

Letter to Shareholders

Dear Shareholder:

Before summarising the main events associated with Telefónica's performance in 2001, I want to briefly outline the global and sector environment in which these took place in order to fully reflect the true worth of our achievements.

The world telecommunications industry is undergoing deep structural changes, which impact many aspects of the business from technology to even finance. These changes combine to form the challenge to future development known as the Information Society, which will provide operators with new opportunities for organic growth via the deployment of broadband services, allowing them to capture new customers and to enter new markets.

However, this exciting sector outlook demands business know-how and financial capabilities of operators, which not all of these possess at present. In fact, last year both customers and the equity markets responded to



this new sector situation, with the former preferring traditional operators and the latter companies with the most solid balance sheets. In both respects, Telefónica has shown itself ready to gain a competitive edge over its peers in Europe despite adverse global economic conditions.

2001 saw a significant cooling of the global economy, which the events of September 11 only made worse, resulting in lower than expected growth rates in the world's leading economies. The main Latin American economies also saw a slowdown in growth, with Argentina being particularly hard hit.

This downbeat macroeconomic backdrop heavily impacted world stock markets, which to date have suffered the third worst crisis in their history, with the main indices losing between 10% and 25% in 2001.

Telecoms stocks saw losses for the second consecutive year due not only to the worsening global economic situation, but also to the financial difficulties of many operators, including key industry players.



Telefónica was the best stock market performer in 2001 among the major European incumbent operators. Our company has emerged from the industry crisis stronger and is firmly positioned to take advantage of the opportunities that may arise from potential sector restructuring.

While in 1999 Telefónica was fifteenth in the global industry ranking in terms of stock market capitalization, at the end of 2001 it was one of the world's top ten telecoms operators, with debt levels well below those of its main European peers.

Results for 2001 showed Telefónica's ability to deliver quality earnings and cash flow growth despite the non-recurrent impact of the Argentine crisis on the company's financial statements.

Operating revenues for 2001 amounted to €31.053bn, a 9% advance on 2000. This growth together with tight cost control underpinned a 7.4% year-on-year increase in EBITDA to €12.804bn.

Operating income rose by 9.5% to €5.430bn, with free cash flow increasing 218% to close to €2.3bn. These figures mean Telefónica has the highest return on capital employed of all the leading European operators.

The Argentine crisis and lower extraordinary results caused the Group's net income to fall 15.9% to €2.107bn. Without these one-off factors net income would not have declined in this way.

More specifically, the devaluation of the Argentine peso had a negative impact of €369mn on Telefónica's Profit & Loss account and an additional negative impact of €1.424bn on equity as a result of the application of international accounting bodies' recommendations.

Telefónica's customer base, its main asset and one of the pillars of its growth strategy, currently stands at 78 million customers and the company carries out all its business lines in 17 different countries.

Total customer numbers rose 15% in 2001 with over 9.3 million net additions from the expansion of mobile telephony and from growth in fixed telephone lines in Latin America. Our mobile division closed 2001 with about 30 million customers and Latin America contributed over 21.6 million customers to the Group total.

The geographical diversification of our customer base represents a firm foundation for Telefónica and is crucial to its competitive strength. In fact, Telefónica is the only European telecoms operator that obtains close to 50% of its EBITDA outside its home country.

In 2001, this multi-domestic aspect of the company became even more entrenched. Thanks to a significant management and investment effort, Telefónica was able to anticipate the Brazilian telecoms regulator Anatel's requirements for the awarding of new licences, enabling the Group to extend its range of operations beyond the São Paulo area. Telefónica is





now in a privileged position from which to spread further throughout Latin America.

Furthermore, in 2001 Telefónica, through its mobile subsidiary, and Portugal Telecom agreed to integrate their Brazilian mobile assets, thereby creating the country's leading mobile telephony operator.

Together with Brazil, Mexico is a key part of Telefónica's Latin American strategy. In 2001 the Group made its first incursion into the Mexican market by acquiring Motorola's cellular assets. And at the beginning of 2002, the Group signed an agreement to expand its business in Mexico, providing nationwide cellular telephony coverage.

In Europe, Telefónica remains interested in the German market, where it has begun mobile telephony operations recently under the Quam brand name and has taken the necessary steps to prevent a negative impact in Italy while waiting for UMTS technology to become available.

Telefónica's strategy now and in the future will revolve around leading the digital revolution. Its main focus will be customer satisfaction, product and service innovation, geographical business diversification, content and network strengthening and a profitable growth model leading to increasing cash flows and returns.

Telefónica firmly believes that the coming together of technologies and the convergence of the communication, computer and content segments in broadband will become the catalyst to the Information Society. The company's endeavours to promote widespread use of ADSL in 2001 have put Spain at the forefront of Europe in broadband development and growth, proving it is capable of spearheading this movement in the markets in which it operates.

And at the same time we want to generate trust. For customers, trust means assuring quality and keeping our promises. For our 160,000 employees, who once again I want to thank for their efforts and dedication, trust means clarity and the opportunity for professional development. For the communities where we operate, trust means contribution and proximity and for you, the shareholder, it means returns and transparency.

On behalf of the Board of Directors of Telefónica I wish to thank you for the trust you have placed in the company.

CÉSAR ALIERTA
Chairman and CEO