

# Telefónica

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## **Telefónica's 7<sup>th</sup> Investor Conference**

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**Guillermo Ansaldo Lutz - Chairman and  
Chief Executive Officer of Telefónica  
España**

***“Leadership as the base for the future”  
transcript***

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Well, good morning, in the next twenty minutes, I will share with you our strategy for the next three years in Spain. As our Chairman and our CFO explained in their presentation, and as you all know, two years ago in London, when we had our last Investor Conference, we were all building estimates and forecasts based on a different world and different hypothesis.

A large part of the world turned south when we're expecting to turn north, and that's particularly the case, as you know, with Spain. In fact if you look at this chart to the green bars on the left, those were the consensus that we had at that time for the years 2006 to 2010 in terms of growth of GDP and private consumption.

Unfortunately reality has been harder, and you can see, we are going through a downturn as you all know, so we were preparing ourselves two-years ago for sunny weather, and we are getting thunderstorms. But in spite of this tough environment, the delivery of operating cash flow has been strong and very consistent.

This focus on cash flow is not at the expense of any liability to growth in the future. Contrary to this, if you see, we have defended successfully our customer base, our market share. So, we will be able to recover very nicely in the next cycle, keeping that we have, the largest part of the customers and the good customers. Second, we have been able to defend our premium quality. We are recognized as the best value for the money provider, and we have the lowest ratio of complaints in the industry.

Additionally, despite the environment, we have been able to capture growth opportunities, selective ones, but double digit growth in areas like IT services and also in mobile broadband. And we have continuously, and we have continued investing in enhancing our capabilities to deliver better value proposition on the customer front. So in sum, we have been focusing both in cash flow, but also in preparing ourselves for the future and in leadership.

Now looking ahead, the key question for Spain is, when is the market to turn around? Well, we expect that we are going to have positive growth in the market, in the telecom market starting in 2011.

This will take two shapes in our opinion. First, we will have cyclical recovery, particularly in voice and particularly in mobile voice. As our CFO explained, we learned the hard way that there's a lot of elasticity between consumption and voice traffic and voice revenues. So, we expect a positive sign to turn, helping our revenues in the near future.

Second, there's going to be additional room for more penetration in fixed broadband and pay TV, since we are not reaching the limit there. And we expect reduction in line loss rates as well. That will add to the structural growth opportunities that we are already enjoying in the market.

As you know, we are growing very well in mobile broadband and also developing new services around Cloud Computing and around IT solutions as well. So, we see in the future that the market will turn positive in 2011. We believe we are hitting the bottom this year. And we see plenty of opportunities and challenges ahead.

Speaking about the challenges, in the competitive environment, we start from a unique starting point. As I mentioned before, we have sustained and defend our market share in this last year, and we have also sustained our revenue market share above 50% in the telecom services. So we have been leaders both in the good times, and also we have been leaders in the downturn.

Our pricing behavior has been very rational. Back in London, we said that our average rate per minute was going to be in the following years, when we were not predicting the crisis, between 5% and 7%. As you can see, ARPM evolution is pretty much in line with that expectation.

If you look at fixed broadband connectivity, another competitive market, we said in London that we were aiming to be between a drop of 4% and 7% decrease per year. And as you can see, we are moving along those lines. So this doesn't look like a price war in our opinion. And we are both defending market share and we both conducting a very rational pricing policy.

Regarding competition, as you know in Spain, there has been a consolidation in the market, so now we have fewer and stronger convergent players. We believe that we continue focusing on stimulating demand, which is our key priority in Spain. They will continue focusing on gaining share of wallet of the customers. And also they will keep an eye on margin as they have been doing so far.

Small players, or niche players, well, they will continue striving to gain critical mass. As you know, this is key in the telecom industry. So, we basically see that we are starting from a unique point of view. We have defended our market share, and we are very well-prepared to capture the upside from the market.

Regarding regulation in Spain, well, some areas have already been defined, providing some stability to our framework. In mobile regulation, both in the mobile termination rate we have a path for the next few years, and also we have a framework for roaming. In both areas, our exposure is pretty low. The exposure of net mobile termination rates, revenues minus expenses, is below 1% of our revenues. And in the case of roaming, our exposure is below 2%.

In the case of fixed broadband regulation, again there have been some reductions as you know in the past, in the recent past, both at the indirect access level and at the unbundling. And right now, we are below the average in Europe. So we foresee some stability in the future in these lines.

On the negative side, as you may know, there has been a new law passed in Spain, creating a new tax to finance the public TV in Spain. And this law is that we're waiting for implementation in the next few weeks, so we don't have the details exactly how it's going to be calculated. But we estimate that we'll have a negative impact between 120 million Euros and 150 million Euros starting next year.

Issues ahead: key issue is spectrum, particularly the refarming of the 900 megahertz in Spain. Again, we're waiting for guidance from the regulator, the national authority in the next few weeks. We expect to secure in that spectrum to conduct our strategy. So this is an issue that will evolve in the next few months, and

particularly in 2010. And we look to this opportunity to, again, build our competencies and also to continue developing our strategy.

In sum, we expect a more balanced regulatory framework. And we are seeing that increasingly the Spanish regulatory framework is becoming more similar to those in other key European markets. So let's review the growth strategy in Spain. As Julio Linares explained, our aim in Telefónica, is to become a truly service company, while developing strong positive emotional relationships with our customers.

That means, in Spain, three things: first, convergence. We truly believe in Spain being that we have both the fixed and the mobile business, that customer wants to be treated as a single entity, because they are a single entity. That means that they want to have a single product portfolio. And technology is a secondary issue that we have to handle with. Second, they want to be served. They want to buy and be served in a single way. And we also need to integrate operations to deliver the value proposition in a seamless way.

Second for us, this is a great opportunity next year, we're going to rebrand our fixed products under the Movistar brand. So we're going to have a single brand in Spain, Movistar. And this is not just a change of name, it's an opportunity to rebuild brand values around customer focus and customer satisfaction.

Third, we started this year to change and adapt our product portfolio. We're basically trying to simplify product portfolio and adapt the products to different needs. For example, there are some customers that want cost control. So we are building a lot of new semi-flat tariffs in the mobile business. And we are continuing expanding our fixed tariffs in the fixed business. We are bundling both mobile and fixed products.

Second, there are some customers that want simple, like SIM-only, type of offers. So we are providing that. And we have to address also, special needs like unemployed people, that is a large community unfortunately in Spain, so we are providing discounts and special offers for them. Our main goal, to summarize here, is to be number one in customer satisfaction in Spain in a sustainable way.

Let me review the mobile business. Two things here, market leadership and recovery. We are going to sustain our market leadership in Spain. We forecast that we're going to grow between 3% and 5% the access base, with sustained market share and with sustained low levels of churn.

How are we going to do this? Well first of all, we will continue working to have the best handset portfolio in Spain, not only in the iPhone. We are launching next week on exclusivity the Palm Pre, as an example of be on the EDGE on handset portfolio. We will continue fostering SIM-only offers to the low cost market. We will lead the growth in machine-to-machine leveraging our strong position in the corporate segment and particularly, we will focus on customer value instead of pure access value.

Recovery, as I mentioned before, the market will turn around and voice traffic will turn around in a very substantial way. We are focusing that despite a decrease this

year of 4% in total minutes, we will be growing at between 2% to 3% in the rest of the period between 2009 and 2012 in total minutes, voice minutes.

We will try to capture as much as possible of these new markets, through more tariffs, semi-flat tariffs on bundling, fixed and mobile voice. So in sum, we are going to defend our market leadership and we will profit from the recovery of the market.

In the fixed business, as you know, one of the concerns is the rate of loss in fixed lines. We truly believe that we are going to decrease this rate of loss. This year, we are estimating a 7% loss rate, and in the next three years, we see that that rate will be reduced between 4% from 5%. We are seeing some good early signs in this third quarter, and we expect that will be consolidated in the future.

What are we going to do here? Well first, we are going to bundle the monthly fee with voice. We are preparing a new family of tariffs that will incorporate the monthly fees. So basically, the customer will be buying a package of minutes included with the monthly fee.

Second, our key weapon here is broadband. We are going to accelerate penetration of fixed broadband, and we will have more than 50% of our customer base with broadband. And also, we will continue working with value added services to give more value for the same money. Again, we pretend here to still be, and remain, as the references in Europe at fixed line loss rates and churn.

Well, to reach to this level, so further penetration and fixed broadband, we will continue working along this three tier offer that we have. First entry offers, we have lower functionality and lower price in order to bring new customers to the broadband arena. Second, in the standard offer, we continue adding new services and adding more value for the same price. And third, we will continue expanding our premium offer based on VDSL and fibre optics where, for example, high definition is one of the key features we are starting to develop.

Here we see our goals that we will grow between 4% and 7% our customer base in fixed broadband. We will have a stable market share. And we will contain total broadband erosion combining both connectivity, ARPU and value added services.

Where we see a great opportunity right now, and in the future, is in mobile broadband. Mobile broadband, you have two type of, in our opinion, of services. One is what we call big screen. It's basically when you need connectivity from your PC. Here we are a truly believers of complementarity between mobile broadband and fixed broadband. In our own experience, with our own customers, there is almost 100% complementarity in large corporates and in medium size companies.

And in the residential segment, we just finished a very in-depth analysis of our over a million customer base. And basically, what we have found is that two-thirds of the cases have been completely complementary. And one-third, there's some kind of cannibalization, but only five percentage points are people that have dropped the fixed broadband line to keep the mobile one. And the other 25 percentage points are people that, in the future, will not be buying fixed broadband.

So here, we believe in complementarity. So we are leveraging our strength in fixed broadband to accelerate the growth in mobile broadband. That's in the big screen.

Regarding the small screen which is connectivity to our smartphones and smaller devices, well, we will foster adoption of smartphones and emerging devices like netbooks, e-readers and so on, in order to get critical mass and more people close to the experience of navigating through small devices.

And we will continue expanding our family of offers in order to have different type of prices, speeds and capacity depending on the type of usage, occasional user or heavy users in the market. Our goal here is to multiply by seven the number of customers in mobile broadband, roughly 1 million at the end of last year multiplied by seven.

In terms of ARPU, data ARPU excluding SMS, will account for 20% of our mobile ARPU. Again here, we will lead from the beginning. And this is a great growth opportunities. And speaking of growth opportunities, I'd like also to mention pay TV. Pay TV, our goal here is to double our customer base, roughly 600,000 customers at the end of last year, 1.2 million at the end of 2012.

What we are we doing here? Well basically, we are paying much more attention and resources to content. We are reviewing our content offer. Recently we have included in our offer, without increasing the price to our customers, Gol TV, which is the main channel for football in Spain, with fantastic results in September. And we will continue working on those lines. We have included Gol TV in standard and high definition, so we are starting to develop our high definition portfolio.

Again here, we believe we can double the customer base. And speaking about other growth opportunities, in the ICT world, we will continue increasing market share in desktop management; this is for large corporate mainly. We will become a key player in the outsourcing market. We're gaining share and we're gaining scale here. And we also enhanced our portfolio in logic securities again this is mainly for large corporates.

There are other new revenue sources, to summarize, opportunities in e-Health and mobile marketing, financial services, basically from the mobile, and service from the Cloud, which is something that is here and getting a lot of hype in the market yet to be developed. In these two categories, ICT solutions and applications related to these services, we believe we can double our revenues growing from 0.5 billion Euros to 1 billion Euros in 2012, again plenty growth opportunities in these two arenas and also in the downturn.

So, to sum up in the revenue side, three messages. First, recovery, the market will recover and that will provide growth to our top line. Second, market leadership, we have been leaders in the good times. We are leaders in the downturn. We will be leaders in the future. And third, revenue diversification, as you can see, more than 30% of our revenue mix in Spain will be linked to revenue sources that are not access and voice. So, that will give you a much more stable type of business in the future.

Our focus will be in customer satisfaction, we truly believe this is the key lever for success in the future. We will reinvent and turn around our traditional business, growing in minutes, and also reducing the loss rate in fixed telephony. Second, we'll recapture the broadband opportunity in fixed and in mobile. And third, we will continue accelerating the growth in new revenue sources.

Moving to transformation, as you know, one of our core competencies in Spain has been efficiency. And that's because we have done our homework before the crisis, as you know. Regarding human resources, between 2002 and 2009, we have reduced 30% our workforce in the business in Spain.

Any benchmark that you can see that can compare our wireline operation in Spain with our peers in Europe, even in lines per employee or even in this more creative ratio of employee per inhabitant, we are obviously leading the pack. This provides us with a lot of tailwind for us. And we are collecting the results, first we have a leaner structure. We have reduced the impact of personnel cost from 27% in 2004 to 22% in 2008. So, we have a leaner structure here.

And second, we have some positive effects on the cash flow side. The commitments that we have acquired from previous workforce are starting to be reduced in time. So that would provide more cash flow in the future, given that the homework was done before.

But this is not enough; we need to continue seeking for new efficiencies. And we have a wide array of projects, to briefly mention some of them. In operations, here the key thing is not doing things quicker; it's trying to avoid activity at all. So we have a lot of initiatives trying to reduce activity. Reduce the number of people going to the homes of our customers to reduce the volume of physical interaction.

Second, we are optimizing our outsourcing practices, and in the system and process side, doing several things. We are drastically reducing legacy IT expenditure, profiting from the group level volume that we're getting. And we are shifting resources to transformation on projects.

We are reducing by 40%, our product portfolio to reduce complexity and cost base. And we are doing much more end-to-end process optimization including the outsourced companies. In the past, we were focused only at home, now we are also optimizing both at home and in the outsource companies with very good results.

And in online, as Julio Linares mentioned, we truly believe that this is not only efficiency, it's quality. In our experience, the satisfactions and efficiency go along in online. So here we plan to multiply by three the number of online transactions that we do in Spain.

So in sum, to summarize in one ratio, if we look at the non-commercial OpEx per access, this is all the OpEx that is not linked to commercial interaction or activity, and per access, we will reduce that ratio between one and three percentage points per year between 2008 and 2012. That means good news for margins, but particularly good news for the commercial side. So being that we are going to be able to devote more resources to the customer focus activities.

And regarding network, we will continue to transform our network. In wireless, we will expand our 3G coverage and reach a 97% of population in 2012. We will increase capacity and speed as needed, using the technology that is most adequate in any time.

And in wireline, in wireline we will maximize copper capabilities through VDSL and traditional technologies. We will continue developing fibre in a selective way, trying to learn from the experience and trying to develop service as well. It's not worth it to pass fibre and connect customers with fibre if the only thing we're going to offer is speed. We need to offer high definition and more services that the fibre enabled too. So we will continue work along those lines.

In terms of numbers, in terms of loops, we will have more than 70% of our loops able to carry 10 megabytes per second or more. And we have almost 25% of or loops able to carry 25 megabytes or more.

Backbone, we are on track. We have unified all our three IP networks in a single one. And we are beefing up our networking to be able to carry all the traffic explosion that we expect to have in the near future. In sum, we will continue having the best network in Spain in terms of quality, capacity, coverage and speed.

So in efficiency, as you know, the starting point is unparalleled. Our efficiency ratio is, in 2008 was 61% which is a very good number and compares extremely well with our peers. In the future in 2012, well, we will be ahead of our peers and that is our goal, to be the benchmark, the reference in this ratio.

Regarding OpEx, we will devote, we will continue with efficiency, but we will devote more OpEx to commercial activity. More than 55% of our OpEx will be linked to customer interaction or customer activity. And regarding CapEx, we're going to devote more than 70% to growth and transformation. So with this, we will remain best in class in efficiency.

Well to sum up, on the context side, good news. We expect market recovery. We are not very sure exactly of the shape, but it will come and it will have a very positive effect on our revenues. We see plenty of opportunities ahead. On the competitive environment, it has been very rational in the downturn. We'll continue to be pretty rational in the future.

And third, we expect a reasonable and stable regulatory environment much more similar to the ones we've seen in large European countries. Regarding our strategy, it's threefold, to defend our leadership, protecting market share and thus allowing us to grow in a very positive way. Second, diversified revenue mix with more than 30% of revenues linked not to access and voice, and third more efficiency not only to protect margins but also to devote more resources to customer focused activities.

In sum, in 2012 we expect to have a single brand, of course, and that single brand Movistar, will be number one in customer satisfaction. Second, we'll continue having outstanding low levels of churn in Spain our services. We will be as now the market leader in broadband, in any access, in mobile and fixed. And we will continue being an international reference in efficiency. Thank you very much.