DBS to its subscribers. Such disruptions may have an adverse effect on DBS's financial results.

**DBS could be subject to labor disruptions.**

DBS is party to a collective agreement with the New General Federation of Workers and the Workers Committee. Implementation of the collective agreement may reduce managerial flexibility and incur additional costs for DBS. DBS's implementation of human resources and organization plans, including retirement and restructuring plans, involves coordination with the New General Federation of Workers and with the employees' committee. The implementation processes of such plans may cause unrest in labor relations and be damaging to Pelephone's ongoing activities.

**DBS is subject to legal proceedings.**

DBS is a party to legal proceedings, including class actions, which may result in it being liable for material amounts that cannot presently be estimated and no provision has been made in its financial statements for these proceedings. In addition, DBS's insurance policies are limited to defined cover limits and to certain causes of action, and might not cover claims for certain types of damages. In recent years, class actions against large commercial companies have become more numerous and severe. By their very nature, class actions may result in significant judgments or settlements.

## **Risks Relating to the Bezeq International's Business**

### **Bezeq International's operations are subject to currency fluctuations.**

The primary currency in which Bezeq International operates is the NIS. While the majority of Bezeq International's revenues are derived from customers in Israel, Bezeq International uses services from providers worldwide and pays them for these services in foreign currency, primarily in US dollars. Changes in the exchange rates of the currencies in which Bezeq International operates against the NIS exposes it to rate differentials on the gap generated, which could adversely affect its profitability by increasing financing expenses, as well as its cash flows. To protect itself against currency exposure, for specific material transactions, Bezeq International engages in hedging transactions and purchases other financial instruments.

### **Technological developments and improvements may negatively affect Bezeq International's operations.**

Bezeq International's operations are characterized by frequent technological developments. The development of technologies constituting attractive alternatives to some of Bezeq International's products, such as Skype as an alternative to long-distance calling, is likely to have a materially adverse effect on its operations. Furthermore, technological developments require frequent investment in infrastructure which could impact its financial condition.

### **Bezeq International is subject to governmental control and regulation**

Bezeq International operations are subject to obligations and restrictions set out in legislation and to a system of licensing and oversight. Consequently, Bezeq International may be affected and restricted by policy considerations dictated by its regulators and by their decisions and changes in communications legislation. Regulatory changes could impact Bezeq International operations and could have a material adverse effect on its financial results.

### **Bezeq International is subject to legal proceedings, which could result in its being ordered to pay significant sums.**

Bezeq International is a party to legal proceedings, including class actions, which may result in it being liable for material amounts. Bezeq International one's insurance policies are limited to defined cover limits and to certain causes

of action, and might not cover claims for certain types of damages. In recent years, class actions against large commercial companies have become more numerous and severe. By their very nature, class actions may result in significant judgments or settlements.

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

Bezeq International provides services using various infrastructure systems. If any part of Bezeq International's infrastructure becomes subject to a flood, fire, other natural disaster, terrorism, acts of war, a computer virus, a power loss, material bugs in software or other catastrophe or unauthorized access, its operations and customer relations could be materially adversely affected. In addition, disaster recovery, security and service continuity protection measures that Bezeq International has, or may in the future undertake, and its monitoring of network performance, may be insufficient to prevent losses. In such event, Bezeq International might incur liabilities or reputational damages.

**Bezeq International could be subject to labor disruptions.**

Bezeq International has a collective agreement with the New General Federation of Workers and with the employees' committee which applies to most of its employees. Implementation of the collective agreement may reduce managerial flexibility and incur additional costs for Bezeq International. Bezeq International's implementation of human resources and organization plans, including retirement and restructuring plans, involves coordination with the New General Federation of Workers and with the employees' committee. The implementation processes of such plans may cause unrest in labor relations and be damaging to Bezeq International's ongoing activities.

**Risks Related to Our Company**

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

We and B Communications have a substantial amount of indebtedness. As of April 26, 2017, we and B Communications had approximately NIS 3.6 billion (approximately \$0.9 billion) of debt. This significant level of debt could have important consequences, including, but not limited to, the following:

making it more difficult for us to service our debt obligations and liabilities;

making us vulnerable to, and reducing our flexibility to respond to, general adverse economic and industry conditions;

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requiring that a substantial portion of our cash flows from operations be dedicated to servicing debt, thereby reducing the funds available to us to fund working capital, or other general corporate purposes;

impeding our ability to obtain additional debt or equity financing and increasing the cost of any such borrowing, particularly due to the financial and other restrictive covenants contained in the agreements governing our debt; and

adversely affecting public perception of us.

Our credit ratings impact the cost and availability of future borrowings and, accordingly, our cost of capital. Our ratings at any time will reflect each rating organization's then opinion of our financial strength, operating performance and ability to meet our debt obligations. In February 2017, we announced that Midroog Ltd., an Israeli rating company affiliated with Moody's, has affirmed an A3.il local rating of our Series C and D Debentures with a stable outlook. Any reductions in our credit ratings will limit our ability to borrow at interest rates consistent with the interest rates that were available to us in the past. If our credit ratings are downgraded or put on watch for a potential downgrade, we may not be able to sell additional debt securities or borrow money in the amounts, at the times or interest rates or upon the more favorable terms and conditions that might be available if our current credit ratings are maintained.

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

Pursuant to the Communications Order, we were required to obtain the prior written consent of the Ministers in order to obtain a permit to acquire the controlling interest in Bezeq. Under the Communications Order, no person may hold, directly or indirectly, "significant influence" over Bezeq or 5% or more of any particular class of Means of Control in Bezeq, nor may any person, together with any other person, appoint, elect or dismiss the general manager of Bezeq or cause the election, appointment or dismissal of any director of Bezeq, without the prior written consent of the Ministers. Subject to certain exceptions, prior written approval of the Ministers is also required to increase the holdings or other rights in excess of those determined in the initial approval, including by means of an agreement (including a voting agreement). No person may transfer control, "significant influence" or Means of Control in Bezeq to another, if, as a result of the transfer, the holdings of the transferee would require approval pursuant to the Israeli Communications Law or Communications Order and the transferor is aware that the transferee is not in possession of the requisite approval. For the foregoing purposes, "significant influence" means the ability to significantly influence the activity of a corporation, whether alone or together with or through others, directly or indirectly, other than as a result of holding Means of Control in that corporation or in another corporation, and including the ability derived from the corporation's articles of association, a written, oral or other kind of agreement, or from any other source. In this context, the right to appoint an officer or holding 25% of our Means of Control is presumed to confer significant influence. "Means of Control" means the right to vote at a general meeting of the company, appoint a director or general manager of the company, or to participate in the profits of the company or a share of the remaining assets of the

company after payment of its debts upon liquidation.

The Control Permit includes several conditions, including, among others, the requirement that SP2 be controlled exclusively by the other parties to the Control Permit and that the parties to the Control Permit hold not less than 30% of any type of Means of Control of Bezeq and SP2. In February 2011, the Ministers permitted such percentage to decrease to 29% for a period of six months commencing from the date such holdings fall below 30%, in the event of dilution resulting from the exercise of options by Bezeq employees.

Despite the 30% rule, according to Article 3(a3) of the Communications Order, which is included as part of the Control Permit, the parties may hold less than 30% under certain circumstances, including the requirement that the parties control Bezeq and maintain at least a 25% ownership interest in Bezeq.

In addition, the Control Permit requires that 19% of SP2 be held at all times by an "Israeli Party," as defined in the Communications Order. The Control Permit also includes certain notice requirements regarding changes in the composition of the board of directors and certain holdings in us and B Communications. If we, B Communications or any other member of the Eurocom Group subject to the Control Permit fails to comply with the terms of the Control Permit or with other regulatory provisions relating to the control of Bezeq, such permit could be revoked and our rights with respect to our Bezeq interest would be adversely impacted, which would have a material adverse effect on our business and financial position.

Any event in which a receiver is appointed with respect to B Communications' holdings in SP2 or SP2's holdings in Bezeq will constitute grounds for the cancellation of the Control Permit. In addition, in the event that the Ministers determine that a material change in the details included in the application for the Control Permit has occurred or the members to the Control Permit failed to provide requisite notifications in accordance with the Control Permit, and there is a real concern that the essential service provided by Bezeq will be harmed, the Ministers may cancel the Control Permit or set conditions for its continuation pursuant to the provisions of the Israeli Communications Law. In the event that the Control Permit is cancelled and an application to reissue another control permit is denied, our holdings in Bezeq must be liquidated within 15 to 60 days (depending on the cause for such cancellation) pursuant to the Communications Order.

**In accordance with Concentration Law, if either we or B Communications are unable to delist our ordinary shares from the TASE and redeem any publicly held debt or go private prior to December 10, 2019, B Communications will not be permitted to control Bezeq after such date.**

Under the recently enacted Concentration Law, a second-tier company (i.e., a company with publicly held debt or equity securities that is subject to reporting obligations under the Israeli Securities Law and controlled by a first-tier company), is prohibited from controlling another tier company. In the case of existing companies, a second-tier company is entitled to continue to control another tier company that it controlled on the publication date of the Concentration Law for a period of six years from the date of publication of the Concentration Law, i.e., until December 10, 2019. In the event that a second-tier company controls another tier company contrary to the provisions of the Concentration Law, a district court may appoint a trustee, who will be awarded the Means of Control in such tier company for the purpose of selling such Means of Control. The trustee shall act pursuant to the orders of such court with respect to the Means of Control. Such court may, instead of appointing a trustee and under certain circumstances, order that the Means of Control held by the controlling shareholder shall not provide any rights whatsoever. Until the appointment of a trustee by a district court, the Means of Control held by a tier company that illegally controls another tier company shall not grant any voting rights at the illegally held tier company's shareholder meetings. The Concentration Law sets forth certain mechanisms intended to enable a tier company to make various arrangements for the repurchase of its publicly-held shares and the early redemption of publicly-held debt in order to comply with the provisions of the law.

Under the Concentration Law, we are deemed to be a first-tier company, B Communications is deemed to be a second-tier company and Bezeq is deemed to be a third-tier company. Accordingly, if either B Communications or we are unable to redeem any publicly held debt and delist our ordinary shares from the TASE (which would require 90-days' prior notice to the TASE) or go private prior to December 10, 2019, B Communications will not be permitted to control Bezeq after such date and its holdings in Bezeq may be transferred to a trustee for the purpose of selling such holdings. Furthermore, if a trustee is appointed, he may motion a district court to order the cancellation of distributions made by Bezeq prior to his appointment if they are deemed to not be in Bezeq's interest.



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

Section 3(a)(1)(A) of the Investment Company Act of 1940, or the Investment Company Act, defines an investment company as any issuer that is, holds itself out as being, or proposes to be, primarily engaged in the business of investing, reinvesting or trading in securities and Section 3(a)(1)(C) of the Investment Company Act defines an investment company as any issuer that is engaged or proposes to engage in the business of investing, reinvesting, owning, holding or trading in securities and owns or proposes to acquire “investment securities” (within the meaning of the Investment Company Act) having a value exceeding 40% of the value of the issuer’s total assets (exclusive of U.S. government securities and cash items) on an unconsolidated basis. However, an issuer will be deemed not to be an investment company if no more than 45% of the value of such issuer’s total assets (exclusive of government securities and cash items) consists of, and no more than 45% of such issuer’s net income after taxes (for the last four fiscal quarters combined) is derived from, securities other than, among other things, securities issued by companies which are controlled primarily by such issuer. Primary control is presumed if the issuer owns over 25% of the controlled company’s voting securities and the issuer has control greater than that of any other person. Accordingly, so long as we maintain control of Bezeq, we will not be deemed an investment company.

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

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

**Our success depends on the continued service of certain key executives and personnel of Bezeq and the management of our company.**

The Bezeq Group's key executives and employees possess substantial knowledge of its business and operations. We cannot assure you that the Bezeq Group will be successful in retaining their services or that the Bezeq Group would be successful in hiring and training suitable replacements without undue costs or delays. As a result, the loss of any of these key executives and employees could cause significant disruptions in the Bezeq Group's business operations, which could materially adversely affect our results of operations. Similarly, our management has been instrumental in our success and loss of any key members of our management could materially adversely affect our financial condition, results of operations and prospects.

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

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

Failure to maintain effective internal control over financial reporting could result in investigation or sanctions by regulatory authorities and could have a material adverse effect on our operating results, investor confidence in our reported financial information and the market price of our ordinary shares.

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

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

Messrs. Shaul and Yossef Elovitch, directly and through their control of Eurocom Communications, beneficially owned 61.14% of our outstanding ordinary shares, as of April 26, 2017. For as long as Eurocom Communications has a controlling interest in our company, it, Mr. Shaul Elovitch, the chairman of our board of directors and the controlling shareholder and chairman of the board of directors of Eurocom Communications will have the power to determine or significantly influence the outcome of matters submitted to a vote of our shareholders that require a simple majority, including the power to elect all of the members of our board of directors (except external directors, within the meaning of Israeli law) and will have the ability to exercise a controlling influence over our business and affairs, including any determinations with respect to potential mergers or other business combinations involving us, our acquisition or disposition of assets, our incurrence of indebtedness, our issuance of any additional ordinary shares or other equity securities, our repurchase or redemption of ordinary shares and our payment of dividends. Because the interests of Eurocom Communications and Mr. Elovitch may differ from the interests of our other shareholders, actions taken by Eurocom Communications with respect to us may not be favorable to our other shareholders.

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

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

*Cross officerships, directorships and share ownership.* A few of our directors and officers also serve or are employed by Eurocom Communications and/or B Communications. The cross officerships and directorships as well as the ownership interests of our directors and officers in our ordinary shares could create, or appear to create, conflicts of interest when directors and executive officers are faced with decisions that could have different implications for the different companies; and

*Intercompany transactions.* From time to time, Eurocom Communications, B Communications or other companies within the Eurocom Group may enter into transactions with us or our subsidiaries or other affiliates. Although the terms of any such transactions will be established based upon negotiations between employees of such companies and us and, when appropriate, subject to the approval of our independent directors or a committee of disinterested directors and in some instances a vote of shareholders, the terms of any such transactions may not be as favorable to us or our subsidiaries or affiliates as may otherwise be obtained in arm's-length negotiations with unaffiliated third parties.

## **Risks Related to Our Ordinary Shares**

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

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

Quarterly variations in our operating results;

Global economic conditions;

Price movements in the market price of Bezeq's ordinary shares;

Operating results that vary from the expectations of securities analysts and investors;

Changes in expectations as to our future financial performance, including financial estimates by securities analysts and investors;

Regulatory changes that impact pricing of services and competition in Bezeq's markets;

Changes in market valuations of other communications companies;

Announcements of technological innovations or new services by Bezeq or its competitors;

Announcements by Bezeq or its competitors of significant contracts, acquisitions, strategic partnerships, joint ventures or capital commitments;

Changes in the status of Bezeq's intellectual property rights;

Announcements by third parties of significant claims or proceedings against us or Bezeq;

Additions or departures of key personnel;

Future sales of our ordinary shares; and

Stock market price and volume fluctuations.

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

**There is a significant risk that we are a passive foreign investment company, which would subject our U.S. investors to adverse tax rules.**

For U.S. federal income tax purposes, we would be classified as a passive foreign investment company, or PFIC, for any taxable year in which either: (i) 75% or more of our gross income is passive income or (ii) at least 50% of the average quarterly value of our assets for the taxable year produce or are held for the production of passive income. Based on our current and projected income, assets and activities, there is a significant risk that we are currently a PFIC.

If we were classified as a PFIC for U.S. federal income tax purposes, complex rules would apply to U.S. investors owning our ordinary shares. Such investors could suffer adverse U.S. tax consequences. If eligible, a U.S. investor may avoid many of the negative consequences of the PFIC rules by making a "mark-to-market" election (as explained below) for each taxable year in which our company is a PFIC. For more information please see "Item 10. Additional Information – E. Taxation – United States Federal Income Taxation – Passive Foreign Investment Companies." You are urged to consult your tax advisors regarding the application of the PFIC rules to you.

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

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

We, B Communications and the Bezeq Group companies are organized and based in the State of Israel and Bezeq derives substantially all of its revenues from markets within the State of Israel. As a result, political, economic and military conditions affecting Israel directly influence us. In recent years, there have been hostilities between Israel and Hezbollah in Lebanon and Hamas in the Gaza strip, both of which resulted in rockets being fired into Israel causing casualties and disruption of economic activities. In addition, Israel faces threats from more distant neighbors, in particular, Iran. In recent years riots and uprisings in several countries in the Middle East and neighboring regions have led to political instability in several neighboring states and to a decrease in the regional security situation. Such instability may affect the local and global economy, could negatively affect business conditions and, therefore, could adversely affect our operations. Although these matters have not had any material effect on our business and results of operations to date, the regional security situation and worldwide perceptions of it are outside our control and there can be no assurance that these matters will not negatively affect us in the future. Any major hostilities involving Israel, a full or partial mobilization of the reserve forces of the Israeli army, the interruption or curtailment of trade between Israel and its present trading partners, or a significant downturn in the economic or financial condition of Israel could have a material adverse effect on our business, financial condition and results of operations.

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

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

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

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

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

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

Pursuant to the Communications Order, we were required to obtain the prior written consent of the Ministers in order to acquire the controlling interest in Bezeq. Under the Communications Order, no person may hold, directly or indirectly, “significant influence” over Bezeq or 5% or more of any particular class of means of control in Bezeq, nor may any person, together with any other person, appoint, elect or dismiss the general manager of Bezeq or cause the election, appointment or dismissal of any director of Bezeq, without the prior written consent of the Ministers. Subject to certain exceptions, prior written approval of the Ministers is also required to increase the holdings or other rights in excess of those determined in the initial approval, including by means of an agreement (including a voting agreement). Furthermore, under the Communications Order, no person may transfer control, “significant influence” or means of control in Bezeq to another, if, as a result of the transfer, the holdings of the transferee would require approval pursuant to the Communications Law or Communications Order and the transferee is not in possession of the requisite approval. For the foregoing purposes, “significant influence” means the ability to significantly influence the activity of a corporation, whether alone or together with or through others, directly or indirectly, other than as a result of holding “means of control” in that corporation or in another corporation, and including ability derived from the corporation’s articles of association, a written, oral or other kind of agreement, or from any other source. In this context, the right to appoint an officer and holding 25% of our means of control is presumed to confer significant influence. “Means of control” means the right to vote at a general meeting of the company, to appoint a director or general manager of the company, to participate in the profits of the company or a share of the remaining assets of the company after payment of its debts upon liquidation.

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

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

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

#### **ITEM 4. INFORMATION ON THE COMPANY**

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

We were organized under the laws of the State of Israel in April 1992 under the name Euronet Golden Lines (1992) Ltd. In June 1999 we changed our name to Internet Gold - Golden Lines Ltd. We are a public limited liability company under the Israeli Companies Law 1999 and our shares are traded on the NASDAQ Global Select Market and



TASE. Our registered offices and principal place of business are located at 2 Dov Friedman Street, Ramat Gan 5250301, Israel, and our telephone number is +972-72-924-0000. Our website address is [www.igld.com](http://www.igld.com). The information on our website is not incorporated by reference into this annual report on Form 20-F.

We are a leading communications group in Israel. Our principal subsidiary, B Communications, is the controlling shareholder of Bezeq (TASE: BZEQ), Israel's largest telecommunications provider. Since B Communications' initial public offering in October 2007, its ordinary shares have been listed on the NASDAQ Stock Market (symbol: BCOM) and the TASE. We currently own 64.78% of the ordinary shares of B Communications. B Communications maintains a website at [www.bcommunications.co.il](http://www.bcommunications.co.il). The information on B Communications' website is not incorporated by reference into this annual report on Form 20-F.

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

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

In addition to our ownership of Bezeq shares through B Communications, a total of 1,000,000 ordinary shares of Bezeq are jointly held by Mr. Shaul Elovitch, our controlling shareholder, and his brother, Mr. Yossef Elovitch. Further, 72,360 ordinary shares of Bezeq are held by Ms. Iris Elovitch, the wife of Mr. Elovitch, and 11,556 ordinary shares of Bezeq are held by Ms. Orna Elovitch, the daughter-in-law of Mr. Elovitch.

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

According to the Companies' Control Permit, the parties (through SP2) must hold not less than 30% of any type of means of control of Bezeq. Such percentage is permitted to decrease to 29% for a period of six months commencing from the date such holdings fall below 30%, in the event of dilution resulting from the exercise of stock options by Bezeq employees. Despite the 30% rule, according to Article 3(a3) of the Communications Order, which is included as part of the Control Permit, the parties to the Control Permit may hold less than 30% under certain circumstances, including the requirement that the parties control Bezeq and maintain at least a 25% ownership interest in Bezeq.

For additional discussion about the Control Permit, see Item 4B. "Information On The Company-Regulatory- *Permit to Control Bezeq Granted to Members of the Eurocom Group.*"

## **B. Business Overview**

Since April 14, 2010, we, through our subsidiaries, have been the controlling shareholder of Bezeq (TASE:BZEQ), Israel's largest telecommunications provider. Bezeq is the principal provider of communications services in Israel, providing a broad range of telecommunications operations and services, including domestic fixed-line, cellular and international communication services, Internet services, multi-channel television, television and radio broadcasts,

satellite broadcasts, customer call centers, maintenance and development of communications infrastructures, provision of communications services to other communications providers and the supply and maintenance of equipment on customer premises, which is referred to as network end point, or NEP services. Bezeq was founded as a government company in 1980 and became a public company in 1990 with its shares traded on the TASE and included in the TA-35 Index.

The principal Bezeq Group segments are as follows:

| Bezeq Group Segments | Service   | As of December<br>31, 2016<br>Estimated<br>Market<br>Share | Market<br>Position |
|----------------------|---|--|--------------------|
| Bezeq                | Fixed-Line Telephony (private sector)               | 55.0%  | 1 of 4             |
|                      | Fixed-Line Telephony (business sector)              | 73.0%  | 1 of 2             |
|                      | Fixed-Line Broadband Internet Infrastructure Access | 68.0%  | 1 of 2             |
| Pelephone            | Cellular Telephony                                  | 22.7%  | 3 of 5             |
| Bezeq International  | ISP   | 44.0%  | 1 of 4             |
|                      | ILD   | 21.0%  | —                  |
| DBS                  | Pay Television                                      | 40.0%  | 2 of 2             |

The Bezeq Group had approximately 2.12 million active fixed telephone lines in its fixed-line telephony business, 1.56 million fixed-line broadband Internet infrastructure access services subscribers (retail and wholesale), 2.40 million cellular telephony services subscribers and 614,000 pay television services subscribers as of December 31, 2016. For the year ended December 31, 2016, the Bezeq Group had revenues of NIS 10.08 billion (approximately \$2.62 billion).

In view of a decision of the Supreme Court on August 21, 2009, not to approve the merger of Bezeq and DBS, Bezeq discontinued consolidation of its financial statements with those of DBS, and from that date the investment in DBS shares was presented according to the equity method. The balance of DBS shares were held by Eurocom D.B.S., a company controlled indirectly by Messrs. Shaul and Yossef Elovitch, controlling shareholders of Bezeq.

Until March 25, 2015, Bezeq held 49.78% of the shares of DBS and it also owned stock options which entitled it to acquire an additional 8.6% of the shares of DBS. On March 25, 2015, Bezeq exercised the stock options that it owned, for no payment, and on June 24, 2015 Bezeq completed a transaction in which it acquired all the holdings of Eurocom D.B.S. in DBS, which at that time constituted 50.22% of the issued share capital of DBS (41.62% fully diluted) as well as all the shareholders' loans that Eurocom provided to DBS (NIS 1,538 million as at December 31, 2014).

On the completion of the transaction, Bezeq transferred the cash consideration of NIS 680 million to Eurocom DBS and Eurocom D.B.S. transferred to Bezeq all its shares and rights to shares in DBS and assigned to Bezeq its entire rights in the shareholders' loans that it had provided to DBS. Upon completion of the transaction, DBS became a wholly owned subsidiary of Bezeq.

In addition to the cash payment of NIS 680 million, the consideration also included two additional contingent payments consisting of: (i) an additional payment of up to NIS 200 million to be paid in accordance with the tax synergy ("First Contingent Payment"; and (ii) an additional payment of NIS 170 million to be paid according to the business results of DBS in the three years following the closing (the "Second Contingent Payment"). Most of the First Contingent Payment was paid after Bezeq entered into a tax assessment agreement and tax decision with the Israeli Tax Authority. Bezeq paid advances on account of the Second Contingent Payment that were not recorded as an expense in its financial statements. Additionally, Bezeq's financial reports contain a commitment of NIS 84 million for the Second Contingent Payment based on a management estimate. In the event the proposed merger between Bezeq and DBS takes place in 2017, the amount owed to Eurocom D.B.S. is expected to be the full amount of the Second Contingent Payment, and in the event the proposed merger takes place after the end of 2017, the amount payable to Eurocom D.B.S. will be contingent on the results of DBS for 2017.

According to the conditions prescribed in the Antitrust Authority's approval of the merger between Bezeq and DBS in March 2014, the following limitations apply with respect to Bezeq and DBS:

Bezeq and any person associated with it will not impose any restriction on the use of fixed-line Internet infrastructure services stemming from the customer's cumulative surfing volume, and it may not restrict or block the customer ability to make use of any service or application provided on the Internet.

Bezeq will deduct amounts for providing multi-channel TV services from the payments of ISPs for connecting them to the Bezeq network.

Bezeq will sell and provide Internet infrastructure services and TV services under equal conditions to all Bezeq customers (the sale of Internet infrastructure services as part of a bundle will not, in itself, be considered a sale under non-equal conditions).

Bezeq and DBS will cancel any exclusivity arrangements pertaining to productions that are not original productions and they will not be a party to any such exclusivity arrangements, except in with respect to a third party that held a broadcast license on the date of the decision. For two years from the approval date of the merger, Bezeq will not prevent any entity (excluding an entity that held a broadcast license on the date of the decision) from acquiring rights in original productions.

The main purpose of the merger, from the business and economic perspective, is to streamline the activity and operation of Bezeq and DBS and to consolidate it under a single legal entity in order to save operating costs in the long term.

Further to the announcement by the Director General of the Ministry of Communications of December 21, 2016 concerning “cancellation of the structural separation obligation in Bezeq Group, Bezeq and DBS entered into a merger agreement on December 25, 2016. Subject to the conditions precedent set out in the Antitrust Authority’s approval of the merger and as noted below, on the date of completion of the merger, and to be effective retroactively from December 31, 2016, all the activity of DBS will be merged with and into Bezeq, for no payment, in accordance with the provisions of Section 323 of the Companies Law and under the provisions of Sections 103B and 103C of the Income Tax Ordinance. At such time DBS will cease to exist as a separate legal entity, it will be dissolved without liquidation, and the Registrar of Companies will delete it from the register of companies.

Completion of the merger is subject to compliance with the following conditions:

Obtaining the approval of the Companies Registrar (merger certificate).

Obtaining various regulatory approvals from the Ministry of Communications, Minister of Communications and head of the Civil Administration.

Obtaining approvals from any third parties whose approval is required. If Bezeq's Board of Directors believes that such approval is immaterial to completion of the merger, it may, in its discretion, waive the obtaining of any third party approval.

The arrangement of any incompatibility that is found upon completion of the merger between the Deed of Trust and the debentures of DBS and fixed liens registered on a particular asset of DBS, and Bezeq's financing documents, under which a commitment is in place to refrain from creating charges on Bezeq's assets, lifting the financial restrictions and covenants set out in the financing agreements of DBS, so that they will not apply to the merged company, and all to Bezeq's satisfaction and as will be approved by Bezeq's Board of Directors.

Subsequently, the NIS 389 million of shareholders' loans registered in Bezeq's name in the books of DBS, including principal and accrued interest at December 27, 2016, were converted to equity and Bezeq made an additional investment in the capital of DBS against a premium in the amount of NIS 130 million. In September 2016, shareholders' loans in the amount of NIS 5.3 billion were converted into equity.

Bezeq and DBS continue to operate as separate companies.

## **Our Strategy**

We view our controlling interest in Bezeq (through B Communications) as a strategic asset and currently expect to maintain a long-term controlling interest in Bezeq. The telecommunications market has historically served as a growth engine for the Eurocom Group and we intend to continue to focus our business on the telecommunications field. We intend to leverage our long-term experience and expertise in the telecommunications field to continue to contribute to Bezeq's management and operations, through ongoing involvement in its business and provision of extensive consulting and strategic services. We intend to continue to reduce our leverage through the repayment of debt.

***The Bezeq Group is a leading provider of telecommunications services and owner of telecommunications infrastructure in Israel and provides diversified telecommunications offerings across all Israeli telecom markets.***

The Bezeq Group is the largest and the incumbent telecommunications provider in Israel, offering a broad range of services through its advanced, comprehensive and nationwide telecommunications infrastructure. The Bezeq Group holds a leading position in each of the markets in which it operates. As a leading provider in each of these markets, the Bezeq Group has been able to maintain its strong performance and benefit from economies of scale. In addition, such leading positions across a diverse range of telecommunications offerings reduce the Bezeq Group's exposure to market and regulatory conditions. We believe that the Bezeq Group's ability to maintain a leading position in the Israeli telecommunications market in the face of competitive and regulatory pressures reflects, among other things, the underlying strength of its advanced nationwide network infrastructures, the strength of its brands and its extensive offering of high quality content.

***The Bezeq Group operates in an attractive macroeconomic environment with a developed telecommunications market.***

Israel is a developed, industrialized market characterized by strong macroeconomic fundamentals.

The Israeli telecommunications market is highly developed and benefits from favorable dynamics, including high penetration rates across all telecommunications services, high penetration of postpaid contracts in the cellular telephony market, rapid adoption rates of new technologies and significant expenditures on telecommunications services by consumers and businesses. In addition, Israel is expected to experience steady population growth, which should provide a natural expansion of the addressable market. In particular, Bezeq expects such population trends will lead to a steady demand for fixed-line telephony services in Israel, especially among certain sectors of the growing population in Israel where fixed-line telephony is in widespread use. Furthermore, a relatively young population contributes to the attractiveness of the market, as such consumers typically spend more on telecommunications products and services while also driving increased demand for new technologies. We believe that the potential future growth in the Israeli telecommunications market will be driven by continued strong demand for higher bandwidth, both on the broadband Internet and mobile platforms, and advanced value-added services and technologies across all telecommunications services.

*The Bezeq Group owns advanced nationwide network infrastructures and is positioned at the forefront of technological innovation across all of the telecom markets in Israel.*

The Bezeq Group has historically made substantial investments in its fully owned infrastructure, which is one of the most technologically advanced in Israel and enables the Bezeq Group to reach customers nationwide. Bezeq has a Next-Generation Network (NGN) based on a core IP network and deployment of an optical fiber network to street cabinets (a network topology known as Fiber to the Curb, or FTTC) and also based on an access network (a system that connects NEPs on the subscriber's premises to the network and engineering systems). Bezeq completed the deployment of the network at the end of 2015. The connection from the home, or the terminal equipment (equipment which is installed on the subscriber's premises, e.g., the actual telephone, private exchanges, fax machines, modems, routers, etc.) through which the subscriber receives the service, to the access network is based on copper cables and optical cables that connect the access systems to the backbone over optic cables (through special pipes or an above ground network) and to a limited degree through wireless systems. Today, using VDSL2 technology, it is possible to provide a bandwidth of up to 100 Mbps downstream, as well as innovative added-value services. Other advantages of the new technology are simplification of the network structure and better management ability.

Pelephone currently operates communications networks using three main technologies:

LTE 4G technology is based on GSM standards. The advantages of this technology are larger data communication capacity and faster download rates than with the 3G technologies. All the terminal devices that support this technology also support the 3G technologies and the transition between the technologies is seamless.

The UMTS/HSPA technology is based on GSM 3G standard. This technology is globally widespread, and enables subscriber identification and services to be provided through a SIM card, which can be moved from one handset to another. This technology supports download speeds of up to 42 Mbps and upload speeds of up to 5.7 Mbps.

CDMA technology. To date, this network serves a limited number of subscribers who seldom use the network. Pelephone expects to cease operating this network in 2017, subject to the approval of the Ministry of Communications. Pelephone is acting to transfer the existing CDMA network subscribers to the UMTS/HSPA and LTE networks.

The infrastructures for Pelephone's networks are mainly based at two switch farms which are connected to more than 2,300 sites.

Under an agreement entered into in 2014, L.M. Ericsson Israel Ltd., or Ericsson, serves as Pelephone's supplier for the deployment of its 4G LTE radio network. In recent years Pelephone invested NIS 460 million in the deployment of



the network, including acquisition of frequencies, and Pelephone estimates that its total investments in infrastructures in 2017 will not be materially different from the investments it made in 2016. Pelephone does not expect to significantly increase its investment in infrastructure. In addition, over the coming decade Pelephone will be required to continue to establish new broadcast sites, in order to comply with the terms of its mobile telephony license.

In the ISP, ILD, data transfer, networks and ICT services segment, Bezeq International is currently the sole ISP in Israel to own and operate its own high-speed submarine optical fiber communications cable system. The JONAH cable, which was launched in January 2012, has a capacity of over 7.0 Tbps and provides Bezeq International with greater capacity for utilization than any other ISP in Israel. In addition, Bezeq International is able to obtain such capacity at an incremental cost, while other ISPs in Israel are required to purchase capacity and rely on one of the two other cable operators in Israel (MedNautilus and Tamares). The JONAH cable is fully redundant (i.e., utilizes two equipped fiber pairs), and in addition, Bezeq International has available capacity on two alternate submarine routes to Europe.

In the multi-channel pay television segment, DBS is the only licensed provider of multi-channel television broadcasts via satellite in Israel. While DBS relies on third party providers for the provision of satellite capacity, it owns the satellite dishes that carry the signals from such satellites to subscriber residences and set-top boxes. DBS differentiates itself from its main competitor, HOT, by offering a wide range of high quality content and by utilizing technology to be the first pay television services provider to offer new and innovative value-added services to subscribers. For instance, DBS was the first provider in Israel to offer a set-top box that combined PVR, VOD and HD capabilities in one device (branded as “yes MaxTotal”). DBS’s PVR offering enables subscribers to download a movie or series to their yes MaxTotal set-top box over the Internet and watch recorded content immediately or at a later time. DBS is also the only provider in Israel that offers a multiroom service allowing subscribers to watch recorded content on multiple capable set-top boxes (“yes MultiRoom”) and in 2014 DBS introduced its TV Everywhere service, branded as yesGo, which allows subscribers to watch content from mobile devices. In 2015, DBS began to offer a HDPVR converter known as yesQuattro that allows the recording of up to 4 channels simultaneously in addition to the channel being viewed, has increased the number shows that may be recorded, and allows the automatic recording of prime time content (6:00 PM to midnight) on two channels that the subscriber can select for seven days (known as PrimeTime service).

DBS also operates its yesGo service, which allows subscribers to view the channels included under the service that they have purchased for home television viewing and VOD content, over a variety of terminal devices (smartphones, tablets and PCs).

Other providers enable VOD viewing through the Internet, such as AppleTV and Netflix (which currently offer content without Hebrew translations). Several entities are considering launching similar services.

***The Bezeq Group's brands are among the strongest and most widely recognized brands in Israel and are supported by its substantial investments in marketing, strong product and service offerings, extensive distribution network and leading customer service offerings.***

The Bezeq Group's brands are among the strongest and most widely recognized brands in Israel, including Bezeq, Pelephone, Bezeq International and DBS. The Bezeq Group's brands have been supported by its sustained and substantial investments in strong product and service offerings, marketing, extensive distribution network and leading customer service offerings. We believe the Bezeq Group's product and service offerings combined with its advanced technology and infrastructure are the key factors driving the association of the Bezeq, Pelephone, Bezeq International and YES brands with reliability, speed, excellent service and innovation throughout Israel. The Bezeq Group's marketing campaigns focus on and highlight various elements regarding each of its brands. For example, Bezeq focuses on the value-added services offered with its fixed-line broadband Internet infrastructure access service, Pelephone highlights the speed of its network, Bezeq International focuses on providing faster Internet speed than its competitors and its strong customer service, and DBS emphasizes its large selection of high quality international content and the subscriber viewing experience associated with it. Furthermore, the Bezeq Group also provides its customers with award winning customer service offerings in order to enhance customer loyalty.

***The Bezeq Group has an extensive offering of high quality content.***

Through its wholly-owned subsidiary, DBS, the Bezeq Group is able to complement its extensive telecommunications infrastructure with a wide array of high quality content. For instance, DBS, which benefits from strong content differentiation in the pay television market, provides a leading selection of television series and movies. With respect to television series, DBS broadcasts new television series at a minimal delay, in some cases within hours from the time the content is originally aired in the United States or worldwide. DBS also has an agreement with HBO pursuant to which DBS aired all of HBO's new English language television series and movies, the majority of which were only aired in Israel on DBS. The Bezeq Group's extensive offering of high quality content distinguishes it from competitors, and we believe that such distinction will likely enhance the Bezeq Group's competitive position if and when the Israeli wholesale market develops and the Bezeq Group's competitors that do not currently offer bundled packages with pay television begin doing so.

*The Bezeq Group's strong cash flow generation supports substantial and consistent dividends while providing for investment in the business and maintenance of a conservative level of leverage.*

The Bezeq Group is a highly cash generative business and has a proven track record of consistent operating cash flow generation. The Bezeq Group's stable, and in some segments, growing customer base and attractive offerings and services, together with its focus on profitability, provide it with strong revenues, Adjusted EBITDA margin and operating cash flow. While generating strong cash flow, the Bezeq Group has continued to invest in its business, technologies and infrastructure through major capital expenditure programs, several of which were completed in the last four years (including, the deployment of Bezeq's NGN, Pelephone's advanced 3.5G UMTS/HSPA+4G cellular network and the launch of Bezeq International's JONAH cable).

The following table sets forth the Bezeq Group's operating cash flow and ratio of capital expenditures to revenues for the years ended December 31, 2014, 2015 and 2016. The operations of DBS have been included for the last nine months of 2015.

|  | Year ended December 31,              |        |        |
|--|--------------------------------------|--------|--------|
|  | 2014                                 | 2015   | 2016   |
|  | (NIS in millions except percentages) |        |        |
| Operating cash flow                        | 3,796                                | 3,740  | 3,526  |
| Capital expenditure, net                   | 1,045                                | 1,484  | 1,278  |
| Capital expenditure, net as a % of revenue | 11.5 %                               | 14.9 % | 12.7 % |

We believe the Bezeq Group has a conservative capital structure and that such conservative capital structure and strong cash flow generation have historically enabled Bezeq to make consistent dividend payments to its shareholders. Since 2006, Bezeq has distributed dividends in an amount equal to 100% of its net income after minority share in each year and has also approved a special dividend on two occasions.

***The Bezeq Group has an experienced management team with a proven track record in the Israeli telecommunications industry.***

The Bezeq Group's management team has significant experience in the telecommunications industry, including with respect to the transformation of telecommunications companies and generating growth. The Bezeq Group's executive management has a proven track record in leading international and domestic technology and telecommunications companies and has successfully delivered efficient operating performance and strong returns for its shareholders despite increasing regulatory hurdles and competition in recent years. In recent years, the Bezeq Group's management has overseen significant investments in infrastructure to position the members of the Bezeq Group at the forefront of technology for the coming years.

***We are the sole controlling shareholder of Bezeq and have a management team with significant experience in developing and operating telecommunications companies.***

We have sole control of Bezeq and, together with our controlling shareholders and members of the Eurocom Group, are the only entities or persons that hold a permit to control and direct the activities of Bezeq. Since our acquisition of the controlling interest in Bezeq, we have nominated all of the members of Bezeq's board of directors who were elected by shareholders, excluding employee representatives on the Board whose nominations require the prior approval of our ultimate controlling shareholder, Mr. Shaul Elovitch, as chairman of Bezeq's Board of Directors, pursuant to Bezeq's collective bargaining agreement.

Our management team and controlling shareholder have long-standing experience in the communications sector. Our founder and Chairman, Mr. Shaul Elovitch, was one of the founders of some of Israel's leading telecommunications businesses (including, among others, DBS, Partner and Internet Gold) and other major investment businesses, and has over 40 years of experience in the telecommunications market. Our Chief Executive Officer, Doron Turgeman, has over 20 years of experience in the telecommunications sector.

Our controlling shareholder, Eurocom Communications, is one of Israel's largest holding groups, with extensive experience in the telecommunications market and controlling stakes in other telecommunications companies, including Spacecom, Satcom, all of which operate in the field of satellite communications, Eurocom Cellular, a leading supplier in Israel of cellular devices, and Eurocom Digital, a leading supplier in Israel of communications products.

## **Products and Services**

The Bezeq Group provides a wide range of telecommunications services for its business and private customers, including domestic fixed-line telephony and fixed-line broadband Internet infrastructure access services, cellular telephony services, ISP, ILD, data services, ICT solutions, multi-channel television broadcasts via satellite, customer call centers, maintenance and development of communications infrastructures, provision of communications services to other communications providers and the supply and maintenance of equipment on customer premises, also known as network end point (NEP) services.

Since May 2010, Bezeq has been permitted to offer joint service packages with its subsidiaries to private subscribers, and since July 2012, Bezeq has been permitted to offer joint service packages with its subsidiaries to business subscribers, in each case, subject to the approval of the joint service package by the Ministry of Communications and other conditions contained in Bezeq's license. The joint service packages must be capable of being "unbundled" such that each service included in a package must be offered separately and on the same terms, which effectively prevents the Bezeq Group from enhancing the attractiveness of the offer by offering a discount on the joint service packages. Joint service packages marketed by Bezeq's subsidiaries that include the services of Bezeq are also subject to similar limitations, including "unbundling" (except for a bundle offered by a subsidiary that only contains Bezeq's fixed-line broadband Internet infrastructure access service).

Bezeq currently offers packages that combine a subscription to Bezeq's fixed-line broadband Internet infrastructure access and to the accompanying ISP service, with the ability to choose from any ISP provider in Israel, including Bezeq International. The packages are "unbundled" and offered at the same price that the standalone services would cost if subscribed to separately. In addition, Bezeq offers packages to business customers that combine Bezeq's business data lines and the accompanying ISP service from Bezeq International. These packages are also "unbundled" and offered at the same price that the standalone services would cost if subscribed to separately. Business customers are also not required to use Bezeq International as their ISP provider and have the ability to choose any ISP provider in Israel.

These restrictions, and in particular the unbundling obligation which severely limits the Group's ability to offer discounts on the components of the bundle, puts the Group in a competitively inferior position as compared to the competing communications groups which are not subject to similar restrictions in marketing joint bundles (other than a restriction on marketing a joint bundle of HOT-Net and other companies in the HOT Group). Bezeq's restrictions are more significantly manifested with the implementation of the wholesale BSA services and the option for ISPs to provide end-to-end services to customers at reduced prices compared with the bundles that Bezeq can market, which can be unbundled.

*Domestic Fixed-Line Communications (Bezeq)*

Bezeq is the incumbent and largest provider of fixed-line telephony and fixed-line broadband Internet infrastructure access services in Israel. Its products and services include basic telephony services on domestic telephone lines and associated services and fixed-line broadband Internet infrastructure access services through its nationally deployed, high quality infrastructure network. Bezeq also offers, among other services, transmission and data communication services, services to other communications operators and broadcasting services. Bezeq's new high-speed next generation network, or NGN, is the most advanced fixed-line communications network in Israel. The NGN, which covers 100% of Israeli households, uses VDSL2 technology and enables Bezeq to provide bandwidth of up to 100 Mbps (download) speed, as well as innovative value-added services.

|   | As at and<br>for the<br>year ended<br>December<br>31,<br>2016<br>(in millions,<br>except<br>percentages) |   |
|---|--|---|
| Bezeq Domestic Fixed-Line Communications            |  |   |
| Revenues (in NIS)                                   | 4,383  |   |
| Fixed-line telephony                                |  |   |
| Estimated market share <sup>(1)</sup>               | 64   | % |
| Active lines  | 2.119  |   |
| Churn rate  | 10.4   | % |
| Fixed-line broadband Internet infrastructure access |  |   |
| Estimated market share                              | 69   | % |
| Subscribers   | 1.558  |   |

(1) As of December 31, 2016, Bezeq's market share in the business and private sectors of the fixed-line telephony market is estimated to be 73% and 55%, respectively.

*Fixed-Line Telephony Services*

Bezeq had approximately 2.12 million active fixed telephone lines as of December 31, 2016. Bezeq's fixed-line telephony services include basic telephony service on domestic telephone lines and associated value-added services, such as voice mail, caller ID, call waiting, call forwarding and conference calls. Bezeq also offers its business

customers national toll free numbers which provide for full or partial payment for customer calls by the business customer.

Bezeq offers a variety of payment plans, ranging from a monthly subscription fee per fixed telephone line and charge per second of use, to various fixed-line telephony packages comprised of monthly amounts of minutes for a fixed monthly fee.

Most of Bezeq's fixed-line telephony services are subject to regulatory tariff control and the prices for such services are governed by such regulations. With respect to services that are not subject to tariff control, Bezeq is required under the Israeli Communications Law to set reasonable tariffs for such services. In addition, Bezeq is allowed to offer "alternative payment packages" for services that are subject to tariff control, with different pricing than the regulated tariff, subject to certain conditions.

#### *Fixed-Line Broadband Internet Infrastructure Access Services*

Bezeq provides broadband Internet access infrastructure services in xDSL technology. Internet service has become one of Bezeq's main activities and is a central focus for its investments in technology, marketing, advertising, customer acquisition and upgrades. The average surfing speed of Bezeq's Internet subscribers at the end of 2016 was 43.2 Mbps compared with an average of 37.8 Mbps at the end of 2015. The minimum speed of the package provided for new customers is usually 15 Mbps.

xDSL service is also provided free of charge on subscriber lines with no telephony and at no additional cost. According to a decision of the Ministry of Communications (in respect of the cancellation of NDSL services), Bezeq may not apply differential xDSL pricing between subscribers who use the service together with telephony service and subscribers who only use the xDSL service. Bezeq also provides a free WiFi service that enables its customers to share part of their wireless bandwidth in return for browsing outside of their homes as well and benefiting from nationwide and worldwide hotspots.

Bezeq is obligated to provide broadband Internet access services in a BSA wholesale format to service providers that provide end-to-end Internet services in this way to their customers, including infrastructure.

Graph – Changes in the surfing speeds of Bezeq's Internet subscribers in 2012-2016  
(in Mbps at the end of each year):

#### *Transmission and Data Communication Services*

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

Bezeq offers transmission services, including high speed, to communications operators and their business customers over a variety of interfaces.

There is also a decline in use of Bezeq's transmission and data communication services by communications providers, in part as a result of the trend of entry of communications groups.

#### *Other Services*



Bezeq provides services to other communications operators, including cellular operators, international call operators, HOT, NEP operators, ISPs, domestic carriers, and Palestinian communications providers.

Among the services provided by Bezeq are infrastructure services, infrastructure upgrades, connection to Bezeq's network, billing services, leasing of space, and services in leased premises.

*Broadcast services*

Bezeq operates and maintains radio transmitters which are operated by the Israel Broadcasting Corporation, Israel Army Radio (Galei Zahal), among others, and also maintains and operates the transmitters of several regional radio stations and the DTT transmitters for the Second Authority. Bezeq is not responsible for the content of the broadcasts.

*Contract work*

Bezeq installs, maintains, and operates networks or subnetworks for various customers (e.g., the Ministry of Defense, HOT Telecom, radio and television broadcasting companies, cellular operators, international call operators, local authorities, municipalities, and government bodies). Bezeq has agreements with HOT Telecom to provide installation, maintenance and network hosting services using Bezeq's infrastructures.

*Private and virtual exchange services*

Bezeq operates an IP Centrex service, which is a private and virtual exchange service in a public network (including a private cloud exchange service (HIPT) to customers with a large number of extensions).

*Data Center*

A service enabling a backup and survivability solution for customers.

*144 website (B144)*

A search engine for telephone numbers of businesses and private persons, including a classified search.

*Bcloud service*

Enables Bezeq's Internet customers to store data and digital media in a virtual cloud.

*Bhome service*

A smart home service that allows Bezeq's Internet subscribers to be updated and control everything that happens at home in real time by smartphone using cameras and sensors installed at home.

*Smart city service*

A service launched in August 2016 that includes a complete urban management system for a variety of urban services aimed at improving the service to residents while streamlining and saving municipal resources using advanced technology. The system is planned to include a command and control system, wireless surfing throughout the city, security cameras and management of various municipal services. A similar platform is also planned for services to businesses and other smart facilities.

The following table shows the distribution of Bezeq's Domestic Fixed-Line Communications revenues from its main products and services in its segment of operation, 2014-2016 (in NIS millions):

|  | 2016   | 2015   | 2014   |
|--|--------|--------|--------|
| Revenues from Bezeq's fixed-line telephony                     | 1,490  | 1,586  | 1,668  |
| Percentage of total Bezeq's Fixed-Line revenues in the segment | 33.99% | 35.99% | 38.64% |
| Revenues from Internet infrastructure services                 | 1,597  | 1,542  | 1,394  |
| Percentage of total Bezeq's Fixed-Line revenues in the segment | 36.43% | 34.99% | 32.30% |

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|   |              |              |              |
|---|--------------|--------------|--------------|
| Revenues from transmission and data communication services            | 1,077        | 1,058        | 1,022        |
| Percentage of total Bezeq's Fixed-Line revenues in the segment        | 24.57%       | 24.01%       | 23.67%       |
| Revenues from other services  | 219          | 221          | 233          |
| Percentage out of total Bezeq's Fixed-Line revenues in the segment    | 5.01%        | 5.01%        | 5.39%        |
| Total revenues of the Bezeq Domestic Fixed-Line Communication segment | <b>4,383</b> | <b>4,407</b> | <b>4,317</b> |

The Bezeq Domestic Fixed-Line Communication segment revenues are attributable to two main customer types: private (53%), and business (47%). The distribution by revenues is shown in the following table:

|                                 | 2016  | 2015  | 2014  |
|---------------------------------|-------|-------|-------|
| Revenue from private customers  | 2,329 | 2,507 | 2,498 |
| Revenue from business customers | 2,054 | 1,900 | 1,819 |
| Total revenue                   | 4,383 | 4,407 | 4,317 |

***Cellular Telephony (Pelephone)***

Pelephone is among the leading cellular telephony services providers in Israel. Pelephone provides cellular telephony services, sells handsets and other end-user equipment, and provides repair services for handsets sold by Pelephone.

|                        | As at and<br>for the<br>year ended<br>December<br>31,<br>2016<br>(in millions,<br>except<br>percentages) |   |
|------------------------|--|---|
| Revenues (in NIS)      | 2,630  |   |
| Estimated market share | 22.7   | % |
| Active lines           | 2.59   |   |
| Churn rate             | 23.7   | % |

*Services provided by Pelephone:*

*Package services.* Package services provided by Pelephone include:

Basic telephone services (voice) – basic voice services, call completion and auxiliary services such as call waiting, follow-me, voice mailbox, voice conference call and caller ID, MMS multimedia messages and more.

Browsing and data communications services – Internet browsing using 3G and 4G mobile devices.

Messaging service – a service for sending and receiving SMS text messages and multimedia MMS messages.

*Content services.* Pelephone offers its customers content services such as video services, Pelephone cloud backup and storage, anti-virus, a variety of televisions channels (Super TV) and a music library (Musix) that enables listening to a variety of music via mobile phone and PC.

*Roaming services.* Pelephone offers roaming services to customers traveling to countries throughout the world by using their own personal handset, with roaming coverage in more than 220 countries. Pelephone also provides incoming roaming services for the customers of foreign operators staying in Israel.

*Service and repair services.* Pelephone offers expanded repair and warranty services; for a monthly fee entitling the customer to mobile handset repair and warranty services, or for a one-time payment at the time of repair. Pelephone provides these services to its subscribers as well as under hosting agreements.

The mobile radio telephony segment is extremely competitive. The continuous competition in this sector has led to the high churn of subscribers between the cellular operators and erosion of their revenues, and to an increase in the Internet browsing volume included in the base package that has caused significant erosion of the average revenue per user (ARPU). These trends continued and even increased in 2016. In 2016, revenues from mobile radio services amounted to NIS 1,818 million compared with NIS 1,999 million in 2015 and NIS 2,453 million in 2014.

Opening of the market to parallel imports and opening of multiple stores selling terminal equipment has led to a decline in the sales of cellular handsets and terminal equipment by the cellular operators. To minimize the loss of revenues, Pelephone increased the range of equipment it sells and it also sells non-cellular electronic equipment. The

launch of Chinese brands alongside the launch of lower price models of devices of other manufacturers has led to a decline in the average revenue per device. In February 2016, Pelephone launched a private brand of terminal equipment (GINI) that includes several models. Pelephone's revenues from the sale of terminal and electronic equipment amounted to NIS 812 million in 2016, representing 31% of Pelephone's total revenues, compared to revenues of NIS 891 million in 2015. Most terminal and electronic equipment is sold on credit. The decrease in terminal equipment sales over the years has led to a decrease in trade receivables as well as a decline in trade payables to terminal equipment suppliers.

Pelephone also offers various types of mobile phones, on-board telephones, hands-free devices and accessories that support its range of services. Pelephone also offers its customers other terminal equipment such as tablets, laptops, modems, television sets and game consoles.

Pelephone offers its subscribers comprehensive voice, data and text messaging services and advanced multimedia services through its nationwide network. Pelephone's basic cellular telephony (voice) services include basic call services, call completion services and auxiliary services such as call waiting, call forwarding, voice mail, voice conference call and caller ID. Pelephone's customers can also access Internet services by using their handsets or through a cellular modem, or netstick, with download speeds of up to 42 Mbps. Pelephone's value-added services include short text messages, or SMS, multimedia messages, or MMS, and content services. Pelephone also offers its customers handset repair services for a monthly payment.

Pelephone offers a variety of packages that combine the several services it makes available to subscribers.

Pelephone also provides international roaming services, based on agreements it has with cellular telephony operators abroad. In addition, Pelephone provides inbound roaming services to the customers of foreign operators while they are in Israel.

*Revenue from products and services*

The following table provides a breakdown of Pelephone's revenues from products and services (NIS in millions) in the last three years:

|  |        |        |        |
|--|--------|--------|--------|
| Products and services                      | 2016   | 2015   | 2014   |
| Revenue from services                      | 1,818  | 1,999  | 2,453  |
| Percentage of Pelephone's total revenue    | 69.1 % | 69.2 % | 71.7 % |
| Revenue from products (terminal equipment) | 812    | 891    | 966    |
| Percentage of Pelephone's total revenue    | 30.9 % | 30.8 % | 28.3 % |
| Total revenue                              | 2,630  | 2,890  | 3,419  |

The following table provides a breakdown of revenue from customers (in NIS millions) in the last three years:

|                                  |       |       |       |
|----------------------------------|-------|-------|-------|
| Products and services            | 2016  | 2015  | 2014  |
| Revenue from private customers   | 1,616 | 1,750 | 1,930 |
| Revenue from business customers* | 1,015 | 1,140 | 1,490 |
| Total revenue                    | 2,630 | 2,890 | 3,419 |

\*Revenue from business customers includes revenues from hosting agreements.

At the end of 2016 Pelephone had 2.4 million subscribers. Pelephone also had 733,000 prepaid subscribers (customers who pay for communications services in advance) at the end of 2016. The revenues from these customers are not material in relation to Pelephone's total revenues. The number of prepaid subscribers includes 57,000 subscribers who were considered postpaid subscribers and were reclassified as prepaid subscribers in 2016.

In addition to the abovementioned subscribers, who are end customers actually using Pelephone's network, Pelephone provides services under hosting agreements to other cellular operators that use its network to provide services to their customers. Most of Pelephone's hosting revenues in 2016 came from Rami Levy and in 2015 most of such revenues came from Rami Levy and Alon Cellular (which was acquired by Pelephone in October 2015).

At the end of the second quarter of 2016, Pelephone implemented a one-time derecognition of 499,000 CDMA network subscribers (of which 455,000 were pre-paid subscribers and 44,000 were post-paid subscribers) subscribers that had not made outgoing calls or used the network for browsing during the six months prior to the date of the

derecognition. The derecognition of subscribers followed a series of actions taken by Pelephone to reduce the number of CDMA network subscribers, which include, among other things, initiating contact and marketing offers targeting CDMA subscribers to switch to its UMTS/HSPA and LTE networks.

### **ISP, ILD, Data Services and ICT (Bezeq International)**

Bezeq International is the leading provider of ISP services in Israel and one of Israel's leading providers of ILD and international and domestic data transfer and network services. Bezeq International provides comprehensive communications solutions that include ISP and related value-added services, international and domestic telephony, PBX supply and support, ICT, cloud computing services, data communications and information security, website server hosting and related managed services. Bezeq International also owns the JONAH high-speed submarine optical fiber communications cable system connecting Israel and Europe, which provides increased bandwidth (capacity and speed) and has positioned Bezeq International as the sole ISP in Israel to own and operate an advanced international network.

The international telephony market in Israel has in recent years seen a decline in call volume, (incoming and outgoing), mainly due to the service bundles offered by the cellular companies that include international calls as well as the multiple free applications that enable calls via the web. In 2016 the international telephony market declined (in number of minutes) by 11%.

The Internet market recorded continued growth stagnation in 2016 together with an increase in the surfing speeds consumed. Generally, the increase in demand for high speed browsing requires Bezeq International to periodically increase its operating capacity via its Jonah submarine cable and the international capacity rights it acquires.

|                        |  |   |
|------------------------|--|---|
|                        | As at and<br>for the<br>year ended<br>December<br>31,<br>2016<br>(in millions,<br>except<br>percentages) |   |
| Bezeq International    |  |   |
| Revenues (NIS)         | 1,548  |   |
| ISP                    |  |   |
| Estimated market share | 44.0   | % |
| Churn rate             | 20.4   | % |
| ILD                    |  |   |
| Estimated market share | 21.0   | % |

#### *ISP Services*

In the Internet services sector Bezeq International provides Internet service provider (ISP) services for private and business customers, including requisite terminal equipment and support over DSL based transmission, configuration and cable infrastructure. and access services to the Company's Internet infrastructure (as part of the wholesale market); hosting services offering site and server storage services at a designated installation, including value added services (such as monitoring and control); information security services; Internet and LAN network connection security using required terminal equipment or software, including monitoring; data services including international IP based data communication solutions for business customers with global deployment; and high speed Wi-Fi services, including public hotspots.

Bezeq International provides these Internet services primarily via its exclusive wholly-owned Jonah submarine cable between Israel and Italy, launched in December 2011. Bezeq International is the only provider among ISPs operating in Israel to own a submarine cable.

#### *International data services*

Bezeq International provides international data communication solutions for business customers including customized global deployment. The services are provided via Bezeq International's submarine cable and the optic cables deployed from Israel to Europe over which Bezeq International has long-term user rights, and through its business partnerships with leading global telecom providers such as British Telecom, which provide its customers access to their sophisticated global network services.



In addition to the foregoing services, Bezeq International offers ITS licensees to provide Bezeq International's services and ISP licensees the use of its international capacities (through leasing or by purchasing indefeasible rights of use), over Bezeq International's submarine cable, and the user rights it acquired in European terrestrial infrastructures and in other international networks.

*Business Sector-Data Services and ICT*

Bezeq International provides ICT (Information and Communication Technology) solutions for business customers. Customer ICT solutions include extensive communications solutions such as server and web hosting services ("Hosting Services"), technical maintenance and support services, system and networking services, outsourcing and out-tasking services, security and risk management solutions, IP based services, cloud computing services, online backup services, market and advertising services for businesses over a digital platform (Bigger) and equipment sales. Bezeq International has adopted a comprehensive solution model with a single contact person, fully responsible for dealing with the customer (one service provider, one responsibility).

Bezeq International markets and maintains communication systems for the entire the Israeli market, and PBX exchanges, telephony networks and IP communications, mainly for its business customers. As part of its service contracts, Bezeq International provides maintenance services for various PBX exchange manufacturers. These services are given for gateways, PBX exchanges and network end points (NEP) for lines used as both internal and external lines.

*Multi-Channel Pay Television (DBS)*

DBS offers nationwide coverage through its DTH technology and innovative and advanced technologies, including PVR, VOD and HD television. It is the only company in Israel licensed to provide multi-channel pay television broadcasts via satellite and is one of two companies in Israel licensed to provide multi-channel television services. DBS focuses on creating clear differentiation from its main competitor, HOT, with respect to brand, content and service quality. In addition, DBS has a strong track record of innovative technology development and is a leading provider of value-added services, including hybrid IP and DTH based set-top boxes (including PVR and VOD).

|                            |  |   |
|----------------------------|--|---|
| DBS                        | As at and<br>for the<br>year ended<br>December<br>31,<br>2016<br>(in millions,<br>except<br>percentages) |   |
| Revenues (NIS)             | 1,745  |   |
| Estimated market share     | 40.0   | % |
| Subscribers (in thousands) | 614  |   |
| Churn rate                 | 15.9   | % |

*VOD services*

DBS provides VOD services for its subscribers via the Internet, allowing user selectable content viewing. These services are provided for a service subscription fee, with additional charge for some of the content. Connecting to a service requires, among other things, certain types of decoders. In recent years, the number of DBS subscribers connected to VOD services and the consumption of VOD services has increased significantly, inter alia, due to the increased supply of available content, increase in available band width at subscribers' homes and significant increase in use of advanced decoders.

*Revenue of products and services*

The following table contains a breakdown of DBS' revenues (NIS in millions):

|  | 2016  | 2015  | 2014  |
|--|-------|-------|-------|
| Revenue from broadcasts and multi-channel television services to subscribers | 1,715 | 1,748 | 1,708 |
| Percentage of revenue  | 98 %* | 99 %* | 99 %* |

\* The revenues balance is mainly due to payments from channels to DBS for broadcasting their content.

**Marketing, Sales and Customer Service**

Under the structural separation limitations, each of the Bezeq Group companies maintains independent marketing and sales operations.

*Domestic Fixed-Line Communications (Bezeq)*

Bezeq has marketing, sales and service systems for its business and private customers, which include customer managers for the business sector, combined sales and service call centers around the country, technical support centers for private and business customers, Bezeq stores throughout Israel offering sales and services, as well as a virtual online shop.

Bezeq markets its services mainly through advertising in the mass media, telephone sales centers, customer managers and an array of independent dealers which are mainly ISPs, outsourced sales centers, and ISPs which, upon establishment of the wholesale market, mainly market end-to-end service packages based on Bezeq's wholesale BSA services. Bezeq also has independent service and sales channels on its website (adapted to surfing from mobile phones), a dedicated application (Bezeq Sheli, My Bezeq), and also offers an Interactive Voice Response (IVR).

*Cellular Telephony (Pelephone)*

Pelephone's distribution system includes 28 service and sales centers dispersed throughout the country that provide customer service, sales, repair and customer retention services. In addition to the service centers, the distribution network is reinforced by over 200 stores and stalls (some of which are operated by Pelephone and some by certified resellers). As a rule, these dealers are paid a commission on sales.

During the course of the past year, Pelephone increased its distribution network and began, among other things, to market its services through two large retail networks, at dozens of points of sale throughout the country.

Pelephone's subscriber service network includes its website and 13 special purpose call centers which provide information and service regarding various matters in three languages, technical support, information regarding customer billing, value added services, sales and general information.

*ISP, ILD, Data Services and ICT (Bezeq International)*

Bezeq International has sales channels for the private market, including customer recruitment and retention call centers, a country-wide direct sales network (providing "door to door" and point of sale services), a technical support and customer service network and a distribution channel system that includes external marketing and dealership centers. The business market sales channels include customer recruitment centers and business and administration service and solution centers for business customers. The Company sells Bezeq International services as part of joint service bundles.

*Multi-Channel Pay Television (DBS)*

DBS customer service operations are carried out mainly by in-house and outsourced call centers, as well as by self-service via interactive voice response, DBS's website and set-top boxes. Field technical support and installations are performed by DBS technicians and subcontractors.

DBS's sales operations are carried out via door-to-door sales personnel, call centers and third party dealers. DBS focuses its marketing strategy on media campaigns with high presence on television as well as other medias such as radio, newspapers, Internet and billboard commercials, using well-known international actors and marketing special offers. DBS's campaigns highlight its role as a global technology pioneer with leading value-added services (VOD, PVR, HD, yes MultiRoom, streamer and mobile applications). DBS also highlights its relationships with other well-known, popular brands.

**Networks**

*Domestic Fixed-Line Communications (Bezeq)*

Bezeq offers private and business customers, as well as communication providers, a wide variety of services through a nationally deployed, fully-owned, advanced communication networks. Bezeq was the first fixed-line communications company in the world to provide a national NGN deployment. Over the past four years, Bezeq has deployed thousands of street cabinets, equipped with MSAG systems containing ADSL2+ and VDSL2 cards, through which Bezeq supplies its customers with telephone services, Internet access, data and value-added services, all on a unified IP network. The thousands of street cabinets are fiber optically linked through a metro Ethernet network, reaching dozens of aggregation sites leading to Bezeq's nationally distributed mega points of presence (POP) sites. The street cabinets

are distributed in a manner by which the average distance from the customer does not exceed several hundred meters, enabling Bezeq to offer its customers, using VDLS2 technology, up to 100 Mbps bandwidth.

NGN network deployment and the transition to providing the array of services on a unified IP network has generated significant operational savings, by enabling Bezeq to gradually “shut down” the old PSTN network, as a result of which many structures that were formerly used to store the PSTN switches became redundant and are offered for sale upon removal of the PSTN switches (certain structures have already been sold) and following the removal of the copper cables in segments that were replaced by fiber optics.

Bezeq operates an extensive national network of optic fibers, providing relay and data communication services for business customers, government offices and security forces, as well as communication operators, while utilizing a wide variety of technologies, including SDH, metro Ethernet, IPVPN and more, with a wide variety of bandwidths. Bezeq recently began an initiative to extend the optical fiber network to be as close as possible to buildings and customer homes (FTTB/FTTH). This activity is expected to result in ultra-fast data transfer rates, significantly higher than the maximum rate provided on the current network (100 Mbps).

The data communication networks consist of thousands of switches and routers spread throughout hundreds of sites nationwide, as well as tens of thousands of kilometers of optical fiber, usually installed within duct infrastructures, enabling simple and rapid installation and maintenance. This array is deployed in a ring configuration, enhancing survivability.

#### *Cellular Telephony (Pelephone)*

Pelephone has a resilient and advanced network system in Israel, allowing it to offer its services with nationwide coverage and consistent high quality. Pelephone’s cellular telephony license is valid until September 8, 2022. During the years ended December 31, 2014, 2015 and 2016, Pelephone had net capital expenditures of NIS 321 million, NIS 426 million and NIS 241 million (approximately \$63 million), respectively, for its network infrastructure.

Pelephone currently operates communications networks using the 4G LTE, UMTS/HSPA and CDMA technologies.

The 4G LTE technology is based on GSM standards. The advantages of this technology are greater data communication capacity and faster download rates than with the 3G technologies. All the terminal devices that support this technology also support the 3G technologies and the transition between the technologies is seamless.

UMTS/HSPA is a digital technology based on the GSM standard. This technology is globally widespread, and enables subscriber identification and services to be provided through a SIM card, which can be moved from one handset to another. The advantage of this technology, inter alia, is that it supports download speeds of up to 42 Mbps and upload speeds of up to 5.7 Mbps. This communication network is Pelephone's primary network.

CDMA digital technology is less prevalent worldwide than UMTS/HSPA. At present, this network serves a limited number of subscribers and Pelephone expects to cease operating this network in 2017, subject to the approval of the Ministry of Communications. Pelephone is acting to transfer the existing CDMA network subscribers to its UMTS/HSPA and LTE networks.

Pelephone's networks cover substantially all of the population in Israel. Pelephone is continuing to expand and improve the coverage, capacity and quality of its 3.5G UMTS/HSPA+ network. Pelephone's network architecture is based on two mobile telephone switching offices (MTSOs), each one with an IP based core network that can support all the traffic in the network.

At present, Pelephone's network infrastructure is based at two switch farms that are connected to more than 2,200 sites. Pelephone's network is interconnected with the networks of Bezeq and HOT in several locations across Israel. Pelephone's network is also connected to all of the cellular networks in Israel, the eight Israeli ILD operators, the fixed-line telephone network of Paltel and the cellular network of Wataniya, and indirectly to the cellular network of Jawwal in the Palestinian Authority.

Pelephone's transmission network is made up of leased lines (fiber optic) from Bezeq and Pelephone's own microwave links. Pelephone's UMTS base stations are connected using a hybrid connection (ATM for voice calls through Bezeq's SDH network and IP for data calls through Bezeq's metro Ethernet network).

In April 2014, Pelephone signed an agreement with Ericsson to upgrade its network center to support LTE, purchase and install radio equipment and implement additional adjustments to the network to support LTE. The equipment to be supplied to Pelephone will also support Advanced 4.5G LTE technology. In September 2014, Pelephone signed a three-year framework agreement under which Ericsson will be Pelephone's exclusive supplier for expanding the deployment of the 4G LTE radio network. The agreement is an extension of the agreement signed in April 2014. The cost of establishing the network, including payments to Ericsson and additional costs linked to the deployment and

adaptation of the network, is expected to amount to NIS 600 million through 2017, including NIS 96 million paid to acquire frequencies in a governmental auction. In addition, over the coming decade, Pelephone will be required to continue to establish new broadcasting sites, among other things, to comply with the terms of its cellular license.

Under its cellular license and the Wireless Telegraph Ordinance, Pelephone has rights of use of frequencies in the 850 MHz spectrum ( CDMA network), the 850 MHz and 2100 MHz spectrums (UMTS/HSPA network) and 15 MHz of bandwidth within 1800 MHz spectrum ( LTE technology network). Pelephone was awarded its bandwidth within the 1800 MHz spectrum after participating in a government tender in 2015.

***Infrastructure sharing agreements and providing right of use of networks***

To the best of Pelephone's knowledge the following active radio segment network sharing agreements are in effect:

*HOT – Mobile.* According to the radio segment network sharing agreement between Partner and HOT Mobile, Partner and HOT Mobile established a joint company that obtained a special license for providing radio infrastructure services to a MVNO operator, for 10 years. The purpose of the company, which is owned by Partner and HOT Mobile in equal shares, is to maintain and develop one advanced cellular network for both companies and to operate the radio segment jointly.

*Electra - Golan Telecom – Cellcom.* In January 2017 an agreement was signed by the shareholders of Golan Telcom and Electra Commodities Ltd., or Electra, for the acquisition of Golan Telcom shares. At the same time, Golan Telcom entered into a network sharing agreement with Cellcom for its 3G and 4G networks and for hosting services for its 2G network. The acquisition transaction and sharing agreement were approved by the Ministry of Communications and Antitrust Commissioner. According to an announcement by Electra, once the sharing agreement between Cellcom and Electra has been approved, Golan Telecom will no longer be considered to have not complied with the terms of its license with regard to the geographic deployment, as required by the Ministry of Communications.

*Cellcom - Marathon 018.* In July 2016, a network sharing agreement was signed by Cellcom and Marathon 018 for the 4G network radio segment and for providing the right of use of Cellcom's 2G and 3G networks. The agreement was approved by Antitrust Commissioner and Ministry of Communications. This agreement increases the number of infrastructure owning operators to six.

Pelephone is not party to any network sharing agreement. The inventory of frequencies available for its network may be smaller than those of some of its competitors and could allow it less flexibility in managing its networks and require it to find alternative solutions in order to be able to provide competitive services.

#### *Construction and Operation of Sites: Permits, Licenses*

Once a new coverage area has been identified, Pelephone's technical staff determines the optimal base station location and the required coverage characteristics. The area is then surveyed to identify network sites. In urban areas, typical sites are building rooftops. In rural areas, masts are usually constructed. Technical staffs also identify the best means of connecting the base station to the network. Once a preferred site has been identified and the exact equipment configuration for that site decided, Pelephone begins the process of obtaining necessary approvals.

The construction and changing of most of these network sites requires building permits from local or regional authorities, as well as a number of additional permits from governmental and regulatory authorities, such as construction and operating permits from the Ministry of Environmental Protection, permits from the Civil Aviation Authority, in certain cases, and permits from the Israeli Defense Forces.

Pelephone uses software and computer systems, some under purchased licenses and others which were developed by Pelephone's IT department. Many of these licenses are limited in time, and are periodically renewed. The primary systems used by Pelephone are: Oracle Application ERP system and Amdocs customer management and billing system.

#### *ISP, ILD, Domestic Services and ICT (Bezeq International)*

In December 2011, Bezeq International completed the deployment of a new high-speed submarine optical fiber communications cable system connecting Israel and Europe, which was launched in January 2012 and has increased bandwidth (capacity and speed) at affordable rates and positioned Bezeq as the sole Internet service provider in Israel to own and operate such infrastructure. This high-speed optical fiber system named JONAH, covers 2,300 kilometers



across the Mediterranean, is fully redundant (i.e., utilizes two equipped fiber pairs) and leverages Alcatel-Lucent's advanced submarine communications networking technology. The cable system can operate at 100 gigabits-per-second data transmissions to enable data capacity of over 7.0 Tbps between Tel Aviv and Bari, Italy. This ultimate data capacity could allow the simultaneous download of 100,000 MP3 files in one minute and the streaming of 15,000 HDTV channels. The system integrates Alcatel-Lucent OALC-5 cable, optimized with coherent submarine fiber (CSF), repeaters and the 1620 Light Manager submarine line terminal which is designed to accommodate 10G/40G/100G wavelengths in the same platform, enabling seamless capacity upgrades on a flexible grid for channel spacing without traffic interruption. This solution, which features advanced optical coherent technology, offers a pathway to multi-terabit capacity using 100G channels, far exceeding the maximum capacity achievable with 40G. This protects the investment from the risk of obsolescence or capacity limitations due to changes in transmission technology. Bezeq International's submarine optical fiber communications cable is extended from Bari terrestrially through Interoute's network to major European cities such as London, Frankfurt and Milan.

In parallel with the completion of the deployment of JONAH in the fourth quarter of 2011, Bezeq International invested in the purchase of a submarine fiber pair connecting Israel to Cyprus, known as the ARIEL cable, which extends to Marseilles, France via the ALEXANDROS submarine cable. In addition, Bezeq International holds multiple 10Gbps capacity indefeasible rights of use via the MedNautilus submarine cable system.

Bezeq International's capacity on the JONAH, ARIEL and MedNautilus submarine cables allows the delivery of faster connectivity to Israel and the Mediterranean region, fostering the delivery of innovative IP-based services for which capacity and speed are critical elements to meet end-users' demand. Bezeq International is the only telecom operator in Israel that provides three different routes of multiple 10Gbps to Europe.

In July 2014, Bezeq International launched the "Bigger" service for the business sector in which it offers an innovative digital platform for managing the marketing and advertising of small and medium size businesses.

#### *PBX services*

Bezeq International markets and maintains communication systems for the entire Israeli market, and PBX exchanges, telephony networks and IP communications, mainly for its business customers. As part of its service contracts, Bezeq International provides maintenance services for various PBX exchange manufacturers. These include services for gateways, PBX exchanges and network end points (NEP) for lines used as both internal and external lines.

The following table provides a breakdown of Bezeq International's revenue (NIS in millions) over the last three years:

|   | 2016   | 2015   | 2014   |
|---|--------|--------|--------|
| Voice services  | 325    | 379    | 395    |
| % of total revenue  | 20.99% | 24.02% | 26.26% |
| Revenue from business Internet and telecommunication services (ISP, PBX, ICT, data) | 1,223  | 1,199  | 1,109  |
| % of total revenue  | 79.01% | 75.98% | 73.74% |
| Total revenue   | 1,548  | 1,578  | 1,504  |

The following table provides a breakdown of revenue to private and business customers (NIS in millions) over the last three years:

|                                 | 2016  | 2015  | 2014  |
|---------------------------------|-------|-------|-------|
| Revenue from private customers  | 570   | 555   | 529   |
| Revenue from business customers | 978   | 1,023 | 975   |
| Total revenue                   | 1,548 | 1,578 | 1,504 |

### ***Multi-Channel Pay Television (DBS)***

DBS is the sole DTH provider in Israel. DBS operates a hybrid platform of satellite and IPTV OTT. DBS's IP platform, based on progressive download technology, enables DBS to provide its VOD service, which was launched in March 2010 using OTT technology, with a versatile and user friendly interface in HD quality incorporated into the electronic program guide.

DBS owns the satellite dishes and other endpoint devices that carry and receive the signals from such satellites to subscriber residences and set-top boxes. In addition, DBS leases some of the set-top boxes and cards that decode the coded signals received from the satellite to its subscribers, while other set-top boxes and cards are provided to subscribers for a deposit (an immaterial number of set-top boxes are sold to subscribers).

### ***Competition in the Israeli Telecommunications Market***

The communications industry around the world and in Israel is characterized by rapid development and frequent changes in technologies, the business structure of the industry and applicable regulation. Below is a description of the

main trends and central characteristics of the communications industry in recent years, which have significantly affected the operations of the Bezeq Group as a whole.

Recently, the competition in the communications industry, particularly in cellular telephony, has been fierce (with the entry of the operators HOT Mobile and Golan Telecom), with packages consisting of several services and packages for a fixed price with unlimited use are offered. This stronger competition has brought down prices, increased customer switching, led to a decline in the use of fixed-line telephony minutes, and higher churn rates, which in turn has affected the Bezeq Group's results. Implementation of the wholesale market has also intensified competition in the Internet service packages and enhanced implementation of wholesale services may lead to even fiercer competition and customer switching. In the business sector, the competition by competing communications groups is strengthening, which is also expressed in participation and award of tenders. To reduce the impact on performance, the Bezeq Group companies are introducing streamlining and other measures to improve the services they provide and differentiate themselves from their competitors.

Considering the diversity of the Bezeq Group's communication operations, regulatory developments could, in certain cases, have different effects on different areas of operation in the Bezeq Group, meaning that changes in regulation that adversely affect one area, could potentially have a positive effect on another area. In certain cases, opposing effects on the areas of operation might be offset one against the other at the Group level.

*Communications groups in the Israeli market*

Recently, the market is characterized by competition among the communications groups operating in several segments with the aim of providing a solution for all of the customer's communications requirements, as indicated in the following table:

| Group Activity                               | Bezeq Group companies                      | Cellcom (a) | Partner (b) | HOT (c) |
|--|--|-------------|-------------|---------|
| Cellular telephony                           | Pelephone<br>Bezeq                         | V           | V           | V       |
| Fixed-line telephony                         | Bezeq International<br>Bezeq               | V           | V           | V       |
| Internet services<br>(fixed-line / cellular) | Pelephone                                  | V           | V           | V       |
| International calls                          | Bezeq International<br>Bezeq International | V           | V           | V       |
| Multi-channel television                     | DBS  | V           | -           | V       |

Cellcom Group - to the best of Bezeq's knowledge, Cellcom Group provide cellular telephony services; fixed-line telephony on its own infrastructure, transmission and data communication services for business customers through Cellcom's own transmission network, ISP services, end-to-end ISP service packages, wholesale service-based Internet infrastructure, international telecommunication services, fixed-line telephony services using VoB technology; an Internet-based television (OTT) service which includes VOD services, several linear channels, and integration of Idan+ channels.

Partner Group - to the best of Bezeq's knowledge, Partner Group provides cellular telephony services, transmission and data-communications services, ISP services, end-to-end ISP service packages, wholesale service-based Internet infrastructure, and fixed-line telephony services using VoB technology.

HOT Group - to the best of Bezeq's knowledge, Hot Group owns a nationwide cable infrastructure and provides multi-channel television services, cellular telephony services, fixed-line telephony services, Internet infrastructure, transmission and data communications services, and IPS services. Certain structural separation restrictions were imposed on Hot Group and specific restriction on marketing joint service bundles that include ISP services.

Additional competitors that do not belong to the above communications groups (such as Golan Telecom, MVNO cellular operators, international operators and ISPs, including service providers in the wholesale market) also operate in the market.

The competition between the communications groups is reflected by increased use of service bundles (including various combinations of several different communication services). Communications groups market or may in future market "joint" service bundles consisting of different communication services of the companies in each group. As a rule, the marketing of the joint bundle enables the communications group to offer its customers more attractive tariffs than purchasing each service separately (in some cases with "cross-subsidization" among the bundle's components), and a comprehensive solution that does away with the need to be subscribed of several different providers. These trends were reinforced with implementation of a wholesale BSA service, which allows operators that do not own infrastructure and those that are not part of a communications group to offer a full end-to-end service bundle (including infrastructure) to their customers. Unlike the other groups, at the date of this report, Bezeq Group is subject to the stricter restrictions in marketing joint service bundles.

Provision of comprehensive services that meet a range of needs for the customer has become easier due to the technological unity trend, regulatory changes, and the transition to regulation through a consolidated business license that was granted to different communications operators, as part of which different communication services that in the past required separate licenses may be provided under the same license.

### *Fixed-Line Telephony Services Market*

#### *Wholesale market*

The wholesale market enables communications providers to compete with Bezeq while using its physical infrastructure, including infrastructure segments, and its services, at controlled prices that are not set by Bezeq. The wholesale market allows communications providers to offer their subscribers broadband services and end-to-end service packages, including access infrastructure.

To the best of Bezeq's knowledge, HOT does not yet provide wholesale services in the absence of a price set by the Ministry of Communications. On January 14, 2016, the Ministry of Communications published a hearing to determine the maximum tariffs for wholesale services on HOT's network.

#### *Telephony*

Bezeq estimates that at the end of 2016, its market share in the fixed-line telephony market was approximately 55% of the private sector and 73% of the business sector, a 1% decrease compared with 2015 in each of the markets. There is significant competition in the fixed-line communications segment.

Bezeq and HOT Telecom both own nationally-deployed fixed-line telephony infrastructures and are in fierce competition with each other, which is manifested, among other things, by HOT combining Internet infrastructure, telephony and cable television, and possibly cellular services as well, to households. HOT also markets telephony services to business customers.

Bezeq also faces competition from license-holders for domestic fixed-line communication services, including VoB, which provide the service on Bezeq's broadband access service, including the wholesale BSA service.

#### *Competition in telephony from the cellular companies*

The penetration rate of cellular telephony in Israel is among the highest in the world. In the opinion of Bezeq, this penetration rate combined with low airtime rates on an international scale and large-scale bundles of minutes at fixed monthly prices have made the cellular telephone a product that largely substitutes for the landline telephone. Bezeq believes that a deepening of the substitution of fixed lines by mobile lines is one of the causes of the reduction in the average traffic per line, and of the growing removal rate of telephone lines.

In 2016, the trends that began in 2012 continued, marking a leap in competition in the cellular communications market in Israel. The activity of the new infrastructure operators, Golan and HOT Mobile, and to a lesser extent the activity of virtual cellular operators, continued the trend of erosion of prices and maintained the high level of mobility of customers between the companies. However, the continuation of these trends has a minor effect on the fixed-line operation compared with previous years, and since 2015 there has been a decrease in the average movement per line and in the rate of removal of fixed telephone lines.

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

#### *VoC services*

According to the Ministry of Communications policy, VoC service is a fixed service, the provision of which will be regulated by a general Domestic Carrier License or special license that currently provide VOB services, since VOB or VoC telephony services are telephony services which use IP technology over another entity's data transmission network (irrespective of whether such network is mobile or fixed) and it is therefore a single fixed service.

As a result of the Ministry of Communications' decision that provides an exemption to cellular operators from requiring a general license or a permit to set up and operate access points, the cellular operators can use Wi-Fi access points as part of their networks to provide services. This provides them with a transition to providing cellular telephony services over a Wi-Fi network and assists in diverting loads to this network from their cellular network.

#### *Internet infrastructure segment*

Bezeq estimates that at the end of 2016 its market share in the Internet infrastructure market was approximately 69% (compared with 68% at the end of 2015). There is significant competition in this field.

Competition from HOT Group – HOT's Internet infrastructure is deployed nationwide, and a range of communication services and interactive applications can be provided. On September 28, 2016, the Advisory Committee that was

appointed in accordance with the Communications (Telecommunications and Broadcasts) (Advisory Committee) Regulations, 2011, submitted a recommendation to the Minister of Communications to postpone the date for implementing its decision of November 13, 2014 with respect to deployment of HOT Telecom's infrastructure by one year to November 13, 2017. The advisory committee also recommended that HOT be required no later than December 31, 2016 to provide its services to all subscribers on OTT technology on broadband Internet (which in practice belongs to Bezeq) in all the communities in which it does not currently provide services. HOT will start using Bezeq's physical infrastructure on October 1, 2017 at prices to be determined.



This network is currently the main alternative to Bezeq's infrastructures in the private sector. The upgrading of the infrastructure and the service bundles marketed by the HOT Group increased the level of competition in the Internet segment. HOT was obligated to provide wholesale services, including BSA services, but to the best of Bezeq's knowledge, it does not yet actually provide them.

Competition from ISPs and telecommunication groups - operating the wholesale market enables ISPs and telecommunication companies (holders of a single license) to offer customers service bundles that also include Internet infrastructure based on Bezeq's infrastructures and services (in exchange for controlled tariffs to be paid by the telecommunication providers to Bezeq). Moreover, if and insofar as the mechanism for preventing a 'margin squeeze' is implemented, similar to the one described in the Ministry of Communications hearing, Bezeq's ability to market promotional offers of its wholesale services will also suffer, in terms of both time to market and prices at which the services are offered.

Competition from cellular operators – The cellular companies have deepened their Internet activities on the cellular range both in the private sector and in the business sector. Unlike the fixed-line communications segment (where the provision of access infrastructure services – by HOT, is separate from provision of Internet access services – by the ISP), the cellular Internet service is provided as one unit. Surfing services are provided both from the cellular handset and through a cellular modem that connects laptop and desktop computers in combination with Internet access services. The capacity of cellular networks have increased substantially due to the rise in popularity of 4G services. However, Bezeq believes that the migration of the cellular operators to 4G in 2015 did not change the interchangeability between cellular Internet and fixed-line Internet.

Competition from Israel Broadband Company Ltd. In August 2013, Israel Broadband Company Ltd., or IBC, a telecommunications joint venture between the government owned Israel Electric Corporation and a consortium of non-governmental companies, was granted a license to provide telecommunications infrastructure services (including data services, digital transmissions and VPN) via fiber optic networks to telecommunications service providers. IBC is deploying a fiber-optic infrastructure to provide Internet services over the electrical grid, and has started operating commercially in several cities. According to media reports, the volume of subscribers enlisted by IBC is not material.

Pursuant to the provisions of the license, IBC was obligated to make a gradual universal deployment over a period of 20 years. IBC was granted a special license (which does not impose a universal obligation) to provide domestic fixed data-communication services, according to which it is entitled to provide IPVPN services and broadband data-communication lines.

To the best of Bezeq's knowledge, the joint holdings of IBC (other than IEC's holdings) are for sale. On June 21, 2016, a Ministry of Communications announcement was published whereby communications companies that have no fixed-line infrastructure (Cellcom and Partner) were granted permission to compete for investment in IBC and in

parallel, Partner informed the Ministry of Communications that it intends to deploy optical fibers. According to the announcement, these measures are designed to open the fixed-line market (in which Bezeq has a monopoly) to competition, with the emphasis on infrastructure upgrading. However, under the Arrangements Law, Bezeq was obligated to allow IEC to use its physical infrastructure.

*Transmission and data communications*

In addition to Bezeq, other companies operating in this segment are Cellcom, Partner, HOT and Internet companies that also use leased infrastructures. To the best of Bezeq's knowledge, Cellcom has deployed and set up a transmission network which it uses for its own needs and for competition with Bezeq's services in the transmission and data communications market. Partner also provides transmission and data communication services combined with telephony and Internet to business customers.

*Other potentially competing infrastructures*

In addition to HOT's cable and optical fiber network and the optical fiber infrastructures of Cellcom and Partner, there are currently a number of infrastructures in Israel with the potential to serve as communications infrastructures, which are based on optical fibers and are mostly owned by government companies and entities, such as Israel Electric Corporation, or IEC, Israel Railways, Mekorot Israel National Water Co., Petroleum & Energy Infrastructures Ltd., and the Cross Israel Highway Ltd. Some municipalities are also trying to create an alternative to installation of pipes or fibers by deploying their own infrastructures.

In recent years this segment has been characterized by a decline in demand, which is reflected in the decrease in the rate of ownership of fixed telephone lines and in a gradual erosion of the number of calls originating in fixed-line networks. Bezeq believes that this trend stems primarily from the rise in the number of cellular subscribers in view of the comprehensive call-minute packages the cellular companies market extensively in recent years and the decrease in prices in the segment (Bezeq estimates that 80% of all calls originate in the cellular network), and from an increase in VoIP calls. In 2016, the number of Bezeq's lines declined by about 3% (compared with a decline of 1% in the number of lines in 2015). Likewise, the number of call minutes (incoming and outgoing) declined by 8% on Bezeq's fixed telephone lines compared with 2015. The average monthly revenue per phone line decreased by approximately 4%.

Fixed-line telephony is characterized by a lively competitive dynamic. Bezeq's competitors are HOT Telecom and VoB service providers which have been operating under license for several years with no obligation to provide universal services, and without their own independent access infrastructure. Some of them compete with Bezeq as part of telecommunications groups, and Bezeq believes that the cellular companies are also its competitors in the telephony segment. Bezeq estimates that if a decision is made to implement the hearing regarding the wholesale telephony in the resale format, service providers with a unified license that are permitted to provide domestic fixed-line services without any infrastructure to BSA service subscribers will compete with Bezeq.

The Internet segment is characterized by high rates of penetration, which is attributable to the deployment of a national access infrastructure. Bezeq's main competitor in this segment is HOT. Upon implementation of a wholesale market, ISPs compete with Bezeq in providing service packages, including broadband Internet access infrastructure using Bezeq's infrastructures, at wholesale prices. Bezeq is also exposed to competition from the cellular companies.

In the wholesale service segment, HOT competes with Bezeq as an infrastructure owner compelled to provide wholesale services, although these services have not yet been provided by HOT.

In the transmission and data-communications segment, Bezeq competes mainly with HOT Telecom, Cellcom and Partner, which operate as communications groups and provide a full communications solution to customers. These companies can compete with Bezeq by using its physical infrastructure. HOT Telecom will begin using Bezeq's on October 1, 2017).

Competition in the industry depends on a number of factors, such as regulatory decisions, possible changes in the terms of the licenses of Bezeq and the subsidiaries, and in the terms of the licenses of their competitors, mergers and joint ventures between companies that compete with the Group companies, the possible repercussions of the Market Concentration Law, further development of the wholesale market, the lack of symmetry between the ability of Bezeq and the competitors to provide a comprehensive service, the new services that Bezeq will be permitted to provide, the tariff policy, cancellation of the structural separation, the extent of flexibility granted to Bezeq when offering unbundlable service bundles, including with subsidiaries, and technological developments.

*Internet Access-Infrastructure and ISP Services*

In the Internet segment, growth has been recorded in recent years in terms of number of subscribers. The Internet segment is characterized by a rise in surfing speeds and the adoption of advanced services and value-added applications. In 2016, there was a 4% increase in the number of fixed-line Internet subscribers in Israel. In 2016, against the backdrop of introduction and expansion of the wholesale Internet services, the number of Bezeq's Internet subscribers (retail and wholesale) increased by 5% compared with 2015. Average monthly revenue per Internet subscriber (retail) rose by 2% compared with 2015.

Graph - Internet subscribers - wholesale market since launching of the service in the first quarter of 2015 (quarterly, in thousands):

Graph - distribution of Internet lines on Bezeq infrastructure (quarterly, in thousands):

*The transmission and data communications segment*

The transmission and data communications segment for business customers and communications providers is characterized by a rapid increase in the customers' broadband consumption, but in general by lower prices per given volume of traffic. This stems both from development of the technology allowing greater bandwidth at lower prices than in the past, and from competition in this area. There is also a decline in use of the Company's transmission and data communication services by communications providers, in part as a result of the trend of entry of communications groups. This trend is expected to increase due to the use of physical infrastructure (as part of the wholesale services provided by Bezeq) also for cellular requirements.

*ISP Market*

There are a number of competitors in this market, including Bezeq International, 013 Netvision (Cellcom), 012 Smile (Partner), Hot Net and two minor niche players whose share is not material.

Bezeq International estimates that its share of the Internet access market at December 31, 2016 was 44% compared with a market share of 44% at December 31, 2015.

Competition in 2016 was marked by price erosion.

*Broadband infrastructure and ISP Services Markets Trends in 2016*

Strengthening the service bundle sales trend, particularly due to the expansion of the wholesale sales model operations (provider + infrastructure) in 2016.

Continuing the increasing trend in sales of added value services such as anti-phishing, cyber protection and remote backup services.

Due to market saturation, emphasis is given to strengthening customer loyalty.

*Cellular Telephony Services Market*

The Israeli cellular telephony market is mature and highly competitive. Three cellular telephony operators, Cellcom, Partner and Pelephone, have historically led the Israeli cellular telephony market. The Israeli cellular telephony market is characterized by a dominant post-paid market (i.e. purchased subscriptions rather than use of pre-paid cards). The cellular market growth rate is lower due to “penetration rate” saturation. Penetration rate is the ratio between the number of subscribers in the market and the total population in Israel (excluding foreign workers and Palestinians, although they are included in the number of subscribers). The penetration rate at December 31, 2016 was 122%.

The numerous cellular operators in the market, resulting from the regulatory measures adopted by the Ministry of Communications in recent years to increase competition in the radio telephony market, led to strong competition that continued in 2016 as well. The continuing trend led to high subscriber churn among the cellular operators and to significant erosion of tariffs and in profit margins, in the private customer market as well as the business customer market.

Pelephone expects these trends to continue in 2017, leading to further erosion of revenues. Pelephone is introducing streamlining measures and cost structure adjustments in an effort to reduce the erosion of revenues.

As present there are five operators with mobile telephony licenses in the cellular telecommunications market in Israel (Pelephone, Cellcom, Partner, Golan Telecom and HOT Mobile) and a few MVNO operators with mobile telephony licenses for hosting on another network (virtual operators).

In 2016, to the best of Pelephone's knowledge, two key changes occurred regarding competition:

A network sharing agreement was signed by Cellcom and Marathon 018. This agreement, if approved by the Ministry of Communications, increases the number of infrastructure sharing operators to six.

A network sharing agreement was signed between Cellcom and Electra, which acquired Golan Telecom. The acquisition of Golan Telecom and the network sharing agreement between Electra and Cellcom were approved by the Antitrust Commissioner and of the Ministry of Communications.

#### *Infrastructure sharing*

The infrastructure sharing allows consolidation of the cellular operators' sites that substantially reduces the operating and maintenance costs of the radio sites. To the best of Pelephone's knowledge, as of Reporting Date, infrastructure sharing on the market are as follows:

Partner and HOT Mobile operate under radio segment infrastructure sharing through a joint company that received a special license for providing radio cellular infrastructure services to cellular operators.

Cellcom and Marathon 018 engaged in a network sharing agreement, which was approved by the Ministry of Communications.

Golan Telecom hosted on Cellcom's network (to the best of the Pelephone's knowledge, without a network sharing agreement). At the same time as Electra's acquisition of Golan Telecom, Golan Telecom, Electra and Cellcom entered into a network sharing agreement that was approved by the Ministry of Communications and Antitrust Authority.

*Virtual operators - MVNOs*

To date, several MVNO licenses have been granted to virtual operators. Only a few MVNO licenses are active in the market at present.

In October 2015 Pelephone completed the acquisition of the MVNO operator, Alon Cellular Ltd. ("Alon Cellular"). Part of Alon Cellular's subscribers were hosted on Pelephone's network. As part of the acquisition, Pelephone gained approximately 70,000 new subscribers.

The cellular telecommunications market is dynamic with frequent technological developments in all areas of operation (handsets, telecommunications network technologies and value added services). These developments impact the segment of operation on a number of levels.

*Establishment of cellular networks using advanced technologies*

Technology developments and the desire to widen the range and quality of services offered to the customer, require the cellular operators to periodically upgrade their network technologies. The cellular networks in Israel primarily use the UMTS/HSPA and LTE technologies (which are planned to be upgraded to the LTEA (LTE Advanced) technology). Pelephone intends to upgrade its LTE network to a LTEA network and submitted an application to the Ministry of Communications in February 2017 to use this technology. The investment in this technology is not expected to be substantial.

Since 2014, Pelephone has been extending its LTE network and the network is presently available in most parts of the country. Pelephone is continuing to extend this network to the rest of the country. Pelephone constantly reviews new technologies and the need to upgrade its existing network technologies, depending on the competitiveness of the market and the economic viability of the investment in such technologies.

*Smartphones*

The penetration of smartphones has led to a rise in the consumption of data transfer services while simultaneously increasing the supply of alternative applications and services to Pelephone's products and services that are provided by other entities. In addition, there has been an increase in the rate of smartphones that support LTE technology, a technology that allows better browsing. This increase has led to a further increase in consumption of 4G Data.





Below is a breakdown, to the best of Pelephone's knowledge, of the number of subscribers of Pelephone and of its competitors in 2015 and 2016 (thousands of subscribers, approximate).

|                         |                        | Pelephone | Partner | Cellcom | HOT<br>Mobile | Golan<br>Telecom | MVNOs(1) | Total<br>subscribers<br>in market |
|-------------------------|------------------------|-----------|---------|---------|---------------|------------------|----------|-----------------------------------|
| As at December 31, 2015 | No. of subscribers (2) | 2,651     | 2,718   | 2,835   | 1,229         | 900              | 177      | 10,510                            |
|                         | Market share           | 25.2 %    | 25.9 %  | 27 %    | 11.7 %        | 8.6 %            | 1.7 %    |                                   |
| At Sept 30, 2016        | No. of subscribers (2) | 2,348     | 2,693   | 2,822   | 1,409         | 863              | 209      | 10,344                            |
|                         | Market share           | 22.7 %    | 26.0 %  | 27.3 %  | 13.6 %        | 8.3 %            | 2 %      |                                   |

(1) Golan Telecom and most of the other MVNOs are private companies which do not publish figures regarding the number of their subscribers and these figures are based on estimates.

(2) The number of subscribers as of September 30, 2016 and December 31, 2015, are based on the public reports issued by Cellcom, Partner and HOT Mobile.

### *ILD Market*

As of the end of 2016, there were more than ten participants in the market (including Bezeq International, Cellcom, Partner, Golan Telecom and HOT Mobile). Bezeq International estimates that its market share for outgoing international calls at December 31, 2016 and December 31, 2015 was 21%.

The general characteristics of competition in the ILD market in 2016 were:

In 2016 the number of minutes used declined.

WhatsApp app call services are continuing to increase the rate of decline in number of minutes in the general market.

Competition is focused on specific population sectors.

The product is a commodity.

*Communication solutions for the business sector*

In the ICT sector Bezeq International competes with competitors such as Binat, Teldor, IBM and others. In 2016, Bezeq International continued to establish its position in the ICT market and gained recognition and endorsement from leading global suppliers in the market.

NEP services - the traditional telephone exchange sector includes a large number of competitors and fierce competition which has given rise to erosion of service prices.

Bezeq International promotes its business with emphasis on differentiating it from its competitors as the owner of its own international infrastructure (Jonah cable) for its customers' traffic providing high quality browsing performance, as well as its leading customer service.

The fact that, unlike some of its competitors, Bezeq International is unable to offer its services as part of a non-detachable communications services bundle, adversely affects its operations.

*Pay Television Services Market*

An increase in the number of subscribers may be accomplished mainly by recruiting subscribers from the competition and recruiting new subscribers following the natural growth in the number of households. The broadcast sector is characterized by fierce competition, which requires the investment of substantial resources to retain existing subscribers and recruit new ones.

There has been a slight erosion in the overall penetration rate of DBS and HOT is estimated by DBS to be 59.2% of the total number of households in Israel, and the penetration rate of Cellcom is estimated to be 4% of the total number of households in Israel. DBS estimates that the chances of increasing the total market share of these market participants is not high due to the fact that a large part of the remaining households are not potential audiences. To the best of DBS's knowledge, there has not been a significant change in the overall number of subscribers of DBS and HOT in recent years, despite the increase in the number of households in Israel. After several years during which the number of DBS subscribers remained stable and even increased, there has been a decline in DBS's share of this market due to the entry of Cellcom into this market in 2015. Competition also increased due to the increased number of users gaining access to pirated broadcasts.

*Competitors in the market*

DBS's main competitor is HOT, which also provides multi-channel television services to subscribers, under a broadcast license. Another significant competitor is Cellcom, which has in recent years expanded its services and content that are based on both DTT broadcasting and VOD content, and 30 linear channels transmitted via OTT configuration. There are also other OTT players operating in the market as well as pirated services.

The following is a breakdown of DBS and HOT subscriber numbers and market shares to the best of DBS's knowledge, at December 31, 2014, 2015 and 2016\*.

| 2016                          |                 |  | 2015                          |                 |  | 2014                          |                 |  |
|-------------------------------|-----------------|--|-------------------------------|-----------------|--|-------------------------------|-----------------|--|
| Subscribers<br>(in thousands) | Market<br>share |  | Subscribers<br>(in thousands) | Market<br>share |  | Subscribers<br>(in thousands) | Market<br>share |  |
| 614                           | 40 %            |  | 635                           | 42 %            |  | 630                           | 42 %            |  |

\* The number of subscribers is approximate and the market share is rounded. Subscriber – one household or small business customer. In the case of business customers who have more than a minimum number of decoders (such as hotels, kibbutz or gym), the number of subscribers are standardized.

Competition in this market focuses on broadcast content, and price and quality of services, as well as offering additional services, such as HD and VOD services, and advanced decoders, as a result of the demand for advanced and personalized television broadcasting.

**Regulatory**

*Permit to Control Bezeq Granted to Members of the Eurocom Group*

The Israeli Communications Law and the Communications Order provide that the control over Bezeq requires a control permit from the Ministers. As part of B Communications' acquisition of the controlling interest in Bezeq, we, B Communications, SP2, SP1, and other members of the Eurocom group applied for authorization to control Bezeq, pursuant to the Israeli Communications Law and Communications Order. On April 13, 2010, the Control Permit was granted subject to the condition that SP2 is controlled exclusively by the other parties to the control permit.

Concurrently, a separate control permit was also granted to Messrs. Shaul Elovitch and Yossef Elovitch, (the controlling shareholders of our company and B Communications), or the Individuals' Control Permit. According to the Communications Order, B Communications is not allowed to transfer control or any Means of Control which will result in a decrease of B Communications' minimum holding requirement in Bezeq without the prior consent of the Ministers. The foregoing includes a transfer of the Bezeq interest in one transaction or a series of transactions, by one party or together with the other parties to the Control Permit or the parties to the Individuals' Control Permit. However, the parties may transfer the Means of Control of Bezeq among themselves, subject to compliance with certain conditions set forth in the Control Permit.

According to the Control Permit, the parties (through SP2) must hold not less than 30% of any type of Means of Control (as described below) of Bezeq. Such percentage is permitted to decrease below 30% to no less than 29% for a period of six months, in the event of dilution resulting from the exercise of stock options by Bezeq employees. However, the Communications Order prohibits the issuance of shares which will result in a decrease of B Communications' minimum holding requirement in Bezeq (30%) or B Communications ceasing to control Bezeq without the prior consent of the Ministers (certain permitted issuances do not require the Minister's prior consent). Despite the 30% rule, according to Article 3(a3) of the Communications Order, which is included as part of the Control Permit, the parties to the Control Permit may hold less than 30% under certain circumstances, including the requirement that the parties control Bezeq and maintain at least a 25% ownership interest in Bezeq. On February 2, 2016, B Communications announced that its wholly-owned subsidiary, SP2, sold 115,500,000 Bezeq shares. As a result, B Communications received gross proceeds of NIS 8.50 per share, or NIS 982 million in the aggregate (approximately \$248 million). B Communications retained a 26.34% ownership interest in Bezeq following the closing of the transaction. In addition to B Communications' ownership of Bezeq shares, a total of 1,000,000 ordinary shares of Bezeq are jointly held by Mr. Shaul Elovitch, our and B Communications' controlling shareholder, and his brother Mr. Yossef Elovitch. An additional 72,360 ordinary shares of Bezeq are held by Ms. Iris Elovitch, the wife of Mr. Elovitch, and 11,556 ordinary shares of Bezeq are held by Ms. Orna Elovitch, the daughter-in-law of Mr. Elovitch.

B Communications' SP2 subsidiary owns most of B Communications' Bezeq shares. In accordance with the Control Permit, SP2 is required to notify the Ministers of any changes in the composition of its board of directors every six months and if the change represents half or more of the members of the board of directors, within 30 days of the change. We and B Communications are also required to notify the Ministers of any "Exceptional Holdings" in Bezeq (as described below) immediately upon becoming aware of such event. We and B Communications are also required to notify the Ministers in the event a shareholder becomes a "principal shareholder" (namely, holds, directly or indirectly, over 5% of our issued and outstanding share capital) and regarding any 1% or more change in the holdings of a "principal shareholder" within 48 hours of becoming aware of such change. Our and B Communications' Articles of Association require shareholders to notify us, within a specified period of time after crossing any such threshold.

Under the Communications Order, no person may hold, directly or indirectly, "significant influence" over Bezeq or 5% or more of any particular class of Means of Control in Bezeq. The Communications Order defines "holding" as the holding, acquisition, transfer and encumbrance of the Means of Control in Bezeq, defines "significant influence" as the ability to substantially influence the activity of a company, either alone or together with others or using others, directly or indirectly, which arises by virtue of the possession of Means of Control therein or in another corporation, including where such ability is pursuant to the corporation's articles of association, or pursuant to an agreement (whether written or oral) with the controlling shareholder. "Means of Control" is defined under the Communications Order as the right to vote at a general meeting of the company, to appoint a director or general manager of the company, or to participate in the profits of the company or a share of the remaining assets of the company after payment of its debts upon liquidation. Additionally, no person, together with any other person, appoint, elect or dismiss the general manager of Bezeq or cause the election, appointment or dismissal of any director of Bezeq, without the prior written consent of the Ministers. A person shall be deemed to have "significant influence" if (i) he has the right to appoint a director or the chief executive officer; or (ii) if that person holds 25% or more of the Means of Control of a corporation. Additionally, no person, together with any other person, may appoint, elect or dismiss the general manager of Bezeq or cause the election, appointment or dismissal of any director of Bezeq, without the prior written consent of the Ministers.

Subject to certain exceptions, prior written approval of the Ministers is also required to increase the holdings or other rights in excess of those determined in the initial approval, including by means of an agreement (including a voting agreement). Furthermore, under the Communications Order, no person may transfer control, "significant influence" or Means of Control in Bezeq to another, if, as a result of the transfer, the holdings of the transferee would require approval pursuant to the Israeli Communications Law or Communications Order and the transferee is not in possession of the requisite approval. Any such unauthorized holding or acquisition is referred to as "Exceptional Holdings."

The Communications Order provides that in the event that a person holds "significant influence" or Means of Control in Bezeq, to a degree that requires the Ministers' prior approval, without receiving prior approval for such Exceptional Holdings (including as a result of the realization of a pledge over Means of Control), such person must report such Exceptional Holdings in writing to Bezeq and must submit an application to the Ministers for approval of such Exceptional Holdings all within 48 hours. Such application is required to be in the form of the questionnaire annexed to the Communications Order and must be accompanied by a power of attorney authorizing Bezeq's board of directors

to sell the applicant's Exceptional Holdings (unless the Ministers have granted an exemption from providing a power of attorney). Following the submission of the application and all relevant documents, the Ministers have 60 days to inform the applicant and Bezeq as to their decision.

In addition to the possibility of obtaining a retroactive approval as described above, the Communications Order establishes the following procedure for the sale of Exceptional Holdings: (i) with respect to a person who has not applied for approval by the Ministers, as described above, such person must sell his Exceptional Holdings within seven days; (ii) with respect to a person whose permit has been revoked or has expired, and who has not submitted a new application, such person must sell his Exceptional Holdings within 14 days after the date of the revocation or expiration, as the case may be; and (iii) with respect to a person who has applied for approval by the Ministers, including a party whose permit has been revoked or has expired and who has submitted a new application, and whose application has been rejected, such person must sell his Exceptional Holdings within 60 days after the date on which the Ministers informed such person that his application has been rejected. If a person does not sell his Exceptional Holdings as detailed in sub-sections (i)-(iii) and Bezeq holds a power of attorney from such person as required by the Communications Order, Bezeq will sell the Exceptional Holdings within 60 days, on a stock exchange, in Israel or abroad, or through an off-exchange transaction. The proceeds of the sale will be delivered to the holder, less expenses involved in the sale.

In accordance with the Israeli Communications Law and Communications Order, and as set forth in our Articles of Association, a holder of Exceptional Holdings (including a holder that submitted an application for approval which was submitted to the Ministers, whether such application was rejected or has not yet been approved) will not be entitled to any rights in respect of its holdings in Bezeq, including with regard to the receipt of dividends, unless and to the extent permitted under the Communications Order. Accordingly, a holder of Exceptional Holdings will not have any voting rights at a general meeting of shareholders. Each shareholder participating in a general meeting of shareholders is required to certify to us prior to the vote or, if the shareholder is voting by a proxy or any similar instrument, on such proxy card or similar instrument, as to whether or not his holdings in our company or his vote require the approval of the Ministers pursuant to the Israeli Communications Law and Communications Order. In addition, no director may be appointed, elected or removed from office by virtue of the vote of a holder of Exceptional Holdings. If a director is appointed, elected or removed from office by virtue of the vote of a holder of Exceptional Holdings, such appointment, election or removal from office shall have no effect.

The holding of control, "significant influence" or 5% or more of any particular class of Means of Control without the required approval or in violation of the terms of the approval constitutes a criminal offense and could subject the holder to criminal penalties as follows: (i) a person transferring control of Bezeq or acquiring and holding control over Bezeq without the required approval is subject to three years imprisonment or a fine currently in the amount of NIS 2.26 million as well as an additional fine for each day the offense continues (currently in the amount of NIS 14,000 per day); (ii) a person holding "significant influence" or more than 5% of the Means of Control of Bezeq without the required approval is subject to six months imprisonment or a fine currently in the amount of NIS 226,000 as well as an additional fine for each day the offense continues (currently in the amount of NIS 14,000 per day); and (iii) a person transferring "significant influence" or Means of Control of Bezeq, knowing that as a result of the transfer, the holdings of the transferee require approval pursuant to the Israeli Communications Law or the Communications Order, without being first shown the appropriate approval by the transferee, shall be subject to a fine currently in the amount of NIS 226,000.

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

At least 19% of each of the Means of Control of SP2 must be held by an Israeli Party at all times; or

At least 19% of the rights to vote at the general meeting of shareholders of SP2 and the rights to appoint directors of SP2 must be held by an Israeli Party at all times; and

The right to appoint at least one-fifth of the directors of Bezeq and Bezeq's subsidiaries and not less than one director of each such company will be held by an Israeli Party at all times, provided that the percentage of the Israeli Party's direct or indirect shareholdings in Bezeq is not less than 3% of any of the Means of Control of Bezeq. Indirect shareholdings will be calculated as the product of the Israeli Party's lowest rate of holdings in each of the Means of Control in SP2, multiplied by the percentage of the holdings of the parties to the Control Permit in each of the Means



of Control in Bezeq.

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

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

According to the Communications Order a “principal shareholder” or a person with “significant influence” in Bezeq shall not be; (i) a hostile state, a citizen or resident of a hostile state, a corporation registered or incorporated in a hostile state or a corporation controlled by a citizen or resident of a hostile state; or (ii) a government corporation, unless approved by the Ministers.

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

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

If we, B Communications or any other member of the Eurocom Group subject to the Control Permit fails to comply with the terms of the Control Permit or with other regulatory provisions relating to the control of Bezeq, such permit could be revoked and B Communications' rights with respect to its Bezeq interest would be adversely affected.

Any event in which a receiver is appointed with respect to our holdings in SP2 or SP2's holdings in Bezeq will constitute grounds for the cancellation of the Control Permit. In the event that the Control Permit is cancelled and an application to reissue a Control Permit is denied, B Communications' holdings in Bezeq must be liquidated within 15 to 60 days (depending on the cause for such cancellation) pursuant to the Communications Order.

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

## **The Concentration Law**

In December 2013, the Knesset passed the Concentration Law, which regulates the following principal matters: (i) limitations on the control over companies with publicly held debt or equity securities through a pyramidal ownership structure by imposing a limitation on the number of public companies (tiers) in such pyramidal structure; (ii) authorizes financial regulators to set forth limitations on the amount of credit that financial institutions are permitted to provide to a corporation or a group of companies under the control of the same controlling shareholder; and (iii) limitations on the holdings by a significant non-finance company in a significant finance company or the holdings of both kinds of companies under common control; and (iv) requires governmental authorities responsible for the award of rights in public assets (including in the communications field) in certain events to consider control concentration factors and industry-specific competitive factors.

### ***Limitations on the control of public companies through a pyramidal ownership structure***

*Prohibition on a second-tier company controlling another tier company*

The purpose of the Concentration Law is to limit the possibility to control a “tier company” (generally defined as a company with publicly held debt or equity securities that are subject to reporting obligations under the Israeli Securities Law) through a pyramidal structure of additional tier companies. Each of our company, B Communications and Bezeq is considered a “tier company” for the purposes of the Concentration Law. A “second-tier” company is a tier company that is directly controlled by a first-tier company, and accordingly, B Communications is deemed a “second-tier” company under the Concentration Law.

The Concentration Law prohibits a second-tier company, such as B Communications, from controlling another tier company. In the case of existing pyramidal structures, a second-tier company is entitled to continue to control another tier company that it controlled on the publication date of the Concentration Law for a period of six years from the date of publication of the Concentration Law (until December 10, 2019). For the purpose of the law, Bezeq is considered a third tier company, and accordingly, if by December 10, 2019, B Communications remain a tier company, B Communications will not be allowed to control Bezeq from that date.

In the event that a second-tier company controls another tier company contrary to the provisions of the Concentration Law, a district court may appoint a trustee, who will be awarded the means of control (including voting rights and right to appoint directors) in such tier company for the purpose of selling such means of control. The trustee shall act pursuant to the orders of the district court with respect to such means of control and will be entitled to petition the district court to rule, among other things, that an appointment of directors in the tier company that was made prior to the trustee’s appointment is void, to cancel transactions between the controlled tier company and its controlling shareholder or transactions in which the controlling shareholder had a personal interest if they have not yet been completed and to order the cancellation of a dividend distribution that was not in the tier company’s interests which occurred prior to the trustee’s appointment. The district court may, instead of appointing a trustee and under certain circumstances, order that the means of control held by the controlling shareholder shall not provide any rights whatsoever. Until the appointment of a trustee by the district court, the means of control held by a second-tier company that illegally controls another tier company shall not grant any voting rights at the illegally held tier company’s shareholder meetings.

The Concentration Law sets forth certain mechanisms intended to enable a tier company, which is subject to the prohibition of controlling another tier company, to make various arrangements for the repurchase of its publicly-held shares and the early redemption of publicly-held debt in order to comply with the provisions of the law. These mechanisms enable the repurchase of publicly-held shares and the early redemption of publicly-held debt securities under a court-approved scheme of arrangement pursuant to the Israeli Companies Law, at fair value and in accordance with the conditions prescribed by the Concentration Law, while providing certain relief from shareholders or debenture holder majority requirements for the approval of the arrangement.

*Appointment of directors and the composition of the board of a “third- tier” company during the transition period*

Beginning six months after the publication of the Concentration Law and until the end of the six years’ transition period during which a “third-tier” company can no longer be controlled by a second-tier company, the board of directors of a company that is a “third-tier” company (such as Bezeq) must be comprised of a majority of “independent directors,” within the meaning of the Israeli Companies Law, and the number of “external directors” pursuant to the Israeli Companies Law shall be at least half the number of the company’s directors less one (rounded upwards) but not less than two. The election of such external directors will be by a majority vote of the shareholders and the controlling shareholder’s vote will not be counted for such purpose. The Israeli Minister of Justice is authorized to enact regulations setting forth a lower number of required external directors, provided that such number will not be lower than one-third of the board members.

In June 2014, the Regulations to Promote Competition and Reduce Concentration (Relief with Regard to the Number of External Directors), 2014, were published. Pursuant to these regulations, if a director of a company who is appointed according to the proposal of a representative labor union under a collective labor agreement serves in another tier company, the number of external directors in the tier company required under the Concentration Law who meet the provisions of the law may be reduced, provided that the external directors account for at least one-third of the board members. Bezeq complies with the provisions of the Concentration Law in this respect.

*Limitations on the provision of credit to corporations and issuer groups*

The Minister of Finance and the Governor of the Bank of Israel are authorized to enact regulations and directives limiting the amount of credit provided by financial institutions in Israel, cumulatively, to a corporation or a group of companies under the control of the same controlling shareholder. Such regulations have not yet been enacted.

**Regulatory Requirements Relating to the Bezeq Group**

The Bezeq Group is subject to various regulatory requirements and obligations including communications and broadcasting laws (including provisions applicable to providers of essential services), general antitrust law, securities and companies laws, consumer protection laws, planning and construction laws, environment, health and safety laws, as well as technical and other regulations. The communications and broadcasting industry in Israel is highly regulated and requires service providers to obtain licenses from, and comply with the terms of such licenses and the policy statements of, the Ministry of Communications or the Israeli Council for Cable and Satellite Broadcasting, or the Broadcasting Council, with respect to the various communications and broadcasting services, respectively, before offering such services to the public. Holding Means of Control in telecommunications services providers is also subject to regulation, including certain prohibitions on cross-holdings in communications companies. The ever-changing regulatory environment has had and will likely continue to have a material effect on the Bezeq Group's activities. Certain key provisions of the regulations governing the Bezeq Group's activities are set forth below. This description is not intended to be an exhaustive description of all regulations nor a review of specific obligations which have been imposed on the Bezeq Group.

As a general matter, the regulatory principles are set forth in the laws enacted by the Knesset, primarily the Israeli Communications Law. These laws are amended from time to time upon enactment by the Knesset. The laws authorize the Ministry of Communications (in some cases with the approval of the Economic Affairs Committee of the Knesset) to issue regulations which provide for specific requirements based upon the principles set forth in the applicable laws. In addition to the regulations, the Ministry of Communications issues policy statements after a public review and consultation process. These policy statements expand upon the Ministry of Communications' policy with respect to certain basic issues in the relevant market. The Ministry of Communications grants licenses in accordance with the Israeli Communications Law and regulations. Bezeq was also declared a provider of essential services under the Communications Order and is subject to the provisions of such order.

### ***Structural separation***

The Communications Law grants the minister the authority to order accounting separation between different services provided by the same group/company and to demand separate companies for the provision of different services, including separation between rendering of services to a license holder and services rendered to a subscriber, and provisions regarding implementation of the separation.

Bezeq's domestic carrier license stipulates that it must maintain structural separation between itself and its subsidiaries. This requires, among other things that management of the companies be fully separate. The structural separation restrictions place the Bezeq Group at a competitive disadvantage, which is worsening over time compared with other communications groups that are not subject to such far-reaching limitations, and based on the ability for the operators to provide end-to-end services to subscribers using wholesale services, mainly BSA. These structural separation restrictions also contribute to high management overheads.

On December 22, 2016, Bezeq received a notice from the Director General of the Ministry of Communications regarding "cancellation of the structural separation in Bezeq Group." According to the notice, the Ministry is initially promoting cancellation of the corporate separation in Bezeq Group so as to have the activities of Bezeq's subsidiaries under the corporate structure of a single company, but with separation of divisions between the different activities. Accordingly, at this time the current regulations applicable to Bezeq's license regarding structural separation in terms of competition between the different activities will be maintained. Subsequently, the Director General informed Bezeq that the modification to the license in respect of cancellation of the corporate separation will be accompanied by a hearing. The notice states that the foregoing is subject to Bezeq's undertaking to invest in infrastructure by accelerating the deployment of broadband infrastructure (optic fibers) with the intention to launch the service at the beginning of 2017, to establish an accelerated deployment plan to 76% of households in Israel within three years, and to complete the universal deployment that was undertaken by Bezeq at a time to be determined. In the notice, the Ministry clarified that it also intends to hold a hearing regarding the structural separation cancellation arrangements during 2017. A hearing date has not yet been published.

Bezeq is reviewing the options for implementation of the cancellation of corporate separation and is seeking to effect a merger with DBS, subject to compliance with certain preconditions.

The structural separation cancellation notice deals with cancellation of the corporate separation in the Group, but does not provide a solution with respect to other aspects of structural separation. On May 2, 2012, a policy document concerning expansion of competition in the fixed-line communications segment - wholesale market ("the Policy Document") stipulates, among other things, with regard to structure separation that:-

Within nine months of publication of the shelf offering for the sale of wholesale services, the Minister will order elimination of the structural separation between the infrastructure provider who published the shelf offering and the international call providers and ISPs, changing it to accounting separation (unless the Minister believes that this will materially harm competition or public interest), so that Bezeq will be able to offer non-divisible plans of its services together with these services (as opposed to plans that can be unbundled, i.e. plans in which each service is offered separately and not part of a bundle, under the same terms as those offered under the plan).

Unbundling of the broadcasts included in the joint bundles will be reviewed and structural separation between the infrastructure providers and multi-channel TV sector will be eliminated by granting suppliers without nation-wide fixed-line infrastructure a reasonable possibility to provide a basic Internet-based TV service package.

The Minister will consider an easing or cancellation of the structural separation between an infrastructure provider and a cellular operator who has an interest in the said provider, taking note of the development of the wholesale market and competition based on joint service bundles.

In Bezeq's opinion, the policy document conditions for cancellation of structural separation were met following the launch on February 17, 2015 of a broadband wholesale market, in which various service providers operate providing end-to-end broadband services on Bezeq's infrastructure and in view of the fact that there is fierce competition in the cellular service segment and there are companies providing television services over the Internet.

Bezeq was permitted to offer subscribers joint service bundles with its subsidiaries, subject to approvals by the Ministry of Communications and several terms laid down in the Domestic Carrier license, including the following requirements:

The bundles must be unbundlable (a service included in them must also be offered separately and on the same terms).

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

Joint service bundles marketed by the subsidiaries including the services of Bezeq, are also subject, according to their licenses, to similar limitations, including a requirement for unbundling (except for a bundle marketed by a subsidiary that contains only Bezeq's Internet infrastructure service).

These limitations, and in particular the unbundling obligation, which severely limits the Bezeq Group's ability to offer discounts on the components of the bundle, places the Bezeq Group at a competitively disadvantage as compared to the competing communication groups which are not subject to similar limitation in marketing joint bundles (other than a limitation on marketing a joint bundle of HOT-Net and other HOT Group companies,). Bezeq's limitation is more significantly manifested with implementation of the wholesale BSA services and the option for ISPs to provide end-to-end services to customers at reduced prices compared with the unbundlable bundles that Bezeq can market.

With respect to the terms of the agreement for bundles of Internet infrastructure services together with ISP services marketed by Bezeq, on January 1, 2017, the Ministry of Communications notified Bezeq that it must make changes to the current bundle format and cancel the section in the agreement prohibiting ISPs from making commercial use of the customer data that Bezeq has collected and transferred to them. Otherwise, the approval granted to Bezeq to market a joint service bundle will be canceled. On March 27, 2017, the Ministry of Communications notified Bezeq that it would not approve Bezeq's request to market a joint service bundle with DBS, given that the Ministry will, in the near future, be completing several regulatory measures that will allow a more complete implementation of the wholesale market reform, including the regulation of telephony resales, new regulations relating to Bezeq's retail tariffs, regulation of a mechanism to reduce profit margins and regulation of the conditions for marketing reverse bundles. According to the Ministry's notice, it is willing to review requests for joint service bundles which include telephony and TV, in at least six months' time, after it has examined the effect of the aforementioned measures on the market and is certain that Bezeq satisfies the regulatory requirements. In its notice, the Ministry reiterated its intention to review, subject to a hearing, the cancellation of the structural separation obligation in the Bezeq Group and to examine regulations that will replace the existing structural separation regime, in a manner that could affect the marketing of joint service bundles.

There are other limitations on cooperative ventures between Bezeq and Bezeq Group companies, both under the antitrust laws and conditions laid down by the Antitrust Commissioner in approvals of mergers between Bezeq and Bezeq Group companies, which prohibit discrimination in favor of Bezeq Group companies when providing certain services, and pursuant to the provisions of Bezeq's license, which requires it to provide its services equally to all.

Lifting of the restrictions on structural separation and waiving the limitations applicable to cooperative ventures between the Bezeq Group companies, may provide the Bezeq Group with various opportunities to utilize synergies or the facilitate utilization of such synergies.

Recently a wholesale market model has started being implemented in Israel. The model includes the obligation imposed on Bezeq and HOT, owners of a country-wide fixed-line access infrastructure, to sell wholesale services to other communications operators.

### ***Wholesale services***

The wholesale services were established pursuant to the policy document in which the Minister of Communications adopted the main recommendations of the committee appointed to review and revise the structure of Bezeq's tariffs and to set wholesale service tariffs in the communications segment (Hayek Committee). The policy document states, among other things, that owners of country-wide fixed-line access infrastructures who provide retail services, including Bezeq, will be obligated to sell wholesale services to holders of telecommunication licenses on a non-discriminatory basis and with no discounts for size. The document also stipulates the terms for cancellation of the



structural separation and that within six months of publication of the Shelf Offering for the sale of wholesale services by the infrastructure owners, the Minister of Communications will take action to change to a method of oversight of Bezeq's prices by setting a maximum price and within nine months and that the Ministry of Communications will formulate regulations aimed at increasing the investment in and upgrading fixed-line communications infrastructure in Israel.

Further to the policy document, the Ministry of Communications established service portfolios setting out the format for provisions of the services by the infrastructure owners. The maximum tariffs that Bezeq is permitted to charge for these services were determined by the Minister of Communications with the agreement of the Minister of Finance in the Communications (Telecommunications and Broadcasts) (Use of a Domestic Carrier's Public Network) Regulations, 2014 ("the Use Regulations"). No tariffs for HOT's wholesale services have been set as yet.

### *BSA services*

Bezeq started to provide BSA services on February 17, 2015. This service allows service providers that do not own infrastructure to offer their customers full end-to-end Internet services, including Internet connectivity services and infrastructure services of Bezeq. Since launching of the service, hundreds of thousands of customers have switched to receiving services through these service providers who rely on Bezeq's infrastructure..

In the initial period of provision of the service, the Ministry conducted an oversight proceeding regarding Bezeq, which led to the imposition of NIS 8.5 million in fines. Bezeq paid the fines and submitted a petition with the court against this proceeding. Disputes erupted between Bezeq and the service providers regarding implementation of the service portfolio. These disputes concerned the recruitment and movement of customers, the payments owing to Bezeq for the service and the use of routers leased by Bezeq to its customers.

The Ministry held hearings on various issues related to implementation of this service. Some of the hearings were initiated by the Ministry for implementation of its policy, some stemmed from the disputes regarding implementation of the service and others derived from Bezeq's petition to the court prior to launching the service. The results of the hearings may affect the service tariffs and Bezeq's competitive position in the market.

The main hearings on the matter dealt with mechanisms for reviewing and revising the forecast for demand for the purpose of updating the wholesale market tariffs (in which a decision was made regarding reduction of the tariffs of the BSA service component), revising the service level (SLA) requirements, and the procedure for movement of customers between operators, etc.

On November 17, 2014, a hearing was published on the subject of determining the format for reviewing a margin squeeze by the fixed-line broadband network owners: According to the hearing, the infrastructure owners will be required to send any marketing proposal for review by the Ministry of Communications and the Ministry will notify the infrastructure owner within 14 days whether it prohibits marketing of the package due to fears of margin squeeze. This review mechanism and the resulting restriction on prices for retail services, if and insofar it is applied, may affect Bezeq's ability to propose marketing offers for its wholesale services from the time to market perspective and the prices that it can offer. To date, no decision has been published.

#### ***Wholesale service use of physical infrastructures***

Pursuant to the service portfolio that entered into force on July 31, 2015, Bezeq allows service providers without infrastructure to use its physical available-for-transfer communication cable infrastructure and available dark fibers out of Bezeq's available optic cables. In order to connect the service provider's infrastructure to Bezeq's infrastructure, the service provider must set up a passive infrastructure near Bezeq's passive infrastructure facility.

In a letter dated July 6, 2016, the Ministry of Communications announced its decision that the infrastructure work will be performed by Bezeq or several companies whose services Bezeq uses in exceptional cases in coordination with it, as opposed to a situation in which the service providers without infrastructure that use Bezeq's infrastructure perform the work. In another letter, it was clarified that these provisions will also apply with respect to the use of Bezeq's infrastructure by infrastructure owners.

Due to a dispute between Bezeq and another communication provider regarding the use of Bezeq's physical infrastructure for its cellular requirements, the Ministry of Communications clarified its position that provision of the service is not conditional to the manner of use by the service provider and in fact rejected Bezeq's position that the wholesale market services are designated exclusively for the fixed-line market. Bezeq provides the service accordingly.

In the amendment to the Communications Law, as applied in the Economic Arrangements Law, a licensed domestic carrier must allow other licensed domestic carriers (which are not necessarily license holders without infrastructure) access to its passive infrastructure (excluding the passive infrastructure of a licensed domestic carrier owned by IEC

and which it requires, for the purpose of its operations as the holder of a critical service provider license) for performance of any telecommunications operation and provision of any telecommunications service under its license. This means allowing IEC and HOT Telecom to use Bezeq's passive infrastructure beginning October 1, 2017 at tariffs to be set by the Minister of Communications with the agreement of the Minister of Finance by April 1, 2018. Until these tariffs are set, the tariffs published in the Use Regulations will apply. Once these tariffs have been set, settling of accounts will be made between Bezeq and HOT Telecom only.

Bezeq began to provide wholesale services to service providers in the beginning of 2015 and as of the end of 2016, the number of Internet lines provided on a wholesale basis on the Company's network was 377,000, or approximately 24% of the all Bezeq's subscribers. Bezeq estimates that 17% of the fixed-line Internet subscribers in Israel use the wholesale BSA services.

### *Wholesale telephony service*

The policy document states that Bezeq will be able to provide a wholesale telephony service to its subsidiaries that are not supplied over a broadband network, provided that these services are also available to everyone without discrimination. The Ministry of Communications' decision document regarding the list of wholesale services dated January 15, 2014 includes a telephony service, however, the BSA service portfolio (dated November 17, 2014) includes a wholesale telephony service to be provided beginning May 17, 2015 at significantly lower tariffs than Bezeq's telephony services.

On December 29, 2014, Bezeq petitioned the High Court of Justice claiming, among other things, a lack of jurisdiction and inapplicability of the wholesale telephony service in the format included in the BSA service portfolio. In response, the Ministry of Communications argued that there is technological applicability for the service portfolio format, in accordance with the solutions offered after Bezeq filed its petition. These solutions were rejected by experts on Bezeq's behalf as impossible to implement.

On December 10, 2015, the Ministry of Communications announced a hearing regarding provision of a telephony service in a different format to the wholesale format. The resale service allows a domestic carrier with a unified license to purchase telephony services from Bezeq, allowing outgoing and incoming calls and provision of accompanying and added value services by Bezeq (as opposed to the wholesale service in which the call also passes through the license holder's switch), as a temporary interim solution for a period of one year from adoption of the decision at the hearing, after which Bezeq would provide a wholesale telephony service. In reference to the possibility of returning to the wholesale telephony service portfolio, Bezeq stressed that the format in the service file could not be applied automatically, since it was impossible to implement, unjust and contradicts global trends. Bezeq indicated that the only way that Bezeq could provide the service in the service portfolio format would require a switch replacement and would cause Bezeq to perform a complex, disproportionate, and seemingly unauthorized procedure that could not be justified. At the hearing, the tariffs for the telephony service (in the resale format) were presented. The tariffs were derived from the retail price of Bezeq's tracks and reflected a discount of 40% compared with Bezeq's tariffs. Bezeq argued that the discount was unfair as the standard discount rate worldwide is a maximum of 10% to 20%. No decision or new hearing has been published by the Ministry of Communications as of yet.

Due to the Ministry's notice regarding publication of the foregoing hearing, on October 11, 2015 the High Court of Justice dismissed Bezeq's petition insofar as it relates to wholesale telephony services.

Bezeq estimates that implementation of the wholesale telephony service may adversely affect its results of operations and financial condition. At present, there is uncertainty as to the date of implementation of the service and its characteristics. Accordingly, Bezeq is unable to estimate how it will implement the wholesale telephony service.

***Additional regulatory aspects relevant to the entire Group or several Group companies***

*Change in interconnect tariffs.* The Group's telecom companies (Bezeq, Pelephone and Bezeq International) pay interconnect fees to other carriers for calls that are terminated on the networks of those carriers, and some of them (Bezeq and Pelephone), receive interconnect fees for calls that are terminated on their networks and from international communications operators for outgoing calls on their networks. The interconnect fees are determined by the Ministry of Communications as the maximum tariffs in the interconnection regulations. Changes in the interconnect tariffs have an offsetting effect at the Bezeq Group's level, in view of their impact on both the expenses and revenues of Bezeq and its subsidiaries.

*Restriction of the exit penalty a license-holder can collect from a subscriber.* Under the provisions of the Communications Law, holders of domestic carrier licenses, ITS licenses and broadcast licenses, including Bezeq, Bezeq International, DBS and B.I.P, may not collect disconnection fees from subscribers who cancel agreements if their average monthly bill is less than NIS 5,000, or deny them a benefit that they would have received had they not ended the agreement. Cellular operators, including Pelephone, may not collect disconnect fees from customers who

hold up to 100 phone lines or condition a contract for cellular services on an agreement to purchase, rent or lease terminal equipment. As a rule, these restrictions make customer retention difficult for the communications operators that are subject to them.

*Non-discrimination in the offering of benefits and special tariffs.* Due to the different positions expressed by the Ministry of Communications in the past, communications companies may be restricted under certain circumstances in their ability to offer benefits and special tariffs to their new customers or to prevent a subscriber from switching to plans marketed to new customers. The Ministry of Communications announced its intention to hold a hearing regarding revision of the provisions of the licenses regarding price discrimination between subscribers in a manner that is also consistent with the changes and developments in the market.

### ***Amendments of licenses and additional legislation***

*Hearing about call center waiting times.* On August 18, 2014, the Ministry of Communications published hearings for communication license holders on the subject of regulating the response time of the telephone service and support call centers, including the definition of the obligations of human responses, a series of other provisions, and a memorandum to amend the Communications Law, which prescribes compensation without the need to prove loss if the response time is longer than that prescribed, and compensation for overcharges. Responses to the hearing opposing the arrangements proposed were submitted. There have been no developments on the subject to date. If the proposed arrangement is approved in the format prescribed in the hearings, the operating costs of the call centers of the Bezeq Group companies may increase.

*Amendment of licenses to ensure operational continuity of communication companies in emergencies.* On March 1, 2015, the licenses of communications operators were amended, including the licenses of Bezeq, Pelephone and B.P.I. According to the amendments, the license holders must comply with minimum requirements to ensure operational continuity (a business continuity plan and network disaster recovery plan) in the event of emergencies. On November 1, 2016, the Ministry of Communications published a hearing for further amendments to the licenses, including provisions concerning the installation of supporting infrastructure on core sites. Bezeq submitted its comments to the hearing.

*Consumer legislation.* Changes in consumer legislation affect the operations of the Bezeq Group companies on a regular basis. Various amendments have been made in recent years to the Consumer Protection Law and regulations, concerning the cancellation of transactions even after service has begun, disconnection from on-going services, the need for the customer to give express consent to continue transactions after the end of the specified period and sending of messages, provisions concerning a refund of charges collected from the subscribers which are not in accordance with the communication agreement plus fixed handing charges prescribed in the Law, restrictions on debt collection procedures, maximum waiting time for a human response, and extension of the visiting times of technicians at the subscribers' homes. Various bills have also been tabled in the Knesset introducing further amendments to the Consumer Protection Law which may affect the terms of customer agreements and the conduct of the Bezeq Group companies towards their subscribers.



*Enforcement and financial sanctions.* Over the last few years, the Communications Law, the Antitrust Law, the Securities Law and the Consumer Protection Law were amended, giving regulators powers of enforcement, supervision and imposition of graded fines for violation of these laws or regulations and their provisions. Likewise, the Law to Increase the Enforcement of Labor Laws was enacted. This legislation affects the way in which the Bezeq Group companies manage their affairs, in part with respect to concern about the imposition of sanctions and their ability to protect themselves.

The Ministry of Communications has begun to make wide use of its authority to supervise and provide notices of its intention to impose fines for ongoing regulatory matters and issues related to implementation of the wholesale market. Bezeq sent the Ministry of Communications its response to the supervision documents and notices regarding the imposition of fines. In some instances, the Ministry of Communications rejected Bezeq's position and imposed fines.

*Restrictions on providing credit to business groups.* Powers were granted to the Minister of Finance and the Governor of the Bank of Israel to promulgate regulations and provisions limiting the cumulative credit that financial institutions in Israel may give to a corporation or business group (a group of companies under joint control and their controlling shareholder).

*Restrictions on the allocation of rights in critical infrastructures to a highly concentrated entity.* The Market Concentration Law prescribes a special, restrictive procedure that must be applied prior to the allocation of rights (such as a license, franchise, contractual agreement with the State to operate a critical infrastructure and in certain circumstances also to extend existing licenses) in those areas that are defined as a “critical infrastructure” to entities that are defined as a “highly concentrated entity.” In this regard, a list of areas was defined that will be deemed “areas of critical infrastructure”, including operations for which certain communications licenses are required (domestic carriers, excluding a specialist domestic carrier (such as VoB operators and cellular operators), broadcast licenses, and other areas. Bezeq, the companies that it controls and that are controlled by its controlling shareholder are included in the list published by the Antitrust Authority and are considered highly concentrated entities. The procedure prescribed in the law in relation to the allocation of a right to a highly concentrated entity will also apply to approval given for transferring the means of control in state-owned companies or companies that were previously government companies (Bezeq included) at the rates defined in the law, to a highly concentrated entity.

The provisions of this law became effective in December 2014, although the provisions relating to extending the validity of existing licenses, will go into effect in December 2017. This law may adversely affect the Bezeq Group's ability to enter new areas of activity as well as its current operations.

*Restrictions on creating charges on the assets of Group companies.* The Communication Law, the Communication Order (which applies to Bezeq), and some of the communications licenses of Bezeq Group companies, contain restrictions on granting rights to a third party on assets used to provide the critical service or on the assets of the

license, as the case may be, including the need to obtain regulatory approval to create charges on these assets. In some cases, such as Pelephone's cellular operator's license, and Bezeq International's unified license, there are exceptions permitting the creation of charges in favor of banks without the need for advanced approval, provided that the charge agreement includes instructions to ensure that the services rendered under the license will not be affected if the bank exercises the charge. In addition, under the provisions of the law and the communications licenses, the license and the resulting rights are not transferable and they cannot be pledged or confiscated (with certain exceptions).

Bezeq has provided undertakings to certain financing entities not to pledge its assets without simultaneously creating a charge of the same class, rank and amount (negative charge) in favor of those financing entities, subject to specific exceptions. DBS created a floating charge on all its assets and a fixed charge on certain assets, whose conditions include, restrictions on the creation of additional charges without obtaining the consent of the holder of the charge.

### *Bezeq*

#### *Control of Bezeq's tariffs*

The control of Bezeq's tariffs as described below has a number of implications. Bezeq's tariffs are subject to regulatory intervention and from time to time, Bezeq is exposed to significant changes in its tariff structure and tariff levels. The review mechanism for the controlled tariffs, as defined in the authorizing legislation and the regulations, results in a real average erosion of the tariffs over the years. Control of the tariffs could make it difficult for Bezeq to provide an appropriate and competitive response to market changes and to offer competitive prices on short notice. Furthermore, the restrictions on granting discounts on tariffs limit Bezeq in participation in certain tenders.



The following are the main control arrangements over Bezeq's prices:

Under the Communications Law, the Minister of Communications is entitled, with the approval of the Minister of Finance, to determine payments (including maximum payments or minimum payments) for services from a license holder. The payment can be determined on the basis of (1) the cost, according to the calculation method instructed by the Minister plus a reasonable profit; or (2) reference points deriving from: payment for services provided by the license holder; payment for comparative services; payments in other countries for such services.

The competition expansion policy document stipulated that within six months of publication of the Shelf Offering (for the sale of wholesale services), the Minister will take action to change the method of oversight of Bezeq's prices so as to be controlled by the setting of a maximum price. Negotiations are being conducted with the Ministry of Communications in this matter.

The tariffs for Bezeq's controlled services (telephony and others) which are fixed in the regulations, were updated in accordance with a linkage formula less an efficiency factor provided in the regulations, so that on average, Bezeq's controlled tariffs have eroded in real terms. In the last three years, the prices in the regulation have not been updated and the date of the update has been postponed. Under the provisions of the regulations and the relevant temporary orders, the postponement will be taken into consideration in the next update.

The Ministers of Communications and Finance are authorized to prescribe interconnect payments or for the use by a license holder of the telecommunication facilities of another license holder, and to provide instructions.

If tariffs that are neither at the maximum nor minimum levels are determined for supervised services, Bezeq may offer an alternative payments package for a bundle of telecommunication services at such fixed payments, provided that the Ministers of Communications and Finance do not oppose the package. The Gronau report states that an alternative payment package will be approved only if it is worthwhile for 30% or more of subscribers who use the services offered in the package, and that the smaller the market share of the Bezeq Group in fixed-line telephony is, the higher the maximum discount rate permitted in an alternative payment package will be.

If maximum or minimum payments are determined according to Sections 5 or 15 the Communications Law, for telecommunication services provided to another license holder, Bezeq may indiscriminately offer any other license holder an alternative payments package for the bundle of services at maximum or minimum payments, and such services together with services for which payment has not been determined according to Sections 5 or 15 to the Law, provided the Ministers are not opposed or approved the package.

Bezeq may request a reasonable payment for a service for which a payment is not determined according to Sections 5 or 15, or for which a maximum or minimum payment has been determined. The Minister of Communications may require Bezeq to notify him of any payment Bezeq intends to request as set out above and of any change in the payment prior to the provision of the service or the change. If the Minister of Communications determines that Bezeq

intends to request an unreasonable payment, or a payment that raises suspicion of harming competition, the Minister may set (for a period not exceeding one year) the maximum payment it may request for the service or separation of the payment for the service from the payment for the bundle of services.

*Bezeq's Domestic Carrier license*

Bezeq operates under a Domestic Carrier license which enumerates the services Bezeq must provide and its duty of universal service. Bezeq is required to provide its services to all on equal terms for each type of service, irrespective of location or unique cost. While the license is unlimited in time; the Minister may modify or cancel the license or make it contingent. The license and any part of it cannot be transferred, no charge can be imposed on it, nor can it be subject to attachment.

Bezeq is required to maintain and operate the network and provide its services at all times, including in emergencies, in an orderly and proper manner according to the technical and service quality requirements, and to work towards improving its services. The license includes a Service Standards for the Subscriber appendix, which is to be amended after Bezeq provides the Ministry with data. Bezeq submitted its proposals for amendment of the appendix to the Ministry, adapting it to the current state of affairs and the licenses of other operators, but the amendment report has not yet been published.

Provisions are stated for the duty of interconnect to another public switching network and the option of use by another license-holder; a duty to provide infrastructure services to another license-holder on reasonable and equal terms is also provided, as well as refraining from preferring a license-holder that is a company with an interest.

Provisions have been made for the operation of Bezeq's network in times of emergency, including the obligation to operate it in a manner that prevents its collapse in emergencies. Bezeq is required to provide telecommunication services and set up and maintain the terminal equipment infrastructure for the security forces in Israel and abroad, as provided in its agreements with the security forces. Bezeq is required to appoint a security officer and to comply fully with the security instructions contained in the appendix to the license. Bezeq provides special services to the security forces. Bezeq is required to ensure that each purchase and installation of hardware in its telecommunications installations, except for terminal equipment, will be made in full compliance with instructions given to Bezeq according to Section 13 of the Communications Law.

Extensive reporting duties to the Ministry of Communications are imposed on Bezeq. In addition, the Director General of the Ministry of Communications has the authority to enter facilities and offices used by Bezeq and to seize documents.

The Domestic Carrier license includes restrictions on the acquisition, maintenance and transfer of means of control pursuant to the Communications Order and on cross-ownership, which are mainly a ban on cross-holding by entities in which those with an interest in a another material Domestic Carrier as noted in the license, and restrictions on a cross-holding by entities with Domestic Carrier licenses or general licenses in the same segment of operation.

Bezeq submitted a bank guarantee of US\$ 10 million to the Director General of the Ministry of Communications to secure fulfillment of the terms of the license and for indemnifying the State for any loss it incurs due to their violation by Bezeq. The Director General at the Ministry of Communications is authorized to impose a fine for violation of any of the terms of the license.

During a calendar year, Bezeq may invest up to 25% of its annual income in activities not intended for providing its services (the incomes of Bezeq's subsidiaries are not considered income for this purpose).

### ***The Communications Order***

Bezeq was declared a provider of telecommunication services under the Communications Order. By power of that declaration, Bezeq is required to provide certain types of services and may not cease to provide them or narrow them. Among these services are basic telephone service, infrastructure service, transmission service and data communication service including interconnect, and other services listed in the schedule to the Order.

The main provisions of the Communications Order are these:

Restrictions on the transfer and acquisition of means of control in a company, which includes a ban on holding 5% or more of means of control of a certain kind without the prior written approval of the Prime Minister and the Minister of Communications, or the Ministers.

Transfer or acquisition of control in a company requires the approval of the Ministers. The Control Permit establishes the minimum holding percentage in each of the means of control in Bezeq by the holder of the Control Permit. A transfer of shares or an issuance of shares that causes the ownership percentage of the Control Permit holder to fall below the minimum percentage is prohibited without the prior approval of the Ministers, subject to permitted exceptions (among them are an issuance to the public under a prospectus or sale or private placement to institutional investors).

Holdings not approved will be considered "exceptional holdings" and the Order states that exercise of a right by power of exceptional holdings will not be valid. The Order also contains provisions authorizing the Ministers and Bezeq to submit an application for the enforced sale of exceptional holdings to the courts.

At least 75% of the members of the Board of Directors of Bezeq must be Israeli citizens and residents who have security clearance and security compatibility as determined by the General Security Service. The Chairman of the Board, the external directors, the CEO, the Deputy CEO and other office-holders in Bezeq as listed in the Order, must be Israeli citizens and residents and have security clearance appropriate to their functions.

"Israeli" requirements are laid down for the controlling shareholder in Bezeq: for an individual – he is an Israeli Entity (as defined in the Order); for a company – it is incorporated in Israel, the center of its business is in Israel, and an Israeli Entity holds at least 19% of the means of control in it.

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

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

*Authority with respect to real estate*

Pursuant to the provisions of Section 4(F) of the Communications Law, the Minister of Communications granted Bezeq certain powers in connection with real estate, as set out in Chapter Six of the Law. The law distinguishes between land owned by the State, the Development Authority, the Jewish National Fund, a local authority or a company lawfully established and owned by one of them, and a road ("Public Land"), and other land ("Private Land"). With regard to Public Land, Bezeq and any person authorized by it, can enter it to perform network deployment and maintenance works and to provide telecommunication services, provided that the deployment is executed according to the provisions of the Planning and Construction Law. The amendment to the Communications Law and the Planning and Construction Law in the Economic Arrangements Law cancel the duty to obtain the approval of the local Planning and Construction Committee, so certain actions do not require a building permit if performed by a license holder that was granted powers under section F of the Communications Law, if carried out according to an approved plan.

A network on Private Land will be deployed according to the provisions of the Planning and Construction Law and requires the consent of the landowner, the lessee in perpetuity or the protected tenant, as the case may be. Under the provisions of the Telecommunications (Installation, Operation and Maintenance) Regulations, 1985, if Bezeq is of the opinion that providing a telecommunications service to an applicant requires the installation of a telecommunications device on the applicant's premises (or shared premises), Bezeq may request that the applicant, as a prerequisite for providing the requested service, allocate a suitable place on the premises for installation of the device, for the sole use of Bezeq, and it may use the device to provide service to other applicants as well.

Under the provisions of the Planning and Construction (Application for a Permit, its Terms and Fees) Regulations, 1970, an applicant for a permit to construct a residential building is required to install infrastructures for telephone, radio, television and Internet services so that the customer can choose whichever provider it prefers. In commercial buildings, if preparations for communications are installed, an underground infrastructure must be laid. At the same time, Bezeq's license was amended (as were the licenses of HOT Telecom and DBS), so that if Bezeq uses the internal wiring (part of the access network installed in residences and in apartments intended to be used by those residences only) for provision of its services, it is obliged to provide maintenance services for that wiring installed by the permit applicant, without this granting it any proprietary rights in the internal wiring. Pursuant to the hearing published on May 7, 2015 on the subject of wiring in residential buildings, the Ministry of Communications is holding a round table with Bezeq, DBS, HOT and IBC to reach an arrangement regarding installation of infrastructure in new buildings.

*Immunity and exceptions to liability*

The Minister of Communications granted Bezeq immunity from certain liabilities for damages listed in Chapter Nine of the Communications Law, in accordance with his authority to grant immunity to a general license-holder. In addition, Section 13 of the Communications Law contains exceptions to criminal and civil liability for an act done in

fulfillment of a directive to provide services to the security forces in that section.

*Regulations and rules under the Communications Law*

Regulations in three additional and important areas currently apply to Bezeq: (1) cessation, delay or restriction of telecommunications actions and services; (2) installation, operation and maintenance; and (3) ways of supervising the actions of the license-holder.

*Antitrust laws*

The Antitrust Commissioner declared Bezeq a monopoly in the following areas:

Basic telephone services, provision of communications infrastructure services, and transfer and transmission of broadcasting services to the public.

Provision of high-speed access services through the access network to the subscriber.

Provision of high-speed access services for ISPs through a central public telecommunications network.

The Commissioner's declaration of Bezeq as a monopoly constitutes prima facie evidence of its content in any legal proceeding, including criminal proceedings.

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

In connection with the approval of the merger of Bezeq and Pelephone, restrictive terms were imposed, mainly prohibiting discrimination in favor of Pelephone in the supply of a product in which Bezeq is a monopoly, prohibiting the bundling of the supply of certain products by any of the companies when purchasing products or services from the other, and restrictions on certain joint activities.

In connection with the approval of the merger of Walla and Bezeq, terms were imposed restricting discrimination in favor of Walla against its competitors.

On October 11, 2011, the Antitrust Authority informed Bezeq that the Commissioner was considering the issuance of a ruling in accordance with his powers under Section 43(A)(5) of the Antitrust Law, that Bezeq had abused its position in contravention of the provisions of Section 29A of the Antitrust Law. The notice stated that the Commissioner was considering stipulating that Bezeq refused to provide transmission services for the provision of telephony and Internet services to Cellcom and Partner. In accordance with the decision of the Ministry of Communications, Bezeq provides infrastructure and transmission services to both Cellcom and Partner.

On November 16, 2014, Bezeq received the decision of the Deputy Commissioner of the Antitrust Authority pursuant to Section 43(A)(5) of the Antitrust Law, to the effect that Bezeq had abused its position as a monopoly and determined unfair purchase and sale prices of a service in a monopoly, in contravention of the provisions of Section 29A to the Antitrust Law 1988 in setting a negative margin by determining lower prices for Internet and telephony services than for Internet infrastructure only, in a campaign. The decision states that these prices places competitors who wish to offer this service at a disadvantage. Bezeq filed an appeal with the Antitrust Tribunal against the decision.

### *The Telegraph Ordinance*

The Telegraph Ordinance regulates the use of the electromagnetic spectrum, and applies, inter alia, to Bezeq's use of radio frequencies as part of its infrastructure. The set-up and operation of a system that uses radio frequencies is subject, under the Telegraph Ordinance, to grant of a license, and the use of radio frequencies is subject to the designation and allocation of a suitable frequency. The Telegraph Ordinance imposes license fees and fees for the designation and allocation of frequencies. The Government deals with the shortage of radio frequencies for public use in Israel (among other reasons, due to the allocation of a large number of frequencies for security purposes), by limiting the number of licenses granted for the use of frequencies, and providing incentives for efficient use of frequencies.

### *Setting up communications facilities*

The National Outline Plan for communications, NOP 36 (within the Green Line) and NOP 56 (in the Administered Territories), were designed to regulate the deployment and manner of set-up of communication facilities in a way that would ensure coverage for transmitting and receiving radio, television and wireless communications, while avoiding radiation hazards and minimizing the damage to the environment and the landscape, and also to simplify and increase the efficiency of the processes involved in setting up the facilities.

The classification of the facilities according to their technical variables and physical dimensions, which affect the determination of safety ranges for protection against the effects of radiation and the extent to which they protrude on the landscape, determine which facilities will be included in Part A of the NOP 36 and which in Part B of the Plan.

Bezeq has erected and is erecting broadcasting facilities and wireless communication facilities for providing broadcasting services to its customers, and uses such communication facilities, mainly for providing services to areas that are not connected to the fixed-line communications infrastructure (remote areas or new towns).

*NOP 36A.* Part A of NOP 36 deals with guidelines for erecting small and miniature broadcasting installations. Bezeq has obtained building permits for most of the small broadcast installations in accordance with NOP 36A. From time to time, a need arises to add broadcast installations which require that building permits be obtained in accordance with NOP 36A. Given the exemption granted under the orders of the Planning and Construction Law and of the Communications Law, Bezeq believes that it is not obliged to obtain building permits for miniature broadcasting installations, which are “wireless access facilities” under those laws.

Since 2008, a draft amendment to NOP 36A (NOP 36/A/1) has been tabled. The draft amendment mainly deals with changing the guidelines for the licensing of small and miniature broadcast installations, including determination of different licensing tracks (fast and standard) depending on the location and the public safety range of each installation, and indemnification arrangements for compensation claims under Section 197 of the Planning and Construction Law. If adopted, the draft amendment may give rise to practical difficulties which could impede Bezeq's ability to provide the public with some of the services it is required by law to provide.

*NOP 36B.* Part B of NOP 36 contains guidelines for setting up large broadcasting facilities. In the January 2008 draft plan (which was presented to the government for approval in August 2010, but is yet to be approved), the definition of a large broadcast facility was changed so that the licensing of broadcast facilities which prior to the proposed amendment were classified as large, would be according to NOP 36/A/1 (if and when approved). The change in definition for small and large broadcasting facilities may give rise to practical difficulties which could impede Bezeq's ability to provide the public with the services it is required by law to provide.



The January 2008 draft contains a transition provision which is expected to allow the grant of a license for existing broadcast installations even if they do not meet the requirements of NOP 36B, subject to certain terms and restrictions, provided that they are in compliance with the safety restrictions described in the Plan. The January 2008 draft also proposes to include a provision requiring the permit applicant (including for existing sites) to provide the local committee with a deed of indemnity for compensation under Section 197 of the Planning and Construction Law, if a court rules against the committee.

NOP 36B has not yet been approved by the government and there is no certainty as whether it will be approved. As mentioned above, at this stage, before publication of the final text of the NOP, Bezeq is unable to estimate the full impact of the amendments on Bezeq.

*NOP 56.* NOP 56 came into force in June 2008, and regulates the manner of erection and licensing of communications facilities in the Administered Territories. The Plan contains transition provisions for facilities erected with a permit for small installations. The Plan also includes a requirement for production of a communications license and receipt of the consent of the Commissioner of Government Property at the Civil Administration.

Bezeq has arranged licensing for 76 installations in the Administered Territories, and is in the process of licensing the remaining five installations in the Administered Territories. Moreover, in November 2016, Bezeq received a notice from the Civil Administration (Communications Staff Officer) that it must also organize the licensing of facilities on the customer's premises (as opposed to the foregoing facilities in Bezeq's possession). Bezeq estimates that this means obtaining licensing for dozens of sites and it is reviewing its position on the subject.

*Exemption from a permit to add antennas to existing lawful broadcasting facilities.* The addition of an antenna to an existing, lawful broadcasting facility is exempt from a permit, subject to meeting a combination of conditions and exclusions, which are set out in the Planning and Building (Works and Buildings that are Exempt from a Permit) Regulations, 2014. Bezeq is taking the required steps to add antennas to its broadcast facilities according to the mechanism set out in these regulations.

### ***Pelephone***

#### **Statutory provisions relating to the environment applicable to Pelephone's operations**

The broadcast sites used by Pelephone are "radiation sources" as defined in the Non-Ionizing Radiation Law. The erection and operation of these sites, excluding those listed in the addendum to the law, requires a radiation permit.

The law prescribes a two-step licensing mechanism for obtaining a radiation source operating permit under which the applicant first applies for a permit to construct a radiation source, or the Erection Permit, which may be in effect for no more than three months and may be extended by the Commissioner for up to nine months, then for a permit to operate the radiation source, or the Operating Permit, which has term of five years or as otherwise determined by the Minister for Environmental Protection.

The issuance of an Erection Permit is contingent upon the assessment of the maximum radiation levels to which human beings and the environment are expected to be exposed from the radiation source when in operation, including in the event of a malfunction, and the required measures for limiting the levels of exposure of human beings and the environment to the expected radiation from the radiation source when operating, including implementation of technological means that are in use, or the Limiting Measures.

The issuance of an Operating Permit is contingent upon application of the Limiting Measures and to measuring the levels of exposure of human beings and the environment to the radiation generated while the radiation source is operating. The law further provides that the Operating Permit is contingent upon presentation of a license under the Communications Law and in certain cases, a construction permit pursuant to the Building and Planning Law. The Ministry of Environmental Protection supervises and monitors broadcast sites to check that they comply with the provisions of the Law. The law includes a punitive chapter under which the construction or operation of a source of radiation in contravention of the provisions of the permit and the construction or operation of a source of radiation without a permit, after having been warned in writing by the Commissioner, are strict liability offenses.

The regulation of the maximum permissible human exposure levels to radiation from a source of radiation and the safety ranges from communication broadcasting installations, including a limit on the placing of radiation masts on roof terraces, is pending in the Knesset's Interior Committee for Environmental Quality, as part of a proposed amendment to the regulations under the Non-Ionizing Radiation Law.

In January 2009, the Radiation Supervisor at the Ministry of Environmental Protection published guidelines regarding safety ranges and maximum permitted exposure levels with respect to radio frequency radiation, including from cellular antennas. Discussions are underway regarding these ranges following the World Health Organization's International Agency for Research on Cancer (IARC) announcement to the effect that radio frequency electromagnetic fields associated with the use of mobile phones may be carcinogenic to humans.

Cellular phones also emit non-ionizing radiation (also known as electromagnetic radiation). Consumer Protection Regulations (Information regarding Non-Ionizing Radiation from a Cellular Telephone) 2002, specify the maximum permitted radiation level for a cellular phone which is measured in units of Specific Absorption Rate (SAR) and requires that Pelephone informs its customers of such measurements. To the best of Pelephone knowledge, all the cellular phones that it markets comply with the relevant SAR standards.

*Pelephone's environmental risk management policy.* Pelephone conducts periodic radiation tests to ascertain its compliance with permitted operating and international standards. These tests are outsourced and carried out by companies authorized by the Ministry of Environmental Protection. Pelephone applies an internal enforcement procedure for monitoring implementation of the provisions of the Non-Ionizing Radiation Law, under the supervision of a senior manager.

*Transparency for consumers.* Pelephone is required to publicize and inform customers about the radiation sources that it operates and the mobile handsets that it supplies. The Radiation Supervisor of the Ministry of Environmental Protection publishes information on the Ministry's website concerning active cellular broadcast facilities and Pelephone publishes information on its website regarding the SAR levels emitted from cellular phones and Ministry of Health regulations regarding preventive steps to be taken when using cellular phones.

*Communications Law.* The cellular services provided by Pelephone are subject to the provisions of the Communications Law and its regulations. The law authorizes the Director General of the Ministry of Communications to impose financial sanctions for violations of the provisions of the law and of orders and directives issued thereunder, and for violations of the terms of the license.

*Wireless Telegraph Ordinance.* The Telegraphy Ordinance regulates the use of the electromagnetic spectrum, including Pelephone's use of radio frequencies as part of its infrastructure. Setting up and operating a system using radio frequencies requires a license and the use of radio frequencies is subject to designation and allocation of a suitable frequency. The Telegraph Ordinance imposes license fees and fees for designation and allocation of frequencies. Due to the current shortage of frequencies for public use in Israel resulting from the designation of numerous frequencies for security uses and other uses, the government limits the number of licenses granted for the use of frequencies.

*Pelephone's mobile telephony licenses.* Pelephone's mobile telephony license and its general license for providing cellular services in Judea and Samaria are valid through September 2022. The primary provisions of Pelephone's mobile telephony license include:

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

The license is non-transferable and contains restrictions on the acquisition or transfer (including by way of a charge), directly or indirectly, of control or of 10% or more of any means of control in Pelephone, including a pledge on said means of control, unless the Minister has given prior consent.

Pelephone is obliged to provide interconnect services to all other operators on equal terms and it must refrain from any discrimination in carrying out such interconnect service.

Pelephone is required to refrain from granting infrastructure service priority to an affiliate licensee company (as defined in the license) over another licensee.

Pelephone may not sell, lease or mortgage any of the assets used for the implementation of the license without the consent of the Minister of Communications, other than certain exceptions as set out in the license.

In times of emergency, whoever is statutorily competent shall have the authority to issue instructions on Pelephone's mode of operation and/or manner of provision of services.

The license stipulates the types of payments Pelephone may bill its subscribers for cellular services and the reports that it is required to submit to the Ministry of Communications. The license also determines the Minister's power to intervene in tariffs, in certain cases.

The license obligates Pelephone to provide services at a minimum standard of service.

To secure Pelephone's undertakings and to compensate and indemnify the State of Israel for any damage that may be caused by Pelephone's acts, Pelephone is required to furnish NIS 84 million of bank guarantees to the Ministry of Communications.

*Ministry of Communications' decision regarding amendments to the license.* In January 2017, the Ministry of Communications issued new guidelines that include dozens of changes to the cellular operators' license regarding various issues relating to their ongoing handling of customers (including the way billing data is presented, method for joining services, pro rata charges, options for cancelling services, etc.). The applicability dates range from immediate applicability and up to six months from the date of issuance of the guidelines. Pelephone is reviewing these amendments and is preparing to apply them. Implementing the guidelines will require substantial preparation from operational, mechanical and other aspects.

*Site construction licensing.* Pelephone's cellular service is provided through cellular sites deployed throughout Israel in accordance with engineering requirements. The constant need to upgrade and improve the quality of cellular services necessitates setting up cellular sites, configuration changes and changes in existing deployment of antennas. Pelephone uses two main types of broadcast sites along two tracks: macro sites that require a building permit from planning and construction committees (see reference to NOP 36) and wireless access devices which do not require a building permit under the Communications Law and the Building and Planning Law ("the 334").

*Building permits for erecting a cellular broadcasting facility under NOP 36.* Licensing for the construction of cellular broadcast sites that require building permits is governed under NOP 36. The licensing procedure under NOP 36 requires, among other things, that the following permits be obtained: (i) an erection and operating permit from the Ministry of Environmental Protection; (ii) approval of the Civilian Aviation Administration in certain cases; and (iii) IDF approval.

In addition, in order to obtain a permit for erecting a cellular communications broadcasting facility a deed of indemnity must be submitted to the local committee for impairment compensation claims. Pelephone has deposited 234 such indemnity notes with various local councils.

Pelephone and its competitors continue to encounter difficulties in obtaining some of the required permits, especially permits from planning and construction authorities. In view of the criticism with respect to NOP 36 by various entities, a proposed amendment was published ("Proposed New NOP 36/A"). The terms of the amendment are more stringent and onerous than the current version and could result in making the permitting process for cellular sites using this track more difficult. The amended NOP 36 is currently pending government approval.

*Access devices exempt from building permits.* The second track under which Pelephone sets up broadcast sites is the access installation track. The access installations are subject to obtaining specific radiation permits, but are exempt from obtaining a construction permit provided that they are erected under the conditions that are set out in the exemption provision. Some local authorities have disputed the applicability of the exemption provision on cellular network access installations and their use. Pelephone's position on the applicability of the exemption was accepted in a number of rulings and decisions by local affairs courts and the use of such facilities and the supporting equipment was approved. Appeals have been filed against some of these rulings and decisions, some of which are still pending before the Supreme Court.

A petition is pending in the Supreme Court regarding this exemption and other matters connected to the grant of permits for access installations tracks. Due to this petition, a draft Planning and Construction (Installation of a Cellular Wireless Communication access installation) Regulations, 2010, or the Access Installation Regulations, was published in 2010. The proposed Access Installation Regulations include restrictive conditions for application of the building permit exemption for a wireless access installation.

In view of the delays in the legislation process, the High Court of Justice issued a temporary injunction forbidding the erection of additional wireless access installations for holders of mobile telephony licenses under the exemption from obtaining a permit: however, cellular providers may, under certain conditions, replace access installations that are no longer in use or that are out of order.

Pelephone believes that if the Access Installation Regulations are approved as proposed, the option of using the building permit exemption track to erect cellular access installations will be severely restricted. A restriction of this track, together with the proposed tightening of the terms for construction of base sites in the parallel Proposed New NOP 36A track is likely to lead to increased obstacles to the construction of new broadcast sites and access installations and may have an adverse effect on the quality of the cellular network.

Pelephone currently operates 400 wireless access installations. A few sites constructed years ago still lack approvals from the Civil Aviation Administration and the IDF, even though applications for such approvals were submitted a long time ago. Consequently, Pelephone operates several broadcast sites that have not yet been granted the requisite building permits.

Construction of a broadcast site without a building permit constitutes a breach of the law and in some cases it has led to the issuance of demolition orders, the filing of indictments and the initiation of civil proceedings against Pelephone and some of its officers. Pelephone has succeeded in avoiding the demolition of sites or in delaying implementation of the demolition orders as part of arrangements made with the planning and building authorities in order to attempt to regulate the missing licenses. These understandings did not require admission of guilt or the conviction of Pelephone's officers. No assurance can be given that this situation will not continue in the future, or that demolition orders will not be issued or indictments filed because of the failure to obtain building permits.

Like other cellular operators in Israel, Pelephone may be required to dismantle broadcast sites before the requisite approvals and permits have been obtained. Pelephone uses access installations to provide coverage and capacity for highly populated areas. If legal grounds are established requiring the simultaneous demolition of a number of sites in a given geographic area, service in that area may deteriorate until alternative broadcast sites can be established.

*Standardization.* Pelephone conducts routine durability and quality control tests of its facilities. The quality control and supervision do not detract from Pelephone's responsibility towards its customers for the quality of the services it provides. Pelephone complies with the 2015 version of Israeli ISO 9001 requirements for mobile radio telephony (cellular) services and undergoes periodic inspections by the Institute of Quality & Control (IQC) to verify compliance with the standard. The current IQC approval is valid until December 2019. Once a year, an inspection is conducted to ensure that Pelephone's operations comply with the requirements of the standard. The last inspection was carried out in December 2016, and was successful.

*Material Agreements.* On July 14, 2016 a new online tender was held by the Ministry of Finance Accountant General for the provision of mobile telephony services to State employees. Pelephone, which has provided various mobile telephony services to the State and its employees for several years after winning previous RFPs also participated in this RFP and was awarded the tender. As a result, Pelephone will continue to be the primary provider of mobile telephony services for State employees.

On July 31, 2016 Pelephone and the State entered into an agreement under which Pelephone will provide mobile telephony services for an estimated 100,000 State employees for three years, with the State having an option to extend the agreement for up to 45 months in addition to the 36 basic months. Pelephone is at present in the advanced stages of implementing the agreement with the government ministries and other organizations affiliated with it.

## **Bezeq International**

On February 21, 2016 Bezeq International's license was amended by the Director General of the Ministry of Communications and was replaced by a unified general license for providing telecommunications services, or the Unified License. The Unified License, which is valid until May 2, 2025, covers all the services that Bezeq International was permitted to provide to date. Pursuant to Ministry of Communications requirements, Bezeq International provided a bank guarantee of NIS 5 million in compliance with the terms of the Unified License.

Since 2013 the Ministry of Communications has conducted hearings with regard to the re-regulation of the international telecommunications market. Originally, the proposed regulation enabled any fixed-line domestic operator or mobile telephony operator to provide international telecommunications services as part of the service bundles they offer to their subscribers, with conditions, as well as international data transmission and configuration services. Resolutions adopted subsequent to this hearing could have a significant impact on the structure of competition in the international telecommunications sector, and consequently also on the results of Bezeq International's operations. Bezeq International is unable to estimate the scope of the new regulations that are expected to be adopted subsequent to the hearing.

## **DBS**

Operations in the multi-channel television broadcast sector are subject to extensive communications regulation, particularly the Communications Law, a strict licensing and monitoring regime and Ministry of Communications policy decisions. Broadcast operations are also under the ongoing supervision of the Council, which sets policy, makes rules and monitors many areas of the sector, including broadcast content, compliance regarding original Israeli productions, broadcast ethics, consumer protection and approval of the channels broadcast and price controls. Providing multi-channel television services by non-licensed broadcasters is not subject to the foregoing supervision.



*Filber Committee recommendations.* In June 2016, the Filber Committee, an advisory committee established to advise on the regulation of the broadcast and content sector, submitted its conclusions and recommendations regarding regulation of the broadcast market, including with respect to providers of content that is not broadcast via satellite or cable. In March 2017, the Minister of Communications decided to adopt most of the Filber Committee recommendations and ordered their adoption through legislation and guidelines to be submitted by the end of April 2017.

The Filber Committee recommended that the audio-visual content providers be defined as: (i) Small provider - has a market share exceeding 10% of the total market revenues; (ii) Stable Small Provider - has a market share exceeding 10% of the total market revenues for 3 consecutive years; (iii) Substantial Provider - has a market share exceeding 20% of the market revenues. Under this definition scheme DBS would be considered a substantial provider.

Narrow regulation will apply to small providers under the license granted to them and they will be able to select either commercials or subscription fees as their source of financing. Narrow and broad regulation will apply to stable small providers and substantial providers, which will include obligations to invest in and present original productions.

The Filber Committee recommended a gradual reduction whereby the obligation of the substantial providers (HOT and DBS) to invest in original productions will gradually decrease from an amount equal to 8% revenues to 6.5% of revenues by 2021 and investment in high-end productions will increase from 4% of revenues to 5% of revenues.

The recommendation of the Eyal Committee, the previous committee established to advise regarding the distribution of rights in purchased original productions or independent productions, was adopted in accordance with the criteria set out in the report. In addition, at the end of three years following the initial broadcast of a production, must sell rules will apply to the independent channels that receive original production funds, for further broadcast of the original productions that they produced for the substantial providers. The price will be set by the independent channels, and the reasonableness of the price will be reviewed by the Minister and the Council over time.

The Filber Committee further recommended applying to the Antitrust Authority to grant general permission for collaboration between the owners of the independent channels for marketing and billing to enable them to provide joint content bundles to subscribers.

The Filber Committee also recommended the grant of a commercial license to anyone that broadcasts a channel that is funded by advertising (including a license holder for cable broadcasts via dedicated channels) and under certain conditions, to grant industry protections to a "new commercial license holder" and to an "established commercial license holder", and to subject them to narrow regulation with no obligation to invest in original productions. It also

recommended the imposition of broad regulation on "regular commercial license holders" that include an obligation to invest in original productions to broadcast news (including minimum investments) and to subject the license holders to regulation regarding cross ownerships and news broadcasting. The Committee also recommended that the amount that commercial license holders are required to invest in local high-end productions (starting from 2019) in purchased local productions be reduced and to gradually reduce the obligation to invest minimum amounts in news broadcasts.

In addition to adopting the foregoing recommendations, several remaining issues included in the Filber Committee report, as decided by the Minister, are being reviewed by a special team that is to submit its recommendations to the Minister in April 2017, including:

Regulation of must sell requirements and competition in the content sector - the Committee sought to avoid situations whereby certain content, primarily sports programs, will be inaccessible to subscribers of certain license holders, that could constitute a competition barrier against these license holders. The Committee recommended imposing a must sell obligation on sports channels towards licensed content providers, and a must sell obligation on sports operators towards sports channels. The programs will be offered for sale by the channel purchasing the broadcast rights according to the average cost plus per subscriber model. The entire channels will be offered for sale at an average price per subscriber to be fixed by the channel's owner and will be collected equally, based on the total number of subscribers of all the providers. An obligation to obtain "approval for broadcasting in Israel" will be imposed on independent channels that receive funding for original productions and on sports channels, which will include a must sell obligation for sports broadcasts as described below, as well as a "special license" appendix granting them the right to switch between broadcasting platforms against payment of a channel transfer fee.

The Committee also stipulated that the obligation to share sports content will be regulated at two levels: The first is an obligation that will apply to the owners of rights in significant sports operators that are broadcast to the Israeli public, to grant licenses to broadcast the significant sports operator to the producer of a sports channel that requests such a license, in return for a price that is based on an average cost per subscriber. The second is an obligation that will apply to the producer of a sports channel that broadcasts sports content to the Israeli public from one or more of the foregoing significant sports operators (or from another sports operator as determined by the Council) to grant to any content provider that so requests, a license to broadcast the sports channel at a uniform price per viewer.

Cancellation of the basic package and the initial basic package - it was suggested that the basic packages that HOT and DBS are required to offer be cancelled and in parallel to upgrade the existing basic package, to be called the "core package", so that it includes in addition to the mandatory channels that the license holders are obligated to provide by law, a sports channel and children's channel that will be produced in Israel. In addition, 75% of the original productions will be available to all core package subscribers on VOD, which will be provided equally to all core package subscribers. The price of the core package will be set by the substantial providers so that its current price will serve as an upper price limit and its reasonableness will be reviewed by the Minister and the experts. If the price is found to be unreasonable, the Minister will set a binding maximum price.

As the implementation of the Filber Committee recommendations, including those adopted by the Minister, require legislative amendments and appropriate regulatory decisions, DBS is unable to assess whether these recommendations will in fact be implemented whole or in part, or in what format. DBS is also unable to assess the effect of such legislative amendments, if adopted, on its business.

*DBS's key licenses.* DBS owns the following key licenses:

a broadcast license valid through January 2023 – this license is material to DBS's operations and is the main regulatory permit for its operations;

a satellite television license that permits broadcasts in the Administered Territories and is valid through December 2022; and

a license to perform uplink operations (transfer of broadcasts from DBS's broadcast centers to the broadcast satellite and implementation of set and ancillary operation activities) which is valid until January 2023 or until the end of DBS's broadcast license, whichever is the earlier - this license is essential to DBS's operations and is the regulatory permit for the transmission of broadcast messages from the broadcast center to the broadcast satellites and from them to the subscribers' homes.

#### *Tariff control*

The broadcast license contains provisions regarding the types of fees the licensee may collect from its subscribers for services provided under the license and those fixed in DBS's price list. The vast majority of subscribers join special campaigns offering DBS services, including various content combination packages, related services, as well as the receipt and installation of terminal equipment at prices below the listed price. The Council chairperson may intervene in campaigns or reductions offered by DBS if he/she finds that they are misleading to the public or discriminate between subscribers.

Under Section 6(49) of the Communications Law, the license may stipulate maximum prices that can be charged to subscribers. To date no such prices had been set. In addition, the Minister may fix the price of the basic packages.

In July 2016, the Council's resolution on the policy of special offers and applicability of transparency provisions came into effect as follows:

Each primary deal (that includes the broad basic package, the narrow basic package or any other basic package that will be offered in the future) will be priced for a defined and fixed period of 4 to 18 months only ("the Initial Price Period") during which no price increase will be allowed.

Notwithstanding the foregoing, it will be possible to grant an additional discount during the first four months of the Initial Price Period.

It will not be possible to cancel a special offer during the Initial Price Period, unless permitted by law.

It will be possible to agree in advance with a subscriber on the price that will apply after the Initial Price Period ("Continuation Prices"), subject to certain conditions concerning the Continuation Prices and the method for notifying the subscriber regarding their coming into effect and regarding the subscriber's rights to give notice of termination of the agreement during the period of the Continuation Prices.

All primary deals must be published on the website (excluding special retention offers). It is not mandatory to publish bonuses and compensation offers.

Customer service centers must offer subscribers the best deals that are relevant to them.

The provisions of the decision will not apply at this stage to business customers and with respect to groups that provide economies of scale, including kibbutzim, workers' committees, etc.

The Council does not intend to prevent differentiation between special deals targeting new customers and those targeting existing customers.

*Obligation to invest in local productions.* Under the provisions of the broadcast license and the Council's decisions, in 2016 and 2017 DBS is required to invest no less than 8% of its revenues from subscription fees in local productions, and according to the communications regulations and the decisions of the Council, DBS is required to invest of these funds in various genres of local productions. During 2016, DBS completed the investment required to satisfy previous shortfalls.

In December 2016, the Council decided to postpone its previous decision that DBS investment in local productions be increased to 9% of its revenues from subscription fees until 2018, so long as the Council does not order otherwise and so long as there is no decline in DBS's revenues or the number of its subscribers, at a rate and in a manner that are prescribed in the decision. The Council further decided that in the third quarter of 2017 it will review the prevailing legislative status and the financial situation of the license holders in accordance with a formula fixed in the decision for the rate of investment and will issue provisions if it deems fit.

*Requirement to transmit channels.* In accordance with the requirements under the law and license, DBS is required to allow the producers of channels set out in the law to use its infrastructures to transmit broadcasts to its subscribers in exchange for a payment to be determined in the agreement, and if no agreement is reached, in exchange for a payment to be determined by the Minister, after consulting with the Council.

*Content of the broadcasts and obligations with respect to subscription.* The broadcasting license sets out provisions that relate to the content of DBS's broadcasts, including an obligation to obtain the Council's approval of the channels broadcast by DBS. The Communications Law forbids holders of broadcasting licenses to broadcast commercials, other than a few exceptions. The broadcasting license also includes provisions regarding the subscriber service terms, including discrimination prohibition.

*Ownership of broadcast channels.* Pursuant with the Communications Rules, DBS, including its affiliates as defined in the Communications Rules, may own up to 30% of the domestic channels it broadcasts (compared with the 20% applicable to HOT.) DBS is restricted under the Communications Law from owning a new program producer.

*General provisions regarding the broadcast license.* The Minister and the Council have parallel authority to amend DBS's broadcast license. The Minister was authorized to cancel or postpone the broadcast license for causes set out in the Communications Law and the broadcast license. The Communications Law and broadcast license stipulate restrictions on the transfer, attachment and encumbrance of the broadcast license and any of the assets of the broadcast license. The broadcast license requires receipt of the approval of the Minister for specific changes in the holding of the means of control in DBS and imposes a reporting requirement regarding the holders of the means of control; hurting competition by way of an agreement, arrangement or understanding with a third party in terms of provision of broadcasts and services is prohibited, unless approved in advance and in writing by the Council. The obligation to file reports to the Ministry of Communications was defined as well as conditions regarding the regulation of the activity of the licenses. In addition, an obligation was stipulated to provide bank guarantees that are currently NIS -40 million (principal) to the Ministry of Communications to guarantee DBS's undertakings under the license (in order to issue these guarantees, DBS shareholders provided securities to the issuing banks).

*Offering service bundles.* Under the broadcast license, DBS may offer joint service bundles that include service provided by Bezeq and service by DBS, subject to obtaining Ministry of Communications approval (and if no objections are raised within the period specified in the license, such approval will be deemed granted) and subject to conditions, the most important of which are the "unbundling" obligation, and the existence of a corresponding bundle marketed by a licensee that is unrelated to the Company. A joint service bundle that includes Bezeq's Internet infrastructure service only, does not require Ministry of Communications approval and the unbundling obligation does not apply.

DBS believes that in view of the development of competition between the communications groups and the growing importance of the supply of comprehensive communications services, the adverse impact of such restrictions on DBS's results may increase if the restrictions on Bezeq's collaboration with DBS remain in place.

*Regulation of the transmission of video content via media infrastructures.* The committees' decisions, if applied, may affect the developing trend of video content transmitted over the web DBS believes that the VOD services it provides over the web, are not subject to the regulations currently applicable to the multi-channel television broadcasts and as far as it is aware. DBS also believes that the other services it provides via the Internet (such as yesGo) are also not subject to such regulation. Nonetheless, from the Council's various decisions it appears that the Council believes it is authorized to also regulate these services. If these regulations are formulated or applied, they may affect the services provided by DBS.

## Suppliers

The Bezeq Group has important relationships with several suppliers of hardware, software and related services that are used to operate its businesses. During 2015, no supplier accounted for more than 5% of the Bezeq Group's total annual purchases, nor did any supplier account for more than 10% of total purchases in a specific segment of operation.

### *Bezeq*

Most of the equipment purchased by Bezeq for data communication, switching, transmission and radio systems has been specially modified or developed for its use, and the ability to obtain support other than through the manufacturer is limited. Bezeq relies on manufacturer support from a number of its key suppliers for certain of its systems, and may have difficulty replacing them. Bezeq's key suppliers include: (i) Alcatel Group (represented in Israel by Alcatel Telecom Israel Ltd.) in the areas of public switching and metro transmission, (ii) Dialogic Networks (Israel) Ltd. for migration exchanges for linking operators to Bezeq's switching network, (iii) Comverse, Inc. for switching exchanges for end customers on the NGN network, (iv) the NGN of Adtran Holdings Ltd., (v) Oracle in the area of databases, (vi) EMC for hardware solutions for back-up, recovery and archiving of systems and infrastructures, (vii) VMware for infrastructure for the entire virtualization of Bezeq's servers, and (viii) Juniper Networks for Metro transmission.

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

### *Pelephone*

Pelephone sells a wide range of cellular handsets and auxiliary accessories (such as batteries, hand-free kits, earphones, data cables and chargers). Pelephone also maintains spare parts to supply repair services to its customers and an inventory of used handsets. Pelephone purchases handsets and accessories from a variety of suppliers and importers. Contractual engagements with most of the suppliers are based on framework agreements, which also set forth the technical support provided by the supplier for the equipment and spare parts and turnaround time for repairs. These agreements generally do not include a commitment of Pelephone to acquire a minimum quantity of devices and acquisitions are made by means of purchase orders. Generally, if an agreement with a particular supplier of equipment is cancelled, Pelephone can increase the quantity purchased from other suppliers or purchase equipment from a new supplier.

On October 1, 2016, a new agreement came into effect with Apple Distribution International for the purchase and distribution of iPhones, under which Pelephone agreed to purchase a minimum annual quantity of phones over an additional period of three years at the manufacturer's current prices on the date of purchase. Pelephone believes that similar to prior years, these quantities will constitute a significant portion of the devices it expects to sell during the term of the contract.

The UMTS/HSPA and LTE network infrastructure equipment are manufactured by Ericsson. Pelephone has long-term agreements with Ericsson for maintenance, support and upgrading of software for the UMTS/HSPA and an agreement for the deployment of the 4G LTE networks with Ericsson. Pelephone believes that it may become dependent on Ericsson regarding support for the 4G LTE network and its expansion. In addition, the cellular network uses transmission networks, for which Bezeq is Pelephone's main supplier.

#### *Bezeq International*

Bezeq International is dependent upon Bezeq for domestic capacity to provide its services. Most of the international capacity that Bezeq International uses is transmitted via its wholly owned submarine cable. As backup, Bezeq International uses capacity purchased from Med Nautilus. Under its agreement with Med Nautilus, Bezeq International purchased indefeasible rights of use to a particular non-specific part of the communication capacity transferred by the undersea cable system operated by Med Nautilus between Israel and Europe for a period of up to 15 years from the date on which it started using this capacity (with an option to extend the period of use). The periods of use are at least until 2022 – 2027, depending on the date of the start of use of the capacity. Bezeq International paid for these rights of use in a lump sum payment shortly before the date on which it started using the capacity.



*DBS*

*Terminal Equipment.* DBS installs a receiver dish and other terminal equipment in its subscribers' homes, including decoders enabling reception of broadcasts and smart cards for decoding the encrypted broadcasts. The decoders are leased to subscribers for a fixed fee that is paid during the entire period the services are received, or are lent to subscribers. In 2016, DBS purchased decoders from two suppliers under framework agreements. HDPVR decoders, in a total amount of NIS -41 million, were purchased from Advanced Digital Broadcast S.A. ("ADB"), the decoder manufacturer, and Eurocom Digital Communications Ltd. ("Eurocom Digital Communications"), the importer that also provides product warranty for the decoders which ADB undertook under the agreement. Eurocom Digital Communications is controlled (indirectly) by Shaul Elovitch, the controlling shareholder of the Company (the "ADB Agreement"). HD Zapper decoders are purchased from Altech Multimedia International (Pty) Ltd. ("Altech"). In April 2016 DBS engaged in a framework agreement for the development and supply of advanced HDPVR decoders with Draco Inc. (decoder supplier) and Altech (decoder manufacturer). DBS may become dependent upon these suppliers. The amounts for purchases from these suppliers in the reporting year are not material to the Group. DBS amortizes the end equipment installation costs as part of its property, plant and equipment.

Replacing a supplier with another supplier does not involve additional material costs, however a substantial preparatory period is required to adapt the decoders of the alternative supplier to the DBS broadcasting and transmission systems (which is also dependent on these service providers, Cisco), which could, in the event of the termination of the engagement at short notice, cause DBS loss of revenues.

*Broadcasting equipment and computer and communications systems.* DBS has its central broadcasting center in Kfar Saba and a secondary broadcasting center close to Re'em Junction from where it transmits its broadcasts. The broadcasting centers operate reception and broadcasting equipment, as well as computer and communication systems. The secondary broadcasting center is operated by a third party which provides services for operating and maintenance of the secondary broadcasting center for DBS under a contract which is valid until the end of 2018 (with DBS having an extension option).

*Operating and encryption systems.* D.B.S. purchases from Cisco Group companies ("Cisco") development, licensing, assimilation, maintenance and warranty services with regard to the operating systems of the broadcasting system and the decoders, and the hardware related to these services, including those connected to the encoding of DBS services, and viewing cards that allow the foregoing encoded content to be viewed

For these services and products DBS pays Cisco one-time payments and periodic payments part of which are in a fixed amount and part are based on the number of active decoders of each type, and the ratio of part of the payments is fixed in the agreement as minimum annual amounts. The term of the agreement with Cisco is until December 2020 (with an automatic extension mechanism, unless one of the parties decides to end the agreement, subject to prior

notice period as set in the Cisco agreement. In 2016, DBS's payments to Cisco were not material. DBS is dependent upon the regular supply of these services and products, including integration of the various decoders that DBS uses for its operating system.

*Computerized billing system.* DBS uses software and computer systems for managing its subscriber agreements, including its billing and collection system. In this context, DBS engaged in agreements with NetCracker Technology Solutions Ltd. and NetCracker Technology EMEA Limited (jointly "NetCracker").

DBS is dependent upon NetCracker's system and services due to their importance for managing and monitoring services and content purchased by subscribers and for billing its subscribers. System malfunctions or shutdown of these services to DBS could cause operational difficulties until the fault is repaired or the system/supplier is replaced. As of Reporting Date the current project agreement for services and technical support is until the end of 2019. In 2016, DBS's payments to NetCracker were not material.

*Space segment leasing agreement.* Under an agreement with Spacecom, DBS leases Amos satellite space segments. The 2013 agreement is valid through 2028. Under the initial stage of the agreement, the space segments that were available for DBS's use were on the Amos 2 and Amos 3 satellites. In September 2016, Spacecom informed DBS that Amos 2 had reached the end of its useful life, but that its commercial operation would continue indefinitely. DBS was informed by Spacecom that the Amos 2 satellite is expected to continue in commercial operation until mid-2017.

Under the terms of the 2013 agreement, DBS will lease space segments on the Amos 3 satellite (until 2022) at such time as Amos 2 satellite ceases to operate. In June 2016, during the course of a routine, periodic maneuver of the Amos 2 satellite, the channels broadcast to DBS customers were shut down for about two hours, during which time DBS transferred the broadcasts to the Amos 3 satellite. When the normal function of the Amos 2 satellite was restored, the broadcasts were returned to it and DBS resumed normal, ongoing operation to its subscribers.

In September 2016, an explosion occurred during ground fueling of the launch rocket for the Amos 6 satellite causing total loss of the satellite, which was scheduled to replace the Amos 2 satellite for DBS's broadcasts.

In February 2017, the boards of directors of Bezeq and DBS approved DBS's entry into an addendum to the 2013 agreement with Spacecom, or the 2017 Spacecom Agreement. The 2017 Spacecom Agreement was approved at general meetings of Bezeq and Spacecom in April 2017.

On March 31, 2017, DBS ceased using space segments from the Amos 2 satellite after receiving notice from Spacecom that Amos 2 had reached the end of its life. DBS is currently using the Amos 3 and Amos 7 satellites.



The term of the 2017 Spacecom Agreement is until December 31, 2028, without changing the term of the 2013 agreement, subject to the early termination options described below. The satellites on which DBS will lease space segments are the: (i) Amos 3 satellite - that serves DBS at the present time; (ii) Amos 7 satellite - an existing satellite on which Spacecom owns rights to lease space segments and which, according to Spacecom, positioning was completed at the end of February 2017; and (iii) Amos 8 satellite - a new satellite that is expected to serve DBS once it enters into operation. Spacecom undertook to make all reasonable efforts to ensure that the Amos 8 satellite will enter into service no later than February 2021.

During the term of the 2017 Spacecom Agreement, and subject to availability, DBS is expected to lease 12 space segments from Spacecom on two different satellites, according to a division enumerated in the agreement. The agreement also regulates the availability of alternative segments to the leased space segments during the term of the agreement. The estimated total nominal cost for the duration of the term of the lease is \$263 million, reflecting an average annual cost of \$21.9 million, subject to a discount and reimbursement mechanism. The lease fee paid to Spacecom in 2016 amounted to NIS 65 million (approximately \$17 million, after receiving a partial credit for the failure of the Amos 6 satellite.

The agreement provides for early termination without cause, subject to prior notice of 12 months and payment of a termination fee. There is also an early termination right in the event the commissioning of the Amos 8 satellite is delayed, or if the Amos 8 satellite is unavailable at the end of Amos 3 useful life, without requiring payment of any compensation.

DBS is materially dependent on Spacecom, as the exclusive holder of the rights and the sole provider of space segments used by DBS, which is also responsible for operation of the space segments.

## **Property**

### *Bezeq*

According to a settlement agreement entered into in 2004 between Bezeq, the Israel Land Administration, or ILA and the State of Israel, which concerns most of the real estate that was transferred to Bezeq pursuant to the 1984 asset transfer agreement with the State of Israel, the assets remaining in Bezeq's possession have the status of a capitalized lease and are subject to the execution of individual lease contracts (contracts have been signed for approximately 110 of the 205 properties for which contracts are required). The settlement agreement allows Bezeq to enter into transactions and to improve the properties beyond the rights according to plans approved in the settlement agreement and it provides for a mechanism for payment to the ILA for such improvements, if undertaken, at the rate of 51% of

the increase in value of the property following the enhancement (less part of the amounts paid for a betterment levy, if paid). The settlement agreement also provides that 17 properties must be returned to the ILA. Bezeq has returned 15 of those properties and the two remaining properties will be returned after Bezeq receives substitute properties, as provided in the settlement agreement.

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The following is a list of Bezeq's real estate assets in accordance with the material rights in the asset. Bezeq also has interests (transition rights, etc.) in other real estate (such as for the construction of offices and for laying cables):

| Right   | Number of Assets                              | Area of the Plot (thousand sq. m.) | Built Area (thousand sq. m.) | Notes   |
|---|---|------------------------------------|------------------------------|---|
| Ownership, lease or right of lease                | 330   | 900                                | 150                          | Of these assets, 330 properties cover an area of 870 thousand sq. m., and 120 thousand sq. m. built up are assets for communication needs, and the remainder for administration needs. 25 are jointly owned with the Ministry of Communications and/or the Israel Postal Co. Ltd., with whom an agreement was signed for defining and regulating the rights of the parties in these properties. The parties operate as required by the orders of the agreement, and inter alia, to separate joint debits and systems. |
| Possession (authorized/possession rights by law)  | 40  | 1.5                                | 0.8                          | Assets in Israeli settlements in the Administrated Territories, all for communication needs. There is no written regulation of the contractual rights for these properties, but in Bezeq's opinion this does not create material exposure.  |
| Lease   | 320   | 30                                 | 65                           | 305 properties, out of which 7 thousand sq. m. built up are for communication needs and the remainder for administration needs. Out of which, approximately 2 sq.m. built up are sublet. These are rooms for cables and installations for residential communications.   |
| Miscellaneous rights in 'residential rooms'       | 1,1600  | 10                                 | 18                           | For most of the assets there is no arrangements for rights in writing (for example, the ILA, settlement entities, the entrepreneurs of the projects in which the properties are located, and house committees).   |
| Right to receive areas for warehouses and offices | An asset in Sakia (near the Mesubim junction) | 7 net                              | -                            | See below.  |

In April 2013, an authorization agreement was signed with the Israel Lands Administration for an area of 11.5 hectares in Sakia. According to the provisions of the authorization agreement, Bezeq designed a detailed outline plan for the property, setting out the purpose, use, building rights and building provisions for zoning of the land in the plan. On May 2, 2016, approval of the plan was published in the Official Gazette and it entered into force. Subsequently, Bezeq is expected to sign a lease agreement for the property with respect to a net area of 7 hectares. Bezeq is

reviewing the different options available for exercising its rights in the property, including the option of selling it or part thereof, some of which may lead to recording of material gain in a volume that, according to Bezeq's initial estimation and prior to performing any of the relevant tests, could reach hundreds of thousands of NIS (at the date of the financial statements, a property appraiser has estimated the fair value of the rights in the land at NIS 460 million.

Bezeq's rights in a considerable number of its real estate assets are not registered in the Lands Registry and therefore they correspond to contractual rights. Bezeq is in the process of registering in its name those properties which can be registered in the Lands Registry.

On March 10, 2004, a settlement agreement among Bezeq, the Administration and the State was validated in a court decision. The settlement agreement concerns most of the real estate assets transferred to Bezeq under the asset transfer agreement signed for commencement of Bezeq's business activity. The settlement agreement provided that the assets remaining in Bezeq's possession have the status of capitalized leases and subject to the execution of individual lease contracts, Bezeq will be entitled to make any transaction in the properties and to enhance them. The settlement agreement sets out a mechanism for payment to the Administration for enhancement actions in the properties, if undertaken, beyond the rights according to plans approved by 1993 as set out in the Agreement, at the rate of 51% of the increase in value of the property following the enhancement and less part of amount paid for a betterment levy or to the Administration for an increase in value, if a betterment levy was paid. The settlement agreement also requires the return of 17 assets to the State through the Administration, on various dates ending in 2010. Bezeq has returned 15 of properties and two additional properties will be returned after Bezeq receives substitute properties, as provided in the settlement agreement.

Following a new review of Bezeq's real estate by Bezeq's management, the Board of Directors of Bezeq approved further sales of assets which are inactive /or which can be relatively easily vacated without incurring significant expenses. The deployment of Bezeq's NGN allows Bezeq to increase the efficiency of its network and to sell some of the real estate assets that will be vacated as a result of the transition. During 2016, Bezeq sold 14 such properties, having a total area of 18,200 sq.m. of land and 20,200 sq.m. built up, for NIS 107 million.

According to Bezeq's estimates, the sale of real estate assets that are inactive or that can easily be vacated without incurring significant expenses and for which Bezeq has no use after they are vacated, may generate significant capital gains for Bezeq, that in the aggregate may total hundreds of millions of shekels before tax. Bezeq's estimate also relates to real estate assets where no concrete decision has yet been made to sell them, and there is no certainty regarding the timing of their sale, if any. The estimate is based on appraisals prepared for some of the assets, some of which are not final or current, as well as internal estimates prepared by Bezeq. In addition, the sale of some of the assets may involve difficulties, including if there is a lack of demand or there are various planning restrictions. Bezeq is unable to foresee what consideration will be received or when any of these real estate assets will be sold.

### *Pelephone*

Pelephone does not own any of its sites and leases the premises that it uses for its operations from others, including Bezeq. Pelephone's radio and switching sites are spread out around the country and are leased for various periods (in many instances, for a period of five years and Pelephone has an option to extend the agreements for another five years).

Pelephone's headquarters are located in Givatayim, Israel and cover a total area of 17,800 square meters. The lease for these premises expires on December 31, 2020. Pelephone has an option to terminate the lease, under certain circumstances, commencing in 2017. Pelephone leases 31 service and sale centers throughout Israel and has additional lease agreements for warehouses, offices and telephone call centers that it uses for its operations.

Some of the radio sites leased by Pelephone are in areas owned by the ILA. Pelephone previously entered into an agreement with the ILA to use land in those areas for the construction and operation of communications sites for the period ended December 31, 2010. From 2010 negotiations were held with the ILA to conclude the terms for further use of the sites in the ILA areas. In June 2013, Pelephone entered into a framework agreement with the ILA for the use of land in the areas owned by the ILA for the construction and operation of communications sites for the period from January 1, 2011 until December 31, 2019, which agreement regulates, among other things, the fee for the use of the land.



*Bezeq International*

Bezeq International's property plant and equipment include switching and Internet equipment, marine cable, PBX equipment, office equipment, computers, vehicles and leasehold improvements. Bezeq International utilizes Veraz SoftSwitch switches. These switches are used to route Bezeq International's voice traffic. The value-added services, including dialing cards, are based on an intelligent network. Bezeq International's technological infrastructures, which support voice, data and Internet systems, are deployed at six sites, inside and outside Israel, inter alia, to provide services with high survivability.

Bezeq International has long-term agreements for the lease of the two main buildings in which it is based. The lease period for one of the buildings is until March 2024, subject to several exit options for Bezeq International during this period. The lease period of the other building is until December 2019 with four equal extension options until 2027. Bezeq International has other lease agreements for warehouses (including a main logistics center) and for buildings where it operates the call centers that it uses for its operations.

*DBS*

DBS leases several real estate properties for its operations. Its head offices and main broadcasting center are located on leased land in Kfar Saba. The lease periods for these sites expire in 2019 and the lease periods for the other properties leased by DBS vary from 3 to 6.5 years (these periods are based on the assumption that DBS will exercise its options to extend these leases).

## **Intellectual Property**

### *Trademarks*

We are the registered owner of the trademark “B Communications” in Israel.

The Bezeq Group uses a variety of trade names and trademarks in its business. Bezeq has approximately 190 trademarks that are registered or are in the process of being registered in Israel, including its denominative trademark “Bezeq,” the trademark “NGN Next Generation Network” and its logo “B.” Pelephone owns a number of trademarks registered in Israel, including its denominative trademark “Pelephone.” Bezeq International owns a number of trademarks registered in Israel, including its denominative trademark “Bezeq International” and the trademark “Private NGN.” DBS owns a number of trademarks registered in Israel, including its denominative trademark “YES.”

### *Broadcast Rights and Copyrights*

DBS has the broadcast rights of two types of video content.

Content purchased from third parties, including content and channels, that own the broadcasting rights thereto;

Content which DBS invests in producing (in full or in part), and in addition to the actual right to include the content in its broadcasts, DBS generally also has rights in such content, at the rates specified in agreements with the producers. In most instances, DBS is also entitled to issue authorizations to use the rights and share the revenues stemming from additional use of the content, in addition to DBS broadcasting thereof

The broadcast and distribution of content by DBS over various media involves payment of royalties to the owners of copyrights and performance rights to music, sound recordings, scripts and directing of content, and for secondary broadcasting included under the Copyright Law, 2007 and the Performers and Broadcasters Rights Law, 1984. Such royalties are paid to several organizations operating in Israel, for collecting royalties on behalf of the owners of the intellectual property rights, under blanket licenses. Royalty payments under these licenses are, at times, based on a fixed payment and sometimes on various pricing methods, and with respect to some of the organizations, DBS may be required to pay additional amounts as royalties for transmitting content via certain media, and in amounts that DBS estimates are not expected to be material.

Given the many content providers from which DBS purchases broadcast rights, DBS does not have a main content provider and is not materially dependent on any single content provider. However, with respect to broadcasts of Israeli sports, at the date of this report DBS is dependent on the purchase of the broadcast rights for local sports channels from two providers, and the term of the contract with one of them terminates at the end of 2018.

In 2016, DBS paid NIS 311 million for the purchase of broadcast rights.

## **Employees**

On December 31, 2016, we had five employees who also provided services to B Communications. Our direct employees are all located in Israel and are not represented by any labor union. Since our inception, we have not experienced any labor-related work stoppages and believe that our relations with our employees are good.

As of December 31, 2016, the Bezeq Group employed 11,901 persons, of whom 5,649 persons were employed by Bezeq, 2,594 persons were employed by Pelephone, 1,905 persons were employed by Bezeq International and 1,753 persons were employed by DBS.

### *Bezeq*

The number of Bezeq employees as at December 31, 2016 was 5,649 (compared with 5,896 employees at the end of 2015). The decrease in the number of employees in 2016 compared with 2015 stems primarily from streamlining as a result of continued improvement of processes and technological developments in the interface with the customers. 90% of Bezeq's employees are employed under a collective agreement (out of which 60% are permanent employees and the remainder are non-permanent employees). The remainder of Bezeq's employees (10%) are employed under personal agreements, not under collective agreements.

Bezeq has 9 directors, of whom three are external directors, one is an employee-director, and two are independent directors (who are not external directors) pursuant to Section 249B to the Companies Law. In addition, senior management has 11 members (of which one is also a member of the Bezeq Group's headquarters) and four members of the Bezeq Group headquarters (one of whom will begin his term of office on April 23, 2017).

The members of the senior management and members of the Bezeq Group's headquarters are employed under personal agreements which include, inter alia, pension coverage, payment of bonuses based on targets, and advance notice months before retirement.

Labor relations in Bezeq are regulated in collective agreements between Bezeq, the representatives of Company employees and the New General Federation of Workers ("Histadrut"), and in personal agreements. Company employees are also subject to expansion orders to certain general collective agreements such as cost-of-living increment agreements.

In December 2006, a special collective agreement was signed between Bezeq, the union and the Histadrut, or the Special Collective Agreement, regulating labor relations in Bezeq following the transfer of control in Bezeq from the State to Ap.Sb.Ar. Holdings Ltd., Bezeq's previous controlling shareholder, and set a new organizational structure for Bezeq.

Under the terms of the Special Collective Agreement, all the agreements, arrangements and traditional behavior in Bezeq prior to execution of the Special Collective Agreement, including the mechanism for linkage of wages to the public sector, would continue to apply only to the veteran permanent employees of Bezeq to which the Special Collective Agreement would apply, subject to changes inserted specifically into the Special Collective Agreement. The hiring of existing and future temporary workers would be on the basis of monthly/hourly wage agreements based on a wage model according to occupation, with high managerial flexibility. The Special Collective Agreement sets out restrictions on certain kinds of future organizational changes, and a mechanism of notification, negotiation and arbitration with the union in the event of organizational changes.

During the term of the Special Collective Agreement, two employee-directors who are proposed by the union will serve on Bezeq's Board of Directors (subject to their approval by the Board of Directors and their election by the general meeting). The employee-directors are not entitled to payment for their service as directors, and will not participate in Board discussions of the terms of employment of senior employees.

The Special Collective Agreement also defines the "new permanent employee", whose terms of employment differ from those of a veteran permanent employee of Bezeq (under the collective agreement): his wage model is according to Bezeq's wage policy and market wages; at the end of his employment in Bezeq he is entitled to increased severance pay only (depending on the number of years of employment). As part of the retirement arrangements, Bezeq may, at its discretion, terminate the employment of 203 permanent employees (including new permanent employees) each year (relevant for 2017-2021).

The latest amendment to the Agreement was approved by Bezeq's Board of Directors on August 30, 2015, under which the Agreement and the retirement arrangement were extended to December 31, 2021.

In 2016, 90 permanent employees retired under the early retirement plan and early retirement was approved for another 58 employees on the early retirement track in 2017 in accordance with the conditions of the collective labor agreement from December 2006, as amended in August 2015, at a budget of NIS 78.5 million.

On March 22, 2017, the Board of Directors of Bezeq approved an expansion of the Bezeq Group's headquarters staff to assist the Board of Directors in implementing the tasks involved in setting out the strategy and oversight conferred upon it according to the Companies Law, and also in exercising certain performance and management powers stemming from assuming these powers with respect to the activity of the subsidiaries and activities that may be absorbed by Bezeq in future, insofar as they are absorbed, within the context of mergers and acquisitions. This includes a decision to appoint a director of strategy and business development for the Bezeq Group and the appointment of a legal advisor.

*Agreements with alternative entities that replaced the Makefet Fund in everything relating to early retirement arrangements of Bezeq employees.* As of 2005, the early retirement arrangements of Bezeq's employees is implemented through alternative entities in place of Makefet Fund. On April 24, 2014, Bezeq and Menorah Mivtachim Insurance Ltd. signed an agreement regulating pension payments for the early retirement of Company employees and provision for the payment of old-age and survivors' pensions to employees who retire from Bezeq under the special collective retirement agreement signed by Bezeq, the Union and the Histadrut on February 12, 2014. The Commissioner of Insurance approved the policy and it entered into force on March 31, 2016. Accordingly, as of May 1, 2016, Menorah issued policies for retiring employees, and payment of the annuities and related payments is made on the basis of these policies. The agreement period is until the end of 2016 and in February 2017 it was extended for a further three years.

*Management agreement.* On June 1 2016, Bezeq entered an agreement between Bezeq and Eurocom Communications granting Bezeq regular management and advisory services for a period of three years as from June 1, 2016 in consideration of NIS 6,432 thousand per year.

*Pelephone*

The table below provides data with respect to the number of Pelephone employees at December 31, 2016 and December 31, 2015:

| Department                                | <b>Number of employees</b> |                   |
|---|----------------------------|-------------------|
|   | December 31, 2016          | December 31, 2015 |
| Management and HQ                         | 189                        | 186               |
| Marketing                                 | 48                         | 43                |
| Business customers                        | 1,367                      | 1,424             |
| Business customers                        | 353                        | 375               |
| Logistics and terminal equipment division | 202                        | 185               |
| Engineering and information systems       | 435                        | 466               |
| Total                                     | 2,594                      | 2,679             |

The total number of employees in the above table includes employees employed in part time positions. The total number of positions at Pelephone at December 31, 2016 was 2,176 and 2,234 at December 31, 2015.

The majority of Pelephone's employees are employed under monthly or annual contracts, based on the professions and positions in which they are employed. Most of the service and sales employees are shift workers who work part time and are employed on an hourly basis. Pelephone's other employees are employed under monthly contracts, and some of them are employed under a monthly contract with a global addition for extra hours. The employment contracts include confidentiality, non-competition, and intellectual property restrictions.

In December 2013, Pelephone signed a collective labor agreement between Pelephone and the New General Federation of Workers and Pelephone's workers committee (the "Committee"), which will apply to all Pelephone's employees, other than its senior management and certain employees in predefined positions. The agreement stipulates that Pelephone employees employed at date of signing of the agreement will receive employment tenure after 36 months and 48 months for new employees joining Pelephone subsequent to signing. In addition, the agreement sets out mechanisms for integrating the Committee in processes relating to placement, mobility and termination of employment of Pelephone's tenured employees.

The agreement also provides that it is valid until December 31, 2016 and following this date, it will be extended for additional periods as provided unless one of the parties seeks to change it. At the present time negotiations are

underway for a new collective agreement between Pelephone and the New General Federation of Workers and the Workers' Committee.

On February 7, 2017 the New General Federation of Workers - Cellular, Internet and High-Tech Workers Union, announce a labor dispute pursuant to the Settlement of Labor Disputes Law, 1957 and a strike starting February 22, 2017 onwards. According to the announcement, the matter under dispute is the deadlock in the negotiations for a new collective agreement. On February 27, 2017 Pelephone announced that various services provided to its customers may be impaired due to the labor disruptions and strikes that began on February 22, 2017. These disruptions are steadily worsening, and have caused among other things, the failure to provide service and support for customer needs, including repair of faulty terminal equipment and a delay in handling malfunctions of technology systems. Efforts to initiate negotiations are continuing.

*Bezeq International*

The following table provides data relating to the number of persons employed by Bezeq International, including outsourced employees, at December 31, 2016 and December 31, 2015:

| Department                        | Number of employees |                   |
|-----------------------------------|---------------------|-------------------|
|                                   | December 31, 2016   | December 31, 2015 |
| Head office employees             | 1,169               | 1,157             |
| Sales and service representatives | 736                 | 809               |
| Total                             | 1,905               | 1,966             |

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

On January 12, 2016 Bezeq International signed a collective agreement with the New General Federation of Workers and the Bezeq International Workers Committee that expires on December 31, 2018. The key terms of the agreement include:

The agreement will apply to all Bezeq International employees other than the executive management (VPs and those who report directly to them) and another group of employees and managers that the parties agreed upon.

The period after which Bezeq International's employees will be considered as tenured is 36 months, with an option to extend the period for an additional six months with the Committee's agreement.

The agreement prescribes mechanisms that include the Committee in decision making with regard to the termination of the employment of tenured employees, disciplinary measures imposed against them, and the execution of organizational changes.

The agreement also provides for annual wage hikes and other financial benefits (such as subsidies, summer camp and welfare activities) to be provided by Bezeq International for its employees during the agreement period.

The agreement will automatically be renewed for additional 12 month periods, unless one of the parties gives notice of their intention to change the agreement.

*DBS*

The following table provides data with respect to the number of persons employed by DBS at December 31, 2016 and December 31, 2015:

| <b>Division</b> | <b>Number of<br/>Employees</b> |
|-----------------|--------------------------------|
|-----------------|--------------------------------|



|                                 | As at<br>December<br>2016 | As at<br>December 31,<br>2015 |
|---------------------------------|---------------------------|-------------------------------|
| Marketing                       | 36                        | 37                            |
| Customer Division               | 951                       | 1,169                         |
| Content Division                | 41                        | 40                            |
| Engineering                     | 114                       | 118                           |
| Finance and Operations          | 127                       | 115                           |
| Human Resources                 | 62                        | 60                            |
| Regulation and Legal Management | 10                        | 11                            |
| Technologies and Information    | 134                       | 141                           |
| Management and Spokesperson     | 8                         | 7                             |
| Sales                           | 270                       | 286                           |
| Total                           | 1,753                     | 1,984                         |

In September 2016, DBS signed a collective agreement with the New General Federation of Workers (which represents DBS workers) and the Workers Committee at DBS. Thereafter the agreement will automatically be renewed for further period of 12 months each, unless one of the parties give notice of their intention to change the agreement. The agreement applies to all DBS employees (other than a certain percentage of employees and managers). The agreement provides, among other things, the periods after which DBS employees will become tenured employees, mechanisms for involving the Workers Committee in decision making concerning employment and termination of the employment of tenured employees at DBS, as well as annual wage increments and other general benefits DBS will grant to its employees during the term of the agreement.

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

### **C. Organizational Structure**

Mr. Shaul Elovitch, Mr. Yossef Elovitch, Eurocom Communications and Eurocom Holdings (1979) Ltd. are the beneficial owners of 11,740,701 ordinary shares of our company that are held by Eurocom Communications (1,125,000 of these shares are held directly by a joint account of Messrs. Shaul and Yossef Elovitch). Mr. Shaul Elovitch and his brother, Mr. Yossef Elovitch, own 80% and 20%, respectively, of Eurocom Holdings (Mr. Shaul Elovitch and Mr. Yossef Elovitch own 75% and 25%, respectively, of Eurocom Holdings' management shares). Eurocom Communications is 99.33% owned by Eurocom Holdings. The remaining 0.67% interest in Eurocom Communications is directly owned by Mr. Shaul Elovitch. Accordingly, Mr. Shaul Elovitch may be deemed to have the sole voting and dispositive power as to the ordinary shares of the Issuer held of record directly by Eurocom Communications. Mr. Shaul Elovitch may also deem to be the beneficial owner of 26,893 ordinary shares held of record by his wife, Mrs. Iris Elovitch. In addition, the above includes 8,300 shares that are held by other family members of Mr. Shaul Elovitch.

We operate through our 64.78% ownership interest in B Communications, which is the controlling shareholder of Bezeq, Israel's largest telecommunications provider. B Communications and its wholly-owned subsidiaries own 26.34% of Bezeq's outstanding shares.

### **D. Property, Plants and Equipment**

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

### **ITEM 4A. UNRESOLVED STAFF COMMENTS**

Not applicable.

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

#### **A. Operating Results**

*The following discussion of our results of operations should be read together with our audited consolidated financial statements and the related notes, which appear elsewhere in this annual report. The following discussion contains*

*forward-looking statements that reflect our current plans, estimates and beliefs and involve risks and uncertainties. Our actual results may differ materially from those discussed in the forward-looking statements. Factors that could cause or contribute to such differences include those discussed below and elsewhere in this annual report.*

## **Overview**

We are the controlling shareholder of B Communications which currently holds 26.34% of Bezeq's outstanding shares, and we consolidate Bezeq's financial results into our financial statements.

The Bezeq Group operates the most comprehensive telecommunications infrastructure in Israel, with a broad range of telecommunications services across all of its markets. Through its wholly-owned subsidiaries, the Bezeq Group is a leading provider in Israel of fixed-line telephony services and fixed-line broadband Internet infrastructure access services, cellular telephony services, ISP services, ILD services, international and domestic data transfer and network services and ICT, pay television services and other communications infrastructures and services. In each of these markets, the Bezeq Group holds a significant market share.

## **Key Factors Affecting the Businesses of the Bezeq Group**

The operations of the Bezeq Group and the operating metrics discussed below have been, and will likely continue to be, affected by certain key factors as well as certain historical events and actions. The key factors affecting the business of the Bezeq Group and its results of operations include, among others, competition, government regulation, the build out of infrastructures, macro- economic and political risks, churn, seasonality, impact of currency fluctuations, effective corporate tax rate, conditions in Israel and trade relations. For further discussion of the factors affecting our results of operations, see "*Risk Factors.*"

### ***Competition***

The Bezeq Group faces significant competition from established and new competitors who provide fixed-line telephony, fixed-line broadband Internet infrastructure access, cellular telephony, ISP and pay television services. In addition to the entrance of new competitors, competition among the existing communications groups in Israel is intensifying. Four main groups, each consisting of companies under common or joint control, hold a significant share of the communications market in Israel today. The Bezeq Group's three principal competitors may in some cases be required to comply with fewer regulations because, among other reasons, they use different technologies to provide their services or do not own their own fixed-line network.

Bezeq expects competition to continue to increase amid the changing legislation in Israel and consolidation in the telecommunications industry that permits certain service providers to market a combination of fixed-line telephony, fixed-line broadband Internet infrastructure access, ISP and pay television services (a "bundle") for an aggregate price which is lower than the price of the individual products and services in the bundle. The Bezeq Group is currently subject to restrictions on marketing bundles, which are stricter than the restrictions applicable to its competitors.

### ***Government Regulation***

The Bezeq Group operates in a highly regulated industry in Israel, which limits its flexibility in managing its business efficiently, and may increase its administrative and operational expenses and limit its revenue. The Bezeq Group is subject to government supervision and regulation relating to, among other things:

regulations requiring structural separation between the members of the Bezeq Group;

regulations restricting the Bezeq Group's ability to market bundles;

price regulation for certain services that the Bezeq Group provides;

rules and regulations imposed on telecommunications service providers with significant market share;

rules governing the interconnection between different telephone networks and the interconnection rates that the Bezeq Group can charge and pay;

regulations governing the prohibition of exit-fees or cancellation charges;

regulations requiring the Bezeq Group to grant other telecommunications operators access to its infrastructure;

regulations governing roaming charges and other billing and customer service matters;

rules for authorizations, licensing, acquisitions, renewals, pledging and transfers of licenses;

requirements covering a variety of operational areas such as land use, health and safety and environmental protection, technical standards and subscriber service requirements rules and regulations relating to subscriber privacy;

rules and regulations relating to payment of royalties (zero rate as of 2014);

rules and regulations relating to universal service provision and requirements to extend the Bezeq Group's services to areas of Israel even where it is not economically profitable to do so; and

regulations restricting the number of television channels DBS can own and specifying the minimum investment DBS is required to make in local content productions.

For additional information see "*Regulatory.*"

### ***Build Out of Infrastructure***

The Bezeq Group has historically made substantial investments in its fully owned infrastructure, which is one of the most technologically advanced in Israel and enables the Bezeq Group to reach customers nationwide.

In the domestic fixed-line communications segment, Bezeq's NGN, which was completed in 2012, is the most advanced fixed-line communications network in Israel, offering broadband Internet bandwidth of up to 100 Mbps (download) speed, as well as innovative value-added services. In January 2013, Bezeq began laying optical FTTB and FTTH.

In the cellular telephony segment, Pelephone's nationwide 3.5G UMTS/HSPA. While Pelephone substantially completed the installation of its 3.5G UMTS/HSPA+ network in 2010, it has continued to invest in the network. We believe these network features provide Pelephone with a strong platform to continue to offer a variety of advanced services and products to its customers and to capitalize on the continued increasing demand for smartphones and

advanced data services, which constitute the higher value segment of the cellular telephony market.

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In the ISP, ILD, data transfer, networks and ICT services segment, Bezeq International is currently the sole ISP in Israel that owns and operates its own high-speed submarine optical fiber communications cable system. The JONAH cable, which was launched in January 2012 provides Bezeq International with greater capacity for utilization than any other ISP in Israel. In addition, Bezeq International is able to obtain such capacity at an incremental cost, while other ISPs in Israel are required to purchase capacity and rely on one of the two other cable operators in Israel (MedNautilus and Tamares).

In the multi-channel pay television segment, DBS is the only licensed provider of multi-channel television broadcasts via satellite in Israel and one of only two companies in the Israeli pay television services market. While DBS relies on third party providers for the provision of satellite capacity, it owns the satellite dishes that carry the signals from such satellites to subscriber residences and set-top boxes. Such equipment and infrastructure act as a significant barrier to entry against any potential competitor in the satellite pay television market.

During the years ended December 31, 2014, 2015 and 2016, the Bezeq Group companies invested NIS, NIS 1.3 billion, NIS 1.6 billion and NIS 1.3 billion (approximately \$332 million), respectively, in capital improvements, substantially all of which was invested in infrastructure and technology.

### ***Macro-Economic and Political Risks***

The Bezeq Group is subject to macro-economic and political risks that are outside of its control. For example, high levels of sovereign debt in the U.S., certain European countries and countries in the Middle East, combined with weak growth and high unemployment, could lead to fiscal reforms (including austerity measures), sovereign debt restructurings, currency instability, increased counterparty credit risk, high levels of volatility and, potentially, disruptions in the credit and equity markets, as well as other outcomes that might adversely impact the Bezeq Group. Moreover, as a business operating in Israel, we and the Bezeq Group are subject to the inherent risks associated with the political and military conditions in Israel and the potential for armed conflicts with Israel's neighbors. Further, while the majority of the Bezeq Group's revenues are in NIS, a portion of the Bezeq Group's operational expenses are in U.S. dollars. The exchange rate between U.S. dollars and NIS has been volatile in the past and may continue to be so in the future. Although we attempt to mitigate currency rate risk through hedging, sharp changes in the exchange rate could have a material effect on our results of operations.

### ***Churn***

The fixed-line telephony, fixed-line broadband Internet infrastructure access, cellular telephony and multi-channel pay television industries typically exhibit churn as a result of high levels of competition. Churn levels may be affected by

changes in our or our competitors' pricing, our level of customer satisfaction, disconnection of non-paying subscribers and changes in regulations. Increases in churn may lead to increased costs and reduced revenues. In recent years our churn rates increased, particularly in our cellular telephony segment as new competitors entered the market and advantageous billing plans were introduced. Similarly, competition has increased in recent years as a result of the prohibition on exit fees, long-term commitments and linkage of the price and terms of handsets sales to cellular telephony service prices and benefits.

### *Seasonality*

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

### *Impact of Currency Fluctuations*

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

During 2016, the U.S. dollar depreciated against the NIS by 1.5%. A devaluation of the dollar in relation to the NIS has the effect of reducing the NIS value of any of our expenses or liabilities which are payable in dollars, unless those expenses or liabilities are linked to the dollar. This devaluation of the dollar also has the effect of decreasing the NIS value of any asset which consists of dollars or receivables payable in dollars, unless the receivables are linked to the dollar.



### ***Effective Corporate Tax Rate***

Israeli companies were generally subject to corporate tax at a rate of 25% in 2016. In December 2016, the Israeli Parliament approved a measure whereby the corporate tax rate would be reduced in two stages from 25% to 23%, starting with a corporate income tax rate of 24% beginning in January 2017 which is to be reduced to 23% beginning in January 2018.

As of December 31, 2016, we had tax loss carryforwards in the amount of NIS 165 million (approximately \$43 million) and capital losses carry forward in the amount of NIS 326 million (approximately \$85 million). Under current Israeli tax laws, tax loss carryforwards do not expire and may be offset against future taxable income.

### ***Conditions in Israel***

We are organized in, based in and derive substantially all of our revenues from markets within the State of Israel. See “*Risk Factors—Risks Relating to the Operations of the Bezeq Group and Our Company in Israel*” for a description of governmental, economic, fiscal, monetary or political policies or factors that have materially affected or could materially affect our operations.

### ***Trade Relations***

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

Israel and the European Union Community concluded a Free Trade Agreement in July 1975, which confers certain advantages with respect to Israeli exports to most European countries and obligates Israel to lower its tariffs with respect to imports from these countries over a number of years. In 1985, Israel and the United States entered into an agreement to establish a Free Trade Area. The Free Trade Area has eliminated all tariff and specified non-tariff barriers on most trade between the two countries. On January 1, 1993, an agreement between Israel and the European Free Trade Association, known as EFTA, established a free-trade zone between Israel and the EFTA nations. In

November 1995, Israel entered into a new agreement with the European Union, which included a refinement of rules of origin and other improvements, including providing for Israel to become a member of the research and technology programs of the European Union. In recent years, Israel has established commercial and trade relations with a number of other nations, including China, India, Russia, Turkey and other nations in Eastern Europe and Asia.

On May 10, 2010, the Organization for Economic Co-operation and Development, or OECD, invited Israel to become a member of the organization, whose mission is to promote co-operation between its members while keeping high international economic standards. On September 7, 2010, on signing the OECD Convention, Israel pledged its full dedication to achieving the Organization's fundamental aims. Israel was the 32nd country to join the organization, along with Estonia and Slovenia.

### **Explanation of Key Income Statement Items**

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

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

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

DBS's revenues are primarily derived from the sale of subscriptions for its multi-channel satellite pay television broadcast services. Revenue from subscriptions is recognized ratably over the contract period, which is generally one to twelve months. DBS does not provide revenues to Bezeq.

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

On May 20, 2014, Walla completed the sale of all the share capital of Coral-Tell Ltd. ("Coral-Tell"), a subsidiary which operates the Yad2 website, to Axel Springer Digital Classifieds Holding GmbH, a foreign media company incorporated in Germany, for NIS 805 million. Bezeq recorded a pre-tax profit of NIS 582 million with respect to the sale.

*Depreciation and Amortization.* Subsequent to our acquisition of the controlling interest in Bezeq, we adopted policies regarding the depreciation and amortization expenses related to Bezeq's communications business network equipment and capacity that were based on Bezeq's policies. Depreciation and amortization expenses primarily consist of depreciation on computer equipment, software, leasehold improvements, capitalized software development costs and amortization of purchased intangibles. In connection with our acquisition of the controlling interest in Bezeq, we assigned fair value to fixed assets acquired in the Bezeq acquisition. The difference between the book value and the fair value of those assets was recognized as an asset in our consolidated statement of financial position. The acquired assets are depreciated and amortized according to their expected useful life. Over time such assets are fully depreciated by Bezeq, and by us respectively. As a result, the excess fair value balance we assigned to the acquired assets decreases and our related future depreciation expenses will decrease as well.

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

*General and Operating Expenses.* Bezeq's consolidated general and operating expenses primarily consist of cellular telephone expenses, general expenses including outside consulting, legal and accounting services, materials and spare

parts, building maintenance, services and maintenance by sub-contractors, international communication expenses, vehicle maintenance expenses, royalties paid to the State of Israel and collection fees.

*Other operating expenses.* Other operating expenses primarily include Bezeq's provision for severance pay on early retirement, capital gains from the sale of property, plant and equipment, provisions for contingent liabilities and income or losses from copper forward contracts.

*Finance Expenses.* Our finance expenses primarily include interest expenses, U.S. dollar exchange rate differences and CPI linkage expenses on our recently redeemed Senior Secured Notes, bank and institutional loans and debentures. In addition our finance expenses also include interest and exchange rate differences on other financial liabilities and changes in fair value of financial assets or liabilities measured at fair value through profit or loss. Bezeq's financing expenses primarily consist of interest expenses for its financial liabilities, linkage and exchange rate differences, changes in fair value of financial assets measured at fair value through profit or loss, financing expenses for employee benefits and other financing expenses.

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

The applicable Israeli company income tax rate was 25% in 2013. In 2014 and 2015, our applicable income tax rate increased to 26.5% and commencing January 1, 2016 it was reduced to 25%, and will be further reduced in two stages from 25% to 23%, starting with a corporate income tax rate of 24% beginning in January 2017 which is to be reduced to 23% beginning in January 2018.

## Results of Operations

The following table sets forth our consolidated results of operations in NIS in millions and as a percentage of revenues for the three years ended December 31, 2016:

|  | Year ended December 31, |       |        |       |          |       |
|--|-------------------------|-------|--------|-------|----------|-------|
|  | 2014                    |       | 2015   |       | 2016     |       |
|  | NIS                     | %     | NIS    | %     | NIS      | %     |
| Revenues   | 9,055                   | 100 % | 9,985  | 100 % | 10,084   | 100 % |
| Depreciation and amortization                          | 1,873                   | 21 %  | 2,131  | 21 %  | 2,161    | 21 %  |
| Salaries   | 1,771                   | 19 %  | 1,960  | 20 %  | 2,017    | 20 %  |
| General and operating expenses                         | 3,371                   | 37 %  | 3,878  | 39 %  | 4,024    | 40 %  |
| Other operating expenses (income)                      | (535 )                  | (6 )% | 3      | - %   | 21       | - %   |
| Operating profit                                       | 2,575                   | 29 %  | 2,013  | 20 %  | 1,861    | 18 %  |
| Finance expense  | 1,329                   | 15 %  | 759    | 8 %   | 1,108    | 11 %  |
| Finance income   | (635 )                  | (7 )% | (164 ) | (2 )% | (133 )   | (1 )% |
| Profit after financing expenses, net                   | 1,881                   | 21 %  | 1,418  | 14 %  | 886      | 10 %  |
| Share of losses (profit) in equity- accounted investee | 170                     | 2 %   | (12 )  | - %   | 5        | - %   |
| Profit before income tax                               | 1,711                   | 19 %  | 1,430  | 14 %  | 881      | 8 %   |
| Income tax expenses                                    | 667                     | 7 %   | 347    | 3 %   | 442      | 4 %   |
| Profit for the year                                    | 1,044                   | 12 %  | 1,083  | 11 %  | 439      | 4 %   |
| Profit (loss) attributable to owners of the company    | (103 )                  | (1 )% | 87     | 1 %   | (202 )   | (2 )% |
| Profit attributable to non-controlling interests       | 1,147                   | 13 %  | 996    | 10 %  | 628      | 6 %   |
| Net profit for the year                                | 1,044                   | 12 %  | 1,083  | 11 %  | 426      | 4 %   |
| Basic earnings (loss) per share                        | (5.38 )                 |       | 4.54   |       | (10.52 ) |       |
| Diluted earnings (loss) per share                      | (5.50 )                 |       | 4.47   |       | (10.52 ) |       |

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

The following three tables provide summary financial information regarding the operating results of the individual operating segments of the Group on a consolidated basis for the three years ended December 31, 2016. Amounts are in NIS in millions. Beginning on March 23, 2015, Bezeq began to consolidate the operations of DBS in its consolidated financial statements.

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|  | Year ended December 31, 2016             |                            |   |                             |        |             |              |
|--|--|----------------------------|---|-----------------------------|--------|-------------|--------------|
|  | Domestic<br>fixed-line<br>communications | Cellular<br>communications | International<br>communications<br>and internet<br>services | Multi-channel<br>television | Others | Adjustments | Consolidated |
|  | NIS                                      | NIS                        | NIS   | NIS                         | NIS    | NIS         | NIS          |
| Revenue from external entities   | 4,063                                    | 2,587                      | 1,478   | 1,745                       | 198    | -           | 10,071       |
| Inter-segment revenues   | 320                                      | 43                         | 70  | -                           | 20     | (440)       | 13           |
| Total revenue  | 4,383                                    | 2,630                      | 1,548   | 1,745                       | 218    | (440)       | 10,084       |
| Depreciation and amortization  | 717                                      | 380                        | 137   | 296                         | 16     | 615         | 2,161        |
| Segment results- operating income  | 2,076                                    | 32                         | 176   | 264                         | (34)   | (653)       | 1,861        |
| Finance income   | 30                                       | 52                         | 5   | 13                          | 4      | 29          | 133          |
| Finance expenses   | (475)                                    | (6)                        | (15)  | (539)                       | (2)    | (71)        | (1,108)      |
| Total finance income (expense),<br>net                                   | (445)                                    | 46                         | (10)  | (526)                       | 2      | (42)        | (975)        |
| Segment profit (loss) after finance<br>expenses, net                     | 1,631                                    | 78                         | 166   | (262)                       | (32)   | (695)       | 886          |
| Share in profit (loss) of<br>equity-accounted investee                   | -  | -                          | 1   | -                           | (5)    | (1)         | (5)          |
| Segment profit (loss) before<br>income tax                               | 1,631                                    | 78                         | 167   | (262)                       | (37)   | (696)       | 881          |
| Income tax   | 399                                      | 17                         | 42  | (330)                       | -      | 314         | 442          |
| Segment results - net profit (loss)                                      | 1,232                                    | 61                         | 125   | 68                          | (37)   | (1,010)     | 439          |
| Additional information:  |  |                            |   |                             |        |             |              |
| Segment assets   | 7,111                                    | 3,294                      | 1,177   | 2,026                       | 193    | 3,642       | 17,443       |
| Goodwill   | -  | -                          | 6   | -                           | 10     | 3,050       | 3,066        |
| Investment in equity-accounted<br>investee                               | -  | -                          | 5   | -                           | 1      | 12          | 18           |
| Segment liabilities  | 11,988                                   | 569                        | 380   | 1,434                       | 104    | 3,315       | 17,790       |
| Investments in property, plant and<br>equipment and<br>intangible assets | 828                                      | 277                        | 126   | 227                         | 13     | -           | 1,471        |

|  | Year ended December 31, 2015             |                            |   |                             |        |             |              |        |       |       |     |      |   |
|--|--|----------------------------|---|-----------------------------|--------|-------------|--------------|--------|-------|-------|-----|------|---|
|  | Domestic<br>fixed-line<br>communications | Cellular<br>communications | International<br>communications<br>and internet<br>services | Multi-channel<br>television | Others | Adjustments | Consolidated |        |       |       |     |      |   |
|  | NIS                                      | NIS                        | NIS   | NIS                         | NIS    | NIS         | NIS          |        |       |       |     |      |   |
| Revenue from external entities                                     | 4,122                                    | 2,831                      | 1,485   | 1,774                       | 197    | (440        | )            | 9,969  |       |       |     |      |   |
| Inter-segment revenues   | 285                                      | 59                         | 93  | -                           | 24     | (445        | )            | 16     |       |       |     |      |   |
| Total revenue  | 4,407                                    | 2,890                      | 1,578   | 1,774                       | 221    | (885        | )            | 9,985  |       |       |     |      |   |
| Depreciation and amortization                                      | 725                                      | 419                        | 132   | 322                         | 13     | 520         |              | 2,131  |       |       |     |      |   |
| Segment results- operating income                                  | 2,148                                    | 157                        | 240   | 250                         | (15    | )           | (767         | )      | 2,013 |       |     |      |   |
| Finance income   | 30                                       | 53                         | 7   | 32                          | 17     | 25          |              | 164    |       |       |     |      |   |
| Finance expenses   | (362                                     | )                          | (4  | )                           | (15    | )           | (635         | )      | (2    | )     | 259 | (759 | ) |
| Total finance income (expense), net                                | (332                                     | )                          | 49  | (8                          | )      | (603        | )            | 15     | 284   | (595  | )   |      |   |
| Segment profit (loss) after finance expenses, net                  | 1,816                                    | 206                        | 232   | (353                        | )      | -           | (483         | )      | 1,418 |       |     |      |   |
| Share in profit (loss) of equity-accounted investee                | -  | -                          | -   | -                           | (2     | )           | 14           | 12     |       |       |     |      |   |
| Segment profit (loss) before income tax                            | 1,816                                    | 206                        | 232   | (353                        | )      | (2          | )            | (469   | )     | 1,430 |     |      |   |
| Income tax   | 492                                      | 55                         | 60  | 1                           | -      | (261        | )            | 347    |       |       |     |      |   |
| Segment results - net profit (loss)                                | 1,324                                    | 151                        | 172   | (354                        | )      | (2          | )            | (208   | )     | 1,083 |     |      |   |
| Additional information:  |  |                            |   |                             |        |             |              |        |       |       |     |      |   |
| Segment assets   | 7,311                                    | 3,269                      | 1,160   | 1,667                       | 661    | 5,251       |              | 19,319 |       |       |     |      |   |
| Goodwill   | -  | -                          | 6   | -                           | 10     | 3,050       |              | 3,066  |       |       |     |      |   |
| Investment in equity-accounted investee                            | -  | -                          | 4   | -                           | 7      | 14          |              | 25     |       |       |     |      |   |
| Segment liabilities  | 12,117                                   | 513                        | 343   | 6,685                       | 104    | 47          |              | 19,809 |       |       |     |      |   |
| Investments in property, plant and equipment and intangible assets | 837                                      | 419                        | 127   | 281                         | 33     | (80         | )            | 1,617  |       |       |     |      |   |



|  | Year ended December 31, 2014             |                            |   |                             |        |             |          | Consolidated |
|--|--|----------------------------|---|-----------------------------|--------|-------------|----------|--------------|
|  | Domestic<br>fixed-line<br>communications | Cellular<br>communications | International<br>communications<br>and internet<br>services | Multi-channel<br>television | Others | Adjustments | NIS      |              |
|  | NIS                                      | NIS                        | NIS   | NIS                         | NIS    | NIS         |          |              |
| Revenue from external entities                                     | 4,045                                    | 3,361                      | 1,419   | 1,724                       | 209    | (1,724 )    | 9,034    |              |
| Inter-segment revenues   | 272                                      | 58                         | 85  | -                           | 17     | (411 )      | 21       |              |
| Total revenue  | 4,317                                    | 3,419                      | 1,504   | 1,724                       | 226    | (2,135 )    | 9,055    |              |
| Depreciation and amortization                                      | 688                                      | 430                        | 130   | 298                         | 23     | 304         | 1,873    |              |
| Segment results- operating income                                  | 1,980                                    | 449                        | 232   | 273                         | 629    | (988 )      | 2,575    |              |
| Finance income   | 285                                      | 77                         | 9   | 26                          | 11     | 227         | 635      |              |
| Finance expenses   | (472 )                                   | (21 )                      | (18 )   | (619 )                      | (2 )   | (197 )      | (1,329 ) |              |
| Total finance income (expense), net                                | (187 )                                   | 56                         | (9 )  | (593 )                      | 9      | 30          | (694 )   |              |
| Segment profit (loss) after finance expenses, net                  | 1,793                                    | 505                        | 223   | (320 )                      | 638    | (958 )      | 1,881    |              |
| Share in profit (loss) of equity-accounted investee                | -  | -                          | 1   | -                           | (3 )   | (168 )      | (170 )   |              |
| Segment profit (loss) before income tax                            | 1,793                                    | 505                        | 224   | (320 )                      | 635    | (1,126 )    | 1,711    |              |
| Income tax   | 478                                      | 132                        | 60  | 1                           | 147    | (151 )      | 667      |              |
| Segment results - net profit (loss)                                | 1,315                                    | 373                        | 164   | (321 )                      | 488    | (975 )      | 1,044    |              |
| Additional information:  |  |                            |   |                             |        |             |          |              |
| Segment assets   | 8,483                                    | 3,541                      | 1,206   | 1,820                       | 682    | 2,087       | 17,820   |              |
| Goodwill   | -  | -                          | 6   | -                           | 10     | 2,665       | 2,681    |              |
| Investment in equity-accounted investee                            | -  | -                          | 4   | -                           | 11     | 1,042       | 1,057    |              |
| Segment liabilities  | 12,369                                   | 696                        | 392   | 6,484                       | 107    | (1,256 )    | 18,792   |              |
| Investments in property, plant and equipment and intangible assets | 835                                      | 339                        | 110   | 332                         | 17     | (332 )      | 1,301    |              |

### **Year Ended December 31, 2016 Compared with Year Ended December 31, 2015**

*Revenues.* Our revenues increased by 1.0% to NIS 10.1 billion (approximately \$2.6 billion) in the year ended December 31, 2016 from NIS 10.0 billion in the year ended December 31, 2015. For both periods, our consolidated revenues consisted entirely of Bezeq's consolidated revenues. The increase in revenues in 2016 was primarily due to the consolidation of DBS's revenues for a full year (consolidation began in the second quarter of 2015). Revenues declined across the Bezeq group's main segments, primarily in the Cellular Communications segment.

Bezeq's revenues decreased by 0.5% to NIS 4.38 billion (approximately \$1.14 billion) in the year ended December 31, 2016 from NIS 4.41 billion in the year ended December 31, 2015. The decrease in the segment's revenues was primarily due to a NIS 96 million (approximately \$25 million), or 6.1%, decrease in telephony services revenues as a result of a reduction of 3.3% in average revenue per line in 2016 as well as a decrease of 2.8% in the number of access lines. The decrease in revenues was partially offset by a NIS 55 million (approximately \$14 million), or 3.6%, increase in broadband Internet revenues as a result of continued growth in the number of wholesale Internet lines, which increased by 133,000 during 2016, partially offset by a decrease in the number of retail Internet lines and by a NIS 19 million (approximately \$5 million), or 1.8%, increase in transmission and data revenues. The increase in revenues from transmission and data communication services resulted from growth in the number of business customers and data lines as well as the expansion of communication solutions offered to customers.

Telephone's revenues decreased by 9.0% to NIS 2.6 billion (approximately \$684 million) in the year ended December 31, 2016 from NIS 2.9 billion in the year ended December 31, 2015. Revenues from services decreased to NIS 1.8 billion (approximately \$473 million), or 9.1%, in the year ended December 31, 2016 from NIS 2.0 billion in the year ended December 31, 2015. The decrease in revenues from cellular services was due to a decrease in tariffs as a result of increased competition in the cellular market as well as from the transition of government customers to new tariff plans. Revenues from repair services were also down in the year ended December 31, 2016. Revenues from the sale of terminal equipment decreased by 8.9% to NIS 812 million (approximately \$211 million) in the year ended December 31, 2016 from NIS 891 million in the year ended December 31, 2015.

Bezeq International's revenues decreased by 1.9% to NIS 1.55 billion (approximately \$403 million) in the year ended December 31, 2016 from NIS 1.58 billion in the year ended December 31, 2015. The decrease in revenues was primarily due to a reduction in hubbing revenues. After excluding hubbing revenues, total revenues increased by approximately 0.5% in 2016 compared to 2015 due to the continued growth in Internet services delivered across the submarine cable infrastructure, which was partially offset by lower revenues in the international long distance call market.

DBS had revenues of NIS 1.75 billion (approximately \$454 million) for the year ended December 31, 2016, while its revenues were NIS 1.33 billion for the nine months ended December 31, 2015 after its consolidation.

*Depreciation and Amortization.* We recorded depreciation and amortization expenses of NIS 2.2 billion (approximately \$563 million) in the year ended December 31, 2016 compared to NIS 2.1 billion in the year ended December 31, 2015, an increase of approximately 2.4%. The increase was primarily due to the consolidation of DBS for a full year, which was partially offset by a reduction in depreciation expenses at Pelephone.

The Bezeq Group recorded consolidated depreciation and amortization expenses of NIS 1.74 billion (approximately \$452 million) in the year ended December 31, 2016 compared to NIS 1.68 billion in the year ended December 31, 2015, an increase of 3.3%. The increase was primarily due to the consolidation of DBS for a full year, which was partially offset by a reduction in depreciation expenses at Pelephone.

Bezeq's depreciation and amortization expenses were NIS 717 million (approximately \$186 million) in the year ended December 31, 2016 compared with NIS 725 million in the year ended December 31, 2015, a decrease of 1.1%.

Pelephone's depreciation and amortization expenses in the year ended December 31, 2016 were NIS 380 million (approximately \$99 million) compared to NIS 419 million in the year ended December 31, 2015, a decrease of 9.3%.

Bezeq International's depreciation and amortization expenses in the year ended December 31, 2016 were NIS 137 million (approximately \$36 million) compared to NIS 132 million in the year ended December 31, 2015, an increase of 3.8%.

DBS's depreciation and amortization expenses in the year ended December 31, 2016 were NIS 296 million (approximately \$77 million) while its depreciation and amortization expenses were NIS 246 million for the nine months ended December 31, 2015 after its consolidation.

*Salaries.* Salaries increased by 2.9% to NIS 2.02 billion (approximately \$524 million) in the year ended December 31, 2016 from NIS 1.96 billion in the year ended December 31, 2015. The increase was primarily due to the consolidation of DBS starting in the second quarter of 2015.

Bezeq's salary expenses decreased by 1.5% to NIS 898 million (approximately \$234 million) in the year ended December 31, 2016 from NIS 912 million in the year ended December 31, 2015. The decrease was due to a reduction in the workforce and an increase in salaries attributed for investment, offset by salary increases.

Pelephone's salary expenses decreased 0.8% to NIS 378 million (approximately \$98 million) in the year ended December 31, 2016 from NIS 381 million in the year ended December 31, 2015.

Bezeq International's salary expenses increased 8.9% to NIS 330 million (approximately \$86 million) in the year ended December 31, 2016 from NIS 303 million in the year ended December 31, 2015. The increase was mainly due to salary updates after signing the collective agreement in the first quarter of 2016.

DBS's salary expenses in the year ended December 31, 2016 were NIS 249 million (approximately \$65 million) while its salary expenses were NIS 201 million for the nine months ended December 31, 2015 after its consolidation.

*General and Operating Expenses.* General and operating expenses increased by 3.7% to NIS 4.02 billion (approximately \$1.04 billion) in the year ended December 31, 2016 from NIS 3.88 billion in the year ended December 31, 2015. The increase was primarily due to the consolidation of DBS beginning in the second quarter of 2015, partially offset by a decrease in expenses in most of the Bezeq Group segments and primarily at Pelephone.

Bezeq's general and operating expenses decreased by 2.2% to NIS 705 million (approximately \$183 million) in the year ended December 31, 2016 from NIS 721 million in the year ended December 31, 2015. The decrease in operating expenses in 2016 was primarily due to a reduction in interconnect payments to telecom operators as well as lower building maintenance expenses partially offset by an increase in subcontractor expenses.

Pelephone's general and operating expenses decreased by 4.6% to NIS 1.8 billion (approximately \$478 million) in the year ended December 31, 2016 from NIS 1.9 billion in the year ended December 31, 2015. The decrease was primarily due to a decrease in the cost of handset sales, mirroring the change in the sales mix. The decrease was also attributable to a reduction in engineering expenses, call completion fee expenses, and expenses for doubtful debts. This decrease in expenses was partially offset by an increase in frequency leasing fees following the acquisition of

new 4G LTE frequencies.

Bezeq International's general and operating expenses decreased by 1.8% to NIS 887 million (approximately \$231 million) in the year ended December 31, 2016 from NIS 903 million in the year ended December 31, 2015. The decrease was primarily due to a reduction in the cost of call transfers between global operators and international call expenses, offset by higher Internet service costs driven by growth in the subscriber base and increased demand for high bandwidth rates, corresponding to revenues.

DBS's general and operating expenses in the year ended December 31, 2016 were NIS 92 million (approximately \$24 million) while its general and operating expenses were NIS 70 million for the nine months ended December 31, 2015 after its consolidation.

*Other Operating Expenses, net.* We had other operating expense, net of NIS 21 million (approximately \$5 million) in the year ended December 31, 2016 compared with other operating income, net of NIS 3 million in the year ended December 31, 2015. The decrease was primarily due to a reduction in capital gains from the sale of real estate at Bezeq Fixed-Line.

*Finance expenses, net.* Our consolidated net finance expenses increased by 64% to NIS 975 million (approximately \$253 million) in the year ended December 31, 2016 from NIS 595 million in the year ended December 31, 2015.

Our unconsolidated net finance expenses in the year ended December 31, 2016 decreased by 26.7% to NIS 44 million (approximately \$11 million) from NIS 60 million in the year ended December 31, 2015. The decrease was primarily attributable to an increase in our finance income from short term investments and due to the decrease in our debt as a result of principal payments.

B Communications' unconsolidated net finance expenses increased by 65.7% to NIS 484 million (approximately \$126 million) in the year ended December 31, 2016 from NIS 293 million in the year ended December 31, 2015. The increase was primarily attributable to one-time refinancing expenses related to the early redemption of its 7 % Senior Secured Notes due 2021.

The Bezeq Group's consolidated finance expenses, net increased by 70% to NIS 447 million (approximately \$116 million) in the year ended December 31, 2016 from NIS 263 million in the year ended December 31, 2015. Net finance expenses of the Bezeq Group included a change in a liability on a contingent consideration following the DBS business combination in the amount of NIS 55 million. Finance expenses in 2015 reflect a reduction in a provision for interest on previous years' taxes in the amount of NIS 76 million following an agreement that was reached with the tax assessor relating to the Domestic Fixed-Line Communications segment.

*Income Tax.* Consolidated income tax expenses increased by 23.5% to NIS 442 million (approximately \$115 million) in the year ended December 31, 2016 from NIS 358 million in the year ended December 31, 2015. The increase in income tax expenses was primarily due to the decrease in deferred tax assets following a reduction in the corporate tax rate for 2017 and 2018.

Bezeq's consolidated income tax expenses in the year ended December 31, 2016 represented 33.4% of its pre-tax profit, compared to 25.9% in the year ended December 31, 2015.

*Profit (Loss) Attributable to the Owners of Our Company.* Loss attributable to the owners of our company amounted to NIS 202 million (approximately \$53 million) in the year ended December 31, 2016 compared with net profit of NIS 87 million in the year ended December 31, 2015. The loss is primarily attributable to the one-time refinancing expenses related to the early redemption of B Communications' 7 % Senior Secured Notes.

*Profit Attributable to Our Non-Controlling Interests.* Profit attributable to our non-controlling interests decreased to NIS 641 million (approximately \$167 million) in the year ended December 31, 2016 from NIS 1.0 billion for the year ended December 31, 2015. The decrease is primarily attributable to the decrease in the Bezeq Group's net profit in 2016 compared with 2015.

#### **Year Ended December 31, 2015 Compared with Year Ended December 31, 2014**

*Revenues.* Our revenues increased by 10.3% to NIS 10.0 billion (approximately \$2.59 billion) in the year ended December 31, 2015 from NIS 9.1 billion in the year ended December 31, 2014. For both periods, our consolidated revenues consisted entirely of Bezeq's consolidated revenues. The increase in revenues in 2015 was primarily due to the consolidation of DBS revenues in the amount of NIS 1.33 billion (approximately \$342 million) as of the second quarter of 2015. The increase in revenues is also attributable to the NIS 90 million (approximately \$23 million), or 1%, increase in revenues of the Domestic Fixed-Line segment and the NIS 74 million (approximately \$19 million), or 1%, increase in the revenues of the International Communications and Internet Services segment. The increase in revenues was partially offset by the NIS 529 million (approximately \$136 million), or 5%, decrease in revenues of the

Cellular Communications segment, which resulted from the continuing intense competition in the cellular market in 2015.

Bezeq's revenues in the year ended December 31, 2015 increased to NIS 4.4 billion (approximately \$1.1 billion) from NIS 4.3 billion in the year ended December 31, 2014, an increase of 2.1%. The increase in the segment's revenues was primarily due to a NIS 148 million (approximately \$38 million), or 10.6%, increase in Internet services revenues as a result of an increase in the number of Internet subscribers (including wholesale service subscribers) and higher retail ARPU. The increase in revenues was partially offset by a NIS 82 million (approximately \$21 million), or 4.9%, decrease in telephony revenues as a result of a decrease in the average revenue per line, or ARPL, and the decrease in the number of access lines.

Pelephone's revenues in the year ended December 31, 2015 decreased to NIS 2.9 billion (approximately \$741 million) from NIS 3.4 billion in the year ended December 31, 2014, a decrease of 15.5%. Revenues from services in the year ended December 31, 2015 decreased to NIS 2.0 billion (approximately \$512 million) from NIS 2.45 billion in the year ended December 31, 2014, a decrease of 18.5%. The decrease was due to a NIS 211 million (approximately \$54 million) reduction in hosting service revenues, following termination of Pelephone's contract with HOT Mobile in December 2014. Revenues were also impacted by lower rates resulting from increased market competition and the migration of existing customers to cheaper rate plans, both of which factors lowered ARPU. Revenues from repair services were also down in the year ended December 31, 2015. Revenues from the sale of terminal equipment in the year ended December 31, 2015 decreased to NIS 891 million (approximately \$228 million) from NIS 966 million in the year ended December 31, 2014, a decrease of 7.8%. The decrease is primarily attributable to a reduction in terminal equipment sales, partially offset by higher selling prices. Revenues from repair services were also down in the year ended December 31, 2015.

Bezeq International's revenues in the year ended December 31, 2015 increased to NIS 1.6 billion (approximately \$404 million) from NIS 1.5 billion in the year ended December 31, 2014, an increase of 4.9%. The increase in revenues is primarily attributable to higher revenues from enterprise communication solutions (ICT), higher Internet service revenues due to the growth in the number of subscribers and an increase in revenues from data communication services. The increase was partially offset by lower revenues from outgoing calls, following a decrease in the number of minutes caused by ongoing competition with cellular providers and increased use of substitute software products.

*Depreciation and Amortization.* We recorded depreciation and amortization expenses of NIS 2.1 billion (approximately \$546 million) in the year ended December 31, 2015 compared to NIS 1.9 billion in the year ended December 31, 2014, an increase of approximately 13.8%. The increase was primarily due to the consolidation of DBS's depreciation and amortization expenses of NIS 245 million (approximately \$63 million) as of the second quarter of 2015 along with amortization of purchase price allocation costs Bezeq incurred while acquiring control over DBS. The increase was partially offset by a decrease in depreciation and amortization expenses arising from the purchase price allocation relating to B Communications' purchase of the controlling interest in Bezeq to NIS 447 million (approximately \$115 million) during the year ended December 31, 2015 compared with NIS 593 million in the year ended December 31, 2014.

The Bezeq Group recorded consolidated depreciation and amortization expenses of NIS 1.7 billion (approximately \$432 million) in the year ended December 31, 2015 compared to NIS 1.3 billion in the year ended December 31, 2014, an increase of 31.5%. The increase was primarily attributable to the consolidation of the depreciation and amortization expenses of DBS beginning in the second quarter of 2015.

Bezeq's depreciation and amortization expenses amounted to NIS 725 million (approximately \$186 million) in the year ended December 31, 2015 compared with NIS 688 million in the year ended December 31, 2014, an increase of 5.4%.

Telephone's depreciation and amortization expenses in the year ended December 31, 2015 amounted to NIS 419 million (approximately \$107 million) compared to NIS 430 million in the year ended December 31, 2014, a decrease of 2.6%.

Bezeq International's depreciation and amortization expenses in the year ended December 31, 2015 amounted to NIS 132 million (approximately \$34 million) compared to NIS 130 million in the year ended December 31, 2014, an increase of 1.5%.

*Salaries.* Salaries increased by 10.6% to NIS 2.0 billion (approximately \$502 million) in the year ended December 31, 2015 from NIS 1.8 billion in the year ended December 31, 2014, primarily due to the consolidation of DBS salaries as of the second quarter of 2015.

Bezeq's salary expenses increased by 1.9% to NIS 912 million (approximately \$234 million) in the year ended December 31, 2015 from NIS 895 million in the year ended December 31, 2014. The increase in salary expenses was primarily attributable to increased salaries and related costs, and was offset by employee retirements.



Pelephone's salary expenses decreased 8.6% to NIS 381 million (approximately \$98 million) in the year ended December 31, 2015 from NIS 417 million in the year ended December 31, 2014. The decrease in salary expenses is primarily attributable to a decrease in the number of employees.

Bezeq International's salary expenses increased 1.7% to NIS 303 million (approximately \$78 million) in the year ended December 31, 2015 from NIS 298 million in the year ended December 31, 2014. The increase in salary expenses was primarily attributable to an increase in the number of employees providing outsourcing services in ICT operations.

*General and Operating Expenses.* General and operating expenses increased 15.1% to NIS 3.9 billion (approximately \$994 million) in the year ended December 31, 2015 from NIS 3.4 billion in the year ended December 31, 2014. The increase was primarily attributable to the consolidation of DBS' general and operating expenses as of the second quarter of 2015.

Bezeq's general and operating expenses decreased by 7.2% to NIS 721 million (approximately \$185 million) in the year ended December 31, 2015, from NIS 777 million in the year ended December 31, 2014. The decrease is primarily attributable to a decrease in call completion fees to telecom operators, building maintenance costs, and consultancy costs.

Pelephone's general and operating expenses decreased by 8.4% to NIS 1.9 billion (approximately \$494 million) in the year ended December 31, 2015, from NIS 2.1 billion in the year ended December 31, 2014. The decrease was primarily attributable to: (i) reduction in sales of terminal equipment; (ii) a decrease in rental costs, content expenses, doubtful debt expenses and advertising expenses; and (iii) a decrease in repairs and extended warranties service costs following the decrease in the number of service subscribers and the number of repairs. The decrease was partially offset by an increase in frequency leasing fees following the acquisition of 4G LTE frequencies.

Bezeq International's general and operating expenses increased by 7.0% to NIS 903 million (approximately \$231 million) in the year ended December 31, 2015, from NIS 844 million in the year ended December 31, 2014. The increase is primarily attributable to an increase in ICT equipment costs, Internet services and data communications services, corresponding with the increase in revenues.

*Other Operating Expenses, net.* We had other operating expense, net of NIS 3 million (approximately \$1 million) in the year ended December 31, 2015 compared to other operating income, net of NIS 535 million in the year ended December 31, 2014. The decrease was primarily the result of the one-time capital gain of NIS 582 million (\$150 million) generated from the sale of Coral-Tell shares by Bezeq in 2014.

*Finance expenses, net.* Our consolidated finance expenses, net decreased by 14.3% to NIS 595 million (approximately \$152 million) in the year ended December 31, 2015 from NIS 694 million for the year ended December 31, 2014.

Our finance expenses, net for the year ended December 31, 2015 decreased by 28.6% to NIS 60 million (approximately \$15 million) from NIS 84 million in the year ended December 31, 2014. The decrease was primarily attributable to the 1.0% decrease in the Israeli CPI in 2015, which our three series of debentures are linked to.

B Communications' finance expenses, net in the year ended December 31, 2015 decreased 42.3% to NIS 293 million (approximately \$75 million) from NIS 508 million in the year ended December 31, 2014. The decrease was primarily attributable to the one-time expenses of NIS 183 million in 2014, relating to the early repayment by B Communications of the loans incurred to acquire its controlling interest in Bezeq, and the early redemption of all of its outstanding Series A Debentures.

The Bezeq Group's consolidated finance expenses, net increased by 102.3% to NIS 263 million (approximately \$67 million) in the year ended December 31, 2015 from NIS 130 million in the year ended December 31, 2014. The increase was primarily due to financing income from shareholder loans to DBS which were recorded in 2014 and were not included in the consolidated results as of April 1, 2015 due to the consolidation of DBS. Such increase was partially set off as a result of the cancellation of taxes' interest related provision owed by Bezeq for previous years. Such cancellation was executed further to the proposed agreement with the Tax Authorities. The consolidation of DBS financing expenses as of the second quarter of 2015 in the amount of NIS 91 million (\$23 million) was offset by the amortization of purchase price allocation costs attributed to the DBS debentures.

*Income Tax.* Consolidated income tax expenses decreased by 48.0% to NIS 347 million (approximately \$89 million) in the year ended December 31, 2015 from NIS 667 million in the year ended December 31, 2014. The decrease was primarily attributable to the decrease in the pre-tax profit of the Bezeq Group in 2015 and from the NIS 101 million

(\$26 million) income tax benefit B Communications recorded in 2015 as a result of the sale of its Bezeq shares in the first quarter of 2016. 2014 pre-tax profit included capital gain from Bezeq's sale of the Coral Tell shares.

Bezeq's consolidated income tax expenses in the year ended December 31, 2015 represented 25.8% of its pre-tax profit, compared to 27.9% in the year ended December 31, 2014.

*Profit (Loss) Attributable to the Owners of Our Company.* Profit attributable to the owners of our company amounted to NIS 87 million (approximately \$22 million) in the year ended December 31, 2015, compared to a loss of NIS 103 million in year ended December 31, 2014. The increase is primarily attributable to the decrease in B Communications' net finance expenses, along with the income tax benefit B Communications' recorded in 2015.

*Profit Attributable to Our Non-Controlling Interests.* Profit attributable to our non-controlling interests decreased to NIS 1.00 billion (approximately \$256 million) in the year ended December 31, 2015 from NIS 1.15 billion in the year ended December 31, 2014. The decrease is primarily attributable to the decrease in the Bezeq Group's net income in 2015 compared with 2014 as a result of the one-time capital gain arising from the sale of the Coral-Tell shares in 2014.

## **B. Liquidity and Capital Resources**

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

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

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

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

In December 2009, we issued additional Series B debentures in two private placements to institutional investors in Israel for NIS 400 million. The terms of these additional Series B debentures issued in December 2009 are identical to those of the Series B debentures issued in September 2007. As of December 31, 2015, the Series B Debentures were fully repaid.

In 2009, we completed the repurchase of 5,481,859 of our ordinary shares for an aggregate of NIS 140 million, or an average price of NIS 25.30 per share, under two repurchase programs. In 2010, our Board of Directors authorized a third repurchase program, for the repurchase of up to an additional NIS 44 million of our ordinary shares in the open market from time to time at prevailing market prices. We repurchased 330,756 ordinary shares under the third program at a total purchase price of NIS 30 million (\$8 million), or an average price of NIS 90.7 (\$24.30) per share. No repurchases have been made since 2011.

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

In December 2010, we issued NIS 148 million of our Series C Debentures in a private placement to certain institutional investors in exchange for NIS 125 million of our outstanding Series B Debentures, reflecting an exchange ratio of 1:1.188. In February 2011, we issued additional Series C Debentures in a private placement to a number of Israeli institutional investors. The offering price was NIS 1.0275 per debenture, which represented a yield of 4.2%. The aggregate proceeds were approximately NIS 133.6 million. In December 2011, January 2012, November 2013

and December, 2013 we completed private placements of NIS 65 million, NIS 14 million, NIS 60 million and NIS 65 million, respectively, of our Series C Debentures. The private placements were offered to a number of Israeli institutional investors pursuant to Regulation S under the Securities Act. The terms of all issued Series C Debentures are identical to the terms of the Series C Debentures issued in 2010, and they are listed on the TASE. In November 2013, Midroog confirmed a Baa1 rating for our Series C Debentures in connection with our NIS 60 million sale of Series C Debentures. As of December 31, 2016, NIS 388 million (approximately \$101 million) of Series C Debentures are outstanding.

In March 2014, we completed a public tender for an offering in Israel of Series D Debentures, with a fixed annual interest rate of 6%. In the tender, we accepted orders for 117,597 units of the non-convertible Series D Debentures for an aggregate principal amount of NIS 117.5 million (approximately \$33.7 million) at a price per unit of NIS 1,070. Midroog assigned a local Baa1 stable rating for the Series D Debentures Offering. The Series D Debentures are listed on the TASE.

We will repay the principal amount of the Series D Debentures in five installments as follows: (i) payments of 10% of the principal amount of the Series D Debentures will be made on each of September 15, 2018 and 2019; (ii) payments of 30% of the principal amount of the Series D Debentures will be made on each of September 15, 2020 and 2021; and (iii) a final payment of 20% of the principal amount of the Series D Debentures will be made on September 15, 2022. Interest on the outstanding principal of the Series D Debentures is paid on March 15 and September 15 of each of the years 2014-2022, other than the first interest payment which was made on September 15, 2014. The principal and interest is linked to the Israeli consumer price index of January 2014.

On June 9 and 22, 2014 we completed a private placement of NIS 219,238,087 par value of Series D Debentures to certain institutional investors in Israel in exchange for NIS 106,938,290 par value of our outstanding Series B Debentures and NIS 95,324,216 par value of our outstanding Series C Debentures held by such institutional investors (or approximately 51% and 12% of the outstanding Series B Debentures and Series C Debentures, respectively). On October 22, 2014 we completed an additional private placement of NIS 106,813,717 par value of Series D Debentures to certain institutional investors in Israel in exchange for NIS 103,102,043 par value of our outstanding Series C Debentures held by such institutional investors (or approximately 15% of the outstanding Series C Debentures). On November 20 and 26, 2014 we completed an additional private placement of NIS 86,254,219 par value of Series D Debentures to certain institutional investors in Israel in exchange for NIS 84,979,526 par value of our outstanding Series C Debentures held by such institutional investors (or approximately 15% of the outstanding Series C Debentures). As of December 31, 2016, NIS 530 million (approximately \$138 million) of Series D Debentures are outstanding.

In January 2015, Midroog confirmed the Baa1 stable outlook rating with respect to our Series B, C and D Debentures and in February 2016, Midroog raised the rating for our Series C and D Debentures from Baa1.il to A3.il stable outlook. In February 2017, Midroog affirmed the A3.il local rating of our Series C and D Debentures with a stable outlook.

As of December 31, 2016 and 2015, we had on an unconsolidated basis cash and cash equivalents as well as marketable securities of NIS 382 million (approximately \$99 million) and NIS 277 million, respectively.

#### *Agreement with Norisha*

On June 27, 2013, we and Norisha Holdings Limited, or Norisha, entered into a share purchase agreement, or the SPA, pursuant to which we sold 3,571,741 ordinary shares, par value NIS 0.1 each, of B Communications to Norisha; and agreed, that upon certain terms, Norisha would be entitled to receive adjustment shares and to purchase option shares. On May 29, 2014, we and Norisha agreed to revise the terms of the SPA under the following basic terms: (1) Norisha would waive any of its current and future rights under the SPA, including any rights to receive any additional shares under the SPA; and (2) instead of the previous rights, we would transfer to Norisha 396,860 additional ordinary shares of B Communications without any further payment.

#### *January 2016 Sale of B Communications Shares*

In January, 2016, we sold 575,000 ordinary shares of B Communications, representing approximately 1.92% of its issued and outstanding shares, and received gross proceeds of NIS 56 million (approximately \$14 million) from the

sale. As a result of the sale, our ownership interest in B Communications declined to 64.78% of its outstanding shares.

#### *Bezeq's Dividend Distributions*

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

Bezeq paid total cash dividends of NIS 2.1 billion, NIS 1.8 billion and NIS 1.4 billion (approximately \$375 million) in the three years ended December 31, 2016, out of which B Communications received NIS 638 million, NIS 545 million and NIS 379 million (approximately \$100 million), respectively.

#### *Debt Incurred by B Communications for the Acquisition of the Bezeq Shares*

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

On the closing date of the acquisition of the Bezeq interest, B Communications' indirect fully owned-sub subsidiary SP2, which holds the Bezeq interest acquired on that date, obtained loans of NIS 4.6 billion from certain banking and financial institutions. SP2 also created liens for the lenders as security for its obligations under the loan agreement and agreed to pay the lenders certain fees, expenses and cost increases. SP2 also issued phantom stock options to the banks. On November 5, 2013, SP2, entered into an amendment which provided for improved terms.

The proceeds of B Communications' February 2014 \$800 million senior secured note offering were used to repay all of the outstanding balances under the loans B Communications incurred to acquire its controlling interest in Bezeq.

*B Communications' \$800 Million Note Offering*

On February 19, 2014, B Communications completed a private offering to eligible purchasers of \$800 million of 7 % Senior Secured Notes due 2021, or the Notes. The Notes were offered and sold in the United States to qualified institutional buyers pursuant to Rule 144A under the U.S. Securities Act of 1933, as amended (the "Securities Act"), and to certain qualifying investors in offshore transactions, including in Israel, in reliance on Regulation S under the Securities Act. The proceeds of the February 2014 Note offering were used to repay all of the outstanding balances under the loans B Communications incurred to acquire its controlling interest in Bezeq.

The Notes, which were redeemed in October 2016 were senior obligations that were guaranteed by our two subsidiaries, SP1 and SP2, on a senior secured basis. The Notes and the guarantees were secured by first priority liens over all of the capital stock of SP2, the capital stock of Bezeq held by SP2, which, as of the date of the issuance of the Notes, constituted approximately 30% of the outstanding voting capital stock of Bezeq, and additional collateral.

The indenture for the Notes, or the Indenture, among other things, restricted B Communications' ability to: (i) incur additional indebtedness; (ii) use a portion of the proceeds of any dividends received from the Bezeq Group and make certain payments and investments create certain liens; (iii) impose restrictions on the ability of B Communications' subsidiaries to pay dividends or other payments to B Communications; (iv) transfer or sell ownership interests in the Bezeq Group; (v) merge or consolidate with other entities; and enter into transactions with affiliates.

On February 2, 2016, B Communications sold 115,500,000 Bezeq shares and received net proceeds of NIS 978 million in the aggregate (approximately \$254 million). The sale took place in accordance with the provisions of Section 3(a3) of the Communications Order. B Communications retained a 26.34% ownership interest in Bezeq following the closing of the transaction.

According to the terms of the Indenture, the net proceeds from the sale of the Bezeq shares held were deposited into a "Lockbox Account" and were subject to certain conditions and covenants relating to asset sales and release of liens on sold assets. B Communications was required to make an offer within 365 days of the sale of the Bezeq shares to the holders of the Notes to purchase Notes with the proceeds deposited in the lockbox account at a cash offer price equal to 100% of the principal amount of the Notes, plus accrued and unpaid interest to the date of purchase. On June 28, 2016, B Communications announced the final results of its modified Dutch auction tender offer pursuant to a Tender Offer Memorandum dated May 26, 2016 to purchase a portion of the Notes. Approximately \$ 18,600,000 in aggregate principal amount of the Notes were validly tendered.



In August 2016, B Communications announced its intention to raise further funds to redeem its outstanding Notes through the offering of new non-convertible debentures in Israel pursuant to a shelf prospectus in Israel. Midroog issued an Aa3.il rating with a stable outlook for B Communications' new Series C Debentures, in a scope of up to NIS 1.9 billion par value. In September 2016 B Communications completed the offering of NIS approximately 1.88 billion (approximately \$489) par value of the Series C Debentures.

B Communications fully redeemed the Notes on October 25, 2016. Following this process, the Bezeq shares which served as collateral for the Notes and were held by SP2 became free and clear of any pledges (subject to the general governmental control permit) and all of the Bezeq shares that were held by Mishmeret Trust Company Ltd., the trustee and security agent for the Notes, were transferred back to SP2.

### *B Communications' Series C Debentures*

In September 2016, B Communications announced that it received NIS 1.85 billion (approximately \$489 million) of binding commitments (out of about NIS 3.0 billion of offers) from Israeli institutional investors to purchase new Series C Debentures maturing in 2024. The net proceeds from the offering were used to redeem B Communications' outstanding 7 % Senior Secured Notes, and further strengthened B Communications' balance sheet. Midroog Ltd. approved an Aa3.il Rating for the Series C Debentures. In January 2017, B Communications announced a private placement of NIS 118,000,000 par value of its Series C Debentures to Israeli institutional investors for an aggregate consideration of approximately NIS 118 million (approximately US\$ 31 million). The private placement was carried out as an increase to the outstanding Series C Debentures. Midroog issued an Aa3.il rating with a stable outlook for the new Series C Debentures

The principal of the Series C Debentures is payable in four equal annual installments payable on November 30 of each of the years 2020 through 2023 and one installment payable on November 30, 2024. Each of the first four installments will be equal to 7.5% of the principal amount of the aggregate amount of the Series C Debentures sold and the last installment will equal to 70% of such principal amount. The annual interest rate is 3.6%. The interest on the outstanding principal of the Series C Debentures is payable in semi-annual payments on May 31 and November 30 of each year, while the first interest payment will be paid on May 31, 2017 and the last interest payment will be payable together with the last principal payment on November 30, 2024.

The indenture governing the Series C Debentures restricts B Communications' creating a lien in favor of any third party over its direct and/or indirect holdings of 691,361,036 ordinary shares of Bezeq, or the Bezeq Shares, including any of the rights accompanying such shares without the prior consent of the holders of the Series C Debentures. B Communications' also agreed to refrain from making any disposition of the Bezeq Shares without obtaining the prior consent of the holders of the Series C Debentures. Notwithstanding the foregoing, and subject to the provisions of applicable law and/or permit, B Communications may sell all or a portion of the Bezeq Shares to any third party, provided that in such instance, we use the net proceeds from such sale, less taxes, expenses and deductions associated with the sale of such shares to make a full or partial early redemption of the Series Debentures.

Pursuant to the terms of the Series C Debentures indenture B Communications may not assume additional debt, with the exception of:

financial debt that does not exceed NIS 400 million;

the financial debt is not secured by any collateral and does not have priority over the Series C Debentures upon insolvency; and

the total par value of the Series C Debentures will not exceed an aggregate of NIS 2.3 billion.

B Communications also undertook to hold (directly and/or indirectly) at least 25% of Bezeq's issued and paid-up capital, unless a regulatory permit/approval is received to reduce such ownership percentage. Similarly, Eurocom Communications Ltd. undertook to refrain from transferring control of B Communications (directly or indirectly) to a party which has not been authorized in advance by the necessary regulatory entities, to the extent such approvals are required, at the relevant time.

Pursuant to the terms of the Series C Debentures indenture, B Communications also undertook that its equity (capital attributed to our shareholders, without non-controlling interests) will not be less than NIS 650 million for two or more consecutive calendar quarters. The indenture includes a mechanism to adjust the interest rate in the event that B Communications' equity falls NIS 650 million for two consecutive calendar quarters or in the event of a downgrade in the rating of the Series C Debentures.

B Communications also undertook not to distribute a dividend to its shareholders, buyback any of its ordinary shares or make any other distribution as defined in the Companies Law unless all the following conditions are satisfied:

the distribution will not cause a downgrade in the rating of the Series C Debentures;

B Communications is not in violation of any of the covenants;

no grounds for immediate repayment exist at the time a resolution to make a distribution is adopted, and no such grounds exist as a result of such distribution;

B Communications' equity post-distribution is not less than NIS 800 million;

until full repayment of the principal of the Series C Debentures, B Communications may not distribute a dividend exceeding 75% of the balance of B Communications' distributable surpluses (the surplus balance or surpluses accrued in the last two years, in accordance with the definitions provided in the Companies Law) in accordance with its consolidated financial statements. In addition, B Communications may not make a distribution if it recorded an aggregate net loss in the last four quarters preceding the distribution date, on the basis of its last financial statements and/or the quarterly financial report published prior to the distribution date; and

notwithstanding the foregoing, the restrictions will not apply with respect to the balance of B Communications' profits/surpluses which are distributable in accordance with the provisions of the Companies Law as of June 30, 2016 (i.e. a total of NIS 416 million were excluded from the distribution restrictions).

The Series C Debentures indenture also requires that B Communications' equity may not be less than 15% of its total balance sheet in accordance with its audited or reviewed (unconsolidated) financial statements (or, alternatively, the quarterly financial report figures), for two or more consecutive calendar quarters.

#### *Financing of Ongoing Operations*

We expect to have sufficient funds to meet our long term working capital needs, capital expenditures, debt service and other funding requirements, both on a consolidated level (including B Communications which consolidates Bezeq's results) and with respect to our own debt service (not including B Communications and Bezeq),

We expect to have sufficient funds to service our indebtedness (excluding Bezeq's and B Communications' indebtedness) from our cash, cash equivalents and short term investments, our ability to raise additional funds, including through the sale or pledge of a portion of our shareholdings in B Communications that are free from any encumbrances, and from future dividends from B Communications.

B Communications declared its first dividend as a public company on November 7, 2013, a dividend of NIS 3.41 per share and NIS 102 million in the aggregate. We received NIS 69 million (approximately \$20 million) from the dividend distributed by B Communications.

On May 21, 2015, B Communications declared a dividend of NIS 2.24 per share and approximately NIS 67 million in the aggregate. We received NIS 45 million (approximately \$12 million) from the dividend distributed by B Communications on June 16, 2015.

On August 31, 2015, B Communications declared a dividend of NIS 0.73 per share and approximately NIS 22 million in the aggregate. We received NIS 15 million (approximately \$4 million) from the dividend distributed by B Communications on September 29, 2015.

On November 19, 2015, B Communications declared a dividend of NIS 38 million or NIS 1.27 per share. We received NIS 25 million (approximately \$6 million) from the dividend distributed by B Communications on December 23, 2015.

On May 25, 2016, B Communications declared a dividend of NIS 355 million (approximately \$92 million), or NIS 11.88 per share (approximately \$3.09). We received NIS 230 million (approximately \$60 million) from the dividend distributed by B Communications on May 29, 2016.

Bezeq paid total cash dividends of NIS 1.4 billion (approximately \$375 million) in the year ended December 31, 2016, out of which B Communications received NIS 379 million (approximately \$100 million).

As of December 31, 2016, our liquidity balances comprised of cash and cash equivalents and short term investments on an unconsolidated basis totaled NIS 382 million (approximately \$99 million).

In addition, as of December 31, 2016, we held 19.4 million unencumbered ordinary shares of B Communications having a value at December 31, 2016 of NIS 1.6 billion (64.78 % of B Communications' outstanding share capital). These shares can, if necessary, be used to support the refinancing of existing debt or may be sold for cash (up to 4.4 million shares can be sold without endangering our controlling interest in B Communications).

We believe that we have sufficient funds to service our debt service requirements through December 31, 2018 and we expect to have sufficient funds to serve our expected indebtedness beyond 2018.

### *Liquidity and Capital Resources of the Bezeq Group*

As of December 31, 2016, the Bezeq Group had cash and cash equivalents and short term investments of NIS 1.23 billion (approximately \$321 million) compared to NIS 1.3 billion at December 31, 2015.

The Bezeq Group incurred consolidated capital expenditures of NIS 1.42 billion (approximately \$368 million) in the year ended December 31, 2016, compared with NIS 1.64 billion in the year ended December 31, 2015. The decrease was primarily due to a reduction in investments in all group segments and specifically at Pelephone, mainly due to payments in 2015 for LTE 4G frequencies.

In the year ended December 31, 2016, the Bezeq Group repaid debt and paid interest of NIS 2.3 billion (approximately \$598 million), compared with NIS 2.7 billion for year ended December 31, 2015. In addition, the Bezeq Group paid dividends of NIS 1.4 billion (approximately \$375 million) in 2016 compared to NIS 1.8 billion in 2015.

The Bezeq Group's average debt (including current maturities) to financial institutions and debenture holders for the year ended December 31, 2015 was NIS 11.0 billion (approximately \$2.9 billion). The average supplier credit for the year ended December 31, 2015 was NIS 912 million (approximately \$237 million), the average short-term customer credit for the year ended December 31, 2015 was NIS 2.0 billion (approximately \$527 million), and average long-term customer credit was NIS 476 million (approximately \$124 million).

The Bezeq Group working capital deficit as of December 31, 2016 was NIS 407 million (approximately \$106 million) compared with a surplus of NIS 1.1 billion on December 31, 2015. Bezeq (according to its separate financial statements) had a working capital deficit of NIS 944 million (approximately \$246 million) as of December 31, 2016, compared with a working capital deficit of NIS 2.1 billion as of December 31, 2015.

The Board of Directors of Bezeq reviewed its existing and projected resources and cash flows for the foreseeable future and its investment needs, as well as the sources of finance and the potential amounts that will be required by the Bezeq Group in the foreseeable future. On the basis of its review of all of these factors, Bezeq's Board of Directors concluded that the Bezeq Group can meet its existing cash needs and its needs for the foreseeable future from cash generated from its operations, by receipt of dividends from subsidiaries and by raising debt, from banking and non-banking sources, should it determine to do so.



**Bezeq**

As of December 31, 2016, Bezeq did not have any short-term debt. The following table shows the distribution of long-term loans (including current maturities):

| Loan term       | Source of financing | Principal amount (NIS millions) | Currency or linkage | Type of interest and change mechanism | Average interest rate | Effective interest rate | Interest range in 2016 |
|-----------------|---------------------|---------------------------------|---------------------|---------------------------------------|-----------------------|-------------------------|------------------------|
| Long-term loans | Banks               | 978                             | Unlinked NIS        | Variable, based on prime rate*        | 1.71 %                | 1.72 %                  | 1.27%-1.80%            |
|                 | Banks               | 2,234                           | Unlinked NIS        | Fixed                                 | 4.51 %                | 4.56 %                  | 2.40%-6.85%            |
|                 | Non-bank sources    | 734                             | Unlinked NIS        | Variable, based on annual STL rate**  | 1.57 %                | 1.62 %                  | 1.47%-1.62%            |
|                 | Non-bank sources    | 2,593                           | Unlinked NIS        | Fixed                                 | 4.41 %                | 4.54 %                  | 3.11%-6.65%            |
|                 | Non-bank sources    | 3,344                           | CPI-linked NIS      | Fixed                                 | 2.49 %                | 2.55 %                  | 2.20%-3.70%            |

\* Prime interest rate as at March 2017 – 1.6%.

\*\* STL yield per year (218) – 0.158% (average of last 5 trading days of February 2017) for the interest period that began on March 1, 2017.

For additional details about Bezeq's loans, see Note 12 to its 2016 Financial Statements (which information is not incorporated by reference into this annual report).

**Restrictions on borrowings**

Directives of the Supervisor of Banks include restrictions on liability of a single borrower and of a group of borrowers towards the banks. Concerning these directives, Bezeq could be seen as part of one "group of borrowers" with B Communications Group and its controlling shareholders. The directives of the Supervisor of Banks could from time to time affect the ability of banks to grant further credit to Bezeq.





*Reportable credit**Debentures and loan terms*

|  | Note | December 31,<br>2016                 |                                    | December<br>31,2015                  |                                    | Interest rate range            |
|--|------|--------------------------------------|------------------------------------|--------------------------------------|------------------------------------|--------------------------------|
|  |      | Carrying<br>amount<br>NIS<br>million | Nominal<br>value<br>NIS<br>million | Carrying<br>amount<br>NIS<br>million | Nominal<br>value<br>NIS<br>million |                                |
| Bank loans:  |      |                                      |                                    |                                      |                                    |                                |
| Unlinked loans at variable interest                                | 12.3 | 978                                  | 978                                | 1,331                                | 1,331                              | Prime -0.33% to prime<br>+0.2% |
| Unlinked loans at fixed interest                                   | 12.3 | 1,084                                | 1,084                              | 1,589                                | 1,589                              | 6.85% - 5%                     |
| Unlinked loans at fixed interest                                   | 12.3 | 300                                  | 300                                | 300                                  | 300                                | 2.4%                           |
| Unlinked loans at fixed interest                                   | 12.3 | 914                                  | 900                                | -                                    | -                                  | 3.62% - 3.5%                   |
| Total bank loans   |      | 3,276                                | 3,262                              | 3,220                                | 3,220                              |                                |
| Loan from financial institutions:                                  |      |                                      |                                    |                                      |                                    |                                |
| Unlinked loans at fixed interest                                   | 12.3 | 500                                  | 500                                | -                                    | -                                  | 4.15%                          |
| Unlinked loans at fixed interest                                   | 12.3 | 147                                  | 147                                | -                                    | -                                  | 5.25% - 5%                     |
| Total loans from financial institutions                            |      | 647                                  | 647                                | -                                    | -                                  |                                |
| Total loans  |      | 3,923                                | 3,909                              | 3,220                                | 3,220                              |                                |
| Debentures issued to the public                                    |      |                                      |                                    |                                      |                                    |                                |
| Series 6 - linked to the CPI, at fixed interest                    | 12.3 | 3,041                                | 2,874                              | 3,087                                | 2,874                              | 3.7%                           |
| Series 7 - unlinked loans at variable interest                     | 12.3 | 734                                  | 734                                | 734                                  | 734                                | Makam for one year<br>+1.4%    |
| Series 8 - unlinked loans at fixed interest                        | 12.3 | 443                                  | 443                                | 886                                  | 886                                | 5.7%                           |
| Series 9 - unlinked loans at fixed interest                        | 12.3 | 1,144                                | 1,103                              | 388                                  | 388                                | 3.65%                          |
| Series 10 - linked to the CPI, at fixed interest                   | 12.3 | 400                                  | 400                                | 400                                  | 400                                | 2.2%                           |
| Series 5 - linked to the CPI, at fixed interest                    |      | -                                    | -                                  | 310                                  | 251                                | 5.3%                           |
| Total debentures issued to the public                              |      | 5,762                                | 5,554                              | 5,805                                | 5,533                              |                                |
| Non-marketable debentures issued to<br>financial institutions:     |      |                                      |                                    |                                      |                                    |                                |
| Debentures issued by DBS - linked to the<br>CPI, at fixed interest | 12.4 | 868                                  | 753                                | 1,288                                | 1,097                              | 5.35%-8.4%                     |
| Unlinked loans at fixed interest                                   | 12.3 | 400                                  | 400                                | 400                                  | 400                                | 6.65%                          |
| Total non-marketable debentures                                    |      | 1,268                                | 1,153                              | 1,688                                | 1,497                              |                                |
| Total debentures   |      | 7,030                                | 6,707                              | 7,493                                | 7,030                              |                                |
| Total loans and debentures   |      | 10,953                               | 10,616                             | 10,713                               | 10,250                             |                                |



*Terms of the loans and debentures issued by Bezeq*

Bezeq has undertaken not to create additional liens on its assets unless liens are created at the same time in favor of the debenture holders and the lending banks (negative lien). The lien includes exceptions, including regarding a lien on assets that will be purchased or expanded by Bezeq, if the undertakings underlying the lien are created for the purchase or expansion of those assets and for the matter of a token lien.

For Debentures (Series 6 to 8), loans from banks and financial institutions, and for debentures from financial institutions, standard grounds were included for immediate repayment of the debentures and loans, including breach events, insolvency, dissolution procedures or receivership. In addition, a right was determined to call for immediate repayment if a third-party lender calls for immediate repayment of Bezeq's debts in an amount exceeding the amount determined.

In addition, for loans from financial institutions amounting to NIS 500 million, a standard cause was included for immediate repayment of the loans, if telecommunication ceases to be the Group's core activity.

For Debentures (Series 6 to 10) and banks loans in the amount of NIS 2.8 billion as at December 31, 2016 (for loans from financial institutions amounting to NIS 500 million, and for debentures from financial institutions amounting to NIS 400 million, Bezeq has undertaken that if it Bezeq makes an undertaking towards any entity in respect of compliance with financial covenants, Bezeq will also provide the same undertaking to these debenture holders, banks and financial institutions (subject to certain exceptions).

For Debentures (Series 6 to 10) and for loans from financial institutions amounting to NIS 500 million, Bezeq has undertaken to the lenders to take steps so that, to the extent under its control, the debentures will be rated by at least one rating agency, so long as there are debentures of the relevant series in circulation or a balance in loans, as the case may be.

In addition, for Debentures (Series 9 and 10), standard grounds were included for immediate repayment of the debentures, including events of default, insolvency, liquidation proceedings, or receivership, as well as the right to call for immediate repayment if a third party lender calls for immediate repayment of Bezeq's debts (in an amount exceeding NIS 150 million, if another series of marketable debentures is called for immediate repayment - an unlimited amount), in the event of the sale of more than 50% of the Bezeq Group's assets (consolidated) such that communications will cease being the Group's main activity, in the event of a change of control following which the current controlling shareholders in Bezeq will cease being controlling shareholders (other than transfer of control to a transferee that received approval to control Bezeq in accordance with the provisions of the Communications Law or

change in control under other circumstances that were established), in the event that a going concern qualification is recorded in Bezeq's financial statements for two consecutive quarters, in the event of a material deterioration in Bezeq's business compared with the situation at the time of the issue, and there is real concern that Bezeq will not be able to repay the debentures on time (as set out in section 35I(1)(a)(1) in the Securities Law), all under the terms set out in the deed of trust of the debentures.

As at December 31, 2016 and the approval date of the financial statements, Bezeq was in compliance with all the terms and covenants of its loans and debentures, there were no grounds to call for immediate repayment.

### Reportable credit

Below is information about the Bezeq Group's reportable credit, in accordance with Legal Bulletin No. 104-15: A reportable credit event, issued by the Israel Securities Authority on December 30, 2011 and amended on March 19, 2017 (according to Bezeq's information, debentures and loans amount to more than NIS 1 billion). The debentures were issued by Bezeq without a specific purpose. The debenture principal is repayable in equal payments with the interest payable on the outstanding loan principal, as set out in the table below.

| Lender                | Date of loan | Date of final repayment | Type of loan                | Amount of the original loan or par value (NIS million) | Estimated reserve (plus interest payable) December 31, 2016 (NIS million) | Number of principal payments in the year as of December 31, 2016 | Principal payments from the year in 2016 | Number of interest payments in 2016 | Interest rate December 31, 2016 | Fair value of the liability at December 31, 2016 (NIS million) | Imputed effective interest rate at December 31, 2016 | Imputed effective interest rate at December 31, 2015 | Right to early repayment |
|-----------------------|--------------|-------------------------|-----------------------------|--|---|--|--|-------------------------------------|---------------------------------|--|--|--|--------------------------|
| Debentures (Series 6) | July 3, 2011 | Dec 1, 2022             | CPI-linked fixed interest   | 2,874  | 2,953   | 1  | 2018                                     | 2                                   | 3.70%                           | 3,247  | 1.08%  | 1.43%  | No                       |
| Debentures (Series 9) | Oct 15, 2015 | Dec 1, 2025             | Unlinked fixed interest NIS | 1,103  | 1,106   | 1  | 2022                                     | 2                                   | 3.65%                           | 1,146  | 3.13%  | 3.08%  | No                       |

***Undertakings to provide credit for 2017***

Bezeq entered into agreements with banks and financial institutions, whereby Bezeq received an undertaking from these institutions to provide credit to Bezeq to refinance its future debt in 2017 amounting to NIS 900 million (with an average duration of 4.5 years and an average fixed NIS interest rate of 4.3 %).

The terms of all the undertakings and the loans to be provided thereunder include terms that are similar to the terms provided for other loans taken by Bezeq, as described in section 12.3 above, including the following: an undertaking to refrain from creating additional liens on Bezeq's assets (with certain restrictions); an undertaking that if Bezeq assumes an undertaking towards a party in respect of compliance with financial covenants, Bezeq will also assume the same undertaking for this credit (subject to certain exceptions); and standard terms for immediate repayment (such as default events, insolvency, liquidation or receivership), and cross default (with certain restrictions), which will also apply, with the required changes, to the periods of the undertaking to provide credit. In addition, some of the undertakings to provide credit in 2017 also include terms that are similar to the terms that were established for Debentures (Series 9 and 10) as set out in Note 12.3.5 above.

Subsequent to the date of the financial statements, Bezeq signed another agreement to provide a loan of NIS 500 million in 2017, in similar terms to the above.

***Credit received during the reporting period/commitments to extend credit***

In 2015-2017, Bezeq signed agreements with banks and institutional entities under which it received a commitment to extend credit for future financing of Bezeq in 2017 as follows:

| Credit extension date        | Credit in NIS millions | Average life (years) and repayment dates | Total average interest rate (fixed, NIS and unlinked) |
|------------------------------|------------------------|--|---|
| June 2017 and September 2017 | 1,400                  | 5  | 4.2 %   |

(Repayment as from June 2020 until December 2024)

The terms of all these commitments and the loans granted thereunder include similar terms to those provided with respect to other loans taken by Bezeq defined in Note 12.6 of the 2016 Financial Statements, including: an undertaking not to create any other charges on Bezeq's assets (with certain restrictions), an undertaking that should it make a commitment to any entity in connection with financial covenants, Bezeq will undertake the same commitment also in connection with this credit (subject to certain exceptions), and standard terms for immediate repayment (such as a violations, insolvency, liquidation or receivership, etc., and cross default, with certain restrictions), which will apply, with the necessary changes, also with respect to the credit extension undertaking periods. Some of the commitments to extend credit in 2017 also include the same terms as those given in the public debt raising of October 2015, as set out in Note 12 of the 2016 Financial Statements.

In 2016, credit of NIS 1,400 million was provided to Bezeq, based on undertakings to provide credit given to Bezeq.

#### ***Bezeq debentures***

On April 21, 2016, Bezeq completed an issuance by way of an expansion of an existing series of marketable debentures (Series 9) according to a shelf prospectus. Within the context of this issuance, a total of NIS 714,050,000 par value was issued in consideration of NIS 769 million. The conditions of the issued debentures are the same as those of the outstanding Series 9 debentures.

### ***Credit rating***

Bezeq's debentures are rated il/AA/Stable by S&P Maalot Ltd. and Aa2 with a stable outlook by Midroog Ltd. For information regarding Bezeq's rating history in the last two years, see its immediate reports of April 21, 2015, September 7, 2015, April 17, 2016, April 25, 2016 and April 24, 2017 (S&P Maalot Ltd.) and August 13, 2014, December 28, 2014, March 5, 2015, September 10, 2015, April 18, 2016, June 2, 2016 and July 12, 2016 (Midroog Ltd.).

### ***Bezeq's assessment for raising financing and possible sources in 2017***

In 2017, Bezeq expects to repay NIS 1.71 billion on account of loan principal and interest (including debentures). Bezeq expect to exercise undertakings to provide credit of NIS 1.4 billion received from various banks and institutional entities.

Bezeq raises capital from time to time to finance its cash flow. The financing options at Bezeq's disposal are to raise debt by means of new bank loans and/or by raising private or negotiable debt and to exercise undertakings for credit extension for 2017.

### **Charges and guarantees**

For information about charges and guarantees of Bezeq, see Note 18 to Bezeq's 2016 Financial Statements (which are not incorporated by reference in this annual report).

### **Guarantee of DBS bonds**

In September 2015, Bezeq signed guarantee letters for compliance with DBS' undertakings to pay its full outstanding debt to the holders of debentures (Series B) of DBS totaling NIS 1.05 billion (the outstanding debt as at December 31, 2016 is NIS 636 million) in consideration of a decrease in the annual interest rate of the debentures (by 0.5%), and cancellation of collateral and certain provisions of the Deeds of Trust and debentures (including the undertakings for DBS to comply with financial covenants and restriction on distribution of a dividend by DBS). According to the terms of the debentures, decreasing the interest and canceling collateral and certain other provisions of the debentures are



subject to Bezeq's Maalot rating not falling below (-AA) or a corresponding rating, terms that were complied with as at the date of providing the collateral. If in future Bezeq's rating falls below the Maalot rating of -AA, the interest reduction will be canceled, the canceled collateral will be provided again, the canceled provisions will reapply and the guarantee will expire.

### *Pelephone*

Pelephone's operations are financed out of cash flow from operating activities. In 2015 Pelephone repaid the balance of its liabilities of NIS 93 million. As at December 31, 2015, Pelephone has no approved bank credit facilities. Although Pelephone intends to make further investments in property, plant and equipment (mainly in the LTE network), it estimates that it will not need to obtain any financing in 2016 for its ongoing operations

### *Bezeq International*

Bezeq International has no outstanding debt other than to Bezeq.

### *DBS*

| Source of financing       | Amount at<br>December<br>31, 2015<br>(NIS<br>millions) | Currency or linkage | Average<br>interest<br>rate | Effective<br>interest |
|---------------------------|--|---------------------|-----------------------------|-----------------------|
| Long-term Banking sources | 49   | NIS                 | 3.43 %                      | 3.46 %                |
| loans Non-bank (1)        | 818  | CPI-linked NIS      | 6.03 %                      | 6.12 %                |

(1)The non-banking credit, which is valid until December 31, 2015, is made up of debentures.

In September 2016, the boards of directors of Bezeq and of DBS approved converting the shareholders' loans recorded in Bezeq's name in DBS's books (including loans acquired from Eurocom), that were granted until June 23, 2015, the total balance of which, principle and cumulative interest as of September 7, 2016 amounted to NIS 5,319,400 thousand, into capital that will be recorded in DBS's books as premium on shares. Until they are converted, these loans will be linked to the consumer price index and are classified into three categories: a. interest-free loans; B. loans bearing annual interest of 5.5%; C. loans bearing annual interest of 11%; In this regard, see also Note 6 to the 2016 Financial Statements. In addition, in December 2016, additional loans provided by Bezeq to DBS, in the amount of NIS 389 million, principal and cumulated interest, were also converted.

### *Institutional financings*

As of December 31, 2016, DBS has outstanding Debentures (Series A) with a balance of NIS 190 million and Debentures (Series B) with a balance of NIS 678 million, issued to institutional investors and listed on the TACT-Institutional system of the TASE.

In accordance with Deed of Trust A, DBS created an unlimited floating first lien in favor of the trustee on all of its assets (other than exemptions arising from the provisions of the Communications Law), including a stipulation that limits additional liens (subject to the exceptions), and an unlimited fixed first lien on the rights and assets of DBS (subject to exceptions under the Communications Law), including its rights under material agreements to which it is a party, its unissued registered capital, goodwill, certain intellectual property rights and insurance rights under its insurance policies.

Deed of Trust A and Deed of Trust B stipulate standard events (such as insolvency, default and exercise of liens on most of the assets of DBS and more), which, should they occur, after the warning period and terms set out in each deed of trust, will allow immediate call for repayment of the debentures under the provisions in the deed of trust, and establish the right to call for immediate payment if another debenture series of DBS is called for immediate repayment, if the balance for settlement exceeds the amount set out in the relevant deed of trust.

In September 2015, Bezeq signed a letter of guarantee for the undertakings of DBS in favor of the holders of Debentures (Series B), against a reduction of the interest rate for Debentures (Series B) and cancellation of collateral (similar to those registered in favor of the trustee for Trust A) and certain provisions in Deed of Trust B, all in accordance with the terms set out in Deed of Trust B.

A reduction in the interest rate and cancellation of the collateral and certain provisions in Deed of Trust B are contingent on the rating of Bezeq not falling below a rating of AA- by S&P Maalot or a corresponding rating ("the Minimum Rating"), a condition that was fulfilled as at the date of the guarantee, and as at the date of the financial

statements, and if, in the future, the rating of Bezeq falls below the Minimum Rating, then the reduction in the interest rate will be cancelled, the collateral that was cancelled will be provided again, the provisions that were cancelled will be applicable again, and the guarantee will expire.

As of October 2015, DBS was rated ilAA (stable) by S&P Maalot, following the acquisition of DBS by Bezeq. The debentures issued by DBS are rated by S&P Maalot as ilAA. In July 2016, S&P ratified DBS's ilAA rating with stable outlook, while in its announcement it stated that a change in Bezeq's rating will affect DBS's rating.

## Cash Flows

### *Cash Flows of Our Company*

The following table summarizes our consolidated cash flows on a consolidated basis for the periods presented:

|  | Year ended December 31, |         |         |
|--|-------------------------|---------|---------|
|  | 2014                    | 2015    | 2016    |
|  | (NIS in millions)       |         |         |
| Net cash provided by operating activities            | 3,782                   | 3,644   | 3,457   |
| Net cash (used in) provided by investing activities  | (1,989)                 | 381     | (1,036) |
| Net cash used in financing activities                | (1,928)                 | (4,138) | (2,230) |
| Net increase (decrease) in cash and cash equivalents | (135 )                  | (113 )  | 191     |
| Cash and cash equivalents at beginning of year       | 867                     | 732     | 619     |
| Cash and cash equivalents at end of year             | 732                     | 619     | 810     |

### *Operating Activities*

Consolidated cash provided by operating activities in 2016 amounted to NIS 3.5 billion (approximately \$0.90 billion) compared to NIS 3.6 billion in 2015. The decrease in net cash provided from operating activities was primarily attributable to the Domestic Fixed-Line Communications segment following changes in working capital (mainly employee retirement payments), and the Cellular Communications segment due to lower profits and a more moderate decrease in trade receivables balances as compared to the 2015. The decrease was partially offset by the consolidation of DBS for a full year.

### *Investing Activities*

Consolidated cash used in investing activities in the year ended December 31, 2016, was NIS 1.04 billion (approximately \$269 million) compared with NIS 381 million provided by investing activities in the year ended December 31, 2015. The increase in net cash used in investing activities was due to lower net proceeds from the sale of held-for-trading financial assets in the Domestic Fixed-Line Communications segment of NIS 1.4 billion (approximately \$364 million). The increase was also due to tax payments on finance income from shareholder loans in the amount of NIS 461 million (approximately \$120 million) and from cash of NIS 299 million (approximately \$78 million) added in the first quarter of 2015 after assuming control of DBS.

*Financing Activities*

Consolidated cash used in financing activities in the year ended December 31, 2015 was NIS 2.2 billion (approximately \$580 million) compared to NIS 4.1 billion in the year ended December 31, 2015. The increase was primarily attributable to cash inflows from receipt of loans and a debenture issuance in the Domestic Fixed-Line Communications segment of NIS 2.16 billion (approximately \$562 million) as compared to a debenture issuance of NIS 1.01 billion (approximately \$263 million) in the Domestic Fixed-Line Communications and Multi-Channel Television segments in 2015. The additional payment on the purchase of DBS's shares and loans was lower in the in the year ended December 31, 2016 compared to 2015. DBS debenture repayments were also lower in the year ended December 31, 2016 as compared to 2015.

*The Bezeq Group's Cash Flows*

The following table summarizes the Bezeq Group's consolidated cash flows for the periods presented:

|   | Year ended December 31, |         |         |
|---|-------------------------|---------|---------|
|   | 2014                    | 2015    | 2016    |
|   | (NIS in millions)       |         |         |
| Net cash provided by operating activities                   | 3,796                   | 3,740   | 3,526   |
| Net cash (used in) provided by investing activities         | (1,546)                 | 283     | (1,567) |
| Net cash provided by (used in) financing activities         | (2,200)                 | (4,128) | (1,866) |
| Net increase (decrease) in cash and equivalents             | 50                      | (105 )  | 93      |
| Cash and cash equivalents as at the beginning of the period | 610                     | 660     | 555     |
| Cash and cash equivalents as at the end of the period       | 660                     | 555     | 648     |

*Operating Activities*

Consolidated cash flows provided by operating activities of the Bezeq Group in the year ended December 31, 2016 amounted to NIS 3.5 billion (approximately \$917 million) compared to NIS 3.7 billion in the year ended December 31, 2015, a decrease of NIS 214 million (\$56 million). The decrease in net cash provided from operating activities was primarily attributable to the Domestic Fixed-Line Communications segment following changes in working capital (mainly employee retirement payments) and the Cellular Communications segment due to lower profits and a more moderate decrease in trade receivables balances as compared to the decrease in 2015. The decrease was partially offset by the consolidation of DBS for a full year in the in the year ended December 31, 2016.

*Investing Activities*

Net cash used in investing activities in the year ended December 31 2016 was NIS 1.6 billion (approximately \$408 million) compared to NIS 283 million provided by investing activities in the year ended December 31, 2015. The increase of NIS 1.9 billion (approximately \$481 million) in net cash used in investing activities was due to lower net proceeds from the sale of held-for-trading financial assets in the Domestic Fixed-Line Communications segment of NIS 1.4 billion (approximately \$364 million). The increase was further due to tax payments on finance income from shareholder loans to the amount of NIS 461 million (approximately \$120 million), and from cash of NIS 299 million, added in the first quarter of 2015 after Bezeq assumed control of DBS.

*Financing Activities*

Net cash used in financing activities by the Bezeq Group in the year ended December 31, 2016 was NIS 1.9 billion (approximately \$485 million) compared to NIS 4.1 billion in the year ended December 31, 2015. The decrease in cash used in financing activities was primarily attributable to cash inflows from receipt of loans and a debenture issuance in the Domestic Fixed-Line Communications segment to the amount of NIS 2.16 billion (approximately \$562 million) in the year ended December 31, 2016 as compared to a debenture issuance of NIS 1.01 billion (approximately \$263 million) in the Domestic Fixed-Line Communications and Multi-Channel Television segments in 2015. The additional payment on the purchase of DBS's shares and loans was lower in the year ended December 31, 2016 than in the 2015. Debenture repayments in the Multi-Channel Television segment and dividend payments were also lower in the year ended December 31, 2016 compared to 2015.

**Critical Accounting Policies**

We adopted the critical accounting policies of Bezeq after our acquisition of the controlling interest in Bezeq. The preparation of the consolidated financial statements in accordance with IFRS requires management to make estimates and assumptions that affect the valuation of assets and expenses during the reporting period. There can be no assurance that actual results will not differ from these estimates.

***Consolidation of the financial statements and investments in associates***

***Business combinations.*** Business combinations are accounted for by applying the acquisition method. The acquisition date is the date on which the acquirer obtains control over the acquiree. Control exists when the Bezeq Group is exposed or has rights to variable returns from its involvement with the acquiree and it has the ability to affect those returns through its power over the acquiree. Substantive rights held by the Bezeq Group and others are taken into account when assessing control.

***Transactions eliminated on consolidation.*** Intra-group balances and income and expense arising from intra-group transactions are eliminated in the preparation of the consolidated financial statements.

***Non-controlling interests.*** Transactions with non-controlling interests, while retaining control, are accounted for as equity transactions. Any difference between the consideration paid or received for change in non-controlling interests is included in the owners' share in equity of our company directly in retained earnings.

***Associates (accounted for by the equity method).*** Associates are those entities in which the Bezeq Group has significant influence, but not control, over financial and operating policy. In respect of equity-accounted investments, goodwill is included in the carrying amount of the investment. When the Bezeq Group holds additional long-term interests in the associate (such as loans), which are a part of the Bezeq Group's net investment in the associate, and when the Bezeq Group's proportionate share in the additional interests is different from the Bezeq Group's share in the equity of the associate, the Bezeq Group recognizes its share in the additional losses of the associate at its proportionate share in the additional interests according to the percentage of the Bezeq Group's participation in all the levels of the additional interests and according to the order of priority of the additional levels of interests ("the Levels Method"). If, subsequently, the Bezeq Group recognizes its share in the profits of the associate, the Bezeq Group will recognize its share in the profits up to the amount of the cumulative losses previously recognized.

***Financial instruments***

***Non-derivative financial assets.*** Non-derivative financial assets include mainly investments in exchange traded notes, financial funds, ETFs, deposit certificates, debt instruments, shares, trade and other receivables, and cash and cash equivalents. The Bezeq Group initially recognizes loans and receivables when they are originated. All other financial assets are initially recognized at the date that the Bezeq Group becomes a party to contractual provisions of the instrument. Financial assets are derecognized when the contractual rights of the Bezeq Group to the cash flows from the asset expire, or the Bezeq Group transfers the rights to receive the contractual cash flows from the financial asset in a transaction in which substantially all the risks and rewards of ownership of the financial asset are transferred.



Regular way sales of financial assets are recognized on the trade date, meaning on the date the Bezeq Group undertook to sell the asset.

*Cash and cash equivalents.* Cash comprises cash balances available for immediate use and call deposits. Cash equivalents comprise short-term highly liquid investments (with original maturities of three months or less) that are readily convertible into known amounts of cash and are exposed to insignificant risks of change in value.

*Financial assets at fair value through profit or loss.* A financial asset is classified at fair value through profit or loss if it is held for trading or is designated as such upon initial recognition. Upon initial recognition, attributable transaction costs are recognized in the statement of income as incurred. These financial assets are measured at fair value and changes therein are recognized in the statement of income.

*Available-for-sale financial assets.* The Bezeq Group's investments in shares (through a venture capital fund) are classified as available-for-sale financial assets. These investments are measured at fair value and changes therein, other than impairment losses, are recognized directly in other comprehensive income. At the date of derecognition of the investment, profits from realization of the investment and profits that were recognized in capital reserve, are recognized in profit or loss. The Bezeq Group elected to recognize profits or losses from disposal of available-for-sale financial assets under financing income or expenses.

*Loans and receivables.* Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market. Such assets are recognized initially at fair value plus attributable transaction costs. Subsequent to initial recognition, loans and receivables are measured at amortized cost using the effective interest method, net of impairment losses.

*Non-derivative financial liabilities.* Non-derivative financial liabilities include debentures issued by the Bezeq Group, loans and borrowings from banks and other credit providers, and trade and other payables. The Bezeq Group initially recognizes debt instruments as they are incurred. Financial liabilities are initially recognized at fair value plus any attributable transaction costs. Subsequent to initial recognition, these financial liabilities are measured at amortized cost using the effective interest method. Financial liabilities are derecognized when the obligation of the Bezeq Group, as specified in the agreement, expires or when it is discharged or canceled.

*CPI-linked assets and liabilities that are not measured at fair value.* The value of CPI-linked financial assets and liabilities, which are not measured at fair value, is revaluated in each period according to the actual increase in the CPI.

*Offsetting financial instruments.* Financial assets and liabilities are offset and the net amount presented in the statement of financial position when, and only when we or the Bezeq Group currently have a legal right to offset the amounts and intend either to settle on a net basis or to realize the asset and settle the liability simultaneously.

*Change in terms of debt instruments.* An exchange of debt instruments having substantially different terms, between an existing borrower and lender is accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability at fair value. Furthermore, a substantial modification of the terms of the existing financial liability or part of it is accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability.

The terms are substantially different if the discounted present value of the cash flows according to the new terms, including any commissions paid, less any commissions received and discounted using the original effective interest rate, is different by at least ten percent from the discounted present value of the remaining cash flows of the original financial liability.

### ***Derivative financial instruments***

*Hedge accounting.* The Bezeq Group holds derivative financial instruments to hedge cash flows for risks to future changes in the CPI and foreign currency exchange rate risks. Forward contracts are measured at fair value. Changes in the fair value of the derivative hedging instrument designated as a cash flow hedge are recognized through other comprehensive income, in a hedging reserve under equity, to the extent that the hedge is effective. To the extent that the hedge is ineffective, changes in fair value are recognized in profit or loss. The amount recognized in the hedging reserve is removed and included in profit or loss in the same period as the hedged cash flows affect profit or loss under the same line item in the statement of income as the hedged item.

*Economic Hedges.* The Bezeq Group holds other derivative financial instruments to economically hedge its exposure to foreign currency and changes in the CPI. Hedge accounting is not applied to derivative instruments that economically hedge financial assets and liabilities. Derivative instruments are recognized initially at fair value and attributable transaction costs are recognized in the statement of income as incurred. Subsequent to initial recognition, derivative financial instruments are measured at fair value and the changes in fair value are recognized in the statement of income as incurred.

***Property, plant and equipment***

*Recognition and measurement.* Items of property, plant and equipment are measured at cost less accumulated depreciation and accumulated impairment losses. Cost includes expenditures that are directly attributable to acquisition of the asset. The cost of self-constructed assets includes the cost of materials, direct labor and financing costs as well as any other cost directly attributable to bringing the asset to the condition for its use intended by the management, and the costs of dismantling and removing the items and restoring the site on which they are located in cases where the Bezeq Group has an obligation to vacate and restore the site. The cost of purchased software that is integral to the functionality of the related equipment is recognized as part of the cost of the equipment. Spare parts, servicing equipment and stand-by equipment are classified as property, plant and equipment when they meet the definition of property, plant and equipment in IAS 16, and are otherwise classified as inventory. When major parts of the property, plant and equipment have different useful lives, they are accounted for as separate items (major components) of the property, plant and equipment. Gains or losses on disposal of property, plant and equipment are determined by comparing the proceeds from disposal with the carrying amount of the asset, and are recognized net under “other operating income” in the statement of income.

*Subsequent expenditure.* The cost of replacing part of an item of property, plant and equipment is recognized in the carrying amount of the item if it is probable that the future economic benefit embodied in the replaced item will flow to the Bezeq Group and its cost can be measured reliably. The costs of day-to-day servicing are recognized in the statement of income as incurred.

*Depreciation.* Depreciation is recognized in the statement of income on a straight-line basis over the estimated useful life of each part of an item of property, plant and equipment, since this most closely reflects the expected pattern of consumption of the future economic benefits embodied in the asset. Leased assets under finance lease agreements are depreciated over the shorter of the lease term and their useful lives. Depreciation of an asset starts when it is ready for use, meaning when it reaches the location and condition necessary for it to be capable of operating in the manner intended by management.

Leasehold improvements are depreciated over the shorter of the lease term, including the extension option held by the Bezeq Group and intended to be exercised) and the expected life of the improvement.

Assets are depreciated based on the following annual percentages:

|  | Years | Principal depreciation rate (%) |
|--|-------|---------------------------------|
| Fixed line and international network equipment (switches, transmission, power) | 4-12  | 12                              |
| Network  | 12-33 | 6                               |
| Subscriber equipment and installations   | 4-6   | 20                              |
| Equipment and infrastructure for multichannel television                       | 3-15  | 14                              |
| Vehicles   | 6-7   | 15                              |
| Office and general equipment   | 5-14  | 15                              |
| Electronic equipment, computers and internal communication systems             | 3-7   | 24                              |
| Cellular network   | 4-15  | 13                              |
| Buildings  | 25    | 4                               |
| Submarine communications cable   | 4-25  | 4                               |

Depreciation methods, useful lives and residual values are reviewed at least at each reporting year and adjusted as required.

***Non-current assets***

Non-current assets are classified as held for sale if it is highly probable that they will be recovered primarily through a sale transaction rather than their ongoing use. These assets are presented at the lower of the carrying amount and fair value, less selling costs.

***Intangible assets***

*Goodwill and brand name.* Goodwill and brand names that arise upon the acquisition of subsidiaries are included in intangible assets. Subsequent to initial recognition, goodwill and brand names are measured at cost less accumulated impairment losses. Goodwill and brand names are measured at least once a year to assess impairment.

*Software development costs.* Software development costs are recognized as an intangible asset only if the development costs can be measured reliably; the software is technically and commercially feasible; and the Bezeq Group has sufficient resources to complete the development and intends to use the software. The costs recognized as an intangible asset include the cost of the materials, direct labor and overhead expenses directly attributable to preparation of the asset for its intended use. Other development costs are recognized in the statement of income as incurred. Capitalized development costs are measured at cost less amortization and accumulated impairment losses.

*Software.* Software that is an integral part of the hardware, which cannot function without the programs installed on it, is classified as property, plant and equipment. However, licenses for stand-alone software, which adds functionality to the hardware, is classified (mainly) as intangible assets. Software depreciation is recognized in the statement of income using the straight-line method over the estimated useful life of the asset.

*Rights to frequencies.* Rights to frequencies refer to Pelephone's rights to cellular communication frequencies according to a Ministry of Communications tender. Depreciation of the asset is recognized in the statement of income using the straight line method over the license term, which is 13 years and 7 months starting from the use of the frequencies.

*Other intangible assets.* Other intangible assets acquired by the Bezeq Group, which have a definite useful life, are measured at cost less amortization and accumulated impairment losses.

*Subsequent expenditure.* Subsequent expenditure is recognized as an intangible asset only when it increases the future economic benefits embodied in the specific asset to which it relates. All other expenditures, including expenditures relating to generated goodwill and brands, are recognized in the statement of income as incurred.

*Amortization.* Amortization, except for goodwill, brand name and customer relationships, is recognized in the statement of income on a straight-line basis over the estimated useful life of the intangible assets, from the date on which the assets are available for use. Goodwill and brand name are not systematically amortized but are tested for impairment at least once a year. Customer relationships are amortized according to the economic benefit expected from those customers each period, which results in accelerated amortization during the early years of the relationship.

Estimated useful lives for the current and comparative periods are as follows:

| <b>Type of asset</b>                     | <b>Amortization period</b>  |
|--|---|
| Frequency usage rights                   | Over the term of the license for 10 to 14 years starting from the use of the frequencies      |
| Computer programs and software licenses  | 3 - 10 years according to the term of the license or the estimated time of use of the program |
| Customer relationships                   | 5 - 7 years   |
| Brand acquired in a business combination | 12  |
| Other rights                             | 2 - 6 years according to the useful lives   |
| <b><i>Leased assets</i></b>              |   |

Leases, including leases of land from the ILA, where the Bezeq Group assumes substantially all the risks and rewards of ownership are classified as finance leases. Upon initial recognition, the leased asset is measured at an amount equal to the lower of its fair value and the present value of the minimum lease payments. Subsequent to initial recognition, the asset is accounted for in accordance with the accounting policy applicable to the asset. Other leases are classified as operating leases and the leased assets are not recognized in the Bezeq Group's statement of financial position. Payments made under operating leases are recognized in profit or loss on a straight-line basis over the term of the lease.

Determining whether an arrangement contains a lease: At inception or upon reassessment of an arrangement, the Bezeq Group determines whether such an arrangement is or contains a lease. An arrangement is a lease or contains a lease if the following two criteria are met: (1) The fulfillment of the arrangement is dependent on the use of a specific asset or assets; and (2) The arrangement contains rights to use the asset. If, in accordance with these terms, the Bezeq Group determines that the agreement does not contain a lease, the agreement is accounted for as a service agreement and payments for the service are recognized in profit or loss on a straight line basis, over the service period.

### ***Right of use of capacities***

Transactions for acquiring an indefeasible right of use (IRU) of submarine communication cable capacities are mostly accounted for as service transactions. The prepaid expense is amortized on a straight-line basis as stated in the agreement, but for no longer than the expected estimated useful life of those capacities. Identifiable capacities which serve Bezeq exclusively meet the definition of a finance lease and are recognized in property, plant and equipment. The asset is depreciated on a straight-line basis as stated in the agreement, but for no longer than the expected estimated useful life of those capacities.

### ***Inventory***

Inventories are measured at the lower of cost and net realizable value. The cost of inventories is based on the moving average method. The inventories of a subsidiary include terminal equipment and accessories intended for sale and service, as well as spare parts used for repairs in the repair service it provides to its customers. Slow-moving inventory of terminal equipment, accessories and spare parts are stated net of the provision for impairment.

### ***Impairment***

*Non-derivative financial assets.* The Bezeq Group tests a financial asset for impairment when objective evidence indicates that one or more loss events have had a negative effect on the estimated future cash flows of that asset. Significant financial assets are tested for impairment on an individual basis. The remaining financial assets are assessed for impairment collectively, in groups that share similar credit risk characteristics. The financial statements include specific provisions and Group provisions for doubtful debts, which properly reflect, in the estimation of the management, the loss inherent in debts for which collection is in doubt.

*Non-financial assets.* Timing of impairment testing: The carrying amounts of Bezeq Group's non-financial assets, other than inventory and deferred tax assets are reviewed at each reporting date to determine whether there is any indication of impairment. If any such indication exists, then the recoverable amount of the asset is estimated. The Bezeq Group assesses the recoverable amount of goodwill and brand name once a year, or more frequently if there are indications of impairment.

Measurement of recoverable amount: The recoverable amount of an asset or cash-generating unit is the greater of its value in use and fair value less costs to sell. In assessing value in use, the estimated future cash flows are discounted



to their present value using a pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the asset or cash-generating unit, for which the estimated future cash flows from the asset or cash-generating unit were not adjusted.

**Determining cash-generating units:** For the purpose of impairment testing, the assets are grouped together into the smallest group of assets that generates cash from continuing use that are largely independent of other assets or groups of assets.

**Allocation of goodwill to cash-generating units:** For purposes of goodwill impairment testing, cash-generating units to which goodwill has been allocated are aggregated so that the level at which impairment testing is performed reflects the lowest level at which goodwill is monitored for internal reporting purposes, but in any event is not larger than an operating segment. Goodwill acquired in a business combination is allocated to cash-generating units that are expected to generate benefits from the synergies of the combination.

For purposes of goodwill impairment testing, when the non-controlling interests are initially measured according to their relative share of the acquiree's net identifiable assets, the carrying amount of the goodwill is adjusted according to the share which The Bezeq Group holds in the cash-generating unit to which the goodwill is allocated.

*Investments in equity-accounted investees.* An investment in an associate is tested for impairment when objective evidence indicates that there has been impairment. Goodwill that forms part of the carrying amount of an investment in an associate is not recognized separately, and therefore is not tested for impairment separately.

### *Employee benefits*

*Post-employment benefits.* The Bezeq Group has a number of post-employment benefit plans. The plans are usually financed by deposits with insurance companies and they are classified as defined contribution plans and defined benefit plans.

**Defined contribution plans:** A defined contribution plan is a post-employment benefit plan under which the Bezeq Group pays fixed contributions into a separate entity and has no legal or constructive obligation to pay further amounts. The Bezeq Group's obligations for contributions to defined contribution pension plans are recognized as an employee benefit expense in the statement of income in the periods during which services are rendered by employees.

**Defined benefit plans:** The Bezeq Group's net obligation in respect of defined benefit pension plans is calculated separately for each plan by estimating the amount of future benefit that employees have earned in return for their service in the current and prior periods. That benefit is presented at its present value and the fair value of any plan assets is deducted. The discount rate is the yield at the reporting date on high quality corporate bonds denominated in NIS and linked to the CPI, that have maturity dates similar to the terms of the Bezeq Group's obligations. The calculation is performed annually by a qualified actuary. Net interest costs on a defined benefit plan are calculated by applying the discount rate used to measure the defined benefit obligation at the beginning of the annual period to the then-net defined benefit liability. The Bezeq Group elected to recognize the interest costs that were recognized in the statement of income under financing expenses. Re-measurement of the net defined benefit liability comprises actuarial gains and losses and the return on plan assets (excluding interest). Re-measurements are recognized immediately directly in retained earnings through other comprehensive income. When the benefits of a plan are improved or reduced, the portion of the increased benefit relating to past service by employees or the gain or loss from the reduction are recognized immediately in the statement of income when the plan improvement or reduction occurs.

*Other long-term employee benefits.* Bezeq Group's net obligation in respect of long-term employee benefits other than pension plans is the amount of future benefit that employees have earned in return for their service in the current and prior periods. The amount of these benefits is stated at its present value. The discount rate is the yield at the reporting date on high quality corporate bonds denominated in NIS and linked to the CPI, that have maturity dates similar to the terms of the Bezeq Group's obligations. The calculation is performed using the projected unit credit method. Any actuarial gains or losses are recognized in the statement of income in the period in which they arise.

*Benefits for early retirement and dismissal.* Employment termination benefits are recognized as an expense when the Bezeq Group is committed demonstrably, without realistic possibility of withdrawal, to a formal detailed plan to terminate employment before the normal retirement date. Termination benefits for voluntary redundancies are recognized as an expense if the Bezeq Group has made an offer of voluntary redundancy, it is probable that the offer will be accepted, and the number of acceptances can be estimated reliably.

*Short-term benefits.* Short-term employee benefit obligations are measured on an undiscounted basis and are expensed as the related service is provided. A liability is recognized for the amount expected to be paid under short-term cash bonus or profit-sharing plans if the Bezeq Group has a present legal or constructive obligation to pay this amount as a result of past service provided by the employee and the obligation can be estimated reliably. The employee benefits are classified, for measurement purposes, as short-term benefits or as other long-term benefits depending on the date when the benefits are expected to be wholly settled. In the statement of financial position the employee benefits are classified as current benefits or as non-current benefits according to the time the liability is due to be settled.

*Share-based payments.* The fair value on the grant date of options for Bezeq shares granted to employees is recognized as a salary expense with a corresponding increase in equity over the period during which the employee becomes entitled to the options. The amount recognized as an expense is adjusted to reflect the actual number of share options that are expected to vest. The fair value of the amount payable to employees in respect of share-based payments, which are settled in cash, is recognized as an expense with a corresponding increase in liabilities, over the period that the employees become entitled to payment. The liability is re-measured at each reporting date until the settlement date. Any changes in the fair value of the liability are recognized in the statement of income. The Bezeq Group elected to recognize the changes in fair value of the liabilities under salary expenses.

*Provisions*

A provision is recognized if, as a result of a past event, the Bezeq Group has a present legal or constructive obligation that can be estimated reliably, and it is probable that an outflow of economic benefits will be required to settle the obligation.

*Legal claims.* Contingent liabilities are accounted for according to IAS 37 and its related provisions. Accordingly, the claims are classified by likelihood of realization of the exposure to risk, as follows:

More likely than not-more than 50% probability;

Possible-probability higher than unlikely and less than 50%; or

Remote-probability of 10% or less.

For claims which the Bezeq Group has a legal or constructive obligation as a result of a past event, which are more likely than not to be realized, the financial statements include provisions which, in the opinion of the Bezeq Group, based, among other things, on the opinions of its legal advisers retained in respect of those claims, are appropriate to the circumstances of each case, despite the claims being denied by the Bezeq Group companies. There are also a few legal proceedings, received recently, for which the risks cannot be assessed at this stage, therefore no provisions have been made.

*Site dismantling and clearing costs.* A provision in respect of an obligation to dismantle and clear sites is recognized for those rental agreements where the Bezeq Group has an undertaking to restore the rental property to its original state at the end of the rental period, after dismantling and transferring the site, and restoring it as necessary. The provisions are determined by discounting the expected future cash flows. The carrying amount of the provision is adjusted each period to reflect the time that has passed and is recognized as a financing expense.

*Warranty.* A Bezeq Group subsidiary recognizes a provision for warranty in respect of first-year insurance for cellular handsets. The warranty is limited to technical malfunctions defined by the subsidiary, and does not include a warranty as a result of customer caused damage. However, an asset exists in respect of the manufacturer's warranty for those handsets, which is limited to technical malfunctions defined by the manufacturer.

**C. Research and Development, Patents and Licenses**

We did not engage in any research and development during the last three fiscal years.

**D. Trend Information**

The Bezeq Group's revenues increased to NIS 10.1 billion for the year ended December 31, 2016 due to the first time consolidation of DBS for a full year. Revenues were down across the Bezeq Group's main segments, mainly in the Cellular Communications segment. The continued decline in overall revenues reflects the continuing competition in the communications industry in Israel.

**E. Off-Balance Sheet Arrangements**

We are not a party to any material off-balance sheet arrangements. In addition, we have no unconsolidated special purpose financing or partnership entities that are likely to create material contingent obligations.

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**F. Tabular Disclosure of Contractual Obligations**

The following table summarizes our (including B Communications' and Bezeq's) minimum contractual obligations and commercial commitments as of December 31, 2016 and the effect we expect them to have on our liquidity and cash flow in future periods:

| Contractual Obligations                         | Payments due by period<br>(NIS in millions) |                        |              |              |                         |
|---|---|------------------------|--------------|--------------|-------------------------|
|   | Total                                       | less<br>than 1<br>year | 1-3<br>years | 3-5<br>years | more<br>than 5<br>years |
| Long-term debt obligations (including interest) | 16,149                                      | 2,388                  | 4,788        | 3,966        | 5,008                   |
| Operating lease obligations                     | 1,279                                       | 370                    | 567          | 238          | 104                     |
| Purchase obligations                            | 149   | 149                    | -            | -            | -                       |
| Other long term obligations                     | 2   | 2                      | -            | -            | -                       |
| Total   | 17,579                                      | 2,909                  | 5,355        | 4,204        | 5,112                   |

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

Set forth below are the name, age, principal position and a biographical description of each of our directors and executive officers:

| Name                                       | Age | Position                           |
|--|-----|------------------------------------|
| <b>Our Directors and Senior Management</b> |     |                                    |
| Shaul Elovitch <sup>(1)</sup>              | 69  | Chairman of the Board of Directors |
| Felix Cohen                                | 63  | Director                           |
| Yossef Elovitch                            | 66  | Director                           |
| Dudi Ezra <sup>(2) (3)</sup>               | 48  | External Director                  |
| Shoshana Shidlo <sup>(2) (3)</sup>         | 52  | External Director                  |
| Anat Winner <sup>(2) (3)</sup>             | 57  | Director                           |
| Doron Turgeman                             | 49  | Chief Executive Officer            |
| Itzik Tadmor                               | 36  | Principal Financial Officer        |
| <b>Bezeq Group's Executive Management</b>  |     |                                    |
| Stella Handler                             | 56  | Chief Executive Officer of Bezeq   |
| Allon Raveh                                | 46  | Chief Financial Officer of Bezeq   |

|                |    |  |
|----------------|----|--|
| Ran Guron      | 48 | Chief Executive Officer of Pelephone           |
| Moti Elmaliach | 58 | Chief Executive Officer of Bezeq International |
| Ron Eilon      | 52 | Chief Executive Officer of DBS                 |

(1) Director of B Communications.

(2) Member of our Audit Committee.

(3) Member of our Compensation Committee.

Mr. Shaul Elovitch, Mr. Felix Cohen, Ms. Anat Winner and Mr. Yossef Elovitch will serve as directors until our 2017 annual general meeting of shareholders. Mr. Dudi Ezra and Ms. Shoshana Shidlo each serve as an external director pursuant to the provisions of the Israeli Companies Law for a first three year term until August 2017 (see Item 6C. “Directors, Senior Management and Employees - Board Practices - External and Independent Directors - External Directors”). Mr. Shaul Elovitch and Mr. Yossef Elovitch are brothers. There are no other family relationships among our directors or executive officers. David Mizrahi, the former CFO of Bezeq, notified Bezeq on April 4, 2016 that he would be resigning to pursue other opportunities. but he would stay until a replacement was found. Mr. Allon Raveh assumed the position of CFO of Bezeq in October 2016.

### ***Our Directors***

***Shaul Elovitch*** has served as the chairman of our board of directors since our inception in 1992. Mr. Elovitch is the controlling shareholder of Eurocom Communications and its affiliated companies, one of Israel’s largest private communications groups. Mr. Elovitch has served as the chairman of the board of directors of Eurocom Holdings and Eurocom Communications, our parent company, since 1985. Mr. Elovitch serves as the chairman of the board of directors of Bezeq and as a director and chairman of various companies of the Bezeq Group and the Eurocom Group. Mr. Elovitch also serves as a member of the board of directors of Space Communications Ltd., Satcom Systems Ltd., Satlink Ltd., Eurocom cellular communications Ltd., Eurocom Digital Communications Ltd. and other various companies within the Eurocom Group. Mr. Elovitch has served as chairman of the board of directors of B Communications since 2000. Mr. Elovitch is the brother of Mr. Yossef Elovitch, a director.

**Felix Cohen** was elected to serve as a director by our Board of Directors in February 2010. Mr. Cohen has served as the Chief Financial Officer of the Eurocom Group since 1988, and also serves as a director and/or officer of various other companies within the Eurocom Group, including Enlight Renewable Energy Ltd., Space-Communications Ltd. and D.M Engineering (3000) Ltd. Mr. Cohen also serves as a director of Bezeq and other companies within the Bezeq Group.

**Yossef Elovitch** has served as a director since 1993. Mr. Elovitch has served as director of Eurocom Communications since 1985. Mr. Elovitch serves as a director of various other companies in the Eurocom Group. Mr. Elovitch is the brother of Mr. Shaul Elovitch.

**Dudi Ezra** has served as an external director since August 2014. He has served as a financial officer in multiple companies of the Ituran group, including Carnet On Line Ltd., Hotas Holdings Ltd., Gear Protection Ltd and Hapoel Ironi Kiryat Shmona Football Club since 1996. From 1998 to 2004, Mr. Ezra served as a director of Ituran Location and Control Ltd., which is dual-listed on NASDAQ and the TASE. Mr. Ezra holds a B.B.A. degree in Accounting and Business from Baruch College of the City University of New York and is a certified public accountant in Israel and in the United States.

**Shoshana Shidlo** has served as an external director since August 2014. She has provided internal audit services to various organizations since 1996. Ms. Shidlo holds a B.A. degree in Accounting and Economics from Tel-Aviv University. She is a certified public accountant in Israel and a certified internal auditor in the United States.

**Anat Winner** has served as a director of our company since August 2001 and is a member of our audit committee. She served as a director of B Communications between October 2007 and August 2013. Ms. Winner has been self employed as a business advisor since July 2003 and served as a director of Magal Security Systems Ltd., publicly traded on the NASDAQ Global Market and TASE from 2003 to 2010. From October 2001 to July 2003, Ms. Winner served as chief executive officer and chief financial officer of Israel News Ltd. From 1999 to October 2001, Ms. Winner served as chief financial officer of DBS. Ms. Winner holds a B.A. degree in Accounting and Economics from Haifa University and has been a certified public accountant (Israel) since 1986.

## **Our Senior Management**

**Doron Turgeman** has served as our chief executive officer since October 2011 and previously had served as our deputy chief executive officer since October 2004 and as our chief financial officer since May 2001. Mr. Turgeman also serves as the chief executive officer of B Communications and as the chief financial officer of Eurocom Communications Ltd. Previously, Mr. Turgeman served as B Communications' chief financial officer and vice



president of finance from February 2010 until October 2011 and served as a member of its board of directors from January 2008 to February 2010. Turgeman also serves as a director of XTL Biopharmaceuticals Ltd. (NASDAQ: XTLB, TASE: XTL), Klein International Group Limited and MDG Real Estate Global Limited. Mr. Turgeman holds a B.A. degree in Economics and Accounting from the Hebrew University of Jerusalem and is a certified public accountant in Israel. Mr. Turgeman holds a B.A. degree in Economics and Accounting from the Hebrew University of Jerusalem and is a certified public accountant in Israel.

***Itzik Tadmor*** has served as our company's Principal Financial Officer since May 2015 and was our company's controller from September 2011 until May 2015. Prior to joining our company, he worked at PriceWaterhouseCoopers (PwC) for five years. Mr. Tadmor received a Bachelor's Degree in Accounting and Economics and an M.B.A. degree from Tel-Aviv University. Mr. Tadmor is also a Certified Public Accountant in Israel.

***Bezeq Group's Executive Management***

***Stella Handler*** was appointed as the chief executive officer of Bezeq on April 14, 2013. Ms. Handler has held several senior positions in Israel's communications sector, among them as chairperson of HOT from May 2011 until January 2013 and chief executive officer of our company (then known as 012 Golden Lines) from 2003 until January 2010. Ms. Handler holds B.A. and M.A. degrees in Economics as well as an M.B.A. from the Hebrew University of Jerusalem.

***Allon Raveh*** was appointed as the chief financial officer of Bezeq in October 2016. Mr. Raveh has held senior positions in the Ofer Group, first as VP Business Development of Israel Corporation, then as CFO of ZIM Shipping Services, and most recently as CFO of XT Holdings and Shipping (formerly "Ofer Shipping" and "Ofer Group Holdings"). Prior to these posts, Raveh spent six years with Paz Oil and the Bino Group, where he held such positions as CFO and VP Business Development. Raveh is a certified public accountant as well as a certified attorney, and started out with Prof. Itzhak Swary & Co. He holds a Master's degree in Finance, cum laude, from the London Business School, and a Bachelor's degree in Accounting and Law, cum laude, from Tel Aviv University.

***Ran Guron*** has served as the chief executive officer of Pelephone since November 2015. Previously, he served as the Deputy CEO and VP Marketing of Bezeq from March 2011 to October 2015. Before becoming Deputy CEO at Bezeq, he was VP Marketing – CMO at Bezeq for 5 years. From 2003 to 2005 Mr. Guron was VP Marketing at 013 Barak (currently 013 Netvision Ltd.) He serves as Mentor for Microsoft Ventures Accelerator Tel-Aviv program for startups. Mr. Guron is the founder of the Yair Guron Memorial Scholarship R&D Fund in the Arava region. Mr. Guron holds an M.B.A. degree and a B.A. degree in Economics and Business Administration from the Hebrew University of Jerusalem.

***Moti Elmaliach*** has served as the chief executive officer of Bezeq International since May 2014. He served as the CEO of Eurocom Digital Communications, which markets the Panasonic brands and products in Israel, from 2006 to 2014. Prior to that, he was the chief executive officer of the communications companies Telit Ltd. and Elgadphone Ltd. Mr. Elmaliach also serves on the board of directors of Satcom Systems Ltd., and is the Chairman of DM (3000) Engineering Ltd., a Eurocom Group communications company, and Tafnit Discount Ltd., an investment company. Mr. Elmaliach holds a B.Sc. degree in Industrial Engineering and an M.B.A. degree from Tel Aviv University

***Ron Eilon*** has served as the chief executive officer of DBS since August 2006. Mr. Eilon served as chief financial officer of Bezeq from 2003 to 2005, and as deputy chief executive officer of Bezeq from 2005 to 2006. From 1999 until 2002, he was the chief financial officer of Mirs. Mr. Eilon holds a B.A. in Economics and an M.B.A. degree from the Hebrew University of Jerusalem.

## **B. Compensation**

We have two executive officers, Doron Turgeman, our chief executive officer and Itzik Tadmor, our principal financial officer, and seven directors. Other than such officers, we have three additional employees who are engaged in management, financial and administrative activities. The aggregate direct compensation we paid to our directors and executive officers as a group (9 persons) for the year ended December 31, 2016 was NIS 2 million (approximately \$520,000). This amount includes directors compensation and expenses related to salaries, but does not include expenses such as business travel, professional and business association dues and expenses reimbursed to officers and other fringe benefits commonly reimbursed or paid by companies in Israel. We have entered into an arrangement with B Communications according to which our employees, including the chief executive officer and the principal financial officer will provide services to both companies and we pay one-third of their compensation and B Communications will pay two-third of their compensation.

As of December 31, 2016, no amount was reserved for pension, retirement, recreation payments and vacation or similar benefits for our directors and executive officers.

For so long as we qualify as a foreign private issuer, we are not required to comply with the proxy rules applicable to U.S. domestic companies, including the requirement to disclose information concerning the amount and type of compensation paid to our chief executive officer and chief financial officer, rather than on an aggregate, basis. Nevertheless, a recent amendment to the regulations promulgated under the Israeli Companies Law requires us to disclose the annual compensation of our five most highly compensated officers (or all the named executive officers if there are less than five) on an individual basis, rather than on an aggregate basis, as was previously permitted for Israeli public companies listed overseas. Under the Companies Law regulations, this disclosure is required to be included in the notice of our annual meeting of shareholders each year or in a public document that accompanies such notice, which we furnish to the SEC under cover of a Report of Foreign Private Issuer on Form 6-K. The Companies Law regulations permit us to refer to a report filed pursuant to the laws of the country in which our shares are listed for trading that includes the required information in lieu of its inclusion in the notice of annual meeting. Because of that disclosure requirement under Israeli law, we are including such information in this annual report, pursuant to the disclosure requirements of Form 20-F.

The following table includes information for the year ended December 31, 2016 concerning compensation for our Named Executive Officers. All amounts are in US dollars.

|   | Doron<br>Turgeman<br>(Chief<br>Executive<br>Officer) | Itzik<br>Tadmor<br>(Principal<br>Financial<br>Officer) |
|---|--|--|
| Annual fixed salary   | 137,300  | 37,060   |
| Retention Bonus (treated as salary costs in the company's financial statements).  | 52,000   | 2,150  |
| Annual and special Bonus (treated as salary costs in the company's financial statements).   | 22,000   | 3,900  |
| Car Expenses, including lease costs, gas and maintenance, provided to the officers (treated as management and general costs in our company's financial statements). | 8,000  | 4,700  |

1) The variable portion of Mr. Turgeman's compensation is an annual bonus of up to two months' salary, according to a bonus plan with milestones which will be effective for three years ending December 31, 2018:

- (a) 35% of the bonus will be paid if our company's securities are traded higher than the benchmarks for the respective year, but only an increase of at least 5% higher than the benchmark will entitle Mr. Turgeman to the bonus;
- (b) 35% of the bonus will be paid if our company or one of our publicly traded debentures receives a higher rating from a recognized credit rating agency, compared to the rating given in the previous year by the rating agency. A positive change in the rating outlook will entitle Mr. Turgeman to half of this bonus component;
- (c) 15% of the bonus will be paid if the company's securities' trading volume increases at least 20% higher than the previous year, on average; and

- (d) 15% of the bonus will be paid if the company duly files its financial reports and its annual reports with the SEC within the time schedule set by the Board of Directors and in an appropriate manner.

In June 2015, our shareholders approved a special one-time cash bonus of NIS 500,000 for Mr. Doron Turgeman, our Chief Executive Officer, in recognition of his significant role and contribution to the successful consummation of our \$800 million offering of 7 % Senior Secured Notes, which was completed in February 2014.

We currently pay to each of our external directors, as well as to our independent director, annual fees of annual fees of NIS 69,000 (currently equivalent to approximately \$18,000) and a per meeting attendance fee of NIS 2,500 (currently equivalent to approximately \$670). Such fees are paid based on the "Fixed" fees set forth in regulations promulgated under the Israeli Companies Law. According to the regulations, an external director (and our independent director) is entitled to 60% of the per meeting fee if he or she participated in the meeting by means of communication and not in person, and to 50% of the per meeting fee if resolutions were approved in writing, without convening a meeting. Our other non-employee directors do not receive compensation for their services on our board of directors or any committee of our board of directors. All of our non-employee directors are reimbursed for their expenses for each meeting of the board of directors.

In addition, our internal auditor, who is also deemed to be an "officer" in accordance with the Israeli Companies Law, received approximately NIS 28,800 for his services in 2016. Such costs are treated as management and general costs in our financial statements.

### **C. Board Practices**

According to the Israeli Companies Law and our articles of association, the management of our business is vested in our board of directors. The board of directors may exercise all powers and may take all actions that are not specifically granted to our shareholders. Our executive officers are responsible for our day-to-day management. The executive officers have individual responsibilities established by our chief executive officer and board of directors. Executive officers are appointed by and serve at the discretion of the board of directors, subject to any applicable agreements.

### **Election of Directors**

Our articles of association provide for a board of directors consisting of no less than two and no more than ten directors or such other number as may be determined from time to time at a general meeting of shareholders. Our current board of directors consists of six directors.

In accordance with our articles of association and the Israeli Companies Law, all of our directors (other than our external directors) are elected at annual meetings of our shareholders, which are required to be held at least once during every calendar year and not more than 15 months after the last preceding meeting. Except for our external directors, our directors are elected by a vote of the holders of a majority of the voting power represented and voting at such meeting and hold office until the next annual meeting of shareholders following the annual meeting at which they were appointed. The general meeting of shareholders may remove any director from office, other than an external director, by an ordinary resolution, subject to applicable law. Our board of directors may temporarily fill vacancies in the board of directors until the next general meeting at which directors are appointed, provided that the total number

of directors does not exceed the maximum number permitted under our articles of association. The board of directors is entitled to remove from office any director appointed by it.

The board of directors of an Israeli public company is required to determine that at least one or more directors will have “accounting and financial expertise,” as defined by regulations promulgated under the Israeli Companies Law. Our board of directors determined, accordingly, that at least two directors must have “accounting and financial expertise.” Our Board of Directors has further determined that Mr. Shaul Elovitch, Mr. Dudi Ezra, Mr. Felix Cohen, Ms. Shoshana Shidlo and Ms. Anat Winner have the requisite “accounting and financial expertise.”

As a controlled company within the meaning of the NASDAQ Stock Market Rules, we are exempt from the NASDAQ requirement regarding the nomination process of directors, and instead, follow Israeli law and practice, in accordance with which directors may be recommended by our board of directors for election by our shareholders. See Item 16G. “Corporate Governance - NASDAQ Exemptions for a Controlled Company.”

### **Potential Conflicts of Interest**

Some of our directors also serve in various capacities for entities affiliated with Eurocom Communications and its affiliates. These relationships may give rise to conflicts of interest from time to time relating to (i) contracts, (ii) corporate opportunities, and (iii) use of directors’ time and expertise. We have not adopted any formal plan or procedures to address such conflicts of interest and intend to review all related party transactions on a case-by-case basis. Under Israeli law, certain approvals are required for related party transactions (see below in this Item 6C. “Directors, Senior Management and Employees - Board Practices - Fiduciary Duties; Approval of Related Party Transactions under Israeli Law”).

## **External and Independent Directors**

### *External Directors*

Under the Israeli Companies Law, companies incorporated under the laws of the State of Israel whose shares have been offered to the public are required to appoint at least two external directors. The external directors must meet certain statutory requirements of independence.

At least one of the external directors must have “accounting and financial expertise” and any other external director must have “accounting and financial expertise” or “professional qualification,” as such terms are defined by regulations promulgated under the Israeli Companies Law.

The external directors are elected for their first term of office by shareholders at a general meeting, provided that either:

The majority of shares voting on the matter (not including abstentions), including at least a majority of the shares of the non-controlling shareholders (and of shareholders who do not have a personal interest in the election of the external director as a result of their relationship with the controlling shareholder) voting on the matter, vote in favor of the external director; or

The majority of shares voting on the matter (not including abstentions) vote in favor of the external director and the total number of ordinary shares held by non-controlling shareholders (and of shareholders who do not have a personal interest in the election of the external director as a result of their relationship with the controlling shareholder) that voted against the election of the external director does not exceed 2% of all of the voting rights in the company.

In general, external directors serve for a three-year term and may be reelected to two additional three-year terms if one of the following conditions is met:

One or more shareholders holding at least 1% of the voting rights in the company nominated the external director for an additional term of office and the appointment was approved by a majority of the shares voting on the matter, not including votes of controlling shareholders or shareholders who have a personal interest in the election of the external director as a result of their relationship with the controlling shareholder; and provided that the total number



of shares held by non-controlling persons and by persons who have no personal interest in the appointment of the external director as a result of their relationship with the controlling shareholder, who voted in favor of the election of the nominee, exceeds 2% of the voting rights in the company; or

The board of directors proposed the nominee for an additional term of office, and the election was approved by the general meeting of shareholders by the majority required for the election of an external director for a first term of office, as described above.

External directors can be removed from office only by the same special percentage of shareholders as can elect them, or by a court, and then only if the external directors cease to meet the statutory qualifications with respect to their appointment or if they violate their duty of loyalty to the company. If an external directorship becomes vacant, the board of directors is required under the Israeli Companies Law to convene a shareholders meeting immediately to appoint a new external director.

Each committee of the board of directors that is authorized to exercise powers vested in the board of directors must include at least one external director, and the audit committee and compensation committee must include all the external directors. An external director is entitled to compensation as provided in regulations adopted under the Israeli Companies Law and is otherwise prohibited from receiving any other compensation, directly or indirectly, in connection with such service.

Mr. Dudi Ezra and Ms. Shoshana Shidlo each serve as an external director pursuant to the provisions of the Israeli Companies Law for a third three-year term until August 2017. Both have “accounting and financial expertise,” as such term is defined under the Israeli Companies Law.

### *Independent Directors*

In general, NASDAQ Stock Market Rules require that a NASDAQ-listed company have a majority of independent directors on its board of directors and its audit committee must consist solely of independent directors, as defined under NASDAQ Stock Market Rules. Because Eurocom Communications own more than 50% of our ordinary shares, we are considered a “controlled company” within the meaning of NASDAQ Stock Market Rules. Accordingly, we are exempt from certain requirements under NASDAQ Stock Market Rules, such as the requirement to have a majority of independent directors on our board of directors. If the “controlled company” exemption would cease to be available to us under the NASDAQ Stock Market Rules, we may instead elect to follow Israeli law and would not be required to elect any additional independent directors.

Pursuant to the Israeli Companies Law, a director may be qualified as an independent director if such director is either (i) an external director; or (ii) a director who complies with the following requirements: (y) he or she is eligible for nomination as an external director and the audit committee has approved such eligibility; and (z) he or she has not acted as a director of the company for a period exceeding nine consecutive years.

Our board of directors has determined that each of Mr. Dudi Ezra and Ms. Shoshana Shidlo (both external directors under Israeli law) and Ms. Anat Winner qualifies as an independent director under the requirements of the SEC, NASDAQ and Israeli law.

### **Audit Committee**

Under the Israeli Companies Law, the board of directors of any public company must establish an audit committee. The audit committee must consist of at least three directors, must include all of the external directors and must have a majority of independent directors, as such terms are defined in the Israeli Companies Law. The audit committee may not include the chairman of the board of directors, any director employed by the company or by the controlling shareholder of the company or by a company controlled by the controlling shareholder or any director who provides services on a regular basis to the company or the controlling shareholder or a company controlled by a controlling shareholder, or a director that is financially dependent on the controlling shareholder, or a controlling shareholder or any of the controlling shareholder’s relatives.

Our audit committee also serves, in compliance with the Israeli Companies Law and Israeli Companies Regulations (Provisions and Conditions regarding the Financial Statements’ Authorization Process), 2010 as the committee of our board of directors that is required to examine our financial statements.

In addition, the NASDAQ Stock Market Rules require us to establish an audit committee comprised of at least three members, all of whom must be independent directors, each of whom is financially literate and satisfies the respective “independence” requirements of the SEC and NASDAQ and one of whom has accounting or related financial management expertise at senior levels within a company.

Our audit committee assists our Board of Directors in overseeing the accounting and financial reporting processes of our company and audits of our financial statements, including the integrity of our financial statements, compliance with legal and regulatory requirements, our independent registered public accountants’ qualifications and independence, the performance of our internal audit function and independent registered public accountants, finding any defects in the business management of our company and proposing to our Board of Directors ways to correct such defects, approving related-party transactions as required by Israeli law, and such other duties as may be directed by our Board of Directors. The role of our audit committee also includes the determination of whether certain related party transactions are regarded as material, extraordinary, or insignificant, the review of the internal audit program and the operation of the internal auditor, as well as setting procedures for whistleblower protection.

Our audit committee consists of three members of our Board of Directors who satisfy the respective “independence” requirements of the SEC, NASDAQ and Israeli law for audit committee members. Our audit committee is currently composed of Mr. Ezra, Ms. Shidlo, and Ms. Winner. Our Board of Directors has determined that Ms. Winner qualifies as an audit committee financial expert. The audit committee meets at least once each quarter. Our audit committee charter is available on our website at [www.igld.com](http://www.igld.com).

### **Compensation Committee**

Our Board of Directors has established a Compensation Committee consisting of our three external directors (within the meaning of the Israeli Companies Law) who are also the members of our audit committee. The three members satisfy the “independence” requirements of the SEC, NASDAQ and Israeli law for audit committee members. Pursuant to a recent amendment to the Israeli Companies Law (the “Compensation Amendment”), which became effective on December 12, 2012, a compensation committee must be comprised of no fewer than three members and must include all of the external directors, whom must also constitute a majority of its members. All other members of the compensation committee must be directors who receive compensation that is in compliance with regulations promulgated under the Israeli Companies Law. In addition, the chairperson of the compensation committee must be an external director. Directors who are not qualified to serve on the audit committee may not serve on the compensation committee.

Under the Compensation Amendment, the compensation committee is responsible for: (i) making recommendations to the board of directors with respect to the approval of the compensation policy applicable to the company's office holders and any extensions thereto. The compensation policy must be based on those considerations, must include those provisions and needs to reference those matters as are detailed in the Israeli Companies Law; (ii) providing the board of directors with recommendations with respect to any amendments or updates to the compensation policy and periodically reviewing the implementation thereof; (iii) reviewing and approving arrangements with respect to the terms of office and employment of office holders; and (iv) determining whether or not to exempt a transaction with a candidate for chief executive officer from shareholder approval.

Pursuant to the Compensation Amendment, our Compensation Committee adopted a compensation policy and will be required to approve our compensation policies at least once every three years. The compensation policy was approved by our board of directors, after considering the recommendations of our Compensation Committee, and by our shareholders by a special majority in accordance with the Compensation Amendment. On June 16, 2016, an amended compensation policy was approved by our shareholders.

### **Internal Auditor**

Under the Israeli Companies Law, the board of directors of a public company must appoint an internal auditor nominated by the audit committee. The role of the internal auditor is, among other things, to examine whether a company's actions comply with applicable law and orderly business procedure. The internal auditor must meet certain statutory requirements of independence. In determining the ownership or voting interest of a person, Israeli law is expansive and aggregates that person's direct and indirect holdings, including the holdings of certain affiliates, relatives and associates. Mr. Ilan Chaikin currently serves as our internal auditor.

### **Exculpation, Indemnification and Insurance of Directors and Officers**

#### *Indemnification of Office Holders*

Under the Israeli Companies Law and the Israeli Securities Law, 5738-1968, or the Israeli Securities Law, a company may, if permitted by its articles of association, indemnify an office holder for any of the following liabilities or expenses that they may incur due to an act performed or failure to act in his or her capacity as the company's office holder, either pursuant to an undertaking given by the company in advance of the act or following the act:

monetary liability imposed on the office holder in favor of a third party in a judgment, including a settlement or an arbitral award confirmed by a court. However, if a company undertakes to indemnify an office holder in advance of such a liability, the undertaking must be limited to foreseeable events based on the company's activities when the company undertook such indemnification, and to amounts or standards that the board of directors has determined are reasonable under the circumstances;

reasonable litigation expenses, including attorneys' fees, expended by an office holder as a result of an investigation or proceeding instituted against the office holder by a competent authority, provided that such investigation or proceeding concludes without the filing of an indictment against the office holder and either: no financial liability was imposed on the office holder in lieu of criminal proceedings, or a financial liability was imposed on the office holder in lieu of criminal proceedings with respect to an alleged criminal offense that does not require proof of criminal intent;

reasonable litigation expenses, including attorneys' fees, expended by the office holder or for which the office holder is charged by a court:

in an action brought against the office holder by the company, on behalf of the company or on behalf of a third party,

in a criminal action from which the office holder is acquitted, or

in a criminal action in which the office holder is convicted of a criminal offense which does not require proof of criminal intent.

a payment that the office holder is obligated to make to an injured party pursuant to Section 52(54)(a)(1)(a) of the Israeli Securities Law, and expenses that the office holder incurred in connection with an administrative proceeding under the Israeli Securities Law, including reasonable litigation expenses and attorney fees.

#### *Insurance of Office Holders*

A company may, if permitted by its articles of association and subject to the conditions set forth in the Israeli Companies Law, obtain insurance for an office holder against liabilities incurred in his or her capacity as an office holder. These liabilities include a breach of duty of care to the company or a third-party, a breach of duty of loyalty and any monetary liability imposed on the office holder in favor of a third-party.

In addition, under the Israeli Securities Law, a company may, if permitted by its articles of association, obtain insurance for an office holder against liabilities incurred in his or her capacity as an office holder in connection with a payment that the office holder is obligated to make to an injured party pursuant to Section 52(54)(a)(1)(a) of the Israeli Securities Law, and expenses that the office holder incurred in connection with an administrative proceeding under the Israeli Securities Law, including reasonable litigation expenses and attorney fees.

#### *Exculpation of Office Holders*

Under the Israeli Companies Law, a company may, if permitted by its articles of association, also exculpate an office holder from a breach of duty of care in advance of that breach. A company may not exculpate an office holder from a breach of duty of loyalty towards the company or from a breach of duty of care concerning dividend distribution or a purchase of the company's shares by the company or other entities controlled by the company.

#### *Limitations on Exculpation, Insurance and Indemnification*

Under the Israeli Companies Law, a company may indemnify or insure an office holder against a breach of duty of loyalty only to the extent that the office holder acted in good faith and had reasonable grounds to assume that the action would not prejudice the company. In addition, a company may not indemnify, insure or exculpate an office holder against a breach of duty of care if committed intentionally or recklessly (excluding mere negligence), or committed with the intent to derive an unlawful personal gain, or for a fine or forfeit levied against the office holder in connection with a criminal offense. According to the Israeli Administrative Enforcement Law, a company cannot insure or indemnify an office holder for an administrative enforcement procedure, regarding payments to victims of the infringement or for expenses expended by the officer with respect to certain proceedings held concerning him or her, including reasonable litigation expenses and legal fees.

Pursuant to the Israeli Companies Law, exculpation of, procurement of insurance coverage for, and an undertaking to indemnify or indemnification of, our office holders must be approved by our Compensation Committee and our Board of Directors and, if the office holder is a director or the chief executive officer, also by our shareholders.

Our articles of association allow us to insure, indemnify and exempt our office holders to the fullest extent permitted by law, subject to the provisions of the Israeli Companies Law and Israeli Securities Law. We maintain a directors' and officers' liability insurance policy with liability coverage of up to \$10 million per claim and in the aggregate. We have undertaken to indemnify all of our directors and officers to the extent permitted by law, in an aggregate amount for all directors and officers not to exceed \$10,000,000.

#### **D. Employees**

On December 31, 2016, we had five employees who also provided services to B Communications. Our direct employees are all located in Israel and are not represented by any labor union. Since our inception, we have not experienced any labor-related work stoppages and believe that our relations with our employees are good.

As of December 31, 2016, the Bezeq Group employed 11,901 persons, of whom 5,649 persons were employed by Bezeq, 2,594 persons were employed by Pelephone, 1,905 persons were employed by Bezeq International and 1,753 persons were employed by DBS.

As of December 31, 2015, the Bezeq Group employed 12,615 persons, of whom 5,986 persons were employed by Bezeq, 2,679 persons were employed (or otherwise retained) by Pelephone, 1,966 persons were employed by Bezeq International and 1,984 persons were employed by DBS.

As of December 31, 2014, the Bezeq Group employed 12,939 persons, of whom 5,964 persons were employed by Bezeq, 3,001 persons were employed (or otherwise retained) by Pelephone, 1,932 persons were employed by Bezeq International and 2,042 persons were employed by DBS.

Israeli labor laws govern the length of the workday, minimum wages for employees, procedures for hiring and dismissing employees, determination of severance pay, annual leave, sick days and other conditions of employment. Israeli law generally requires severance pay upon the retirement or death of an employee or termination of employment by our company. For those of our employees who are entitled to a pension arrangement, we fund future severance pay obligations by contributing to managers' insurance or other pension arrangements. A provision in our financial statements covers severance pay to those employees who are not entitled to managers' insurance or other pension arrangements. Furthermore, we and our employees are required to make payments to the National Insurance Institute, which is similar to the U.S. Social Security Administration. Such amounts also include payments by the employee for health insurance.

Labor relations with Bezeq's employees involved in fixed-line communications are regulated by the collective agreements among Bezeq, the workers representatives and the Histadrut, as well as by personal contracts. Additionally, expansion orders to certain general collective agreements apply Bezeq's employees, such as cost-of-living increment agreements.

## **E. Share Ownership**

As of April 26, 2017, none of our directors and executive officers beneficially owns any of our ordinary shares, other than Mr. Shaul Elovitch, the chairman of our board of directors. Mr. Shaul Elovitch, Mr. Yossef Elovitch, Eurocom Communications and Eurocom Holdings (1979) Ltd. are the beneficial owners of 11,740,701 of our ordinary shares. Eurocom Communications Ltd., or Eurocom Communications, holds 10,615,701 of our ordinary shares directly. Eurocom Communications is 99.33% owned by Eurocom Holdings (1979) Ltd., or Eurocom Holdings, and 0.67% by Mr. Shaul Elovitch. Mr. Shaul Elovitch and Mr. Yossef Elovitch own 80% and 20%, respectively, of Eurocom Holdings (Mr. Shaul Elovitch and Mr. Yossef Elovitch own 75% and 25%, respectively, of Eurocom



Holdings' management shares). Accordingly, Mr. Shaul Elovitch may be deemed to have the sole voting and dispositive power as to our ordinary shares held of record by Eurocom Communications. Mr. Shaul Elovitch may also be deemed to be the beneficial owner of 26,893 ordinary shares held of record by his wife, Mrs. Iris Elovitch. 1,125,000 of our ordinary shares are held directly by a joint account of Messrs. Shaul and Yossef Elovitch.

Mr. Shaul Elovitch also serves as the chairman of the board of directors of B Communications, Eurocom Communications and Eurocom Holdings. Accordingly, Mr. Shaul Elovitch may be deemed to have the sole voting and dispositive power over our ordinary shares beneficially owned by Eurocom Communications. See also Item 7A. "Major Shareholders and Related Party Transactions - Major Shareholders."

**ITEM 7. MAJOR SHAREHOLDERS AND RELATED PARTY TRANSACTIONS****A. Major Shareholders**

The following table sets forth certain information as of April 26, 2017, regarding the beneficial ownership by all shareholders known to us to own beneficially 5% or more of our ordinary shares:

| Name   | <b>Number of<br/>Ordinary<br/>Shares<br/>Beneficially<br/>Owned <sup>(1)</sup></b> | <b>Percentage<br/>of<br/>Ownership<br/><sup>(2)</sup></b> |   |
|--|--|---|---|
| Messrs. Shaul and Yossef Elovitch, through Eurocom Communications <sup>(3)</sup> | 11,740,701   | 61.14   | % |
| Yelin Lepidot <sup>(4)</sup>   | 1,511,131  | 7.87  | % |

Beneficial ownership is determined in accordance with the rules of the Securities and Exchange Commission and generally includes voting or investment power with respect to securities. Ordinary shares relating to options currently exercisable or exercisable within 60 days of the date of this table, are deemed outstanding for computing (1) the percentage of the person holding such securities but are not deemed outstanding for computing the percentage of any other person. Except as indicated by footnote, and subject to community property laws where applicable, the persons named in the table above have sole voting and investment power with respect to all shares shown as beneficially owned by them.

(2) The percentages shown are based on 19,203,186 ordinary shares issued and outstanding (which exclude 5,862,615 ordinary shares held as treasury shares) as of April 26, 2017.

(3) Mr. Shaul Elovitch, Mr. Yossef Elovitch, Eurocom Communications and Eurocom Holdings (1979) Ltd. are the beneficial owners of 11,740,701 of our ordinary shares. Eurocom Communications Ltd., or Eurocom Communications, holds 10,615,701 of our ordinary shares directly. Eurocom Communications is 99.33% owned by Eurocom Holdings (1979) Ltd., or Eurocom Holdings, and 0.67% by Mr. Shaul Elovitch. Mr. Shaul Elovitch and Mr. Yossef Elovitch own 80% and 20%, respectively, of Eurocom Holdings (Mr. Shaul Elovitch and Mr. Yossef Elovitch own 75% and 25%, respectively, of Eurocom Holdings' management shares). Accordingly, Mr. Shaul Elovitch may be deemed to have the sole voting and dispositive power as to our ordinary shares held of record by Eurocom Communications. Mr. Shaul Elovitch may also be deemed to be the beneficial owner of 26,893 ordinary shares held of record by his wife, Mrs. Iris Elovitch. 1,125,000 of our ordinary shares are held directly by a joint account of Messrs. Shaul and Yossef Elovitch.

Based on a Schedule 13G/A filed by Dov Yelin, Yair Lapidot and Yelin Lapidot Holdings Management Ltd. on (4)February 8, 2017. Their address is 50 Dizengoff St., Dizengoff Center, Gate 3, Top Tower, 13th floor, Tel Aviv 64332, Israel.

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

In 2014, Eurocom Communications sold 1,645,000 of our ordinary shares in private transactions, and it also sold 925,000 of our ordinary shares to a joint account of Messrs. Shaul and Yossef Elovitch. Eurocom reported sales of our ordinary shares in its Schedules 13D/A filed on December 4, 2015, January 15, January 22, and June 3, 2016. According to the reports, in 2015, Eurocom sold 573,310 of our ordinary shares and in 2016, Eurocom sold 1,205,914 of our ordinary shares in private transactions in Israel.

### **Major Shareholders Voting Rights**

Our major shareholders do not have different voting rights.

### **Record Holders**

Based on a review of the information provided to us by our transfer agent, as of April 25, 2017, there were 24 holders of record of our ordinary shares, of which 20 record holders holding approximately 57% of our ordinary shares had registered addresses in the United States. These numbers are not representative of the number of beneficial holders of our shares nor are they representative of where such beneficial holders reside since many of these ordinary shares were held of record by brokers or other nominees (including one U.S. nominee company, CEDE & Co., which held approximately 34.8% of our outstanding ordinary shares as of such date). According to the information available to us, we believe that we have approximately 968 beneficial holders in the United States.

## **B. Related Party Transactions**

We receive and provide various services and products to and from related parties at market rates and in the ordinary course of business. Other than the transactions described below, none of our related party transactions are material to us or to our related parties. If a related party wishes to supply products or services to us, we generally obtain a bid from a third party to enable us to determine whether the related party's bid is on arm's-length terms. Any of such transaction is subject to the approval of our audit committee and our board of directors (and in some circumstances, our shareholders). In addition, generally we will not purchase a particular type of product or service solely from related parties, but will also have non-related vendors. Prices offered by non-related vendors are compared to those offered by related parties to ensure that the related parties are offering arm's length terms.

In the ordinary course of business, some of our subsidiaries and affiliates engage in business activities with each other. Such business activities are primarily among Bezeq, other Bezeq Group companies and other Eurocom Group companies, such as Eurocom Digital, Eurocom Cellular, Spacecom, Satcom, and to a lesser extent other affiliated companies. Such business activities primarily relate to the provision, purchase or sale of communications and digital services and products, including the provision of satellite or broadcasting services, cellular and electronic products and equipment, and Internet and telephony services. The transactions among these related parties are made at prices and on terms equivalent to those charged in transactions with unrelated parties under similar conditions.

### **Relationship with Eurocom Communications and its affiliates**

Messrs. Shaul Elovitch, chairman of our board of directors, and his brother Yossef Elovitch, a director of our company, also serve as directors of Eurocom Communications and various of its affiliates, together indirectly hold a majority of the outstanding shares of Eurocom Communications. During the past three years, we have entered into transactions with Eurocom Communications and several of their affiliates, referred to as the Eurocom Group. We believe that the transactions with Eurocom Communications and its affiliates described below could have been entered into on comparable terms with unrelated parties and on an arm's length basis. Set forth below are summary descriptions of certain agreements, relationships and transactions between us and members of the Eurocom Group.

### ***Certain Related Party Transactions***

We and B Communications lease our principal offices from Eurocom Communications for an annual rent of NIS 59,000 (approximately \$15,000) for each company. In addition, Eurocom Real Estate Ltd. provides us and B Communications with parking spaces for NIS 8,000 (approximately \$2,000) a year for each company. Eurocom Digital provides us and B Communications with additional services, such as computing services for an annual fee of NIS 12,000 (approximately \$3,000) for each company. All of these expenses are divided one-third to us and

two-thirds to Internet Gold.

Eurocom Communications Ltd. provides us and B Communications with legal services in an annual sum of NIS 96,000 for each company.

In addition, we receive and render various services and products to and from related parties at market rates and in the ordinary course of business. None of these transactions are material to us or to our related parties. If a related party wishes to supply products or services to us, we generally obtain a bid from a third party to enable us to determine whether the related party's bid is on arm's-length terms. Any of such transaction is subject to the approval of our Audit Committee and our board of directors (and our shareholders, if requires). In addition, generally we will not purchase a particular type of product or service solely from related parties, but will also have non-related vendors. Prices offered by non-related vendors are compared to those offered by related parties to ensure that the related parties are offering arm's length terms.

***Registration Rights Agreement with Eurocom Communications***

In July 1999, we entered into a registration rights agreement with Euronet Communications (which was subsequently assigned to Eurocom Communications) and our other than existing shareholders granting them the right to register their ordinary shares under the U.S. Securities Act. The registration rights include unlimited rights to request that their shares be included in any underwritten public offering of our ordinary shares (excluding any registration of employees' shares on Form S-8 or a similar form). Additionally, as of February 4, 2000, the holders of a majority of such shares are entitled to demand, up to three times in aggregate, that we register their shares. As of August 4, 2000, the holders of a majority of these shares are also entitled to request that we effect a registration of their shares on a shelf registration statement once in any 12-month period, up to three times in aggregate. All expenses incurred in connection with such registrations, other than underwriters' and brokers' discounts and commissions, will be payable by us.

Pursuant to the registration rights agreement, on December 9, 2015 we filed a registration statement on Form F-3 including a prospectus relating to the resale, from time to time, by Eurocom Communications, as the selling securityholder, of up to 2,880,000 of our ordinary shares. The registration statement became effective on December 14, 2015.

On January 30, 2017, we filed on behalf of Messrs. Shaul and Yossef Elovitch a registration statement on Form F-3 and a prospectus relating to the resale, from time to time, by Messrs. Shaul and Yossef Elovitch, as the selling securityholders, of up to 925,000 of our ordinary shares. The registration statement became effective on January 30, 2017.

#### ***Execution Services Agreement with Eurocom Capital Finance Ltd.***

In November 2007, we entered into an execution services agreement with Eurocom Capital Finance Ltd., or Eurocom Capital, which is controlled by Mr. Shaul Elovitch, our controlling shareholder and the chairman of our Board of Directors, under which Eurocom Capital provides us with various financial services. Under the agreement, Eurocom Capital handles the execution of investments in our capital, pursuant to direct instructions from our chief executive officer. In consideration for these services, we agreed to pay Eurocom Capital fees which are customary for such agreements and on market terms. Eurocom Capital has agreed to act to preserve our financial resources according to a policy that will be set by our management and approved by the board of directors. We paid Eurocom Capital NIS 615,000, NIS 433,000 and NIS 338,000 (approximately \$88,000) for the years ended December 31, 2014, 2015 and 2016, respectively.

#### **Agreements with B Communications**

##### *Registration Rights Agreement with B Communications*

We and B Communications have entered into a registration rights agreement under which B Communications has granted us the right to register the ordinary shares of B Communications that we hold under the U.S. Securities Act. Under the registration rights agreement, we have “demand” registration rights that allow us, at any time after one year following the initial public offering in the United States of B Communications, to request to register under the U.S. Securities Act, some or all of the ordinary shares of B Communications that we own. We are entitled to an aggregate of five demand registrations. B Communications is not required to effect any demand registration unless such demand registration request is for a number of ordinary shares with a market value that is equal to at least \$7.5 million. B Communications is also not required to effect more than one demand registration during the first 12 months following its initial public offering in the United States or more than one demand registration during any 12-month period

thereafter. B Communications is not obligated to grant a request for a demand registration within 90 days of any other demand registration. We also have “piggyback” registration rights that allow us to include the ordinary shares of B Communications that we own in any public offering of equity securities initiated by B Communications (other than public offerings pursuant to registration statements on Forms F-4, S-8 or any other successor forms). The “piggyback” registration rights are subject to proportional cutbacks based on the manner of the offering and the identity of the party initiating such offering. B Communications has also granted us the right to request a shelf registration on Form F-3, provided that it shall be eligible to utilize a registration statement on such form, providing for an offering to be made on a continuous basis, but for no longer than one year without the consent of the audit committee of B Communications.

Under the registration rights agreement, B Communications has agreed to indemnify us against any losses or damages resulting from any untrue statement or omission of material fact in any registration statement or prospectus pursuant to which we sell ordinary shares, unless such liability arose in reliance upon and in strict conformity with information that we furnished in writing. B Communications will pay all expenses incident to any demand registration, and we will pay our respective portions of all underwriting discounts, commissions and fees attributable to the sale of our ordinary shares it owns under the registration rights agreement.

*Employee compensation costs*

We have entered into an arrangement with B Communications according to which our employees, including the chief executive officer and the principal financial officer provide services to both companies and we pay one-third of their compensation and B Communications pays two-thirds of their compensation.

*Recent Transactions in B Communications' Shares*

On June 17, 2014, we purchased 15,000 of B Communications' ordinary shares and on January 13, 2016, we sold 575,000 of B Communications' ordinary shares. We filed a Schedule 13D/A on January 14, 2016, to reflect these transactions that took place in Israel.

**Bezeq Group Interested Party Guidelines**

In March 2011, Bezeq's board of directors adopted guidelines and regulations to classify a transaction by Bezeq, any of its subsidiaries or affiliates of Bezeq with an interested party as an "insignificant transaction," which is not an "extraordinary transaction," as set out in the Israeli Securities Regulations (Annual Financial Statements), 2010. These guidelines and regulations are used to examine the scope of disclosure in periodic reports, prospectuses (including shelf offering reports) and immediate reports regarding a transaction of Bezeq, a company under its control and a subsidiary or affiliate of Bezeq with a controlling shareholder or in which the controlling shareholder has a personal interest.

From time to time, Bezeq and its subsidiaries or affiliates enter into "insignificant transactions," which are not extraordinary transactions, with an interested party in Bezeq or with related parties, including transactions for the sale or purchase of products and services, such as communication products and services, including fixed-line and cellular telephony handsets, software development products and services, maintenance services, voice-mail service agreements, rental transactions of real estate properties and advertising services.

In the absence of special, qualitative considerations under the specific circumstances, a transaction that is in Bezeq's regular course of business, is carried out in accordance with market conditions and has no material effect on the Bezeq Group, is deemed "insignificant" if all the following parameters exist:



The amount of the transaction does not exceed NIS 10 million;

Bezeq is not required to issue an immediate report for the transaction under applicable law; and

The transaction does not involve employment terms (within the meaning of the Israeli Companies Law) of an interested party or any relative thereof.

According to the Israeli Companies Law, Bezeq's audit committee will review the parameters set out above and the need to update them on a yearly basis, prior to the publication of Bezeq's reports. Bezeq's board of directors may, from time to time and at its discretion, amend the parameters for an "insignificant transaction." In general, each transaction is tested separately for "insignificance." Nevertheless, separate transactions that are part of the same continuing transaction or very similar transactions that are carried out routinely and repeatedly, will be tested as one transaction on an annual basis for "insignificance," provided the scope of the transaction does not exceed NIS 10 million. In 2010, 2011 and 2012, the Bezeq Group entered into "insignificant transactions" with related parties of Bezeq Group or entities in which its controlling shareholder has a personal interest as described above.

In accordance with a recent amendment to the Israeli Companies Law, Bezeq's audit committee has determined that transactions of Bezeq or its subsidiaries (including DBS) with Bezeq's controlling shareholders or in which Bezeq's controlling shareholders have a personal interest, must be approved following a competitive process, which includes approaching three competitors that provide a similar service or product (subject to certain exceptions). The audit committee has determined standards for conducting such competitive process and certain types of transactions for which a different approval procedure shall apply.

**Bezeq Group Transactions Deemed to be Significant**

| Item | Approval date of the general meeting (after approval of the Bezeq Group's audit committee and Board of Directors), unless otherwise stated.  | Nature of the transaction  | Amount of the transaction  |
|------|--|--|--|
| (1)  | May 8, 2013  | Approval of Bezeq's vote at the general meeting of DBS in favor of DBS's agreement with Space Communications Ltd. ("Space Communications") for leasing space segments, in which the original agreement will be amended and extended. The agreement is valid until the end of 2028.   | A total amount of up to USD 227 million for the entire agreement period (up to December 31, 2018) net including discounts for satellite segments leased in the existing agreement) |
| (2)  | June 13, 2013  | This agreement was valid in the reporting year and up to December 31, 2016. On February 12, 2017 and February 14, 2017, Bezeq's audit committee and board of directors, respectively, approved an amendment/addendum to this agreement, which will be presented to the general meeting for approval on April 3, 2017.<br>The amendment to Bezeq's three-year agreement with Eurocom Communications Ltd. ("Eurocom Communications") for ongoing management and consultation services valid until May 31, 2016, unless one of the parties announces its intention to terminate the agreement with three months' notice. This agreement was valid in the reporting year and up to May 31, 2016. | NIS 5.5 million per year   |
| (3)  | November 6, 2013   | Amendment and extension of the agreement between DBS and Eurocom Digital Communications Ltd. ("Eurocom") and Advanced Digital Broadcast SA ("ADB") for the purchase of YesMaxTotal3 converters, for a period up to December 31, 2016.  | The total cost will be USD 10 million per year   |
|      | Approved by Bezeq's Board of Directors in accordance with the Companies Regulations (Relief in Transactions with Interested Parties), 2000 ("the Relief Regulations for Transactions with Interested Parties") |  |  |

| Item | Approval date of the general meeting (after approval of the Bezeq Group's audit committee and Board of Directors), unless otherwise stated. | Nature of the transaction  | Amount of the transaction  |
|------|---|--|--|
|      |   |  | The total cost is comprised of:  |
|      |   |  | A. Total cash of NIS 680 million                                       |
|      |   |  | B. Total cash of up to NIS 200 million (subject to certain conditions) |
|      |   |  | C. Total cash of up to NIS 170 million (subject to certain conditions) |
| (4)  | March 23, 2015  | Approval of Bezeq's acquisition agreement with Eurocom DBS Ltd. ("Eurocom DBS") whereby Bezeq will acquire the entire holdings of Eurocom DBS in DBS shares DBS and all the shareholder loans provided by Eurocom DBS to DBS (including acceptance of the terms established by the Antitrust Commissioner's in his approval of the merger on March 26, 2014, both by Bezeq and by DBS, and announcement of the exercise of Bezeq's option for the allotment of 6,221 DBS shares, at no cost, representing 8.6% of the share capital of DBS). |  |
| (5)  | October 19, 2015  | Approval of Bezeq's vote at the general meeting of shareholders of DBS in favor of DBS's agreement with Eurocom and ADB for the order of yesMaxTotal3 converters, under the existing agreement, until December 31, 2017  | Total cost of USD 14 million   |
| (6)  | December 18, 2015   | Amendment to the framework agreement between Pelephone and Eurocom Cellular Communications Ltd., so that it will be extended to other products and brands, including related services for all products and its extension until December 31, 2018 (or three years after the acquisition date of any additional products or brands, whichever is earlier).   | Annual scope of up to NIS 50 million (for all the products)            |
| (7)  | June 30, 2016   | Extension of the amended agreement with Eurocom Communications Ltd. ("Eurocom Communications") for ongoing management and consultation services for Bezeq. The agreement is for three years, valid until May 31, 2019, unless one of the parties submits three-months' notice of termination of the agreement. This agreement between the parties is in continuation of the agreement approved on June 13, 2013, described in Item (2) above.  | NIS 6.4 million per year   |

A transaction with a controlling shareholder that is not an irregular transaction was valid in the reporting period:

| Date of approval of Bezeq's Board of Directors after receiving the approval of the audit committee | Nature of the transaction  | Amount of the transaction   |
|--|--|---|
| November 27, 2014  | Bezeq's agreement to bring forward payments with Eurocom, according to which DBS may advance, at the supplier's request, payments that are due, or will be due, to Eurocom for orders of converters. | Up to a total cost of USD 6 million<br><br>Approval for acquisition of up to USD 11.3 million (not including VAT)                                     |
| November 3, 2016   | Bezeq's agreement with Eurocom for the additional acquisition of up to 90,000 VTECH N VDSL routers, valid until June 30, 2017.   | In 2016, there were no acquisitions under this framework, however N VDSL routers were acquired in amounts that do not exceed the negligibility level. |

**C. Interests of Experts and Counsel**

Not applicable.

**ITEM 8. FINANCIAL INFORMATION**

**A. Consolidated Statements and Other Financial Information**

See the consolidated financial statements, including the notes thereto, beginning of page F-1 and the exhibits listed in Item 19 hereof and incorporated herein by this reference.

**Legal Proceedings**

The Bezeq Group is involved in certain legal and regulatory actions, all of which have arisen in the ordinary course of business, except for the matters described in the following paragraphs. We believe that the ultimate resolution of such

matters is unlikely to have a material adverse effect on the Bezeq Group's consolidated results of operations and/or financial condition, except as described below.

Our company, B Communications and five members of our Board of Directors have been named as respondents in a motion to certify a claim as a derivative claim instituted in the Tel Aviv District Court (Economic Affairs Division) on July 28, 2016. The plaintiff has alleged that NIS 113 million (approximately \$29 million) out of the dividends distributed by B Communications in May 2016 was distributed unlawfully as such amount was not included in its profit and loss report, and therefore does not qualify as a "surplus" that may be lawfully distributed as dividends under the Israeli Companies Law. In November 2016, we, B Communications and the respondent directors filed responses to the motion to certify indicating that the distribution complied with the distribution tests of the Companies Law and that the amount distributed as a dividend was derived from actual economic profits and was accordingly appropriate and permissible for distribution. The plaintiff filed an answer in February 2017 and a pretrial hearing was held on March 3, 2017, in which the court granted us permission to file an additional response and a supplementary expert opinion by April 26, 2017 in order to respond to the plaintiff's arguments and the plaintiff shall be allowed to respond by April 30, 2017.

We and the other parties to the litigation were instructed by the court to consider the possibility of a dialogue between us regarding the issues in dispute and to inform the court about the results of this dialogue and whether the parties want to set a date for an evidentiary hearing or whether they have any additional preliminary motions, by May 9, 2017. In light of the preliminary stage of the proceedings, no prediction of the outcome is not possible.

On December 28, 2016, B Communications received a “best judgment” tax assessment for the years 2011 and 2012 of approximately NIS 50 million (not including interest and linkage differentials). The Israeli Tax Authority is claiming that additional taxes are due with respect to the alleged capital gain generated from the capital reduction of Bezeq during the period from 2011 to 2013. B Communications disagrees with the position of the Tax Authority and believes that it has good arguments to support its position. Accordingly, B Communications filed an appeal and believes that the tax liability arising from this assessment, if any, will not be material.

## Bezeq

Bezeq's reporting policy is based on qualitative and quantitative considerations. Bezeq decided that the bar of amount materiality would be events affecting Bezeq's net profit by 5% or more according to its latest annual consolidated financial statements. Accordingly, this section describes legal proceedings involving NIS 80 million or more (approximately NIS 60 million of the net profit), and legal proceedings in which the amount claimed is not stated in the statement of claim, except in the case of a claim which prima facie does not reach the above amount bar (and all unless Bezeq believes the claim has other aspects and/or implications beyond its monetary amount). In regards to class actions, it is noted that submission of class actions in Israel does not involve payment of a fee deriving from the amount of the claim. Accordingly, the amount of a claim in claims of this type may be significantly higher than the scope of true exposure for those claims.

| <b>Date of Filing</b> | <b>Parties</b>                          | <b>Type of proceeding</b>         | <b>Description</b>  | <b>Original Amount of the Claim (NIS in millions)</b>   |
|-----------------------|---|-----------------------------------|---|---|
| A. January 2015       | Shareholder v. Bezeq and Bezeq Officers | Request to approve a class action | In an action filed in the Tel Aviv District Court (Economic Department) for compensation of shareholders for losses, which according to the claim, were caused by "omissions by Bezeq to report to the Tel Aviv Stock Exchange (TASE) and to conceal material information from the investors", relative to two significant and material issues: "Reduction of interconnection fees" and the "Reform in the wholesale market". | Approx. NIS 2 billion (based on the Shortage of Money Method) and, alternatively approx. NIS 1.1 billion (according to the Approx. Shortage of Money Method). |
|                       |   |                                   | The members of the represented group are divided into two separate groups: In regards to the reduction of interconnect fees - any person that purchased Bezeq shares (except the Respondents and/or their representatives) as of February 28, 2013 and held the shares until May 29, 2014; and in respect to the reform in the wholesale market - any person that acquired Bezeq shares (except the                           |   |

Respondents and/or their representatives) as of June 9, 2013 and held the shares (in whole or in part) until the date of submission of the claim or, alternatively, until January 15 to January 20, 2014.

As it emerges from Bezeq's reports to the public (and as indicated in the petition), Bezeq reported on these two matters via immediate reports to the public, as well as via its periodic reports (annual and quarterly reports), which included all the material and relevant information relative to these matters, and all reports were lawful.

The claim was filed in the Tel Aviv District Court against Bezeq, Mr. Shaul Elovitch, the controlling shareholder (indirectly) of Bezeq and Chairman of its Board of Directors, and Bezeq directors who voted for Bezeq's transaction under the application, as set out below ("the Respondents").

|               |             |   |   |     |
|---------------|-------------|---|---|-----|
| B. March 2015 | Shareholder | Motion for approval of a claim as a derivative claim, including a statement of derivative claim | According to the allegations in the application, Bezeq decided, through the Respondents, to enter into a transaction to purchase all the holdings and shareholders loans of Eurocom DBS (a company indirectly controlled by Bezeq's controlling shareholder) in DBS in return for NIS 680 million in cash and contingent considerations of a further NIS 370 million. | 502 |
|---------------|-------------|---|---|-----|

| Date<br>of<br>Filing | Parties              | Type of<br>proceeding                                       | Description   | Original<br>Amount of<br>the Claim<br>(NIS in<br>millions) |
|----------------------|----------------------|---|---|--|
| C. August<br>2015    | Customer<br>v. Bezeq | Action and<br>request to<br>approve it as<br>a class action | <p>The plaintiff claims that the consideration which is expected to be paid for the transaction is exorbitant and the decisions of the Respondents to enter into the transaction caused Bezeq great damage after they were in breach of their duty of care and fiduciary duties towards Bezeq and were negligent in their positions. The plaintiff also alleged that Bezeq's controlling shareholder violated his duty of fairness and that Bezeq was in breach of its duty of disclosure and reporting regarding the commitment of the trustee of Eurocom DBS' holdings in DBS to sell the holdings as from the end of March 2015.</p> <p>In view of the foregoing, the plaintiff requested that the court approve filing of a derivative claim on behalf of Bezeq against the Respondents for the damages allegedly incurred by Bezeq as a result of the Respondents' decisions with respect to the transaction of NIS 502 million.</p> <p>On January 26, 2017, the court approved submission of a revised motion by the plaintiff that includes further claims relating, among other things, to the independence of the parties advising Bezeq, alleged faults in the work of the Audit Committee, Board of Directors and general meeting, and alleged faults stemming from representation of Eurocom by entities serving as directors in Bezeq.</p> <p>In an action filed in in the Tel Aviv District Court it was alleged that Bezeq abused its position as a monopoly to price its services in a manner that limits the ability of its competitors to offer fixed-line telephony services at competitive prices, among other things, by offering its customers fixed-line telephony services at the lowest price charged for Internet infrastructure services only, i.e. for a critical input for the activity of its competitors, which operate using VoB technology. The plaintiff argued that the damage to the public resulting from the above was estimated by reviewing the difference between the fixed-line telephony market price and comparing it with the weighted hypothetical price that would be charged in a market with competition that would lead to a long-term reduction in prices. According to the plaintiff's claims, the members of the represented group are all fixed-line telephony service subscribers, whether provided by Bezeq or its competitors, including through VoB technology, as of January 15, 2011 until the date of filing the application.</p> <p>In November 2016, the court approved Bezeq's motion for a stay of</p> | 244  |



proceedings in the case for reasons of pending proceedings at the Antitrust Tribunal, which is deliberating issues of the same nature as those at the center of the approval application.

| Date of Filing   | Parties                        | Type of proceeding                                     | Description   | Original Amount of the Claim (NIS in millions) |
|------------------|--------------------------------|--|---|--|
| D. November 2015 | Customer v. Bezeq              | Action and motion for certification as a class action  | <p>In an action in the Central District Court it was alleged that Bezeq abused its position as a monopoly by "preventing and blocking competition in general and effective competition in the Israeli communication market", and acted to delay and prevent the wholesale market reform, thereby causing damage to the Israeli public and earning unreasonable profits only as a result of abusing its power as a monopoly. According to the plaintiffs' allegations, the damage caused by Bezeq to the communications market in Israel is expressed by Bezeq's excessive and unreasonable profits, and they wish to claim damages of NIS 800 million, which they allege is based on 10% of Bezeq's surplus operating income stemming from abuse of its monopolistic power. Accordingly, the plaintiffs set the amount of the claim at NIS 556 million, after the amount was reduced in another action (an application for certification of a class action dated August 2015, which is described in Section C above, for NIS 244 million for claimed abuse of monopolistic power and refers to the Antitrust Commissioner's decision).</p> <p>Another motion on the same matter that was filed against Bezeq in March 2016 was thrown out in May 2016 due to the similarity to the above motion. Subsequently, and for the court's approval, the above plaintiff filed a motion for certification of a class action on the same matter.</p> <p>In an action in the Tel Aviv District Court it was alleged that Bezeq was deceptive in offering a campaign to upgrade the Internet surfing speed to certain customers without any additional fee and it subsequently actually charged some of the customers.</p> | 556  |
| E. June 2016     | Customer v. Bezeq              | Action and motion for certification as a class action. | <p>On March 28, 2017, the plaintiff filed a motion to abandon the proceeding. On April 3, 2017, a ruling was rendered approving the petitioner's motion to withdraw the class action certification motion and dismissing the petitioner's personal claim.</p>   | 112  |
| F. August 2016   | A customer v. Bezeq and an ISP | Action and motion for certification as a class action  | <p>In an action in the Tel Aviv District Court it was alleged, among other things, that the defendants acted unlawfully with respect to the transfer of Internet subscribers from one ISP to another in that the subscriber is not disconnected immediately from the abandoned ISP and as a result is charged twice for the same service.</p>   | *  |

G. September  
2016

Cellcom  
and  
Partner

Opening order  
for declarative  
relief and  
orders for  
mandamus  
against Bezeq

In an action in the Tel Aviv District Court, the plaintiff asked the court to declare, among other things, that: (1) Bezeq is obligated to market those ISPs who are among the Applicants as part of the joint bundles marketed by Bezeq (“Reverse Bundle”) in an equal manner and in accordance with the Ministry’s instructions, and to instruct Bezeq to do so; (2) the obligations imposed on Bezeq with respect to the supply of managed wholesale broadband access include an obligation to install and connect customers of 013 Netvision and 012 Smile to Bezeq’s infrastructure up to the first socket in their home, and to instruct Bezeq to do so; and (3) Bezeq is obligated to allow the Applicants and/or any one of them to use the passive infrastructure that it owns and to instruct Bezeq to do so. \*

| Date of Filing                   | Parties   | Type of proceeding   | Description   | Original Amount of the Claim (NIS in millions)   |
|----------------------------------|---|--|---|--|
| H. August 2016 and December 2016 | Customer v. Bezeq   | Two actions together with motions for their certification as class actions | <p>Motions were filed in the Tel Aviv District Court and the Central District Court claiming that Bezeq charges a monthly payment of NIS 5.93 for "support and/or liability" as part of using its Internet infrastructure, unlawfully and without consent.</p> <p>Due to the similarity between the motions, the motion pending in the Central District Court was transferred to the Tel Aviv District Court and a motion was filed to strike out one of the actions.</p>   | <p>* One action for an unknown amount and the other for 160</p>  |
| I. February 2017                 | Customer v. Bezeq   | Two motions for certification as class actions                             | <p>On March 26, 2017, the Court ruled to strike out the consolidated motion (the motion from December 2016 in the amount of NIS 160 million).</p> <p>An action was filed in the Central District Court claiming that Bezeq collects payment from some of its customers for an antivirus service, while in practice it does not provide them with such service, and that it starts charging for provision of the service from signing of the agreement with the customers and not from actual provision of the service. Accordingly, the Applicant requests requiring Bezeq to compensate its customers that purchased the service and did not actually receive it for the damages incurred by them, including refunding of amounts collected for the service.</p> | <p>* There is no accurate estimation, estimated at NIS tens of millions.</p> <p>Amount of the additional action - 11</p> |
| J. February 2017                 | HOT v. the Ministry of Communications and others (including | Petition to the Supreme Court  | <p>It is noted that in the same month, another action together with a motion for certification as a class action was filed with the Jerusalem District Court on the same matter.</p> <p>A demand was made in the Supreme Court for a hearing regarding the wholesale market prices for HOT, inter</p>   | -  |

|               |   |   |  |  |
|---------------|---|---|--|--|
|               | Bezeq)  |   | alia, claiming that the prices which are expected to be fixed are lower than the cost price for HOT.   |  |
|               |   |   | The motion was made in the Tel Aviv District Court regarding Bezeq's B144 service, which enables businesses to advertise on the internet. Service on Bezeq was not effected with due process. According to the petitioner, the respondent unlawfully charge subscribers for certain services. Bezeq is studying the motion and is unable to evaluate its likelihood of success at the present stage. | The petitioner estimates the class action amount at NIS 1.11 billion (based on an estimate of 300,000 customers and compensation of NIS 3,700 per customer). |
| K. April 2017 | Customer v. Bezeq, its subsidiary, Walla! Communications Ltd., Yad2 and an advertising company owned by Walla | A motion for class action certification motion filed with the Tel Aviv District Court |  |  |

\*The amount of the claim is not indicated or the claim is not a financial claim.

*Legal proceedings which ended during the reporting period or by the date of publication of this report.*

| Date of Filing  | Parties   | Type of Proceeding  | Description   | Original Amount of the Claim (NIS in millions) |
|---|---|---|---|--|
| A. February 2012  | Claim against Bezeq, Pelephone and two other additional cellular companies        | Action and request to approve it as a class action                                    | In an action filed in the District Court (Jerusalem) the plaintiffs alleged that the Respondents do not offer the disabled members of the public accessible handsets and services in a fitting manner, and that they are therefore in breach of the law and the regulations.<br><br>In January 2014, a decision was made with the consent of the parties whereby the claim will be discussed together with another claim on the same matter, which was filed against other communication companies.   | 361  |
| B. July 2012<br><br>November 2012<br><br>(Two claims that were unified) | Two shareholders v. Bezeq officers (including those that are no longer in office) | Derivative claim and request to approve a derivative claim<br><br>Declarative reliefs | In April 2016, a compromise settlement in this case was validated as a court ruling thus concluding the proceeding.<br><br>In an action filed in the Tel Aviv District Court (Economic Department) It was claimed that members of Bezeq's Board of Directors were in breach of their duty of caution and fiduciary obligations towards Bezeq, by approving loans which were not used for Bezeq's benefit and were designated for the distribution of dividends, and were therefore in a conflict of interests. Alternatively, the Plaintiff alleged that the resolutions passed by the Board of Directors with respect to the aforementioned loans created a tax exposure for Bezeq due to the fact that the financing expenses are not recognized for tax purposes. Inter alia, declarative relief was requested for nullification of loans taken by Bezeq from the date of the change of control t, and restitution of dividends by Bezeq's controlling shareholder.<br><br>On September 17, 2014, a decision was issued rejecting the two claims, finding that it was not proven that the respondents (officers) made their decisions in breach of their duty, or that they deviated from the confines of their prerogative, or that they damaged Bezeq.<br><br>On December 28, 2016, a Supreme Court ruling was | 900, one claim<br><br>2,640 (net) in the other |

handed down with respect to two appeals of the District Court's rulings. The Supreme Court unanimously dismissed the appeals and accepted Bezeq's arguments and the Applicants were charged expenses. On April 6, 2017, a petition for a further hearing that was filed by one of the appellants.

| Date of Filing | Parties   | Type of Proceeding       | Description  | Original Amount of the Claim (NIS in millions) |
|----------------|---|--------------------------|--|--|
| April C. 2013  | Shareholder v. Bezeq and Bezeq's Controlling Shareholder, B Communications  | Declarative relief claim | In an action filed in the Tel Aviv District Court (Economic Department) the court was asked to declare that the controlling shareholder of Bezeq has a personal interest in the distribution of dividends paid in 2013 with the approval of the general meeting, and to instruct Bezeq to publish information and documents, and to summon economic experts whose opinions were published by Bezeq.  | *  |
| June 2013      | A shareholder (the same shareholder that filed the claim in April 2013) against Bezeq and the (indirect) controlling shareholder of Bezeq, Eurocom Communications | Declarative relief claim | In an action filed in the Tel Aviv District Court (Economic Department) a request for a declarative ruling was sought to determine whether the general meetings of Bezeq's shareholders on April 24, 2013 and June 13, 2013 were illegally managed, and that the form of compensation determined and approved in Bezeq's general meeting dated June 13, 2013 relative to the services of four directors (as part of the management agreement with Eurocom) is illegal. | *  |
|                |   |                          | The deliberation on both proceedings was postponed until a final decision is made relative to the appeal to reject the request to approve the derivative claims indicated in section B above (in view of the similarity of the claims in the foregoing proceedings). Upon dismissal of the appeals in the same motions, as set out in the B above, both of these actions were dismissed by agreement on January 3, 2017.   |  |

\*The amount of the claim is not indicated or the claim is not a financial claim.

### *Pelephone*

| Date of Filing | Parties | Type of Action | Details | Amount of claim NIS million |
|----------------|---------|----------------|---------|-----------------------------|
| A.             |         |                |         |                             |



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|                |                          |  |   |   |
|----------------|--------------------------|--|---|---|
| Aug<br>2010    | Customer v.<br>Pelephone | A financial<br>claim filed<br>with a motion<br>to certify it as<br>a class action. | <p>In an action filed in the Central District Court the claimant claims that Pelephone should refrain from collecting Value Added Tax from customers who use its services when they are outside Israel. The motion also seeks an order instructing Pelephone to cease charging its customers VAT for such services which they use outside Israel, and an order instructing that the moneys collected to date be refunded. In August 2014 the Court dismissed the application. In October 2014 an appeal of the ruling was filed. The parties are waiting for a judgment to be handed in the appeal.</p> <p>In an action filed in the Tel Aviv District Court the claimant alleges that Pelephone does not inform customers wishing to use its services using a handset that was not purchased from Pelephone, that if the handset does not support the 850 MHz frequency, they will only get partial reception over one frequency rather than two. In March 2014, the court certified the claim as a class action subsequent to Pelephone announcing its agreement (for reasons of efficiency) to conduct the claim as a class action, while retaining its arguments.</p> | The amount of the claim is not stated, but the application is estimated in the tens of millions of shekels. |
| B. May<br>2012 | Customer v.<br>Pelephone | Financial<br>class action<br>suit  | <p>In an action filed in the Tel Aviv District Court the claimant alleges that Pelephone does not inform customers wishing to use its services using a handset that was not purchased from Pelephone, that if the handset does not support the 850 MHz frequency, they will only get partial reception over one frequency rather than two. In March 2014, the court certified the claim as a class action subsequent to Pelephone announcing its agreement (for reasons of efficiency) to conduct the claim as a class action, while retaining its arguments.</p>   | Approx. 124   |

| Date of Filing   | Parties   | Type of Action   | Details   | Amount of claim NIS million   |
|------------------|---|--|---|---|
| C. December 2012 | Customer v. Pelephone                                       | A financial claim filed with a motion to certify it as a class action. | In an action filed in the Jerusalem District Court the claimants allege that Pelephone allowed its subscribers to be unlawfully charged by the content service company, E-interactive for mobile content services that were not ordered.  | Approx. 107   |
| D. November 2013 | Customer v. Pelephone                                       | A financial claim filed with a motion to certify it as a class action. | In an action filed in the Tel Aviv District Court the claimants allege that Pelephone does not grant the same perks to all of its customers, thereby distinguishing between those customers that they allege Pelephone considers to be highly valuable and others, which they claim is in breach of Pelephone's license and the law. They also request as remedy that Pelephone refrain from granting such perks. A stay six months was ordered in order to enable the Ministry of Communications to formulate its position on the matter.                            | Approx. 300   |
| E. July 2014     | Customer v. Pelephone and other mobile telephony companies. | A financial claim filed with a motion to certify it as a class action. | In an action filed in the Tel Aviv District Court the claimants allege that Pelephone, together with three other mobile telephony companies, registered subscribers for content services without obtaining their consent and in contravention of the law, and thereby creating a "platform" for iQtech Group to unlawfully charge tens of thousands of people for content services.   | Approx. 100 with regard to the mobile telephony companies and 300 against all the defendants.         |
| F. May 2015      | Customer v. Pelephone                                       | A financial claim filed with a motion to certify it as a class action. | In an action filed in the Tel Aviv District Court the claimants allege that Pelephone does not offer "Walla Mobile" tracks to all its existing customers and those who join are subscribers who want to transfer to a different track, and that this is in violation of the provisions of the license that obligates equality, and thereby it misleads its customers. The proceedings in the case were consolidated with another case due to the similarity between the proceedings.  | The amount of the claim is not stated, but the application is estimated to be in millions of shekels. |
| G. December 2015 | Customer v. Pelephone                                       | A financial claim filed with a motion to certify it as a class action. | In an action filed in the Lod District Court the claimant alleged that Pelephone violated the mobility rules. Allegedly, when attempting to move to another operator the applicant found out that she was deliberately blocked by Pelephone from moving. When calling Pelephone to clarify the issue, she found out that the reason for blocking her was an attempt to retain her and prevent her from moving to a competitor. In addition, injunctions are sought to prevent such blocking. On November 6, 2016 the parties filed a motion to dismiss the motion for | The amount of the claim is not stated, but is estimated in the tens of millions of shekels.           |



|    | Date of Filing | Parties                                    | Type of Action   | Details   | Amount of claim NIS million   |
|----|----------------|--|--|---|---|
| H. | May 2016       | Customer v. Pelephone                      | A financial claim filed with a motion to certify it as a class action. | The claimant alleged that Pelephone opted subscribers to its Smart Call service without their consent or their knowledge, and this in contravention of the provisions of the Law and of its license and the Smart Call service portfolio.<br>In an action filed in the Jerusalem District Court the claimant alleged that Pelephone overcharges for calls made from overseas to Israel in the overseas Travel track and charges at the higher rate for a direct dialing call instead the rate for a call via the savings service, because of the fact that the calls were dialed using the country code for Israel, as the phone numbers are saved in the claimant's phone. | Approx. 200   |
| I. | June 2016      | Customer v. Pelephone                      | A financial claim filed with a motion to certify it as a class action. | In an action filed in the Lod District Court the claimant alleged that the defendants do not allow their subscribers to make full use of their overseas package and this through discriminatory terms under which the package can be used for a very short period (between one week to one month only) and that at the end of that period, the unused balance of the package expires and no reimbursement is given.   | Approx. 86  |
| J. | October 2016   | Customer v. Pelephone, Partner and Cellcom | A financial claim filed with a motion to certify it as a class action. |   | The amount of the claim is not stated, but is estimated in the tens of millions of shekels. |

*Legal proceedings which ended during the reporting period or by the date of publication of this report.*

|    | Date of Filing | Parties   | Type of Action   | Details  | Amount of the original claim NIS million   |
|----|----------------|---|--|--|--|
| A. | February 2012  | Customer v. Pelephone, Bezeq, Cellcom and Partner | A financial claim filed with a motion to certify it as a class action. | In an action filed in the Jerusalem District Court, the claimants alleged the failure to comply with the provisions of the law with respect to people with disabilities when rendering services. In April 2016, the Court approved a settlement arrangement between the parties under which the suit will be dismissed in return for implementation of a series of accessibility adjustments and benefits for people with disabilities. In addition, the group of defendants will credit the claimants in amounts that are not material. | Approx. 361 for all the defendants, without noting an amount for each of the defendants. |

| Date of Filing   | Parties   | Type of Action   | Details   | Amount of the original claim NIS million   |
|------------------|---|--|---|--|
| B. August 2012   | Customer v. Pelephone, Partner and Cellcom                      | A financial claim filed with a motion to certify it as a class action. | In an action filed in the Central District Court the claimants allege that under the repair services provided by the defendants for a fee (payment per repair or a monthly fee for repair service), if a certain part in the handset must be replaced, the defendants do not provide the customer with the spare part, and this in contravention of the law. Furthermore, the defendants reuse the replaced parts when providing repair services for other customers, thus ostensibly enriching themselves twice. The action also requests writs of mandamus and declaratory relief. In May 2016 the court approved the settlement agreement reached between the parties, under which the motion will be dismissed and Pelephone will implement future changes in its conduct when receiving products for repair. | Approx. 120 for each of the defendants, in a total amount of 360.  |
| C. August 2015   | Customer v. Pelephone   | A financial claim filed with a motion to certify it as a class action. | In an action filed in the Central District Court the claimants allege that one of the communications companies made improper use of its database in violation of the Privacy Protection Law 1981, when it transferred or sold the customers' particulars to the other respondents, including Pelephone. The claim against Pelephone revolves mainly around the purchase or receipt of this information and its use for marketing purposes, in a way that violates the provisions of the Communications Law regarding the sending of spam. In November\ 2016, the court approved the claimant's withdrawal from the motion to certify a class action and dismissed his personal claim.   | The amount of the claim is not stated, but the application is estimated in the tens of millions of shekels.      |
| D. November 2015 | Customer v. Pelephone and two other mobile telephony companies. | A financial claim filed with a motion to certify it as a class action. | In an action filed in the Central District Court the claimants allege that the pre-paid prices of the companies are higher than the post-paid prices, which is due to cartelization of the three companies in this market. In September the court dismissed the claimant's personal claim and the motion to certify it as a class action and ordered him to pay the expenses. In October 2016 an appeal of the ruling was filed. In January 2017, the appeal was dismissed.   | Approx. 2,800 with regard to Pelephone (and the total amount against the three companies is in excess of 13,000) |

***Bezeq International***

| Date of Filing   | Parties                         | Type of Action     | Details   | Amount of claim NIS million |
|------------------|---------------------------------|--------------------|---|-----------------------------|
| A. December 2011 | Customer v. Bezeq International | Civil class action | In an action filed in the Central District Court the claimants allege that during October 2011, Bezeq International failed to provide its Internet customers with the browsing speed it had undertaken in the contract. The plaintiffs seek the refund of the monthly fees and compensation for mental anguish. On March 13, 2016, the court certified the claim as a class action. | Approx. 120                 |

| Date of Filing    | Parties                         | Type of Action   | Details   | Amount of claim NIS million  |
|-------------------|---------------------------------|--|---|--|
| B. January 2015   | Customer v. Bezeq International | A financial claim filed with a motion to certify it as a class action. | In an action filed in the Central District Court the claimants allege that the Moreshet content filtering services that Bezeq International provides for its religious and traditional sector customers, for a fee, do not protect users from offensive content and that their exposure to such content caused them harm. It is further claimed that Bezeq International must compensate the customers who purchased content filtering services and who were not offered the basic filtering service which is provided free of charge. In an action filed in the Central District Court the claimants allege that Bezeq International charged customers for an overseas dialing plan at "premium prices" that were higher than the agreed price fixed in the communications plan. The plaintiffs contend that Bezeq International exceeded the applicability of the plan, fixed line destinations overseas and defined them as "premium destinations", without basis and by misleading customers. | About 65, with the addition of NIS 1,000 for each of the members of the class (every pupil in the Israeli education system). |
| C. November 2015  | Customer v. Bezeq International | A financial claim filed with a motion to certify it as a class action. | In an action filed in the Jerusalem District Court the claimants allege that Bezeq International misleads its customers by marketing fast Internet packages at 100MB, while the actual speed provided is much lower.  | Not noted.   |
| D. June 2016      | Customer v. Bezeq International | A financial claim filed with a motion to certify it as a class action. | In an action filed in the Central District Court the claimants allege that Bezeq International charges excessive and unreasonable rates in contravention of section 17 of the Communications Law, for outgoing international calls.   | Approx. 187  |
| E. September 2016 | Customer v. Bezeq International | A financial claim filed with a motion to certify it as a class action. |   | Not noted.   |

*Legal proceedings which ended during the reporting period or by the date of publication of this report.*

| Date    | Parties                             | Type of Action     | Details  | Amount of claim NIS million |
|---------|-------------------------------------|--------------------|--|-----------------------------|
| A. 2008 | Customer v. Bezeq International and | Civil class action | Four claims that were filed in the Central District Court were consolidated into one action relating to the use of international phone cards for dialing to destinations in the Philippines, Thailand and Nepal, | 1,159                       |

other  
international  
operators

alleging that the phone cards provide an average of 50% of the time units indicated to the purchasers of the cards. The claimants also allege that Bezeq International deducts call time for time unsuccessfully spent attempting to call someone, does not charge for units of round minutes, provides misleading information about the number of units on the card and formed a cartel with other international telecommunication companies to raise the prices for phone cards. In November 2010, the court recognized the motion to certify a class action on the grounds of deception.

In September 2016, a judgment was handed approving the settlement arrangement, under which Bezeq International will allow calls in the amount of NIS 5 million to be made free of charge, and will pay the representative plaintiffs compensation and legal fees in an amount of NIS 500,000.



| Date             | Parties   | Type of Action   | Details  | Amount of claim<br>NIS<br>million |
|------------------|---|--|--|-----------------------------------|
| B. February 2012 | Customer v. Bezeq International and other international operators | A financial claim filed with a motion to certify it as a class action. | In an action filed in the Tel Aviv District Court the claimants made allegation similar to the action described in section A. above. The foregoing settlement described in section A above also applies to this claim. | 2,700                             |

**DBS**

| Date         | Parties   | Type of Action  | Details  | Amount of claim  |
|--------------|---|---|--|--|
| A. June 2014 | Customer and apartment building representatives vs. DBS | A financial claim filed with a motion (consolidated) to certify it as a class action. | <p>In an action filed in the Tel Aviv District Court the claimants allege that DBS unlawfully charged residents in apartment buildings (subscribers and non-subscribers of DBS) for the electricity consumption for the satellite dishes and/or amplifiers and/or other devices that DBS uses, that are located in these apartment buildings. The applicant has petitioned the court, among other things, to order DBS to refund the amount collected for electricity consumption.</p> <p>The second lawsuit (that was originally filed with the District Court in Haifa, and was moved for hearing before the Tel Aviv District Court in September 2014) includes a claim that DBS installed equipment in apartment buildings that operate on electricity and according to their claim, DBS connected the outside equipment without approval and consent of the apartment buildings to the communal electricity and also consumed electricity without paying for it.</p> <p>In October 2015, the court ruled to consolidate the proceedings in both motions for certification and filing of consolidated statements. In December 2016, the claimants' request for</p> | NIS 80 million is for monetary and non-monetary damages allegedly caused due to the electricity consumption for DBS systems and an injunction ordering DBS to install electricity meters for measuring the electricity consumption of DBS's systems. |

|              |                 |  |   |  |
|--------------|-----------------|--|---|--|
| B. Sept 2014 | Customer v. DBS | A financial claim filed with a motion to certify it as a class action. | <p>interlocutory remedies against DBS regarding the disconnection of subscribers who refuse to bear the electricity costs and the signing of intermediate representatives on agreements to bear these expenses, was struck.</p> <p>In an action filed in the Tel Aviv District Court the claimants allege that electronic advertisements sent by DBS to its customers were in contravention of Section 30A of the Communications Law, in breach of DBS's license and in breach of the agreement between DBS and its customers. The applicants petitioned the court for relief for the inconvenience caused to the customers by DBS, harassment, loss of time, etc. and sought relief in an amount to be determined in the court's discretion.</p> | NIS 402 million (with additional relief to be determined at the court's discretion). |
|--------------|-----------------|--|---|--|

| Date             | Parties         | Type of Action   | Details   | Amount of claim   |
|------------------|-----------------|--|---|---|
| C. July 2015     | Customer v. DBS | A financial claim filed with a motion to certify it as a class action. | <p>In an action filed in the Central District Court the claimants allege discrimination against DBS customers who are not offered or given the best terms or the lowest price for the services they received from DBS; a claim of discrimination against new DBS customers over existing customers who are eligible for receiving a campaign or benefit for joining DBS; and a claim of discrimination of new members who are acquainted with the company's employees, over other new members. According to the allegations, these actions are contrary to DBS's obligation under its license and by law to refrain from discriminating with regard to the price for the services it provides. The applicant requests that DBS will compensate members of the group for the monetary difference between the price that each of them actually paid to DBS for the services, and the lowest price they could have paid for those services. In addition, the applicant requests that the court order DBS to offer and provide its services to everyone requesting its services on the same terms and to publish them in its various publications. In September 2015, following the filing of another motion to certify a class action against DBS alleging price discrimination, the court held that the two actions will be defined as related cases and in November 2015 the court ordered the consolidation of the two motions to certify.</p> <p>With the consent of the parties the court decided that, in view of the fact that a stay order was handed in the hearing of parallel cases against different defendants raising similar legal and factual questions by the court hearing them and in view of the fact that there is a pending motion to transfer the hearing on these petitions to the foregoing other court, the proceedings concerning the motions to certify were suspended until a decision is issued.</p> | <p>The applicant does not specify the amount of the claim, but the extent of the damage is estimated to be tens of millions of shekel.</p> <p>The amount of the second claim is estimated by the applicants to be NIS 13 million plus monetary damages as will be awarded by the Court,</p> |
| D. December 2015 | Customer v. DBS | A financial claim filed with a motion to certify it as a class action. | <p>In an action filed in the Central District Court the claimants allege that DBS and HOT operate illegally by providing their customers with premium content services, (as part of the VOD service of DBS), that is provided under transactions for fixed periods and automatically renewable, while charging their customers for the service unilaterally, without the clients' consent and in violation of the law. Thus, allegedly, they charge their customers illegal amounts while enriching themselves unjustly.</p>  | <p>The applicants do not explicitly mention the amount of the claim, but believe that the conduct described</p>   |

|               |                    |  |  |  |
|---------------|--------------------|--|--|--|
| E. April 2016 | Customer<br>v. DBS | A financial claim with a motion to certify it as a class action. | In an action filed in the Tel Aviv District Court the claimants allege that the condition included in the agreement between DBS and its customers, which allows a subscription to be placed on hold for a limited period thus avoiding the payment of a subscription fee for the period, and provided that the suspension is for a period of at least 30 days is a discriminatory condition and is unreasonable in a standard contract. The claimants also contend that DBS allows customers to have their subscription frozen for shorter periods if they make the request by phone - which the plaintiffs argue misleads consumers, is unfair conduct and is in breach of the provisions of the Contracts Law, the consumer protection laws and Unjust Enrichment Law. | provides DBS and HOT annual income of tens of millions of shekels. The claimants have asked the court to order the cancellation of the Condition of the agreement and alternatively to determine that DBS's conduct as described above is misleading and not in good faith. The court was also petitioned to instruct DBS to compensate the subscribers who are members of the group in the total amount of NIS 736 million. |
|---------------|--------------------|--|--|--|

| Date          | Parties         | Type of Action   | Details   | Amount of claim   |
|---------------|-----------------|--|---|---|
| F. March 2017 | Customer v. DBS | A financial claim with a motion to certify it as a class action. | In an action filed in the Central District Court the claimant alleged that DBS was in breach of the agreement with its customers and the conditions of the license issued by the Ministry of Communications when it discontinued broadcasts of the Children's Channel from January 1, 2017 and instead started to broadcast a channel called Yes KIDZ, which the claimant alleges is not an appropriate substitute. The claimant is seeking a refund from DBS to each member of the class group in the amounts it collected or overcharged (not less than NIS 100 per month) from the date of discontinuation of the channel broadcasts, and that DBS should also compensate all members of the group for the inconvenience caused as a result of discontinuation of the channel broadcasts (a loss which is estimated in the amount of NIS 250 for each group member). | The claimant does not expressly mention the amount sought from DBS, but defines the group as all DBS customers on the date of discontinuation of the channel broadcasts, excluding those customers who have ostensibly already received specific compensation from DBS for discontinuation of the channel broadcasts. |

*Legal proceedings which ended during the reporting period or by the date of publication of this report.*

| Date of filing of the action | Parties         | Type of Action   | Details   | Amount of claim  |
|------------------------------|-----------------|--|---|--|
| March 2013                   | Customer v. DBS | A financial claim filed with a motion to certify it as a class action. | In an action filed in the Central District Court the claimants alleged that DBS disconnected customers from channel 5+ and reconnected them only after the customers contacted DBS and requested reconnection but continued collecting fees for the channel from those customers who did not contact them and were, therefore, not reconnected. Pursuant to an amended settlement agreement DBS will grant each of the members of the group benefits of NIS 14 million. | The applicant estimates the damage to himself at NIS 1,065 of which NIS 1,000 is non-monetary damage, but did not include a total amount for the suit. |

### **Dividend Distribution Policy**

We have never paid cash dividends to our shareholders and do not currently have a dividend distribution policy in place.

B Communications does not currently have a dividend distribution policy in place either. According to the Israeli Companies Law, a company may distribute dividends out of its profits (as such term is defined in the Israeli Companies Law), provided that there is no reasonable concern that payment of the dividend will prevent the company from satisfying all its current and foreseeable obligations, as they become due. Notwithstanding the foregoing, dividends may be paid with the approval of a court, at the company's request, provided that there is no reasonable concern that payment of the dividend will prevent the company from satisfying its current and foreseeable obligations, as they become due. In the event cash dividends are declared, such dividends will be paid in NIS.

B Communications declared its first dividend as a public company on November 7, 2013, a dividend of NIS 3.41 per share and NIS 102 million in the aggregate. The record date for the distribution of the dividend was November 18, 2013 and the payment date was December 3, 2013.

On May 21, 2015, B Communications declared a dividend of NIS 2.24 per share and approximately NIS 67 million in the aggregate. The record date for the distribution of the dividend was June 2, 2015 and the payment date was June 16, 2015.

On August 31, 2015, B Communications declared a dividend of NIS 0.73 per share and approximately NIS 22 million in the aggregate. The record date for the distribution of the dividend was September 16, 2015 and the payment date was September 29, 2015.

On November 19, 2015, B Communications declared a dividend of NIS 1.27 per share and approximately NIS 38 million in the aggregate. The record date for the distribution of the dividend was December 10, 2015 and the payment date was December 23, 2015.

On May 25, 2016, B Communications declared a dividend of NIS 11.88 per share and approximately NIS 355 million in the aggregate. The record date for the distribution of the dividend was June 15, 2016 and the payment date was June 29, 2016.

### **B. Significant Changes**

Except as otherwise disclosed in this annual report, no significant change has occurred since December 31, 2016.

## **ITEM 9. THE OFFER AND LISTING**

### **A. Offer and Listing Details**

#### **Annual Stock Information**

The following table sets forth, for each of the years indicated, the high and low market prices of our ordinary shares on the NASDAQ and the TASE.

| NASDAQ | TASE |
|--------|------|
|--------|------|

|      | High    | Low    | High      | Low       |
|------|---------|--------|-----------|-----------|
| 2012 | \$11.71 | \$1.92 | NIS 45.07 | NIS 7.79  |
| 2013 | \$14.97 | \$2.65 | NIS 53.00 | NIS 9.91  |
| 2014 | \$11.24 | \$6.37 | NIS 39.33 | NIS 23.20 |
| 2015 | \$12.12 | \$4.01 | NIS 47.22 | NIS 15.68 |
| 2016 | \$17.82 | \$9.50 | NIS 65.45 | NIS37.67  |

The following table sets forth, for each of the full financial quarters in the two most recent full financial years and any subsequent period, the high and low market prices of our ordinary shares on the NASDAQ Global Select Market and the TASE:

|                                   | NASDAQ  |         | TASE     |          |
|-----------------------------------|---------|---------|----------|----------|
|                                   | High    | Low     | High     | Low      |
| <u>2015</u>                       |         |         |          |          |
| First Quarter                     | \$6.52  | \$4.02  | NIS26.35 | NIS15.68 |
| Second Quarter                    | \$5.43  | \$4.01  | NIS21.68 | NIS15.83 |
| Third Quarter                     | \$8.36  | \$4.61  | NIS32.82 | NIS17.66 |
| Fourth Quarter                    | \$12.12 | \$7.97  | NIS47.22 | NIS31.17 |
| 2016                              |         |         |          |          |
| First Quarter                     | \$17.82 | \$9.50  | NIS65.45 | NIS37.67 |
| Second Quarter                    | \$15.32 | \$12.17 | NIS57.90 | NIS48.43 |
| Third Quarter                     | \$15.00 | \$12.30 | NIS55.48 | NIS47.65 |
| Fourth Quarter                    | \$13.55 | \$10.58 | NIS50.36 | NIS41.47 |
| 2017                              |         |         |          |          |
| First Quarter                     | \$11.44 | \$10.08 | NIS47.10 | NIS37.49 |
| Second Quarter (through April 25) | \$10.93 | \$10.01 | NIS40.70 | NIS37.00 |



**Monthly Stock Information**

The following table sets forth, for the most recent six months, the high and low market prices of our ordinary shares on the NASDAQ Global Select Market and the TASE:

|                               | NASDAQ  |         | TASE     |          |
|-------------------------------|---------|---------|----------|----------|
|                               | High    | Low     | High     | Low      |
| November 2016                 | \$12.01 | \$10.91 | NIS46.40 | NIS41.47 |
| December 2016                 | \$12.20 | \$10.58 | NIS46.92 | NIS42.11 |
| January 2017                  | \$11.44 | \$10.18 | NIS47.10 | NIS38.49 |
| February 2017                 | \$11.43 | \$10.13 | NIS42.35 | NIS38.28 |
| March 2017                    | \$11.26 | \$10.08 | NIS42.32 | NIS37.49 |
| April 2017 (through April 25) | \$10.93 | \$10.01 | NIS40.70 | NIS37.00 |

**B. Plan of Distribution**

Not applicable.

**C. Markets**

Our ordinary shares were listed on the NASDAQ Global Market (symbol: IGLD) from our initial public offering in August, 1999 until July 21, 2001, at which date the listing of our ordinary shares was transferred to the NASDAQ Capital Market. From February 4, 2005 until December 31, 2010, our shares once again were listed on the NASDAQ Global Market and since January 1, 2011 our ordinary shares have been listed on the NASDAQ Global Select Market. Since March 1, 2005, our ordinary shares have also been traded on the TASE.

**D. Selling Shareholders**

Not applicable.

**E. Dilution**

Not applicable.

**F. Expense of the Issue**

Not applicable.

**ITEM 10. ADDITIONAL INFORMATION**

**A. Share Capital**

Not applicable.

**B. Memorandum and Articles of Association**

*Below is a description of certain provisions of our Articles of Association and of the Israeli Companies Law related to such provisions. This description is only a summary and does not purport to be complete and is qualified by reference to the full text of the Articles of Association, of our company which has been filed as an exhibit to this Annual Report and which is incorporated by reference, and to Israeli law.*

**Purposes and Objects of the Company**

We are a public company registered under the Israel Companies Law as Internet Gold – Golden Lines Ltd., registration number 52-004426-4. Pursuant to our memorandum of association, we were formed for the purpose of providing various services in the telecommunication industry and performing various corporate activities permissible under Israeli law.

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## **The Powers of the Directors**

Under the provisions of the Israeli Companies Law and our Articles of Association, a director cannot participate in a meeting nor vote on a proposal, arrangement or contract in which he or she is materially interested unless such proposal, arrangement or contract is in the ordinary course of business or the majority of directors are personally interested in such proposal, arrangement or contract. In the event the majority of the members of the board of directors have a personal interest in the proposed transaction, approval of our shareholders at a general meeting is required. In addition, our directors cannot vote compensation to themselves or any members of their body without the approval of our compensation committee and, unless exempted under the regulations promulgated under the Israeli Companies Law, our shareholders at a general meeting. If the compensation of our directors is inconsistent with our stated compensation policy, then the approval of our shareholders requires that either:

at least a majority of the shares held by all shareholders who are not controlling shareholders and do not have a personal interest in such matter, present and voting at such meeting, are voted in favor of the compensation package, excluding abstentions; or

the total number of shares of non-controlling shareholders and shareholders who do not have a personal interest in such matter voting against the compensation package does not exceed 2% of the aggregate voting rights in the company.

The authority of our directors to enter into borrowing arrangements on our behalf is not limited, except in the same manner as any other transaction by us.

Under our Articles of Association, retirement of directors from office is not subject to any age limitation and our directors are not required to own shares in our company in order to qualify to serve as directors.

## **Rights Attached to Shares**

Our authorized share capital consists of 50,000,000 ordinary shares of a nominal value of NIS 0.1 each. All of our issued and outstanding ordinary shares are duly authorized, validly issued, fully paid and non-assessable. Our ordinary shares are not redeemable and do not have preemptive rights.

***Dividend and Liquidation Rights.*** The holders of the ordinary shares will be entitled to their proportionate share of any cash dividend, share dividend or dividend in kind declared with respect to our ordinary shares. Our board of directors may declare a dividend to be paid to the holders of ordinary shares in proportion to the paid up capital attributable to the shares that they hold. Dividends may only be paid out of our profits and other surplus funds, as defined in the Israeli Companies Law, as of the end of the most recent fiscal year or as accrued over a period of two years, whichever is higher, provided that there is no reasonable concern that a payment of a dividend will prevent us from satisfying our existing and foreseeable obligations as they become due. If we do not meet the profit requirement, we may seek the approval of the court to distribute a dividend. The court may approve our request if it is convinced that there is no reasonable risk that a distribution might prevent us from satisfying our existing and anticipated obligations as they become due.

Under the Israeli Companies Law, a dividend declaration must be approved by the board of directors and does not require the approval of the shareholders of a company unless the company's articles of association provide otherwise. Our articles of association do not require shareholder approval of a dividend distribution.

In the event of our liquidation, after satisfaction of liabilities to creditors, our assets will be distributed to the holders of ordinary shares in proportion to the paid up capital attributable to the shares that they hold. Dividend and liquidation rights may be affected by the grant of preferential dividend or distribution rights to the holders of a class of shares with preferential rights that may be authorized in the future.

**Exceptional Holdings; Principal Shareholders.** Under the Communications Order, no person may hold, directly or indirectly, “significant influence” over Bezeq or 5% or more of any particular class of means of control in Bezeq, nor may any person, together with any other person, appoint, elect or dismiss the general manager of Bezeq or cause the election, appointment or dismissal of any director of Bezeq, without the prior written consent of the Prime Minister of Israel and the Israeli Minister of Communications. Subject to certain exceptions, prior written approval of such Ministers is also required to increase the holdings or other rights in excess of those determined in the initial approval, including by means of an agreement (including a voting agreement). Furthermore, under the Communications Order, no person may transfer control, “significant influence” or means of control in Bezeq to another, if, as a result of the transfer, the holdings of the transferee would require approval pursuant to the Communications Law or Communications Order and the transferee is not in possession of the requisite approval. Any such unauthorized acquisition is referred to as “Exceptional Holdings.” For the foregoing purposes, “significant influence” means the ability to significantly influence the activity of a corporation, whether alone or together with or through others, directly or indirectly, other than as a result of holding “means of control” in that corporation or in another corporation, and including ability derived from the corporation’s articles of association, a written, oral or other kind of agreement, or from any other source. In this context, the right to appoint an officer and holding 25% of our “means of control” is presumed to confer significant influence. “Means of control” means the right to vote at a general meeting of the company, to appoint a director or general manager of the company, to participate in the profits of the company or a share of the remaining assets of the company after payment of its debts upon liquidation.

In compliance with the Communications Law and Communications Order following our acquisition of the controlling interest in Bezeq, our Articles of Association provide that Exceptional Holdings will not entitle the holder to any rights in respect of such holdings, unless and to the extent permitted under the Communications Order. Accordingly, Exceptional Holdings will not have any voting rights at a general meeting of shareholders. Each shareholder participating in a general meeting of shareholders will be required to certify to us prior to the vote or, if the shareholder is voting by a proxy or any similar instrument, on such proxy card or similar instrument, as to whether or not his or her holdings in our company or his or her vote require the approval of the Prime Minister of Israel and the Israeli Minister of Communications, pursuant to the Communications Law and Communications Order. In addition, no director may be appointed, elected or removed from office by virtue of the vote of a holder of Exceptional Holdings. If a director is appointed, elected or removed from office by virtue of the vote of a holder of Exceptional Holdings, such appointment, election or removal from office shall have no effect.

Under our Articles of Association, any person holding a number of our shares that requires approval under the Communications Order shall notify us, Bezeq, the Prime Minister of Israel and the Israeli Minister of Communications of such holdings in writing, no later than 48 hours from the date of acquiring such holdings.

Our Articles of Association include reporting requirements applicable to “Principal Shareholders,” meaning a holder, directly or indirectly, of 5% of our issued and outstanding share capital. Any person who, after acquiring, directly or indirectly, shares in our company becomes a “Principal Shareholder,” is required, no later than 48 hours after becoming a Principal Shareholder, to notify us in writing, specifying the number of our shares held by such shareholder and the date on which such shareholder became a Principal Shareholder. Any person who ceases to be a Principal Shareholder is required, no later than 14 days thereafter, to notify us in writing of the date on which such person ceased to be a

Principal Shareholder. In addition, a Principal Shareholder is required to notify us in writing of any aggregate change in its holdings of our shares in an aggregate amount equal to 1% or more of our outstanding share capital compared to the last notice of holdings submitted by such Principal Shareholder, no later than 48 hours after such change. In the event a Principal Shareholder fails to provide any required notice, as discussed above, then until such Principal Shareholder provides us with the requisite notice, the Principal Shareholder will not be entitled to any rights in respect of such shares and the provisions of the Communications Order with respect to the exercise of rights underlying Exceptional Holdings will apply, and the undisclosed holdings shall also be deemed “dormant shares,” as defined under the Israeli Companies Law.

Under our Articles of Associations, we are required to notify the Prime Minister of Israel and the Israeli Minister of Communications of any Exceptional Holdings immediately upon becoming aware of such event. We are also required to notify such Ministers in the event a shareholder becomes a Principal Shareholder and regarding any change in the holdings of a Principal Shareholder within 48 hours of becoming aware of such change.

***Voting Rights.*** Holders of ordinary shares have one vote for each ordinary share held on all matters submitted to a vote of shareholders, subject to the restrictions described above relating to Exceptional Holdings and Principal Shareholders. Such voting rights may be affected by the grant of any special voting rights to the holders of a class of shares with preferential rights that may be authorized in the future.

## **Election of Directors**

Our ordinary shares do not have cumulative rights for the election of directors. Rather, under our articles of association, our directors (other than the external directors) are elected by a vote of the holders of a majority of the voting power represented and voting at our annual general meetings of shareholders, and hold office until the next annual general meeting of shareholders and until their successors have been elected. See Item 6C. “Directors, Senior Management and Employees - Board Practices - Election of Directors.” For information regarding the election of external directors, see Item 6C. “Directors, Senior Management and Employees - Board Practices - External Directors.” All the members of our Board of Directors (except the external directors) may be reelected upon completion of their term of office.

Under our Articles of Association, provisions relating to the election and removal of directors who are not external directors, within the meaning of the Israeli Companies Law, may not be modified without the prior written consent of the Israeli Minister of Communications.

Regulations promulgated under the Communications Law require that our chief executive officer, any member of our board of directors holding an executive role, as well as a majority of the members of the board of directors, be citizens and residents of the State of Israel.

## **Annual and Extraordinary Meetings**

Under the Israeli Companies Law and our articles of association, our board of directors must convene an annual meeting of shareholders at least once every calendar year and within 15 months of the last annual meeting. Depending on the matter to be voted upon, and subject to the Israeli Companies Law and regulations thereunder, notice of at least 14 days or 21 days or 35 days prior to the date of the meeting is required. Our articles of association provide that notice of a general meeting of shareholders will be delivered to all eligible shareholders by publication in two daily Hebrew language newspapers in Israel that have a reasonably-sized readership. Our board of directors may, in its discretion, convene additional meetings as “special general meetings.” In addition, the board must convene a special general meeting upon the demand of: (a) two of the directors or 25% of the directors in office, (b) one or more shareholders having at least 5% of the outstanding share capital and at least 1% of the voting power in the company, or (c) one or more shareholders having at least 5% of the voting power in the company. The chairman of the board of directors presides at each of our general meetings. The chairman of the board of directors is not entitled to a vote at a general meeting in his capacity as chairman.

## **Quorum**

The quorum required for any general meeting is the presence, in person or by proxy, of shareholders holding or representing, in the aggregate, at least one third of the voting rights. No business shall be considered or determined at a general meeting, unless the requisite quorum is present within half an hour from the time designated for the general meeting. If within half an hour from the time designated for the general meeting a quorum is not present, the general meeting shall stand adjourned to the same day in the following week, at the same time and place, or to such other time as designated in the notice of such adjourned meeting. If within half an hour from the time designated for the adjourned meeting a quorum is not present, any number of shareholders present will constitute a quorum. However, if the general meeting was convened on the demand of shareholders, the adjourned meeting shall take place only if there are present at least the number of shareholders required to convene a general meeting under our articles of association (as discussed above).

A general meeting in which a quorum is present may resolve to adjourn the meeting, the discussion or the vote on a matter included in the agenda to such other time and place as it may determine. Only matters that were on the agenda and in respect of which no resolution was passed shall be discussed at the adjourned meeting.

## **Resolutions**

An ordinary resolution requires approval by the holders of a simple majority of the voting rights represented at the meeting, in person, by proxy or by written ballot, and voting on the resolution.

Under the Israeli Companies Law, unless otherwise provided in the articles of association or applicable law, all resolutions of the shareholders require a simple majority. A resolution for the voluntary winding up of the company requires approval by holders of 75% of the voting rights represented at the meeting, in person, by proxy or by written ballot and voting on the resolution.



### **Modification of Class Rights**

Under the Israeli Companies Law and our articles of association, any amendment, conversion, cancellation, expansion, addition to or other change in the rights, preferences, privileges, restrictions or provisions attached to any particular class of shares issued to shareholders of our company, shall require the written consent of holders of all issued shares of such particular class, or authorization by an ordinary resolution adopted at an extraordinary meeting of such class.

### **Limitations on the Rights to Own Ordinary Shares in Our Company**

None of our memorandum of association, our articles of association or the laws of the State of Israel restrict in any way the ownership or voting of ordinary shares by non-residents, except that shares held by citizens of countries which are in a state of war with Israel will not confer any rights to their holders unless the Minister of Finance consents otherwise.

In addition, pursuant to the Communications Order, so long as we control Bezeq, any state, government corporation or a corporation controlled by a government corporation cannot control our company. Ownership of our shares, directly or indirectly, by a government corporation requires the prior written approval of the Israeli Prime Minister and Israeli Minister of Communications, provided that the government corporation's total direct and indirect holdings in Bezeq does not exceed more than 5% of any type of "means of control" (as such term is described above) of Bezeq. Ownership by a government corporation, directly or indirectly, of 5% or more of Bezeq's outstanding shares or a "significant influence" (as such term is described above) in Bezeq requires the approval of the Prime Minister of Israel and the Israeli Minister of Communications as well as the consent of the Israeli Minister of Defense. A "Hostile State," as such term is defined in the Communications Order, a citizen or resident of a Hostile State, a corporation incorporated in a Hostile State or controlled by a resident or citizen of a Hostile State is not allowed to hold, directly or indirectly, 5% or more or a "significant influence" (as described above) in Bezeq.

### **Anti-Takeover Provisions; Mergers and Acquisitions**

*Full Tender Offer.* A person wishing to acquire shares, or any class of shares, of a publicly traded Israeli company and who would as a result hold over 90% of the company's issued and outstanding share capital, or a class of shares which are listed, is required by the Israeli Companies Law to make a tender offer to all of the company's shareholders for the purchase of all of the remaining issued and outstanding shares of the company, or any class of shares, as the case may be. If (i) less than 5% of the outstanding shares are not tendered in the tender offer and the majority of the offerees who have no personal interest in the acceptance of the tender offer have accepted the offer; or (ii) less than 2% of the

outstanding shares are not tendered in the tender offer, all of the shares that the acquirer offered to purchase will be transferred to the acquirer by operation of law. However, the shareholders may petition the court within six months after receipt of the offer to alter the consideration for the acquisition. The Israeli Companies Law allows an acquirer to determine in the terms of the offer that offerees who accepted the offer will not be entitled to appraisal rights. If the terms described above for the completion of a tender offer are not met, the acquirer may not acquire additional shares of the company from shareholders who accepted the tender offer if following such acquisition the acquirer would then own over 90% of the company's issued and outstanding share capital.

*Special Tender Offer.* The Israeli Companies Law provides that an acquisition of shares of a public company be made by means of a special tender offer if as a result of the acquisition the purchaser would hold 25% or more of the voting rights at the company's general meeting, unless one of the exemptions described in the Israeli Companies Law are met. This rule does not apply if there is already another shareholder who holds 25% or more of the voting rights at the company's general meeting. Similarly, the Israeli Companies Law provides that an acquisition of shares in a public company must be made by means of a tender offer if as a result of the acquisition the purchaser would hold more than 45% of the voting rights of the company, if there is no other shareholder of the company who holds more than 45% of the voting rights in the company. A tender offer is not required in the following circumstances: (i) the purchase was made in a private placement that was approved by the shareholders as a private placement and was meant to grant the purchaser 25% or more of the voting rights of a company in which no other shareholder holds 25% or more of the voting rights, or to grant the purchaser more than 45% of the voting rights of a company in which no other shareholder holds more than 45% of the voting rights, (ii) the purchaser would hold 25% or more of the voting rights after purchasing shares from a person that held 25% or more of the voting rights, or (iii) the purchaser would hold more than 45% of the voting rights after purchasing shares from a person that held more than 45% of the voting rights.

*Merger.* The Israeli Companies Law permits merger transactions if approved by each party's board of directors and, unless certain requirements described under the Israeli Companies Law are met, the majority of each party's shares voted on the proposed merger at a shareholders' meeting called on at least 35 days' prior notice. Under the Israeli Companies Law, if the approval of a general meeting of the shareholders is required, merger transactions may be approved by holders of a simple majority of the shares present, in person or by proxy, at a general meeting and voting on the transaction. In determining whether the required majority has approved the merger, if shares of the company are held by the other party to the merger, or by any person holding at least 25% of the outstanding voting shares or 25% of the means of appointing directors of the other party to the merger, then a vote against the merger by holders of the majority of the shares present and voting, excluding shares held by the other party or by such person, or anyone acting on behalf of either of them, is sufficient to reject the merger transaction. If the transaction would have been approved but for the exclusion of the votes of certain shareholders as provided above, a court may still approve the merger upon the request of holders of at least 25% of the voting rights of a company, if the court holds that the merger is fair and reasonable, taking into account the value of the parties to the merger and the consideration offered to the shareholders. Upon the request of a creditor of either party to the proposed merger, the court may delay or prevent the merger if it concludes that there exists a reasonable concern that, as a result of the merger, the surviving company will be unable to satisfy the obligations of any of the parties to the merger and the court may also provide instructions to assure the rights of creditors. In addition, a merger may not be completed unless at least 50 days have passed from the date that a proposal for approval of the merger was filed with the Israeli Registrar of Companies and 30 days from the date that shareholder approval of both merging companies was obtained.

Notwithstanding the foregoing, a merger is not subject to shareholders approval of (i) the target company, if it is a wholly-owned subsidiary of the acquiring company and (ii) the acquiring company, if no changes are required to its articles and memorandum of association and it is not issuing to the shareholders of the target company more than 20% of its voting rights and no person will become, as a result of the issuance, a controlling shareholder of the acquiring company, subject to certain limitations relating to the continuing of the votes, at a meeting of the shareholders of a company that is a party to the merger, of any entity or person that is either the other party to the merger or a control person thereof.

### **C. Material Contracts**

None.

### **D. Exchange Controls**

Israeli laws and regulations do not impose any material foreign exchange restrictions on non-Israeli holders of our ordinary shares. In May 1998, a new "general permit" was issued under the Israeli Currency Control Law, 1978, which removed most of the restrictions that previously existed under such law, and enabled Israeli citizens to freely invest outside of Israel and freely convert Israeli currency into non-Israeli currencies.

Non-residents of Israel who purchase our ordinary shares will be able to convert dividends, if any, thereon, and any amounts payable upon our dissolution, liquidation or winding up, as well as the proceeds of any sale in Israel of our ordinary shares to an Israeli resident, into freely repatriable dollars, at the exchange rate prevailing at the time of conversion, provided that the Israeli income tax has been withheld (or paid) with respect to such amounts or an exemption has been obtained.

## **E. Taxation**

The following is a discussion of Israeli and United States tax consequences material to our shareholders. To the extent that the discussion is based on tax legislation which has not been subject to judicial or administrative interpretation, the views expressed in the discussion might not be accepted by the tax authorities in question or by court. The discussion is not intended, and should not be construed, as legal or professional tax advice and does not exhaust all possible tax considerations.

### **Israeli Tax Considerations**

The following summary describes the current tax structure applicable to companies in Israel, with special reference to its effect on us. The following discussion also summarizes the material Israeli income tax consequences applicable to the purchase, ownership and disposition of our ordinary shares. This discussion does not address all of the tax consequences that may be relevant to purchasers of our ordinary shares in light of their particular circumstances, or certain types of purchasers of our ordinary shares subject to special tax treatment. Examples of this kind of investor include residents of Israel and traders in securities who are subject to special tax regimes not covered in this discussion. Each individual/entity should consult its own tax or legal advisor as to the Israeli tax consequences of the purchase, ownership and disposition of our ordinary shares. To the extent that part of the discussion is based on new tax legislation, which has not been subject to judicial or administrative interpretation, we cannot assure that the tax authorities or the courts will accept the views expressed in this section.

### **General Corporate Tax Structure**

The applicable Israeli company income tax rate was 25% in 2012 and 2013. In 2014 and 2015, the applicable income tax rate increased to 26.5% and commencing on January 1, 2016, the tax rate was reduced to 25%.

### **Tax on Capital Gains of Shareholders**

Israeli law imposes a capital gains tax on the sale of capital assets by an Israeli resident and on the sale of capital assets located in Israel or the sale of direct or indirect rights to assets located in Israel, including on the sale of our

Shares by some of our shareholders (see discussion below). The Israeli Income Tax Ordinance distinguishes between “Real Gain” and “Inflationary Surplus.” Real Gain is the excess of the total capital gain over Inflationary Surplus computed on the basis of the increase in the CPI between the date of purchase and the date of sale. In 2012, the Real Gain accrued on the sale of our Shares is generally taxed at a rate of 25% for corporations (24% in 2011) and a rate of 25% for individuals (20% in 2011). Additionally, if such individual shareholder is considered a “Significant Shareholder” at any time during the 12-month period preceding such sale (i.e. if such individual shareholder holds directly or indirectly, along with others, at least 10% of any means of control in the company), the tax rate will be 30% (25% in 2011). However, the foregoing tax rates will not apply to (i) dealers in securities; and (ii) shareholders who have acquired their shares prior to an initial public offering (that may be subject to a different tax arrangement). Inflationary surplus that accrued after December 31, 1993, is exempt from tax. Generally, a semi-annual detailed return, including a computation of the tax due should be submitted to the Israeli Tax Authorities and a tax advance amounting to the tax liability arising from the capital gain is payable. At the sale of traded securities, the aforementioned detailed return may not be submitted and the tax advance should not be paid, if all tax due was withheld at the source according to applicable provisions of the Israeli Tax Ordinance and regulations promulgated thereunder. Capital gains are also reportable on annual income tax returns.

### *Individuals*

As of January 1, 2012, a shareholder will generally be subject to tax at 25% rate on realized real capital gain (if the shareholder is a Significant Shareholder, as defined above, the tax rate will be 30%). To the extent that the shareholder claims a deduction of financing expenses, the gain will be subject to tax at a rate of 30% (until otherwise stipulated in bylaws that may be published in the future).

### **Taxation of Non-Israeli Shareholders**

#### *Taxation of Non-Israeli Shareholders on Receipt of Dividends*

Non-residents of Israel are generally subject to Israeli income tax on the receipt of dividends paid on our ordinary shares at the rate of 25%, which tax will be withheld at source, unless a different rate is provided in a treaty between Israel and the shareholder’s country of residence.

However, the tax rate on dividends paid to a “substantial shareholder” (a shareholder who alone, or together with another person, holds, directly or indirectly, at least 10% in one or all of any of the means of control in the corporation) is 30%.

Under the U.S.-Israel Tax Treaty, the maximum rate of tax withheld in Israel on dividends paid to a holder of our ordinary shares who is a U.S. resident (within the meaning of the U.S.-Israel Tax Treaty) is 25%. Furthermore, the maximum rate of withholding tax on dividends that are paid to a U.S. corporation holding 10% or more of our outstanding voting capital during the part of the tax year that precedes the date of the payment of the dividend and during the whole of its prior tax year, is 12.5%. This reduced rate will not apply if more than 25% of the Israeli company’s gross income consists of interest or dividends, other than dividends or interest received from a subsidiary corporation 50% or more of the outstanding shares of the voting shares of which are owned by the company. Investors should consult their own tax advisors to determine if they are eligible for benefits under the U.S. Israel Tax Treaty.

A non-resident of Israel who receives dividends from which tax was fully paid is generally exempt from the duty to file returns in Israel in respect of such income, provided such income was not derived from a business conducted in Israel by the taxpayer, and the taxpayer has no other taxable sources of income in Israel.

Upon a distribution of dividend the following withholding tax rates will apply: (i) Israeli resident corporations - 0%, (ii) Israeli resident individuals - 25% and (iii) non-Israeli residents (whether an individual or a corporation) - 25%, subject to a reduced tax rate under the provisions of an applicable double tax treaty, provided that a certificate from the Israeli Tax Authorities allowing for a reduced withholding tax rate is obtained in advance.

#### *Capital Gains Taxes Applicable to Non-Israeli Shareholders*

Israeli law imposes a capital gains tax on the sale of capital assets. The law distinguishes between real gain and inflationary surplus. The inflationary surplus is the portion of the total capital gain that is equivalent to the increase of the relevant asset’s purchase price (net of depreciation) which is attributable to the increase in the Israeli CPI between the date of purchase and the date of sale. Foreign residents who purchased an asset in foreign currency may request that the inflationary surplus be computed on the basis of the depreciation of the NIS against such foreign currency. The real gain is the excess of the total capital gain over the inflationary surplus. The inflationary surplus accumulated from and after December 31, 1993, is exempt from any capital gains tax in Israel while the real gain is taxed at the applicable rate discussed above.

Dealers in securities in Israel are taxed at regular tax rates applicable to business income.

Under the convention between the United States and Israel concerning taxes on income, Israeli capital gains tax will not apply to the sale, exchange or disposition of ordinary shares by a person:

who qualifies as a resident of the United States within the meaning of the U.S.-Israel tax treaty; and

who is entitled to claim the benefits available to the person by the U.S.-Israel tax treaty.

However, this exemption does not apply, among other cases, if the gain is attributable to a permanent establishment of such person in Israel, or if the holder is a resident of the United States within the meaning of the U.S.-Israeli tax treaty who holds, directly or indirectly, shares representing 10% or more of our voting power during any part of the 12-month period preceding the sale, exchange or disposition, subject to specified conditions. Under these circumstances, the sale, exchange or disposition would be subject to Israeli tax, to the extent applicable. However, under the U.S.-Israel tax treaty, a U.S. resident generally would be permitted to claim a credit for the Israeli taxes paid against the U.S. federal income tax imposed on the sale, exchange or disposition, subject to the limitations under U.S. law applicable to foreign tax credits. The U.S.-Israel tax treaty does not relate to U.S. state or local taxes.

Under Israeli law, the capital gain from the sale of shares by non-Israeli residents is tax exempt in Israel provided that, in general, both of the following conditions are met: (A) the capital gain is not attributed to the foreign resident's permanent establishment in Israel, (B) if the seller is a corporation, less than 25% of its means of control are held by Israeli residents.

The purchaser of the shares, the stockbrokers who effected the transaction or the financial institution holding the shares through which payment to the seller is made are obligated, subject to the above-referenced exemptions if certain conditions are met, to withhold tax on the Real Gain resulting from a sale of shares at the rate of 25%.

## United States Federal Income Taxation

The following is a description of the material U.S. federal income tax consequences of the acquisition, ownership and disposition of our ordinary shares. This description addresses only the U.S. federal income tax considerations that are relevant to U.S. Holders (as defined below) who hold our ordinary shares as capital assets. This summary is based on the U.S. Internal Revenue Code of 1986, as amended, or the Code, Treasury regulations promulgated thereunder, judicial and administrative interpretations thereof, and the U.S.-Israel Tax Treaty, or the Treaty, all as in effect on the date hereof and all of which are subject to change either prospectively or retroactively. There can be no assurance that the U.S. Internal Revenue Service, or the IRS, will not take a different position concerning the tax consequences of the acquisition, ownership and disposition of our ordinary shares or that such a position would not be sustained. This description does not address all tax considerations that may be relevant with respect to an investment in our ordinary shares. This description does not account for the specific circumstances of any particular investor, such as:

broker-dealers,

financial institutions,

certain insurance companies,

investors liable for alternative minimum tax,

tax-exempt organizations,

non-resident aliens of the United States or taxpayers whose functional currency is not the U.S. dollar,

persons who hold the ordinary shares through partnerships or other pass-through entities,

persons who acquire their ordinary shares through the exercise or cancellation of employee stock options or otherwise as compensation for services,

investors that actually or constructively own 10% or more of our shares by vote or value, and

investors holding ordinary shares as part of a straddle, appreciated financial position, a hedging transaction or conversion transaction.



If a partnership or an entity treated as a partnership for U.S. federal income tax purposes owns ordinary shares, the U.S. federal income tax treatment of a partner in such a partnership will generally depend upon the status of the partner and the activities of the partnership. A partnership that owns ordinary shares and the partners in such partnership should consult their tax advisors about the U.S. federal income tax consequences of holding and disposing of ordinary shares.

This summary does not address the effect of any U.S. federal taxation (such as estate and gift tax) other than U.S. federal income taxation. In addition, this summary does not include any discussion of state, local or non-U.S. taxation. You are urged to consult your tax advisors regarding the non-U.S. and U.S. federal, state and local tax consequences of an investment in ordinary shares.

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For purposes of this summary, a U.S. Holder is:

an individual who is a citizen or, for U.S. federal income tax purposes, a resident of the United States;

a corporation or other entity taxable as a corporation created or organized in or under the laws of the United States or any political subdivision thereof;

an estate whose income is subject to U.S. federal income tax regardless of its source; or

a trust that (a) is subject to the primary supervision of a court within the United States and the control of one or more U.S. persons or (b) has a valid election in effect under applicable U.S. Treasury regulations to be treated as a U.S. person.

Unless otherwise indicated, this discussion assumes that our company is not, and will not become, a “passive foreign investment company,” or a PFIC, for U.S. federal income tax purposes. See “—*Passive Foreign Investment Companies*” below.

### **Taxation of Distributions**

Subject to limitations, including the discussion below under the heading “—*Passive Foreign Investment Companies*,” the gross amount of any distributions received with respect to our ordinary shares, including the amount of any Israeli taxes withheld therefrom, will constitute dividends for U.S. federal income tax purposes to the extent of our current and accumulated earnings and profits, as determined for U.S. federal income tax purposes. Because we do not expect to maintain calculations of our earnings and profits under U.S. federal income tax principles, it is expected that the entire amount of any distribution will generally be reported as dividend income to you. Dividends are included in gross income as ordinary income. Distributions in excess of our current and accumulated earnings and profits would be treated as a non-taxable return of capital to the extent of your tax basis in our ordinary shares and any amount in excess of your tax basis will be treated as gain from the sale of ordinary shares. See “—*Disposition of Ordinary Shares*” below for a discussion of the taxation of capital gains. Our dividends would not qualify for the dividends-received deduction generally available to corporations under section 243 of the Code.

Dividends that we pay in NIS, including the amount of any Israeli taxes withheld therefrom, will be included in your income in a U.S. dollar amount calculated by reference to the exchange rate in effect on the day such dividends are received, regardless of whether the payment is in fact converted into U.S. dollars. A U.S. Holder who receives payment in NIS and converts NIS into U.S. dollars at an exchange rate other than the rate in effect on such day may

have a foreign currency exchange gain or loss that would be treated as U.S.-source ordinary income or loss. U.S. Holders should consult their own tax advisors concerning the U.S. tax consequences of acquiring, holding and disposing of NIS.

Subject to complex limitations, some of which vary depending upon the U.S. Holder's circumstances, any Israeli withholding tax imposed on dividends paid with respect to our ordinary shares will be a foreign source income tax eligible for credit against a U.S. Holder's U.S. federal income tax liability (or, alternatively, for deduction against income in determining such tax liability). The limitation on foreign income taxes eligible for credit is calculated separately with respect to specific classes of income. Dividends generally will be treated as foreign-source passive category income or, in the case of certain U.S. Holders, general category income for U.S. foreign tax credit purposes. Further, there are special rules for computing the foreign tax credit limitation of a taxpayer who receives dividends subject to a reduced tax rate (see discussion below). A U.S. Holder may be denied a foreign tax credit with respect to Israeli income tax withheld from dividends received on our ordinary shares if such U.S. Holder fails to satisfy certain minimum holding period requirements or to the extent such holder's position in ordinary shares is hedged. The rules relating to the determination of the foreign tax credit are complex, and you should consult with your personal tax advisors to determine whether and to what extent you would be entitled to this credit.

Subject to certain limitations, “qualified dividend income” received by a non-corporate U.S. Holder will be subject to tax at the lower long-term capital gain rates (currently at 20%). Distributions taxable as dividends paid on our ordinary shares should qualify for a reduced rate provided that either: (i) we are entitled to benefits under the Treaty or (ii) our ordinary shares are readily tradable on an established securities market in the United States and certain other requirements are met. We believe that we are entitled to benefits under the Treaty and that our ordinary shares currently are readily tradable on an established securities market in the United States. However, no assurance can be given that our ordinary shares will remain readily tradable. The rate reduction does not apply unless certain holding period requirements are satisfied, nor does it apply to dividends received from a PFIC (see discussion below) or in respect of certain risk-reduction transactions or in certain other situations. The legislation enacting the reduced tax rate on qualified dividend income contains special rules for computing the foreign tax credit limitation of a taxpayer who receives dividends subject to the reduced tax rate. U.S. Holders of our ordinary shares should consult their own tax advisors regarding the effect of these rules in their particular circumstances.

### **Disposition of Ordinary Shares**

If you sell or otherwise dispose of our ordinary shares, you will generally recognize gain or loss for U.S. federal income tax purposes in an amount equal to the difference between the amounts realized on the sale or other disposition and your adjusted tax basis in our ordinary shares, in each case determined in U.S. dollars. Such gain or loss will generally be capital gain or loss and will be long-term capital gain or loss if you have held the ordinary shares for more than one year at the time of the sale or other disposition. Long-term capital gain realized by a non-corporate U.S. Holder is generally eligible for a preferential tax rate (currently at 20%). In general, any gain that you recognize on the sale or other disposition of ordinary shares will be U.S.-source for purposes of the foreign tax credit limitation; losses will generally be allocated against U.S. source income. Deduction of capital losses is subject to certain limitations under the Code.

In the case of a cash basis U.S. Holder who receives NIS in connection with the sale or disposition of our ordinary shares, the amount realized will be based on the U.S. dollar value of the NIS received with respect to the ordinary shares as determined on the settlement date of such exchange. A cash basis U.S. Holder who receives payment in NIS and converts NIS into U.S. dollars at a conversion rate other than the rate in effect on the settlement date may have a foreign currency exchange gain or loss, which would be treated as ordinary income or loss.

An accrual basis U.S. Holder may elect the same treatment required of cash basis taxpayers with respect to a sale or disposition of our ordinary shares that are traded on an established securities market, provided that the election is applied consistently from year to year. Such election may not be changed without the consent of the IRS. In the event that an accrual basis U.S. Holder does not elect to be treated as a cash basis taxpayer (pursuant to the Treasury regulations applicable to foreign currency transactions), such U.S. Holder may have a foreign currency gain or loss for U.S. federal income tax purposes because of differences between the U.S. dollar value of the currency received prevailing on the trade date and the settlement date. Any such currency gain or loss would be treated as ordinary income or loss and would be in addition to the gain or loss, if any, recognized by such U.S. Holder on the sale or

disposition of such ordinary shares.

Any foreign currency gain or loss a U.S. Holder realizes will be U.S. source ordinary income or loss.

### **Passive Foreign Investment Companies**

We believe that we were not a PFIC for U.S. federal income tax purposes for the taxable year of 2016. However, since PFIC status depends upon the composition of our income and assets and the market value of our assets from time to time, there can be no assurance that we will not be considered a PFIC for any future taxable year. If we were a PFIC for any taxable year during which a U.S. Holder owned an ordinary share (and under proposed Treasury regulations, a right), certain adverse consequences could apply to the U.S. Holder. Specifically, gain recognized by a U.S. Holder on a sale or other disposition of such ordinary share (or right) would be allocated ratably over the U.S. Holder's holding period for the ordinary share (or right). The amounts allocated to the taxable year of the sale or other disposition and to any year before we became a PFIC would be taxed as ordinary income. The amount allocated to each other taxable year would be subject to tax at the highest rate in effect for individuals or corporations, as appropriate, for that taxable year, and an interest charge would be imposed on the resulting tax liability. Further, any distribution in excess of 125% of the average of the annual distributions received by the U.S. Holder on our ordinary shares during the preceding three years or the U.S. Holder's holding period, whichever is shorter, would be subject to taxation as described immediately above. Certain elections (such as a mark-to-market election) may be available to U.S. Holders and may result in alternative tax treatment. In addition, if we were a PFIC for a taxable year in which we pay a dividend or the prior taxable year, the favorable dividend rates discussed above with respect to dividends paid to certain non-corporate U.S. Holders would not apply. If we were a PFIC for any taxable year in which a U.S. Holder owned our shares, the U.S. Holder would generally be required to file annual returns with the Internal Revenue Service, or the IRS, on IRS Form 8621.

### **Additional Tax on Investment Income**

In addition to the income taxes described above, U.S. Holders that are individuals, estates or trusts and whose income exceeds certain thresholds will be subject to a 3.8% Medicare contribution tax on net investment income, which includes dividends and capital gains.

### **Backup Withholding and Information Reporting**

Payments in respect of our ordinary shares may be subject to information reporting to the IRS and to U.S. backup withholding tax at the rate (currently) of 28%. Backup withholding will not apply, however, if you (i) are a corporation or fall within certain exempt categories, and demonstrate the fact when so required, or (ii) furnish a correct taxpayer identification number and make any other required certification.

Backup withholding is not an additional tax. Amounts withheld under the backup withholding rules may be credited against a U.S. Holder's U.S. tax liability. A U.S. Holder may obtain a refund of any excess amounts withheld under the backup withholding rules by filing the appropriate claim for refund with the IRS.

U.S. citizens and individuals taxable as resident aliens of the United States that own "specified foreign financial assets" with an aggregate value in a taxable year in excess of certain thresholds (as determined under rules in Treasury regulations) and that are required to file a U.S. federal income tax return generally will be required to file an information report with respect to those assets with their tax returns. IRS Form 8938 has been issued for that purpose. "Specified foreign financial assets" include any financial accounts maintained by foreign financial institutions, foreign stocks held directly, and interests in foreign estates, foreign pension plans or foreign deferred compensation plans. Under those rules, our ordinary shares, whether owned directly or through a financial institution, estate or pension or deferred compensation plan, would be "specified foreign financial assets". Under Treasury regulations, the reporting obligation applies to certain U.S. entities that hold, directly or indirectly, specified foreign financial assets. Penalties can apply if there is a failure to satisfy this reporting obligation. A U.S. Holder is urged to consult his tax adviser regarding its reporting obligation.

U.S. Holders that transfer more than \$100,000 to us within a twelve-month period, through direct purchase of ordinary shares or otherwise, generally will be required to file IRS Form 926. Substantial penalties may be imposed upon a U.S. Holder that fails to comply. Each U.S. Holder should consult its own tax advisor about the obligation to file IRS Form 926.

**The above description is not intended to constitute a complete analysis of all tax consequences relating to acquisition, ownership and disposition of our ordinary shares. You should consult your tax advisor concerning the tax consequences of your particular situation.**

**F.Dividends and Paying Agents**

Not applicable.

**G.Statement by Experts**

Not applicable.

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## **H. Documents on Display**

We are subject to certain of the reporting requirements of the Securities and Exchange Act of 1934, as amended, or the Exchange Act, as applicable to “foreign private issuers” as defined in Rule 3b-4 under the Exchange Act. As a foreign private issuer, we are exempt from certain provisions of the Exchange Act. Accordingly, our proxy solicitations are not subject to the disclosure and procedural requirements of Regulation 14A under the Exchange Act, and transactions in our equity securities by our officers and directors are exempt from reporting and the “short-swing” profit recovery provisions contained in Section 16 of the Exchange Act. In addition, we are not required under the Exchange Act to file periodic reports and financial statements as frequently or as promptly as U.S. companies whose securities are registered under the Exchange Act. However, we file with the SEC an annual report on Form 20-F containing financial statements audited by an independent accounting firm. We also submit to the SEC reports on Form 6-K containing (among other things) press releases and unaudited financial information. We post our annual report on Form 20-F on our website ([www.igld.com](http://www.igld.com)) promptly following the filing of our annual report with the SEC. The information on our website is not incorporated by reference into this annual report.

This annual report and the exhibits thereto and any other document we file pursuant to the Exchange Act may be inspected without charge and copied at prescribed rates at the SEC public reference room at 100 F Street, N.E., Room 1580, Washington, D.C. 20549. You may obtain information on the operation of the SEC’s public reference room in Washington, D.C. by calling the SEC at 1-800-SEC-0330. The Exchange Act file number for our SEC filings is 000-30198.

The SEC maintains a website at [www.sec.gov](http://www.sec.gov) that contains reports, proxy and information statements, and other information regarding registrants that make electronic filings with the SEC using its EDGAR (Electronic Data Gathering, Analysis, and Retrieval) system.

The documents concerning our company referred to in this annual report may also be inspected at our offices located at 2 Dov Friedman Street, Ramat Gan 5250301, Israel. We will provide a copy of this annual report containing our financial statements upon shareholders’ request.

## **I. Subsidiary Information**

Not applicable.

## **ITEM 11. QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISKS**



We are exposed to a variety of risks, including foreign currency fluctuations and changes in interest rates. We regularly assess currency and interest rate risks to minimize any adverse effects on our business as a result of those factors.

### **Effects of Currency Fluctuations**

Our unconsolidated net exposure to changes in foreign currency exchange rates (primarily the U.S. dollar) was NIS 118 million (approximately \$31 million) at December 31, 2016. Each increase or decrease of 1% in the NIS-US\$ exchange rate will result in an increase or decrease in our yearly financial income of NIS 1 million (approximately \$260 thousand).

B Communications' unconsolidated net exposure to changes in foreign currency exchange rates (primarily the U.S. dollar) was NIS 169 million (approximately \$44 million) at December 31, 2016. Each increase or decrease of 1% in the NIS-US\$ exchange rate will result in an increase or decrease in its yearly financial income of NIS 2 million (approximately \$1 million).

The Bezeq Group is exposed to foreign currency risks mainly due to payments for purchases of terminal equipment and property, plant and equipment which are in or linked to the U.S. dollar or the Euro. In addition, the Bezeq Group provides services for customers and receives services from suppliers worldwide for which it is paid and it pays in foreign currency, mainly the U.S. dollar. The Bezeq Group has surplus liabilities over assets in foreign currency. To hedge its exposure, the Bezeq Group makes forward transactions against the U.S. dollar.

Bezeq Group holds derivative financial instruments to hedge its exposure to foreign currency. Hedge accounting is not applied to these derivative instruments that economically hedge financial assets and liabilities. Derivative instruments are recognized initially at fair value; attributable transaction costs are recognized in the statement of income as incurred. Subsequent to initial recognition, derivative financial instruments are measured at fair value and the changes in fair value are recognized in the statement of income as incurred.

Bezeq's total net exposure to changes in foreign currency exchange rates was NIS 1.1 billion (approximately \$286 million) at December 31, 2016. Each increase or decrease of 1% in the NIS-US\$ exchange rate will result in an increase or decrease in Bezeq's yearly financial loss of NIS 7 million (\$2 million).

### **Effects of Changes in Interest Rates and the Israeli Consumer Price Index**

Our total net exposure to changes in the Israeli CPI was NIS 714 million (approximately \$186 million) at December 31, 2016. The exposure relates to NIS 946 million (approximately \$246 million) of our outstanding debentures that are partially hedged by forward contracts on the Israeli CPI in the amount of NIS 190 million (approximately \$49 million) and our investment of NIS 42 million (approximately \$11 million) of CPI linked marketable securities. Each increase or decrease of 1% in the Israeli CPI will result in an increase or decrease in our yearly financial expense of NIS 7 million (approximately \$2 million).

B Communications' total net exposure to changes in the Israeli CPI was NIS 4 million (approximately \$1 million) at December 31, 2016. Each increase or decrease of 1% in the Israeli CPI will result in an increase or decrease in our yearly financial income of less than NIS one million.

The Bezeq Group's total exposure to changes in the Israeli CPI was NIS 5.5 billion (approximately \$1.4 billion) at December 31, 2016. The exposure primarily consists of Bezeq's debentures which are linked to the CPI. As of December 31, 2016, Bezeq holds forward contracts on the Israeli CPI in the amount of NIS 2 billion (approximately \$519 million). Each increase or decrease of 1.5% in the Israeli CPI will result in an increase or decrease in the Bezeq Group's yearly financial expense of NIS 50 million (\$13 million).

### **Cash Investments, Marketable Securities and Interest Rate Risk Management**

Our cash investment policy seeks to preserve principal and maintain adequate liquidity while maximizing the income we receive from our investments without significantly increasing the risk of loss. To minimize investment risk, we maintain a diversified portfolio across various maturities, types of investments and issuers, which may include, from time to time, money market funds, U.S. government bonds, state debt, bank deposits and certificates of deposit, and investment grade corporate debt. As of December 31, 2016, we had NIS 48 million (approximately \$12 million) in cash and cash equivalents and NIS 334 million (approximately \$87 million) in marketable securities (not including the amounts of B Communications or Bezeq).

The performance of the capital markets affects the values of the funds we hold in marketable securities. These assets are subject to market fluctuations. In such case, the fair value of our investments may decline. We periodically monitor our investments for adverse material holdings related to the underlying financial solvency of the issuers of the marketable securities in our portfolio.

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

### **Bezeq's Exposure to Market Risks**

Bezeq is exposed to market risks, mainly as a result of changes in interest rates, exchange rates, inflation, the prices of raw materials and equipment, and the prices of securities. Bezeq seeks to hedge against such risks in accordance with a financial exposure management policy adopted by its Board of Directors. Pursuant to that policy, Bezeq takes partial hedging actions depending on the circumstances and its own judgment, primarily for reducing its exposure to changes in the Israeli CPI and foreign currency exchange rates. Bezeq monitors and reviews the Bezeq Group's exposure management every month, including, when necessary, making recommendations for change, if required, in the exposure management.

Bezeq has a significant surplus of liabilities for CPI linked assets, and the bulk of its financial exposure from the risk of a rise in inflation. The rate of inflation also affects Bezeq's operating income and operating expenses in the course of the year. In addition, Bezeq's tariff updating mechanism, which is subject to government regulation, is reviewed once a year and is influenced by the CPI. As a result, the annual rate of inflation and its distribution during the year can have a material influence on the erosion of Bezeq's tariffs and its revenues and expenses during the year.

Bezeq's exposure to change in the interest rate largely depends on the character of its financial liabilities and assets as well as future financing needs. Most of Bezeq's debt bears fixed interest, and therefore a change in the interest rate will affect its fair value rather than its carrying value.

Bezeq has investments in negotiable bonds that are stated in its books at their market value. This market value is influenced by changes in the interest rates in the economy. In addition, a change in the NIS exchange rate constitutes economic exposure that can affect Bezeq's future profit and cash flows, mainly the repayment of currency-linked liabilities and payments for currency-linked purchases of equipment and raw materials.

The cash flow generated by Bezeq's operations is used partially for investment in equipment. The prices of the equipment are affected by the indices to which they are linked, including industry price indices, exchange rates and global prices. Bezeq does not hedge against this exposure. Bezeq is also exposed to changes in copper prices that result in a change in the residual value of its copper cable infrastructure. In deploying its NGN, Bezeq removes copper cables previously used to provide its services and sells the copper from such cables, and the prices received are subject to the volatility of the copper market.

**ITEM 12. DESCRIPTION OF SECURITIES OTHER THAN EQUITY SECURITIES**

Not applicable.

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## **PART II**

### **ITEM 13. DEFAULTS, DIVIDEND ARREARAGES AND DELINQUENCIES**

None.

### **ITEM 14. MATERIAL MODIFICATIONS TO THE RIGHTS OF SECURITY HOLDERS AND USE OF PROCEEDS**

#### **Material Modifications to the Rights of Security Holders**

None.

#### **Use of Proceeds**

Not applicable.

### **ITEM 15. CONTROLS AND PROCEDURES**

#### **Disclosure Controls and Procedures**

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in our Exchange Act reports is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to our chief executive officer and chief financial officer to allow timely decisions regarding required disclosure. Our management, including our chief executive officer and chief financial officer, conducted an evaluation of our disclosure controls and procedures, as defined under Exchange Act Rule 13a-15(e), as of the end of the period covered by this annual report on Form 20-F. Based upon that evaluation, our chief executive officer and principal financial officer have concluded that, as of such date, our disclosure controls and procedures were effective.

### **Management's Annual Report on Internal Control Over Financial Reporting**

Our management, including our chief executive officer and principal financial officer, is responsible for establishing and maintaining adequate internal control over financial reporting, as defined under Exchange Act Rules 13a-15(f) and 15d-15(f). Our internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with accounting principles generally accepted in the United States. Internal control over financial reporting includes those policies and procedures that: (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of our assets, (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that our receipts and expenditures are being made only in accordance with appropriate authorizations; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of our assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Our management assessed the effectiveness of our internal control over financial reporting as of December 31, 2016. In conducting its assessment of internal control over financial reporting, management based its evaluation on the framework in “Internal Control – Integrated Framework” (2013) issued by the Committee of Sponsoring Organizations, or the COSO, of the Treadway Commission. Based on that assessment, our management has concluded that our internal control over financial reporting was effective as of December 31, 2016.

#### **Attestation Report of the Registered Public Accounting Firm**

Our independent registered accounting firm, Somekh Chaikin, a member firm of KPMG International, has issued an audit report on the effectiveness of our internal control over financial reporting. The report is included our audited consolidated financial statements set forth in “Item 18 - Financial Statements.”

#### **Changes in Internal Control over Financial Reporting**

There were no changes in our internal control over financial reporting during the period covered by the Report that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting

#### **ITEM 16. [RESERVED]**

#### **ITEM 16A. AUDIT COMMITTEE FINANCIAL EXPERT**

Our board of directors has determined that Ms. Anat Winner, an independent director and Mr. Dudi Ezra and Ms. Shoshana Shidlo, External Directors, meet the definition of an audit committee financial expert, as defined by rules of the SEC. For a brief listing of their relevant experience, see Item 6.A. “Directors, Senior Management and Employees - Directors and Senior Management.”

**ITEM 16B. CODE OF ETHICS**

We have adopted a code of ethics that applies to our chief executive officer and all senior financial officers of our company, including the principal financial officer, chief accounting officer or controller, or persons performing similar functions. Our code of ethics is available for viewing on our website at [www.igld.co.il](http://www.igld.co.il). Written copies are available upon request. If we make any substantive amendment to the code of ethics or grant any waivers, including any implicit waiver, from a provision of the codes of ethics, we will disclose the nature of such amendment or waiver on our website.

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**ITEM 16C. PRINCIPAL ACCOUNTANT FEES AND SERVICES****Fees Billed by Independent Public Accountants**

The following table sets forth, for each of the years indicated, the aggregate fees billed to us, Bezeq, B Communications, Pelephone and Bezeq International by the independent registered public accounting firm that prepares their financial statements. All of such fees were pre-approved by the relevant committee for the examination of the financial statements.

| Services Rendered                        | Year Ended December 31, |                     |                       |                     |
|--|-------------------------|---------------------|-----------------------|---------------------|
|  | 2015                    |                     | 2016                  |                     |
|  | <b>Unconsolidated</b>   | <b>Consolidated</b> | <b>Unconsolidated</b> | <b>Consolidated</b> |
| Audit fees and audit-related fees (1)(2) | NIS 330,000             | NIS 6,662,000       | NIS 345,000           | NIS 6,555,000       |
| Tax fees and all other fees (3)          | NIS 122,000             | NIS 1,277,000       | NIS 82,000            | NIS 1,541,000       |
| Total                                    | NIS 452,000             | NIS 7,939,000       | NIS 427,000           | NIS 8,096,000       |

(1) Audit fees are for audit services for each of the years shown in the table, including fees associated with the annual audit and audit services provided in connection with other statutory and regulatory filings.

(2) Audit related fees are the aggregate fees billed for assurance and related services that are not reported under audit fees.

(3) Tax fees are the aggregate fees billed for professional services rendered for tax compliance and tax advice.

**Pre-Approval Policies and Procedures**

Our audit committee has adopted a policy and procedures for the pre-approval of audit and non-audit services rendered by our independent registered public accounting firm, Somekh Chaikin, a member firm of KPMG International. Somekh Chaikin also acts as Bezeq's independent registered public accounting firm. Pre-approval of an audit or non-audit service may be given as a general pre-approval, as part of the audit committee's approval of the

scope of the engagement of our independent auditor, or on an individual basis. Any proposed services exceeding general pre-approved levels also require specific pre-approval by our audit committee. The policy prohibits retention of the independent registered public accountants to perform the prohibited non-audit functions defined in Section 201 of the Sarbanes-Oxley Act or the rules of the SEC, and also requires the audit committee to consider whether proposed services are compatible with the independence of the registered public accounting firm.

**ITEM 16D. EXEMPTIONS FROM THE LISTING STANDARDS FOR AUDIT COMMITTEES**

Not applicable.

**ITEM 16E. PURCHASES OF EQUITY SECURITIES BY THE ISSUER AND AFFILIATED PURCHASERS**

No ordinary shares of our company were purchased by us or on our behalf or by any affiliated purchaser during 2015.

**ITEM 16F. CHANGES IN REGISTRANT'S CERTIFYING ACCOUNTANT**

Not applicable.

**ITEM 16G. CORPORATE GOVERNANCE**

**NASDAQ Exemptions for a Controlled Company**

We are a controlled company within the meaning of NASDAQ Stock Market Rule 5615(c)(1), since Eurocom Communications holds more than 50% of our voting power. Under NASDAQ Stock Market Rule 5615(c)(2), a controlled company is exempt from the following requirements of NASDAQ Stock Market Rule 5605:

The requirement that the majority of the company's board of directors qualify as independent directors, as defined under NASDAQ Stock Market Rules. Instead, we follow Israeli law and practice which requires that we appoint at least two external directors, within the meaning of the Israeli Companies Law, to our board of directors. In addition, we have the mandated three independent directors, within the meaning of the rules of the SEC and NASDAQ, on our audit committee. See Item 6C. "Directors, Senior Management and Employees - Board Practices - External and Independent Directors."

The requirement that the compensation of the chief executive officer and all other executive officers be determined, or recommended to the board of directors for determination, either by (i) a majority of the independent directors or (ii) a compensation committee comprised solely of independent directors. Under the Israeli Companies Law, any compensation arrangement with an office holder (including an exemption from liability and the insurance and indemnification of an office holder), require the approval of the compensation committee, the board of directors and in certain circumstances, shareholders.

The requirement that director nominees either be selected or recommended for the board of directors' selection, either by (a) a majority of independent directors or (b) a nominations committee comprised solely of independent directors. Instead, we follow Israeli law and practice, in accordance with which directors may be recommended by our board of directors for election by our shareholders.

If the "controlled company" exemptions cease to be available to us under NASDAQ Stock Market Rules, we may instead elect to follow Israeli law instead of the foregoing NASDAQ requirements, as described below.

#### **NASDAQ Stock Market Rules and Home Country Practice**

Under NASDAQ Stock Market Rule 5615(a)(3), foreign private issuers, such as our company, are permitted to follow certain home country corporate governance practices instead of certain provisions of the NASDAQ Stock Market Rules. As a foreign private issuer listed on the NASDAQ Global Select Market, we may follow home country practice with regard to, among other things, the composition of the board of directors, compensation of officers, director nomination process and quorum at shareholders' meetings. In addition, we may follow home country practice instead of the NASDAQ requirement to obtain shareholder approval for certain dilutive events (such as for the establishment or amendment of certain equity-based compensation plans, an issuance that will result in a change of control of the company, certain transactions other than a public offering involving issuances of a 20% or more interest in the company and certain acquisitions of the stock or assets of another company). A foreign private issuer that elects to follow a home country practice instead of NASDAQ requirements must submit to NASDAQ in advance a written statement from an independent counsel in such issuer's home country certifying that the issuer's practices are not prohibited by the home country's laws. In addition, a foreign private issuer must disclose in its annual reports filed with the SEC each such requirement that it does not follow and describe the home country practice followed by the issuer instead of any such requirement. Accordingly, our shareholders may not be afforded the same protection as provided under NASDAQ's corporate governance rules.

#### **ITEM 16H. MINE SAFETY DISCLOSURE**

Not applicable.



**PART III**

**ITEM 17. FINANCIAL STATEMENTS**

We have elected to furnish financial statements and related information specified in Item 18.

**ITEM 18. FINANCIAL STATEMENTS**

**Consolidated Financial Statements of Internet Gold-Golden Lines Ltd.**

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## ITEM 19. EXHIBITS

### Index to Exhibits

#### Exhibit Description

- 1.1 Memorandum of Association of the Registrant <sup>(1)</sup>
- 1.2 Amended and Restated Articles of Association of the Registrant <sup>(2)</sup>
- 2.1 Specimen of Share Certificate <sup>(1)</sup>
- 4.1 Officers' Compensation Policy, April 2016 <sup>(3)</sup>
- 4.2 Registration Rights Agreement, dated July 30, 1999, among the Registrant, Euronet Communications Ltd., Shaul Elovitch and Eli Holtzman <sup>(1)</sup>
- 4.3 English Translation of the Terms of the Bezeq – DBS Merger Agreement<sup>(4)</sup>
- 4.4 Share Purchase Agreement between the Registrant and Norisha Holdings Limited dated June 27, 2013 <sup>(5)</sup>
- 4.5 Amendment No. 1 to the Share Purchase between the Registrant and Norisha Holdings Limited dated May 29, 2014 <sup>(6)</sup>
- 4.6 English translation of Deed of Trust dated September 14, 2016 between the Registrant and Reznik, Paz, Nevo Trustees Ltd.
- 4.7 Form of Indenture entered into on February 23, 2013, between the Registrant and Reznik Paz Nevo Trusts Ltd. <sup>(7)</sup>
- 4.8 English translation of Bezeq Control Permit issued by the Prime Minister of Israel and Israeli Minister of Communications to members of the Eurocom Group on April 13, 2010 <sup>(8)</sup>
- 4.9 English translation of Deed of Trust dated September 14, 2016 between the Registrant and Reznik, Paz, Nevo Trustees Ltd.
- 8 List of Subsidiaries of the Registrant
- 12.1 Certification of Chief Executive Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act, as amended
- 12.2 Certification of Principal Financial Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act, as amended
- 13.1

Certification of Chief Executive Officer pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

13.2 Certification of Principal Financial Officer pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

15.1 Consent of Somekh Chaikin, a member firm of KPMG International

- (1) Previously filed as an exhibit to the Registrant's Registration Statement on Form F-1 (Registration No. 333-10576), and incorporated herein by reference.
- (2) Previously filed as an exhibit to the Registrant's Annual Report on Form 20-F for the year ended December 31, 2012, and incorporated herein by reference.
- (3) Filed as Exhibit 99.1 to the Registrant's Report on Form 6-K for the month of May 2016, and incorporated herein by reference.
- (4) Previously filed as Exhibit 99.1 to the Registrant's Report on Form 6-K for the month of March 2015, submitted to Securities and Exchange Commission on March 18, 2015, and incorporated herein by reference.
- (5) Previously filed as Exhibit 99.1 to the Registrant's Schedule 13D/A filed with respect to holdings in B Communications on June 27, 2013, and incorporated herein by reference.
- (6) Previously filed as Exhibit 99.1 to the Registrant's Report on Form 6-K for the month of May 2014, submitted to Securities and Exchange Commission on May 29, 2014, and incorporated herein by reference.
- (7) Previously filed as Exhibit 99.1 to the Registrant's Report on Form 6-K for the month of March 2014 submitted to Securities and Exchange Commission on March 21, 2014, and incorporated herein by reference.
- (8) Previously filed as an exhibit to the Registrant's Annual Report on Form 20-F for the year ended December 31, 2009, and incorporated herein by reference.

Internet Gold – Golden Lines Ltd.

## **Consolidated Financial Statements**

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## **Report of Independent Registered Public Accounting Firm**

### **To the Board of Directors and Shareholders of Internet Gold – Golden Lines Ltd.**

We have audited the accompanying consolidated statements of financial position of Internet Gold-Golden Lines Ltd. (hereinafter - “the Company”) and its subsidiaries as of December 31, 2015 and 2016 and the related consolidated statements of income, comprehensive income, changes in equity, and cash flows for each of the years in the three-year period ended December 31, 2016. We also have audited Internet Gold- Golden Lines Ltd.’s internal control over financial reporting as of December 31, 2016, based on criteria established in *Internal Control - Integrated Framework (2013)* issued by the Committee of Sponsoring Organizations of the Treadway Commission (hereinafter - “COSO”). Internet Gold-Golden Lines Ltd.’s management is responsible for these consolidated financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying management’s report under Item 15 - Control and Procedures. Our responsibility is to express an opinion on these consolidated financial statements and an opinion on Internet Gold-Golden Lines Ltd.’s internal control over financial reporting based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the consolidated financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of the Company as of December 31, 2015 and 2016 and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2016 in conformity with International Financial Reporting Standards as issued by the International Accounting Standards Board. Also in our opinion, Internet Gold- Golden Lines Ltd. maintained, in all material respects, effective internal control over financial reporting as of December 31, 2016, based on criteria established in *Internal Control - Integrated Framework (2013)* issued by the COSO.

The accompanying consolidated financial statements as of and for the year ended December 31, 2016 have been translated into United States dollars (“dollars”) solely for the convenience of the reader. We have audited the translation and, in our opinion, the consolidated financial statements expressed in New Israeli Shekels have been translated into dollars on the basis set forth in Note 2D to the consolidated financial statements.

/s/ Somekh Chaikin

Somekh Chaikin

Certified Public Accountants (Isr.)

Member Firm of KPMG International

Tel Aviv, Israel

April 26, 2017

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Internet Gold - Golden Lines Ltd.

**Consolidated Statements of Financial Position as of****(In millions)**

|  |      | December 31   |               | Convenience<br>translation<br>into<br>U.S. dollars<br>(Note 2D)<br>2016<br>US\$ |
|--|------|---------------|---------------|---|
|  | Note | 2015<br>NIS   | 2016<br>NIS   |   |
| <b>Current assets</b>                                      |      |               |               |   |
| Cash and cash equivalents                                  | 5    | 619           | 810           | 211   |
| Restricted cash  | 13 B | 155           | -             | -   |
| Investments  | 6    | 1,774         | 1,240         | 323   |
| Trade receivables, net                                     | 7    | 2,058         | 2,000         | 520   |
| Other receivables  | 7    | *270          | 217           | 56  |
| Inventory  |      | 115           | 106           | 28  |
| <b>Total current assets</b>                                |      | <b>4,991</b>  | <b>4,373</b>  | <b>1,138</b>  |
| <b>Non-current assets</b>                                  |      |               |               |   |
| Long-term trade receivables                                | 7    | 674           | 644           | 168   |
| Property, plant and equipment                              | 8    | *7,213        | 7,072         | 1,839   |
| Intangible assets  | 9    | 7,118         | 6,534         | 1,699   |
| Deferred expenses and investments                          | 10   | 643           | 447           | 116   |
| Broadcast rights   | 11   | 456           | 432           | 112   |
| Investments in equity-accounted<br>investee (mainly loans) | 12   | 25            | 18            | 5   |
| Deferred tax assets  | 19   | 1,290         | 1,007         | 262   |
| <b>Total non-current assets</b>                            |      | <b>17,419</b> | <b>16,154</b> | <b>4,201</b>  |
| <b>Total assets</b>  |      | <b>22,410</b> | <b>20,527</b> | <b>5,339</b>  |

\*Reclassified

The accompanying notes are an integral part of these consolidated financial statements.

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Internet Gold - Golden Lines Ltd.

**Consolidated Statements of Financial Position as of (cont'd)****(In millions)**

|   |      | December 31 |             | Convenience<br>translation<br>into<br>U.S. dollars<br>(Note 2D) |
|---|------|-------------|-------------|---|
|   | Note | 2015<br>NIS | 2016<br>NIS | 2016<br>US\$  |
| <b>Current liabilities</b>                  |      |             |             |   |
| Bank loans and credit and debentures        | 13   | 2,219       | 2,181       | 568   |
| Trade and other payables                    | 14   | 1,717       | 1,661       | 432   |
| Related party                               | 12 B | 233         | 32          | 8   |
| Current tax liabilities                     | 19   | 705         | 138         | 36  |
| Provisions                                  | 15   | 100         | 80          | 21  |
| Employee benefits                           | 18   | 378         | 315         | 82  |
| Total current liabilities                   |      | 5,352       | 4,407       | 1,147   |
| <b>Non-current liabilities</b>              |      |             |             |   |
| Bank loans and debentures                   | 13   | 13,215      | 12,241      | 3,184   |
| Employee benefits                           | 18   | 240         | 258         | 67  |
| Other liabilities                           |      | 227         | 244         | 63  |
| Provisions                                  | 15   | 46          | 47          | 12  |
| Deferred tax liabilities                    | 19   | 729         | 593         | 154   |
| Total non-current liabilities               |      | 14,457      | 13,383      | 3,480   |
| Total liabilities                           |      | 19,809      | 17,790      | 4,627   |
| <b>Equity</b>                               |      |             |             |   |
| Attributable to shareholders of the Company | 23   | (93 )       | 194         | 50  |
| Non-controlling interests                   |      | 2,694       | 2,543       | 662   |
| Total Equity                                |      | 2,601       | 2,737       | 712   |
| Total liabilities and equity                |      | 22,410      | 20,527      | 5,339   |

Date of approval of the financial statements: April 26, 2017

/s/ Doron Turgeman /s/ Itzik Tadmor  
CEO Principal Financial Officer

The accompanying notes are an integral part of these consolidated financial statements.

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Internet Gold - Golden Lines Ltd.

**Consolidated Statements of Income for The Year Ended December 31****(In millions, except per share data)**

|  |      | 2014   | 2015   | 2016   | Convenience<br>translation<br>into<br>U.S. dollars<br>(Note 2D)<br>2016<br>US\$ |
|--|------|--------|--------|--------|---|
|  | Note | NIS    | NIS    | NIS    |   |
| Revenues   | 24   | 9,055  | 9,985  | 10,084 | 2,623   |
| Costs and expenses                                     |      |        |        |        |   |
| Depreciation and amortization                          |      | 1,873  | 2,131  | 2,161  | 563   |
| Salaries   | 25   | 1,771  | 1,960  | 2,017  | 525   |
| General and operating expenses                         | 26   | 3,371  | 3,878  | 4,024  | 1,047   |
| Other operating expenses<br>(income), net              | 27   | (535 ) | 3      | 21     | 5   |
|  |      | 6,480  | 7,972  | 8,223  | 2,140   |
| Operating profit                                       |      | 2,575  | 2,013  | 1,861  | 483   |
| Financing (income) expenses                            | 28   |        |        |        |   |
| Finance expenses                                       |      | 1,329  | 759    | 1,108  | 288   |
| Finance income   |      | (635 ) | (164 ) | (133 ) | (35 )   |
| Financing expense, net                                 |      | 694    | 595    | 975    | 253   |
| Profit after financing expenses, net                   |      | 1,881  | 1,418  | 886    | 230   |
| Share of loss (income) in equity - accounted investees | 12   | 170    | (12 )  | 5      | 1   |
| Profit before income tax                               |      | 1,711  | 1,430  | 881    | 229   |
| Income tax expenses                                    | 19   | 667    | 347    | 442    | 115   |

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|                                |    |         |       |          |         |
|--------------------------------|----|---------|-------|----------|---------|
| Net profit for the year        |    | 1,044   | 1,083 | 439      | 114     |
| Profit (loss) attributable to: |    |         |       |          |         |
| Shareholders of the Company    |    | (103 )  | 87    | (202 )   | (53 )   |
| Non-controlling interests      |    | 1,147   | 996   | 641      | 167     |
| Net profit for the year        |    | 1,044   | 1,083 | 439      | 114     |
| Earnings (loss) per share      | 30 |         |       |          |         |
| Basic                          |    | (5.38 ) | 4.54  | (10.52 ) | (2.74 ) |
| Diluted                        |    | (5.50 ) | 4.47  | (10.52 ) | (2.74 ) |

The accompanying notes are an integral part of these consolidated financial statements.

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Internet Gold - Golden Lines Ltd.

**Consolidated Statements of Comprehensive Income for the year ended December 31****(In millions)**

|  | 2014   | 2015  | 2016  | Convenience<br>translation<br>into<br>U.S. dollars<br>(Note 2D)<br>2016 |
|--|--------|-------|-------|---|
|  | NIS    | NIS   | NIS   | US\$  |
| Net profit for the year                          | 1,044  | 1,083 | 439   | 114   |
| Items of comprehensive profit (loss), net of tax | (36 )  | 7     | (15 ) | (4 )  |
| Total comprehensive profit for the year          | 1,008  | 1,090 | 424   | 110   |
| Attributable to:                                 |        |       |       |   |
| Shareholders of the Company                      | (110 ) | 89    | (206) | (54 )   |
| Non-controlling interest                         | 1,118  | 1,001 | 630   | 164   |
| Total comprehensive profit for the year          | 1,008  | 1,090 | 424   | 110   |

The accompanying notes are an integral part of these consolidated financial statements.

Internet Gold - Golden Lines Ltd.

**Consolidated Statements of Changes in Equity****(In millions except share data)**

|   | Attributable to shareholders of the Company   |                            |                    |                   |                        |        |       | Non-controlling interest | Total equity |
|---|---|----------------------------|--------------------|-------------------|------------------------|--------|-------|--------------------------|--------------|
|   | Share capital<br>Number of<br><b>Shares</b> <sup>(1)</sup><br>NIS 0.01<br>par value | Share<br>premium<br>Amount | Treasury<br>shares | Other<br>reserves | Accumulated<br>deficit | Total  |       |                          |              |
|   | NIS   | NIS                        | NIS                | NIS               | NIS                    | NIS    | NIS   | NIS                      |              |
| Balance as at January 1, 2014                 | 19,203,186  | *                          | 658                | (169 )            | (50 )                  | (525 ) | (86 ) | 3,239                    | 3,153        |
| Changes during 2014:                          |   |                            |                    |                   |                        |        |       |                          |              |
| Share-based compensation in subsidiary        | -   | -                          | -                  | -                 | -                      | -      | -     | (1 )                     | (1 )         |
| Exercise of options in subsidiary             | -   | -                          | -                  | -                 | (1 )                   | -      | (1 )  | 14                       | 13           |
| Transactions with non-controlling interest    | -   | -                          | -                  | -                 | -                      | 14     | 14    | 10                       | 24           |
| Dividends to non-controlling interests        | -   | -                          | -                  | -                 | -                      | -      | -     | (1,431 )                 | (1,431)      |
| Other comprehensive profit (loss), net of tax | -   | -                          | -                  | -                 | (8 )                   | 1      | (7 )  | (29 )                    | (36 )        |
| Net profit (loss) for the year                | -   | -                          | -                  | -                 | -                      | (103 ) | (103) | 1,147                    | 1,044        |
| Comprehensive profit (loss) for the year      | -   | -                          | -                  | -                 | (8 )                   | (102 ) | (110) | 1,118                    | 1,008        |
| Balance as at December 31, 2014               | 19,203,186  | *                          | 658                | (169 )            | (59 )                  | (613 ) | (183) | 2,949                    | 2,766        |

(\*)Represent an amount less than NIS 1.

(1)Net of treasury shares.

The accompanying notes are an integral part of these consolidated financial statements.

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Internet Gold - Golden Lines Ltd.

**Consolidated Statements of Changes in Equity (cont'd)****(In millions except share data)**

|  | Attributable to shareholders of the Company                                  |                                   |                           |                          |                               |              |        | Non-controlling interest | Total equity |
|--|--|-----------------------------------|---------------------------|--------------------------|-------------------------------|--------------|--------|--------------------------|--------------|
|  | Share capital<br>Number of<br>Shares <sup>(1)</sup><br>NIS 0.01 par<br>value | Share<br>Amount<br>premium<br>NIS | Treasury<br>shares<br>NIS | Other<br>reserves<br>NIS | Accumulated<br>deficit<br>NIS | Total<br>NIS |        |                          |              |
| Balance as at January 1, 2015          | 19,203,186   | *                                 | 658                       | (169 )                   | (59 )                         | (613 )       | (183 ) | 2,949                    | 2,766        |
| Changes during 2015:                   |  |                                   |                           |                          |                               |              |        |                          |              |
| Exercise of options in subsidiary      | -  | -                                 | -                         | -                        | 1                             | -            | 1      | 18                       | 19           |
| Dividends to non-controlling interests | -  | -                                 | -                         | -                        | -                             | -            | -      | (1,274 )                 | (1,274)      |
| Other comprehensive profit, net of tax | -  | -                                 | -                         | -                        | 2                             | -            | 2      | 5                        | 7            |
| Net profit for the year                | -  | -                                 | -                         | -                        | -                             | 87           | 87     | 996                      | 1,083        |
| Comprehensive profit for the year      | -  | -                                 | -                         | -                        | 2                             | 87           | 89     | 1,001                    | 1,090        |
| Balance as at December 31, 2015        | 19,203,186   | *                                 | 658                       | (169 )                   | (56 )                         | (526 )       | (93 )  | 2,694                    | 2,601        |

(\*) Represent an amount less than NIS 1.

(1) Net of treasury shares.

The accompanying notes are an integral part of these consolidated financial statements.

Internet Gold - Golden Lines Ltd.

**Consolidated Statements of Changes in Equity (cont'd)****(In millions except share data)**

|  | Attributable to shareholders of the Company |        |                 |                |                     |        |       | Non-controlling interest | Total equity | Convenience translation into US\$ (Note 2D) |
|--|---|--------|-----------------|----------------|---------------------|--------|-------|--------------------------|--------------|---|
|  | Share capital                               |        | Treasury shares | Other reserves | Accumulated deficit | Total  |       |                          |              |   |
|  | Number of Shares <sup>(1)</sup>             | Amount |                 |                |                     |        |       |                          |              |   |
|  | NIS 0.01 par value                          | NIS    | NIS             | NIS            | NIS                 | NIS    | NIS   |                          |              |   |
| Balance as at January 1, 2016                          | 19,203,186                                  | *      | 658             | (169 )         | (56 )               | (526 ) | (93 ) | 2,694                    | 2,601        | 677   |
| Changes during 2016:                                   |   |        |                 |                |                     |        |       |                          |              |   |
| Exercise of options in subsidiary                      | -   | -      | -               | -              | 1                   | -      | 1     | 4                        | 5            | 1   |
| Transactions with non-controlling interest, net of tax | -   | -      | -               | -              | -                   | 492    | 492   | 402                      | 894          | 233   |
| Dividends to non-controlling interests                 | -   | -      | -               | -              | -                   | -      | -     | (1,187 )                 | (1,187)      | (309 )                                      |
| Other comprehensive profit (loss), net of tax          | -   | -      | -               | -              | 3                   | (7 )   | (4 )  | (11 )                    | (15 )        | (4 )  |
| Net profit (loss) for the year                         | -   | -      | -               | -              | -                   | (202 ) | (202) | 641                      | 439          | 114   |
| Comprehensive profit (loss) for the year               | -   | -      | -               | -              | 3                   | (209 ) | (206) | 630                      | 424          | 110   |
| Balance as at December 31, 2016                        | 19,203,186                                  | *      | 658             | (169 )         | (52 )               | (243 ) | 194   | 2,543                    | 2,737        | 712   |

(\*)Represent an amount less than NIS 1.

(1) Net of treasury shares.

The accompanying notes are an integral part of these consolidated financial statements.

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Internet Gold - Golden Lines Ltd.

**Consolidated Statements of Cash Flows for the Year Ended December 31****(In millions)**

|   | 2014   | 2015   | 2016   | Convenience<br>translation<br>into<br>U.S. dollars<br>(Note 2D)<br>2016<br>US\$ |
|---|--------|--------|--------|---|
|   | NIS    | NIS    | NIS    | US\$  |
| Cash flows from operating activities                    |        |        |        |   |
| Net profit for the year                                 | 1,044  | 1,083  | 439    | 114   |
| Adjustments:  |        |        |        |   |
| Depreciation and amortization                           | 1,873  | 2,131  | 2,161  | 563   |
| Profit from the sale of Coral Tell Ltd. shares          | (582 ) | -      | -      | -   |
| Profit from consolidating an investee                   | -      | (12 )  | 5      | 1   |
| Share of losses of equity accounted investees           | 170    | (12 )  | -      | -   |
| Finance expenses, net                                   | 791    | 626    | 1,025  | 266   |
| Capital gain, net                                       | (124 ) | (136 ) | (86 )  | (22 )   |
| Income tax expenses                                     | 667    | 347    | 442    | 115   |
| Others  | (8 )   | (13 )  | -      | -   |
| Change in inventory                                     | 28     | (20 )  | (20 )  | (5 )  |
| Change in trade and other receivables                   | 547    | 323    | 110    | 29  |
| Change in trade and other payables                      | (41 )  | (271 ) | (24 )  | (6 )  |
| Changes in provisions                                   | (63 )  | 18     | (19 )  | (5 )  |
| Changes in employee benefits                            | 3      | 110    | (65 )  | (17 )   |
| Change in other liabilities                             | 4      | 4      | 23     | 6   |
| Net income tax paid, net                                | (527 ) | (534 ) | (534 ) | (140 )  |
| Net cash provided by operating activities               | 3,782  | 3,644  | 3,457  | 899   |
| Cash flows from investing activities                    |        |        |        |   |
| Investment in intangible assets and deferred expenses   | (194 ) | (311 ) | (223 ) | (58 )   |
| Proceeds from the sale of property, plant and equipment | 230    | 151    | 138    | 36  |
| Tax payments due to owners loans                        | -      | -      | (461 ) | (120 )  |

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|   |         |         |         |       |   |
|---|---------|---------|---------|-------|---|
| Change in investments, net                          | (1,485) | 1,638   | 528     | 137   |   |
| Purchase of property, plant and equipment           | (1,081) | (1,324) | (1,193) | (309) | ) |
| Net proceeds from the sale of Coral Tell shares     | 596     | -       | -       | -     |   |
| Deposits from (to) restricted cash                  | (65 )   | (90 )   | 155     | 40    |   |
| Cash from gaining control over investee             |         | 299     | -       | -     |   |
| Other   | 10      | 18      | 20      | 5     |   |
| Net cash provided by (used in) investing activities | (1,989) | 381     | (1,036) | (269) | ) |

The accompanying notes are an integral part of these consolidated financial statements.

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Internet Gold - Golden Lines Ltd.

**Consolidated Statements of Cash Flows for the Year Ended December 31 (cont'd)****(In millions)**

|   | 2014    | 2015    | 2016    | Convenience<br>translation<br>into<br>U.S. dollars<br>(Note 2D)<br>2016<br>US\$ |
|---|---------|---------|---------|---|
|   | NIS     | NIS     | NIS     | US\$  |
| Cash flows from financing activities                      |         |         |         |   |
| Proceeds from issuance of debentures and loans received   | 4,330   | 1,010   | 4,184   | 1,088   |
| Repayment of debentures and loans                         | (4,054) | (2,358) | (5,000) | (1,300)   |
| Interest paid   | (755)   | (826)   | (967)   | (251)   |
| Dividends to non-controlling interests                    | (1,431) | (1,274) | (1,187) | (309)   |
| Transactions with non-controlling interests               | -       | -       | 1,034   | 269   |
| Payments to Eurocom DBS                                   | -       | (680)   | (256)   | (67)  |
| Other   | (18)    | (10)    | (38)    | (10)  |
| Net cash used in financing activities                     | (1,928) | (4,138) | (2,230) | (580)   |
| Net increase (decrease) in cash and cash equivalents      | (135)   | (113)   | 191     | 50  |
| Cash and cash equivalents as at the beginning of the year | 867     | 732     | 619     | 161   |
| Cash and cash equivalents as at the end of the year       | 732     | 619     | 810     | 211   |

The accompanying notes are an integral part of these consolidated financial statements.

Internet Gold – Golden Lines Ltd.

## **Notes to the Consolidated Financial Statements**

(All amounts are in millions except where otherwise stated)

### **Note 1 - Reporting Entity**

Internet Gold–Golden Lines Ltd. (“the Company”) is an Israeli resident company incorporated in Israel. The address of the Company’s registered office is: 2 Dov Friedman Street, Ramat-Gan, Israel. The consolidated financial statements of the Company as at and for the year ended December 31, 2016, comprise the Company and its subsidiaries (together referred to as the Group). The Company holds the majority of the outstanding shares of B Communications Ltd. (“B Communications”). The Company is a subsidiary of Eurocom Communications Ltd. (“Eurocom” or “the Parent Company”) and its ultimate parent is Eurocom Holdings (1979) Ltd.

On April 14, 2010, B Communications completed the acquisition of 30.44% of the outstanding shares of Bezeq - The Israel Telecommunications Corp. Limited. (“Bezeq”) and became the controlling shareholder of Bezeq. Bezeq’s ordinary shares are registered for trade on the Tel-Aviv stock exchange.

On February 1, 2016, B Communications sold 115,500,000 shares of Bezeq (4.18% of the outstanding shares of Bezeq) for NIS 8.5 per share or NIS 978, net of transaction costs. B Communications retained a 26.34% ownership interest in Bezeq, following the closing of the transaction. For more information relating to B Communications’ control over Bezeq, see note 12F.

The ordinary shares of the Company are registered for trade on the NASDAQ Global Select Market and on the Tel Aviv Stock Exchange.

### **Note 2 - Basis of Preparation**

**A. Statement of compliance**

The consolidated financial statements have been prepared in accordance with International Financial Reporting Standards, as issued by the International Accounting Standards Board.

The consolidated financial statements were authorized to be issued by the Company's Board of Directors on April 26, 2017.

**B. Definitions**

In these financial statements-

(1)The Company: Internet Gold – Golden Lines Ltd.

(2)The Group: Internet Gold – Golden Lines Ltd. and its subsidiaries, as listed in Note 12 - Investees.

(3)B Communications: B Communications Ltd. and its subsidiaries, as listed in Note 12 - Investees.

(4)Bezeq: Bezeq - The Israel Telecommunication Corp. Limited.

(5) Bezeq Group: Bezeq The Israel Telecommunication Corp. Limited and its subsidiaries, as listed in Note 11- Investees.

(6)DBS: DBS Satellite Services (1998) Ltd.

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Internet Gold – Golden Lines Ltd.

## Notes to the Consolidated Financial Statements

(All amounts are in millions except where otherwise stated)

### Note 2 - Basis of Preparation (cont'd)

#### B. Definitions (cont'd)

- (7) Subsidiaries: Companies whose financial statements are fully consolidated, directly or indirectly, with the financial statements of the Company.
- (8) Associates: Companies in which the Group's investment is included, directly or indirectly, in the consolidated financial statements on the equity basis.
- (9) Investees: Subsidiaries or associates.
- (10) Related party: As defined in IAS 24 (2009), Related Party Disclosures.
- (11) Israeli CPI: The consumer price index as published by the Israeli Central Bureau of Statistics.

#### C. Functional currency and presentation currency

The consolidated financial statements are presented in NIS, which is the Group's functional currency, and have been rounded to the nearest million. The NIS is the currency that represents the principal economic environment in which the Group operates.

#### D. Convenience translation into U.S. dollars (“dollars” or “\$”)

For the convenience of the reader, the reported NIS figures as at December 31, 2016, have been presented in dollars, translated at the representative rate of exchange as at December 31, 2016 (NIS 3.845 = US\$ 1.00). The dollar amounts presented in these financial statements are merely supplementary information and should not be construed as complying with IFRS translation method or as representing amounts that are receivable or payable in dollars or convertible into dollars, unless otherwise indicated.

**E. Basis of measurement**

The consolidated financial statements have been prepared on the historical cost basis except for the following items:

- \* Financial instruments, including financial derivative instruments, measured at fair value recognized through profit or loss.
- \* Inventories measured at the lower of cost and net realizable value.
- \* Equity-accounted investments.
- \* Deferred tax assets and liabilities.
- \* Provisions.
- \* Assets and liabilities for employee benefits.
- \* Liabilities for payment of contingent consideration in a business combination.

For further information regarding the measurement of these assets and liabilities see Note 3 regarding significant accounting policies. The methods used to measure fair value are specified in Note 17E.

Internet Gold – Golden Lines Ltd.

## Notes to the Consolidated Financial Statements

(All amounts are in millions except where otherwise stated)

### Note 2 - Basis of Preparation (cont'd)

#### F. Use of estimates and judgments

##### Use of estimates and judgments

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

Estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are recognized in the period in which the estimates are revised and in any future periods affected.

Significant estimates and judgments made when applying accounting policies and changes in these estimates and assumptions that could potentially have a material effect on the financial statements are as follows:

| Subject   | Main assumptions   | Possible implications   | Reference                  |
|---|--|---|----------------------------|
| Useful life of fixed assets, intangible assets, and broadcasting rights | Assumptions of the useful life of groups of fixed assets and intangible assets | Change in the value of fixed assets and intangible assets and in depreciation and amortization expenses | Note 8, Note 9 and Note 11 |
| Measurement of recoverable amounts of                                   | Assumption of expected cash flows from cash-generating units                   | Recognition of impairment loss  | Note 11                    |

cash-generating units  
that include goodwill

|                         |   |   |         |
|-------------------------|---|---|---------|
| Deferred taxes          | Assumption of anticipated future realization of the tax benefit in the future, including assumptions for the use of carry-forward losses in DBS.  | Recognition or reversal of deferred tax asset in profit or loss | Note 19 |
| Uncertain tax positions | The extent of the certainty that the Group's tax positions will be accepted (uncertain tax positions) and the risk of it incurring any additional tax and interest expenses. This is based on an analysis of a number of matters including interpretations of tax laws and the Group's experience | Recognition or reversal of income tax expenses                  | Note 19 |

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Internet Gold – Golden Lines Ltd.

## Notes to the Consolidated Financial Statements

(All amounts are in millions except where otherwise stated)

### Note 2 - Basis of Preparation (cont'd)

#### F. Use of estimates and judgments (cont'd)

| Subject  | Main assumptions  | Possible implications   | Reference           |
|--|---|---|---------------------|
| Fair value measurement of contingent consideration | Assumptions of expected cash flows  | Change in the value of a liability for contingent consideration for a business combination      | Note 17             |
| Provisions and contingent liabilities              | Assessment of the likelihood of claims against Group companies and measuring potential liabilities attributable to claims | Reversal or creation of a provision for a claim and recognition of income/expenses respectively | Note 15 and Note 20 |
| Post-employment employee benefits                  | Actuarial assumptions such as discount rate, future salary increases and churn rate                                       | Increase or decrease in the post-employment defined benefit obligation                          | Note 18             |

#### G. Determination of fair value

When preparing the financial statements, the Group is required to determine the fair value of certain assets and liabilities. Further information about the assumptions made in determining fair values is disclosed in Note 17E regarding fair value.

### Note 3 - Significant Accounting Policies



The accounting policies set out below have been applied consistently by Group entities for all periods presented in these consolidated financial statements.

In this Note, where the Group has chosen accounting alternatives permitted in accounting standards and/or in accounting policy where there is no explicit provision in accounting standards, such disclosure is presented in bold. This does not attribute greater importance compared to other accounting policies that are not presented in bold.

#### **A. Changes in accounting policy**

Non- controlling interests

On January 1, 2016, the Group changed its accounting policy with respect to transactions with non-controlling interests, while retaining control. According to the new accounting policy, the difference between the consideration paid or received for change in non-controlling interests is recognized in retained earnings. The Group believes that this presentation provides more relevant information about its distributable earnings.

Internet Gold – Golden Lines Ltd.

## Notes to the Consolidated Financial Statements

(All amounts are in millions except where otherwise stated)

### Note 3 - Significant Accounting Policies (cont'd)

#### A. Changes in accounting policy (cont'd)

This change in accounting policy was applied retrospectively and did not have any impact on earnings per share. The following table summarizes the adjustments to equity reserves upon implementation of the new accounting policy:

|                   | December 31,2014                    |                                |  | December 31,2015                    |                                |  |
|-------------------|-------------------------------------|--------------------------------|--|-------------------------------------|--------------------------------|--|
|                   | As<br>previously<br>reported<br>NIS | Effect of<br>adjustment<br>NIS | As<br>reported<br>in these<br>financial<br>statements<br>NIS | As<br>previously<br>reported<br>NIS | Effect of<br>adjustment<br>NIS | As<br>reported<br>in these<br>financial<br>statements<br>NIS |
| Other reserves    | (197)                               | 138                            | (59 )  | (194)                               | 138                            | (56 )  |
| Retained earnings | (475)                               | (138 )                         | (613 )   | (388)                               | (138 )                         | (526 )   |

#### B. Consolidation of the financial statements and investments in associates

##### (1) Business combinations

In view of the consolidation of DBS as from March 23, 2015, as described in Note 12, below is a description of the accounting policy for the consolidation of DBS in these financial statements:

A. The Group implemented the acquisition method for all business combinations. The acquisition date is the date on which the acquirer obtained control over the acquiree.

B. The Group recognized goodwill at acquisition based on the fair value of the consideration transferred, and the fair value at the acquisition date of any pre-existing equity right of the Group in the acquiree, less the net amount of the identifiable assets acquired and the liabilities assumed.

C. The consideration transferred includes the fair value of the assets transferred to the previous owners of the acquiree and the liabilities incurred by the acquirer to the previous owners of the acquiree, including the obligation to acquire the acquiree's equity instruments. In addition, the consideration transferred includes the fair value of any contingent consideration. Subsequent to the acquisition date, the Group recognizes changes in fair value of contingent consideration classified as a financial liability in profit or loss under **financing expenses**.

D. In the step acquisitions, the difference between the fair value at the acquisition date of the Group's pre-existing equity rights in the acquiree and the carrying amount at that date is recognized in the statement of income under other operating income or expenses.

E. Costs associated with the acquisition that were incurred by the Group in the business combination such as advisory, legal, valuation and other professional or consulting fees were recognized as expenses in the period the services are received.

## (2) Transactions eliminated on consolidation

Intra-group balances and income and expense arising from intra-group transactions are eliminated in the preparation of the consolidated financial statements.

Internet Gold – Golden Lines Ltd.

## **Notes to the Consolidated Financial Statements**

(All amounts are in millions except where otherwise stated)

### **Note 3 - Significant Accounting Policies (cont'd)**

#### **C. Foreign currency transactions**

Transactions in foreign currency are translated into the functional currency of the Group at the exchange rate on the dates of the transactions. Monetary assets and liabilities denominated in foreign currencies on the reporting date are retranslated to the functional currency at the exchange rate at that date.

#### **D. Financial instruments**

##### **(1) Non-derivative financial assets**

Non-derivative financial assets include mainly investments in exchange traded notes, financial funds, exchange traded funds ("ETFs"), deposit certificates, debt instruments, shares, trade and other receivables, and cash and cash equivalents.

The Group initially recognizes financial assets at the date the Group becomes a party to contractual provisions of the instrument, meaning the date that the Group undertakes to buy or sell the asset.

Financial assets are derecognized when the contractual rights of the Group to the cash flows from the asset expire, or the Group transfers the rights to receive the contractual cash flows on the financial asset in a transaction in which substantially all the risks and rewards of ownership of the financial asset are transferred.

Regular way sales of financial assets are recognized on the trade date, meaning on the date the Group undertook to sell the asset.

(2) Classification of financial assets and the accounting treatment in each group

The Group classifies its financial assets as follows:

Cash and cash equivalents

Cash comprises cash balances available for immediate use and call deposits. Cash equivalents comprise short-term highly liquid investments (with original maturities of three months or less) that are readily convertible into known amounts of cash and are exposed to insignificant risks of change in value.

Financial assets at fair value through profit or loss

A financial asset is classified at fair value through profit or loss if it is held for trading or is designated as such upon initial recognition. Upon initial recognition. These financial assets are measured at fair value and changes therein are recognized in the statement of income.

Loans and receivables

Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market. Such assets are recognized initially at fair value plus attributable transaction costs. Subsequent to initial recognition, loans and receivables are measured at amortized cost using the effective interest method, net of impairment losses.

Internet Gold – Golden Lines Ltd.

## Notes to the Consolidated Financial Statements

(All amounts are in millions except where otherwise stated)

### Note 3 - Significant Accounting Policies (cont'd)

#### D. Financial instruments (cont'd)

##### (3) Non-derivative financial liabilities

Non-derivative financial liabilities include debentures issued by the Group, loans and borrowings from banks and other credit providers, and trade and other payables.

The Group initially recognizes debt instruments as they are incurred.

Financial liabilities are initially recognized at fair value plus any attributable transaction costs. Subsequent to initial recognition, these financial liabilities are measured at amortized cost using the effective interest method.

Financial liabilities are derecognized when the obligation of the Group, as specified in the agreement, expires or when it is discharged or canceled.

##### (4) CPI-linked assets and liabilities that are not measured at fair value

**The value of CPI-linked financial assets and liabilities, which are not measured at fair value, is revaluated in each period according to the actual increase in the CPI.**

(5) Offsetting financial instruments

Financial assets and liabilities are offset and the net amount presented in the statement of financial position when, and only when, the Group has a legal right to offset the amounts and intends either to settle on a net basis or to realize the asset and settle the liability simultaneously.

(6) Derivative financial instruments including hedge accounting

a. Hedge accounting

The Group holds derivative financial instruments to hedge cash flows for risks to future changes in the CPI.

Forward contracts are measured at fair value. Changes in the fair value of the derivative hedging instrument designated as a cash flow hedge are recognized through other comprehensive income, in a hedging reserve under equity, to the extent that the hedge is effective. To the extent that the hedge is ineffective, changes in fair value are recognized in profit or loss. The amount recognized in the hedging reserve is removed and included in profit or loss in the same period as the hedged cash flows affect profit or loss under the same line item in the statement of income as the hedged item.

b. Economic hedges

The Group holds other derivative financial instruments to hedge cash flows for foreign currency risks. Hedge accounting is not applied for these instruments. The derivative instruments are recognized at fair value; changes in fair value are recognized in profit and loss as incurred.

Internet Gold – Golden Lines Ltd.

## Notes to the Consolidated Financial Statements

(All amounts are in millions except where otherwise stated)

### Note 3 - Significant Accounting Policies (cont'd)

#### D. Financial instruments (cont'd)

(7) Share capital

a. Ordinary shares

Incremental costs directly attributable to the issue of ordinary shares are recognized as a deduction from equity.

b. Treasury shares

When share capital recognized as equity is repurchased, the amount of the consideration paid, which includes directly attributable costs, net of any tax effects, is recognized as a deduction from equity. Repurchased shares are classified as treasury shares and are presented as a deduction from total equity. When treasury shares are sold or reissued subsequently, the amount received is recognized as an increase in equity, and the resulting surplus or deficit on the transaction is carried to share premium.

#### E. Broadcast rights

**Broadcast rights are recognized at cost, net of rights exercised.** The costs of rights to broadcast acquired content include the amounts paid to the rights provider, plus direct costs for preparing the rights to the broadcast. Broadcast rights are amortized in accordance with the actual broadcasts of the total number of expected broadcasts based on the management's estimate or broadcasts permitted under the agreement (the part that is unamortized at the end of the



agreement term is amortized in full upon its termination), or on a straight line basis in accordance with the term of the rights agreement or the economic life, whichever is shorter. **The net change of broadcast rights is presented in the cash flows statements as adjustments to net income in operating activities.**

## **F. Property, plant and equipment**

(1) Recognition and measurement

**Items of property, plant and equipment are measured at cost less accumulated depreciation and accumulated impairment losses.**

Cost includes expenditures that are directly attributable to acquisition of the asset. The cost of self-constructed assets includes the cost of materials, direct labor and financing costs as well as any other cost directly attributable to bringing the asset to the condition for its use intended by the management, and the estimated costs of dismantling and removing the items and restoring the site on which they are located when the Group has an obligation to vacate and restore the site. The cost of purchased software that is integral to the functionality of the related equipment is recognized as part of the cost of the equipment.

Spare parts, servicing equipment and stand-by equipment are classified as property, plant and equipment when they meet the definition of property, plant and equipment under IAS 16, otherwise they are classified as inventory.

Internet Gold – Golden Lines Ltd.

## Notes to the Consolidated Financial Statements

(All amounts are in millions except where otherwise stated)

### Note 3 - Significant Accounting Policies (cont'd)

#### F. Property, plant and equipment (cont'd)

When major parts of the property, plant and equipment have different useful lives, they are accounted for as separate items (major components) of the property, plant and equipment.

Gain or loss from the disposal of an item of property, plant and equipment is determined by comparing the proceeds from disposal of the asset with its carrying amount. **Gain or loss from the sale of fixed assets is recognized under operating income in the statement of income.**

#### (2) Subsequent expenditure

The cost of replacing part of an item of property, plant and equipment is recognized in the carrying amount of the item if it is probable that the future economic benefit embodied in the replaced item will flow to the Group and its cost can be measured reliably. The costs of day-to-day servicing are recognized in the statement of income as incurred.

#### (3) Depreciation

Depreciation is recognized in the statement of income on a straight-line basis over the estimated useful life of each part of an item of property, plant and equipment, since this most closely reflects the expected pattern of consumption of the future economic benefits embodied in the asset. Leased assets under finance lease agreements are depreciated over the shorter of the lease term and their useful lives. An asset is depreciated when it is ready for use, meaning when it reaches the location and condition necessary for it to be capable of operating in the manner intended by

management.

Leasehold improvements are depreciated over the shorter of the lease term, including the extension option held by the Group and expected to be exercised and the expected life of the improvement.

The estimated useful lives for the current period are as follows:

|  | Useful life             |
|--|-------------------------|
| Fixed line and international network equipment (switches, transmission, power) | 4-12                    |
| Network  | 12-33                   |
| Subscriber equipment and installations   | 4-6                     |
| Equipment and infrastructure for multichannel television                       | 3-15                    |
| Vehicles   | 6-7                     |
| Office and general equipment   | 5-14                    |
| Electronic equipment, computers and internal communication systems             | 3-7                     |
| Cellular network   | 4-15                    |
| Passive radio equipment at cellular network sites                              | up to December 31, 2030 |
| Buildings  | 25                      |
| Submarine communications cable   | 4-25                    |

Depreciation methods, useful lives and residual values are reviewed at least at each reporting year and adjusted as required.

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Internet Gold – Golden Lines Ltd.

## Notes to the Consolidated Financial Statements

(All amounts are in millions except where otherwise stated)

### Note 3 - Significant Accounting Policies (cont'd)

#### G. Intangible assets

##### (1) Goodwill and brand name

Goodwill and brand names that arise upon the acquisition of subsidiaries are included in intangible assets. Subsequent to initial recognition, brand name (Bezeq CGU, Bezeq International CGU and Pelephone CGU) and goodwill are measured at cost less accumulated impairment losses. Goodwill and brand names are measured at least once a year to assess impairment.

##### (2) Software development costs

Software development costs are recognized as an intangible asset only if the development costs can be measured reliably; the software is technically and commercially feasible; and the Group has sufficient resources to complete the development and intends to use the software. The costs recognized as an intangible asset include the cost of the materials, direct labor and overhead expenses directly attributable to preparation of the asset for its intended use. Other development costs are recognized in the statement of income as incurred. Capitalized development costs are measured at cost less amortization and accumulated impairment losses.

##### (3) Software

Software that is an integral part of the hardware, which cannot function without the programs installed on it, is classified as property, plant and equipment. However, licenses for stand-alone software, which adds functionality to the hardware, is classified (mainly) as intangible assets. Software depreciation is recognized in the statement of

income using the straight-line method over the estimated useful life of the asset.

(4) Frequency rights

Rights to frequencies refer to frequencies assigned to Pelephone for cellular activities, after it won the dedicated tenders of the Ministry of Communications. Depreciation of the asset is recognized in the statement of income on the straight-line basis over the allocation of frequencies term, which started from the use of the frequencies. The 4G frequencies (LTE) are being amortized over a period of 10 years. The 3.5G frequencies (UMTS / HSPA) are being amortized over a period of 13 years and seven months.

(5) Other intangible assets

**Other intangible assets acquired by the Group, which have a definite useful life, are measured at cost less amortization and accumulated impairment losses.**

(6) Subsequent expenditures

Subsequent expenditures are recognized as an intangible asset only when they increase the future economic benefits embodied in the specific asset to which they relate. All other expenditures, including expenditures relating to generated goodwill and brands, are recognized in the statement of income as incurred.

Internet Gold – Golden Lines Ltd.

**Notes to the Consolidated Financial Statements**

(All amounts are in millions except where otherwise stated)

**Note 3 - Significant Accounting Policies (cont'd)**

**G. Intangible assets (cont'd)**

(7) Amortization

Amortization, except for goodwill, brand name (excluding brand acquired in DBS business combination) and customer relationships, is recognized in the statement of income on a straight-line basis over the estimated useful life of the intangible assets, from the date on which the assets are available for use. Goodwill and brand name are not systematically amortized but are tested for impairment at least once a year.

Customer relationships are amortized according to the economic benefit expected from those customers each period based on their expected churn rate, which results in accelerated amortization during the early years of the relationship.

Estimated useful lives for the current and comparative periods are as follows:

| Type of asset                            | Amortization period  |
|--|--|
| Frequency usage rights                   | Over the term of the license for 10 to 14 years starting from the first use of the frequencies |
| Computer programs and software licenses  | 3 - 10 years according to the term of the license or the estimated time of use of the program  |
| Customer relationships                   | 5 - 12 years   |
| Brand acquired in a business combination | 12   |

Other rights 2 - 3 years according to the useful lives

Amortization methods and useful lives are reviewed at least once a year and adjusted if appropriate.

#### **H. Leased assets**

Leases, including leases of land from the Israel Land Administration, where the Group assumes substantially all the risks and rewards of ownership are classified as finance leases. Upon initial recognition, the leased asset is measured at an amount equal to the lower of its fair value and the present value of the minimum lease payments. **Subsequent to initial recognition, the assets are measured at cost less accumulated amortization and impairment losses.**

Other leases are classified as operating leases and the leased assets are not recognized in the Group's statement of financial position. Payments made under operating leases are recognized in profit or loss on a straight-line basis over the term of the lease.

At inception or upon reassessment of an arrangement, the Group determines whether such an arrangement is or contains a lease. An arrangement is a lease or contains a lease if the following two criteria are met:

A. The fulfillment of the arrangement is dependent on the use of a specific asset or assets;

Internet Gold – Golden Lines Ltd.

## **Notes to the Consolidated Financial Statements**

(All amounts are in millions except where otherwise stated)

### **Note 3 - Significant Accounting Policies (cont'd)**

#### **H. Leased assets (cont'd)**

B. The arrangement contains rights to use the asset

If, in accordance with these terms, the Group determines that the agreement does not contain a lease, the agreement is accounted for as a service agreement and payments for the service are recognized in profit or loss on a straight-line basis, over the service period.

#### **I. Right of use of capacities**

Transactions for acquiring an indefeasible right of use of submarine communication cable capacities are mostly accounted for as service transactions. The prepaid expense is amortized on a straight-line basis as stated in the agreement, but for no longer than the expected estimated useful life of those capacities.

Identifiable capacities which serve Bezeq exclusively meet the definition of a finance lease and are recognized in property, plant and equipment. The asset is depreciated on a straight-line basis as stated in the agreement, but for no longer than the expected estimated useful life of those capacities.

#### **J. Inventory**



The cost of inventories includes the cost of purchase and cost incurred in bringing the inventories to their present location and condition.

Inventories are measured at the lower of cost or net realizable value. **The Group elected to base the cost of inventories on the moving average principle.**

The inventories include terminal equipment and accessories intended for sale and service, as well as spare parts used for repairs in the repair service provided to its customers.

Slow-moving inventory of terminal equipment, accessories and spare parts are stated net of the provision for impairment.

## **K. Impairment**

### (1) Non-derivative financial assets

The Group tests a financial asset for impairment when objective evidence indicates that one or more loss events have had a negative effect on the estimated future cash flows of that asset.

Significant financial assets are tested for impairment on an individual basis. The remaining financial assets are assessed for impairment collectively, in groups that share similar credit risk characteristics. The financial statements include specific provisions and Group provisions for doubtful debts, which properly reflect, in the estimation of the management, the loss inherent in debts for which collection is in doubt.

Internet Gold – Golden Lines Ltd.

## Notes to the Consolidated Financial Statements

(All amounts are in millions except where otherwise stated)

### Note 3 - Significant Accounting Policies (cont'd)

#### K. Impairment (cont'd)

(2) Non-financial assets

##### Timing of impairment testing

The carrying amounts of the Group's non-financial assets, other than inventory and deferred tax assets are reviewed at each reporting date to determine whether there is any indication of impairment. If any such indication exists, then the recoverable amount of the asset is estimated.

The Group assesses the recoverable amount of goodwill and brand name once a year, or more frequently if there are indications of impairment.

##### Measurement of recoverable amount

The recoverable amount of an asset or cash-generating unit is the greater of its value in use and fair value less costs to sell. In assessing value in use, the estimated future cash flows are discounted to their present value using a discount rate that reflects current market assessments of the time value of money and the risks specific to the asset or cash-generating unit, for which the estimated future cash flows from the asset or cash-generating unit were not adjusted.

##### Determining cash-generating units

For the purpose of impairment testing, the assets are grouped together into the smallest group of assets that generates cash from continuing use that are largely independent of other assets or groups of assets (“cash-generating unit”).

#### Allocation of goodwill to cash-generating units

For purposes of goodwill impairment testing, cash-generating units to which goodwill has been allocated are aggregated so that the level at which impairment testing is performed reflects the lowest level at which goodwill is monitored for internal reporting purposes, but in any event is not larger than an operating segment. Goodwill acquired in a business combination is allocated to cash-generating units that are expected to generate benefits from the synergies of the combination.

For purposes of goodwill impairment testing, when the non-controlling interests are initially measured according to their relative share of the acquiree’s net identifiable assets, the carrying amount of the goodwill is adjusted according to the share which the Group holds in the cash-generating unit to which the goodwill is allocated.

#### Recognition of impairment loss

An impairment loss is recognized if the carrying amount of an asset or cash-generating unit exceeds its estimated recoverable amount. Impairment losses are recognized in profit or loss. As regards cash-generating units that include goodwill, an impairment loss is recognized when the carrying amount of the cash-generating unit, after including the balance of goodwill, exceeds its recoverable amount. Impairment losses recognized in respect of cash-generating units are allocated first to reduce the carrying amount of any goodwill allocated to the units and then to reduce the carrying amounts of the other assets in the cash-generating unit on a pro rata basis.

Internet Gold – Golden Lines Ltd.

## Notes to the Consolidated Financial Statements

(All amounts are in millions except where otherwise stated)

### Note 3 - Significant Accounting Policies (cont'd)

#### L. Employee benefits

##### Allocation of impairment loss to non-controlling interests

If an impairment loss allocated to non-controlling interest relates to goodwill that was not recognized in the consolidated financial statements, the said impairment is not recognized as an impairment loss on goodwill. In such cases, only an impairment loss relating to goodwill that was allocated to the owners of the Company is recognized as an impairment loss on goodwill.

##### (1) Post-employment benefits

The Group has a number of post-employment benefit plans. The plans are usually financed by deposits with insurance companies and they are classified as defined contribution plans and defined benefit plans.

##### a. Defined contribution plans

A defined contribution plan is a post-employment benefit plan under which the Group pays fixed contributions into a separate entity and has no legal or constructive obligation to pay further amounts.

The Group's obligations for contributions to defined contribution pension plans are recognized as an employee benefit expense in the statement of income in the periods during which services are rendered by employees.

b. Defined benefit plans

The Group's net obligation in respect of defined benefit pension plans is calculated separately for each plan by estimating the amount of future benefit that employees have earned in return for their service in the current and prior periods. That benefit is presented at its present value, and the fair value of any plan assets is deducted. The calculation is performed annually by a qualified actuary. The discount rate is the yield at the reporting date on high-quality linked corporate debentures denominated in NIS, with maturity dates approximating the terms of the Group's obligations.

Net interest costs on a defined benefit plan are calculated by applying the discount rate used to measure the defined benefit obligation at the beginning of the annual period to the then-net defined benefit liability.

**The Group elected to recognize the interest costs that were recognized in profit or loss under financing expenses.**

Remeasurement of the net defined benefit liability comprises actuarial gains and losses and the return on plan assets (excluding interest). Remeasurements are recognized immediately directly **in retained earnings** through other comprehensive income.

When the benefits of a plan are improved or curtailed, the portion of the increased benefit relating to past service by employees or the gain or loss on curtailment are recognized immediately in profit or loss when the plan improvement or curtailment occurs.

Internet Gold – Golden Lines Ltd.

## Notes to the Consolidated Financial Statements

(All amounts are in millions except where otherwise stated)

### Note 3 - Significant Accounting Policies (cont'd)

#### L. Employee benefits (cont'd)

##### (2) Other long-term employee benefits

The Group's net obligation in respect of long-term employee benefits other than pension plans is the amount of future benefit that employees have earned in return for their service in the current and prior periods. The amount of these benefits is stated at its present value. The discount rate is the yield at the reporting date on high-quality linked corporate debentures denominated in NIS, with maturity dates approximating the terms of the Group's obligations. Any actuarial gains or losses are recognized in the statement of income in the period in which they arise.

##### (3) Benefits for early retirement and dismissal

Termination benefits are recognized as an expense when the Group is committed demonstrably, without realistic possibility of withdrawal, to a formal detailed plan to terminate employment before the normal retirement date. Termination benefits for voluntary redundancies are recognized as an expense if the Group has made an offer of voluntary redundancy, it is probable that the offer will be accepted, and the number of acceptances can be estimated reliably.

##### (4) Short-term benefits

Short-term employee benefit obligations are measured on an undiscounted basis and are expensed as the related service is provided. A liability is recognized for the amount expected to be paid under short-term cash bonus or profit-sharing plans if the Group has a present legal or constructive obligation to pay this amount as a result of past

service provided by the employee and the obligation can be estimated reliably.

The employee benefits are classified, for measurement purposes, as short-term benefits or as other long-term benefits depending on the date when the benefits are expected to be to be wholly settled.

In the statement of financial position the employee benefits are classified as current benefits or as non-current benefits according to the time the liability is due to be settled.

### **M. Provisions**

A provision is recognized if, as a result of a past event, the Group has a present legal or constructive obligation that can be estimated reliably, and it is more likely than not that an outflow of economic benefits will be required to settle the obligation.

#### **(1) Legal claims**

Contingent liabilities are accounted for according to IAS 37 and its related provisions. Accordingly, the claims are classified by likelihood of realization of the exposure to risk, as follows:

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## Notes to the Consolidated Financial Statements

(All amounts are in millions except where otherwise stated)

### Note 3 - Significant Accounting Policies (cont'd)

#### M. Provisions (cont'd)

- a. More likely than not - more than 50% probability
- b. Possible - probability higher than unlikely and less than 50%
- c. Remote - probability of 10% or less

For claims which the Group has a legal or constructive obligation as a result of a past event, which are more likely than not to be realized, the financial statements include provisions which, in the opinion of the Group, based, among other things, on the opinions of its legal advisers retained in respect of those claims, are appropriate to the circumstances of each case, despite the claims being denied by the Group companies. There are also a few recently filed legal proceedings for which the risks cannot be assessed at this stage, therefore no provisions have been made.

Note 20 describe the amount of additional exposure due to contingent liabilities that are likely to be realized.

#### (2) Site restoration and clearing costs

A provision in respect of an obligation to restore and clear sites is recognized for those rental agreements where the Group has an undertaking to restore the rental property to its original state at the end of the rental period, after dismantling and transferring the site, and restoring it as necessary. The provisions are determined by discounting the expected future cash flows. The carrying amount of the provision is adjusted each period to reflect the time that has



passed and is recognized as a financing expense.

## **N. Revenues**

Revenues are measured at the fair value of the consideration received or receivable, net of returns, trade discounts and volume rebates.

### **(1) Equipment sales**

Revenues from sales of terminal equipment are recognized in the statement of income when the significant risks and rewards of ownership have been transferred to the buyer, recovery of the consideration is probable, the associated costs and possible return of goods can be estimated reliably and the Group companies have no continuing involvement with the goods.

Revenues from the sale of terminal equipment to subscribers in long-term credit arrangements are recognized upon delivery to the customer at the present value of the future cash flow expected from them, **at the appropriate interest rate for transactions of this kind** (see Note 7). Financing income in respect of these transactions is recognized in the statement of income over the period of the installments using the effective interest method.

Internet Gold – Golden Lines Ltd.

## **Notes to the Consolidated Financial Statements**

(All amounts are in millions except where otherwise stated)

### **Note 3 - Significant Accounting Policies (cont'd)**

#### **N. Revenues (cont'd)**

##### (2) Revenues from services

Revenues from services rendered are recognized in the statement of income proportionately over the term of the agreement or upon providing the service if the flow of the economic benefits associated with providing the service is likely.

##### (3) Reporting gross or net revenues

When the Group acts as an agent or intermediary without bearing the risks and rewards deriving from the transaction, its revenues are recognized on a net basis (as profit or commission). The Group operates as an agent mainly for certain content services provided by other suppliers and payment is collected by the Group. However, when the Group acts as principal and bears the risks and rewards associated with the transaction, its revenues are recognized on a gross basis (such as interconnect fees).

#### **O. Financing expenses (income)**

Finance income comprises mainly interest income accrued using the effective interest method in respect of the sale of terminal equipment in installments, interest income from deposits and changes in the fair value of financial assets at fair value through profit or loss.

Finance expenses include mainly interest and linkage expenses on borrowings received and debentures issued and financing expenses for provisions arising from legal claims.

In the statements of cash flows, **interest received and dividends received are presented as part of cash flows from investing activities. The Group elected to present interest and linkage differences paid for loans and debentures under cash flows used for financing activities.**

#### **P. Income tax expense**

Income tax expense comprises current and deferred tax and is recognized in the statement of income, or in other comprehensive income to the extent it relates to items recognized in other comprehensive income.

##### Current taxes

Current tax is the expected tax payable on the taxable income for the year, using tax rates enacted or substantively enacted at the reporting date. Current taxes also include taxes in respect of prior years.

##### Uncertain tax positions

A provision for uncertain tax positions, including additional tax and interest expenses, is recognized when it is more likely than not that the Group will have to use its economic resources to pay the obligation.

Internet Gold – Golden Lines Ltd.

## Notes to the Consolidated Financial Statements

(All amounts are in millions except where otherwise stated)

### Note 3 - Significant Accounting Policies (cont'd)

#### P. Income tax expense (cont'd)

##### Deferred taxes

Deferred tax is recognized in respect of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for taxation purposes. The Group does not recognize deferred taxes for the following temporary differences:

Initial recognition of goodwill.

Differences arising from investment in subsidiaries and associates, if it is probable that they will not reverse in the foreseeable future and if the Group controls the date of reversal.

Deferred tax is measured at the tax rates that are expected to be applied to temporary differences when they reverse, based on the laws that have been enacted or substantively enacted by the reporting date.

A deferred tax asset is recognized for carry-forward losses, tax benefits and deductible temporary differences, to the extent that it is probable that future taxable profits will be available against which they can be utilized. Deferred tax assets are reviewed at each reporting date and are reduced to the extent that it is no longer probable that the related tax benefit will be realized.

Offsetting deferred tax assets and liabilities

The Group sets off deferred tax assets and liabilities if there is a legally enforceable right to offset deferred tax liabilities and assets, and they relate to income taxes levied by the same tax authority on the same taxable entity, but they intend to settle deferred tax liabilities and assets on a net basis or their tax assets and liabilities will be realized simultaneously.

Presentation of tax expenses in the statement of cash flows

Cash flows arising from taxes on income are classified in the statement of cash flows as cash flows from operating activities, unless they can be specifically identified with investing and financing activities.

**Q. Earnings per share**

The Group presents basic and diluted earnings per share (EPS) data for its ordinary shares. Basic EPS is calculated by dividing the profit or loss attributable to ordinary shareholders of the Company by the weighted average number of ordinary shares outstanding during the year. Diluted EPS is determined by adjusting the profit or loss attributable to ordinary shareholders and the weighted average number of ordinary shares outstanding for the effects of all dilutive potential ordinary shares, which comprise warrants and share options granted to employees.

**R. Dividend**

An obligation relating to a dividend proposed or declared after the reporting date is recognized only in the period in which the declaration was made (approved by the general shareholders' meeting). In the statement of cash flows, **dividend paid is presented as part of cash flows used in financing activities.**

Internet Gold – Golden Lines Ltd.

## **Notes to the Consolidated Financial Statements**

(All amounts are in millions except where otherwise stated)

### **Note 3 - Significant Accounting Policies (cont'd)**

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

##### **(1) IFRS 9, Financial Instruments ("IFRS 9")**

IFRS 9 replaces the current guidance in IAS 39, Financial Instruments: Recognition and Measurement. The new Standard includes revised guidance on the classification and measurement of financial instruments, a new 'expected credit loss' model for calculating impairment for most financial assets, and new guidance and requirements with respect to hedge accounting.

IFRS 9 is effective for annual periods beginning on January 1, 2018, with early adoption being permitted. IFRS 9 will be applied retrospectively, except for a number of exemptions.

The Group has examined the effects of applying IFRS 9, and in its opinion the effect on the financial statements will be immaterial.

##### **(2) IFRS 15, Revenues from Contracts with Customers ("IFRS 15")**

IFRS 15 replaces the current guidance regarding recognition of revenues and presents a new model for recognizing revenue from contracts with customers. IFRS 15 provides two approaches for recognizing revenue: at a point in time or over time. The model includes five steps for analyzing transactions so as to determine when to recognize revenue and at what amount.

IFRS 15 is applicable for annual periods beginning on or after January 1, 2018 and earlier application is permitted. The Group decided to early apply IFRS 15 as from January 1, 2017, using the cumulative catch-up approach, without restatement of comparative figures, by adjusting the balance of retained earnings as at January 1, 2017 with application of the practical expedient at the transition date, according to which the cumulative catch-up approach will only be applied for contracts not yet completed at the transition date.

The main effect on the Group of application of IFRS 15 is the accounting treatment for the incremental costs of obtaining a contract with a customer ("Subscriber Acquisition"), which, in accordance with IFRS 15, are recognized as an asset when it is probable that the Group will recover these costs, and not only where there is an obligation of the customer to acquire services from the Group for a defined period. Accordingly, direct commissions paid to agents and sales employees for sales and upgrades under agreements that do not include an obligation period of the customer, are recognized as an asset for obtaining a contract instead of an expense in the statement of income. The contracts that are renewed every month and that may be cancelled by the customer at any time, without any penalty, are contracts were completed at the date of initial application of IFRS 15. Accordingly, the Group chose, under the practical expedient included in the transitional provisions of IFRS 15, not to apply IFRS 15 for contracts that ended prior to January 1, 2017, therefore the Subscriber Acquisition costs incurred prior to January 1, 2017 and were recognized in the statement of income as an expense, will not be accounted for retrospectively. Other than the accounting treatment of Subscriber Acquisition costs, the Group does not expect there to be any other material effects arising from application of IFRS 15.

Internet Gold – Golden Lines Ltd.

## **Notes to the Consolidated Financial Statements**

(All amounts are in millions except where otherwise stated)

### **Note 3 - Significant Accounting Policies (cont'd)**

#### **S. New standards and interpretations not yet adopted Dividend (cont'd)**

##### **(2) IFRS 15, Revenues from Contracts with Customers ("IFRS 15") (cont'd)**

In view of the above, adoption of IFRS 15 is not expected to have a material effect on the retained earnings at the transition date. Subscriber Acquisition amortization expenses will be recognized in the statement of income at the expected average duration of the subscribers.

The effect of the application of IFRS 15 on the financial results for 2017 will depend on Subscriber Acquisition costs incurred by the Group in 2017 and the estimated expected average duration of subscribers acquired by the Group in 2017.

##### **(3) IFRS 16, Financial Instruments ("IFRS 16")**

IFRS 16 replaces IAS 17, Leases and its related interpretations. The standard's instructions annul the existing requirement for lessees to classify leases as operating or finance leases. Instead, for lessees, the new standard presents a unified model for the accounting treatment of all leases according to which the lessee has to recognize an asset and liability in respect of the lease in its financial statements IFRS 16 also establishes new and more extensive disclosure requirements. IFRS 16 is applicable for annual periods as from January 1, 2019, with the possibility of early adoption, provided the Group has also early adopted IFRS 15, Revenue from Contracts with Customers.



IFRS 16 includes several alternative transitional provisions, so that companies can choose between one of the following alternatives at initial application: full retrospective application or application (with the possibility of certain practical expedients) as from the mandatory effective date, with an adjustment to the balance of retained earnings at that date. The Group is still examining the alternatives for initial application of IFRS 16.

The Group is also examining the anticipated effects of IFRS 16 on the financial statements, but at this stage, it is unable to reliably estimate the quantitative impact on its financial statements.

IFRS 16 is expected to affect the accounting treatment of real estate leasing agreements, cellular sites, vehicles and Group assets. The Group believes that IFRS 16 will have a material effect on its financial statements in the following issues:

- a. Application of IFRS 16 is expected to decrease the Group's operating expenses and increase depreciation expenses and financing expenses.
- b. An increase in non-current assets and liabilities is expected.
- c. An increase in cash flow from operating activities and a decrease in cash flow from financing activities are expected.
- d. Due to the change in assets and liabilities, a change in financial ratios and financial information is expected, such as a decrease in the Group's working capital.

It should be noted that the Group is still examining the effect of IFRS 16 on the Group's financial statements, therefore the list of issues presented above represents issues that the Group has identified up to the authorization date of the financial statements, and additional subjects may be added to the list. The issues presented may require adjustment as the examination of the effects of the application of IFRS 16 progresses.

Internet Gold – Golden Lines Ltd.

## **Notes to the Consolidated Financial Statements**

(All amounts are in millions except where otherwise stated)

### **Note 4 - Segment Reporting**

The Group operates in various segments in the communications sector and every company in the Group operates in one separate business segment. The primary reporting format, by business segments, is based on the Group's management and internal reporting structure.

Each company provides services in the segment in which it operates, using the property, plant and equipment and the infrastructure it owns. The infrastructure of each company is used only for providing its services. Each of the companies in the Group is exposed to different risks and yield expectations, mainly with respect to the technology and competition in the segment in which it operates. Accordingly, the separable components in the Group are each company in the Group.

The Group's investment in DBS was accounted for using the equity method up to March 23, 2015. As from this date, the financial statements of DBS are consolidated with the financial statements of the Group as described in Note 12B below. The Group reports on multichannel television as an operating segment without adjustment to ownership rates and excess cost in all reporting periods.

Based on the above, the business segments of the Group are as follows:

- Bezeq - The Israel Telecommunication Corp. Ltd.: fixed line domestic communications
- Pelephone Communications Ltd.: cellular communications
- Bezeq International Ltd.: international communications, internet services and network end point
- DBS Satellite Services (1998) Ltd.: multichannel television

The other companies in the Group are presented under the "Other" item. Other operations include call center services (Bezeq Online) and online shopping and classified ads, (through Walla). These operations are not reported as reporting segments as they do not fulfill the quantitative thresholds.

Inter-segment pricing is set at the price determined in a transaction between unrelated parties.

The results, assets and liabilities of a segment include items directly attributable to that segment, as well as those that can be allocated on a reasonable basis.

Segment capital expenditure is the total cost incurred during the period for acquisition of property, plant and equipment and intangible assets.

Internet Gold – Golden Lines Ltd.

**Notes to the Consolidated Financial Statements**

(All amounts are in millions except where otherwise stated)

**Note 4 - Segment Reporting (cont'd)****A. Operating Segments (cont'd)**

|   | Year ended December 31, 2014             |                            |  |                             |        |             |              |
|---|--|----------------------------|--|-----------------------------|--------|-------------|--------------|
|   | Domestic<br>fixed-line<br>communications | Cellular<br>communications | International<br>communications<br>and<br>internet<br>services | Multi-channel<br>television | Others | Adjustments | Consolidated |
|   | NIS                                      | NIS                        | NIS  | NIS                         | NIS    | NIS         | NIS          |
| Revenue from external entities                      | 4,045                                    | 3,361                      | 1,419  | 1,724                       | 209    | (1,724 )    | 9,034        |
| Inter-segment revenues                              | 272                                      | 58                         | 85   | -                           | 17     | (411 )      | 21           |
| Total revenue                                       | 4,317                                    | 3,419                      | 1,504  | 1,724                       | 226    | (2,135 )    | 9,055        |
| Depreciation and amortization                       | 688                                      | 430                        | 130  | 298                         | 23     | 304         | 1,873        |
| Segment results- operating income                   | 1,980                                    | 449                        | 232  | 273                         | 629    | (988 )      | 2,575        |
| Finance income                                      | 285                                      | 77                         | 9  | 26                          | 11     | 227         | 635          |
| Finance expenses                                    | (472 )                                   | (21 )                      | (18 )  | (619 )                      | (2 )   | (197 )      | (1,329 )     |
| Total finance income (expense), net                 | (187 )                                   | 56                         | (9 )   | (593 )                      | 9      | 30          | (694 )       |
| Segment profit (loss) after finance expenses, net   | 1,793                                    | 505                        | 223  | (320 )                      | 638    | (958 )      | 1,881        |
| Share in profit (loss) of equity-accounted investee | -  | -                          | 1  | -                           | (3 )   | (168 )      | (170 )       |
| Segment profit (loss) before income tax             | 1,793                                    | 505                        | 224  | (320 )                      | 635    | (1,126 )    | 1,711        |
| Income tax  | 478                                      | 132                        | 60   | 1                           | 147    | (151 )      | 667          |
| Segment results - net profit (loss)                 | 1,315                                    | 373                        | 164  | (321 )                      | 488    | (975 )      | 1,044        |
| Additional information:                             |  |                            |  |                             |        |             |              |
| Segment assets                                      | 8,483                                    | 3,541                      | 1,206  | 1,820                       | 682    | 2,087       | 17,820       |
| Goodwill  | -  | -                          | 6  | -                           | 10     | 2,665       | 2,681        |
|   | -  | -                          | 4  | -                           | 11     | 1,042       | 1,057        |

|  |        |     |     |       |     |        |   |        |
|--|--------|-----|-----|-------|-----|--------|---|--------|
| Investment in equity-accounted investee                            |        |     |     |       |     |        |   |        |
| Segment liabilities  | 12,369 | 696 | 392 | 6,484 | 107 | (1,256 | ) | 18,792 |
| Investments in property, plant and equipment and intangible assets | 835    | 339 | 110 | 332   | 17  | (332   | ) | 1,301  |

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Internet Gold – Golden Lines Ltd.

**Notes to the Consolidated Financial Statements**

(All amounts are in millions except where otherwise stated)

**Note 4 - Segment Reporting (cont'd)****A. Operating Segments (cont'd)**

|   | Year ended December 31, 2015             |                            |  |                             |        |            |     | Consolidated |
|---|--|----------------------------|--|-----------------------------|--------|------------|-----|--------------|
|   | Domestic<br>fixed-line<br>communications | Cellular<br>communications | International<br>communications<br>and<br>internet<br>services | Multi-channel<br>television | Others | Adjustment |     |              |
|   | NIS                                      | NIS                        | NIS  | NIS                         | NIS    | NIS        | NIS | NIS          |
| Revenue from external entities                      | 4,122                                    | 2,831                      | 1,485  | 1,774                       | 197    | (440)      | )   | 9,969        |
| Inter-segment revenues                              | 285                                      | 59                         | 93   | -                           | 24     | (445)      | )   | 16           |
| Total revenue                                       | 4,407                                    | 2,890                      | 1,578  | 1,774                       | 221    | (885)      | )   | 9,985        |
| Depreciation and amortization                       | 725                                      | 419                        | 132  | 322                         | 13     | 520        |     | 2,131        |
| Segment results- operating income                   | 2,148                                    | 157                        | 240  | 250                         | (15)   | (767)      | )   | 2,013        |
| Finance income                                      | 30                                       | 53                         | 7  | 32                          | 17     | 25         |     | 164          |
| Finance expenses                                    | (362)                                    | (4)                        | (15)   | (635)                       | (2)    | 259        | )   | (759)        |
| Total finance income (expense), net                 | (332)                                    | 49                         | (8)  | (603)                       | 15     | 284        | )   | (595)        |
| Segment profit (loss) after finance expenses, net   | 1,816                                    | 206                        | 232  | (353)                       | -      | (483)      | )   | 1,418        |
| Share in profit (loss) of equity-accounted investee | -  | -                          | -  | -                           | (2)    | 14         |     | 12           |
| Segment profit (loss) before income tax             | 1,816                                    | 206                        | 232  | (353)                       | (2)    | (469)      | )   | 1,430        |
| Income tax  | 492                                      | 55                         | 60   | 1                           | -      | (261)      | )   | 347          |
| Segment results - net profit (loss)                 | 1,324                                    | 151                        | 172  | (354)                       | (2)    | (208)      | )   | 1,083        |
| Additional information:                             |  |                            |  |                             |        |            |     |              |
| Segment assets                                      | 7,311                                    | 3,269                      | 1,160  | 1,667                       | 661    | 5,251      |     | 19,319       |
| Goodwill  | -  | -                          | 6  | -                           | 10     | 3,050      |     | 3,066        |
|   | -  | -                          | 4  | -                           | 7      | 14         |     | 25           |

|  |        |     |     |       |     |     |   |        |
|--|--------|-----|-----|-------|-----|-----|---|--------|
| Investment in equity-accounted investee                            |        |     |     |       |     |     |   |        |
| Segment liabilities  | 12,117 | 513 | 343 | 6,685 | 104 | 47  |   | 19,809 |
| Investments in property, plant and equipment and intangible assets | 837    | 419 | 127 | 281   | 33  | (80 | ) | 1,617  |

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Internet Gold – Golden Lines Ltd.

**Notes to the Consolidated Financial Statements**

(All amounts are in millions except where otherwise stated)

**Note 4 - Segment Reporting (cont'd)****A. Operating Segments (cont'd)**

|   | Year ended December 31, 2016             |                            |  |                             |        |             |              |
|---|--|----------------------------|--|-----------------------------|--------|-------------|--------------|
|   | Domestic<br>fixed-line<br>communications | Cellular<br>communications | International<br>communications<br>and<br>internet<br>services | Multi-channel<br>television | Others | Adjustments | Consolidated |
|   | NIS                                      | NIS                        | NIS  | NIS                         | NIS    | NIS         | NIS          |
| Revenue from external entities                      | 4,063                                    | 2,587                      | 1,478  | 1,745                       | 198    | -           | 10,071       |
| Inter-segment revenues                              | 320                                      | 43                         | 70   | -                           | 20     | (440)       | 13           |
| Total revenue                                       | 4,383                                    | 2,630                      | 1,548  | 1,745                       | 218    | (440)       | 10,084       |
| Depreciation and amortization                       | 717                                      | 380                        | 137  | 296                         | 16     | 615         | 2,161        |
| Segment results- operating income                   | 2,076                                    | 32                         | 176  | 264                         | (34)   | (653)       | 1,861        |
| Finance income                                      | 30                                       | 52                         | 5  | 13                          | 4      | 29          | 133          |
| Finance expenses                                    | (475)                                    | (6)                        | (15)   | (539)                       | (2)    | (71)        | (1,108)      |
| Total finance income (expense), net                 | (445)                                    | 46                         | (10)   | (526)                       | 2      | (42)        | (975)        |
| Segment profit (loss) after finance expenses, net   | 1,631                                    | 78                         | 166  | (262)                       | (32)   | (695)       | 886          |
| Share in profit (loss) of equity-accounted investee | -  | -                          | 1  | -                           | (5)    | (1)         | (5)          |
| Segment profit (loss) before income tax             | 1,631                                    | 78                         | 167  | (262)                       | (37)   | (696)       | 881          |
| Income tax  | 399                                      | 17                         | 42   | (330)                       | -      | 314         | 442          |
| Segment results - net profit (loss)                 | 1,232                                    | 61                         | 125  | 68                          | (37)   | (1,010)     | 439          |
| Additional information:                             |  |                            |  |                             |        |             |              |
| Segment assets                                      | 7,111                                    | 3,294                      | 1,177  | 2,026                       | 193    | 3,642       | 17,443       |
| Goodwill  | -  | -                          | 6  | -                           | 10     | 3,050       | 3,066        |
|   | -  | -                          | 5  | -                           | 1      | 12          | 18           |



|  |        |     |     |       |     |       |        |
|--|--------|-----|-----|-------|-----|-------|--------|
| Investment in equity-accounted investee                            |        |     |     |       |     |       |        |
| Segment liabilities  | 11,988 | 569 | 380 | 1,434 | 104 | 3,315 | 17,790 |
| Investments in property, plant and equipment and intangible assets | 828    | 277 | 126 | 227   | 13  | -     | 1,471  |

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Internet Gold – Golden Lines Ltd.

**Notes to the Consolidated Financial Statements**

(All amounts are in millions except where otherwise stated)

**Note 4 - Segment Reporting (cont'd)****B. Adjustments for segment reporting of revenue, profit or loss, assets and liabilities**

|  | Year ended December 31, |        |        |
|--|-------------------------|--------|--------|
|  | 2014                    | 2015   | 2016   |
|  | NIS                     | NIS    | NIS    |
| Revenue  |                         |        |        |
| Revenue from reporting segments  | 10,964                  | 10,649 | 10,306 |
| Revenue from other segments  | 226                     | 221    | 218    |
| Elimination of revenue from inter-segment sales except for revenue from sales to an associate reporting as a segment | (411 )                  | (445 ) | (440 ) |
| Elimination of revenue for a segment classified as an associate  | (1,724 )                | (440 ) | -      |
| Consolidated revenue   | 9,055                   | 9,985  | 10,084 |
|  |                         |        |        |
|  | Year ended December 31, |        |        |
|  | 2014                    | 2015   | 2016   |
|  | NIS                     | NIS    | NIS    |
| Profit or loss   |                         |        |        |
| Operating income for reporting segments  | 2,934                   | 2,795  | 2,548  |
| Elimination of expenses from a segment classified as an associate  | (273 )                  | (59 )  | -      |
| Financing expenses, net  | (694 )                  | (595 ) | (975 ) |
| Share in the losses (profit) of equity-accounted investees   | (170 )                  | 12     | (5 )   |
| Profit (loss) for operations classified in other Categories  | 629                     | 44     | (34 )  |
| Depreciation and amortization of intangible assets resulting from the Bezeq PPA adjustments                          | (644 )                  | (545 ) | (442 ) |
| Other adjustments  | (71 )                   | (222 ) | (211 ) |
| Consolidated profit before income tax  | 1,711                   | 1,430  | 881    |

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Internet Gold – Golden Lines Ltd.

## Notes to the Consolidated Financial Statements

(All amounts are in millions except where otherwise stated)

### Note 4 - Segment Reporting (cont'd)

#### B. Adjustments for segment reporting of revenue, profit or loss, assets and liabilities (cont'd)

|   | December 31,<br>2015<br>NIS | 2016<br>NIS |
|---|-----------------------------|-------------|
| Assets  |                             |             |
| Assets from reporting segments  | 13,417                      | 13,619      |
| Assets attributable to operations in other categories                           | 676                         | 204         |
| Goodwill not attributable to segment assets                                     | 3,050                       | 3,050       |
| Investment in an equity-accounted investee (mainly loans) reported as a segment | 14                          | 12          |
| Inter-segment assets  | 1,165                       | 703         |
| Assets resulting from the Bezeq PPA, net  | 2,561                       | 2,119       |
| Assets attributable to a non-reportable segment                                 | 1,527                       | 820         |
| Consolidated assets   | 22,410                      | 20,527      |

December 31,  
2015    2016

|  | NIS      | NIS    |
|--|----------|--------|
| Liabilities  |          |        |
| Liabilities from reporting segments                        | 19,658   | 14,371 |
| Liabilities attributable to operations in other categories | 104      | 104    |
| Inter-segment liabilities                                  | (5,494 ) | (730 ) |
| Liabilities resulted from the Bezeq PPA, net               | 678      | 491    |
| Liabilities attributable to a non-reportable segment       | 4,863    | 3,554  |
| Consolidated liabilities                                   | 19,809   | 17,790 |

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Internet Gold – Golden Lines Ltd.

## Notes to the Consolidated Financial Statements

(All amounts are in millions except where otherwise stated)

### Note 5 - Cash and Cash Equivalents

As of December 31, 2015 and December 31, 2016, cash and cash equivalents include mainly bank deposits with a maturity of up to 90 days.

### Note 6 - Investments including Derivatives

|                                   | December 31, |       |
|-----------------------------------|--------------|-------|
|                                   | 2015         | 2016  |
|                                   | NIS          | NIS   |
| Current investments               |              |       |
| Financial assets held for trading | 1,151        | 654   |
| Bank deposits                     | 556          | 546   |
| Monetary funds and others         | 67           | 40    |
|                                   | 1,774        | 1,240 |

Financial assets held for trading include investments in ETFs, and marketable securities. Investments in financial assets held for trading and monetary funds are designated for trading and are presented at fair value as at the reporting date. The deposits in Bezeq are repayable until May 2017 and the other investments in Bezeq are exercisable in 2017.

### Note 7 - Trade and Other Receivables

A.

#### Composition of trade and other receivables

|   | December 31, |       |
|---|--------------|-------|
|   | 2015         | 2016  |
|   | NIS          | NIS   |
| Trade receivables, net                                    |              |       |
| Outstanding debts   | 841          | 785   |
| Credit cards and checks receivable                        | 434          | 450   |
| Unbilled receivables                                      | 240          | 241   |
| Current maturities of long-term receivables               | 534          | 505   |
| Related parties   | 9            | 19    |
| Total trade receivables                                   | 2,058        | 2,000 |
| Other receivables and current tax assets                  |              |       |
| Prepaid expenses  | 135          | 145   |
| Other receivables   | 119          | 72    |
| Current tax assets  | 16           | -     |
| Total other receivables                                   | 270          | 217   |
| Long-term trade and other receivables                     |              |       |
| Trade receivables- open debts (1)                         | 509          | 445   |
| Long term receivables (from real estate sales) and others | 165          | 199   |
|   | 674          | 644   |
|   | 3,002        | 2,861 |

Internet Gold – Golden Lines Ltd.

## Notes to the Consolidated Financial Statements

(All amounts are in millions except where otherwise stated)

### Note 7 - Trade and Other Receivables (cont'd)

#### A. Composition of trade and other receivables (cont'd)

(1) Discounted interest rates for long-term trade payables are based the estimated credit risk of trade payables. The discounted interest rates used by the Bezeq Group in 2016 are 3.3% - 3.5% (in 2015: 3.4% - 3.6%).

#### B. Change in provision for doubtful debts during the year

|                          | December<br>31 |       |
|--------------------------|----------------|-------|
|                          | 2015           | 2016  |
|                          | NIS            | NIS   |
| Balance at January 1     | 174            | 173   |
| Impaired loss recognized | 34             | 25    |
| Lost debts               | (35 )          | (87 ) |
| Balance at December 31   | 173            | 111   |

#### C. Aging of trade receivables

The aging of trade receivables at the reporting date was as follow:

| December 31, 2015 |            | December 31, 2016 |            |
|-------------------|------------|-------------------|------------|
| Gross             | Impairment | Gross             | Impairment |
| NIS               | NIS        | NIS               | NIS        |



|                              |       |      |   |       |      |   |
|------------------------------|-------|------|---|-------|------|---|
| Current                      | 2,377 | (11  | ) | 2,282 | (8   | ) |
| Past due up to one year      | 201   | (47  | ) | 183   | (46  | ) |
| Past due one to two years    | 74    | (50  | ) | 50    | (31  | ) |
| Past due more than two years | 88    | (65  | ) | 41    | (26  | ) |
|                              | 2,740 | (173 | ) | 2,556 | (111 | ) |

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Internet Gold – Golden Lines Ltd.

**Notes to the Consolidated Financial Statements**

(All amounts are in millions except where otherwise stated)

**Note 8 - Property, Plant and Equipment**

|   | Land<br>and<br>buildings<br>NIS | Switching<br>Transmission,<br>power,<br>Cellular,<br>And satellite<br>equipment<br>NIS | Network<br>equipment<br>NIS | Multi-<br>channel<br>equipment<br>and<br>infrastructure<br>NIS | Subscriber<br>equipment<br>NIS | Office<br>equipment,<br>computers<br>and<br>vehicles<br>NIS | Total<br>NIS |
|---|---------------------------------|--|-----------------------------|--|--------------------------------|---|--------------|
| <b>Cost</b>                               |                                 |  |                             |  |                                |   |              |
| Balance as at January 1, 2015             | 1,145                           | 4,473  | 5,251                       | -  | 978                            | 834   | 12,681       |
| Additions                                 | 41                              | 527  | 254                         | 164  | 225                            | 71  | 1,282        |
| Consolidation of subsidiary               | 16                              | -  | -                           | 749  | -                              | 36  | 801          |
| Disposals                                 | (141 )                          | -  | -                           | (46 )  | -                              | -   | (187 )       |
| Balance as at December 31, 2015           | 1,061                           | 5,000  | 5,505                       | 867  | 1,203                          | 941   | 14,577       |
| Balance as at January 1, 2016             | 1,061                           | 5,000  | 5,505                       | 867  | 1,203                          | 941   | 14,577       |
| Additions                                 | 27                              | 457  | 247                         | 180  | 265                            | 73  | 1,249        |
| Disposals                                 | (37 )                           | -  | (12 )                       | (11 )  | (4 )                           | (11 )   | (75 )        |
| Balance as at December 31, 2016           | 1,051                           | 5,457  | 5,740                       | 1,036  | 1,464                          | 1,003   | 15,751       |
| <b>Depreciation and impairment losses</b> |                                 |  |                             |  |                                |   |              |
| Balance as at January 1, 2015             | 313                             | 2,375  | 2,264                       | -  | 573                            | 568   | 6,093        |
| Depreciation for the year                 | 76                              | 576  | 222                         | 189  | 197                            | 96  | 1,356        |
| Disposals                                 | (39 )                           | -  | -                           | (46 )  | -                              | -   | (85 )        |
| Balance as at December 31, 2015           | 350                             | 2,951  | 2,486                       | 143  | 770                            | 664   | 7,364        |
| Balance as at January 1, 2016             | 350                             | 2,951  | 2,486                       | 143  | 770                            | 664   | 7,364        |

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|                                 |       |       |       |       |     |     |       |
|---------------------------------|-------|-------|-------|-------|-----|-----|-------|
| Depreciation for the year       | 64    | 521   | 250   | 236   | 183 | 83  | 1,337 |
| Disposals                       | (12 ) | -     | -     | (10 ) | -   | -   | (22 ) |
| Balance as at December 31, 2016 | 402   | 3,472 | 2,736 | 369   | 953 | 747 | 8,679 |
| Carrying amounts                |       |       |       |       |     |     |       |
| As at January 1, 2015           | 816   | 2,050 | 2,987 | -     | 405 | 314 | 6,572 |
| As at December 31, 2015         | 711   | 2,049 | 3,019 | 724   | 433 | 277 | 7,213 |
| As at December 31, 2016         | 649   | 1,985 | 3,004 | 667   | 511 | 256 | 7,072 |

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Internet Gold – Golden Lines Ltd.

## Notes to the Consolidated Financial Statements

(All amounts are in millions except where otherwise stated)

### Note 8 - Property, Plant and Equipment (cont'd)

A. The residual value of the Bezeq Group's copper cables is assessed at the end of each quarter. The residual value is NIS 154 as at December 31, 2016 and NIS 140 as at December 31, 2015.

B. Property, plant and equipment in the Bezeq Group is derecognized at the end of each year upon reaching full depreciation, except for land, buildings, vehicles, copper cables and specific components for Pelephone's UMTS network, which are derecognized upon their sale. In 2016, the Bezeq Group derecognized fully depreciated property at a cost of NIS 894 (in 2015, NIS 557).

C. Bezeq Group companies review the useful life of the property, plant and equipment through the depreciation committees, in order to determine the estimated useful life of their equipment. The change is not expected to have a material impact on the depreciation expenses of the Group. Following the findings of the committees, minor changes were made in the estimated useful life of certain assets.

D. Most of the real estate assets used by the Bezeq Group are leased under a capitalized finance lease from the Israel Lands Administration for 49 years beginning as of 1993, with an option for an extension of another 49 years. The lease rights are amortized over the term of the lease period.

E. In 2013, Bezeq started to install a fiber optic network that will reach the subscriber's home. As at December 31, 2016, the unexercised investment in assets amounts to NIS 352.

F. At the reporting date, there are commitments to purchase property, plant and equipment in the amount of NIS 139 (in 2015: NIS 75).

G. In accordance with the Telecommunications Order (Telecommunications and Broadcasts) (Determination of Essential Service Provided by Bezeq - The Israel Telecommunication Corp. Ltd.), 1997, approval from the Minister

of Communications is required to confer rights in some of Bezeq's assets (switches, cable network, transmission network, and information and databases).

**H.** In accordance with its cellular license, Pelephone is not permitted to sell, lease or pledge any of its assets used for the implementation of the license, without the consent of the Minister of Communications, except for:

(1) A pledge on one of the license assets in favor of a bank operating lawfully in Israel, to receive bank credit, provided that it submitted notice to the Ministry of Communications regarding the pledge it intends to register, noting that the pledge agreement includes a clause ensuring that in any event, exercise of the rights by the bank will not impair, in any way, the services provided under the license.

(2) Sale of items of equipment when implementing an upgrade, including sale of equipment by the trade-in method.

**I.** For information about pledges for loans and borrowings, see Note 13.

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Internet Gold – Golden Lines Ltd.

**Notes to the Consolidated Financial Statements**

(All amounts are in millions except where otherwise stated)

**Note 9 - Intangible Assets**

|  | Goodwill | Computer software and licenses | Right of use in cellular frequencies | Customer relationships and brand names | Others | Total  |
|--|----------|--------------------------------|--------------------------------------|--|--------|--------|
|  | NIS      | NIS                            | NIS                                  | NIS                                    | NIS    | NIS    |
| <b>Cost</b>  |          |                                |                                      |  |        |        |
| Balance as at January 1, 2015                          | 2,681    | 1,256                          | 384                                  | 6,342                                  | 292    | 10,955 |
| Acquisitions or additions from independent development | -        | 188                            | 96                                   | -                                      | 28     | 312    |
| Business combination                                   | 385      | 148                            | -                                    | 1,137                                  | -      | 1,670  |
| Disposals  | -        | -                              | -                                    | -                                      | (51 )  | (51 )  |
| Balance as at December 31, 2015                        | 3,066    | 1,592                          | 480                                  | 7,479                                  | 269    | 12,886 |
| Balance as at January 1, 2016                          | 3,066    | 1,592                          | 480                                  | 7,479                                  | 269    | 12,886 |
| Acquisitions or additions from independent development | -        | 187                            | -                                    | -                                      | 11     | 198    |
| Disposals  | -        | -                              | -                                    | -                                      | (11 )  | (11 )  |
| Balance as at December 31, 2016                        | 3,066    | 1,779                          | 480                                  | 7,479                                  | 269    | 13,073 |
| <b>Amortization and impairment losses</b>              |          |                                |                                      |  |        |        |
| Balance as at January 1, 2015                          | -        | 767                            | 174                                  | 3,870                                  | 236    | 5,047  |
| Amortization for the year                              | -        | 242                            | 31                                   | 469                                    | 20     | 762    |
| Disposals  | -        | -                              | -                                    | -                                      | (41 )  | (41 )  |
| Balance as at December 31, 2015                        | -        | 1,009                          | 205                                  | 4,339                                  | 215    | 5,768  |

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|                                 |       |       |     |       |      |       |
|---------------------------------|-------|-------|-----|-------|------|-------|
| Balance as at January 1, 2016   | -     | 1,009 | 205 | 4,339 | 215  | 5,768 |
| Amortization for the year       | -     | 229   | 37  | 487   | 24   | 777   |
| Disposals                       | -     | -     | -   | -     | (6 ) | (6 )  |
| Balance as at December 31, 2016 | -     | 1,238 | 242 | 4,826 | 233  | 6,539 |
| Carrying amounts                |       |       |     |       |      |       |
| As at January 1, 2015           | 2,681 | 498   | 210 | 2,517 | 2    | 5,908 |
| As at December 31, 2015         | 3,066 | 583   | 275 | 3,140 | 54   | 7,118 |
| As at December 31, 2016         | 3,066 | 541   | 238 | 2,653 | 36   | 6,534 |

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Internet Gold – Golden Lines Ltd.

## Notes to the Consolidated Financial Statements

(All amounts are in millions except where otherwise stated)

### Note 9 - Intangible Assets (cont'd)

Total value of goodwill attributable to each cash-generating unit:

|  | December 31 |       |
|--|-------------|-------|
|  | 2015        | 2016  |
|  | NIS         | NIS   |
| Domestic fixed-line communications                 | 1,548       | 1,548 |
| Cellular telephone                                 | 1,205       | 1,205 |
| Multi-channel television (DBS)                     | 120         | 120   |
| International communications and internet services | 181         | 181   |
| others   | 12          | 12    |
| Total  | 3,066       | 3,066 |

### Goodwill impairment testing

For the purpose of impairment testing, goodwill is allocated to the Group's cash generating units ("CGU") which represent the lowest level within the Group at which the goodwill is monitored for internal management purposes. Several goodwill balances result from the requirement to recognize a deferred tax liability on business combination, calculated as the difference between the tax effect of the fair value of the acquired assets and liabilities, and their tax bases. For the purpose of testing this goodwill for impairment, any of the related deferred tax liabilities recognized on acquisition that remain at the balance sheet date are treated as part of the carrying amount of the relevant CGU. The annual impairment test date is December 31.



The recoverable amount of each CGU was calculated as its value in use which was based on the Discounted Cash Flow method under the Income Approach. Value in use of the traditional voice and broadband CGUs was determined by discounting the future cash flows generated from the continuing use of the CGUs and was based on the following key assumptions:

Domestic fixed-line communications (Bezeq Fixed Line) -

The value in use for the Group's domestic fixed line CGU was calculated using the future discounted cash flow method, based on the expected cash flow for the next five years. The expected cash flow is based on results of the domestic fixed-line communications segment in recent years, taking into account the effect of opening up the wholesale market in 2016. The revenue forecast is based on assumptions about the number of users and average revenue per user of internet infrastructure, the number of users and average revenue per user of telephony services, and revenue from transmission, data communication and other revenue. The main assumption underlying the forecast is that the wholesale market will function properly and will provide effective competition to the infrastructure owners. In addition, the effect of the elimination of the structural separation on the domestic fixed-line communication segment was not taken into account.

The operating, sales, marketing and investment expenses were adjusted for domestic-fixed line communication operations. The price of nominal capital used is 7.5% (after tax). In addition, it was assumed that the permanent growth will be 1%. The valuation was conducted by an independent appraiser. Based on this valuation, there was no impairment of a fixed line domestic communications cash-generating unit.

Internet Gold – Golden Lines Ltd.

## Notes to the Consolidated Financial Statements

(All amounts are in millions except where otherwise stated)

### Note 9 - Intangible Assets (cont'd)

Cellular telephone (Pelephone) -

The value in use for the Group's cellular CGU (Pelephone) was calculated using the future discounted cash flow method, based on the expected cash flow for the next five years. The expected cash flow is based on Pelephone's results in recent years, such that future growth and market shares are affected by directions in the cellular market, such as price competition, regulation and the scope of operations of the new cellular operators. The revenue forecast is based on assumptions regarding the number of users, average revenue per user, and sales of terminal equipment. The main assumption underlying the forecast is the recovery in Pelephone's business activity as from 2018, due to the expected stabilization of the market and the start of competitive balance. In addition, the valuation included synergies on the Group revenue level based on the high certainty of the structural separation in the long term.

The operating, sales, marketing and investment expenses were adjusted for Pelephone's volume of operations. The cost of nominal capital used is 10% (after tax). In addition, it was assumed that the permanent growth will be 2.5%. The valuation was made by an independent appraiser. Based on this valuation, the Group was not required to record impairment of a cellular communication cash-generating unit.

Multi-channel television (DBS) -

The value in use for the Group's multichannel television cash-generating unit was calculated using the discounted cash flow (DCF) method, based on the expected cash flow for the next five years. The expected cash flow is based on the results of DBS in recent years, such that future growth and market shares are affected by directions in the multichannel television market, such as competition, regulation, and the entry of new players. The revenue forecast is based on assumptions regarding the number of users and average revenue per user. The main assumption underlying

the forecast is the relative stability in the number of subscribers and average revenue per user as from the second half of 2018.

The operating, sales, marketing and investment expenses were adjusted for the volume of operations of DBS. The price of nominal capital used is 8.5% (after tax). In addition, it was assumed that the permanent growth of Pelephone will be 1%. The valuation was made by an independent appraiser. Based on this valuation, the Group was not required to record amortization for impairment of a multichannel television cash-generating unit.

International communications and Internet services (Bezeq International) -

The value in use for the Group's international communications and Internet services CGU was calculated using the discounted cash flow method, based on the expected cash flow for the next five years. The expected cash flow is based on the results of Bezeq International in recent years, such that future growth and market shares are affected by directions both in the International communications and Internet services markets, such as competition, regulation, and the wholesale market. The revenue forecast is based on assumptions regarding the number of users and average revenue per user. The main assumption underlying the forecast is a decrease in average revenue per line ("ARPL") due to the expected increase in competition in the coming years as a result of the wholesale market in the Internet services business line along with the decrease in the revenues of International communications business as a result of increased use of cellular phones and other communication solutions.

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## Notes to the Consolidated Financial Statements

(All amounts are in millions except where otherwise stated)

### Note 9 - Intangible Assets (cont'd)

In addition, the revenue forecast is based on assumptions of an increase in wholesale revenues along with an increase in revenues from value added services.

The operating, sales, marketing and investment expenses were adjusted for the volume of operations of Bezeq International. The price of nominal capital used is 10% (after tax). In addition, it was assumed that the permanent growth will be 1.5%. The valuation was made by an independent appraiser. Based on this valuation, the Group was not required to record impairment of the International communications and Internet services cash-generating unit.

### Note 10 - Deferred Expenses and Non-Current Investments

|                         | December<br>31 |      |
|-------------------------|----------------|------|
|                         | 2015           | 2016 |
|                         | NIS            | NIS  |
| Deferred expenses       | 358            | 337  |
| Non-current investments | 285            | 110  |
|                         | 643            | 447  |

Deferred expenses include prepaid expense amounts for acquisition of an indefeasible right of use (IRU) of seabed A.cable capacities. The prepaid expense is amortized on a straight-line basis up to 2022 and 2027 according to the period set out in the agreements.

**B.** Non-current investments include a bank deposit for loans to the Group's employees with a redemption date that has yet to be determined and a deposit for hedge transactions.

**Note 11 - Broadcast Rights, Net of Rights Exercised**

|                       | December<br>31 |       |
|-----------------------|----------------|-------|
|                       | 2015           | 2016  |
|                       | NIS            | NIS   |
| Cost                  | 621            | 800   |
| Less rights exercised | (165)          | (368) |
| Total                 | 456            | 432   |

As at December 31, 2016, DBS has agreements for the acquisition of broadcast rights. In 2016, acquisition of these broadcast rights amounted to NIS 186.

Internet Gold – Golden Lines Ltd.

## Notes to the Consolidated Financial Statements

(All amounts are in millions except where otherwise stated)

### Note 12 - Investees

#### A. Material subsidiaries held directly and indirectly by the Company

##### 1. General

|  | Principal location of the company's activity | Ownership interest | % |
|--|--|--------------------|---|
| B Communications Ltd.  | Israel                                       | 64.78              | % |
| Subsidiaries of B Communications Ltd.                                      |  |                    |   |
| B Communications (SP1) Ltd. and B Communications (SP2) Ltd. <sup>(1)</sup> | Israel                                       | 100                | % |
| Bezeq - The Israel Telecommunication Corp. Limited                         | Israel                                       | 26.34              | % |
| Subsidiaries of Bezeq - The Israel Telecommunication Corp. Limited.        |  |                    |   |
| Pelephone Communications Ltd.  | Israel                                       | 100                | % |
| Bezeq International Ltd.   | Israel                                       | 100                | % |
| DBS  | Israel                                       | 100                | % |
| Walla! Communications Ltd.   | Israel                                       | 100                | % |

(1) Held by B Communication (SP1) Ltd.

##### 2. Details of Group entities

**a. B Communications Ltd.**

B Communications Ltd., is a majority-owned subsidiary of the Company. B Communications is the sole shareholder of B Communications (SP1) Ltd. which holds B Communications (SP2) Ltd. which directly holds the Bezeq controlling interest.

**b. Bezeq - The Israel Telecommunications Corporation Ltd.**

Bezeq is controlled by SP2 which holds 25.82% of Bezeq's outstanding shares. An additional 0.52% of Bezeq outstanding shares are held by B Communications. Bezeq is the largest communications group in Israel.

**c. B Communications (SP1) Ltd. and B Communications (SP2) Ltd.**

B Communications (SP1) Ltd. ("SP1"), founded in 2010, is a wholly-owned subsidiary of B Communications. SP1 is the sole shareholder of B Communications (SP2) Ltd. ("SP2") which directly holds the Bezeq controlling interest.

**d. Pelephone Communications Ltd.**

Pelephone Communications Ltd. ("Pelephone") is a wholly-owned subsidiary of Bezeq. Pelephone provides cellular communication services and value added services and markets terminal equipment.

**e. Bezeq International Ltd.**

Bezeq International Ltd. ("Bezeq International") is a wholly-owned subsidiary of Bezeq. Bezeq International provides internet access (ISP) services, international communications services and network end point (NEP) services.

Internet Gold – Golden Lines Ltd.

## Notes to the Consolidated Financial Statements

(All amounts are in millions except where otherwise stated)

### Note 12 - Investees (cont'd)

#### A. Material subsidiaries held directly and indirectly by the Company (cont'd)

##### 2. Details of Group entities (cont'd)

##### f. Walla! Communications Ltd.

Walla! is wholly owned by Bezeq. Walla! provides internet, management and media services for a range of populations.

3. Dividend paid by Bezeq to non-controlling interests during 2016 was in the amount of NIS 1,062 (in 2015: NIS 1,232).

##### 4. Bezeq's Dividend Distribution Policy

In August 2009, Bezeq's Board of Directors resolved to implement a dividend policy to distribute 100% of the semi-annual profit ("profit for the period attributable to the shareholders of Bezeq") in accordance with its consolidated financial statements as a dividend to its shareholders. Application of the policy to distribute a dividend is subject to the provisions of the law, including the distribution criteria prescribed in the Companies Law, and the estimation of the Board of Directors of Bezeq regarding its ability to meet its existing and anticipated liabilities, taking into consideration the projected cash flow, its operations and liabilities, the cash balance, its plans and position as will be from time to time and subject to the approval of the its general meeting of shareholders regarding any specific distribution, as set out in the articles of association of Bezeq. Since the date of the resolution, Bezeq's dividend policy has not changed.



Following Bezeq's Board of Director's resolution on February 10, 2015 regarding its engagement with Eurocom DBS for the acquisition of the full holdings of Eurocom DBS in DBS, Bezeq's Board of Directors determined that the revaluation gains, which were expected to arise in accordance with accounting principles, will be excluded from the dividend policy and will not be distributed as a dividend. These gains amounted to NIS 12.

In 2015 and 2016, Bezeq declared and paid the following dividends in cash:

|   | 2015  | 2016  |
|---|-------|-------|
|   | NIS   | NIS   |
| Distribution of a regular dividend (see section B4 above) |       |       |
| 2016 (NIS 0.52 per share)                                 | -     | 1,441 |
| 2015 (NIS 0.65 per share)                                 | 1,777 | -     |
|   | 1,777 | 1,441 |

**B. Business combination with DBS Satellite Services (1998) Ltd. ("DBS")**

As at December March 25, 2015, Bezeq held 49.78% of the share capital of DBS and it held options to acquire 8.6% of DBS's shares, which Bezeq was unable to exercise. Eurocom DBS Ltd. held the balance of DBS shares. On March 25, 2015, Bezeq exercised the options that were allotted, for no consideration, and on June 24, 2016, Bezeq 1. completed the acquisition of the entire holdings of Eurocom DBS in DBS ("the Acquisition Transaction"), which at that date represented 50.22% of the issued share capital of DBS (41.62% fully diluted) and all the shareholder loans provided by Eurocom to DBS. On completion of the Acquisition Transaction, DBS became a wholly owned subsidiary (100%) of Bezeq.

Internet Gold – Golden Lines Ltd.

## Notes to the Consolidated Financial Statements

(All amounts are in millions except where otherwise stated)

### Note 12 - Investees (cont'd)

#### **B. Business combination with DBS Satellite Services (1998) Ltd. ("DBS") (cont'd)**

Bezeq consolidates the financial statements of DBS as from March 23, 2015. The statements of income for 2014 and the first quarter of 2015 include the operating results of DBS based on the equity method.

In accordance with the Assessment Agreement and taxation decision of the Tax Authority (as set out in Note 19), on September 27, 2016, the shareholder loans amounting to NIS 5.319 billion (including shareholder loans acquired from Eurocom DBS) that were provided to DBS through June 23, 2016, were converted to equity and recognized in the financial statements of DBS as a premium on shares.

Under the terms of the Acquisition Transaction, in addition to the cash consideration of NIS 680, the consideration included two additional contingent payments, as follows: one additional payment of up to NIS 200, which was to be paid in accordance with the amount of the carry-forward losses of DBS used for tax purposes ("the First Contingent Consideration"); and another additional payment of up to NIS 170, which was to be paid in accordance with the business results of DBS in the 2015-2017 period ("the Second Contingent Consideration").

In September 2016, Bezeq paid Eurocom DBS NIS 188 (plus interest differences of NIS 10) for the First Contingent Consideration, under the Assessment Agreement and taxation decision of the Tax Authority as set out in Note 19. The consideration paid was for the losses of DBS as at December 31, 2013. Following the decision regarding the additional and final losses as at December 31, 2014, the additional amount due to Eurocom DBS will be calculated and paid out, and the unpaid amount will continue to bear interest in accordance with the acquisition agreement up to the payment date. As at December 31, 2016, the balance of the amount owed to Eurocom for the First Contingent Consideration was NIS 6.

The liability for the Second Contingent Consideration was paid in two payments of NIS 57 each, one in 2016 and the other in 2017. These payments were not recognized as an expense. The liability for the Second Contingent Consideration was adjusted in the reporting year according to the management's estimate, to NIS 84 and the increase of NIS 55 was recognized in financing expenses.

If the DBS merger is completed in 2017, the amount of this liability is expected to amount to the full amount of the Second Contingent Consideration, and if the merger is completed after the end of 2017, the amount of the liability will be contingent on the results of DBS for 2017. As at the reporting date, this amount may be less than the amount of the liability included in the financial statements.

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Internet Gold – Golden Lines Ltd.

## Notes to the Consolidated Financial Statements

(All amounts are in millions except where otherwise stated)

### Note 12 - Investees (cont'd)

#### B. Business combination with DBS Satellite Services (1998) Ltd. ("DBS")

Following the announcement of the Director of the Ministry of Communications on December 21, 2016, regarding "Cancellation of the structural separation obligation in Bezeq Group", (as described below), on December 25, 2016, Bezeq and DBS signed a merger agreement ("the Merger Agreement"), which, subject to the preconditions set out in the agreement, at the completion date of the merger, and effective retroactively from the effective date for the merger (December 31, 2016), all activities of DBS will be merged with and into Bezeq, for no consideration, in accordance with the provisions of section 323 of the Companies Law and the provisions of section 103B and section 103C of the Income Tax Ordinance (as described in Note 19), and DBS will cease to exist as a separate legal entity, will be wound up without liquidation and the Registrar of Companies will delete it from the Register.

Completion of the merger is subject to the fulfillment of the preconditions in the merger agreement.

It is noted that in accordance with the announcement of the Ministry of Communications, in the first stage, the Ministry is advancing the elimination of the corporate separation within the Bezeq Group, in such a way that the operations of Bezeq's subsidiaries will be under a corporate structure of one company, but with a separation of divisions among the different operations, so that at this stage, the rules of the arrangement set out in Bezeq's license will be maintained for structural separation in competitive aspects among the different activities.

After signing the merger agreement, the shareholders' loans registered in the name of Bezeq in the financial statements of DBS, the balance of which, including principal and accrued interest as at December 27, 2016 amounted to NIS 389, were converted to equity, and Bezeq made an additional investment in DBS against a premium of NIS 130 (which was paid in cash on January 1, 2017).

Following the conversion of shareholder loans and the investment in capital as set out above, as at December 31, 2016, the equity of DBS amounted to NIS 592, against a capital deficit of NIS 5,018 at the end of 2015.

<sup>3</sup> Notwithstanding its improved financial position, as at December 31, 2016, the working capital deficit of DBS amounted to NIS 510.

The management of DBS believes that the financial resources at its disposal, which include the receipt of loans from Bezeq, will be sufficient for its operations for the coming year, based on the cash flow forecast approved by DBS's board of directors.

### **C. Bezeq distributable earnings**

On March 29, 2017 the Board of Directors of Bezeq resolved to recommend to the general meeting of shareholders the distribution of a cash dividend in the amount of NIS 578. As at the approval date of the financial statements, the dividend has not yet been approved by the general meeting. Subsequent to this distribution, Bezeq will have a negative retained earnings balance and under the Companies Law its future distributions will be based on its future earnings. For Bezeq's dividend distribution policy see note 12A4 above, for covenants and liens, see note 13.

Internet Gold – Golden Lines Ltd.

**Notes to the Consolidated Financial Statements**

(All amounts are in millions except where otherwise stated)

**Note 12 - Investees (cont'd)**

**D. Non-controlling interests in subsidiaries**

The table hereunder presents summary information of the Group’s subsidiaries including fair value adjustments that were made on the date of acquisition, other than goodwill, in which there are non-controlling interests that are material to the Group.

|             | December 31,   |                    |                    |                         | Year ended December 31, |  |          |        |                            |                            |   |   |                           |       |
|-------------|--|--------------------|--------------------|-------------------------|-------------------------|--|----------|--------|----------------------------|----------------------------|---|---|---------------------------|-------|
|             | Rate of direct ownership interests held by non-controlling interests % | Current assets NIS | Non-current assets | Non-current liabilities | Total net assets        | Carrying amount of non-controlling interests | Revenues | Profit | Other comprehensive income | Total comprehensive income | Profit (loss) attributable to non-controlling interests | Total comprehensive income (loss) attributable to non-controlling interests | Cash flow from operations |       |
| <u>2016</u> |  |                    |                    |                         |                         |  |          |        |                            |                            |   |   |                           |       |
| Bcom Group  | 35.22  | 3,991              | 16,154             | 4,256                   | 12,588                  | 3,301  | 2,543    | 10,084 | 439                        | (15)                       | 424   | 641   | 630                       | 3,460 |
| <u>2015</u> |  |                    |                    |                         |                         |  |          |        |                            |                            |   |   |                           |       |

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Bcom  
Group

33.29 4,730 17,392 5,199 13,532 3,391 2,694 9,985 1,136 7 1,143 996 1,001 3,65

2014

Bcom  
Group

33.29 6,498 14,738 3,898 13,750 3,588 2,949 9,055 1,132 (36 ) 1,096 1,147 1,118 3,78

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Internet Gold – Golden Lines Ltd.

## Notes to the Consolidated Financial Statements

(All amounts are in millions except where otherwise stated)

### Note 12 - Investees (cont'd)

#### E. Increasing Competition and Reducing Concentration, 2013 law

In December 2013, the Knesset passed the Israeli Law for Increasing Competition and Reducing Concentration, 2013 ("Concentration Law"), which: (i) imposes limitations on the control over companies with publicly held debt or equity securities through a pyramidal ownership structure by imposing a limitation on the number of public companies (tiers) in such pyramidal structure; (ii) authorizes financial regulators to set forth limitations on the amount of credit that financial institutions are permitted to provide to a corporation or a group of companies under the control of the same controlling shareholder; (iii) imposes limitations on the holdings by a significant non-finance company in a significant finance company or the holdings of both kinds of companies under common control; and (iv) requires governmental authorities responsible for the award of rights in public assets (including in the communications field) in certain cases to consider control concentration factors and industry-specific competitive factors.

The Company is deemed to be a "first tier" company, B Communications is deemed to be a "second tier" company and Bezeq is deemed to be a "third-tier" company under the Concentration Law. Accordingly, if either the Company or B Communications are unable to redeem any of their publicly held debt and delist their ordinary shares from the TASE (which would require 90-days' prior notice to the TASE) or go private prior to December 10, 2019, B Communications will not be permitted to control Bezeq after such date and its holdings in Bezeq may be transferred to a trustee for the purpose of selling such holdings.

The Concentration Law sets forth certain mechanisms intended to enable a tier company, which is subject to the prohibition of controlling another tier company, to make various arrangements for the repurchase of its publicly-held shares and the early redemption of publicly-held debt in order to comply with the provisions of the law. These mechanisms enable the repurchase of publicly-held shares and the early redemption of publicly-held debt securities under a Court-approved scheme of arrangement pursuant to the Israeli Companies Law, at fair value and in accordance with the conditions prescribed by the Concentration Law, while providing certain relief from shareholders or debenture holder majority requirements for the approval of the arrangement. Furthermore, if a trustee is appointed,



he may seek a district court to order the cancellation of distributions made by Bezeq prior to his appointment if they are deemed not to be in Bezeq's interest. In addition, beginning six months after the publication of the Concentration Law and during a six years transition period, the board of directors of a company that is a "third-tier" company (such as Bezeq) must be comprised of a majority of "independent directors," within the meaning of the Israeli Companies Law, and the number of "external directors" pursuant to the Israeli Companies Law shall be at least half the number of the company's directors less one (rounded upwards) but not less than two. The election of such external directors will be by a majority vote of the shareholders and the controlling shareholder's vote will not be counted for such purpose. The Israeli Minister of Justice is authorized to enact regulations setting forth a lower number of required external directors, provided that such number will not be lower than one-third of the board members.

The Company estimates that the application of the Concentration Law will not affect its controlling shareholder's vote position in Bezeq.

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Internet Gold – Golden Lines Ltd.

## Notes to the Consolidated Financial Statements

(All amounts are in millions except where otherwise stated)

### Note 12 - Investees (cont'd)

#### F.B Communications' control over Bezeq

B Communications has control over Bezeq based on the facts that it holds significantly more voting rights than any other shareholder. Bezeq's other shareholders are widely dispersed and are not allowed to increase their holdings above 5% without regulatory approval, appoint a director or the chief executive officer of Bezeq nor have any influence on Bezeq's day-to-day operational decision making policies. In addition the Israeli law and regulations were formulated in order to ensure that no individual or entity will interfere with the control of Bezeq by the holder of the Control Permit. These regulations enable B Communications to nominate the majority of the board of directors of Bezeq.

#### G. Transactions with non-controlling interests

(1) On June 27, 2013 the Company sold 3,571,741 ordinary shares of B Communications for an aggregate sales price of NIS 125 to Norisha Holdings Limited ("NHL"). The shares sold represented approximately 11.95% of B Communications' issued and outstanding shares. NHL is a holdings company incorporated under the laws of The British Virgin Islands. According to the share purchase agreement with NHL (the "Share Purchase Agreement") NHL had the contingent right to receive up to 892,935 ordinary shares of B Communications from the Company without additional consideration pursuant to a price adjustment mechanism ("the Adjustment Shares"). According to the Share Purchase Agreement if the number of Adjustment Shares transferred was less than 892,935 ordinary shares, NHL would have the option to purchase the remainder of the 892,935 ordinary shares from the Company according to a price mechanism detailed in the Share Purchase Agreement. On May 29, 2014 the Share Purchase Agreement was amended in order to permit NHL to pay the Exercise Price through a "cashless exercise". Following the amendment to the Share Purchase Agreement the Company transferred 396,860 additional ordinary shares of B Communications to NHL.

(2) On January 14, 2016, the Company sold 575,000 ordinary shares of B Communications, representing approximately 1.92% of its issued and outstanding shares. The total proceeds from the sale amounted to

approximately NIS 56. As a result of the sale, the Company's ownership interest in B Communications declined to 64.78% of its outstanding shares.

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Internet Gold – Golden Lines Ltd.

## Notes to the Consolidated Financial Statements

(All amounts are in millions except where otherwise stated)

### Note 13 - Debentures, Loans and Borrowings, including Obligations to Banks, Institutions and Others

#### A. Composition

|                                  | December 31 |        |
|----------------------------------|-------------|--------|
|                                  | 2015        | 2016   |
|                                  | NIS         | NIS    |
| Current liabilities              |             |        |
| Current maturities of debentures | 1,508       | 1,342  |
| Current maturities of bank loans | 711         | 839    |
|                                  | 2,219       | 2,181  |
| Non-current liabilities          |             |        |
| Debentures                       | 10,707      | 9,157  |
| Bank loans                       | 2,508       | 3,084  |
|                                  | 13,215      | 12,241 |
|                                  | 15,434      | 14,422 |

#### B. Terms and debt repayment schedule

|  | December 31,<br>2015 |                           | December 31,<br>2016 |                           | Nominal                        |
|--|----------------------|---------------------------|----------------------|---------------------------|--------------------------------|
|  | Par<br>value<br>NIS  | Carrying<br>amount<br>NIS | Par<br>value<br>NIS  | Carrying<br>amount<br>NIS | interest<br>Currency rate<br>% |
| Loans from banks and others:               |                      |                           |                      |                           |                                |
| Linked to the Israeli CPI - Fixed interest | -                    | -                         | -                    | -                         | NIS                            |
| Unlinked - Variable interest               | 1,331                | 1,331                     | 978                  | 978                       | NIS P-0.33 to P+0.2            |
| Unlinked - Fixed interest                  | 1,889                | 1,889                     | 2,931                | 2,945                     | NIS 2.40 to 6.85               |

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|  |        |        |        |        |      |              |
|--|--------|--------|--------|--------|------|--------------|
|  | 3,220  | 3,220  | 3,909  | 3,923  |      |              |
| Debtures:                                  |        |        |        |        |      |              |
| Linked to the Israeli CPI - fixed interest | 5,643  | 6,140  | 4,925  | 5,234  | NIS  | 2.20 to 8.40 |
| Linked to the US\$ - fixed interest        | 3,017  | 2,966  | -      | -      | US\$ | 7.375        |
| Unlinked - variable interest               | 734    | 734    | 734    | 734    | NIS  | Makam + 1.4  |
| Unlinked - fixed interest                  | 2,380  | 2,374  | 4,505  | 4,531  | NIS  | 3.60 to 6.65 |
|  | 11,774 | 12,214 | 10,164 | 10,499 |      |              |
| Total interest-bearing liabilities         | 14,994 | 15,434 | 14,073 | 14,422 |      |              |

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Internet Gold – Golden Lines Ltd.

## Notes to the Consolidated Financial Statements

(All amounts are in millions except where otherwise stated)

### Note 13 - Debentures, Loans and Borrowings, including Obligations to Banks, Institutions and Others (cont'd)

#### B. Debt terms and repayment schedule (cont'd)

##### Loans from banks and others and debentures

|     |                                 |
|-----|---------------------------------|
| (1) | Issuance of Series C Debentures |
|-----|---------------------------------|

On September 28, 2010, the Company issued Series C Debentures at a par value of NIS 170 for a total consideration of NIS 169. The Series C Debentures were listed on the TASE.

In November and December of 2013, the Company completed private placements of additional Series C Debentures in the amount of NIS 60 and NIS 65 par value, respectively, to certain Israeli institutional investors. As of December 31, 2016 the par value of the outstanding Series C Debentures was NIS 368.

The Series C Debentures are payable in four equal annual installments on March 10 of each of the years 2016 through 2019 and pay interest at a fixed annual rate of 4.45% which is payable semi-annually on March 10 and September 10 of each of the years 2011 through 2019 (the first interest payment was made on March 10, 2011, and the last interest payment is payable on March 10, 2019). The Series C Debentures are NIS denominated and are linked to the Israeli CPI.

The Series C Debentures contain standard terms and conditions and are unsecured, non-convertible and do not restrict the Company's ability to issue any new series of debt instruments or distribute dividends in the future.

As at December 31, 2016 the Company was in compliance with the financial covenants of the debentures.

(2) Issuance of Series D Debentures and replacement of debentures

On March 3, 2014 the Company issued Series D Debentures at a par value of NIS 117.5 for a total consideration of NIS 126. The Series D Debentures were listed on the TASE.

The Series D Debentures are repayable in five installments as follows: (i) 10% of the principal amount on September 15, 2018 and 2019; (ii) 30% of the principal amount on September 15, 2020 and 2021; and (iii) the final 20% of the principal amount on September 15, 2022. Series D Debentures bear annual interest of 6% payable on March 15 and September 15 of each of the years 2014-2022, other than the first interest payment which was made on September 15, 2014. Both principal and interest are linked to the Israeli CPI as of January 2014.

Internet Gold – Golden Lines Ltd.

## Notes to the Consolidated Financial Statements

(All amounts are in millions except where otherwise stated)

### Note 13 - Debentures, Loans and Borrowings, including Obligations to Banks, Institutions and Others (cont'd)

#### B. Debt terms and repayment schedule (cont'd)

##### Loans from banks and others and debentures (cont'd)

The Series D Debentures contain standard terms and conditions and are unsecured, non-convertible and do not restrict the Company's ability to issue any new series of debt instruments or distribute dividends in the future. The Series D Debentures contain certain limitation on distribution of dividends by the Company.

On June 9 and 22, 2014 the Company completed an additional private placement of NIS 219 principal amount of Series D Debentures to certain institutional investors in Israel in exchange for approximately NIS 107 principal amount of the Company's outstanding Series B Debentures and NIS 95 principal amount of the Company's outstanding Series C Debentures (or approximately 51% and 12% of the outstanding Series B Debentures and Series C Debentures, respectively), reflecting an exchange ratio of 1:1.132 and 1:1.03 (NIS 1.132 principal amount of Series D Debentures for NIS 1 principal amount of Series B Debentures and NIS 1.03 principal amount of Series D Debentures for NIS 1 principal amount of Series C Debentures, respectively).

On October 22, 2014 the Company completed an additional private placement of NIS 107 principal amount of Series D Debentures to certain institutional investors in Israel in exchange for approximately NIS 103 principal amount of the Company's outstanding Series C Debentures held by such institutional investors (or approximately 15% of the outstanding Series C Debentures), reflecting an exchange ratio of 1:1.036 (NIS 1.036 principal amount of Series D Debentures for NIS 1 principal amount of Series C Debentures).



On November 20 and 26, 2014 the Company completed an additional private placement of NIS 86 principal amount of Series D Debentures to certain institutional investors in Israel in exchange for approximately NIS 85 principal amount of the Company's outstanding Series C Debentures (or approximately 15% of the outstanding Series C Debentures), reflecting an exchange ratio of 1:1.015 (NIS 1.015 principal amount of Series D Debentures for NIS 1 principal amount of Series C Debentures).

As of December 31, 2016 par value of the outstanding Series D Debentures was NIS 530.

As at December 31, 2016 the Company was in compliance with the financial covenants of the debentures.

#### B Communications debentures

On September 21, 2010, B Communications issued, NIS 400 of Series B Debentures, at par value, to the public in (4) Israel. In January, 2012 and August 2013, B Communications completed private placements of additional Series B Debentures in the amount of NIS 126 and NIS 180 par value, respectively, to certain Israeli institutional investors.

On April 1, 2016, B Communications completed a private placement of NIS 148 par value of its Series B Debentures to Israeli institutional investors for an aggregate consideration of NIS 162.

As at December 31, 2016 par value of the outstanding Series B Debentures was NIS 677.

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## Notes to the Consolidated Financial Statements

(All amounts are in millions except where otherwise stated)

### Note 13 - Debentures, Loans and Borrowings, including Obligations to Banks, Institutions and Others (cont'd)

#### B. Debt terms and repayment schedule (cont'd)

##### Loans from banks and others and debentures (cont'd)

The Series B Debentures are denominated in NIS, bear interest at a fixed annual rate of 6.5% which is payable semi-annually on March 31 and September 30 of each of the years 2011 through 2019 (the first interest payment was made on March 31, 2011 and the last interest payment is payable on March 31, 2019). The Series B Debentures principal is payable in four equal installments on March 31 of each year starting from 2016. The Series B Debentures interest is payable on March 31 of each year starting from the date of issuance.

According to the financial covenants of the Series B Debentures B Communications is obligated to the following:

1. Not issue any additional Series B Debentures if such increase will decrease the A2 rating of the Series B Debentures.
2. To maintain control of Bezeq.
3. The investors will have the right to require the immediate repayment of the Series B debentures if Eurocom will no longer holds the controlling interest in B Communications.

As at December 31, 2016, B Communications was in compliance with the financial covenants of the Series B debentures.

On February 19, 2014, B Communications issued \$800 of 7 Senior Secured Notes ("the Notes"). The Notes were offered and sold in the United States to qualified institutional buyers pursuant to Rule 144A under the U.S. Securities Act of 1933, as amended (the "Securities Act") and to certain qualifying investors in offshore transactions, including in Israel, in reliance on Regulation S under the Securities Act. The Notes were senior obligations of B (5) Communications and were guaranteed by its two wholly-owned subsidiaries, SP1 and SP2, on a senior secured basis ("the Guarantees"). The Notes and the Guarantees were secured by first priority pledges over all of the capital stock of SP2, the capital stock of Bezeq held by SP2, and additional collateral. The Notes were admitted for trading on the institutional trading system of the Tel Aviv Stock Exchange for by known as TACT Institutional.

B Communications used the net proceeds from the offering to repay all amounts outstanding under the loans received by SP2 and SP1 from Bank Hapoalim Ltd. ("Bank Hapoalim"), and Migdal Insurance and Financial Holdings Ltd. Group ("Migdal") respectively and to deposit funds into a debt service account.

Under the terms of the indenture for the Notes funds maintained by SP2 had to be deposited in one or more accounts designated as a lockbox account and pledged as collateral to the security agent for the benefit of the holders of the Notes.

On August 10, 2014 B Communications' Board of Directors approved the buyback of up to \$50 of the Notes. On January 20, 2016, B Communications completed its \$50 repurchase program and its Board of Directors approved the extension and increase of the program by an additional \$50. During 2015 and 2016, B Communications purchased \$65 par value of the Notes.

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## Notes to the Consolidated Financial Statements

(All amounts are in millions except where otherwise stated)

### Note 13 - Debentures, Loans and Borrowings, including Obligations to Banks, Institutions and Others (cont'd)

#### B. Debt terms and repayment schedule (cont'd)

##### Loans from banks and others and debentures (cont'd)

On May 26, 2016 B Communications announced that its wholly-owned subsidiary, B Communications (SP4) LP, had invited holders of the Notes to submit tenders to purchase their Notes for cash within a purchase price range of \$1.00 to \$1.07 per \$1.00 nominal amount of the Notes. The aggregate par value of the Notes tendered and purchased was approximately \$18.6.

The total loss from the repurchase of the Notes during 2015 and 2016 amounted to NIS 33.

In September 2016, the Notes were fully repaid following the issuance of Series C Debentures, as detailed below in note 13B(6).

On September 18, 2016, B Communications issued, at par value, NIS 1.9 billion of Series C Debentures to the public in Israel. The principal of the Series C Debentures will be payable in four equal instalments payable on November 30 of each of the years 2020 through 2023 and one instalment payable on November 30, 2024. Each of (6) the first four instalments will be equal to 7.5% of the principal amount of the aggregate amount of the Series C Debentures issued and the last instalment will equal to 70% of such principal amount. The annual coupon of the Series C Debentures is 3.6% and will be denominated in NIS. The interest on the outstanding principal of the Series C Debentures is payable in semi-annual payments on May 31 and November 30 of each year.

The net proceeds from the offering together with cash and cash equivalents of B Communications were used to fully redeem the outstanding Notes and to deposit the upcoming interest payment due in May 2017 into a trustee account solely for the benefit of the holders of the Series C Debentures.

As at December 31, 2016 par value of the outstanding Series C Debentures was NIS 1.9 billion.

As at December 31, 2016, B Communications was in compliance with the financial covenants of the Series C Debentures.

On January 16, 2017, subsequent to the balance sheet date, B Communications completed a private placement of NIS 118 par value of its Series C Debentures to Israeli institutional investors for an aggregate consideration of NIS 118.

Below are the main undertakings and Covenants with respect to the Series C Debentures:

B Communications undertook to refrain from creating in favor of any third party a lien of any ranking whatsoever over its direct and/or indirect holdings of 691,361,036 shares of Bezeq, including any of the rights accompanying such shares (hereinafter, the "Undertaken Shares") without the prior consent of the holders of the Series C Debentures by a special resolution (hereinafter, "Negative Lien Undertaking").

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## Notes to the Consolidated Financial Statements

(All amounts are in millions except where otherwise stated)

### Note 13 - Debentures, Loans and Borrowings, including Obligations to Banks, Institutions and Others (cont'd)

#### B. Debt terms and repayment schedule (cont'd)

##### Loans from banks and others and debentures (cont'd)

B Communications further undertook to refrain from making any disposition of the Undertaken Shares without the prior consent of the holders of the Series C Debentures by a special resolution. Notwithstanding the foregoing, and subject to the provisions of applicable law and/or permit, B Communications may sell all or a portion of the Undertaken Shares to any third party, provided that in such instance, B Communications uses the net proceeds it receives from such sale, less the taxes, expenses and deductions entailed in the sale of such shares (hereinafter, the “Net Sale Proceeds”), to make full or partial early redemption, of the Series C Debentures (exclusively) in accordance with the provisions the indenture for the Series C Debentures .

B Communications undertook to refrain from assuming additional debt, with the exception of:

a. Financial debt in an amount (principal) which does not exceed NIS 400;

b. The financial debt is not secured by any collateral and does not have priority over Series C Debentures in creditor ranking upon insolvency.

The total par value of the Series C Debentures together with the total principal amount of the additional debt c. together with the (principal) amount of the new debt which B Communications intends to assume does not exceed an aggregate of NIS 2.3 billion.

### **Control of Bezeq**

B Communications undertook to hold (directly and/or indirectly) at least 25% of Bezeq's issued and paid-up capital, unless a regulatory permit/approval is received to reduce such shareholding percentage.

### **Control in the Company**

Eurocom Communications Ltd., undertook to refrain from transferring control of B communications (directly or indirectly) to a party which has not been authorized in advance by the necessary regulatory entities, to the extent such approvals are required, at the relevant time.

### **Minimum equity**

B Communications undertook that its equity (capital attributed to B Communications' shareholders, without non-controlling interests) (hereinafter, the "Equity") according to its last consolidated financial statements published, shall not be less than NIS 650 for the duration of two or more consecutive calendar quarters. The indenture for the Series C Debentures includes a mechanism of adjustment of interest rate in the event of a drop below the Minimum Equity or in the event of a downgrade in the rating of the Series C Debentures.

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## Notes to the Consolidated Financial Statements

(All amounts are in millions except where otherwise stated)

### Note 13 - Debentures, Loans and Borrowings, including Obligations to Banks, Institutions and Others (cont'd)

#### **B. Restriction on distribution**

B Communications undertook not to distribute a dividend to its shareholders and/or perform a buyback of its shares and/or any other distribution as defined in the Companies Law unless all the conditions provided in subsections (a) through (f) below are satisfied:

a. The distribution will not cause a downgrade in the rating of the Series C Debentures.

b. B Communications is not in violation of any of the covenants.

c. No grounds for immediate repayment exist at the time a resolution to make a distribution is adopted, and no such grounds exist as a result of such distribution.

d. B Communications' Equity post-distribution is not less than NIS 800.

Until full repayment of the principal of the Series C Debentures, B Communications shall not distribute a dividend exceeding 75% of the balance of B Communications' distributable surpluses (the surplus balance or surpluses accrued in the last two years, in accordance with the definitions provided in the Companies Law) in accordance with its consolidated financial statements. In addition, B Communications shall not make a distribution if it recorded an aggregate net loss in the last four quarters preceding the distribution date, on the basis of its last financial statements and/or the quarterly financial report published prior to the distribution date.

f.



Notwithstanding the foregoing, the restrictions set forth in this subsection (f) shall not apply with respect to the balance of B Communications' profits/surpluses which are distributable in accordance with the provisions of the Companies Law, B Communications' financial statements as of June 30, 2016 (i.e. a total of NIS 416 which shall be excluded from the distribution restrictions under this subsection (f); for the avoidance of doubt, the restrictions provided in subsections (a) through (e) shall apply with respect to such distribution).

**Ratio of unconsolidated equity to total unconsolidated balance sheet**

Ratio of unconsolidated equity to total unconsolidated balance sheet: B Communications' equity shall not be less than 15% of the total balance sheet in accordance with B Communications' audited or reviewed (unconsolidated) financial statements (or, alternatively, the quarterly financial report figures, as elected by B Communications), as the case may be, for two or more consecutive calendar quarters.

(7) Below are details of the terms that Bezeq undertook for the loans that were received and the debentures that were issued:

For the Bezeq's total debt, Bezeq has undertaken not to create additional liens on its assets unless liens are created at the same time in favor of the debenture holders and the lending banks (negative lien). The lien includes exceptions, including regarding a lien on assets that will be purchased or expanded by Bezeq, if the undertakings underlying the lien are created for the purchase or expansion of those assets and for the matter of a token lien.

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## Notes to the Consolidated Financial Statements

(All amounts are in millions except where otherwise stated)

### Note 13 - Debentures, Loans and Borrowings, including Obligations to Banks, Institutions and Others (cont'd)

#### B. Restriction on distribution (cont'd)

For Debentures (Series 6 to 8), loans from banks and financial institutions, and for debentures from financial institutions, standard grounds were included for immediate repayment of the debentures and loans, including breach b. events, insolvency, dissolution procedures or receivership. In addition, a right was determined to call for immediate repayment if a third-party lender calls for immediate repayment of Bezeq's debts in an amount exceeding the amount determined.

In addition, for loans from financial institutions amounting to NIS 500, a standard cause was included for immediate repayment of the loans, if telecommunication ceases to be the Bezeq Group's core activity.

For Debentures (Series 6 to 10) and banks loans in the amount of NIS 2.8 billion as at December 31, 2016 (for loans from financial institutions amounting to NIS 500, and for debentures from financial institutions amounting to NIS 400, Bezeq has undertaken that if it Bezeq makes an undertaking towards any entity in respect of compliance with financial covenants, Bezeq will also provide the same undertaking to these debenture holders, banks and financial c. institutions (subject to certain exceptions). For Debentures (Series 6 to 10) and for loans from financial institutions amounting to NIS 500, Bezeq has undertaken to the lenders to take steps so that, to the extent under its control, the debentures will be rated by at least one rating agency, so long as there are debentures of the relevant series in circulation or a balance in loans, as the case may be.

d. In addition, for Debentures (Series 9 and 10), standard grounds were included for immediate repayment of the debentures, including events of default, insolvency, liquidation proceedings, or receivership, as well as the right to call for immediate repayment if a third party lender calls for immediate repayment of Bezeq's debts (in an amount exceeding NIS 150, if another series of marketable debentures is called for immediate repayment - an unlimited amount), in the event of the sale of more than 50% of the Group's assets (consolidated) such that telecommunications will cease being the Group's main activity, in the event of a change of control following which

the current controlling shareholders in Bezeq will cease being controlling shareholders (other than transfer of control to a transferee that received approval to control Bezeq in accordance with the provisions of the Communications Law or change in control under other circumstances that were established), in the event that a going concern qualification is recorded in Bezeq's financial statements for two consecutive quarters, in the event of a material deterioration in Bezeq's business compared with the situation at the time of the issue, and there is real concern that Bezeq will not be able to repay the debentures on time (as set out in section 35I(1)(a)(1) in the Securities Law), all under the terms set out in the deed of trust of the debentures.

As at December 31, 2016 and the approval date of the financial statements, Bezeq was in compliance with all its financial covenants.

### **C. Non-marketable debentures issued by DBS**

DBS has Debentures (Series A) with a balance of NIS 190 as at December 31, 2016 and Debentures (Series B) with a balance of NIS 678 as at December 31, 2016, issued to institutional investors and listed on the TACT-Institutional system of the TASE.

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Internet Gold – Golden Lines Ltd.

## Notes to the Consolidated Financial Statements

(All amounts are in millions except where otherwise stated)

### Note 13 - Debentures, Loans and Borrowings, including Obligations to Banks, Institutions and Others (cont'd)

#### C. Non-marketable debentures issued by DBS (cont'd)

In accordance with Deed of Trust A, DBS created an unlimited floating first lien in favor of Trustee A on all of its assets (other than exemptions arising from the provisions of the Communications Law), including a stipulation that limits additional liens (subject to the exceptions), and an unlimited fixed first lien on the rights and assets of DBS (subject to exceptions under the Communications Law), including its rights under material agreements to which it is a party, its unissued registered capital, goodwill, certain intellectual property rights and insurance rights under its insurance policies.

Deed of Trust A and Deed of Trust B stipulate standard events (such as insolvency, default and exercise of liens on most of the assets of DBS and more), which, should they occur, after the warning period and terms set out in each deed of trust, will allow immediate call for repayment of the debentures under the provisions in the deed of trust, and establish the right to call for immediate payment if another debenture series of DBS is called for immediate repayment, if the balance for settlement exceeds the amount set out in the relevant deed of trust.

In September 2015, Bezeq signed a letter of guarantee for the undertakings of DBS in favor of the holders of Debentures (Series B), against a reduction of the interest rate for Debentures (Series B) and cancellation of collateral (similar to those registered in favor of Trustee A) and certain provisions in Deed of Trust B, all in accordance with the terms set out in Deed of Trust B.

A reduction in the interest rate and cancellation of the collateral and certain provisions in Deed of Trust B are contingent on the rating of Bezeq not falling below a rating of AA- by S&P Maalot or a corresponding rating ("the Minimum Rating"), a condition that was fulfilled as at the date of the guarantee, and as at the date of the financial statements, and if, in the future, the rating of Bezeq falls below the Minimum Rating, then the reduction in the interest rate will be cancelled, the collateral that was cancelled will be provided again, the provisions that were cancelled will be applicable again, and the guarantee will expire.

**D. Undertakings to provide credit for 2016-2017**

Bezeq entered into agreements with banks and financial institutions, whereby Bezeq received an undertaking from these institutions to provide credit to Bezeq to refinance its future debt in 2017 amounting to NIS 900 (with an average duration of 4.5 years and an average fixed NIS interest rate of 4.3%).

The terms of all the undertakings and the loans to be provided thereunder include terms that are similar to the terms provided for other loans taken by Bezeq, including the following: an undertaking that if Bezeq assumes an undertaking towards a party in respect of compliance with financial covenants, Bezeq will also assume the same undertaking for this credit (subject to certain exceptions); and standard terms for immediate repayment (such as default events, insolvency, liquidation or receivership), and cross default (with certain restrictions), which will also apply, with the required changes, to the periods of the undertaking to provide credit.

In addition, some of the undertakings to provide credit in 2017 also include terms that are similar to the terms that were established for Bezeq's Debentures (Series 9 and 10) as set out in Note 13B above.

Subsequent to the balance sheet date, Bezeq signed another agreement to obtain a loan of NIS 500 in 2017, in similar terms to the above.

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## Notes to the Consolidated Financial Statements

(All amounts are in millions except where otherwise stated)

### Note 14 - Trade and Other Payables

|   | December<br>31 |      |
|---|----------------|------|
|   | 2015           | 2016 |
|   | NIS            | NIS  |
| Open accounts   | 885            | 808  |
| Checks payable  | 28             | 92   |
| Trade payables  | 913            | 900  |
| Trade payables consisting of related parties                | 17             | 21   |
| Other payables  |                |      |
| Liabilities to employees and other liabilities for salaries | 369            | 353  |
| Institutions  | 79             | 98   |
| Accrued expenses  | 90             | 102  |
| Accrued interest  | 125            | 99   |
| Deferred income   | 85             | 82   |
| Options and derivatives                                     | 22             | 10   |
| Other payables  | 34             | 17   |
| Total other payables  | 804            | 761  |

### Note 15 - Provisions

|  | Customer<br>claims | Additional<br>legal<br>claims | Dismantling<br>and clearing<br>of cellular<br>and other<br>sites | Total |
|--|--------------------|-------------------------------|--|-------|
|--|--------------------|-------------------------------|--|-------|

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|                                    | NIS  | NIS   | NIS | NIS   |
|------------------------------------|------|-------|-----|-------|
| Balance as at January 1, 2016      | 52   | 45    | 49  | 146   |
| Provisions created in the period   | 4    | 4     | 4   | 12    |
| Provisions used in the period      | (7 ) | (14 ) | -   | (21 ) |
| Provisions cancelled in the period | (5 ) | (5 )  | -   | (10 ) |
| Balance as at December 31, 2016    | 44   | 30    | 53  | 127   |
| Current                            | 44   | 30    | 6   | 80    |
| Non-current                        | -    | -     | 47  | 47    |

**Claims**

For details of legal claims, see Note 20.

Internet Gold – Golden Lines Ltd.

## **Notes to the Consolidated Financial Statements**

(All amounts are in millions except where otherwise stated)

### **Note 16 - Financial Risk Management**

#### **A. General**

The Group is exposed to the following risks, arising from the use of financial instruments:

- Credit risk
- Liquidity risk
- Market risk (which includes currency, interest, inflation and other price risks)

This Note provides information about the Group's exposure to each of the above risks, an explanation as to how the risks are managed, and the measurement processes.

#### **B. Framework for risk management**

The Company's Board of Directors has overall responsibility for the Company's and B Communications' risk management. Bezeq's Board of Directors has responsibility for the Bezeq Group's risk management. The purpose of risk management in the Group is to define and monitor those risks constantly, and to minimize their possible effects arising from the exposure on the basis of assessments and expectations for parameters that affect the risks. The Company's policy is to hedge, in part and where required according to policies determined by the board, exposure from fluctuations foreign currency rates and in the Israeli CPI rates. Bezeq's policy is to hedge, in part and where required according to policies determined by the board, exposure from fluctuations in foreign currencies and the Israeli CPI.



### **C. Credit risk**

Our management monitors our Company's exposure to credit risks on a regular basis. B Communications' management monitors its exposure to credit risks on a regular basis. Bezeq's management monitors the Bezeq Group's exposure to credit risks on a regular basis. Cash and investments in deposits and securities are deposited in highly-rated banks.

### **Trade and other receivables**

Bezeq's management regularly monitors customer debts, and the financial statements include provisions for doubtful debts which properly reflect, in the management's estimation, the loss inherent in doubtful debts. In addition, the balances of trade receivables are widely spread.

### **Investments in financial assets**

The Company's investment policy, which was approved by its Audit Committee, and established by the Company's Board of Directors, seeks to preserve principal and maintain adequate liquidity while maximizing the income received from investments without significantly increasing the risk of loss. According to the Company's investment policy approximately 80% of the funds must be invested in investment-grade securities. The Company's securities consist of investment grade securities, corporate debts securities and equity investments (stocks). The Company's and B Communications' investment policies impose limitations on invested amounts by investment ratings, duration, exposure to a single issuer, exposure to a group of issuers with the same ownership, industries, geographic spread and currency exposure, thereby reducing credit risk concentrations. Transactions involving derivatives are made with entities that have high credit ratings.

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## **Notes to the Consolidated Financial Statements**

(All amounts are in millions except where otherwise stated)

### **Note 16 - Financial Risk Management (cont'd)**

#### **C. Credit risk (cont'd)**

##### **Investments in financial assets (cont'd)**

Any investments made by Bezeq in securities are made in securities which are liquid, marketable and have low risk. Transactions involving derivatives are made with entities that have high credit ratings.

As of the reporting date there is no significant concentration of credit risk.

#### **D. Liquidity risk**

Liquidity risk is the risk that the Group will be unable to honor their financial obligations on time. The Group's policy for liquidity management is to ensure, as far as possible, that it will always have sufficient liquidity to honor those liabilities on time, without incurring undesirable losses. In addition, for debentures issued by the Group and its subsidiaries, see Note 13.

#### **E. Market risks**

The purpose of market risk management is to manage and oversee the exposure to market risks within accepted parameters to prevent significant exposures to market risks that will influence the Group's results, liabilities and cash

flows.

During the normal course of its business, the Group takes full or partial hedging actions. The Group's takes into account the effects of the exposure in its considerations for determining the type of loans it takes and in the management of its investment portfolio.

#### Israeli CPI risk

Changes in the rate of Israeli inflation affect the Group's profitability and its future cash flows, mainly due to its Israeli CPI-linked liabilities. In applying a policy of minimizing the exposure the Company has invested in bonds that are linked to the Israeli CPI in order to partially hedge the exposure to changes in the Israeli CPI. In addition, the Group enters into forward transactions against the Israeli CPI. The duration of the forward transactions is the same as or shorter than the duration of the hedged exposures. Bezeq applies hedge accounting with regards to its forward CPI hedge transactions.

A considerable part of the Bezeq's cash balances are invested in deposits, monetary funds or ETF's which are exposed to changes in their real value as a result of changes in the Israeli CPI.

#### Foreign currency risk

Bezeq is exposed to foreign currency risks mainly due to payments for purchases of terminal equipment and property, plant and equipment which are in or linked to US\$ or Euro. In addition, the Group provides services for customers and receives services from suppliers worldwide for which it is paid and it pays in foreign currency, mainly the US\$.

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## Notes to the Consolidated Financial Statements

(All amounts are in millions except where otherwise stated)

### Note 17 - Financial Instruments

#### A. Liquidity risk

Below are the contractual repayment dates of financial liabilities, including estimated interest payments:

|  | December 31, 2016 |             |       |       |           |       |
|--|-------------------|-------------|-------|-------|-----------|-------|
|  | Carrying          | Contractual |       |       |           | 2022  |
|  | amount            | cash flow   | 2017  | 2018  | 2019-2021 | and   |
|  | NIS               | NIS         | NIS   | NIS   | NIS       | later |
|  |                   |             |       |       |           | NIS   |
| Non-derivative financial liabilities             |                   |             |       |       |           |       |
| Trade and other payables                         | 1,613             | 1,613       | 1,613 | -     | -         | -     |
| Bank loans                                       | 3,923             | 4,117       | 719   | 797   | 1,861     | 740   |
| Debentures                                       | 10,499            | 11,999      | 1,635 | 1,799 | 4,297     | 4,268 |
| Liability to Eurocom DBS                         | 32                | 32          | 32    | -     | -         | -     |
| Total  | 16,067            | 17,761      | 3,999 | 2,596 | 6,158     | 5,008 |
| Financial liabilities for derivative instruments |                   |             |       |       |           |       |
| Forward contracts on CPI                         | 182               | 182         | 6     | 40    | 115       | 21    |

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Internet Gold – Golden Lines Ltd.

## Notes to the Consolidated Financial Statements

(All amounts are in millions except where otherwise stated)

### Note 17 - Financial Instruments (cont'd)

#### B. Linkage and foreign currency risks

The Group's exposure to linkage and foreign currency risk was as follows based on notional amounts:

|                                   | December 31, 2015 |                              |  |
|-----------------------------------|-------------------|------------------------------|--|
|                                   | Unlinked<br>NIS   | Israeli<br>CPI-linked<br>NIS | Foreign<br>currency<br>linked<br>(mainly<br>U.S. dollars)<br>NIS |
| Current assets                    |                   |                              |  |
| Cash and cash equivalents         | 592               | -                            | 27   |
| Restricted cash                   | 154               | -                            | 1  |
| Trade receivables                 | 2,019             | 21                           | 18   |
| Other receivables                 | 19                | 111                          | -  |
| Investments including derivatives | 1,108             | 92                           | 574  |
| Total current assets              | 3,892             | 224                          | 620  |
| Non-current assets                |                   |                              |  |
| Trade and other receivables       | 482               | 192                          | -  |
| Investments including derivatives | 55                | -                            | 230  |
| Total non-current assets          | 537               | 192                          | 230  |
| Total assets                      | 4,429             | 416                          | 850  |
| Current liabilities               |                   |                              |  |

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|   |         |         |         |
|---|---------|---------|---------|
| Debentures, loans and borrowings                      | 1,396   | 823     | -       |
| Trade and other payables                              | 1,324   | 82      | 225     |
| Total current liabilities                             | 2,720   | 905     | 225     |
| Non-current liabilities                               |         |         |         |
| Debentures and bank loans                             | 5,141   | 5,106   | 2,968   |
| Other liabilities including derivatives               | -       | 160     | 5       |
| Total non-current liabilities                         | 5,141   | 5,266   | 2,973   |
| Total liabilities                                     | 7,861   | 6,171   | 3,198   |
| Total exposure in the statement of financial position | (3,432) | (5,755) | (2,348) |
| Forward transactions                                  | (5,448) | 2,471   | 2,977   |

DBS has forward transaction to reduce exposure to changes in the US\$ exchange rate. As at March 31, 2015, the net fair value of these transactions is NIS 11.

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Internet Gold – Golden Lines Ltd.

## Notes to the Consolidated Financial Statements

(All amounts are in millions except where otherwise stated)

### Note 17 - Financial Instruments (cont'd)

#### B. Linkage and foreign currency risks (cont'd)

|                                   | December 31, 2016 |                   |                                 |
|-----------------------------------|-------------------|-------------------|---------------------------------|
|                                   | Israeli           |                   | Foreign<br>currency<br>linked   |
|                                   | Unlinked<br>NIS   | CPI-linked<br>NIS | (mainly<br>U.S. dollars)<br>NIS |
| Current assets                    |                   |                   |                                 |
| Cash and cash equivalents         | 778               | -                 | 32                              |
| Trade receivables                 | 1,954             | 18                | 28                              |
| Other receivables                 | 20                | 48                | -                               |
| Investments including derivatives | 896               | 76                | 269                             |
| Total current assets              | 3,648             | 142               | 329                             |
| Non-current assets                |                   |                   |                                 |
| Trade and other receivables       | 429               | 215               | -                               |
| Total non-current assets          | 429               | 215               | -                               |
| Total assets                      | 4,077             | 357               | 329                             |
| Current liabilities               |                   |                   |                                 |
| Debentures, loans and borrowings  | 1,668             | 513               | -                               |
| Trade and other payables          | 1,340             | 77                | 203                             |
| Total current liabilities         | 3,008             | 590               | 203                             |
| Non-current liabilities           |                   |                   |                                 |
| Debentures and bank loans         | 7,667             | 4,574             | -                               |

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|   |          |          |     |
|---|----------|----------|-----|
| Other liabilities including derivatives               | -        | 176      | 9   |
| Total non-current liabilities                         | 7,667    | 4,750    | 9   |
| Total liabilities                                     | 10,675   | 5,340    | 212 |
| Total exposure in the statement of financial position | (6,598 ) | (4,983 ) | 117 |
| Forward transactions                                  | (2,456 ) | 2,184    | 272 |

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Internet Gold – Golden Lines Ltd.

## Notes to the Consolidated Financial Statements

(All amounts are in millions except where otherwise stated)

### Note 17 - Financial Instruments (cont'd)

#### B. Linkage and foreign currency risks (cont'd)

The Group has CPI forward transactions for the Israeli CPI:

|  | Currency/<br>linkage<br>receivable | Currency/<br>linkage<br>payable | Expiry date | Par value<br>(currency)<br><b>NIS</b> | Fair<br>value<br>NIS |
|--|------------------------------------|---------------------------------|-------------|---------------------------------------|----------------------|
| December 31, 2015                                  |                                    |                                 |             |                                       |                      |
| Forward exchange contracts on foreign currencies   | US\$                               | NIS                             | 2018        | 2,561                                 | 180                  |
| Israeli CPI forward contracts<br>December 31, 2016 | Israeli CPI                        | NIS                             | 2015-2022   | 2,887                                 | (180 )               |
| Israeli CPI forward contracts                      | Israeli CPI                        | NIS                             | 2017-2022   | 2,184                                 | (182 )               |

Information regarding the Israeli CPI and significant exchange rates:

|                | Year ended<br>December 31 |      |       | December 31 |       |       |
|----------------|---------------------------|------|-------|-------------|-------|-------|
|                | 2014                      | 2015 | 2016  | 2014        | 2015  | 2016  |
| Rate of change | Reporting date spot rate  |      |       |             |       |       |
|                | %                         | %    | %     | NIS         | NIS   | NIS   |
| 1 US dollar    | 12.0                      | 0.3  | (1.5) | 3.889       | 3.902 | 3.845 |

|                       |        |         |        |        |        |        |
|-----------------------|--------|---------|--------|--------|--------|--------|
| 1 euro                | (1.2 ) | (10.1 ) | (4.8 ) | 4.725  | 4.2468 | 4.044  |
| Israeli CPI in points | (0.3 ) | (0.9 )  | (0.3 ) | 141.28 | 140.01 | 139.59 |

### C. Interest rate risk

#### 1. Profile

At the reporting date the interest rate profile of the Group's interest-bearing financial instruments was:

|                           | December 31 |          |
|---------------------------|-------------|----------|
|                           | 2015        | 2016     |
|                           | NIS         | NIS      |
| Fixed rate instruments    |             |          |
| Financial assets          | 3,016       | 2,503    |
| Financial liabilities     | (13,371)    | (12,711) |
|                           | (10,355)    | (10,208) |
| Variable rate instruments |             |          |
| Financial assets          | 226         | 99       |
| Financial liabilities     | (2,065 )    | (1,712 ) |
|                           | (1,839 )    | (1,613 ) |

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Internet Gold – Golden Lines Ltd.

## **Notes to the Consolidated Financial Statements**

(All amounts are in millions except where otherwise stated)

### **Note 17 - Financial Instruments (cont'd)**

#### **C. Interest rate risk (cont'd)**

##### **2. Fair value sensitivity analysis for fixed rate financial liabilities and derivatives**

The Group does not account for any fixed rate financial liabilities at fair value through profit or loss, and the Group does not designate derivatives (interest swap contracts) as hedging instruments under a fair value hedge accounting model. Therefore a change in interest rates at the reporting date would not affect profit or loss.

##### **3. Sensitivity analysis of cash flow for instruments at variable interest**

An increase of 100 basis points in the interest rates at the reporting date would have decreased shareholders' equity and profit or loss by NIS 12 (2015 - NIS 14).

#### **D. Cash flow hedge accounting**

Bezeq entered into several forward contracts, as described in the table below, in order to reduce its exposure to changes in the CPI for its CPI-linked debentures (Series 5 and Series 6). These transactions hedge specific cash flows of certain of the Bezeq debentures and are recognized as cash flow hedge accounting. The expiry date of these transactions complies with the repayment schedule of the relevant debentures. The fair value of the forward contracts is based on observable market-based data (level 2) in fair value hierarchy.

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| Hedge item                | Repayment date                | Number of Transactions | Nominal Value<br>NIS | Fair value<br>NIS | Capital reserve<br>NIS |
|---------------------------|-------------------------------|------------------------|----------------------|-------------------|------------------------|
| <u>December 31, 2015:</u> |                               |                        |                      |                   |                        |
| Debentures (Series 5)     | June 2016                     | 2                      | 322                  | (22 )             | 3                      |
| Debentures (Series 6)     | December 2018 - December 2022 | 8                      | 1,699                | (146 )            | 67                     |
|                           |                               |                        | 2,021                | (168 )            | 70                     |
| <u>December 31, 2016:</u> |                               |                        |                      |                   |                        |
| Debentures (Series 6)     | December 2018 - December 2022 | 8                      | 1,994                | (176 )            | 54                     |
|                           |                               |                        | 1,994                | (176 )            | 54                     |

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Internet Gold – Golden Lines Ltd.

## Notes to the Consolidated Financial Statements

(All amounts are in millions except where otherwise stated)

### Note 17 - Financial Instruments (cont'd)

#### E. Fair value

##### (1) Financial instruments measured at fair value for disclosure purposes only

The table below shows the difference between the carrying amount and the fair value of groups of financial instruments. The carrying amount of other financial assets and liabilities does not differ significantly from their fair value. The fair value of debentures issued to the public is based on their quoted closing price at the reporting date (Level 1). The fair value of loans and non-marketable debentures is based on the present value of future principal and interest cash flows, discounted at the market rate of interest suitable for similar liabilities plus the required adjustments for risk premium and non-marketable at the reporting date (Level 2).

|                                     | December 31,<br>2015      |                      | December 31, 2016         |                      |   |
|-------------------------------------|---------------------------|----------------------|---------------------------|----------------------|---|
|                                     | Carrying<br>amount<br>NIS | Fair<br>value<br>NIS | Carrying<br>amount<br>NIS | Fair<br>value<br>NIS | Fair<br>value<br>weighted<br>average<br>discount<br>rate<br>% |
| Secured loans from banks and others |                           |                      |                           |                      |   |
| Unlinked                            | 1,904                     | 2,044                | 2,947                     | 3,089                | 2.60  |
| Debentures                          |                           |                      |                           |                      |   |
| Issued to the public (CPI-linked)   | 4,891                     | 5,104                | 4,419                     | 4,677                | 1.34  |
| Issued to the public (unlinked)     | 2,986                     | 3,258                | -                         | -                    | -   |

|   |        |        |        |        |      |
|---|--------|--------|--------|--------|------|
| Issued to institutional investors (US\$ linked) | 1,991  | 2,119  | 4,166  | 4,246  | 2.65 |
| Issued to institutional investors (unlinked)    | 1,310  | 1,314  | 830    | 879    | 2.43 |
| Issued to institutional investors (CPI-linked)  | 403    | 458    | 403    | 440    | 2.17 |
|   | 13,485 | 14,297 | 12,765 | 13,331 |      |

(2) **Financial instruments measured at fair value**

The table below analyses financial instruments carried at fair value, by valuation method.

|   | December 31, 2015 |         |         |        |
|---|-------------------|---------|---------|--------|
|   | Level 1           | Level 2 | Level 3 | Total  |
|   | NIS               | NIS     | NIS     | NIS    |
| Financial assets held for trading                   |                   |         |         |        |
| Monetary funds and ETFs                             | 193               | -       | -       | 193    |
| Marketable securities                               | 1,011             | -       | -       | 1,011  |
| Derivatives not used in hedging                     |                   |         |         |        |
| Forward contracts on foreign currencies             | -                 | 180     | -       | 180    |
| Forward contracts on CPI                            | -                 | (169)   | -       | (169 ) |
| Available-for-sale financial assets                 |                   |         |         |        |
| Unmarketable shares                                 | -                 | -       | 2       | 2      |
| Contingent consideration for a business combination | -                 | -       | (233)   | (233 ) |
|   | 1,204             | 11      | (231)   | 984    |

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Internet Gold – Golden Lines Ltd.

## Notes to the Consolidated Financial Statements

(All amounts are in millions except where otherwise stated)

### Note 17 - Financial Instruments (cont'd)

#### E. Fair value (cont'd)

#### (2) Financial instruments measured at fair value (cont'd)

|   | December 31, 2016 |         |         | Total |
|---|-------------------|---------|---------|-------|
|   | Level 1           | Level 2 | Level 3 |       |
|   | NIS               | NIS     | NIS     |       |
| Financial assets held for trading                   |                   |         |         |       |
| Monetary funds and ETFs                             | 31                | -       | -       | 31    |
| Marketable securities                               | 655               | -       | -       | 655   |
| Derivatives not used in hedging                     |                   |         |         |       |
| Forward contracts on CPI                            | -                 | (176)   | -       | (176) |
| Contingent consideration for a business combination | -                 | -       | (84 )   | (84 ) |
|   | 686               | (176)   | (84 )   | 426   |

a. The fair value of investments in financial funds and ETFs is determined by reference to their average quoted selling price at the reporting date (Level 1).

b. The fair value of forward contracts on the CPI or foreign currency is based on discounting the difference between the price in the forward contract and the price of the present forward contract for the balance of the contract term until redemption, at an appropriate interest rate (level 2). The estimate is made under the assumption that a market participant takes into account the credit risks of the parties when pricing such contracts.

c. Information about fair value measurement of contingent consideration in a business combination (Level 3)

Below is the fair value of the contingent consideration liability for a business combination, as described in Note 12B:

|  | December<br>31, 2015  |     | December 31,<br>2016  |     |
|--|---|-----|---|-----|
|  | Maximum<br>additional<br>consideration<br>under<br>the<br>agreement |     | Maximum<br>additional<br>consideration<br>under<br>the<br>agreement |     |
|  | Fair<br>value   |     | Fair<br>value   |     |
|  | NIS   | NIS | NIS   | NIS |
| Additional consideration for tax synergy (first additional consideration)                  | 200   | 204 | -   | -   |
| Additional consideration for the business results of DBS (second additional consideration) | 170   | 29  | 170   | 84  |
|  | 370   | 233 | 170   | 84  |

The fair value of the first additional consideration was estimated by the assessor, using the Monte Carlo simulation with risk neutral measure of the underlying asset which is the expected income of DBS in 2017 and based on the assumptions regarding expected cash flows.



Internet Gold – Golden Lines Ltd.

## Notes to the Consolidated Financial Statements

(All amounts are in millions except where otherwise stated)

### Note 17 - Financial Instruments (cont'd)

#### F. Offset of financial assets and liabilities

The Group has agreements with various communication companies to supply and receive communication services. The table below presents the carrying amount of the balances as stated in the statement of financial position:

|  | December<br>31, |       |
|--|-----------------|-------|
|  | 2015            | 2016  |
|  | NIS             | NIS   |
| Trade and other receivables, gross   | 147             | 119   |
| Offset amounts   | (115)           | (97 ) |
| Trade and other receivables presented in the statement of financial position | 32              | 22    |
| Trade payables, gross  | 157             | 147   |
| Offset amounts   | (115)           | (97 ) |
| Trade and other payables presented in the statement of financial position    | 42              | 50    |

### Note 18 - Employee Benefits

Employee benefits include post-employment benefits, other long-term benefits, termination benefits, short-term benefits and share-based payments. For details of share-based payments, see Note 29 below.

#### A. Liabilities for employee benefits

|  | December |       |
|--|----------|-------|
|  | 31,      |       |
|  | 2015     | 2016  |
|  | NIS      | NIS   |
| Current liabilities for:                             |          |       |
| Holiday  | 104      | 104   |
| Sick leave   | 117      | 122   |
| Early retirement                                     | 150      | 82    |
| Current maturities of pensioner benefits             | 7        | 7     |
| Total current liability for employee benefits        | 378      | 315   |
| Non-current liabilities for:                         |          |       |
| Liability for pensioner benefits                     | 114      | 118   |
| Severance compensation (net) (see composition below) | 55       | 51    |
| Early notice   | 16       | 19    |
| Pension  | 55       | 70    |
| Total non-current liabilities for employee benefits  | 240      | 258   |
| Total liabilities for employee benefits              | 618      | 573   |
| Composition of liabilities for severance pay:        |          |       |
| Liabilities for severance pay                        | 221      | 212   |
| Fair value of plan assets                            | (166)    | (161) |
|  | 55       | 51    |

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Internet Gold – Golden Lines Ltd.

**Notes to the Consolidated Financial Statements**

(All amounts are in millions except where otherwise stated)

**Note 18 - Employee Benefits (cont'd)**

**B. Defined contribution plans**

Liabilities for employee benefits at retirement age in respect of the period of their service with Bezeq and its (1) subsidiaries, and for employees to which Section 14 of the Severance Pay Law – 1963 applies, are covered in full by regular payments made by Bezeq and its subsidiaries to pension funds and insurance companies.

| Year ended   |      |      |
|--------------|------|------|
| December 31, |      |      |
| 2014         | 2015 | 2016 |
| NIS          | NIS  | NIS  |

|   |     |     |     |
|---|-----|-----|-----|
| Amount recognized as an expense for a defined contribution plan | 191 | 199 | 209 |
|---|-----|-----|-----|

The pension rights of Bezeq's employees for the period of their employment in the civil service through January (2) 31, 1985, are covered by a pension fund ("the Makefet Fund"), which assumed the obligations of State of Israel following an agreement between the Government of Israel, Bezeq, the General Federation of Laborers in Israel ("Histadrut") and the Makefet Fund.

Severance obligation to employees who will retire on terms entitling them to compensation is covered for the (3) period from February 1, 1985 by on-going contributions to such pension funds and insurance companies (in accordance with Section 14 of the Severance Pay Law).

Severance pay for the period of employment in the civil service through January 31, 1985, is paid by Bezeq, and the sums accumulated in the Makefet Fund for that period are kept in a fund that will be used for the employees' rights.

- (4) For certain employees, Bezeq has an obligation to pay severance in excess of the amount accumulated on behalf such employees in the compensation fund. See section 18C(1) below.

### **C. Defined benefit plans**

Obligations for defined benefit plans in the Bezeq Group include the following:

- (1) Severance obligation for the balance of the obligation that is not covered by contributions and/or insurance policies in accordance with the existing labor agreements, the Severance Pay Law, and the salary components for which the management of the Bezeq Group believes entitle the employees to receive compensation. For this part of the obligation, there are deposits in the name of the Bezeq Group in pension funds and insurance companies. The deposits in pension funds and insurance companies include accrued linkage differences and interest. Withdrawal of the reserve sums is contingent upon fulfillment of the provisions in the Severance Pay Law.

- (2) An obligation in accordance with the collective agreement of 2006 for employees who were transferred from civil service to Bezeq and who are entitled following retirement to a supplement in pension payments for the difference between the Civil Service Law and the standard policy of Makefet. Bezeq also has an obligation to a number of senior employees who are entitled to early retirement terms (pension and retirement grants) which are not dependent on the existing retirement agreements for all employees.

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Internet Gold – Golden Lines Ltd.

## Notes to the Consolidated Financial Statements

(All amounts are in millions except where otherwise stated)

### Note 18 - Employee Benefits (cont'd)

#### C. Defined benefit plans (cont'd)

- (3) An obligation in accordance with the employment agreements of some of the senior employees in the Bezeq Group for payment of a benefit for early termination notice.

(4) Bezeq's retirees receive, in addition to pension payments, benefits which consist mainly of a holiday gift (linked to the dollar exchange rate), financing for the upkeep of retiree clubs and social activities. Bezeq's liability for these costs accumulates during the employment period. The Company's financial statements include the liabilities for expected costs in the post-employment period.

#### D. Other long-term employee benefits (Sick leave provision)

The financial statements include a provision in respect of redemption and utilization of sick leave. The right to accumulate sick leave was taken into account for all employees in the Bezeq Group. Only employees eligible under the terms of the employment agreement may redeem sick leave. The provision was computed on the basis of an actuarial calculation, including the assumption of positive accumulation of days by most of the employees and utilization of days in accordance with the last in first out (LIFO) method.

#### E. Benefits for early retirement and termination in Bezeq

According to the collective agreement of December 2006, between Bezeq and the employees union and the Histadrut, and according to the amendment to the agreement of August 2015, Bezeq may, at its discretion, terminate the employment of 163 permanent employees in each of the years 2015-2021 (Bezeq's right is cumulative for the period).

Bezeq recognizes expenses for early retirement when it is significantly committed, without any real possibility of withdrawal, to a defined plan to terminate employment before the defined date, according to a defined plan. The collective agreement allows Bezeq to dismiss employees, but does not create a significant commitment without any real possibility of withdrawal. Accordingly, Bezeq recognizes the expense for early retirement on the date the plan is approved by its Board of Directors, since only after the approval of its Board of Directors and publication of the decision, does Bezeq have a significant commitment without any real possibility of withdrawal.

In 2016, expenses of the early retirement plan amounted to NIS 96.

In addition, the Bezeq Group companies have collective agreements with the Histadrut New General Federation of Labor and the employees' committees. The agreements include mechanisms to integrate the employees' committees in decisions regarding the termination of permanent employees and the terms of severance.

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Internet Gold – Golden Lines Ltd.

**Notes to the Consolidated Financial Statements**

(All amounts are in millions except where otherwise stated)

**Note 18 - Employee Benefits (cont'd)**

**F. Collective agreement at Pelephone**

Principal actuarial assumptions for defined benefit plans at the reporting date are as follows:

(1) Mortality rates are based on the rates published in Insurance Circulars 2013-3-1 of the Ministry of Finance.

(2) Churn rates were determined on the basis of the past experience of Bezeq and its subsidiaries, distinguishing between different employee populations and taking into account the number of years of employment. The churn rates include a distinction between severance with entitlement to full severance compensation and severance without entitlement to this right.

(3) The discount rate (nominal) is based on the yield on linked high-quality corporate debentures with maturity dates approximating those of the gross obligation.

The main discount rates are as follows:

|                        | December 31,<br>2015                   | December 31,<br>2016                   |
|------------------------|--|--|
|                        | Average<br>capitalization<br>rate<br>% | Average<br>capitalization<br>rate<br>% |
| Severance compensation | 4.1                                    | 4.2                                    |

|                     |     |     |
|---------------------|-----|-----|
| Retirement benefits | 4.7 | 4.3 |
|---------------------|-----|-----|

- (4) Assumptions regarding salary increments for calculation of the liabilities were made on the basis of the management's assessments, distinguishing between the groups of employees. The main assumptions (in nominal terms) regarding salary increases are as follows:

|                               | Salary increase assumptions  |
|-------------------------------|--|
| Bezeq permanent employees     | Average update of 7% for young employees, decreasing gradually to 2.7% at the age of 66.   |
| New Bezeq permanent employees | Average update of 3.2% for young employees, decreasing gradually to 1.4% at the age of 66. |
| Bezeq non-permanent employees | 6.5% for young employees decreasing gradually to 0%, 3.5% for senior employees             |
| Pelephone employees           | An increase of 3.1%, as set out in the collective agreement at Pelephone                   |
| Bezeq International employees | An increase of 3.0%, as set out in the collective agreement at Bezeq International         |

Regarding Bezeq's employees, as well as the assumption of the age-dependent wage increase, an expected individual wage growth was assumed for 2017-2026, arising from the collective agreement that was signed in August 2015.

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Internet Gold – Golden Lines Ltd.

## Notes to the Consolidated Financial Statements

(All amounts are in millions except where otherwise stated)

### Note 18 - Employee Benefits (cont'd)

#### F. Actuarial assumptions (cont'd)

(5) Sensitivity analysis for actuarial assumptions

The following is an analysis of the possible effect of the changes in the principal actuarial assumptions on liabilities to employee benefits. The calculation is made for each assumption separately, assuming that the remaining assumptions remain unchanged.

|  | Year ended<br>December<br>31, |       |
|--|-------------------------------|-------|
|  | 2015                          | 2016  |
|  | Years                         | Years |
| Discount rate - addition of 0.5%                   | (25)                          | (28)  |
| Rate of future salary increases - addition of 0.5% | 36                            | 36    |
| Rate of employees leaving - addition of 5.0%       | (13)                          | (10)  |

(6) Average weighted useful life of liabilities for the main severance benefits:

|                        | Year ended<br>December<br>31, |       |
|------------------------|-------------------------------|-------|
|                        | 2015                          | 2016  |
|                        | Years                         | Years |
| Severance compensation | 10.2                          | 10.0  |

Retirement benefits            14.4    14.1

## **Note 19 - Income Tax**

### **A. Corporate tax rate**

As from January 1, 2014 until December 31, 2015, the rate of corporate tax was 26.5%. The corporate tax rate for 2016 was 25%.

On January 4, 2016, the Knesset plenum passed the Law for the Amendment of the Income Tax Ordinance (Amendment 216), 2016, which includes a reduction in the corporate tax rate from 26.5% to 25% as from January 1, 2016. On December 22, 2016, the Knesset plenum passed the Economic Efficiency Law (Legislative Amendments for Achieving Budget Objectives in 2017 and 2018) – 2016, by which, among other things, the corporate tax rate would be reduced from 25% to 24% in 2017 and to 23% as from January and thereafter.

Deferred tax balances as at December 31, 2016 were calculated according to the new tax rates expected to apply on the date of reversal. As a result of the lower tax rate as set out above, deferred tax balances were reduced and deferred tax expenses of NIS 67 were recognized in the statement of income for 2016.

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Internet Gold – Golden Lines Ltd.

## Notes to the Consolidated Financial Statements

(All amounts are in millions except where otherwise stated)

### Note 19 - Income Tax (cont'd)

#### B. Composition of income tax expenses (income)

|                                  | Year ended  |       |       |
|----------------------------------|-------------|-------|-------|
|                                  | December 31 |       |       |
|                                  | 2014        | 2015  | 2016  |
|                                  | NIS         | NIS   | NIS   |
| Current tax expense              | 781         | 567   | 437   |
| Deferred tax expenses (income)   | (126)       | (220) | 33    |
| Adjustments for prior years, net | 12          | -     | (28 ) |
| Income tax expense               | 667         | 347   | 442   |

#### C. Reconciliation between the theoretical tax on the pre-tax income and the tax expense

|  | Year ended December |        |      |
|--|---------------------|--------|------|
|  | 31                  |        |      |
|  | 2014                | 2015   | 2016 |
|  | NIS                 | NIS    | NIS  |
| Income before income tax                 | 1,711               | 1,430  | 882  |
| Statutory tax rate                       | 26.5 %              | 26.5 % | 25 % |
| Income tax at the statutory tax rate     | 453                 | 378    | 220  |
| Changes in tax rate and others           | -                   | -      | 67   |
| Expenses not recognized for tax purposes | (5 )                | (13 )  | 46   |
| Adjusted tax calculated for the          |                     |        |      |

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|  |     |        |       |
|--|-----|--------|-------|
| Company's share in equity-accounted investees                                  | 45  | (3 )   | 1     |
| Recognition of deferred tax assets which were not recognized on prior periods  | -   | (112 ) | -     |
| Current year tax losses and benefits for which deferred taxes were not created | 162 | 97     | 136   |
| Taxes in respect of previous years   | 12  | -      | (28 ) |
| Income tax expenses  | 667 | 347    | 442   |

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Internet Gold – Golden Lines Ltd.

## **Notes to the Consolidated Financial Statements**

(All amounts are in millions except where otherwise stated)

### **Note 19 - Income Tax (cont'd)**

#### **D. Unrecognized deferred tax liabilities**

The calculation of deferred taxes does not take into account the taxes that would be applicable in the event of the sale of investments in subsidiaries and associates, since the Group intends to retain the investments. Deferred taxes in respect of a distribution of profit in subsidiaries and associates were also not taken into account since the dividends are not taxable.

#### **E. Unrecognized deferred tax assets and carry-forward tax loss**

As at December 31, 2016, the Company has tax loss carry-forwards in the amount of NIS 165 and capital loss carry forwards in the amount of NIS 326. In addition, the Company's subsidiaries have tax loss carry-forwards in the amount of NIS 172 and no capital loss carry-forwards.

Deferred tax assets relating to carry-forward losses and tax benefits were not recognized because their utilization in the foreseeable future is not probable. The deductible temporary differences and tax losses do not expire under current tax legislation. Deferred tax assets have not been recognized in respect of these items since it is not probable that future taxable profit will be available against which the Group can utilize the benefits.

As a result, as at December 31, 2016, deferred taxes were not created on carry-forward losses and on carry-forwards capital losses of the Company as detailed above.

On January 14, 2016, The Company sold shares of B Communications (see note 12G2), as a result, the Company recognized deferred taxes due to the basis difference attributed to its investment in B Communications in the amount of NIS 11.

On February 1, 2016, B Communications sold shares of Bezeq (see note 1), as a result, B Communications recognized deferred taxes due to the basis difference attributed to its investment in Bezeq in the amount of NIS 101 during 2015.

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## Notes to the Consolidated Financial Statements

(All amounts are in millions except where otherwise stated)

### Note 19 - Income Tax (cont'd)

#### F. Recognized deferred tax assets and liabilities

Deferred tax assets and liabilities are attributable to the following items:

|  | Property,<br>plant<br>equipment,<br>and<br>intangible<br>assets<br>NIS | Employee<br>benefits<br>plan<br>NIS | Carry-<br>forward<br>losses<br>for<br>DBS<br>NIS | Others<br>NIS | Brand<br>Name and<br>Customers<br>relationship<br>NIS | Total<br>NIS |
|--|--|-------------------------------------|--|---------------|---|--------------|
| Balance of deferred tax asset (liability) as at December 31, 2014  | (474 )   | 209                                 | -  | 92            | (662 )  | (835 )       |
| Recognized in profit or loss                                       | 52   | 1                                   | (7 )   | 51            | 124   | 221          |
| Business combination   | -  | -                                   | 1,426  | 45            | (301 )  | 1,170        |
| Recognized in equity   | -  | -                                   | -  | 5             | -   | 5            |
| Balance of deferred tax assets (liability) as at December 31, 2015 | (422 )   | 210                                 | 1,419  | 193           | (839 )  | 561          |
| Balance of deferred tax asset (liability) as at December 31, 2015  | (422 )   | 210                                 | 1,419  | 193           | (839 )  | 561          |
| Recognized in profit or loss                                       | 68   | (28 )                               | (231 )   | (67 )         | 224   | (34 )        |
| Recognized in equity   | -  | (4 )                                | -  | (109 )        | -   | (113 )       |
|  | (354 )   | 178                                 | 1,188  | 17            | (615 )  | 414          |

Balance of deferred tax assets (liability) as at  
December 31, 2016

As at December 31, 2016, deferred taxes are presented in the statement of financial position as follows: under deferred tax assets 1,007 (December 31, 2015: 1,290) and under deferred tax liabilities NIS 593 (December 31, 2015: NIS 729).

#### **G. Final tax assessments**

(1) The Company has final tax assessments up to and including 2012.

(2) B Communications has final tax assessments up to and including 2009. On January 22, 2015, B Communications entered into a tax assessment agreement with the Israeli Tax Authority (the "Agreement"), with respect to final tax assessments with respect to: (i) tax years 2007-2009; and (ii) the sale of its legacy communications business that was completed on January 31, 2010. According to the Agreement, B Communications will pay the Israeli Tax Authority NIS 148, including interest and CPI linkage differences, in 24 monthly instalments starting in February 2015.

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Internet Gold – Golden Lines Ltd.

## Notes to the Consolidated Financial Statements

(All amounts are in millions except where otherwise stated)

### Note 19 - Income Tax (cont'd)

#### G. Final tax assessments

(3) On December 28, 2016, B Communications received a “best judgment” tax assessment for the years 2011 and 2012 of approximately NIS 50 million (not including interest and linkage differentials). The Israeli Tax Authority is claiming that additional taxes are due with respect to the alleged capital gain generated from the capital reduction of Bezeq during the period from 2011 to 2013. B Communications disagrees with the position of the Tax Authority and believes that it has good arguments to support such position. Accordingly, B Communications filed an appeal to the Israeli Tax Authority with respect to such matter.

Based on B Communications’ positions and arguments, B Communications believes that the financial statements include appropriate tax provisions to cover these resolutions.

(4) Bezeq has final tax assessments up to and including 2010.

(5) On September 15, 2016, Bezeq and the Israel Tax Authority signed an assessment agreement (“the Assessment Agreement”) ending the disputes involving the tax assessor’s claims regarding the financing income from the shareholder loans and about the rights and holdings in DBS acquired by Bezeq (“the Tax Issue”) and regarding the claims of DBS that its losses should be recognized in full, as recorded in its tax reports. In addition, the Tax Authority granted preliminary approval for tax purposes for the merger of DBS with and into Bezeq, in accordance with Section 103(B) of the Income Tax Ordinance (“the Approval”).

Under the Assessment Agreement, Bezeq will pay tax in the amount of NIS 462, the total losses of DBS will amount to NIS 5.26 billion as a final assessment up to December 31, 2013 and an additional loss will be added to this amount, for the Tax Issue for the period until June 2015, in the amount of NIS 315 (NIS 223 for 2014 and NIS 91 for 2015). Bezeq’s aggregate shareholdings and rights in DBS will be considered as equity in the financial statements of DBS and

as a capital investment in the financial statements of Bezeq, and no other income will be recorded for Bezeq and it will not pay additional tax for the aforesaid.

Concurrently, the Tax Authority granted approval for tax purposes for the merger of DBS with and into Bezeq, in accordance with Section 103(B) of the Income Tax Ordinance, whereby subsequent to the merger, the losses of DBS as at the merger date may be offset against the profits of the absorbing company, provided that in each tax year, it will not be permitted to offset an amount exceeding 12.5% (spread over eight years) of the total losses of the transferring company and the absorbing company, or 50% of the taxable income of the absorbing company in that tax year prior to offsetting the loss from previous years, whichever is lower.

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Internet Gold – Golden Lines Ltd.

## Notes to the Consolidated Financial Statements

(All amounts are in millions except where otherwise stated)

### Note 19 - Income Tax (cont'd)

#### G. Final tax assessments (con't)

The Approval was granted in accordance with the applicable tax laws in effect at the time. Without derogating from the amount of the losses set out in the Assessment Agreement, if there is any change in the applicable tax laws, the Tax Authority will reconsider the taxation decision in accordance with the tax laws applicable at the merger date. However, it is clarified that the Approval is effective until December 31, 2019. The Tax Authority will extend the date of the Approval each year by an additional year, subject to the declaration of Bezeq and DBS that there has been no material change in their business affairs and subject to the terms of the taxation decision, and subject to the interpretation given to the tax laws, provided that such interpretation is published in writing. Any change in the tax laws that does not require a change in the Approval will not result in any such change.

The Assessment Agreement and the Approval did not affect Bezeq's financial results in the reporting period, since the effect is included in the financial statements as at December 31, 2015, due to the agreement in principle that was agreed upon with the tax assessor. On September 29, 2016, Bezeq paid the agreed tax.

Further to Note 12B above regarding, among other things, the announcement of the Ministry of Communications that the Ministry, in the first stage, is advancing the cancellation of the corporate separation in Bezeq Group, Bezeq is negotiating with the Tax Authority, and at

this state it was agreed that close to the date of merger approval from the Ministry of Communications, its compatibility with the taxation decision will be assessed.

(6) On December 25, 2016, Bezeq received a best-judgment assessment for 2011, in which Bezeq's taxable income for 2011 increased by NIS 246. NIS 144 of the increased taxable income is on account of non-recognition of financing

expenses for dividends distributed and received (for distribution of current earnings, for dividends received from subsidiaries and a small part on account of a distribution for capital reduction), with the balance of NIS 102 for timing differences in the recognition of depreciation expenses. The tax liability arising from this assessment (including interest and linkage differences) is NIS 72. Implementation of the principles of the assessment in subsequent years is likely to lead to a material claim for additional tax for those years. Bezeq disagrees with the position of the Tax Authority and believes it has good arguments to support its own position against that of the Tax Authority. Accordingly, Bezeq intends to file an appeal by the date determined in law.

(7) Pelephone has received final tax assessments up to and including 2012.

(8) Bezeq International has received final tax assessments up to and including 2012.

(9) DBS has final tax assessments under an agreement with the Tax Authority as described in section 19G (3) above.

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## **Notes to the Consolidated Financial Statements**

(All amounts are in millions except where otherwise stated)

### **Note 20 - Contingent Liabilities**

In addition to pending claims, during the normal course of business, new legal claims were filed against Group companies (in this section: “Legal Claims”).

In the opinion of the managements of the Bezeq Group companies, which is based, among other things, on legal opinions as to the likelihood of success of the claims, the financial statements (Note 15 above) include appropriate provisions, where provisions are required to cover the exposure resulting from such claims.

In the opinion of the management of each of the Bezeq Group companies, the additional exposure as at December 31, 2016, due to claims filed against the Group companies on various matters and which are unlikely to be realized, amounts to NIS 6.8 billion. There is also an additional exposure of NIS 284 for claims which the likelihood of realization cannot yet be assessed.

In addition, motions for certification of class actions have been filed against the Group companies, for which the Group has additional exposure beyond the aforesaid, since the exact amount of the claim is not stated in the claim.

These amounts and all the amounts of the additional exposure in this note are linked to the CPI and are stated net of interest.

The Company, B Communications and the members of B Communications’ Board of Directors have been named as respondents in a purported motion to certify a claim as a derivative claim instituted in the Tel Aviv District Court (Economic Affairs Division) on July 28, 2016. The derivative action seeks, among other things, the payment of

damages of NIS 113 (together with interest) and the repayment by the Company of its distributive share of the dividend paid by B Communications in the amount of NIS 73.2 (together with interest), alleging that B Communications unlawfully distributed a portion of dividend distributed in June 2016. The claim is that out of the NIS 355 distribution, NIS 113 was not derived from the net profits of B Communications and therefore could not be considered “retained earnings” that can be legally distributed in accordance with the Israeli Companies Law. The Company’s management and B Communications believe that the purported derivative action has no legal merit and are seeking to dismiss the action.

For updates subsequent to the reporting date, see section B below.

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Internet Gold – Golden Lines Ltd.

## Notes to the Consolidated Financial Statements

(All amounts are in millions except where otherwise stated)

### Note 20 - Contingent Liabilities (cont'd)

A. Following is a detailed description of the Group's contingent liabilities at December 31, 2016, classified into groups with similar characteristics.

| Claims group                             | Nature of the claims   | Balance of provisions<br>NIS | Amount of additional exposure<br>NIS | Amount of exposure for claims for which the amount of exposure cannot be assessed<br>NIS |    |
|--|--|------------------------------|--------------------------------------|--|----|
| Customer claims                          | Mainly motions for certification of class actions concerning contentions of unlawful collection of payment and deterioration in service provided by the Group companies. | 44                           | 4,530                                | 281  | ** |
| Claims by enterprises and companies      | Claims alleging liability of the Group companies in respect of their activities and/or the investments made in various projects.   | 11                           | 2,005                                | *  | -  |
| Claims of employees and former employees | Mainly collective and individual claims filed by employees and former employees of the Company in  | 7                            | 96                                   | 2  |    |

|   |   |    |       |     |
|---|---|----|-------|-----|
| of Group companies  | respect of recognition of various salary components as components for calculation of payments to Company employees, some of which have wide ramifications in the Company.   |    |       |     |
| Claims by the State and authorities                         | Various claims by the State of Israel, government institutions and authorities (“the Authorities”). These are mainly procedures related to regulations relevant to the Group companies and financial disputes concerning monies paid by the Group companies to the Authorities (including property taxes) or by the Authorities to the Group companies. | 6  | 11    | -   |
| Supplier and communication provider claims                  | Legal claims for compensation for alleged damage as a result of the supply of the service and/or the product.   | 3  | 102   | 1   |
| Claims for punitive damages, real estate and infrastructure | Claims for alleged physical damage or damage to property caused by Group companies and in relation to real estate and infrastructure. The additional amount of exposure for punitive damages does not include claims for which the insurance coverage is not disputed.  | 3  | 37    | -   |
| Total legal claims against Bezeq Group companies            |   | 74 | 6,781 | 284 |

This sum includes a total exposure of NIS 2 billion for a claim filed by a shareholder against the Company and \*officers in the Company, which the plaintiff estimates at NIS 1.1 billion or NIS 2 billion (according to the method of calculating the damage to be determined).

\*\*There is an additional exposure in respect of claims; the exposure for these claims cannot yet be assessed.



Internet Gold – Golden Lines Ltd.

## Notes to the Consolidated Financial Statements

(All amounts are in millions except where otherwise stated)

### Note 20 - Contingent Liabilities (cont'd)

#### B. Subsequent customer claims

Subsequent to the reporting date, a claim for NIS 1.3 billion was filed against Bezeq and officers of Bezeq. At the approval date of the financial statements, the exposure for these claims cannot yet be assessed. In addition, claims against Group companies with exposure of NIS 560 came to an end.

### Note 21 - Agreements

The Group companies have operating lease agreements for land, property cellular sites, real estate, and vehicles A. used by them. The minimum future contractual rental payments during the next five years, calculated according to the rental fees in effect as at December 31, 2016, are as follows:

| Year ended December 31 | Real<br>estate<br>NIS | Vehicles<br>NIS | Total<br>NIS |
|------------------------|-----------------------|-----------------|--------------|
| 2017                   | 229                   | 140             | 369          |
| 2018                   | 211                   | 97              | 308          |
| 2019                   | 171                   | 77              | 248          |
| 2020                   | 125                   | -               | 125          |
| 2021                   | 55                    | -               | 55           |
| 2022 onwards           | 110                   | -               | 110          |
|                        | 901                   | 314             | 1,215        |

In 2013, DBS signed an agreement with Space Communications Ltd. ("Spacecom") for space segment capacity (in this section "the 2013 Agreement"). The 2013 Agreement is valid until 2028. In the first stage, the space segments will be available for use by DBS in the Amos 2 and Amos 3 satellites. In September 2016, Spacecom informed A.DB.S that the Amos 2 satellite had come to the end of its lifespan, but its commercial operation is continuing for now. In accordance with the provisions of the 2013 Agreement, after discontinuing the use of the Amos 2 satellite, DBS intends to lease space segments in the Amos 3 satellite (until 2022) and the Amos 6 satellite, which was planned for launchg into space in the third quarter of 2016 and the end of its lifespan was expected to be in 2028.

In September 2016, Spacecom reported that to the best of its knowledge, during ground fueling of the launch rocket for the Amos 6 satellite, the launch rocket exploded, resulting in the total loss of the Amos 6 satellite, which was intended to replace the Amos 2 satellite for DBS broadcasts.

In February 2017, the board of directors of DBS and the board of directors of Bezeq approved an addendum to the 2013 Agreement between DBS and Spacecom. The main points are set out below ("the 2017 Agreement"). The 2017 Agreement was approved by the general meetings of Bezeq and Spacecom on April 3, 2017. The 2017 Agreement is valid until December 31, 2028 (the same term as the 2013 Agreement), subject to the options for early termination set out below.

Internet Gold – Golden Lines Ltd.

## Notes to the Consolidated Financial Statements

(All amounts are in millions except where otherwise stated)

### Note 21 - Agreements (cont'd)

DBS will lease space segments in the following satellites: (a) Amos 3 satellite - which currently serves DBS; (b) Amos 7 satellite - the existing satellite, in which Spacecom holds the right to lease space segments and, according to Spacecom, its positioning was completed at the end of February 2017; (c) Amos 8 satellite - a new satellite that is expected to serve DBS when it becomes operational.

In the contract period (subject to events of unavailability and until the end of the lifespan of Amos 3, which is expected in 2026), DBS is expected to lease space segments from two different satellites, according to the division in the agreement. The agreement also establishes the positioning of backup space segments in the contract period, under the terms and within the limitations in the agreement.

The overall nominal cost for the entire contract period is estimated at US\$ 263 and represents an average annual cost of US\$ 21.9, subject to discounts and reimbursements set out in the agreement.

The agreement stipulates the right to early termination without cause, subject to advance notice of 12 months and payment of the consideration in accordance with the prescribed mechanism. The agreement also stipulates the right to early termination due to a delay in the entry into force of the agreement for construction of Amos 8, and the right to early termination at the end of the lifespan of Amos 3 due to non-availability of Amos 8, without payment of compensation and under the conditions set out in the agreement.

For information about the agreement with Spacecom, see Note 31 regarding the agreements with related parties.

C. In October 2016, the new agreement with Apple Distribution International ("Apple") came into effect for the acquisition and distribution of iPhone devices. In accordance with the agreement, Pelephone is required to purchase a minimum number of devices for an additional three years at the prices in effect at the manufacturer at the actual purchase date.

D. Pelephone has obligations as of December 31, 2016 amounting to NIS 71 (as at December 31, 2015, NIS 74) to acquire terminal equipment.

E. Pelephone utilizes Ericsson infrastructure equipment for the UMTS/HSPA and LTE networks. Pelephone has multi-annual agreements for maintenance, support and upgrade of software for the UMTS/HSPA network and an agreement for deployment of the 4G network (LTE) with Ericsson, and Pelephone believes that it could be dependent on Ericsson for network support and its expansion.

F. As at December 31, 2016, DBS has agreements for the acquisition of channels. In 2016, expenses for consumption of channels acquired by DBS amounted to NIS 319.

G. For information about agreements for the acquisition of broadcast rights by DBS, see Note 11. For information about agreements for the purchase of property, plant and equipment, see Note 8 above.

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Internet Gold – Golden Lines Ltd.

## Notes to the Consolidated Financial Statements

(All amounts are in millions except where otherwise stated)

### Note 21 - Agreements (cont'd)

H. In April 2013, Bezeq and the Israel Lands Administration signed a planning permission contract for 1.15 hectares in Sakia (near Mesubim Junction, close to the southern entrance to Tel Aviv). Under the contract, Bezeq provided a detailed master plan for the property, determining purposes, uses, building rights and building instructions for zoning the land in the plan. On May 2, 2016, approval of the plan was published in the gazette and it came into effect. Bezeq expects to sign a lease for the property covering a net area of 7 hectares. As at the reporting date, the fair value of Bezeq's rights to the land was estimated by an assessor at NIS 460.

I. For information about agreements for undertakings to provide credit for 2017, see Note 13 below.

J. For information about transactions with related parties, see Note 31.

### Note 22 - Securities, Pledges and Guarantees

The Group's policy is to provide tender, performance and legal guarantees. In addition, the Company provides bank guarantees, where necessary, for banking obligations of subsidiaries.

A. The Bezeq Group companies have provided guarantees of NIS 163 in favor of the Ministry of Communications to secure the terms of their licenses (mostly linked to the US\$ exchange rate).

B. The Bezeq Group companies have provided bank guarantees of NIS 77 in favor of third parties.

C. For information about the conditions for loans and borrowings, see note 13.

D. For information about the guarantee provided by Bezeq in respect of DBS's liability for Debentures (Series B) see Note 13C.

**Note 23 - Capital and Capital Reserves**

|  | Authorized<br>December 31<br>2015 and<br>2016 | Registered and<br>paid up<br>December 31<br>2015 and 2016 |
|--|---|---|
|  | Number of shares                              |   |

|   |             |            |
|---|-------------|------------|
| Ordinary shares of NIS 0.1 par value each | 501,000,000 | 19,203,186 |
|---|-------------|------------|

As of December 31, 2016, 5,862,615 ordinary shares of the Company have been purchased pursuant to a share buyback program which was authorized by the Company's Board of Directors.

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Internet Gold – Golden Lines Ltd.

## Notes to the Consolidated Financial Statements

(All amounts are in millions except where otherwise stated)

### Note 24 - Revenues

|   | Year ended December<br>31 |       |        |
|---|---------------------------|-------|--------|
|   | 2014                      | 2015  | 2016   |
|   | NIS                       | NIS   | NIS    |
| Domestic fixed line communications                      |                           |       |        |
| Fixed line telephony                                    | 1,636                     | 1,543 | 1,450  |
| Internet – infrastructure                               | 1,394                     | 1,530 | 1,558  |
| Transmission and data communication                     | 802                       | 840   | 843    |
| Other services  | 220                       | 212   | 213    |
|   | 4,052                     | 4,125 | 4,064  |
| Cellular  |                           |       |        |
| Cellular services and terminal equipment                | 2,399                     | 1,948 | 1,777  |
| Sale of terminal equipment                              | 966                       | 884   | 811    |
|   | 3,365                     | 2,832 | 2,588  |
| International communications, internet services and NEP | 1,425                     | 1,487 | 1,480  |
| Multi-channel television                                | -                         | 1,333 | 1,745  |
| Others  | 213                       | 208   | 207    |
|   | 9,055                     | 9,985 | 10,084 |

### Note 25 - Salaries

|   | Year ended December |       |       |
|---|---------------------|-------|-------|
|   | 31                  |       |       |
|   | 2014                | 2015  | 2016  |
|   | NIS                 | NIS   | NIS   |
| Salaries and incidentals:   |                     |       |       |
| Operating   | 1,691               | 1,871 | 1,922 |
| General and administrative  | 563                 | 588   | 624   |
| Share-based payments  | 1                   | -     | -     |
| Total salaries and incidentals  | 2,255               | 2,459 | 2,546 |
| Less – salaries recognized in investments in property, plant and equipment and in intangible assets | 484                 | 499   | 529   |
|   | 1,771               | 1,960 | 2,017 |

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Internet Gold – Golden Lines Ltd.

## Notes to the Consolidated Financial Statements

(All amounts are in millions except where otherwise stated)

### Note 26 - General and Operating Expenses\*

|  | Year ended December |       |       |
|--|---------------------|-------|-------|
|  | 2014                | 2015  | 2016  |
|  | NIS                 | NIS   | NIS   |
| Terminal equipment and materials                                       | 928                 | 880   | 831   |
| Interconnectivity and payments to domestic and international operators | 847                 | 909   | 825   |
| Maintenance of buildings and sites                                     | 639                 | 616   | 605   |
| Marketing and general expenses   | 608                 | 649   | 709   |
| Services and maintenance by sub-contractors                            | 137                 | 199   | 261   |
| Vehicle maintenance expenses   | 154                 | 167   | 164   |
| Content services expenses  | 58                  | 458   | 629   |
|  | 3,371               | 3,878 | 4,024 |

\* Less expenses of NIS 64 recognized in 2016 for investments in property, plant and equipment and intangible assets (in 2015, NIS 63 and in 2014, NIS 63).

### Note 27 - Other Operating Expenses (Income), net

|   | Year ended  |      |      |
|---|-------------|------|------|
|   | December 31 |      |      |
|   | 2014        | 2015 | 2016 |
|   | NIS         | NIS  | NIS  |
| Provision for severance pay in early retirement | 176         | 117  | 96   |
| Profit from the sale of Coral Tell shares       | (582)       | -    | -    |

|  |       |       |      |
|--|-------|-------|------|
| Capital gain from sale of property plant and equipment | (124) | (136) | (86) |
| Others   | (5)   | 22    | 11   |
|  | (535) | 3     | 21   |

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## Notes to the Consolidated Financial Statements

(All amounts are in millions except where otherwise stated)

### Note 28 - Financing Expenses (Income)

|  | Year ended December<br>31 |               |               |
|--|---------------------------|---------------|---------------|
|  | 2014                      | 2015          | 2016          |
|  | NIS                       | NIS           | NIS           |
| Interest and linkage differences from loans to an associate                            | (213 )                    | (21 )         | -             |
| Linkage and exchange rate differences, net   |                           | (7 )          | (19 )         |
| Income on bank deposits, investments and others  | (40 )                     | (17 )         | (20 )         |
| Change in fair value of financial assets measured at fair value through profit or loss | (247 )                    | (27 )         | (29 )         |
| Income in respect of credit in sales, net of discount commission                       | (84 )                     | (52 )         | (42 )         |
| Other financing income   | (51 )                     | (40 )         | (23 )         |
| <b>Total financing income</b>  | <b>(635 )</b>             | <b>(164 )</b> | <b>(133 )</b> |
| Interest expenses on financial liabilities   | 896                       | 695           | 924           |
| Linkage and exchange rate differences, net   | 333                       | 61            | 38            |
| Change in contingent consideration in a business combination                           | -                         | -             | 55            |
| Change in fair value of financial assets measured at fair value through profit or loss | 27                        | 13            | 24            |
| Financing expenses for employee benefits, net  | 21                        | 16            | 15            |
| Reduction of the provision for assessor nterest expenses                               | -                         | (76 )         | -             |
| Other financing expenses   | 52                        | 50            | 52            |
| <b>Total financing expenses</b>  | <b>1,329</b>              | <b>759</b>    | <b>1,108</b>  |
| <b>Financing expenses, net</b>   | <b>694</b>                | <b>595</b>    | <b>975</b>    |

Internet Gold – Golden Lines Ltd.

**Notes to the Consolidated Financial Statements**

(All amounts are in millions except where otherwise stated)

**Note 29 - Share-Based Payments**

**Bezeq's share-based payments**

In 2010, Bezeq issued 69.4 employee options. As at December 31, 2016, 17 thousand options remain outstanding. In 2016, 4 options were exercised, for which Bezeq issued 4 ordinary shares of NIS 1 par value each.

**Note 30- Earnings (Loss) per Share**

The calculation of basic and diluted earnings per share was based on income (loss) attributable to ordinary shareholders, and on a weighted average number of ordinary shares outstanding, calculated as follows:

|   | Year ended<br>December 31 |      |       |
|---|---------------------------|------|-------|
|   | 2014                      | 2015 | 2016  |
|   | NIS                       | NIS  | NIS   |
| Earnings (loss) attributable to ordinary Shareholders |                           |      |       |
| Basic earnings (loss) for the year                    | (103)                     | 87   | (202) |
| Effect of diluted per share loss in a subsidiary      | (3 )                      | (1 ) | -     |
| Diluted earnings (loss) for the year                  | (106)                     | 86   | (202) |

Year ended December 31

| 2014      | 2015      | 2016      |
|-----------|-----------|-----------|
| Thousands | Thousands | Thousands |
| of        | of        | of        |
| shares    | shares of | Shares of |
| of        | NIS 0.1   | NIS 0.1   |
| NIS 0.1   | par value | par value |
| par       | par value | par value |
| value     |           |           |

|  |        |        |        |
|--|--------|--------|--------|
| Weighted average number of ordinary shares (basic and diluted) | 19,203 | 19,203 | 19,203 |
|--|--------|--------|--------|

Note 31 - Transactions with Related Parties

A. Identity of related parties

The Company's related parties are as defined in IAS 24 (2009)- Related Party Disclosures and include: parent company - Eurocom, and other Eurocom Group companies, related parties of Eurocom, directors and key management personnel in the Company, the Eurocom Group companies and persons who are close to a family member of any of these individuals.

In the ordinary course of business, some of the Company's subsidiaries and affiliates engage in business activities with each other. Such business activities are primarily between Bezeq and Bezeq subsidiaries and between other Eurocom Group companies, such as Eurocom Digital Communications, Eurocom Cellular Communications, Space Communications, Gilat Satcom and to a lesser extent other affiliated companies.

Such business activities primarily relate to the provision, purchase or sale of communications or digital services and products, including, the provision of related satellite or broadcasting services, cellular and electronic products and equipment, and Internet and telephony services.

Internet Gold – Golden Lines Ltd.

**Notes to the Consolidated Financial Statements**

(All amounts are in millions except where otherwise stated)

Note 31 - Transactions with Related Parties

A. Identity of related parties

The transactions among these related parties are made at prices and on terms equivalent to those charged in transactions with unrelated parties under similar conditions.

Ordinary course of business transactions are aggregated in this Note. This Note also includes detailed descriptions of material related party transactions.

B. Balances with related parties

|   | December<br>31, |       |
|---|-----------------|-------|
|   | 2015            | 2016  |
|   | NIS             | NIS   |
| Receivables - associates, net                     | 9               | 10    |
| Liabilities to related parties, net *             | (17 )           | (12 ) |
| Liability to Eurocom for contingent consideration | (233)           | (32 ) |

(\*\*)The amounts are for parent company Eurocom, and their related parties.

## C. Transactions with related parties

|  | Year ended<br>December 31, |      |      |
|--|----------------------------|------|------|
|  | 2014                       | 2015 | 2016 |
|  | NIS                        | NIS  | NIS  |
| Revenues   |                            |      |      |
| From associates (including interest income in respect of shareholders' loans)* | 229                        | 30   | 7    |
| From related parties **  | 9                          | 10   | 13   |
| Expenses   |                            |      |      |
| To related parties * *   | 121                        | 129  | 166  |
| To associates  | 1                          | 3    | 2    |
| Investments  |                            |      |      |
| Related parties **   | 76                         | 76   | 59   |
| Acquisition of DBS   | -                          | 913  | -    |

\*Revenues from associates are include mainly finance income from shareholders loans to DBS, see note 12B.

\*\*The amounts are for parent company Eurocom and its related parties.

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## Notes to the Consolidated Financial Statements

(All amounts are in millions except where otherwise stated)

### Note 31 - Transactions with Related Parties (cont'd)

D. Transactions listed in section 270(4) of the Companies Law

**Approval date of the general meeting (after approval of Bezeq's audit committee and Board of Directors)**

**Nature of the transaction**

**Amount of the transaction**

|               |  |   |
|---------------|--|---|
| May 8, 2013   | Approval of Bezeq's vote at the general meeting of DBS in favor of DBS's agreement with Space Communications Ltd. ("Space Communications") for leasing space segments, in which the original agreement will be amended and extended. The agreement is valid until the end of 2028. This agreement was valid in the reporting year and up to December 31, 2016. On February 12, 2017 and February 14, 2017, Bezeq's audit committee and board of directors, respectively, approved an amendment/addendum to this agreement, and was approved by the general meetings of Bezeq and Spacecom on April 3, 2017. For information about the amendment, see Note 21B above. | A total amount of up to US\$ 227 for the entire agreement period (up to December 31, 2018) net including discounts for satellite segments leased in the existing agreement) |
| June 13, 2013 | The amendment to Bezeq's three-year agreement with Eurocom Communications Ltd. ("Eurocom Communications") for ongoing management and consultation services valid until May 31, 2016, unless one of the parties announces its intention to terminate the agreement with three months' notice. This agreement was valid in the reporting year and up to May 31, 2016. The agreement described in section below came into effect on June 1, 2016.   | NIS 5.5 per year.   |



November 6, 2013

Approved by the Bezeq's Board of Directors in accordance with the relief regulations for transactions with interested parties

Amendment to and extension of DBS's agreement with Eurocom and ADB for acquisition of yesMaxTotal3 converters, for a period up to December 31, 2016.

The total cost will be US\$ 10 per year.

March 23, 2015

Approval of Bezeq's acquisition agreement with Eurocom DBS Ltd. ("Eurocom DBS") whereby Bezeq will acquire the entire holdings of Eurocom DBS in DBS shares DBS and all the shareholder loans provided by Eurocom DBS to DBS (including acceptance of the terms established by the Antitrust Commissioner's in his approval of the merger on March 26, 2014, both by Bezeq and by DBS, and announcement of the exercise of Bezeq's option for the allotment of 6,221 DBS shares, at no cost, representing 8.6% of the share capital of DBS).

The total cost is comprised of: a) total cash of NIS 680; b) total cash of up to NIS 200, subject to certain conditions; c) total cash of up to NIS 170, subject to certain conditions. For additional information about the conditions relating to b and c, see Note 12B above.

October 19, 2015

Approval of Bezeq's vote at the general meeting of shareholders of DBS in favor of DBS's agreement with Eurocom and ADB for the order of yesMaxTotal3 converters, under the existing agreement, until December 31, 2017.

Total cost of US\$ 14.

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Internet Gold – Golden Lines Ltd.

## Notes to the Consolidated Financial Statements

(All amounts are in millions except where otherwise stated)

### Note 31 - Transactions with Related Parties (cont'd)

D. Transactions listed in section 270(4) of the Companies Law (cont'd)

| <b>Approval date of the general meeting (after approval of Bezeq's audit committee and Board of Directors)</b> | <b>Nature of the transaction</b>   | <b>Amount of the transaction</b>                     |
|--|--|--|
| December 18, 2015  | Amendment to the framework agreement between Pelephone and Eurocom Cellular Communications Ltd., so that it will be extended to other products and brands, including related services for all products and its extension until December 31, 2018 (or three years after the acquisition date of any additional products or brands, whichever is earlier).   | Annual scope of up to NIS 50 (for all the products). |
| June 30, 2016  | Extension of the amended agreement with Eurocom Communications Ltd. ("Eurocom Communications") for ongoing management and consultation services for Bezeq. The agreement is for three years, valid until May 31, 2019, unless one of the parties submits three-month notice of termination of the agreement. This agreement between the parties is in continuation of the agreement approved on June 13, 2013, described in section above. | NIS 6.4 per year.                                    |
| November 27, 2014  | Beeq's agreement to bring forward payments with Eurocom, according to which DBS may advance, at the supplier's request, payments that are due, or will be due, to Eurocom for orders of converters.  | Up to a total cost of US\$ 6.                        |

|                  |   |  |
|------------------|---|--|
| November 3, 2016 | Bezeq's agreement with Eurocom for the additional acquisition of up to 90 thousand VTECH N VDSL routers, valid until June 30, 2017. | Approval for acquisition of up to US\$ 11.3 (not including VAT). In 2016, there were no acquisitions under this framework, however N VDSL routers were acquired in amounts that do not exceed the negligibility level. |
|------------------|---|--|

The financial value of the transactions described above, which were carried out in 2016 were as follows:

|  | Amounts<br>included in<br>the<br>consolidated<br>financial<br>statements<br>NIS |
|--|---|
| Expenses   | 90  |
| Property plant and equipment                             | 27  |
| Acquisition of Eurocom DBS holdings in DBS (see Note 12) | 55  |

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Internet Gold – Golden Lines Ltd.

## **Notes to the Consolidated Financial Statements**

(All amounts are in millions except where otherwise stated)

### **Note 31 - Transactions with Related Parties (cont'd)**

#### **E. Agreements with the Eurocom Group and B Communications**

The Company receives various services and products to and from related parties at market rates and in the ordinary course of business. Other than the transactions described below, none of The Company's related party transactions are material to the Company or to the Company's related parties.

If a related party wishes to supply products or services to the Company, the Company generally obtain a bid from a third party to enable us to determine whether the related party's bid is on arm's-length terms. Any of such transaction is subject to the approval of the Company's audit committee and the Company's board of directors (and in some circumstances, The Company's shareholders). In addition, generally the Company will not purchase a particular type of product or service solely from related parties, but will also have non-related vendors. Prices offered by non-related vendors are compared to those offered by related parties to ensure that the related parties are offering arm's length terms.

In the ordinary course of business, some of the Company's subsidiaries and affiliates engage in business activities with each other. Such business activities are primarily among Bezeq, other Bezeq Group companies and other Eurocom Group companies, such as Eurocom Digital, Eurocom Cellular, Spacecom, Satcom, and to a lesser extent other affiliated companies. Such business activities primarily relate to the provision, purchase or sale of communications and digital services and products, including the provision of satellite or broadcasting services, cellular and electronic products and equipment, and Internet and telephony services. The transactions among these related parties are made at prices and on terms equivalent to those charged in transactions with unrelated parties under similar conditions.

#### **Relationship with Eurocom Communications and its affiliates**

Messrs. Shaul Elovitch, chairman of the Company's board of directors, and his brother Yossef Elovitch, a director of the Company, also serve as directors of Eurocom Communications and various of its affiliates, together indirectly hold a majority of the outstanding shares of Eurocom Communications. During the past three years, the Company has entered into transactions with Eurocom Communications and several of their affiliates, referred to as the Eurocom Group. The Company believes that the transactions with Eurocom Communications and its affiliates described below could have been entered into on comparable terms with unrelated parties and on an arm's length basis. Set forth below are summary descriptions of certain agreements, relationships and transactions between us and members of the Eurocom Group.

### **Certain Related Party Transactions**

The Company and B Communications lease the Company's principal offices from Eurocom Communications for an annual rent of NIS 59 thousand (approximately \$15 thousand) for each company. In addition, Eurocom Real Estate Ltd. provides us and B Communications with parking spaces for NIS 8 thousand (approximately \$2 thousand) a year for each company. Eurocom Digital provides us and B Communications with additional services, such as computing services for an annual fee of NIS 12 thousand (approximately \$3 thousand) for each company.

In addition, Eurocom Communications Ltd. provides the Company and B Communications with legal services for the annual consideration of NIS 96 thousand (approximately \$25 thousand) for each company.

Internet Gold – Golden Lines Ltd.

## **Notes to the Consolidated Financial Statements**

(All amounts are in millions except where otherwise stated)

### **Note 31 - Transactions with Related Parties (cont'd)**

#### **E. Agreements with the Eurocom Group and B Communications (cont'd)**

In addition, the Company receives various services and products to and from related parties at market rates and in the ordinary course of business. None of these transactions are material to the Company or to the Company's related parties. If a related party wishes to supply products or services to the Company, the Company generally obtain a bid from a third party to enable us to determine whether the related party's bid is on arm's-length terms. Any of such transaction is subject to the approval of the Company's Audit Committee and the Company's board of directors (and the Company's shareholders, if required). In addition, the Company will generally not purchase a particular type of product or service solely from related parties, but will also have non-related vendors. Prices offered by non-related vendors are compared to those offered by related parties to ensure that the related parties are offering arm's length terms.

#### **Registration Rights Agreement with Eurocom Communications**

In July 1999, the Company entered into a registration rights agreement with Euronet Communications (which was subsequently assigned to Eurocom Communications) and the Company's other than existing shareholders granting them the right to register their ordinary shares under the U.S. Securities Act (the "Securities Act"). The registration rights include unlimited rights to request that their shares be included in any underwritten public offering of the Company's ordinary shares (excluding any registration of employees' shares on Form S-8 or a similar form). Additionally, as of February 4, 2000, the holders of a majority of such shares are entitled to demand, up to three times in the aggregate, that the Company register their shares. As of August 4, 2000, the holders of a majority of these shares are also entitled to request that the Company affect a registration of their shares on a shelf registration statement once in any 12-month period, up to three times in aggregate. All expenses incurred in connection with such registrations, other than underwriters' and brokers' discounts and commissions, will be payable to the Company.

**Execution Services Agreement with Eurocom Capital Finance Ltd.**

In November 2007, the Company entered into an execution services agreement with Eurocom Capital Finance Ltd., or Eurocom Capital, which is controlled by Mr. Shaul Elovitch, the Company's controlling shareholder and the chairman of the Company's Board of Directors, under which Eurocom Capital provides us with various financial services. Under the agreement, Eurocom Capital handles the execution of investments in the Company's capital, pursuant to direct instructions from the Company's chief executive officer. In consideration for these services, the Company agreed to pay Eurocom Capital fees which are customary for such agreements and on market terms. The Company paid Eurocom Capital NIS 615 thousand, NIS 433 thousand and NIS 338 thousand (approximately \$88 thousand) for the years ended December 31, 2014, 2015 and 2016, respectively.

**Form F-3 Registration Statements**

Pursuant to the 1999 registration rights agreements with Eurocom Communications, on December 9, 2015, the Company filed on behalf of Eurocom Communications, a registration statement on Form F-3 relating to the resale, from time to time, by Eurocom Communications of up to 2,880,000 of the Company's ordinary shares. The registration statement became effective on December 14, 2015.

On January 30, 2017, the Company filed on behalf of Messrs. Shaul and Yossef Elovitch a registration statement on Form F-3 relating to the resale, from time to time, by Messrs. Shaul and Yossef Elovitch up to 925,000 of the Company's ordinary shares. The registration statement became effective on January 30, 2017.

Internet Gold – Golden Lines Ltd.

## **Notes to the Consolidated Financial Statements**

(All amounts are in millions except where otherwise stated)

### **Note 31 - Transactions with Related Parties (cont'd)**

#### **E. Agreements with the Eurocom Group and B Communications (cont'd)**

##### **Agreements with B Communications**

###### **Registration Rights Agreement with B Communications**

The Company and B Communications have entered into a registration rights agreement under which B Communications has granted us the right to demand registration under the Securities Act of the ordinary shares of B Communications that we hold. , The Company is entitled to an aggregate of five demand registrations. B Communications is not required to effect any demand registration unless such demand registration request is for a number of ordinary shares with a market value that is equal to at least \$7.5. B Communications is not required to effect more than one demand registration during any 12-month period or within 90 days of any other demand registration. The Company also has “piggyback” registration rights that allow us to include the ordinary shares of B Communications that we own in any public offering of equity securities initiated by B Communications (other than public offerings pursuant to registration statements on Forms F-4, S-8 or any other successor forms). The “piggyback” registration rights are subject to proportional cutbacks based on the manner of the offering and the identity of the party initiating such offering. B Communications has also granted us the right to request a shelf registration on Form F-3, provided that it shall be eligible to utilize a registration statement on such form, providing for an offering to be made on a continuous basis, but for no longer than one year without the consent of the audit committee of B Communications.

Under the registration rights agreement, B Communications has agreed to indemnify us against any losses or damages resulting from any untrue statement or omission of material fact in any registration statement or prospectus pursuant to which the Company sell ordinary shares, unless such liability arose in reliance upon and in strict conformity with



information that the Company furnished in writing. B Communications will pay all expenses incident to any demand registration, and the Company will pay the Company's respective portions of all underwriting discounts, commissions and fees attributable to the sale of the ordinary shares of B Communications.

**Chief Executive Officer Employment Agreement**

The Company entered into an arrangement with B Communications according to which B Communications' employees provide services to both companies and B Communications will pay 2/3 and the Company will pay 1/3 of their compensation. The Company entered into a similar arrangement with B Communications with respect to the management services supplied by Mr. Doron Turgeman. B Communications will pay 2/3 and the Company will pay 1/3 of such costs.

**F. Key management personnel compensation (including directors)**

Key management personnel compensation comprised:

|                   | Year ended  |      |      |
|-------------------|-------------|------|------|
|                   | December 31 |      |      |
|                   | 2014        | 2015 | 2016 |
|                   | NIS         | NIS  | NIS  |
| Employee benefits | 2           | 2    | 4    |

Internet Gold – Golden Lines Ltd.

## Notes to the Consolidated Financial Statements

(All amounts are in millions except where otherwise stated)

### Note 32 - Subsequent Events

On March 30, 2017 Bezeq received notice from DBS that Spacecom had notified it that the AMOS-2 satellite had reached the end of its commercial life and was no longer capable of broadcasting television broadcasts for Yes.  
1. Consequently, on March 31, 2017, DBS ceased using the AMOS-2 satellite and it is presently using the AMOS-3 and AMOS-7 satellites.

Further to Bezeq's immediate report regarding a Supreme Court ruling which dismissed two appeals on a ruling of the Tel Aviv District Court (Economic Department) which dismissed two (consolidated) motions to certify  
2. derivative actions concerning the distribution of dividends and loans of Bezeq, on April 6, 2017, Bezeq received a copy of a petition for a further hearing in the file, which had been filed by one of the appellants.

On April 19, 2017, Bezeq received a class action certification motion which was filed with the Tel Aviv District Court against Bezeq and against its subsidiary, Walla, Yad2 and an advertising company owned by Walla (hereinafter collectively, the "Respondents"). The motion pertains to Bezeq's B144 service, which enables businesses  
3. to advertise on the internet (the "Service"). According to the petitioner, the Respondents sent subscribers to the Service unlawful charges. The petitioner estimates the class action amount at NIS 1.11 billion (based on an estimate of 300 thousand customers and compensation of NIS 3.7 thousand per customer). Bezeq is studying the motion and is unable to evaluate its likelihood of success at the present stage.

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**SIGNATURES**

The registrant 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.

INTERNET GOLD – GOLDEN  
LINES LTD.

By: /s/ Doron Turgeman  
Doron Turgeman  
Chief Executive Officer

By: /s/ Itzik Tadmor  
Itzik Tadmor  
Principal Financial Officer

Dated: April 26, 2017

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