

Letter from the Chairman_



José María Álvarez-Pallete
Chairman & CEO

Dear Shareholders,

It is my great honour to address you for the first time as the Chairman of Telefónica, post that I took over on April 8th with the support and trust of the Company's Board of Directors.

Let me begin by expressing my deepest gratitude and appreciation to César Alierta, my predecessor and architect of the greatest transformation in the more than 90-year history of this Company. Thanks to his vision and ability to think ahead, today Telefónica is a world leader and an example of success, leadership, growth and profitability.

We are at the beginning of a new stage full of expectations. Be certain that my ambition is to continue writing Telefónica's success story and move forward with the digital transformation of the Company. To achieve this, I have the best team in the industry, all the professionals who are part of this great Company.

This letter gives me the opportunity to update you on the results achieved in 2015 and share some thoughts about Telefónica's future.

A KEY YEAR IN CONSOLIDATING TRANSFORMATION AND RETURNING TO GROWTH

Over the last several years, Telefónica has been laying the foundation to capture the sector's growth potential, undertaking an important transformation process thanks to which the Company is now growing.

2015 has been a key year of progression along the path to profitable, sustainable, long-term growth, along with improvement in our competitive position in the major markets of Europe and Latin America, our strategic markets: Spain, Germany and Brazil.

The fruits of the efforts the Company is making as a whole are plain visible and have allowed us to return to organic growth in our major financial figures.

Revenue growth has accelerated to reach 4% year-on-year, almost doubling that achieved in 2014. This solid increase in sales is the result of better trends in Spain, an increase in average revenue per access for the second consecutive year and the firm commitment to higher-value data services.

At the close of 2015 we reached the figure of 322 million customers across the countries where we operate, increasing the number of fibre customers by 30%, tripling the number of LTE users and raising the number of smartphone and pay TV customers by 29% and 12% respectively.

Data monetisation has been and will remain the great lever to boost revenue growth. It is especially significant that in 2015, for the first time in our history, traditional revenues - access and voice - accounted for less than 50% of the total. This bears witness to a very different Telefónica where the core of our business is connectivity.

The Company has also continued to promote several initiatives aimed at increasing efficiency. Notable savings have come from synergies resulting from operation integration in Germany and Brazil and the efficiencies generated by the simplification programme being implemented across all countries. As a result, in 2015 operating income before depreciation and amortisation (OIBDA) grew by 3.6% in organic terms with a stable margin compared to last year.



“The 2015 results are very solid and are an excellent starting point from which to continue forward in our transformation”

In 2015 we also strengthened our differential asset platforms improving our position in key markets. First of all, we have progressed in the deployment of ultra-broadband with a view to building high performance networks. In Spain we have the most extensive fibre-to-the-home network with the highest number of connected customers in all of Europe; in Brazil we have reached over 17 million fibre premises passed and LTE penetration in Europe stands at 75% and 43% in Latin America.

Secondly, we are radically transforming our systems through several different initiatives such as the so-called Full Stack project. We are also working hard toward simplification and digitalisation.

Promoting the best technology platforms, including those linked to different services such as television, the Internet of Things and others, has required a significant increase in the

volume of investment in 2015. This implies that the ratio of investment over revenues amounts to 17%, the highest level in the history of the Company. Spectrum included, total investment reaches 9.6 billion euros.

Besides, operating cash flow has returned to growth in organic terms for the first time in four years, rising nearly 2% despite the significant investment effort.

As a result of all of this, in 2015 we increased underlying net profit per share by 22 cents to 1.12 euros. And the generation of free cash flow per share, excluding spectrum, was at 0.98 euros in 2015, allowing us to distribute a dividend of 0.75 euros per share as announced.

These results mean that, once again, we have been faithful to our commitments; commitments that we revised upwards last July.

As for the Company's leverage, I can tell you that we continue to increase our financial flexibility.

Considering all of this, it is safe to say that the 2015 results are very solid and are an excellent starting point from which to continue forward in our transformation and capture the opportunities offered by the digital age.

Undoubtedly, Telefónica's growth will accelerate in 2016 by leveraging greater data monetisation while maximising the efficiencies of integration and simplification and driving our innovation and Big Data capabilities, key to taking full advantage of the great potential of the digital ecosystem.

ATTRACTIVE REMUNERATION FOR SHAREHOLDERS

For another year running, Telefónica has met its shareholder remuneration commitment which has always been and remains a clear priority for this Company.

In 2016 we intend to propose a dividend payment of 0.75 euros per share. A first tranche will be paid in the second semester of 2016, in accordance with the agreement proposed to this General Shareholders' Meeting, and a second has been proposed in the second quarter of 2017. Also, in 2016 the Company intends to propose the cancellation of 1.5% of shares of the Company's own stock.

In due time, the Company will propose the adoption of the appropriate shareholders resolutions.

The remuneration announced for 2016 represents a yield of 8.1% at current share prices (9.31 euros on 08 April 2016), one of the highest yields per share among Euro Stoxx 50 companies and well above any of our competitors in the industry. This performance makes Telefónica shares a very attractive asset.



A NEW WAVE OF EXPONENTIAL GROWTH

We live in a context of constant technological disruption never before experienced in history. Digitalisation is transforming everything at breakneck speed and this trend will continue into the future at an even faster rate. The scope of technology has grown exponentially and its expansion to all corners of the world is accelerating.

But this is only the beginning. The digital disruption that will take place over the next decade will bring changes that we cannot even imagine today: the arrival of 5G, which will allow speeds and exponential response times; the connection of all objects through sensors which will spell extraordinary growth for the Internet of Things; the explosion of Big Data resulting from the sheer volume of data traffic and the amount of information being shared; and emerging trends that are starting to take shape such as augmented reality, virtual reality and artificial intelligence. This will have an impact on all sectors, radically transforming current business models.

Telecommunication companies are at the centre of all of this disruption because connectivity is the cornerstone around which everything else revolves.

At Telefónica we want to play a leading role in the industry, making this digital opportunity a reality. It is an opportunity that will create new growth possibilities around three waves: connectivity; the wave of digital services or over connectivity where much still remains to be done; and the third wave Big Data, in which we have already started to work. That is why we have built differential technology platforms, with an investment effort of nearly 40 billion euros from 2012 to 2015, which have given us the best ultra-broadband networks, the best systems and the best service platforms.

We are using these assets to build a new customer knowledge platform closely linked to Big Data. This will certainly lead to a new wave of exponential growth in Telefónica that we are going to lead because few sectors have the knowledge of their customers that the companies in our sector have today. This knowledge gives us the chance to build a new relationship with our customers, giving them control over their personal data, ensuring visibility and control of their digital life and guaranteeing transparency, privacy and security.

At Telefónica we are convinced that digital life is life itself and that technology is an essential part of being human. We provide the

connections that give people the ability to choose offering endless possibilities. This is the reason we exist and by putting people at the centre we aspire to become an OnLife Telco.

Differential platforms are the pillars on which we will build our future, offering customers a differential experience. This will allow Telefónica to continue to grow and strengthen its position in the digital ecosystem; an ecosystem that requires a level playing field to ensure the sustainability of the sector and guarantee respect for the rights of citizens, regardless of who their service provider is. Only then can we successfully address the evolution towards the new digital economy and capture its full potential.

COMMITMENT TO PROGRESS

Our Company has always been characterised by its strong commitment to development and forward-looking societies. A commitment that, beyond the direct and indirect impact of our business in creating wealth in the countries where we operate —investment, job creation and tax contributions— has materialised through a number of different programmes and initiatives down through the years.

I would like to highlight the Company's focus on digital education through the Fundación Telefónica. Thanks to these efforts we are ranked No. three in the world in terms of investment in education. We know that education is the most powerful tool with which to reduce inequality and lay the foundations for the sustained growth of societies.

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Also I would draw attention to our commitment to innovation: investment in R&D+i in 2015 has nearly reached 6.6 billion and is further strengthened by Telefónica's support of open innovation, fostering its scope of action through Open Future. This programme covers a range of initiatives focusing on entrepreneurship, innovation and investment that the Company undertakes to develop talent and which has been producing excellent results since its launch.

All these efforts establish Telefónica as a leader in innovation in the industry and in the countries where we operate.

We want to ensure access to digital life without leaving anyone behind. Reducing the digital divide thanks to the connectivity we provide and improving people's lives through innovation have become part of our corporate purpose as a responsible Company.

In 2015 Telefónica was among the nine leading companies in the world in terms of sustainability criteria according to the Dow Jones Sustainability Index (DJSI) and among the world's best telcos for its transparent management of climate change according to the Carbon Disclosure Project.

We believe that it is important to keep our different stakeholders informed about our activity and to do that we use standard publication criteria for non-financial information such as the GRI or the United Nations Global Compact.

Lastly, I would like to point out that at Telefónica we are committed to promoting a responsible business model capable of earning the trust of our customers, investors, employees and shareholders, and of the society at large.

This relationship of trust is even more relevant in the new digital world. A world where traditional models no longer apply and new rules and values are needed.

Values to respond to the demands and concerns of our stakeholders. Very clear values about what is right and what is not, what we believe in and how we behave.

All of this requires a much higher level of ambition, greater courage and being very demanding. Telefónica has to be a trusted Company, guarantor of customer security and privacy, bold in its transformation and with an open mind to interact with its environment. These are our values.

Dear shareholders, I am absolutely convinced that with our vision, strategy and values we will reach all the goals that we have set for ourselves. At Telefónica we are not satisfied with what has been achieved so far; we aspire to more in order to continue writing the success story that this Company is today. Success achieved through the efforts and dedication of all the professionals who are part of this Company.

Before concluding, I would like to thank you personally and on behalf of the Board of Directors for all the support and trust you have placed in us, especially in these new and exciting times. I am firmly convinced that together we will continue to make Telefónica a great company which gets better every day; something to be truly proud of.

Thank you very much,

José María Álvarez-Pallete
Chairman & CEO

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