

## **GAZIT-GLOBE LTD.**

### **Directors' Report to Shareholders** **For the year ended December 31, 2006**

**The Board of Directors of Gazit-Globe Ltd. (hereinafter – “the Company”) is pleased to present the financial statements of the Company and its consolidated subsidiaries for the period ended December 31, 2006:**

#### **1. A. General**

The Company – directly and through its subsidiaries (hereinafter, collectively – “the Group”) and an affiliate – is engaged in the acquisition, development and management of income-producing properties in North America, Europe and Israel, focusing mainly on supermarket-anchored shopping centers. In addition, the Company is active in the senior housing communities and the medical office buildings sectors in the U.S.A. and continues to seek and realize opportunities within its core business and similar asset classes, both in regions where it operates and also in new territories.

#### **B. Growth Strategy in a Stable Business**

The main characteristics of the Company's business policy are as follows:

- Investment in economically and politically stable countries.
- Investment in income-producing properties, primarily shopping centers, which are considered less sensitive to economic cycles (in relation to other real estate classes).
- Operating in growing metropolitan areas, characterized by high barriers to entry for competition.
- Operating through local subsidiaries with experienced local personnel.
- Proactive management motivated by the desire to create value.
- Growth through the acquisition, development and redevelopment of shopping centers.
- Taking advantage of opportunities to merge and acquire, mainly with companies operating in the Group's asset class or in complementary business sectors.
- Expanding the Group's existing field of operations into new geographical regions by leveraging the Group's experience and its competitive advantages.

## C. Properties

As of the date of the financial statements, the Group owns 462 properties, as follows:

- Ø 419 shopping centers and stores
- Ø 26 shopping centers under development
- Ø 12 senior housing communities (with approx. 1,2275 units)
- Ø 2 senior housing communities under development
- Ø 1 medical office building with a multi-story parking garage
- Ø 2 office buildings

The above properties have a gross leasable area (“G.L.A.”) of approximately 4.5 million square meters. They are recorded in the Company’s books and in the affiliate’s books at a value of NIS 31 billion and generate annual rental revenue of NIS 3.4 billion. (Annual rental revenue data is based on the gross annual rent from the properties currently owned at the exchange rate on the signing date of the financial statements).

In the U.S.A., the Company operates mainly through Equity One Inc. (hereinafter – “EQY”), a public company listed on the New York Stock Exchange (NYSE: EQY). EQY is a self-administrated, self-managed REIT (Real Estate Investment Trust) for U.S. tax purposes. As of the signing date of the financial statements, the Company owns, directly and indirectly (through the subsidiary, First Capital Realty Inc., as described below), 42.4% of EQY. EQY’s properties are located primarily in growing metropolitan areas in the southeastern United States (mainly in Florida and Georgia) and in the Boston, Massachusetts metropolitan area. EQY owns 175 operating shopping centers, with a G.L.A. of 1.8 million square meters, as well as six shopping centers under development.

The Company is also active in the United States through Royal Senior Care (hereinafter – “RSC”) and ProMed Properties Inc. (hereinafter – “ProMed”). RSC, in which the Company holds a 50% interest, is active in the senior housing communities sector in the southeastern United States. RSC owns 12 senior housing communities, encompassing approximately 1,227 units, as well as two senior housing communities under development. ProMed, a wholly (100%) owned subsidiary, is engaged in the medical office buildings sector. ProMed owns a medical office building, with a G.L.A. of 24 thousand square meters and an adjacent multi-story parking garage.

In Canada, the Company operates through First Capital Realty Inc. (“FCR”), a public company listed on the Toronto Stock Exchange (TSX: FCR). As of the signing date of the financial statements, the Company holds 54.2% of FCR. FCR’s properties are located primarily in growing metropolitan areas in the provinces of Ontario, Quebec, Alberta and British Columbia in Canada. FCR owns 152 properties in Canada, with a G.L.A. of approximately 1.7 million square meters and six shopping centers under development. In addition, FCR owns 13.9 million shares of EQY.

In Israel, the Company operates through Gazit-Globe Israel (Development) Ltd. (hereinafter – “Gazit Development”), which is 75% owned by the Company. Gazit Development is an owner, developer and operator of shopping centers in Israel and Bulgaria and is assessing investment opportunities in other regions. It owns seven shopping centers in Israel, with a G.L.A. of approximately 96 thousand square meters and has seven shopping centers under development. In addition, the Company owns an office building in Tel-Aviv, part of which serves the uses of the Group.

In Europe, the Company operates mainly through Citycon Oyj. (hereinafter – Citycon), a Finnish public company, whose shares are listed on the Helsinki Stock Exchange (OMX). As of the signing date of the financial statements, the Company owns approximately 39.5% of Citycon’s share capital. Citycon is active in northern Europe (as of the signing date of the financial statements, in Finland, Sweden, Estonia and Latvia) and owns 80 shopping centers and retail properties, which are leased primarily to supermarkets and other retail chains, with a total G.L.A. of approximately 0.8 million square meters and three shopping centers under development. The Company also operates in the European shopping centers sector (in Germany, as of the signing date of the financial statements) through wholly owned subsidiaries (hereinafter – “Gazit Europe”) and owns four shopping centers with a G.L.A. of approximately 40 thousand square meters and two shopping centers under development. The Company is also active in Bulgaria, through wholly owned subsidiaries of Gazit Development (hereinafter – “Gazit Development (Bulgaria)”), where it owns a shopping center with a G.L.A. of approximately 7 thousand square meters, two plots of land for the future development of shopping centers and offices, with an area of approximately 153 thousand square meters and also an office building that is used by the Group.

Other publicly accessible data concerning the Group, including up-to-date presentations, supplemental packages with information regarding assets, liabilities and other information (it is hereby clarified that such information does not constitute part of this report and is also not included as an invitation), can be found on the Group’s Internet website and the Internet websites of the Group’s companies:

[www.gazit-globe.com](http://www.gazit-globe.com)

[www.equityone.net](http://www.equityone.net)

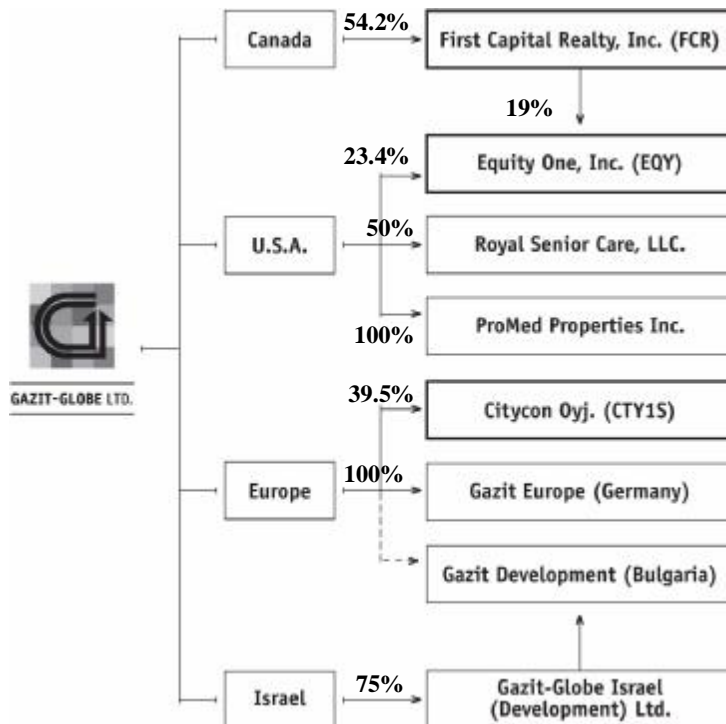
[www.firstcapitalrealty.ca](http://www.firstcapitalrealty.ca)

[www.citycon.fi](http://www.citycon.fi)

**The Regions (Marked ■ ) Where the Company Operates are Shown on the Following Map:**

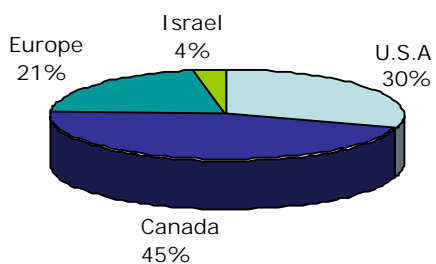


**D. The Company's Major Holdings are Shown Below (Ownership Percentages are as of the Date of the Financial Statements):**

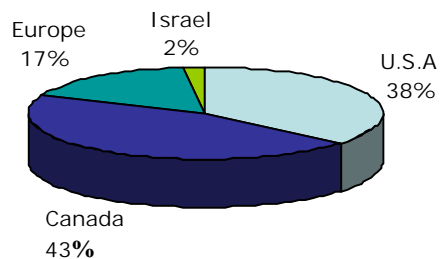


**E. Breakdown of Net Operating Income (“NOI”)<sup>(1)</sup>, According to the Company’s Operating Regions:**

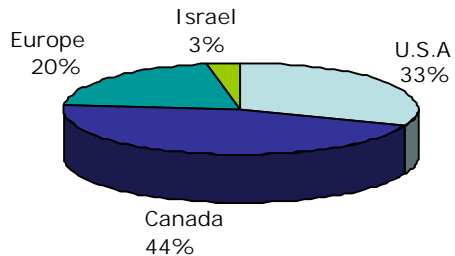
**Q4 2006**



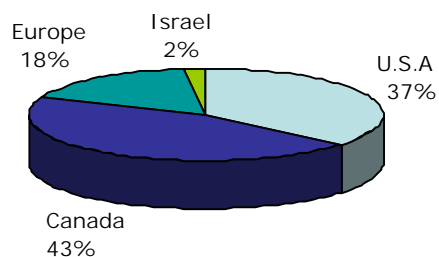
**Q4 2005**



**Year 2006**



**Year 2005**



<sup>(1)</sup> The Company’s share (“by proportionate consolidation”), including its equity in an affiliate - see section 2F below.

## **F. The Company's Assets**

1. The following table presents a summary of the Company's assets as of December 31, 2006, as shown above:

<b>Name of company</b>	<b>Type of security/ property</b>	<b>Holding (millions)</b>	<b>Holding percentage (%)</b>	<b>Book value (NIS in millions)</b>	<b>Market value as of December 31, 2006 (NIS in millions)</b>
EQY <sup>(1)</sup>	Shares (NYSE)	17.1	23.4	994	1,927
FCR	Shares (TSX)	40.3	53.5	2,035	4,078
FCR	Convertible debentures (TSX)	66.4	33.2	245	254
Citycon	Shares (OMX)	64.9	38.8	1,220	1,823
Citycon	Convertible debentures	37	33.6	207	261
RSC	Income-producing property	-	-	216	-
Property in Europe	Income-producing property	-	-	436	<sup>(2)</sup> -
ProMed	Income-producing property	-	-	361	<sup>(2)</sup> -
Property in Israel	Income-producing property	-	-	1,178	<sup>(2)</sup> -6
<b>Total</b>				<b>6,892</b>	

<sup>(1)</sup> Represents only the Company's direct interest in EQY. (In addition, FCR owns 13.9 million shares of EQY).

<sup>(2)</sup> With regard to the fair value of these properties, see section J below.

Below are the Company's monetary balances (including balances of subsidiaries that are not public companies) as of December 31, 2006 (NIS in millions):

Debentures and debts to financial institutions *	5,008
Monetary liabilities, other than debentures and debts to financial institutions	<u>194</u>
Total monetary liabilities	5,202
Less – monetary assets	<u>1,176</u>
Monetary liabilities, net	<u><u>4,026</u></u>

\* Below are the annual repayments of the debentures and debts to other financial institutions (NIS in millions):

<u>Year</u>	<u>Total</u>	<u>%</u>
2007	226	5
2008	91	2
2009	117	2
2010	200	4
2011	536	11
2012	377	8
2013	350	7
2014	491	10
2015	405	8
2016	389	8
2017	201	4
2018	412	8
2019	327	6
2020	328	6
2021	434	9
2022 and after	<u>124</u>	<u>2</u>
<b>Total</b>	<b><u><u>5,008</u></u></b>	<b><u><u>100</u></u></b>

2. Additional information is presented below concerning the Company's share in the income-producing properties owned by the Group as of December 31, 2006, based on capitalized net operating income ("NOI")<sup>(1)</sup> methodology. The presentation of this information is intended to provide additional information, based on methodology that is generally accepted in the regions in which the Company operates, which might serve as an additional method in analyzing the value of the Company's properties on the basis of the Company's financial results for the reporting period. It is emphasized that this information does not represent the Company's present or future value of its assets.

The sensitivity analyses shown in the table below describes the implied value of the income-producing properties<sup>(2)</sup> owned by the Group according to the range of different cap rates generally accepted in the regions in which the Group operates, as of the date of publishing the financial statements. It should be noted that this presentation does not take into account existing building rights potential in respect of the Company's properties.

In calculating the NOI, the following assumptions were made:

- a. The NOI for the period for each of the Group companies.
- b. The Company's proportionate share in the NOI of the Group companies:

	<b>For the fourth quarter that ended December 31, 2006</b>	<b>For the year ended December 31, 2006</b>	<b>For the year ended December 31, 2005</b>	
<b>N I S i n m i l l i o n s</b>				
Property rental revenue	648	2,552	2,196	
Property operating expenses	(223)	(868)	(718)	
NOI for the period	425	1,684	1,478	
Less – minority interests' share in NOI	(220)	(893)	(858)	
Add – Company's share in Citycon's NOI	47	180	127	
NOI for the period	<b>252</b>	<b>971</b>	<b>747</b>	
NOI for the year	<b><sup>(3)</sup>1,009</b>	<b>971</b>	<b>747</b>	
<b>Cap Rate:</b>		<b><u>5.50%</u></b>	<b><u>5.75%</u></b>	<b><u>6.00%</u></b>
Value of proportionately consolidated income-producing property (NIS in millions) <sup>(3)</sup>		<b><u>18,338</u></b>	<b><u>17,541</u></b>	<b><u>16,810</u></b>

<sup>(1)</sup> Property rental revenue, net of property operating expenses.

<sup>(2)</sup> NOI divided by the cap rate.

<sup>(3)</sup> The cap rate for the fourth quarter of 2006 multiplied by 4.

New properties and properties under development, which have not yet come on line and which are presented at their carrying values in the Company's books (according to the proportionate consolidation method) as of December 31, 2006, amounted to NIS 1,141 million.

The Group's liabilities, net of monetary assets (by the proportionate consolidation method) as of December 31, 2006, amounted to NIS 10,443 million.

3. As of December 31, 2006, the Company's issued share capital comprises 117.8 million shares (excluding treasury stock held by the Company).

#### **G. Highlights - 2006**

- **The Group's investments totaled NIS 5.5 billion, compared to NIS 3.1 billion in 2005. In addition, Citycon invested NIS 2.4 billion in acquiring and developing properties, compared to 1 billion in 2005.**
- **Property rental revenue totaled NIS 2.6 billion, an increase of 16% compared to 2005. The increase was due to the enlargement of the property portfolio as a result of the acquisition of new properties, net of properties sold, the development properties coming on-line and the increase in the average rent per square meter received on the Group's properties.**
- **NOI<sup>(1)</sup> totaled NIS 1.7 billion, compared to NIS 1.5 billion in 2005, an increase of 14%.**
- **Gross profit totaled NIS 1.2 billion, compared to NIS 1.1 billion for 2005, an increase of 10%.**
- **Cash inflows from operating activities totaled NIS 590 million, compared to NIS 661 million for 2005, a decrease of 11%, which is due to timing differences on payments to third parties. Neutralizing the effect of these timing differences, cash inflows from operating activities increased by 14%, compared to the previous year.**
- **FFO<sup>(2)</sup> totaled NIS 280 million, NIS 2.59 per share, compared to NIS 217 million, NIS 2.39 per share, for 2005, an increase of 29%.**
- **Net income, which included high capital gains, totaled NIS 361 million, NIS 3.17 per share, compared to net income (after neutralizing the non-recurring effect of Israel Accounting Standard No. 19) of NIS 187.9 million, NIS 2.02 per share, for 2005.**

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<sup>(1)</sup> N.O.I. – Property rental revenue, net of property operating expenses.

<sup>(2)</sup> See section 3E below.

- During the year, EQY sold its entire Texas property portfolio as well as other properties and land for NIS 1.8 billion and recognized a capital gain of NIS 490 million. The Company's share in the capital gain totaled NIS 156 million.
- The Company, EQY and FCR raised NIS 1,188 million, net in share capital from the public, compared to NIS 661 million in 2005. As a result of the offerings made by EQY and FCR, the Company recorded net gains of NIS 33 million in the reporting year, compared to net gains (that also included the conversion of convertible debentures into shares by FCR) of NIS 72 million in 2005.
- Capital surpluses <sup>(1)</sup> (included within the line item "shareholders' equity") fell by NIS 175 million (NIS 1.49 per share), compared to a rise of NIS 132 million (NIS 1.40 per share) in 2005. The reduction in the capital surpluses is due to the weakening of the U.S. dollar against the shekel (an "appreciation" of the shekel), which is partly offset by strengthening of the euro against the shekel (a "devaluation" of the shekel), compared to the strengthening of the U.S. and Canadian dollars (a "devaluation" of the shekel) and the weakening of the euro against the shekel (an "appreciation" of the shekel) in 2005.
- Debt to market capitalization (derived from the market value of the Group's holdings) was 49.4% as of December 31, 2006, compared to 52.2% as of December 31, 2005.

#### **H. Highlights - Fourth Quarter 2006**

- The Group's investments totaled NIS 1.2 billion, compared to NIS 0.7 billion in the corresponding period last year. In addition, Citycon invested NIS 0.3 billion in acquiring and developing properties, a similar amount as in the same period last year.
- Property rental revenue totaled NIS 648 million, an increase of 7% compared to the same period last year. The increase was due to the enlargement of the property portfolio as a result of the acquisition of new properties, net of properties sold, the development properties coming on-line and also the increase in the average rent per square meter received on the Group's properties.
- NOI <sup>(2)</sup> totaled NIS 425 million, compared to NIS 400 million in the same period last year, an increase of 6%.
- Gross profit totaled NIS 312 million, compared to NIS 297 million in the same period last year, an increase of 5%.

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<sup>(1)</sup> Capital surpluses deriving from translation of the financial statements of foreign autonomous subsidiaries.

<sup>(2)</sup> NOI – Property rental revenue, net of property operating expenses.

- Cash inflows from operating activities totaled NIS 85 million, compared to NIS 152 million for the same period last year, a decrease of 44%. Neutralizing the effect of timing differences on payments to third parties, cash inflows from operating activities decreased by 17% due primarily to an increase in administrative expenses that are mainly of a non-recurring nature.
- FFO<sup>(1)</sup> totaled NIS 77 million, NIS 0.66 per share, compared to NIS 59 million, NIS 0.60 per share, for the same period last year, an increase of 30%.
- Net income, which included high capital gains, totaled NIS 145 million, NIS 1.19 per share, compared to NIS 76 million, NIS 0.77 per share, for the same period last year.
- The Company and FCR raised NIS 195 million in share capital from the public, compared to NIS 185 million in the same period last year.
- The Company adjusted the carrying value of its investment in MLS by making a NIS 82 million gross write-back to the impairment allowance that it recorded in the second quarter of the year.

#### **I. Change in Reported Income Due to Changes in Accounting Standards**

Israel Accounting Standard No. 19 – “Taxes on Income”, published by the Israel Accounting Standards Board (hereinafter – “the Standard”), was approved in July 2004. The Standard prescribes criteria for the recognition, measurement, presentation and disclosure for taxes on income in financial statements.

In the first quarter of 2005, the Company included in its statement of income (by means of a non-recurring charge) an expense of NIS 56.5 million in respect of the cumulative effect at the beginning of the year of adopting this Standard. Other than as stated above, the Company does not expect the application of the above Standard to have any further effect on its operating results, its financial position and/or its cash flows.

#### **J. Disclosure Concerning Adoption of International Financial Reporting Standards**

1. The Company prepares its financial statements in accordance with generally accepted accounting principles (“GAAP”) in Israel. The Company is at an advanced stage in the process of preparing for the transition to reporting in accordance with International Financial Reporting Standards (“IFRS”). The Company is intending to make the transition to adopting IFRS in the first quarter of 2007.

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<sup>(1)</sup> See section 3E below.

The Company has yet to complete the whole of its examination of the implications of the transition to IFRS. Accordingly, the Company is not publishing the data concerning the financial impact of the transition to IFRS, with the exception of the fair value data of investment property, which are expected to have the most material effect on the Company's results and which are described below. Also presented below is a qualitative description of the main effects of the transition to IFRS and of the relief provisions granted under IFRS that the Company is taking advantage of in the transition to IFRS.

As part of the Company's preparations for the adoption of IFRS and for the implementation of Israel Accounting Standard No. 16 of the Israel Accounting Standards Board dealing with investment property, which came into effect on January 1, 2007, the Company has assessed the fair value of its income-producing properties in accordance with International Accounting Standard No. 40, mainly with the aid of independent external appraisers. Property under development is presented at cost and is not revalued. Presented below are data showing the effect of the valuations on the investment property item in the financial statements, including the tax effect. It should be noted that the auditors have not yet completed the process of examining the valuations and thus the information below does not include other effects of the valuations on the financial statements.

Entity	Fair value	Depreciated book Balance <sup>(1)</sup>	Pre-tax effect	Post-tax effect
NIS in millions				
EQY	12,327	8,317	4,010	2,286
FCR	12,421	10,311	2,110	1,731
ProMed	479	366	113	74
Gazit Development Israel	1,254	1,189	65	49
Gazit Germany	400	394	6	6
<b>Total</b>	<u>26,881</u>	<u>20,577</u>	<u>6,304</u>	<u>*4,146</u>
Investment property presented as held for sale		(131)		
Fixed assets not meeting the definition of investment property (mainly senior housing communities)		281		
Other assets and long-term receivables included in the fair value of investment property		<u>(308)</u>		
<b>Total fixed assets as presented in these financial statements</b>		<u>20,419</u>		
* Divided between the Group's share and the minority's share				
		<u>NIS in millions</u>		
Share attributable to:				
The Company's shareholders		1,806		
The minority shareholders		<u>2,340</u>		
Total		<u>4,146</u>		

<sup>(1)</sup> Includes other assets and long-term receivables relating to the cost of the properties.

## **2. Relief provisions to be adopted by the Company on transition to IFRS**

IFRS 1, which deals with the first-time adoption of IFRS, lists 12 topics whose restatement in all reporting periods prior to the transition date to IFRS is not required. The Company has elected to adopt the following relief provisions:

### **a) Business combinations**

Business combinations (IFRS 3) that took place prior to the transition date with regard to the acquisition of subsidiaries, affiliates and companies consolidated on a proportionate basis are not adjusted by means of a restatement.

### **b) Translation differences**

The Company will not recognize translation differences that accrued prior to transition date, with regard to any foreign autonomous subsidiaries.

### **c) Deemed cost**

The Company will present fixed assets, investment property under development and deferred charges, as of the transition date, on the basis of “deemed” cost as defined in IFRS 1. In other words, these items are presented at the reported amounts in which they were presented in the financial statements to December 31, 2003. Investment property will be presented at transition date at its fair value.

### **d) Compound financial instruments**

The Company does not separate compound financial instruments into their equity and liability components, with regard to liabilities that did not exist as of the transition date.

### **e) Equity-based benefits**

IFRS 2, which deals with share-based payment transactions, will not be applied with regard to equity instruments granted subsequent to November 7, 2002 and which had vested by the transition date.

## **3. The principle differences between the accounting policies applied in the financial statements drawn-up in accordance with IFRS and the accounting principles applied under Israeli GAAP are as follows:**

### **a. Investment property**

Under Israeli GAAP, investment property is presented as part of the fixed assets according to the cost model. Pursuant to International Accounting Standard No. 40 (“IAS 40”), investment property that is held by the owner or by a lessee under a capital lease for the purpose of generating rental revenue or for the appreciation in the property’s value (or for both objectives) may be presented according to the fair value model.

Furthermore, under IAS 40, a property held under an operating lease can be presented as investment property, but only if the property otherwise complies with the definition of investment property and the company applies the fair value model.

The Company will apply the fair value model in its IFRS statements.

**b. Fixed assets**

Under Israeli GAAP, with regard to certain assets, where parts of fixed asset items have useful lives of different lengths, the various parts are not depreciated separately. Under IFRS, a component of a fixed asset, whose cost is significant in relation to the total cost of the item and whose useful life is of a different length, will be depreciated separately, using the components method, in accordance with the length of its useful life.

**c. Stock options linked to the consumer price index (“CPI”) or to foreign currency**

Under Israeli GAAP, stock options that have an exercise price that is linked to a foreign currency (other than the company’s functional currency) or to the consumer price index are presented in shareholders’ equity. Under IFRS, such equity instruments are to be classified as liabilities that are measured at their fair value in each accounting period with changes in fair value being carried to the financing item in the statement of income. When the stock options are exercised, the balance is carried to shareholders’ equity.

**d. Debentures convertible into subsidiaries’ shares**

Under the Israeli GAAP in effect until December 31, 2005, debentures convertible into a subsidiary’s shares were presented in the balance sheet as a quasi-capital instrument between long-term liabilities and shareholders’ equity at the higher of their equity or capital values, when their conversion into shares was expected and under long-term liabilities at their liability value, when their conversion into shares was not expected. Under IFRS, debentures convertible into a subsidiary’s shares have to be separated into their equity component, which is presented within the framework of minority rights and the liability component, which is presented under long-term liabilities. As part of the relief granted upon the first-time adoption, the aforementioned separation need only be performed for debentures for which there is still a liability balance on the transition date. From January 1, 2006, the date that Israel Accounting Standard No. 22 of the Israel Accounting Standards Board (hereinafter – “the IASB”) went into effect, the difference between Israeli GAAP and IFRS described above no longer exists.

**e. Deferred tax liability in respect of land acquired in business combinations**

Under Israeli GAAP, a deferred tax liability is not recognized for the temporary differences relating to land, which arose on business combinations prior to January 1, 2005. Under IFRS, such a liability has to be recognized.

**f. Goodwill**

Under Israeli GAAP, until the Revised Israel Accounting Standard No. 20 of the IASB became effective on January 1, 2006, goodwill that arose on business combinations was amortized on a straight-line basis over a period of up to 20 years. Since the above date, goodwill is not written down except in the event of its impairment. Under IFRS 3, including the relief provision permitted upon its implementation by virtue of IFRS 1, the amortization of goodwill is revoked with effect from the transition date, subject to review for impairment.

**g. Assets held for sale and discontinued operations**

Under Israeli GAAP, there is no requirement for assets held for sale to be measured differently. Under IFRS 5, an asset held for sale is presented separately and is to be measured at the lower of its carrying value or its fair value, less costs of sale and depreciation or amortization is not to be included for such an asset.

**h. Consolidation of the financial statements**

Under Israeli GAAP, potential voting rights are not taken into account when assessing whether control is exerted over a company. Pursuant to International Accounting Standard No. 27, the effect of potential voting rights exercisable at balance sheet date is to be taken into account.

In the financial statements drawn-up in accordance with IFRS, the Company applies the International Accounting Standards Board's declaration regarding tests for the existence of effective control. Accordingly, in its financial statements drawn-up in accordance with IFRS, the Company will consolidate both EQY and Citycon. However, in the financial statements drawn-up in accordance with Israeli GAAP, the Company only consolidates EQY on the basis of effective control, with this being in line with the approach of the Israel Securities Authority, which differentiates between effective control following a decline from formal control and effective control without there ever having been formal control previously.

**i. Minority interests**

Under Israeli GAAP, minority interests are presented in the balance sheet outside the framework of shareholders' equity, while under IFRS, minority interests are presented as part of the equity. Accordingly, under Israeli GAAP, the minority's share in the results of subsidiaries is included as part of the results in the income statement, while under IFRS, the minority's share in the results is not included in the income statement, but is presented as part of the division of profit between the shareholders.

**j. Financial instruments**

Under Israeli GAAP, the Company presents its investment in marketable securities that fall within the definition of a “fixed investment” at cost, net of any impairment that is not of a temporary nature, while securities that are included as a “current investment” are presented at their fair value, with changes in the valuation being carried to income. On the other hand, under International Accounting Standard No. 39, the Company presents its investments in financial instruments available for sale at their fair value, with valuation differences being carried to capital surplus, except in the case of an impairment, which is charged to the income statement.

Financial liabilities – Under Israeli GAAP, the Company applies Israel Accounting Standard No. 22 with effect from January 1, 2006, whereby the discount, premium and debt-raising expenses of a deferred debt, are amortized according to the effective interest method and are presented as a deduction from the balance of the liability. Under International Accounting Standard No. 32, this policy is applied from the date of the assumption of the liability.

**k. Derivative financial instruments**

Under IFRS, derivative financial instruments are initially recognized at fair value and this is remeasured at each cut-off date. Gains or losses arising from changes in the fair value during the year of the derivatives, where these do not meet the criteria for hedge accounting, are carried immediately to income, as explained below:

**Cash flow hedge**

Under Israeli GAAP, the results of the intrinsic value of a derivative financial instrument that meets the criteria of a hedge instrument are deferred and are recognized in the income statement commensurate with the result of the hedged item. Under International Accounting Standard No. 39, the effective portion of the gain or loss resulting from the change in the fair value of the hedge instrument is recognized directly in shareholders’ equity, while the ineffective portion is immediately recognized in income.

**Net investment hedge**

Under Israeli GAAP, the intrinsic value of an instrument hedging a net investment in foreign autonomous entities is carried to the capital surplus of translation differences from foreign autonomous entities. Under International Accounting Standard No. 39, the hedging of a net investment in foreign autonomous entities, including a hedge of a monetary item that is reported as part of the net investment, is reported in a similar fashion to a cash flow hedge. The effective portion of gains or losses as a result of a change in the fair value of the hedge instrument is carried to shareholders’ equity, while gains or losses deriving from the ineffective portion of the hedge are charged to income.

## **2. The Group and its Business Environment – Key Events and Changes During the Reporting Year**

### **General**

During the reporting year, the Group's investments in the acquisition and development of new properties and in the redevelopment, expansion and construction of various other properties totaled NIS 5.5 billion. In addition, Citycon invested NIS 2.4 billion in acquiring and developing properties during the reporting year. The effect of these investments on the operating results will be reflected in full in 2007.

### **A. Property Activities**

1. During the reporting year, the Group acquired 53 income-producing properties, with a total G.L.A. of approximately 425 thousand square meters and 31 plots of land for future development. The total consideration for these acquisitions totaled NIS 4.9 billion.
2. During the reporting year, the Group invested a total of NIS 0.6 billion in developing new properties and in the redevelopment of existing properties.
3. As at December 31, 2006, EQY and FCR had 12 properties under development with a gross area of approximately 288 thousand square meters, 20 properties being redeveloped and expanded and additional land reserves of approximately 1.988 million square meters, which have been earmarked for future development. The total cost [value?] of these properties and land reserves totals NIS 1.1 billion. The cost to complete these development, redevelopment and expansion projects is expected to amount to a further NIS 0.5 billion.

The total cost [value?] of the properties and land as described above, which are being developed or are intended for future development, as well as the properties of Gazit Development, RSC and Gazit Europe that are being developed, is approximately NIS 1.8 billion. These properties and land did not generate any rental revenue during the reporting year.

4. As at the end of 2006, EQY's and FCR's average basic monthly rental revenue was US\$ 10.22 per square meter. During the year, EQY and FCR renewed leases on 268 thousand square meters, while increasing the average basic monthly rent on these leases by 6% to an average monthly rent of US\$ 11.89 per square meter. Additionally, the companies signed new leases on 148 thousand square meters at an average basic monthly rent of US\$ 10.96 per square meter. During the year, leases on 108 thousand square meters expired, on which the average monthly rent was US\$ 10.09 per square meter. The net operating income from the same properties increased by an average of 3.3%, compared to the previous year.

EQY's and FCR's core properties had an average occupancy rate of 95.4% as of December 31, 2006 (the rate was 94.1% as of December 31, 2005).

5. As of December 31, 2006, RSC's properties had an occupancy rate of 94% (the rate was 93.3% as of December 31, 2005).

During the reporting year, RSC acquired three additional senior housing communities, consisting of 167 units, for a total investment of US\$ 18 million (approximately NIS 80 million), as well as two plots of land for the construction of additional senior housing communities for a total investment of US\$ 8 million (approximately NIS 37 million). The latter will consist of 471 units and the additional investment to bring them to completion is expected to be US\$75 million (approximately NIS 317 million).

6. As of December 31, 2006, Gazit Development's properties had an occupancy rate of 97.5% and yielded average monthly rental revenues of NIS 73.75 per square meter. During the year, Gazit Development renewed leases on 7.4 thousand square meters of space, while increasing the average monthly rent on these leases by 4.5%, as well as signing new leases on 3.3 thousand square meters at an average monthly rent of NIS 157.17 per square meter. During the year, leases on 2,650 thousand square meters expired, with an average monthly rent of NIS 103.45 per square meter.

At the end of 2006, Gazit Development had a stake in 14 properties in Israel, as detailed below (data presented in thousands of NIS, except for rental areas):

	<b>Qty.</b>	<b>Cost (*)</b>	<b>Additional investment to complete development</b>	<b>Rental area(*) (square meters)</b>
Income-producing properties	6	706,541	-	78,809
Properties and land under development	8	472,022	478,986	114,400

(\*) The Company's share

In addition, at the end of 2006, Gazit Development owns two plots of land in Bulgaria that are intended for the development of shopping centers and offices with an area of approximately 153 thousand square meters, representing an investment of €7.8 million (approximately NIS 43 million). The expected additional cost of bringing these properties to completion, in a number of stages, is €14 million (approximately NIS 80 million), with the first stage expected to add approximately 40 thousand square meters out of the total of approximately 200 thousand square meters, whose development will be completed in a number of stages, as stated.

7. At December 31, 2006, Gazit Europe's properties in Germany had an occupancy rate of 99.3% and yielded average monthly rental revenues of €12.01 per square meter.

At the end of 2006, Gazit Europe had a stake in properties in Germany, as detailed below (data presented in thousands of euros, except for rental areas):

	Qty.	Cost	Additional investment to complete development	Rental area (square meters)
Income-producing properties	3	65,237		29,800
Properties and land under development	2	6,392	58,000	38,300

8. In the reporting year, Citycon invested €400 million (approximately NIS 2.2 billion) in the acquisition of income-producing properties, in increasing its stake in existing shopping centers and also in their redevelopment, at a cost of €36 million (approximately NIS 0.2 billion), of income-producing properties.

The net operating income from the same properties increased by 3%, compared to the previous year.

As of December 31, 2006, Citycon's properties had an occupancy rate of 97.1% (the rate was 97.2% as of December 31, 2005).

As of December 31, 2006, Citycon had three properties under development at an investment of €18 million (approximately NIS 100 million); the expected additional cost of bringing these properties to completion is €34 million (approximately NIS 189 million) and their completion is expected to add approximately 28 thousand square meters.

- B.** As to the issuance of Company shares by way of a rights offering for a total consideration of NIS 256 million - see note 22k to the financial statements.
- C.** As to the public debt financing by the Company by way of a shelf prospectus and an offering of debentures by a wholly owned subsidiary of the Company - see note 15 to the financial statements.
- D.** As to the sale of Company shares and Company stock options to institutional and foreign investors, interested parties and the parent company (Gazit Inc.) (and the exercise of the above stock options) for a total consideration of NIS 594 million - see note 22 to the financial statements.
- E.** As to the closing of ProMed's acquisition of a medical office building, with a multi-story parking garage, located in the state of New Jersey in the United States – see note 1b(9) to the financial statements. In addition, ProMed is in the process of conducting a due diligence for the acquisition of another property at an investment of approximately US\$110 million (approximately (NIS 465 million)).

**F.** In January 2006, based on the Company's capabilities and the experience in North America and Europe, its Board of Directors authorized the Company's management to expand the scope of operations in Europe and to study the possibility of entering into Asia. The Board of Directors approved an investment budget of US\$ 1.5 billion over two years. The aforementioned Board of Directors' decision prescribed that these investments would be made in accordance with the Company's financial profile and generally out of existing financial sources, as well as by raising equity and debt in the Israeli and other financial markets.

Pursuant to the Board of Directors' decision, the expansion of the scope of operations in Europe and the possibility of extending operations into Asia will include the Company's existing areas of activity, mainly shopping centers, as well as senior housing communities and medical office buildings. Within this framework (including through Gazit Development), the Company has begun to operate in Germany and Bulgaria and is also currently continuing to assess – in several geographical regions of Europe and Asia – various types of arrangements, including: the acquisition, development and construction of individual buildings, the acquisition of property portfolios and the acquisition of real estate companies – either by itself or through alliances and joint ventures with appropriate partners.

**G.** With regard to the agreements entered into with Mr. Ronen Ashkenazi for the establishment of Gazit Development and the financing agreements with Gazit Development – see note 1b(7) to the financial statements.

**H.** As to the refinancing of EQY's credit facility – see section 22.1.4 of the Description of the Company's Business Report.

**I.** As to the issuance of debentures by EQY – see note 15 to the financial statements.

**J.** As to the issuance of debentures by FCR – see note 15 to the financial statements.

**K.** As to the issuance of convertible debentures by FCR and the Company's participation in this issue – see notes 1b(3)g and 20 to the financial statements.

**L.** As to sale of a portfolio of income-producing properties and land and the sale of other buildings and land to third parties by EQY - see note 10 to the financial statements.

**M.** As to equity raising by FCR - see note 1b(3) to the financial statements.

**N.** As to a rights offering by Citycon and the Company's participation in this equity raising – see note 1b(4)d to the financial statements.

**O.** As to the issuance of convertible debentures by Citycon and the Company's participation in this issue - see note 1b(4)e to the financial statements.

**P.** As to the sale of a portfolio of commercial properties in Finland by Citycon - see section 20.3 of the Description of the Company's Business Report.

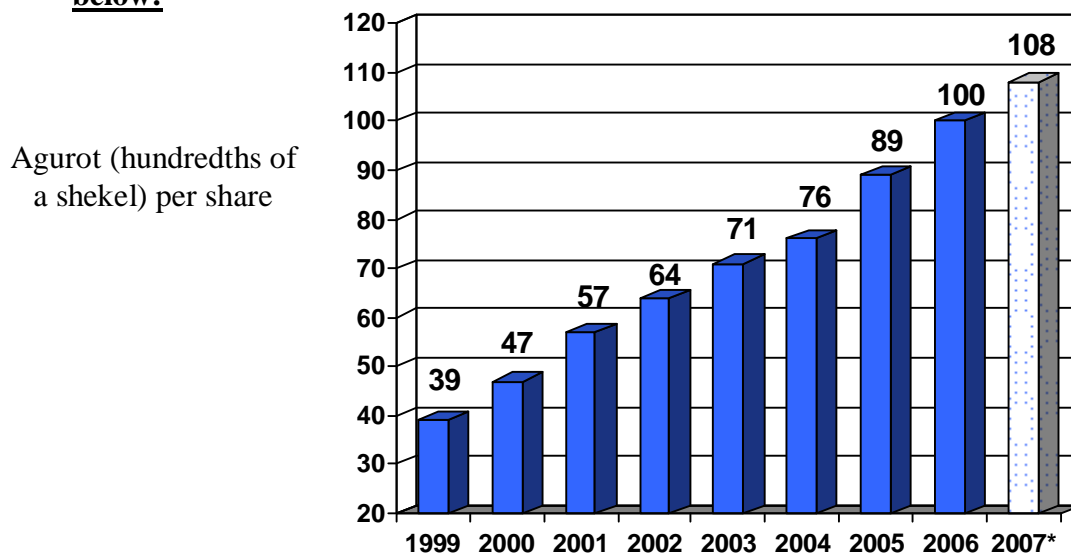
- Q. As to a final assessment agreement with the income tax authorities for the tax years 2001-2003 - see note 19i to the financial statements.
- R. As to VAT assessments issued to the Company for the years 2003 and 2004 and for part of the years 2002 and 2005 – see note 19j to the financial statements.
- S. As to the investment in 5.5 million shares of The Mills Corporation (“MLS”), a company listed on the NYSE, which constitutes 9.7% of that company’s common stock capital and an investment in preferred stock (Series 4) - see note 8(4) to the financial statements.

**T. Dividend Distribution Policy**

Pursuant to the Company’s dividend policy, the Company announces at the end of each year the anticipated dividend for the subsequent year. In November 2006, the Company decided that the dividend to be declared in 2007 would not be less than NIS 0.27 per share per quarter (NIS 1.08 per share on an annualized basis).

The above is subject to the existence of adequate amounts of distributable income at the relevant dates and is subject to the provisions of any law relating to dividend distributions and to decisions that the Company is permitted to take. This includes the appropriation of its income for other purposes and the revision of this policy.

**The Company’s dividend growth in the years 1999-2007 is shown in the graph below:**



\* Forecast

### 3. A. Results of Operations

	For the year ended December 31		
	2006	2005	2004
	NIS in thousands (other than earnings per share data)		
Property rental revenue	2,552,296	2,195,821	1,858,235
Rental property operating expenses	867,838	717,762	598,675
Rental property depreciation	453,259	360,800	282,176
<b>Gross profit</b>	<b>1,231,199</b>	<b>1,117,259</b>	<b>977,384</b>
General and administrative expenses	283,418	<sup>(1)</sup> 189,102	159,392
<b>Operating income</b>	<b>947,781</b>	<b>928,157</b>	<b>817,992</b>
Financing expenses, net	757,617	622,058	519,676
	<b>190,164</b>	<b>306,099</b>	<b>298,316</b>
Other income, net	514,101	122,353	129,202
<b>Income before taxes on income</b>	<b>704,265</b>	<b>428,452</b>	<b>427,518</b>
Taxes on income	84,211	74,545	55,029
<b>Income after taxes on income</b>	<b>620,054</b>	<b>353,907</b>	<b>372,489</b>
Equity in earning of affiliates	270,566	129,960	36,004
Minority interest in earnings of subsidiaries	(529,242)	<sup>(1)</sup> (295,965)	(298,383)
<b>Net income before cumulative effect</b>	<b>361,378</b>	<b>187,902</b>	<b>110,110</b>
Cumulative effect as of the beginning of the year of change in accounting principle <sup>(2)</sup>	-	(56,525)	-
<b>Net income</b>	<b>361,378</b>	<b>131,377</b>	<b>110,110</b>
<b><u>Net earnings of NIS 1 par value</u></b>			
<b><u>(in NIS) <sup>(3)</sup></u></b>			
<b>Before cumulative effect</b>	<b>3.17</b>	<b>2.02</b>	<b>1.32</b>
<b>Cumulative effect as of the beginning of the year of change in accounting principle <sup>(2)</sup></b>	<b>-</b>	<b>(0.62)</b>	<b>-</b>
<b>Net earnings</b>	<b>3.17</b>	<b>1.40</b>	<b>1.32</b>
<b>Number of shares used in computing fully diluted earnings per share (thousands of shares)</b>	<b>108,334</b>	<b>90,599</b>	<b>82,593</b>

<sup>(1)</sup> Reclassified in accordance with Israel Accounting Standard No. 24 – see note 2n to the financial statements.

<sup>(2)</sup> See section 1I above.

<sup>(3)</sup> The data for 2004 and 2005 have been reclassified in accordance with Israel Accounting Standard No. 21 – see note 2p to the financial statements.

## **B. Analysis of Results of Operations for 2006**

### **Property rental revenue**

The 16% increase compared to the previous year is due to the enlargement of the property portfolio as a result of the acquisition of new properties, net of properties sold, development properties coming on-line and the increase in the average rent per square meter received on the Group's properties.

### **Property operating expenses**

The increase in rental operating expenses, compared to the previous year, results from the increased number of properties, as referred to above. Rental property operating expenses, as a percentage of property rental revenue, rose to 34.0% from 32.7% for the previous year. This is mainly due to the reduced share now held in these items by EQY, whose operating expenses represent a lower percentage of revenue than those of the other Group companies.

### **Property depreciation**

The increase in rental property depreciation expenses, compared to the previous year, results from the increased number of properties, as referred to above, as well as from the allocation of certain property costs to the term of the tenants' leases, which is shorter than the lifespan of the properties. Depreciation expenses as a percentage of property rental revenue rose to 17.8% from 16.4% for the previous year.

### **Gross profit**

Gross profit totaled NIS 1,231 million (48.2% of property rental revenue); this compares to NIS 1,117 million (50.9% of property rental revenue) for the previous year – an increase of 10%. The reduction in gross profit as a percentage of property rental revenue is attributable to the increase in rental property depreciation as a percentage of property rental revenue and EQY's reduced share in this item, as explained above.

### **General and administrative expenses**

General and administrative expenses as a percentage of total revenues totaled 8.5%, compared to 7.7% in the previous year. Administrative expenses include salary costs that are calculated as a percentage of the Company's pre-tax income (hereinafter "bonus") in respect of the Chairman of the Board of Directors and the Company's President. In 2006, the Chairman of the Board of Directors and the Company's President waived NIS 8 million and NIS 2 million, respectively, of the bonuses they were entitled to under their employment agreements. The waiver of the bonus by the Company's President has been recorded as a reduction of administrative expenses, while the waiver of the bonus by the Chairman of the Board of Directors has been credited directly to the capital surpluses item in Company's shareholders' equity, this treatment being in accordance with the Securities Regulations (Presentation in the Financial Statements of a Transaction between a Corporation and its Controlling Shareholder), 1996. After neutralizing the amount of the bonus waived by the Chairman of the Board of Directors, the general and administrative expenses constitute 8.3% of the total revenues of the year.

The higher percentage referred to above is mainly due to the following factors:

- a. An increase in the Group's salary expenses as a result of taking on additional staff to cope with the growth in the Group's operations, which includes, inter alia, FCR's changeover to managing its own properties, EQY's enhanced severance pay expenses resulting from the changes that were made in its executive management and salary expenses linked to the increase in the Company's net income.
- b. A non-recurring charge relating to the evaluation of transactions that did not ultimately take place.
- c. An increase in non-recurring fees to professional service providers.

### **Financing expenses, net**

The change in financing expenses results from the following factors:

- 1) An increase in the Group's loans from an average balance of NIS 12 billion in 2005 to an average balance of NIS 15 billion in 2006. Interest expenses reflect an average nominal interest rate of approximately 6% on the Group's indebtedness, compared to 5.9% in 2005.
- 2) The 0.3% decrease in the "known" Israeli consumer price index ("C.P.I.") caused financing expenses to decrease by NIS 9 million (NIS 0.08 per share), following the revaluation of loans that are linked to the Israeli C.P.I., compared to an increase in financing expenses of NIS 21 million (NIS 0.24 per share) in 2005.
- 3) The financing expenses are net of income of NIS 84 million from investments in marketable securities, which includes NIS 36 million from dividends, compared to NIS 70 million received in the previous year, which included NIS 15 million from dividends.

### **Other income, net**

This item consists mainly of gains and losses in respect of capital transactions, such as the dilution of holdings in consolidated subsidiaries and real estate sales, as well as adjustments to the value of long-term investments.

The gain resulting from the dilution of holdings in subsidiaries totals NIS 33 million, compared to gains totaling NIS 72 million (which also includes the redemption in shares of convertible debentures by FCR) in the previous year.

Additionally, EQY sold 33 income-producing properties and land in Texas and in other regions (see note 10 to the financial statements), which produced a gross gain for EQY of NIS 490 million (the Company's share being NIS 156 million), compared to the gain of NIS 48 million (the Company's share being NIS 14 million) from the sale of properties in the previous year.

Furthermore, the Company wrote-down its investment in MLS by a gross amount of NIS 17 million.

### **Equity in earnings of affiliates**

The increase in this item is attributable to the Company's equity in the earnings of Citycon totaling NIS 261 million, compared to NIS 130 million in the previous year.

In 2006, Citycon revalued its investments in fixed assets to their fair value, in conformity with International Accounting Standard No. 40, resulting in an appreciation of €120 million (approximately NIS 673 million) in their gross value (the Company's share, net of related taxes, is approximately NIS 194 million; in 2005 - approximately NIS 80 million). In addition, Citycon sold 75 stores, which are not part of its core activities and which had a G.L.A. of approximately 77 thousand square meters; Citycon received proceeds of €74 million (approximately NIS 408 million) from this sale and recorded a gross gain of €5.8 million (approximately NIS 32 million) (the Company's share, net of related taxes, is approximately NIS 9 million).

### **Minority interest in earnings of subsidiaries**

The increase in this item mainly results from the increase in the subsidiaries' net income, as follows:

- a. An increase in the earnings of EQY, mainly due to capital gains from the sale of income-producing properties and land, primarily in Texas, during the year.
- b. An increase in the earnings of FCR, mainly due to the improvement in its operating results.

**C. Analysis of Principal Operating Results for 2006, by Quarter:**

	<b>Q1 2006</b>	<b>Q2 2006</b>	<b>Q3 2006</b>	<b>Q4 2006</b>	<b>Total 2006</b>
<b>NIS in thousands</b>					
<b>(other than earnings per share data)</b>					
Property rental revenue	661,285	625,537	617,825	647,649	2,552,296
Rental property operating expenses	226,025	213,717	205,413	222,683	867,838
Rental property depreciation	112,931	113,276	113,996	113,056	453,259
<b>Gross profit</b>	<b>322,329</b>	<b>298,544</b>	<b>298,416</b>	<b>311,910</b>	<b>1,231,199</b>
General and administrative expenses	54,820	65,558	65,207	97,833	283,418
<b>Operating income</b>	<b>267,509</b>	<b>232,986</b>	<b>233,209</b>	<b>214,077</b>	<b>947,781</b>
Financing expenses, net	171,087	207,780	196,342	182,408	757,617
	<b>96,422</b>	<b>25,206</b>	<b>36,867</b>	<b>31,669</b>	<b>190,164</b>
Other income, net	7,726	317,251	13,629	175,495	514,101
<b>Income before taxes on income</b>	<b>104,148</b>	<b>342,457</b>	<b>50,496</b>	<b>207,164</b>	<b>704,265</b>
Taxes on income	24,274	24,319	9,775	25,843	84,211
<b>Income after taxes on income</b>	<b>79,874</b>	<b>318,138</b>	<b>40,721</b>	<b>181,321</b>	<b>620,054</b>
Equity in earnings of affiliates	37,672	115,127	56,940	60,827	270,566
Minority interest in earnings of subsidiaries	(77,258)	(306,801)	(47,578)	(97,605)	(529,242)
<b>Net income</b>	<b>40,288</b>	<b>126,464</b>	<b>50,083</b>	<b>144,543</b>	<b>361,378</b>
<b><u>Fully diluted earnings per share</u></b>					
Net earnings	<b>0.38</b>	<b>1.16</b>	<b>0.39</b>	<b>1.19</b>	<b>3.17</b>
<b>Number of shares used in computing fully diluted earnings per share (thousands of shares)</b>	<b>101,628</b>	<b>106,970</b>	<b>109,348</b>	<b>116,513</b>	<b>108,334</b>

## **D. Analysis of Results of Operations for the Fourth Quarter of 2006**

### **Property rental revenue**

The 7% increase compared with the same period last year is due to the enlargement of the property portfolio as a result of the acquisition of new properties, net of properties sold, development properties coming on-line and the increase in the average rent per square meter received on the Group's properties.

### **Property operating expenses**

The increase in rental operating expenses, compared to the same period last year, results from the increased number of properties, as referred to above. Rental property operating expenses, as a percentage of property rental revenue, rose to 34.4% from 33.6% for the same period last year. This is mainly due to a reduced share now held in these items by EQY, whose operating expenses represent a lower percentage of revenue than those of the other Group companies.

### **Property depreciation**

The increase in rental property depreciation expenses, compared to the same period last year, results from the increased number of properties, as referred to above, as well as from the allocation of certain property costs to the term of the tenants' leases, which is shorter than the lifespan of the properties. Depreciation expenses as a percentage of property rental revenue rose to 17.5% from 17.1% for the same period last year.

### **Gross profit**

Gross profit totaled NIS 312 million (48.2% of property rental revenue); this compares to NIS 297 million (49.3% of property rental revenue) for the same period last year – an increase of 5%. The reduction in gross profit as a percentage of property rental revenue is attributable to the increase in rental property depreciation as a percentage of property rental revenue and EQY's reduced share in this item, as explained above.

### **General and administrative expenses**

General and administrative expenses as a percentage of total revenues totaled 11.3%, compared to 8.2% in the same period last year. Administrative expenses include salary costs that are calculated as a percentage of the Company's pre-tax income (hereinafter "bonus") in respect of the Chairman of the Board of Directors and the Company's President. In the fourth quarter of 2006, the Chairman of the Board of Directors and the Company's President waived NIS 8 million and NIS 2 million, respectively, of the bonuses they were entitled to under their employment agreements. The waiver of the bonus by the Company's President has been recorded as a reduction of administrative expenses, while the waiver of the bonus by the Chairman of the Board of Directors has been credited directly to the capital surpluses item in Company's shareholders' equity, this treatment being in accordance with the Securities Regulations (Presentation in the Financial Statements of a Transaction between a Corporation and its Controlling Shareholder), 1996. After neutralizing the amount of the bonus waived by the Chairman of the Board of Directors, the general and administrative expenses constitute 10.2% of the total revenues of the fourth quarter of the year.

The higher percentage referred to above is due to the following factors:

- a. An increase in the Group's salary expenses as a result of EQY's enhanced severance pay expenses resulting from the changes that were made in its executive management and changes in the size of its workforce and salary expenses linked to the increase in the Company's net income.
- b. A non-recurring charge relating to the evaluation of transactions that did not ultimately take place.
- c. An increase in non-recurring fees to professional service providers.

### **Financing expenses, net**

The change in financing expenses results from the following factors:

- 1) An increase in the Group's loans from an average balance of NIS 13.1 billion in the fourth quarter of 2005 to an average balance of NIS 15.8 billion in the fourth quarter of 2006. Interest expenses reflect an average annual rate of nominal interest of approximately 5.8% on the Group's indebtedness, compared to 6.2% in the same quarter last year.
- 2) The 1.7% decrease (reflecting an annual deflation rate of 6.8%) in the "known" Israeli consumer price index ("C.P.I.") caused financing expenses to decrease by NIS 24 million (NIS 0.23 per share), following the revaluation of loans that are linked to the Israeli C.P.I., compared to a 0.8% increase in the Israeli C.P.I. in the same period last year that caused financing expenses to increase, as stated above, by NIS 7.9 million (NIS 0.08 per share).
- 3) The financing expenses are net of income of NIS 25 million from investments in marketable securities, which includes NIS 1 million from dividends, compared to NIS 9 million received in the same period last year, which included NIS 3 million from dividends.

### **Other income, net**

This item consists mainly of gains and losses in respect of capital transactions, such as the dilution of holdings in consolidated subsidiaries and real estate sales, as well as adjustments to the value of long-term investments.

EQY closed the sale of its properties in Texas and in other regions, which produced a total gain for EQY of NIS 88 million (the Company's share being NIS 28 million), compared to the gain of NIS 3 million (the Company's share being NIS 0.5 million) from the sale of properties in the same period last year.

Furthermore, the Company adjusted its long-term investment in MLS by making a NIS 82 million gross write-back to the impairment allowance it recorded in the second quarter of the year.

### **Equity in earnings of affiliates**

The Company's equity in the earnings of Citycon amounted to NIS 59 million, compared to NIS 80 million in the same period last year. In the fourth quarter of 2006, Citycon revalued its investments in fixed assets to their fair value, in conformity with International Accounting Standard No. 40, resulting in an appreciation of €23 million (approximately NIS 127 million) in their gross value (the Company's share, net of related taxes, is approximately NIS 36 million). In the same period last year, the aforementioned revaluation resulted in a gross appreciation of €30 million (approximately NIS 165 million) (the Company's share, net of related taxes, was approximately NIS 45 million).

### **Minority interest in earnings of subsidiaries**

The increase in this item mainly results from the increase in the subsidiaries' net income, as follows:

- a. An increase in the earnings of EQY, mainly due to capital gains from the sale of 20% in a partnership that owned income-producing properties in Texas.
- b. An increase in the earnings of FCR, mainly due to the improvement in its operating results.

## **E. FFO<sup>(1)</sup> and FFO per share**

The Company's practice is to publish its FFO results, which is the net reported income, after neutralizing non-recurring income and expenditure, including capital gains from the sale of properties and the gain from the dilution of its holdings in consolidated subsidiaries and with the addition of the Company's share of depreciation of rental properties and amortization. It also publishes FFO per share results, as is already the accepted practice in those countries in which the Company operates and in accordance with the position paper issued by the NAREIT – the U.S.-based National Association of Real Estate Investment Trusts.

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<sup>(1)</sup> According to the NAREIT position paper, the FFO (Funds From Operations) index does not represent cash flow from current operations according to accepted accounting principles, nor does it reflect the cash held by a company, or its ability to distribute that cash, and it is not a substitute for the reported net income. Furthermore, the FFO is not part of the data audited by the Company's independent auditors.

In addition, beginning in 2006, Israel has adopted a REIT tax regime for companies that are real estate investment trusts, similar to that in effect in various other countries throughout the world. Such companies, under certain conditions, do not pay corporate tax. The Company thus considers that the presentation of FFO and FFO per share data, after neutralizing expenses and income in respect of deferred taxes (in other words, tax income and expenses that are not on a cash flows basis) provides a better comparison of the Company's operating results with those of other REIT companies in Israel and overseas.

The Company is of the opinion that FFO and FFO per share accurately reflect an additional aspect of the Company's operating results, providing a more appropriate basis for comparing the Company's operating results for a given period to those for previous periods and for comparing the Company's operating results to those of other property companies.

The tables below present the breakdown of the Company's FFO and FFO per share:

1) **For the years stated:**

	<b>2006</b>	<b>2005</b>	<b>2004</b>
	<b>NIS in thousands</b>		
	<b>(other than FFO per share data)</b>		
<b>Net income</b>	<b>361,378</b>	<sup>(1)</sup> <b>187,902</b>	<b>110,110</b>
<b>Adjustments to net income:</b>			
Depreciation and amortization	<sup>(2)</sup> 231,644	153,685	115,697
Gains from dilution in holdings of consolidated subsidiaries	(33,301)	(75,264)	(30,039)
Gains from the sale of properties	(147,197)	(13,782)	(19,710)
Losses from discontinued operations	-	12,059	(1,056)
Deferred tax expenses	34,863	22,279	15,414
Equity in earnings of affiliates <sup>(3)</sup>	(270,566)	(129,960)	(36,004)
Equity in FFO of affiliates	82,190	50,758	39,509
Other adjustments <sup>(4)</sup>	21,473	9,075	2,748
<b>Total adjustments to net income</b>	<b>(80,894)</b>	<b>28,850</b>	<b>86,559</b>
<b>FFO</b>	<b>280,484</b>	<b>216,752</b>	<b>196,669</b>
<b>Primary FFO per share <sup>(5)</sup></b>	<b>2.60</b>	<b>2.41</b>	<b>2.37</b>
<b>Fully diluted FFO per share <sup>(5)</sup></b>	<b>2.59</b>	<b>2.39</b>	<b>2.36</b>
<b>Number of shares used in computing fully diluted earnings per share</b>	<b>108,334</b>	<b>90,599</b>	<b>83,336</b>

<sup>(1)</sup> After neutralizing the cumulative effect at the beginning of the year of a change in accounting principle, net (Israel Accounting Standard No. 19) (see section II above).

<sup>(2)</sup> Includes the adjustment to the value of a long-term investment, see note 8(4) to the financial statements.

<sup>(3)</sup> Includes the Company's equity in the revaluation of Citycon's investment in fixed assets to their fair value, in conformity with International Accounting Standard No. 40.

<sup>(4)</sup> Expenses that are directly related to the income and expense items adjusted against the net income for the purpose of calculating FFO.

<sup>(5)</sup> In conformance with Israel Accounting Standard No. 21, which has been applied for the first time in the first quarter of 2006.

2) **For the four quarters of 2006:**

	<b>Q1 2006</b>	<b>Q2 2006</b>	<b>Q3 2006</b>	<b>Q4 2006</b>	<b>Total 2006</b>
	<b>NIS in thousands (other than FFO per share data)</b>				
<b>Net income</b>	<b>40,288</b>	<b>126,464</b>	<b>50,083</b>	<b>144,543</b>	<b>361,378</b>
<b>Adjustments to net income:</b>					
Depreciation and amortization	51,238	<sup>(1)</sup> 151,602	55,095	<sup>(1)</sup> (26,291)	<sup>(1)</sup> 231,644
Gains from dilution in holdings of consolidated subsidiaries	(3,017)	(25,663)	(1,849)	(2,772)	(33,301)
Gains from the sale of properties	(608)	(118,310)	-	(28,279)	(147,197)
Deferred tax expenses	3,970	11,644	3,603	15,646	34,863
Equity in earnings of affiliates <sup>(2)</sup>	(37,672)	(115,127)	(56,940)	(60,827)	(270,566)
Equity in FFO of affiliates	14,495	24,882	19,867	22,946	82,190
Other adjustments <sup>(3)</sup>	1,238	6,254	1,798	12,183	21,473
<b>Total adjustments to net income</b>	<b>29,644</b>	<b>(64,718)</b>	<b>21,574</b>	<b>(67,394)</b>	<b>(80,894)</b>
<b>FFO</b>	<b>69,932</b>	<b>61,746</b>	<b>71,657</b>	<b>77,149</b>	<b>280,484</b>
<b>Primary FFO per share <sup>(4)</sup></b>	<b>0.69</b>	<b>0.58</b>	<b>0.66</b>	<b>0.67</b>	<b>2.60</b>
<b>Fully diluted FFO per share <sup>(4)</sup></b>	<b>0.69</b>	<b>0.58</b>	<b>0.66</b>	<b>0.66</b>	<b>2.59</b>
<b>Number of shares used in computing fully diluted earnings per share</b>	<b>100,722</b>	<b>106,016</b>	<b>109,348</b>	<b>116,513</b>	<b>108,334</b>

<sup>(1)</sup> Includes the adjustment to the value of a long-term investment, see note 8(4) to the financial statements.

<sup>(2)</sup> Includes the Company's equity in the revaluation of Citycon's investment in fixed assets to their fair value, in conformity with International Accounting Standard No. 40.

<sup>(3)</sup> Expenses that are directly related to the income and expense items adjusted against the net income for the purpose of calculating FFO.

<sup>(4)</sup> In conformance with Israel Accounting Standard No. 21, which has been applied for the first time in the first quarter of 2006.

#### 4. Financial Status

##### Liquidity

The Group has a policy of maintaining a high level of liquidity that enables the pursuit of business opportunities in its areas of operations.

The sources of the Group's liquid assets are its cash reserves (derived from its income-producing properties), credit facilities, mortgages and long-term loans and raisings of convertible debentures and equity. As stated, these liquid assets are applied in the acquisition, development and redevelopment of income-producing assets, the settlement of liabilities, investments in affiliates, other investments and the payment of dividends.

As of December 31, 2006, the liquid assets available to the Group, including short-term investments, totaled NIS 342 million, compared to NIS 351 million as of December 31, 2005. In addition, as of December 31, 2006, the Group had unutilized credit facilities available for immediate drawdown of NIS 3.8 billion, compared to NIS 2.1 billion as of December 31, 2005.

Furthermore, as of December 31, 2006, the Group had unpledged assets, which are carried at a cost of NIS 9.3 billion.

**In aggregate, the Group has cash reserves and unutilized credit facilities available for immediate drawdown totaling NIS 4.1 billion.**

##### Current Assets

Current assets, as of December 31, 2006, totaled NIS 0.8 billion, compared to NIS 1.9 billion as of December 31, 2005. The reduction in current assets is due to closing the sale of income-producing properties in Texas, which last year were held for disposal at a net cost of NIS 1.3 billion and which were sold during 2006.

##### Investments in Affiliates

Investments in affiliates, totaling NIS 1,429 million as of December 31, 2006, relate primarily to the investment in 64.9 million shares of Citycon and in convertible debentures of Citycon with a nominal value of €37 million; investments in affiliates as of December 31, 2005 totaled NIS 722 million. During the year, the Company acquired additional Citycon shares, by means of purchases on the stock exchange, through participation in a rights issue and through the issuance of convertible debentures made by Citycon, at an overall cost of NIS 455 million.

### **Long-Term Investments**

Long-term investments, as of December 31, 2006, totaled NIS 1,151 million, compared to NIS 650 million as of December 31, 2005.

The increase in this item is derived primarily from the acquisition of marketable securities in companies with similar businesses activities and in the same geographical regions as the Group. Among the investments included in the balance, as of December 31, 2006, are the investment in 3.8 million shares of DIM (see note 8(3) to the financial statements) and also the investment in the common stock of MLS (see note 8(4) to the financial statements).

### **Fixed Assets, Net**

Net fixed assets, as of December 31, 2006, totaled NIS 20.4 billion, compared to NIS 17 billion at the end of 2005.

During the year, the Group acquired income-producing properties, developed new properties and redeveloped existing properties at a total cost of NIS 5.5 billion. On the other hand, the weakening of the U.S. dollar and the Canadian dollar against the shekel caused a reduction of NIS 1.6 billion to this item. Depreciation expenses for 2006 totaled NIS 0.5 billion.

### **Current Liabilities**

Current liabilities, as of December 31, 2006, totaled NIS 1.6 billion, compared to NIS 1.9 billion at the end of 2005. The balance mainly consists of the line item "credit from banks and other credit granting institutions", which mainly consists of the current maturities of long-term liabilities in the amount of NIS 0.9 billion, compared to NIS 1.2 billion at the end of 2005.

The balance of current maturities includes the final settlement of loans, in the amount of NIS 0.5 billion (at the end of 2005 - NIS 0.5 billion), which are secured by a charge on the properties. Based on past experience, the Group usually renews most of these loans by taking new, long-term secured and unsecured loans.

### **Long-Term Liabilities**

Long-term liabilities, as of December 31, 2006 totaled NIS 15.8 billion, compared to NIS 12.3 billion at the end of 2005.

The increase in this item derives principally from the issuance of debentures and new loans, which primarily financed investments in fixed assets, the acquisition of long-term investments and investments in subsidiaries.

### **Minority Interests**

Minority interests, as of December 31, 2006, mainly consist of the interests of EQY's other shareholders, who as of December 31, 2006, accounted for both 57.6% of EQY's equity and also the interests of FCR's other shareholders. At the same date, FCR's other shareholders accounted for 46.5% of FCR's equity.

The reduction in this item is due to the appreciation of the U.S. and Canadian dollars against the shekel during 2006 which reduced the shekel amount of EQY's and FCR's shareholders' equity and also the buyback of its own shares by EQY and the acquisition on the stock exchange of EQY shares by subsidiaries. The effect of these events was partly offset by FCR's issuance of shares during the year to its shareholders, including the Company.

### **Shareholders' Equity**

The change in shareholders' equity from NIS 1,908 million as of December 31, 2005 to NIS 2,865 million as of December 31, 2006 results mainly from the sale of treasury stock and stock options to institutional investors and their exercise totaling NIS 594 million, from a rights issuance totaling NIS 256 million, from the income for the reporting year totaling NIS 361 million and from the decrease in the item "other capital surpluses" totaling NIS 144 million. These were partly offset by the dividends of NIS 110 million paid and declared by the Company.

Shareholders' equity per share as of December 31, 2006 totaled NIS 24.3 per share, compared to NIS 19.4 per share as of December 31, 2005. This is after a dividend distribution of NIS 1.00 per share during the reporting year.

### **Ratio of Debt to Total Assets**

The ratio of the Group's interest-bearing debt to its gross assets (which includes the accumulated depreciation on the Group's assets) stood at 63.1% as of December 31, 2006, compared to 61.5% as of December 31, 2005.

The ratio of the Group's interest-bearing debt to total market capitalization stood at 49.4% as of December 31, 2006, compared to 52.2% as of December 31, 2005.

The Company considers that the fair value of its assets exceeds their carrying value in the Company's books and accordingly, the ratio of debt to total assets more fairly reflects the Group's leverage ratios.

## **Cash Flows**

Cash inflows from operating activities for the reporting year totaled NIS 590 million, compared to NIS 661 million in 2005. The above reduction is due to timing differences in payments to third parties that were partly offset by the continuing improvement in operating income, which is detailed as follows:

	<b>2006</b>	<b>2005</b>
	<b>NIS in millions</b>	
Net cash provided by operating activities	590	661
Changes in operating asset and liability items, net <sup>(1)</sup>	135	(24)
	<b>725</b>	<b>637</b>

In addition, in order to fund the Group's activities during the reporting year, the Company and its consolidated subsidiaries raised capital totaling NIS 1,188 million, issued debentures in a net amount of NIS 4,235 million and sold fixed assets totaling NIS 1,825 million. The proceeds from the above sources were used primarily to finance investing activities for the purchase of fixed assets, which, in the reporting year, totaled NIS 5,519 million, for further investments in affiliates and long-term investments in an aggregate net amount of NIS 1,197 million and for the buyback by EQY of its own shares in an amount of NIS 302 million.

## **5. Donations**

The Company customarily makes donations to charities and community welfare and education projects.

The Company makes donations to Tel-Aviv University, which has established and operates an institute focusing on research and studies of all manner of real estate related topics (The Chaim Katzman – Gazit-Globe Real Estate Institute). In this connection, the Company has pledged to make an annual donation of US\$ 150 thousand for a period of seven years.

The Company donates to the "College for All" charity – a not-for-profit organization working to close the gaps in education by means of creating equal opportunities. The organization strives to realize its vision of excellence through the provision of learning and other tools to students with ability and motivation, from underprivileged neighborhoods. The goal is to encourage such students into academic studies. Within the framework of this organization, the Company has pledged to provide assistance to a group of students for a period of five years.

During the reporting year, the Group's donations amounted to NIS 4.7 million.

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<sup>(1)</sup> See appendix a ("Adjustments to reconcile net income to net cash provided by operating activities") to consolidated statements of cash flows.

Of the above sum, the Company donated NIS 0.7 million to the Tel-Aviv University, NIS 0.2 million to the College for All charity, NIS 0.6 million to various bodies engaged in charitable, welfare and educational work with the community in Israel, NIS 1.1 million to institutions and charities that provided humanitarian aid to the population living in northern Israel in July 2006 and also NIS 2.1 million to various bodies in the United States, Canada and Europe (through the Company's subsidiaries, such sums being designated for the regions in which they operate).

## **6. Additional Information and Subsequent Events**

- A.** From the balance sheet date through the signing date of the financial statements, the Group invested a total of NIS 1 billion in acquiring new properties and land for future development. In addition, Citycon also invested NIS 0.3 billion in a new property.
- B.** In February 2007, Citycon made an issuance of 25 million shares to international and Finnish institutional investors for a total consideration of €134 million (approximately NIS 746 million). Within the framework of this issuance, the Company invested €54 million (approximately NIS 298 million) to acquire 10 million shares.
- C.** In January 2007, FCR made a C\$100 million issuance of debentures (Series E), which bear annual interest of 5.36%, payable twice a year and which are to be redeemed in one payment on December 31, 2014.
- D.** In March 2007, FCR signed an agreement for the provision of an unsecured credit facility of C\$ 250 million (approximately NIS 900 million), renewable from time to time, for a period of three years. The facility is being provided by a consortium of banks and financial institutions managed by RBC Capital Markets.

## **7. Critical Accounting Estimates**

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assessments that affect the reported amounts of assets, liabilities, revenues and expenses and the disclosure of contingent assets and liabilities.

Management bases its estimates and assessments on past experience and other factors that, in its opinion, are relevant taking the particular circumstances into account. Actual results could differ from these assessments under different assumptions or conditions. The Company has identified the estimates and assessments detailed below as being critical estimates, since any change in such estimates and assumptions has the potential of having a material effect on the financial statements.

**Estimate of the lifespan of intangible assets:**

Intangible assets are methodically amortized over their useful life. The amortization period reflects the best estimate of the period during which the Company will derive economic benefits from the asset. Use of other assumptions could result in a different assessment of the estimate of the period during which economic benefits are expected as stated above. The Company performs a methodical assessment as to the possible impairment of its assets (including goodwill) in conformity with Israel Accounting Standard No. 15.

**Allocation of excess cost on acquisition of acquired companies to the various asset items:**

Pursuant to Opinion No. 57 of the Institute of Certified Public Accountants in Israel, the Company is required to allocate the excess cost arising on the acquisition of companies to the various asset items acquired. Excess cost that cannot be allocated is attributed to goodwill (see above). The excess cost allocated to the various asset items is depreciated/amortized at the same rate as the asset to which it has been allocated. The allocation of the excess cost to the various asset items could result in a different depreciation/amortization period.

**Acquisition of properties**

On the date of acquiring active rental properties, the Company is required to allocate the acquisition cost to land, buildings, leasehold improvements and intangible assets, such as: attributing a value to existing above market and below market leases, attributing an economic value to origination costs, attributing an economic value to benefits and incentives to tenants and attributing a value to mortgages, if such exist. In allocating the acquisition cost to the aforementioned components, the Company's management makes use of estimates and outside appraisals in order to estimate the following elements:

- A. The fair value of the land on the acquisition date.
- B. The replacement cost of the buildings on the acquisition date, based on the price of buildings of a similar age and standard of finish.
- C. The value of the difference between the existing rent under the leases and the market rent for those leases, based on the capitalized difference of the actual cash flows and the estimated cash flows from those leases at market rents.
- D. The value of deferred rental costs, including leasehold improvements at their replacement cost, taking into account the year and the condition of the renovated areas.
- E. Origination costs, based on an estimate of the costs required to obtain leases under the same terms as the existing leases.
- F. The value of the existing tenant relationship, if relevant, based on an estimate of the costs required to renew the lease at the end of the existing lease period and of the likelihood of the tenant renewing the lease.

G. The fair value of the indebtedness, if any, taken on by the Company on the acquisition date, based on interest at the accepted market rates that would be payable on a loan under similar terms.

The actual fair value and market interest rates could differ from the estimates made by the Company's management and could affect the Company's financial results.

## **8. Directors Possessing Accounting and Financial Expertise**

- A. The Company's Board of Directors has decided that the minimum required number of directors possessing accounting and financial expertise is three, after taking into account the Board of Directors legal obligations and duties (including its responsibility for the preparation and approval of the financial statements), the nature of the accounting issues involved in the Group's field of operations and the Group's structure (including its holdings in foreign, public subsidiaries). The decision regarding the above minimum number also takes into account the close accounting support provided to the Company by its auditors (who are one of the world's four largest accounting firms), including their participation in meetings of the Board of Directors at which the financial statements are discussed.
- B. The Board of Directors has determined that the following directors possess accounting and financial expertise:
1. Mr. Chaim Katzman
  2. Mr. Arie Mientkavich
  3. Mr. Dori Segal
  4. Mr. Chaim Ben-Dor
  5. Mr. Eliahu Shahr
  6. Mr. Ovadia Hason
  7. Mr. Shai Pilpel.
- C. Regarding the education and business experience of the above directors, see Article 26 of the Periodic Report for 2006.

## **9. Compensation of Senior Employees**

- A. In 2006, the Chairman of the Board of Directors and the Company's President waived NIS 8 million and NIS 2 million, respectively, from the salary payments (calculated as a percentage of the Company's pre-tax income) to which they are entitled under their employment agreements.
- B. In 2006, the Company's Board of Directors did not set any policy regarding the compensation of senior employees.
- C. With regard to the issue of non-listed stock options to the Deputy Chairman of the Board of Directors, to officers and to an employee of the Company and to an employee of one of its subsidiaries, see note 22 to the financial statements.
- D. Regarding the compensation of the Company's senior employees, who are interested parties in the Company, by consolidated subsidiaries, see note 31 to the financial statements.

## **10. Disclosure Concerning the Company's Internal Auditor**

### **The Company's internal auditor:**

Haguel, Shem-Tov (who was appointed as the Company's internal auditor in 1999) is a CPA and a qualified internal auditor – C.I.A., from the Institute of International Internal Auditors (IAA); he is a partner in the firm of Haguel & Co. and has many years experience in the field.

### **Is the internal auditor an employee of the Company or a person who provides internal audit services on behalf of an outside party:**

The internal auditor provides internal audit services within the framework of an outside service provider, though the firm of S. Haguel & Co., CPAs.

### **Legal requirements met by the internal auditors:**

The internal auditor meets the requirements of Section 461(b) of the companies Law and Section 8 of the Internal Audit Law.

### **Holding of securities of the Company or of a related entity :**

As of the date of the report, the internal auditor held shares in the Company with a par value of NIS 1,200. This negligible holding is not sufficient to influence the quality of the internal auditor's work for the Company.

### **The internal auditor's relationship with the Company or with a related entity:**

The internal auditor also serves as the internal auditor of Gazit Inc, the controlling shareholder of the Company and also as the internal auditor of Gazit Globe Israel (Development) Ltd., a subsidiary of the Company, although this is not sufficient to create a conflict of interests with his duties as the internal auditor of the Company.

### **Other duties of the internal auditor within the Company:**

Apart from his duties as the internal auditor of the Company, the internal auditor is not otherwise employed by the Company and does not provide it with any other outside services.

### **Other duties of the internal auditor outside the Company:**

The internal auditor of the Company is a partner in the accounting firm of S. Haguel & Co., CPAs.

### **Method of the internal auditor's appointment:**

Mr. Haguel was appointed as the Company's internal auditor pursuant to the resolutions of the Company's Audit Committee and the Company's Board of Directors on November 1, 1999 and November 17, 1999, respectively.

### **Identity of the person to whom the internal auditor reports within the organization:**

The internal auditor reports to the Chairman of the Board of Directors.

### **The internal auditor's work program**

The internal auditor's work program is an annual program that takes into account the subjects that have been examined in previous years. The contents of the program are determined in coordination with the Audit Committee of the Board of Directors and the Company's management. The work program is accepted and approved by the Audit Committee.

The annual audit program reflects the activities of companies that are wholly owned by the Company, in Israel and overseas and the order of priorities for the subjects according to their importance and urgency, as by the internal auditor and the Audit Committee.

**Examination of the Company’s material transactions during 2006 by the internal auditor:**

During the year all transactions with interested parties were examined and the internal auditor submitted a report on this subject to the Company’s Audit Committee.

**Overseas audit and audit of investees:**

Private subsidiaries – The audit report also relates to the Company’s private subsidiaries, both in Israel and overseas. Within the framework of the program for 2006, the internal auditor conducted an audit of the operations of the Company’s wholly owned foreign private companies in the United States, this being in accordance with the work program decided upon by the Company’s Audit Committee. Moreover, the audit program for 2007 includes examining various subjects relating to the subsidiary, Gazit Globe Israel (Development) Ltd.

Public subsidiaries – With regard to the audit of the Company’s public subsidiaries that are listed overseas, this is a question that involves the legal restrictions to which they are subject. At the end of 2004, an internal auditor was appointed for EQY (in the U.S.A.) and his activities have been reviewed by the internal auditor (Mr. Haguel) in the following manner: The internal auditor presented a periodic questionnaire to EQY’s internal auditor and a meeting also took place between the Company’s internal auditor and EQY’s internal auditor, who is an employee of the accounting firm BDO, for the purpose of receiving updates regarding the conduct of the audit work. The findings from these questionnaires and the discussion were included in the internal auditor’s reports to the Audit Committee. With regard to the internal audit of FCR, FCR has not appointed an internal auditor, as, under the laws to which FCR is subject, it is not required to make such an appointment. It should nevertheless be noted that FCR maintains internal control processes, in accordance with the laws to which it is subject.

With regard to the internal audit of Citycon, in 2006 this was performed by KPMG Oy ab, with Citycon's Board of Directors, its Audit Committee and its President being involved in the audit processes, their approval and their supervision.

**Extent of the internal auditor’s engagement:**

The extent of the internal auditor’s engagement varies in accordance with the annual audit program; in 2006, approximately 160 hours were spent on audit work activities, in accordance with the breakdown presented in the table below. The abovementioned number of hours was determined in accordance with the requirements of the audit program.

	<b>Work hours</b>
Internal audit of the Company	Approx. 80 hours
Internal audit of the Company’s overseas investees	Approx. 80 hours
<b>Total</b>	<b>Approx. 160 hours</b>

The number of the internal auditor's work hours was decided upon in accordance with the audit subjects prescribed for 2006. The number of hours has increased compared to 2005 due to the audit also having included overseas examinations.

**The professional standards in accordance with which the internal auditor performs his audit:**

The audit is performed in conformity with professional standards generally accepted for internal audit, professional directives and guidance papers of the Institute of Internal Auditors Israel, including the principal pronouncements published by the IIA, the U.S. Institute of Internal Auditors.

The internal auditor has complied with the requirements prescribed in the aforesaid standards.

**Freedom of access for the internal auditor:**

With regard to the information and documents of the Company and the Company's private subsidiaries in Israel and overseas, the internal auditor is given free access to all IT systems, including financial data. With regard to the Company's public subsidiaries, in light of the legal restrictions placed on these companies, the internal auditor has no access to information of the aforesaid companies that is not accessible to the public, except with regard to the report of EQY's internal auditor, which includes the audit program and updates regarding progress made in converting this from theory to practice, include details of steps taken by EQY's management as a consequence of the internal auditor's reports.

**The dates when written reports of the internal auditor's findings were submitted to the Chairman of the Board of Directors, the President and the Chairman of the Audit Committee:**

- a. In February 2006, the internal auditor submitted to the Audit Committee a report on the subject of the management of accounting information.
- b. In May 2006, the internal auditor submitted to the Audit Committee a report on the subject of the work of EQY's internal auditor.
- c. In August 2006, the internal auditor submitted to the Audit Committee a report on the subject of transactions with interested parties.
- d. In August 2006, the internal auditor submitted to the Audit Committee a report on the subject of keeping minutes of management meetings.
- e. In July 2006, the internal auditor submitted to the Audit Committee an audit program for Gazit-Globe Israel (Development) Ltd., having first made a preliminary review.
- f. In January 2007, the internal auditor submitted to the Audit Committee a report on the subject of the private subsidiaries in the U.S.A.
- g. In February 2007, the internal auditor submitted to the Audit Committee a report on the subject of information security. The Company's Audit Committee and the Company's Board of Directors have not yet discussed the findings of this report.

**Opinion of the Company's Board of Directors concerning the internal auditor's activities:**

In the opinion of the Company's Board of Directors, the extent, nature, continuity of the internal auditor's activities and his work program are reasonable in light of prevailing circumstances and are sufficient to attain the internal audit objectives of the Company.

**Remuneration of the internal auditor:**

The internal auditor's fees are determined in accordance with the number of work hours actually invested in performing his assignments, in accordance with a budget approved by the Company's Audit Committee.

In the Company's opinion, the payment of such remuneration does not influence the professional discretion exercised by the internal auditor.

**11. Professional Fees of the Independent Auditors**

Independent auditors of the Company: Kost Forer Gabbay & Kasierer & Co.

The professional fees of the independent auditors that audit the financial statements of the Company and the Company's consolidated subsidiaries, are as follows:

- A. Ernst & Young (the Company, wholly owned subsidiaries of the Company and also EQY and Citycon)

	<u>2006</u>	<u>2005</u>
	<u>NIS in thousands</u>	
Fees for audit and related services	3,774	1,150
Fees for consulting and tax services	759	637
Other fees	<u>2,308</u>	<u>560</u>
<b>Total</b>	<u><b>6,841</b></u>	<u><b>2,347</b></u>

- B. Deloitte Touche, Canada (Gazit Canada, Gazit 2003 and FCR)

	<u>2006</u>	<u>2005</u>
	<u>NIS in thousands</u>	
Fees for audit and related services	4,229	2,190
Fees for consulting and tax services	1,670	1,252
Other fees	<u>629</u>	<u>563</u>
<b>Total</b>	<u><b>6,528</b></u>	<u><b>4,005</b></u>

**12. Reporting of Exposures to Market Risks and their Management**

- A. The individuals responsible for managing and reporting the Company's market risks are Mr. Dori Segal, the Company's President and Mr. Gil Kotler, the Company's Chief Financial Officer.

**B. Principal Market Risks to which the Company is Exposed:**

1. Real estate investments of the Group, held primarily through EQY, FCR and Citycon, are the most significant assets of the Company. Consequently, the relevant risk factors for the Company are the key risk factors to which the operations of EQY, FCR and Citycon are exposed. These are as follows:
  - 1.1 The financial stability of the tenants.
  - 1.2 Changes in consumption habits.
  - 1.3 Changes in the rental policies of retail chains and major tenants.
  - 1.4 The economic conditions affecting the geographical regions in which the Company is active.
  - 1.5 Terror attacks and natural disasters.
  - 1.6 The status of EQY as an REIT.

2. Changes in the exchange rate of the U.S. dollar, the Canadian dollar and the euro relative to the shekel mainly affect the Company's shareholders' equity. An increase in the exchange rate of the above foreign currencies will increase the Company's shareholders' equity, while a decrease in their exchange rate will reduce the Company's shareholders' equity.
3. Changes in interest rates in the U.S.A., Canada, Finland and Israel have an effect on the Company's results, to the extent that a rise in interest rates will increase the investee companies' and the Company's financing expenses, while a decline in interest rates will reduce the investee companies' and the Company's financing expenses.
5. The Company has investments in traded securities, whose value is affected by fluctuations in their market price.

**C. The Company's Policies for Risk Management are as Follows:**

1. The Group companies hire local experts in the field of property management, development and acquisition in the U.S.A., Canada, Europe and Israel, who monitor, on a regular basis, developments in the markets in which the Group operates. In addition, the companies have insurance on most of their properties against terror attacks and natural disasters.
2. It is the Company's policy to maintain as close a correlation as possible between the currency in which properties are acquired and the currency in which the liabilities to finance the acquisition of those properties are taken out. Management regularly evaluates the linkage basis balance sheet and takes appropriate action in accordance with exchange rate developments. As a general rule, the Company tries to hold its shareholders' equity in the currencies of the various markets in which it operates and in the same proportions as the assets in each such currency bear to the total assets, as detailed in section D1 below.
3. The Company and the investee companies finance most of their activities with long-term loans (mortgages on income-producing properties) in U.S. dollars, Canadian dollars and euros, at fixed interest rates. The Company finances most of its investment in shekel assets with shekel credit, at fixed interest rates and regularly monitors developments and changes in the interest policy of the Bank of Israel. In order to reduce the impact of interest rate fluctuations on their loans, from time to time and depending on market conditions, the Company and the investee companies enter into interest rate swaps, whereby they exchange variable interest for fixed interest, and vice versa, as detailed in section D2 below.
4. During 2006, no changes occurred in the Company's market risks management policy.

## D. Linkage Bases Report and Derivatives and Sensitivity Testing Tables:

### 1) Linkage bases report

As of December 31, 2006

	Linked to the consumer price index	In US\$ or linked thereto	In C\$ or linked thereto	In unlinked NIS	In euros	Unlinked	Total
NIS in thousands							
<b>Monetary assets</b>							
Cash and cash equivalents	-	78,721	33,827	37,471	44,202	-	194,221
Short-term investments	-	46,612	3,801	-	-	97,304	147,717
Tenants, accounts receivable and other debit balances	36,090	111,544	124,643	3,878	14,131	53,228	343,514
Investments in affiliates	-	-	-	-	207,425	-	207,425
Long-term investments	4,708	3,393	16,336	-	-	1,126,772	1,151,209
Long-term loans and debit balances	1,499	95,980	53,953	-	-	-	151,432
	42,297	336,250	232,560	41,349	265,758	1,277,304	2,195,518
<b>Non-monetary assets</b> <sup>(1)</sup>	-	8,760,835	10,177,149	1,222,400	1,611,721	223,407	21,995,512
	<b>42,297</b>	<b>9,097,085</b>	<b>10,409,709</b>	<b>1,263,749</b>	<b>1,877,479</b>	<b>1,500,711</b>	<b>24,191,030</b>
<b>Liabilities</b>							
Short-term credit from banks and other credit granting institutions	-	-	-	67,921	-	-	67,921
Trade and other payables and other credit balances	15,652	201,191	291,397	74,161	17,608	27,236	627,245
Debentures	1,364,699	3,643,104	2,147,577	447,346	489,799	-	8,092,525
Liabilities to financial institutions and others	79,595	3,021,883	4,469,437	-	273,984	-	7,844,899
Deposits from tenants	1,387	42,141	23,556	-	-	-	67,084
Liabilities for employee rights upon retirement	-	-	-	259	-	-	259
Deferred taxes	-	-	-	-	-	168,176	168,176
Convertible debentures redeemable for subsidiary's shares	-	-	468,134	-	-	-	468,134
	1,461,333	6,908,3196	7,400,101	589,687	781,391	195,412	17,336,243
Receipts in respect of subsidiary's convertible options	-	-	19,762	-	-	-	19,762
Receipts from issue of subsidiaries' stock options	-	1,952	3,957	-	-	-	5,909
Minority interests	-	-	-	-	-	3,963,738	3,963,738
Shareholders' equity	-	-	-	-	-	2,865,378	2,865,378
	<b>1,461,333</b>	<b>6,910,271</b>	<b>7,423,820</b>	<b>589,687</b>	<b>781,391</b>	<b>7,024,528</b>	<b>24,191,030</b>

<sup>(1)</sup> Mainly fixed assets, net.

**A s o f D e c e m b e r 3 1 , 2 0 0 5**

	<b>Linked to the consumer price index</b>	<b>In US\$ or linked thereto</b>	<b>In C\$ or linked thereto</b>	<b>In unlinked NIS</b>	<b>In euros</b>	<b>Unlinked</b>	<b>Total</b>
<b>N I S i n t h o u s a n d s</b>							
<b>Monetary assets</b>							
Cash and cash equivalents	1,164	47,214	21,682	209,381	2,771	-	282,212
Short-term investments	-	46,182	1,447	-	-	21,062	68,691
Tenants, accounts receivable and other debit balances	20,628	101,638	129,068	662	-	40,797	292,793
Long-term investments	5,531	1,772	18,140	-	-	624,613	650,056
Long-term loans and debit balances	58	89,561	33,775	-	-	-	123,394
	<b>27,381</b>	<b>286,367</b>	<b>204,112</b>	<b>210,043</b>	<b>2,771</b>	<b>686,472</b>	<b>1,417,146</b>
<b>Non-monetary assets<sup>(1)</sup></b>	-	9,165,360	8,783,715	396,456	720,501	318,546	19,384,578
	<b>27,381</b>	<b>9,451,727</b>	<b>8,987,827</b>	<b>606,499</b>	<b>723,272</b>	<b>1,005,018</b>	<b>20,801,724</b>
<b>Liabilities</b>							
Short-term credit from banks and other credit granting institutions	-	89,045	678	3,530	-	-	93,253
Trade and other payables and other credit balances	1,070	206,401	271,359	68,526	1,376	26,903	575,635
Debentures	987,042	2,953,689	526,893	-	66,378	-	4,534,002
Liabilities to financial institutions and others	5,596	3,376,688	5,212,559	13,211	183,046	-	8,791,100
Deposits from tenants	1,230	45,781	18,057	-	-	-	65,068
Liabilities for employee rights upon retirement	-	-	-	164	-	-	164
Deferred taxes	-	-	-	-	-	85,981	85,981
Convertible debentures redeemable for subsidiary's shares	-	-	351,827	-	-	-	351,827
	<b>994,938</b>	<b>6,671,604</b>	<b>6,381,373</b>	<b>85,431</b>	<b>250,800</b>	<b>112,884</b>	<b>14,497,030</b>
Receipts from issue of subsidiaries' stock options	-	-	-	-	-	1,284	1,284
Minority interests	-	-	-	-	-	4,395,154	4,395,154
Shareholders' equity	-	-	-	-	-	1,908,256	1,908,256
	<b>994,938</b>	<b>6,671,604</b>	<b>6,381,373</b>	<b>85,431</b>	<b>250,800</b>	<b>6,417,578</b>	<b>20,801,724</b>

<sup>(1)</sup> Mainly fixed assets, net.

## 2) Derivatives

### Linkage basis swaps:

	Item	Linkage basis swaps from the Company's viewpoint	Transaction amount (in millions)	Transaction currency	Fair value as of December 31, 2006 (NIS in thousands)
The Company	'C' Debentures (listed, CPI-linked, final redemption – 2018)	Paying variable euro interest Receiving CPI	100	ILS	(1,249)
The Company	'C' Debentures (listed, CPI-linked, final redemption – 2018)	Paying fixed Canadian interest Receiving CPI	105	ILS	(6,290)
The Company	'C' Debentures (listed, CPI-linked, final redemption – 2018)	Paying variable Canadian interest Receiving CPI	150	ILS	6,781
The Company	'D' Debentures (listed, CPI-linked, final redemption – 2021)	Paying fixed Canadian interest Receiving CPI	290	ILS	(9,435)
The Company	'D' Debentures (listed, CPI-linked, final redemption – 2021)	Paying fixed euro interest Receiving CPI	210	ILS	(13,289)
The Company	'D' Debentures (listed, CPI-linked, final redemption – 2021)	Paying fixed U.S. interest Receiving CPI	475	ILS	(1,186)
The Company	'D' Debentures (listed, CPI-linked, final redemption – 2021)	Paying variable Canadian interest Receiving nominal shekels	200	ILS	177
Wholly owned subsidiary	Private debenture of wholly owned subsidiary (not listed, final redemption – 2015)	Paying fixed U.S. interest Receiving CPI	50	ILS	4,359
Subsidiary	IRS commitment in U.S. dollars	Paying fixed interest Receiving variable	45	USD	7,550
Subsidiary	IRS commitment in Canadian dollars	Paying fixed interest Receiving variable	15	CAD	(1,795)
Subsidiary	IRS commitment in U.S. dollars	Paying fixed interest Receiving variable	100	USD	16,109

### Interest hedges:

	Type of transaction	Base asset	Interest Protected	Transaction amount (in millions)	Transaction currency	Transaction period	Fair value as of December 31, 2006 (NIS in thousands)
The Company	T-LOCK	Planned acquisitions/ issuances	U.S. interest	35	USD	3 transactions with periods of up to a year	(6,100)
The Company	SWAPTION	Against expected acquisition	U.S. interest	7.5	USD	1 transaction up to 5/07	(1,128)
The Company	SWAPTION	Against expected mortgage on property in Germany	Euro interest	33	EUR	1 transaction up to 11/07	2,594
Subsidiary	T-LOCK	Planned issuances	U.S. interest	85	USD	1 transaction up to 8/07	(10,875)

**3) Reporting currency, interest and derivative exposures in accordance with the Second Addendum to the Securities Regulations (Galai Commission recommendations)**

For the first time, the Group is presenting a report on its currency, interest and derivative exposures in accordance with the aforementioned regulations.

The Group has an economic and accounting exposure due to its operations on various overseas markets. The Group operates in accordance with a broad spectrum of considerations and circumstances to bridge the gaps on its linkage balance sheets in foreign currency, by the use of derivative financial instruments (interest swaps and options).

Sensitivity and fair value calculations for the transactions have been done with the aid of a professional, outside body. In the note in the financial statements relating to this topic, the fair value of the financial instruments has been taken according to a majority of fair values from the trading rooms of the banks. The values presented in the valuations are not necessarily identical, this being due to the different discount rates employed – although the level of variation between the values is negligible.

**Sensitivity of the linkage balance sheet**

The sensitivity analysis has been performed on the foreign currency items and on shekel items that are CPI-linked (data in thousands of NIS):

	-10%	-5%	Unchanged	5%	10%
<u>Assets</u>					
Cash and cash equivalents	178,546	186,384	194,221	202,059	209,896
Long-term investments	45,372	47,892	50,413	52,934	55,454
Tenants, accounts receivable and other debit balances	261,645	275,966	290,286	304,606	318,927
Investments in affiliates	186,683	197,054	207,425	217,796	228,168
Long-term investments	21,993	23,215	24,437	25,659	26,881
Long-term loans and debit balances	136,289	143,860	151,432	159,004	166,575
	830,528	874,371	918,214	962,058	1,005,901
<u>Liabilities</u>					
Short-term credit from banks and other credit granting institutions	67,921	67,921	67,921	67,921	67,921
Trade and other payables and other credit balances	547,424	573,717	600,009	626,301	652,594
Debentures	7,328,007	7,710,266	8,092,525	8,474,784	8,857,043
Liabilities to financial institutions and others	7,060,409	7,452,654	7,844,899	8,237,144	8,629,389
Deposits from tenants	60,376	63,730	67,084	70,438	73,792
Liabilities for employee rights upon retirement	259	259	259	259	259
Convertible debentures redeemable for subsidiary's shares	421,321	444,727	468,134	491,541	514,947
	15,485,717	16,313,274	17,140,831	17,968,388	18,795,945

The Company places emphasis on maintaining the correlation of the currency of its assets with the currency of its liabilities and consequently the balance sheet exposure is proportional to the geographical exposure of the Company's operations.

Presented below are the fair values of the amounts of the Group's core agreements (leases) (in thousands of NIS):

The fair value is the revenue cash flows from long-term leases capitalized at the market interest rate.

Lease currency	Fair value	Sensitivity to changes in the exchange rate				Sensitivity to changes in FC interest for capitalization			
		+5%	+10%	-5%	-10%	+5%	+10%	-5%	-10%
USD	3,896,482	194,824	389,648	(194,824)	(389,648)	(50,526)	(100,276)	51,316	103,437
CAD	4,342,248	217,112	434,224	(217,112)	(434,224)	(51,983)	(104,553)	52,721	105,054

The amounts in brackets denote a reduction in the fair value of the amounts of the leases.

The Company also has revenues in euros, but these are negligible and its exposure to the currency is not material.

Presented below is a sensitivity analysis of the securities that are held by the Group (in thousands of NIS):

The figures in brackets denote a reduction in the fair value of the securities portfolio.

Securities currency	Fair value	Sensitivity to changes in the exchange rate/share price			
		+5%	+10%	-5%	-10%
USD	899,940	44,997	89,994	(44,997)	(89,994)
CAD	177,275	8,864	17,228	(8,864)	(17,228)
EUR (investment in affiliate)	1,822,573	91,129	182,257	(91,129)	(182,257)

Presented below are the fair values of the long-term liabilities to financial institutions and others that are secured by income-producing properties ("mortgages") (in thousands of NIS):

The figures in brackets denote a reduction in the fair value of the indebtedness.

In the light of the fact that the Group has a surplus of assets over long-term liabilities denoted in foreign currency, the exposure to changes in the fair value of the mortgages is offset against the changes in the fair value of the assets, except for that portion of the assets that are financed from shareholders' equity.

Mortgages in euros:

Fair value	Sensitivity to changes in the exchange rate				Sensitivity to changes in euro interest			
	+5%	+10%	-5%	-10%	+5%	+10%	-5%	-10%
279,639	13,972	27,955	(13,972)	(27,955)	(2,637)	(5,264)	2,671	5,386

Mortgages in US dollars:

Fair value	Sensitivity to changes in the exchange rate				Sensitivity to changes in U.S. interest			
	+5%	+10%	-5%	-10%	+5%	+10%	-5%	-10%
2,163,232	108,161	216,322	(108,161)	(216,322)	(33,828)	(159,869)	33,828	59,869

Mortgages in Canadian dollars:

Fair value	Sensitivity to changes in the exchange rate				Sensitivity to changes in Canadian interest			
	+5%	+10%	-5%	-10%	+5%	+10%	-5%	-10%
4,572,706	228,635	457,270	(228,635)	(457,270)	(53,875)	(107,006)	54,626	110,017

Presented below is a sensitivity analysis of the fair values of the Group's debentures (in thousands of NIS):

The figures in brackets denote a reduction in the fair value of the Company's liabilities.

Debentures in Canadian dollars:

Fair value	Sensitivity to the exchange rate				Sensitivity to changes in Canadian interest			
	+5%	+10%	-5%	-10%	+5%	+10%	-5%	-10%
1,509,106	75,455	150,912	(75,455)	(150,912)	(20,113)	(40,225)	20,113	40,225

The debentures in Canadian dollars are those of a consolidated Canadian subsidiary.

Capitalized according to the relevant interest curve.

In light of the fact that the Group has a surplus of assets over long-term liabilities denoted in Canadian dollars, the exposure to changes in the fair value of the debentures is offset against the changes in the fair value of the assets, except for that portion of the assets that are financed from shareholders' equity.

Debentures in U.S. dollars:

Fair value	Sensitivity the exchange rate				Sensitivity to changes in U.S. interest			
	+5%	+10%	-5%	-10%	+5%	+10%	-5%	-10%
2,731,487	136,573	273,146	(136,573)	(273,146)	(50,138)	(100,276)	50,138	100,276

The debentures in U.S. dollars are those of a consolidated U.S. subsidiary.

Capitalized according to the relevant interest curve.

In light of the fact that the Group has a surplus of assets over long-term liabilities denoted in U.S. dollars, the exposure to changes in the fair value of the debentures is offset against the changes in the fair value of the assets, except for that portion of the assets that are financed from shareholders' equity.

Debentures in U.S. dollar-linked shekels:

Fair value	Sensitivity to the exchange rate			
	+5%	+10%	-5%	-10%
667,050	33,352	66,704	(33,352)	(66,704)

Marketable debentures of the Company (debentures (Series A)).

Capitalized according to the relevant interest curve.

Debentures in euro-linked shekels:

Fair value	Sensitivity to changes in the exchange rate			
	+5%	+10%	-5%	-10%
173,771	8,688	17,377	(8,688)	(17,377)

Marketable debentures (Series B) of the Company – debentures bearing variable interest and thus not having a fair value exposure:

Capitalized according to the relevant interest curve.

Debentures in shekels:

	Fair value	Sensitivity to the CPI				Sensitivity to shekel interest			
		+5%	+10%	-5%	-10%	+5%	+10%	-5%	-10%
MARKETABLE DEBENTURES - CPI-LINKED ILS	2,476,838	123,842	247,684	(123,842)	(247,684)	(34,963)	(69,785)	34,963	69,785
MARKETABLE DEBENTURES - NOMINAL	653,250	-	-	-	-	(9,794)	(19,416)	9,794	19,416
PRIVATE DEBENTURES - CPI-LINKED ILS	379,556	18,977	37,954	(18,977)	(37,954)	(2,128)	(4,238)	2,128	4,238
TOTAL	3,509,644	142,819	285,638	(142,819)	(285,638)	(46,885)	(93,439)	46,885	93,439

Measurement of the economic value of the debenture liabilities has been done by capitalizing them in accordance with the debenture curve of the relevant country.

From time to time, the Group transacts swaps in order to maintain the linkage balance sheet correlation between its assets and its liabilities, and consequently the Group's exposure on its debenture liabilities is smaller than that shown in the table.

Presented below is the fair value for interest swap transactions from foreign currency to CPI-linked/nominal shekels (in thousands of NIS) – Hedge accounting:

The figures in brackets represent a reduction in the fair value.

FC currency	Closing date	Fair value	Sensitivity to changes in the exchange rate				Sensitivity to changes in shekel interest				Sensitivity to changes in foreign currency interest			
			+5%	+10%	-5%	-10%	+5%	+10%	-5%	-10%	+5%	+10%	-5%	-10%
CAD – Fixed interest	June 2008	(5,012)	(7,987)	(15,979)	7,987	15,979	(326)	(648)	330	665	439	871	(446)	(899)
CAD – Variable interest	December 2016	523	(4,932)	(9,854)	4,932	9,854	(4,763)	(9,519)	4,772	9,552	-	-	-	-
CAD – Variable interest	June 2018	2,799	(2,501)	(5,004)	2,501	5,004	(651)	(1,302)	653	1,307	-	-	-	-
CAD – Fixed interest	March 2021	(1,236)	(22,350)	(44,713)	22,350	44,713	(1,920)	(3,806)	1,946	3,950	2,473	4,891	(2,529)	(5,118)
TOTAL		(2,926)	(37,770)	(75,550)	37,770	75,550	(7,660)	(15,275)	7,701	15,474	2,912	5,762	(2,975)	(6,017)
USD – Fixed interest	March 2015	(3,198)	(3,057)	(6,114)	3,057	6,114	(88)	(176)	89	179	134	268	(136)	(275)
USD – Variable interest	March 2021	(24,394)	(37,861)	(75,707)	37,861	75,707	(14,901)	(29,744)	14,961	29,985	-	-	-	-
TOTAL		(27,592)	(40,918)	(81,821)	40,918	81,821	(14,989)	(29,920)	15,050	30,164	138	268	(136)	(275)
EUR – Variable interest	December 2016	(10)	(6,844)	(13,689)	6,844	13,689	(1,704)	(3,405)	1,708	3,420	-	-	-	-
EUR – Fixed interest	March 2021	(10,753)	(11,051)	(22,106)	11,051	22,106	(1,422)	(2,819)	1,447	2,923	1,306	2,590	(1,329)	(2,680)
TOTAL		(10,763)	(17,895)	(35,795)	17,895	35,795	(3,126)	(6,224)	3,155	6,343	1,306	2,590	(1,329)	(2,680)

Variable foreign currency interest swaps – No fair value exposure.

The Group's swaps are transacted in order to hedge the linkage balance sheet and to maintain the currency correlation between assets and liabilities. The calculation of the fair value of the swaps is done by capitalizing the cash flows for which the Group has commitments under the swaps where the interest that was determined on December 31, 2006 is applicable to dates in the future. With regard to swaps where the Group has variable interest commitments, the body that did the calculations employed the relevant interest curve in order to estimate the LIBOR rate for future periods.

It is hereby clarified that changes in the rate of interest could also have an additional effect on the other linkage bases to which these financial instruments are linked, such as the U.S. dollar exchange rate. The cross-effect has not been taken into account in calculating the sensitivity of the swaps.

Fair value for interest-fixing (swapping variable interest for fixed interest) transactions (in thousands of NIS) - Hedge accounting:  
The figures in brackets represent a reduction in the fair value.

Transaction currency	Closing date	Fair value	Sensitivity to changes in exchange rate				Sensitivity to changes in U.S. interest			
			+5%	+10%	-5%	-10%	+5%	+10%	-5%	-10%
USD	3/2013	3,161	157	316	(157)	(316)	830	1,660	(830)	(1,660)
USD	12/2013	631	32	63	(32)	(63)	312	625	(312)	(625)
USD	1/2014	884	44	88	(44)	(88)	316	632	(315)	(632)
USD	1/2015	2,126	105	211	(105)	(211)	1,080	2,160	(1,080)	(2,160)
USD	5/2015	822	41	82	(41)	(82)	377	754	(377)	(754)
TOTAL		7,624	379	760	(379)	(760)	2,915	5,831	(2,915)	(5,831)

Transaction currency	Closing date	Fair value	Sensitivity to changes in exchange rate				Sensitivity to changes in Canadian interest			
			+5%	+10%	-5%	-10%	+5%	+10%	-5%	-10%
CAD	5/2016	(2,146)	(106)	(213)	106	231	909	1,818	(909)	(1,818)
TOTAL		(2,146)	(106)	(213)	106	231	909	1,818	(909)	(1,818)

Fair value for interest-fixing transactions (in thousands of NIS) – Not Hedge accounting:

All options are for periods shorter than a year

Transaction currency	Fair value	Sensitivity to changes in exchange rate				Sensitivity to changes in Canadian interest			
		+5%	+10%	-5%	-10%	+5%	+10%	-5%	-10%
USD	(1,045)	(52)	(104)	52	104	631	1,263	(631)	(1,263)
USD	(1,668)	(83)	(166)	83	166	1,172	2,344	(1,172)	(2,344)
USD	(2,070)	(103)	(207)	103	207	1,563	3,126	(1,563)	(3,126)
USD	(1,020)	(51)	(102)	51	102	782	1,564	(782)	(1,564)
USD	(11,190)	(559)	(1,119)	559	1,119	6,574	13,148	(6,574)	(13,148)
TOTAL	(16,993)	(848)	(1,698)	848	1,698	10,722	21,445	(10,722)	(21,445)
EUR	3,112	155	311	(155)	(311)	2,069	4,138	(2,069)	(4,138)
TOTAL	3,112	155	311	(155)	(311)	2,069	4,138	(2,069)	(4,138)

The Group minimizes its interest exposures by taking liabilities under fixed interest terms. On occasions, depending on the market situation, the Group takes liabilities under variable interest terms until the appropriate market conditions are created, at which time, the Group will transact a fixed interest swap.

The Group also customarily performs interest-fixing transactions for the purpose of future acquisitions/issuances, so as to minimize its exposure to market changes.

Fair value of swap transactions from fixed to variable interest (in thousands of NIS):

Fair value	Sensitivity to exchange rate			
	+5%	+10%	-5%	-10%
20,635	1,031	2,063	(1,031)	(2,063)

Notes:

All the derivatives are calculated according to the known interest curve, relevant base-asset rates and the transaction currency. Presented below are the rates on which the calculation is based (year-end data)

<b>Linked interest</b>	<b>14</b>	<b>8</b>	<b>7</b>	<b>6</b>	<b>5</b>	<b>4</b>	<b>3</b>	<b>2.5</b>	<b>1.5</b>	<b>0</b>
	3.59	3.6	3.6	3.59	3.59	3.58	3.65	3.6	3.6	3.8
<b>Euro interest</b>	<b>9</b>	<b>8</b>	<b>7</b>	<b>6</b>	<b>5</b>	<b>4</b>	<b>3</b>	<b>2</b>	<b>1</b>	<b>0</b>
	4.16	4.153	4.13	4.119	4.115	4.115	4.122	4.124	4.068	4.068
<b>Canadian interest</b>	<b>10</b>	<b>9</b>	<b>8</b>	<b>7</b>	<b>6</b>	<b>5</b>	<b>4</b>	<b>3</b>	<b>2</b>	<b>0</b>
	4.459	4.413	4.363	4.317	4.264	4.178	4.2	4.177	4.186	4.186
<b>Dollar interest</b>	<b>10</b>	<b>9</b>	<b>8</b>	<b>7</b>	<b>6</b>	<b>5</b>	<b>4</b>	<b>3</b>	<b>2</b>	<b>0</b>
	5.143	5.126	5.11	5.092	5.078	5.067	5.061	5.072	5.134	5.134

### **E. Means of Implementing and Monitoring Policies:**

Those responsible for managing market risk assess, on a current and daily basis, the need to update the Company's operations in connection with the management of market risks and the Company's management discusses material matters with regard to the management of market risk on a weekly basis. The Board of Directors approves the significant aspects of the market risk management policy on a quarterly basis, in the Directors' Report (and in the same manner, changes to said policy, if and when such changes are made in the future, will require the approval of the Board of Directors).

### **13. Meetings of the Board of Directors**

In 2006, 17 meetings of the Board of Directors were held.

March 25, 2007  
Date of Approval  
Of Directors' Report

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**Chaim Katzman**  
Chairman of the Board of Directors

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**Dori Segal**  
President and Director