

...the Executive Chairman, César Alierta, in his letter to shareholders.

César Alierta Izuel

Executive Chairman, Telefónica, S.A.

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Dear shareholder,

It gives me great pleasure to offer you a brief summary of Telefónica's business activity in 2010. Here at Telefónica, we have taken advantage of this year, a year where we have seen the global economic recovery becoming more firmly established to strengthen our position in our various markets and improve our capacity for innovation. This will enable us to make the most of the opportunities offered by the Information and Communications Technology industry.

Before going into detail, I would just like to point out that 2010 was the eighth year in a row in which we have achieved the financial objectives we committed with the market. This further establishes our position as a highly predictable and reliable company.

Sound results

Diversification was of particular importance to our results in 2010. 83% of our accesses are now outside Spain. Telefónica Latinoamérica and Telefónica Europe accounted for 68% of our consolidated Group revenues, with Telefónica España contributing almost a third of Group revenue. This year, Latin America accounted for a larger share of our results, due both to the growth of our business in the region and the increased contribution from Brazil following the acquisition of Portugal Telecom's stake in Vivo.

The increase in our customer base and the increasing contribution of the mobile-data business have driven the growth of Telefónica's revenues, which amounted to €60.7 billion, up 7.1% on the previous year. In addition, Telefónica's operating efficiency levels continue to set the benchmark for the sector, with an increase in operating income before depreciation and amortisation (OIBDA) of 14% to €25.8 billion.

Telefónica achieved record net income of €10.2 billion in 2010, up 30.8% compared to 2009. As a result, basic earnings per share amounted to €2.25, exceeding the €2.10 target set by the company.

We have continued to invest in order to ensure the company's future growth, with investment rising at a 13.6% rate over the previous year. The company is continuing to focus its investment efforts on growth and transformation projects, boosting the development of fixed-line and mobile broadband services. The total volume of investment in the year, including spectrum acquisition, amounted to €10.8 billion. This resulted in the company achieving an operating cash flow of €14.933 billion in 2010, representing 25% of the total revenue.

Prioritising shareholder remuneration

In 2010 we managed to balance a number of objectives which are often difficult to combine: meeting the commitments made to the financial community; continuing to invest to facilitate future growth; maintaining a robust financial position; and increasing returns to our shareholders.

The remuneration of our shareholders remains one of our highest priorities. In 2010, Telefónica's earnings per share amounted to 8.2%, the highest of any of the 50 largest companies in the world in terms of market capitalisation.

Based on our forecasts of robust cash flow generation during the current year, we have announced a dividend of €1.60/share in 2011, an increase of 14.3% vs. the 2010 dividend. This proposal confirms the company's commitment to prioritising shareholder remuneration in the use of cash flow and progressively increasing the dividend per share, with the objective of distributing a dividend of €1.75 per share in 2012.

The value of our size

Size is a key factor in sectors such as telecommunications. The company's focus on increasing its customer base, and the value of our customers, has resulted in a significant increase in accesses, especially in our fixed-line and mobile broadband businesses due to the rapid adoption of smartphones and our fixed-line package offers.

Our intensive commercial activity in 2010 enabled us to increase the total number of accesses by 23 million, an increase of 8.7% to almost 288 million. Telefónica is now the fifth largest telecommunications operator in the world in terms of accesses.



Telefónica's vision is to make the possibilities offered by this new digital world real

In 2010 we were involved in operations which have reinforced the scale and position of the company and will help us to continue to grow in the markets in which we operate:

- Taking control of Vivo through the acquisition of 50% of Brasilcel has made us the leading integrated telecommunications company in Brazil.
- We have taken a further step forward in our relationships with China Unicom through a new reciprocal investment. Once this agreement has been completed, Telefónica will have increased its shareholding in China Unicom to around 9.7%.
- Our acquisition of Tuenti makes us the leader of the benchmark social networking site in Spain, in particular among the youth segment. Jajah and Hansenet have reinforced our positions in global IP communications and the broadband business in Germany.
- We have obtained a licence to operate in the mobile market in Costa Rica and acquired spectrum -a key asset in our sector- in Germany, Brazil and Mexico.

Our size and our strategic alliances with China Unicom and Telecom Italia have positioned us as a global leader with a combined customer base of over 730 million customers; this makes us ideally positioned to take full advantage of the opportunities offered by the new digital world.

Growth opportunities in the new digital world

The digitalisation of the world is going to go further than merely our need to communicate with each other and to always be connected. The scope of our market has increased enormously due to the most important and valuable opportunity for our industry: the digitalisation of the real economy. Many sectors such as finance, health, government, education and entertainment are demanding new digital applications and services so that they can achieve higher levels of quality, speed and ease of use, anytime, anywhere. All the experts agree, the growth prospects for this new digital world are extremely positive.

In Telefónica we are very aware of this great opportunity, which we can divide into four main pillars: an increasing number of customers; a larger number of devices with even more advanced capabilities; the proliferation of applications and services making people's lives ever easier; and a very likely explosion in traffic on new communication networks.

There are still major growth opportunities for communication services, as is shown by the forecasts of 6% annual growth in accesses worldwide from 2010 to 2013. The driver of this growth will be mobile accesses and broadband, both mobile and fixed, which are expected to grow by 46% and 9% respectively.

The growth in customers will be accompanied by a wide-range of devices connected to the Internet. These devices will be more powerful, cheaper and easier to use. And they will connect both people and machines. It has been forecast that there will be 20% average annual growth in personal devices sales over the period 2010-2013. This growth will be based on increased demand for smartphones and tablets.

These devices will also be the catalysts for new demands for applications and services; for example, to be able to pay using a mobile phone anywhere or to receive a remote medical diagnosis.

This highly likely scenario will bring with it an exponential growth in broadband data traffic, both fixed and mobile. It has been estimated that there will be twice as much data traffic in 2013 as in 2010, and that this will largely be due to the increasing amount of video online.

In short, we can conclude that Telefónica is operating in an industry with very positive growth prospects. And I can assure you that we are, and will continue, taking full advantage of this opportunity.

Telefónica anticipates the future

Telefónica's vision is to make the possibilities offered by this new digital world real, and to be one of the leaders in this area. One of the steps we took in 2010 to get ahead of our competitors was the creation of seven global product and service development units, covering cloud computing, eHealth, financial services, M2M (machine-to-machine connections), video and digital home, applications and security. These units are the pillars of a globalised innovation model which is designed to capture as much of this growth in our sector as possible.

Telefónica has developed a clear strategy for capturing all the opportunities which will be generated in this new digital world. There are two basic aspects to this strategy: growth and transformation of the company. The first is based on broadband and new services. The second will enable us to grow profitably and to maximise our efficiency. We will achieve this whilst keeping the customer at the centre of everything we do and taking advantage of our scale and diversification.

Telefónica has already started to harness the growth opportunities in the sector and this will enable us to continue developing our revenue structure. As a result, the contribution of broadband to revenues will increase from the current level of 18% to 25% in 2013, and services beyond connectivity revenues will increase from 5% at present to 9% in 2013.

However, Telefónica is not just concerned about the results achieved, but also about the way in which we achieve them. For this reason, sustainability and corporate responsibility are important parts of our strategy. This is demonstrated by the fact that Telefónica is leading the Dow Jones Sustainability Index in our sector worldwide for the second year in a row.

Telefónica's future is ever more closely linked to the economic and social wellbeing of the societies in which we operate. That is why Telefónica invests significant resources in social and cultural activities, and in promoting innovation. I would like to make a special mention of the Proniño programme, of which all our shareholders and employees can be very proud. The purpose of this programme is to eradicate child labour in Latin America by facilitating access to high-quality education for children. By 2010 we had already managed to send over 211,000 children to school, and our target is to increase this to 357,000 children by 2013.

Finally, I would like to take this opportunity to share with you our pride in being recognised in 2011 as the "most admired" telecommunications company in the world by Forbes magazine.

This is the icing on the cake for a year in which our company has not only obtained solid results, but has also strengthened itself ready for the opportunities of the future. I would like to thank you all for your support and confidence in our project. We are on the right path to become the best global communications company in the digital world.



César Alierta Izuel
Executive Chairman, Telefónica, S.A.