Telefónica's 8th Investor Conference

April 13th – 14th, 2011

Matthew Key
Chairman and Chief Executive Officer,
Telefónica Europe

Continued outperformance,
whilst seizing the digital opportunity

What am I going to tell you over the next 30 minutes? I'm going to cover Germany, UK and the other three businesses. What you should take out with my German presentation is we've now done a lot of the heavy lifting in Germany as far as investment is concerned. We've built a really good quality asset. It's flexible and gives us capability across the market.

To give you an idea, the LTE Network that we will now build, we have already got about 21,000 sites in Germany. To build a full-coverage LTE Network we think we need about 14,000 or 15,000 sites. So, the incremental sites we need are relatively limited. So, we've done a lot of the heavy lifting from an investment perspective. It's clear that we've got market momentum in Germany. I'll show you some charts that prove that, and we've really got to around delivering a fantastic customer experience and around differentiated propositions, whether that's O2o or My Handy.

The biggest challenge we've got in Germany is convincing the mass market population about our quality, as well as our value. We need to convince mass market in Germany that we are a real credible alternative to Vodafone and T-Mobile when they're selecting their communication needs.

I'll then move on to the UK. Our UK business is clearly still the standout operator in the market whether you look at it in terms of customer quality, whether you look at it at financial performance and customer experience. There are three key focuses in the UK going forward.

Number one, deliver an outstanding customer experience, but make no mistake, today we are sitting on the best customer base in the UK, and we intend to keep them. Number two, deliver value not volume; value not volume. As part of that, data monetization will be a key play for us, but we will manage the business and have been managing our business from a value perspective rather than volume perspective.

And thirdly, to create business model extensions whether that is in WiFi, mobile advertising or financial services. We've already got a great track record of doing that, and I'll show you that as part of the presentation, as well.

And the third element of the presentation will be around the other three businesses, Slovakia, Czech Republic and Ireland, and broadly over the three years going through to 2013, we should be booking them in by the end of the period for about 1 billion euros of operating cash flow.

So, let me tell you a bit more of that value not volume. You've heard it a lot from José María, Guillermo, and also myself now. One of the proof points needed on this one for this week was on Tuesday when the British retail numbers were declared and you saw, I think, maybe the worst for about 16 years. We consciously in the UK in quarter one did not chase volume because we simply didn't think there was value in the market.

Some of our competitors did chase volume. We took aconscious decision not to do it because we didn't think there was value in the market.

Reinvestment to see clearer growth, one of the most often questions you've asked me over the last few years is are you being stalled with CapEx by Madrid? Absolutely not. We're now sitting on one of the best networks in Germany, and I'll show you that.

And also in the UK, our network now can stand absolutely fantastic comparison against any other operators. And the process of learning that we went through in the backend of 2009 is now really bringing its benefits as far as managing the traffic.

Recognize we spent the right money in Germany as far as LTE spectrum was concerned, and that landscape is now set for 15 years. The spectrum has been allocated, we've got the relevant spectrum, we don't expect any discontinuities from a spectrum perspective, so we're sitting on the right spectrum really to exploit it.

We've been investing in growing our core business into peripheral areas such as media and financial services. We've done that very quietly but absolutely in parallel, though, with delivering the core business.

From an environment perspective, MTRs, we're now relatively certain about where we're going to end up, certainly in the UK and Germany, through 2014 and 2013. We will do some data roaming cuts later in the year. It will be a negative this year, but we expect, over a period of time, the usage elasticity to respond to the price reductions that we do.

From an LTE perspective, as I said, in Germany, our upgrade path is relatively simple. The fact that we've rolled out our 3G network relatively recently, the majority of the sites will be upgraded by a simple software drop rather than an engineer having to go to the site. So, the upgrade path is simple, and our opportunity as far as speed is concerned, significantly different from a 3G environment because we don't have to go and buy the sites. We've already got the sites that we need.

Industry partnerships; we will be very pragmatic in terms of how we run the business. When we think we need partnerships with other companies in the industry, we will do it. I'll go through some of the network sharing agreements we've done. When we think we need in market scale, we will create partnerships, either with other telcos or other businesses that are in associated industries.

Data monetization: we fundamentally believe, and you've heard it from all of us, that if you're going to have a sensible business model in the longer term, you need to monetize data. You can't sit on flat-top tariffs. We've already started doing that in the UK. I'll talk to you about our experience.

From a data delivery perspective, we're getting some fantastic results from 900 megahertz in the UK both in terms of coverage and capacity. And we will use a patchwork of networks, whether it's either WiFi, LTE, Femtocells or 3G.

From an overall delivery last three years, we've clearly taken market share whether it's on customer numbers, service revenue or OIBDA. How we've done it? Number one, we've adapted to customer needs, and we've delivered customer experiences in the market that we're in. So, some our competitors may moan about us doing 12-month contracts in the UK. If customers want a 12-month contract there, you need to give customers 12-month contracts.

Beyond our core business, machine-to-machine, we're utilizing the vertical, we're utilizing Jasper, we're starting to get some big wins in machine-to-machine from a customer numbers perspective. Not coming through in the customer numbers yet. When they do, we'll actually split them out so you can see the impact there.

From a cost base: network share, we've got cornerstone in the UK with Vodafone. In Ireland, you will have seen us announce a network sharing agreement with Meteor-Eircom. They were the right partner for us in the market. And in the Czech Republic, you will have seen us announce a network sharing agreement on 3G with T-Mobile. So, we've got those three markets covered.

Germany, I wish I could stand here and say we've got an agreement in Germany. We have our discussions ongoing at the moment. As we look at the next-generation network, transmission, really important and becoming more and more important. In Germany, for example, we've already created two deals with city carriers to use their fibre for backhaul, but the backhaul in terms of fibre going to the base stations would be a key element of delivering the relevant speed and quality on next-generation networks.

So, a little bit more on Germany. I'm going to go down the right-hand side first. So, we've taken two-thirds or over 60% of contract growth in the German market for the last two years. Second chart, you'll notice the word total mobile revenue growth, not mobile service revenue growth. The reason I've done that is, because of My Handy, in terms of the construction of My Handy, revenue that would have previously gone to service revenue is now going into the total revenue in terms of handset revenue line. So, if you talk about total mobile revenue, and it's relatively easy to get for the other operators, last year we grew at 7%; market, 3%; from an OIBDA perspective, 20%; and 10% growth versus the market broadly flat. So, it's clear we're already outperforming the market in Germany.

Discount brands: so, Fonic and Tchibo. We've now got over 4.5 million customers on our discount brands. And later on today, we will announce an agreement with Turk Telekom to market to the Turkish community in Germany (circa 3 million or 4 million people) under the Turk Telekom brand. So, again, very pragmatic approach if we think the Turk Telekom brand is the right brand to go to market in Germany for the Turkish community, that's what we'll do.

From a cost base, we've restructured, we've implemented that 1,100 people have left the business, about 1,300 jobs.

So, we've done that with no fuss, and you'll start to see the benefits come through in quarter two from a financial perspective. So, we've built a platform in Germany that we believe is the right platform for us for sustainable growth.

Smartphones: the good news for us is that the smartphone market in Germany is relatively underpenetrated. UK versus Germany, you can take 38% versus 17% from a penetration perspective. Not only it is underpenetrated from a customer number perspective, also on average, the smartphone customer in Germany is more profitable than the average smartphone customer in the UK. So, the fact that we didn't have the exclusivity on the iPhone in Germany, I wish that we had it, we didn't, but it hasn't been as bad as I thought it could be with T-Mobile's three-year exclusive. We're driving smartphone adoption rates, roughly 88% of the phones we sold in quarter four were smartphones, and we've now got 31% on our contract base on paid for data plans in the German market.

I just wanted to put the Connect results in here. This was Connect Magazine, not us asking somebody to an independent review. This was Connect Magazine doing an independent review themselves in the German market. Now, we've used this in some local advertising, but I don't think that the significance of the results were really picked up that widely. So, what we've done here is put the actual score for voice and the actual score for data for each of the networks. You can see if you look at the voice scores, we were number one on voice in the German market. We beat T-Mobile and Vodafone. And on data, if you look at our score, Vodafone, number one; us, number two; T-Mobile, number three.

But look at the distance between us and E-Plus from a quality perspective on data, 243 played 127. So, we've built a fantastic network in Germany. Back to my first point. The thing we've got to do is convince the German population that it is a really and we are really a valid alternative to T-Mobile and Vodafone.

From an LTE perspective, most or in fact all of us have stopped our 3G rollout at about 60%, 65% indoor coverage. Why? The topography of Germany makes it very difficult to get really broad population coverage, which is why we were so keen in spectrum auction to get the 800 megahertz spectrum. We believe that last 40% is effectively going to be a three-player market by default because economically, you can't go beyond 60% without having that 800 megahertz. So, that's a key element for us in the German marketplace.

HanseNet: so, from a HanseNet perspective, we've driven a lot of cost benefits, and we've driven a lot of network synergy benefits. So, the two networks are already being run together and all of our departments, whether it's marketing, finance, the back-end or front-end, they are now combined. We've rationalized our call centers in Germany already from HanseNet and O2, so we created the right footprint there. The key thing we now need to do is exploit it from a commercial perspective, particularly up-sell and cross-sell. So, you will have seen a change in our profile on DSL net adds, 106,000 net ads in the second half of 2010, fundamentally different to what Alice was doing before we purchased HanseNet.

And also really important point is cross-sell, third point down there. We couldn't cross-sell to the two customer bases under German law until we had one statutory company. On the 1st of April, we created one statutory company, and now we can cross-sell across the two customer bases.

And also that number, bottom right, we've now got one of our products, O2 products, or a HanseNet product, probably under the Alice brand, in 26% of German households. So, our reach in the German market is now significantly more, post the acquisition of HanseNet.

So, in summary, in Germany, market share, we will drive market share. We've underperformed in SME and SoHo. We need to improve our performance in SME and SoHo. That's very clear for us in the German market.

From the new growth engines, you will have seen MPass. MPass in Germany is a capability for our customers to transact, authorize or take purchases direct-to-bill. Three of these are in MPass, ourselves, Vodafone, and Deutsche Telekom. And you will have seen an announcement quite recently that Boku ,which is one of the major online payment providers particularly through things like Facebook, is now aligned with MPass, and all three of us have got that capability to deliver.

You will see some bumpiness in our short-term operating margins as we start to subsidize smartphones a bit more aggressively to drive penetration, but over the three years till the 2013 in terms of operating cash flow, we expect our German business to go up by circa three times, so we'll be approaching about 800 million euros by the end of the period in 2013 in Germany.

One slide on the Czech Republic which maintains and keeps a key element of our portfolio, we are in the best position to exploit mobile data takeoff because of the footprint that we've got and the capability we've got in terms of products. Smartphones have been slow to take off in the Czech Republic, no question, but we do see that happening but it's been relatively slow compared to other markets.

VDSL, we've been rolling out our VDSL network. Over 50% of our customers will have VDSL capability by the end of May and we'll start selling it in the marketplace. Economic recovery starting to come in the Czech Republic and we expect the economic recovery in the communications market to come in 2012. From a cash flow perspective, we delivered 729 million euros last year. Over the period, that will increase towards the back end of the period so circa just over to 729.

The other three businesses, Ireland, tough economic environment, but we'll generate circa 200 million of cash each year across the period, sorry, operating cash across the period.
Slovakia, we're now really on a roll in Slovakia. We came at a very simplified tariff about 18 months ago and we've grown significantly. So we went OIBDA positive in half two 2010. We will go cash flow positive in half two in 2011 and we'll hit about 1 million customers in half two 2011.

And JAJAH, you heard Trevor talk about JAJAH under his product demonstration yesterday. The capability and insight we get from Silicon Valley as far as product development is concerned but also the engineering expertise we get out of Tel Aviv is now proving to be a real strength both in Telefónica in Europe and across the rest of Telefónica.

Multinational Corporates: Julio spoke about this yesterday. We've created a new unit that is hard-line reporting up into me. We manage the top 200 multinational corporates across Telefónica from this unit. Key points of difference, as far as product is concerned, we believe we can stand toe to toe with the other operators in the market. Key point of difference is geography: fantastic outside having the leading operator in Brazil, you've heard Jose Maria talk about that. That is the key point of difference, a lot of companies going into Brazil and also outward investing from Brazil, and also the relationship with China Unicom with companies investing into China and out of China as well. Over the three-year period, we're looking to pick up circa three percentage points of market share. That equates to about 700 million euros of full contract value by 2013 incrementally.

And we talk about the UK. Clear, clear outperformance from the market perspective over the last eight years, through a changing market. Different competitors have targeted us over those eight years but we continue to outperform. As I've said, we've got three key focuses in the UK.

The first is to continue to deliver a great customer experience because we do have the most valuable customer base there at the moment. You can see bottom left which is the churn numbers, we're still market-leading on churn and recognize the difference between 2010 and 2009, a significant amount of churn was taken out of the market numbers because any churn between Orange and T-Mobile customers effectively is now not churn because they're all sitting within everything-everywhere.

Second thing I spoke about was value, not volume. Market share of OIBDA circa 40% last year. So it's clear we're driving value. We will not chase volume for the sake of it. Arguably, our biggest challenge in the UK is that some of our competitors appear to be happy with an OIBDA margin of somewhere between naught and low 20s. That's clearly not a margin we would be happy with. So that's probably our biggest challenge in the UK market, that market structure perspective from the competitive environment.

And the third point is the extension into new businesses. O2 wallet; we applied for an e-money license will apply this month for an e-money license, will deliver an O2 wallet on smart phones in the second half of 2011.

WiFi: we originally went into WiFi as a traffic offload measure. The more we went into it, the more we saw there was a really interesting business model particularly for retailers. Think of the power of WiFi if you're a retailer and you can track a customer who has opted in around your store to see shopping patterns and what he does within your store. So it's a really interesting business model in WiFi we think we've got there.

And JAJAH, Trevor spoke about JAJAH. If you came on the tube this morning, you would have seen our International Favourites propositions that we've got at the moment. So clear stand out operator, biggest challenge in the market is the competitors who appear to be happy with our sort of a naught to low 20s margin which we just don't think is acceptable in the market.

From a market phase perspective, we under-indexed in dongles, we did that on purpose. We didn't think there was value in dongles in the UK market with the pricing and I'm glad to say we were proved right. Clearly, over-indexed on iPhone and I know one of our competitors have been talking about our customers on iPhone flooding to them over the last six months. But if I tell you our iPhone churn is single-digit and not increasing despite us losing some customers around the 10 pound and 15 pound tariff which frankly we're just not interested in. We're keeping all of the medium and high-value customers. It's a single-digit churn on our iPhone base and it's not increasing.

As we go into the next phase, there'll be clear acceleration. So same as Jose Maria said, we think is a real opportunity to drive smartphone penetration further into the base. And you will have seen recently that we were voted number one or recognized as number one by J.D. Power for mobile broadband proposition and customer experience in the UK.

Mobile data and monetization of mobile data. Some of you will have seen me present this chart or a variety of this chart before. There's three things we're doing in mobile data. The first is to give great customer experience. Now, in October, you will know we implemented tiered data tariffs. We set the limit at roughly 500 megabytes. It depended on the customer, but roughly 500 megabytes. And we expected the usage profile of the customer base to move from the gray shade to the blue shade. So more and more people using more and the profile of data usage effectively moving right.

Now, the first reason we did it was we didn't want what I call über users, customers using over three gigabytes, sitting on our network. The great news is that we lost circa 8,000 users and it freed up 7% of our bandwidth on our network.

That effectively means a fantastic customer experience, for all of our smartphone customers by losing those 8,000 customers. They've gone to somebody else's network and somebody else is going to be suffering from them in terms of usage perspective.

The second key thing we need to do on smartphones is drive data, drive data revenue. Now, don't underestimate the challenge here because this is a real challenge to change what has been an industry trend of falling into a trend of increasing prices. We're still very early but the customer experience we get, we're getting, I think is very promising. So we've now got 50% of our smartphone users sitting on a capped data tariff. And we've got 3% of them reaching the threshold. So effectively, 3% are right of that 500 megabytes line drawn on the chart. Of those 3% that are reaching the threshold, 25% are buying additional bolt-on. So not material at the moment but I think very promising from an early stage perspective as far as reeducating customers to pay for data usage.

And the third element we have to do on smartphones is drive penetration. So our prepaid penetration on smartphones is only circa 12% in our customer base. What we've done to drive that is introduce some lower bundle tariffs starting at 3.0, 6.0 and 10.0 pounds. With a combination of cheaper smartphones, we think that will significantly drive a penetration of smartphones through our customer base.

So from UK perspective, there's still a large upside to come from customer profitability around smartphones. Now let me just explain quite carefully the central section. So, what we've done here is compare the specific customer as a feature phone customer versus a smartphone customer. So Matthew Key as the smartphone customer versus a feature phone customer. In 2010, before tiered data tariffs, so as a flat top data tariffs, Matthew Key as specific customer was worth circa 10 pence a month more as the smartphone customer than a feature phone customer. What is clear over the next three years is that the dynamics will move in the right direction such that in 2013 if Matthew Key changes from a feature phone customer to a smartphone customer, he'll be worth circa 2.0 pounds more per month because of tiered data tariffs, because of lower device costs and lower marginal network costs. So the customer lifetime value on customers upgrading will be significantly higher in 2013 than they are today. But it is positive today already.

Mobile advertising: this is where I move into our third element which is extension of our business model. The great news here is this is real, it's happening already, so we've got over 2 million customers opted into O2 more today. We've had a business in Soho, we've got about 50 people sitting in Soho now, today, generating mobile advertising revenue.

Now, if I tell you circa 70% of mobile advertising for the European market is placed within two miles of our Soho office, it's a fantastic position to be in, so it's an existing business. And we'll get three benefits from this; firstly, we're gaining mobile advertising revenue; secondly, our customers that are engaged will churn lower; and thirdly, the benefits that we give to customers, the rewards will cost us less.

So we've got a mobile advertising platform, it exists today, and we're delivering propositions to customers. Now, we think, to really create a compelling market we're going to need a market scale, so we'll be looking for partnerships in this space. And most people agree that mobile advertising will happen in some form or another and there will be upside.

The question everybody's really got, is Google going to take that, is Facebook going to take that are Apple going to take that, or is O2, or the operators going to take that?

We think we're off to a good start but we need market scale. But the process becomes really exciting when you bolt on our financial services capability because for us, to deliver a proposition to a customer, and him to be able to transact on his phone, and then for us to close the loop to report back to the businesses that are placing the adverts to reporting and analytics, becomes a self reinforcing circle, so we are really excited about this, we think there's big upside here for us.

A couple of specific examples of opportunities that we've already delivered. So we did something with Starbucks that was based around geo-fencing, so Starbucks asked us to deliver to a proposition to customers within half a mile of a shop. This is specific to you as a customer. So if you've opted in to O2 More, and you were in Bromley High Street within two miles of a Starbucks store, you would have got an offer that said, go into Starbucks and get 50p off a new coffee sachet it was at the time. The redemption rate was 14% compared to an online proposition, that's a fantastic redemption rate.

Very different one, Hong Kong Tourism Board contacted us. They said we've got an application sitting in the iPhone store, but not enough people are downloading it. Now, what we did was, again customers that have opted in, anybody that has phoned Hong Kong, or been to Hong Kong, we clearly knew that they were interested in Hong Kong. We delivered them a text advert very simple text advertto their phone saying, would you like to download the Hong Kong Tourism Board application from the iPhone store?, a 9% take up. Again, fantastic take up from the business in this example, the Hong Kong Tourism Board. So two very simple examples of us driving benefits to a customer, through our business partner, and through our P&L.

So in summary, over the last few years, it's clear that we've outperformed the market by the business model that we've run. We've been running on value, not volume. In the future, our cash flow growth will be driven by market share growth, data penetration, and managing return per customer. In Germany, we've done the heavy lifting. We've got the network, we've got the quality of assets. What we need to do now is go and exploit it, and go and really convince the mass market that we're a credible alternative to T-Mobile and Vodafone.

From the other three businesses, circa 1 billion euros of operating cash flow by 2013, and lastly, from a UK perspective, clearly the standout operator, we've got real proven track record now in extending our business. We're still delivering the best customer experience in the market, but clearly from the market perspective, some of our competitors are being extremely aggressive. We will not compete on volume. We'll compete on value.

So, thank you very much for listening to Telefónica Europe.