Telefónica January-March 2011 Results Conference Call Transcript

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Introduction

María García-Legaz - *Telefónica S.A. - Head of IR*

Good afternoon, ladies and gentlemen, and welcome to Telefónica's conference call to discuss January-March 2011 results. I am María García-Legaz, Head of Investor Relations. Before proceeding, let me mention that this document contains financial information that has been prepared under international financial reporting standards. This financial information is unaudited.

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We encourage you to review our publicly available disclosure documents filed with the relevant securities market regulators. If you don't have a copy of the relevant press release and the slides, please contact Telefónica's investor relations team in Madrid by dialing the following telephone number, +34-91-482-8700. Now let me turn the call over to our Chief Strategy Officer, Mr. Santiago Fernández Valbuena, who will be leading this conference call.

Presentation

Santiago Fernández Valbuena - *Telefónica S.A. - Chief Strategy Officer*

Good afternoon, ladies and gentlemen, and thank you for attending Telefónica's first quarter results conference call. Today I have with me Julio Linares, Chief Operating Officer, Guillermo Ansaldo, head of Telefónica España, José María Alvarez-Pallete, head of Telefónica Latinoamérica, Matthew Key, head of Telefónica Europe and Miguel Escrig, Chief Financial Officer.

During the Q&A session you will have the opportunity to ask questions directly to any of them.

Q1 11 Results Highlights: Distinctive profile

Q1 results prove a solid start to 2011, with a performance that is totally in line with our expectations, and therefore, affirms our full year guidance.

Our high diversification continues to drive our results, boosting top line growth and sustaining our best-in-class profitability.

The exposure to Latin América, and especially to Brazil, drives our superior growth profile, already accounting for 45% of our sales and OIBDA.

On the other hand, a right data offer to fully monetise the ramp-up in data adoption has led to a 19% year-on-year organic growth in mobile data revenue.

As we explained at the beginning of the year, 2011 marks a change in our commercial strategy, with an increased focus on value instead of chasing volume.

In parallel, we continued strengthening our networks and platforms to meet customers' demand.

Financial Summary

Please turn to slide number 3 to quickly review Q1 11 major financial metrics.

Reported year-on-year growth rates are positively impacted by changes in consolidation, mainly the full consolidation of Vivo, and forex.

Nevertheless, performance in organic terms remained solid.

Revenue grew steadily, by over 10% in nominal terms and 1.4% year-on-year in organic terms.

OIBDA reached close to 5.6 Billion euros, up 9% in reported terms, with a slight organic decrease. As a result, we continued to post a robust OIBDA margin, at 36.1%, showing a limited erosion year-on-year.

Operating Cash Flow exceeded the 4 Billion euros mark in the quarter, with a 4.9% year-on-year decline in organic terms, impacted by a different pace of CapEx execution versus a year ago.

Bottom line strongly impacted by higher D&A

Net income reached 1.6 Billion euros, declining 1.9% year-on year, despite the strong growth in OIBDA. This was due to several factors:

D&A increased year-on-year mainly driven by the full consolidation of Vivo and the recognition of 86 million euros in the quarter due to the amortization of Vivo's purchase price allocation. Please notice that total PPA increased 13% year-on-year. In organic terms, D&A was pretty flattish.

Profit from associates also drove net income down, mainly as a result of PT's deconsolidation from the second half of 2010 and the lower contribution from China Unicom year-on-year.

On top of these impacts, profit attributable to minority interests dragged 110 million euros from net profit in the first quarter, mainly due to change of consolidation of Vivo and the very strong performance of its earnings.

As a result, EPS reached 0.36 euros, 1.5% down year-on-year. Excluding the impact from PPAs, EPS would stand at 0.41 euros, 0.2% up vs. the first quarter of 2010.

Top line growth underpinned by Latam and broadband

Slide number 5 details our value oriented customer base and revenue growth drivers, stressing the benefits of our broad diversification.

Growth in the first 3 months of the year was underpinned by the continued expansion of our mobile base, on the back of strong growth in the contract segment, which accounted for close to 60% of net adds in the quarter and already represents 1/3 of our base.

By region, T. Latam continues to be our key growth engine, which combined with the solid performance posted by T. Europe outpaced the decline in T. España.

By services, we continue to evolve our revenue mix, increasing our exposure to the fastest growth businesses. Broadband services, including fixed and mobile, and services beyond connectivity already account for 25% of our sales, with the strong growth from these services offsetting the lower contribution from traditional voice services.

I'd also like to highlight the very positive performance of organic revenue growth excluding MTR cuts, which would stand at 2.4%.

Smartphone adoption driving mobile data growth

Smartphone demand and data usage continue posting a strong momentum, especially in Europe.

Total MBB penetration has reached 12% of our total mobile base, up 2 percentage points versus December, with significantly higher figures for both T. Europe and T. España.

The increased customer base and our data tariffs, with tiered pricing launched across markets have led to a remarkable 19% year-on-year organic growth in data revenues, in line with the growth recorded in the previous quarter, driven by the 36% increase in non-P2P SMS revenues.

On the hot topic about SMS cannibalization, it is true that there is a growing adoption of messaging applications among our customers, but thanks to the right tariff plans we are being able to monetise new usage patterns, and therefore, we are strongly growing our total data revenues. And let me stress, that P2P SMS revenues are growing 5% year-on-year in organic terms .

What is key for us and for the industry as a whole is that we are generating more revenues. The split by concepts really depends on the type of bundles and revenue allocation criteria that each player applies and therefore, on the different commercial policies of each company.

Balancing growth and profitability

Turning to slide number 7, Telefónica continued to post a very healthy OIBDA margin in Q1 11, despite increased efforts to boost contract and smartphone penetration, which drove commercial costs up and higher network costs.

This performance highlights the benefits of further cost savings initiatives, our scale and efficiency gains derived from our integrated management model, with tangible savings from global projects.

By region, I'd like to mention the good margin at T. Europe and the pretty flattish year-on-year performance in T. Latam, which partially offset the margin erosion suffered in T. España.

Q1 11 performance in-line with year-end targets

Before turning to the regions, let me stress that Q1 results are in line with our full year outlook, and as we anticipated last February, growth rates will accelerate in coming quarters, as the guidance is back-end loaded.

T. España: Continued weakness, slightly better top line performance

Let's move to our operations in Spain, where trading conditions continue to be tough, with a strong price oriented competition and no recovery in voice usage patterns.

In this context, our strategy has focused on value, with limited commercial activity in the quarter.

However, it is relevant to highlight that negative revenue trends seem to be easing, though we need additional quarters to confirm this trend. In Q1 we posted sequential improvements in revenue across businesses, mainly driven by better data growth.

Costs remained virtually frozen, with personnel expenses being the only item rising year-on-year, due to the impact of 2010 CPI. As we announced, we are working to have a more flexible labour framework and we just have the kick-off meeting negotiations with the unions.
Non-labour costs continue to decline despite the negative effect in commercial costs of the increasing weight of smartphones on our sales.

Our permanent focus on efficiency does not mean that we give up future growth. We are investing to continue enhancing our quality gap vs. peers, expanding MBB capacity and coverage, and progressively rolling-out fiber and VDSL. In the coming quarters you should expect some slowdown on CapEx growth because of different execution path vs. 2010.

Solid momentum on data across businesses

Slide 10 adds more colour to the performance by business.

In wireless, MSR continue under strong pressure, though there is a mild sequential improvement driven by outgoing MSR on the back of the double digit growth in data revenues.

Regarding ARPUs, there are two different realities:

On the one hand, the continued fierce price competition in voice is leading to lower prices but no elasticity, driving voice ARPU down. On the other hand, data ARPU is starting to get momentum, on strong MBB revenues.

In the wireline business a similar reading, voice is not recovering and broadband continues strongly affected by competition. Nevertheless, we have recorded a good performance in Data and IT revenues and both areas in which to be competitive you have to rely on differentiated quality infrastructure.

So, all in all we do not see big changes in competitive dynamics in Spain, but we continue to rely in our differential capabilities to defend our value leadership.

T.Latam: Strong growth, sustained healthy profitability

Moving to slide number 11 to review our Latin American operations.

In the first quarter, we grew our customer base by 8% year-on-year, on the back of double digit growth across the different services, with the exception of fixed access, which remained stable. This is a remarkable performance in the region and shows that the strong growth of some of our services is not cannibalizing others.

Let me also stress that 20% of our mobile customers have a contract and 44% of the net adds recorded in the quarter were also contract.

Regarding financial metrics, I'd like to highlight the strong acceleration in growth in Brazil, which has become Latam's main growth engine. On top of that, we continue to deliver a consistent performance in the Southern Region.

On the other hand, the weakness in Mexico and the lower contribution from regional projects have negatively impacted our results. If we were to exclude these initiatives in both years, organic growth would ramp-up from 2010 year-end.

And, we have been able to deliver top line growth maintaining our solid profitability, in contrast with market trends, reaching this quarter an OIBDA margin of 36.2%.

T.Latam: Solid top line across businesses

Turning to the next slide, let's look at revenue breakdown by business:

Wireless already accounts for almost two thirds of our revenues and keeps growing at double digit. The fixed business, although at a lower pace, also posted an outstanding 3% organic growth year-on-year.

Outgoing MSR recorded a very good 13% year-on-year organic increase, driven by the combination of an expanding customer base and ARPUs, with mobile data being clearly the key growth engine. The positive performance in outgoing voice contribution also should be mentioned.

Fixed revenues accelerated their growth pace in the first quarter, thanks to the increased penetration of broadband and Pay TV services. This led to a ramp-up in these revenue streams to double digit growth rates.

Brazil: Outperforming market peers

Please turn to slide 13 to review our outstanding performance in Brazil.

Two quarters after we increased our stake in Vivo, it is evident the improvement in the operating and financial performance of the Company, which has been accompanied by better results from our wireline business.

We continue to lead the wireless market, where we are further increasing our contract market share, leveraging a best-in-class data network.

And Telesp, despite weather factors affecting its commercial activity in Q1, has continued to accelerate its transformation and therefore, FBB revenues. Nevertheless, it is worth to highlight our enhanced commercial TV offer, with positive net adds for the second consecutive quarter.

Q1 total revenue growth in organic terms almost doubled the growth rate posted in 2010, while for the first time in the last five quarters we are expanding our margins in Brazil on a year-on-year basis.

All this despite the fact that synergies generation year to date has been limited. As a consequence, first quarter organic OIBDA growth reached 12% and consolidated OIBDA margin stood at 36%.

Clearly, our Brazilian operations are outperforming market peers, as MSR is showing.

Sound momentum in key operations

To finish with Latin American operations in slide 14, let me just make two comments:
In Mexico, operating trends remained similar to the previous quarter. We continue recording a strong performance in the contract segment, while the weak results in prepay drive down revenues and OIBDA.

There are some initial signs of improvement in commercial activity: gross adds grew 17% year-on-year and traffic is growing sequentially for second quarter in a row. But we need more time to see a recovery of the business here.

In the Southern region, our operations posted solid top line growth, showing an acceleration in the first quarter, with some OIBDA margin expansion on the back of higher margins in Chile and Peru.

In summary, very good growth in Latin America, benefiting again from our diversification and where Brazil continues to post a stellar performance.

T.Europe: driving market dynamics, delivering growth

Let's now turn to slide number 15.

T. Europe delivered strong financial performance in the first quarter of 2011 as it continued to implement its value over volume strategy, especially focusing on MBB, while also driving growth from new business areas.

MBB penetration continued to accelerate, reaching 27% of the total mobile base at the end of March 2011. This, coupled with improving quality mix led to a total organic revenue up 4% excluding MTR cuts, with non-P2P SMS revenue contributing with close to 3 percentage points.

OIBDA rose 6% year-on-year in organic terms due to profitable data growth and continued efficiencies across the business. As a result, OIBDA margin increased 1 percentage points on March 2010 in organic terms, exceeding 26%.

From a network deployment perspective, we are progressing well on our investment program, thus helping solid cash flow generation.

T. UK: value growth, benchmark financial performance

T. UK, as slide 16 shows, consciously took the decision not to chase volumes this quarter, but to continue generating value from the best quality customer base in a competitive market, particularly at the lower value end. Despite lower upgrades contract churn remains stable at market leading 1.1% further proving that Telefónica has the right focus in the UK market.

Contract smartphone handset sales were 82% of sales and upgrades in the quarter, increasing their penetration over total addressable base to 33%. This, together with encouraging trends in adoption of tiered data tariffs from new and existing customers led to a solid 10% year-on-year data revenue growth, which fully offset voice revenue performance, driving total revenue growth of 5%.

OIBDA margin increased 2 percentage points to 27%, mainly as a result of the lower trading activity we've had this quarter, but also due to our consistent approach to maximize customer lifetime value.

Although CapEx evolution in the first quarter does not signal trends, let me highlight here the tangible benefits we are having from spectrum refarming in the 900 MHz band, with limited additional investments.

T. Germany: Growth acceleration, leveraging integration

Let's now turn to slide number 17 to review our operations in Germany.

In the first quarter of the year, the Company posted solid commercial activity. Contract net adds were strong and accounted for 67% of total net adds in the quarter, backed by the successful adoption of MBB and further improvements in churn. MBB penetration continued to rise to 22%.

These results show the benefits from the investment in spectrum and the Company's focus on value. In parallel, the prepay segment recorded solid growth from the partner channels.

We have finalised the integration of HanseNet, resulting in further cross-selling opportunities ahead of us.

The good commercial performance is reflected in the financials. Total mobile revenues ex-MTRs ramped-up to 12%, driven by the robust evolution of data revenues, which already represent 39% of MSR. Strength in non-P2P SMS revenues continued, with growth accelerating to 32% year-on-year.

Also note that handset sales rose strongly due to "My Handy" model, which actually decouples handset subsidies from service revenues.
OIBDA margin remained stable year-on-year despite the commercial focus on contract, thanks to the Company's efforts in efficiency, with the restructuring program commenced in 2010 expected to generate further benefits from Q2.

Net Debt reduced and contained financial expenses

Turning to slide 18, I would like to highlight that we have reduced net financial debt up to 1.4 billion euros from December 2010, which has allowed for an improvement on the leverage ratio of 0.08 points to 2.42 times OIBDA including commitments as of the end of March. The decrease in financial debt is explained mainly by retained FCF, bigger interest payment versus accrual interest, FX translation of non-€ debt and positive MTM on cash flow hedges with no impact on P&L.

Financial expenses add up to 579 million euros, with marginal FX P&L. Taking into account a total average debt in the period of 55.6 billion euros, the effective cost has been 4.23%. In the coming quarters we expect an increase on the effective cost driven mainly by outstanding forward starting swaps for fixing rates in the long-term and expected increase of short term rates.

Is also to highlight the fact that we have restored Telefónica's average net debt life over 6 years, after a temporary deviation, in line with our commitments. This was achieved thanks to our balanced financing activity year to date in the bond and the bank markets, with latest refinancing of 4 billion euros on the Vivo's acquisition facility initially maturing in 2013.

Closing remarks

To recap, Telefónica started 2011 delivering a solid performance, as we capitalise on our execution skills and diversification, outpacing the continued weakness of our operations in Spain.

We have a clear commercial strategy, focused on value rather than on pure volume, with a special bias towards MBB.

Top line continues to grow at healthy rates in organic terms, underpinned by T. Latam and mobile data revenues, while we have posted a very good level of profitability.

At the same time, our strong cash flow generation is combined with our balance sheet strength.

Finally, let me reiterate again our 2011 targets, as we are fully on track to meet them.

Thank you very much for your attention. Now, we are ready to take your questions.

Q&A session

Tim Boddy *- Goldman Sachs*

Yes, thanks for the question. I wanted to ask a couple of questions on LATAM. First of all, in Mexico, I was wondering if you could add more colour, in terms of challenges you're facing in Mexico, and to the turnaround plan you have in place. That would be very helpful, I guess particularly in the prepay market where the pressure is felt.

And then secondly, in the UK, just a question around, obviously, with your slowdown in growth this quarter as you optimized value and the margin obviously is very strong, how do you see your strategy going forward? Is it sustainable to continue on this value path? Thank you.

José María Álvarez-Pallete *- Chairman and CEO Telefónica Latinoamérica*

Thanks for your question. On Mexico, during the first quarter, we still have a poor performance, basically because we are still facing the same issues that we had at the end of the previous quarter. You know that in second quarter of 2010 and in third quarter of 2010, we have eliminated some promotions, free days of traffic and micro-recharges, betting on a more rational behavior from the market. In fact, it didn't happened, and therefore, we have been reinstalling all those promotions, micro-recharges, and be back on the market.

We even back, with several traffic promotions, and we've made a significant and consistent move, and this has created tension in commercial expenses that are partly explaining in the poor performance of OIBDA in this first quarter, as we are not seeing yet revenues flowing through the P&L. It started to happen at the end of March, and now we have some good signs in April, but it is still too soon to say.

We have as well developed a significant effort in deploying our 3G network in Mexico, once we have the spectrum that we needed. And we aim to have a similar cover of our main competitor in 3G by the end of this year, or most of them, in the most significant part of the Mexican market, and that has been creating some tension as well in expenses during the first quarter of 2011. But we think that this will mitigate one of the most significant disadvantages that we have in the Mexican market, which is coverage.

We have slowed down our migration effort from prepay to postpaid, till we have a more clear picture of the soundness of our database. We have restarted that migration process at the end of March, and in April, when we are expecting to have some result.

And as a summary, the turnaround is taking longer than estimated. We have some initial positive signs, like a good level of commercial activity, gross adds were at 16% year on year. Outgoing MOU is down 19% year on year in the quarter, but in the month of March, it was 31% higher than in the month of February.

We have been able to sustain our market share in spite of all those difficulties, and the contract customers are already reaching 8% of the total customer base.

So in summary, we acknowledge that we have a weak performance in this first quarter. We have been accelerating some decisions on both commercial and in network deployment. We expect those decisions to have a significant hit in the coming quarters that should help us accelerate the turnaround.

Matthew Key – C*hairman and CEO Telefónica Europe*

Hi, Tim, it's Matthew here. Let me pick up the question. From a strategy perspective, we believe we've got the right strategy in the UK, and we would never chase value when we don't think it's there. And the reality is, the market in the UK, the High Street has been very quiet over the first quarter, no real change in that trend coming into the second quarter. And we do see a very high level of competition, where some tariffs that are being sold by some of our competitors, we certainly wouldn't want to do, because we think they'd may be value-destroying.

From an OIBDA growth perspective, what you certainly shouldn't be doing is building in sort of the 14% year on year growth through into the second quarter. Let me give you just a bit of colour on that. The two key drivers in the first quarter are, firstly, upgrades, as Santiago said, the 24% lower year on year, which clearly gives us a benefit in the quarter from an OIBDA perspective.

Three things driving that. It's the benefit of the 24 month contracts that we started doing about 18 months ago, which we said we would get the benefit with prolonged customer life. It's a little bit about the economic environment, people not wanting to commit to a new two-year contract. And thirdly, I think there's been a lack of clear differentiation from a handset driver perspective in the market.

The last thing that I should mention is termination rates. In the UK, in quarter one, we got a one-off benefit of about EUR12 million. The way the termination rates work in the UK is, you have a blended rate over the termination rate period. Our competitors in the market have actually over indexed on their revenue last year, so effectively, had to reduce their rates in quarter 1, which gave us a cost of sales upside.

In addition, in quarter two, we clearly had to make an MTR cut on the first of April, which will hit us by a similar amount in quarter two.

Tim Boddy - *Goldman Sachs*

Thank you very much.

Matthew Key – C*hairman and CEO Telefónica Europe*

Okay, thanks, Tim.

Georgios Ierodiaconou - *Citigroup*

Yes, good afternoon. I have two questions, please. The first one is regarding the full year guidance you gave in Madrid for 2% to 4% on OIBDA growth. Looking out at the first two years you did less than 1%. This year, best case scenario is around 2%, probably lower. So that means you need 5% to 6% at least next year, in order to get to the bottom end of that guidance, that is it still valid, and if that's the case, can you give us some colour onto what's going to drive the EBITDA acceleration next year?

And my second question is on the domestic mobile strategy. When France Telecom reported results, they reported higher commercial expenses, and they seek now that's something that could continue. I believe during the Investor Day, you've seeking out the potential to reduce subscriber acquisition costs. Do you think that would be possible if Orange and maybe some of the other competitors remain aggressive on subsidies? Thank you.

Julio Linares - *Telefónica S.A. – COO*

This is Julio Linares. Regarding your first question, I have to refer to the updated guidance that we provided in London in our last Investors' Conference. And as you know, there, we referred to OIBDA margin and we talked about upper 30s with limited erosion. And that's the reference for our OIBDA margin guidance today.

Guillermo Ansaldo - *Chairman and CEO Telefónica España*

Georgios, this is Guillermo Ansaldo, taking up the second question, regarding the domestic mobile market. Yes, in London, I mentioned that our strategy is to, along the next three years, to gradually move from the commercial expenditure in mobile from pure acquisition, more to retention, and that's a gradual movement. Depends, obviously, on the different moments of the market and it's also segmented across different type of client, customers, classes, sorry.

So we started to do so. Obviously, we had to keep an eye on the market, and be very pragmatic, and we are already doing that, trying to protect the customers that have the largest customer life value, and in order to produce the better value for the Company.

María García-Legaz - *Telefónica S.A. - Head of IR*

Next question, please.

Paul Marsch - *Berenberg Bank*

Yes, hi, I've got two questions. Firstly, on SMS trends, in Spain, SMS ARPU seems to have fallen significantly from last year's level of about EUR1.80 per calendar month to

EUR1.60 in the first quarter. Now, looking back at last year's first quarter, there was a similar fall in the first quarter from the EUR2.00 level, and I'm just wondering what the reason is for that reduction that seems to happen each first quarter. Last year, it was then stable through the rest of the year.

And just following on from that, there's a clear reversal of SMS ARPU in the UK and also in Germany, with SMS reversing from year-over-year growth in Q4 to year-over-year declines in Q1. And I'm just wondering if you can maybe cast some light on that, given some of the concerns that have been raised by other operators, that smartphones and instant messaging are cannibalizing SMS traffic and revenues.

Guillermo Ansaldo - *Chairman and CEO Telefónica España*

This is Guillermo, taking up; let me see if I understand the question regarding SMS. Obviously, SMS overall revenues or ARPUS are following the overall macroeconomic conditions, and some trends based on the different activity and different substitutes.

However, when you take into account SMS and the premium SMS, the premium SMS, which put some noise in the series quarter-on-quarter, was affected by the level of activity of contests that we have in the market, and also, in changes in regulation last year. So that's placing some noise.

So the trend is similar this quarter to the other one, as you mentioned before, and there's no particular thing that happens one quarter. Very strong quarter-to-quarter, depending on changes in regulation, which happened more than one year ago, so that has made some noise in the comparison, and some trends in the market. But it's basically the same path, there's no news there.

Matthew Key - *Chairman and CEO Telefónica Europe*

Hi, Paul, it's Matthew. Let me pick up your SMS point. Let me talk about the UK, because I know there was some questions around certainly the level of activity. And your underlying question, in terms of are we seeing a shift to IP messaging, absolutely not. We're not, including in the UK market things like Blackberry Messenger, and what's happened, Facebook, etc., have been around for a while. Our SMS per customer year on year is actually up 16%.

I think what you might be looking at is the ARPUs on SMS, recognizing in quarter one we had a voluntary reduction in termination rates on SMSs, across all the networks. We took the termination rate down from 3 pence to 2 pence. No OIBDA impacts. It's actually offset in cost of sales, because you would get the benefit on the other side. So that may be what you're looking at, but we're certainly seeing no shift in customer behavior to IP type messaging.

Paul Marsch - *Berenberg Bank*

That's great. Thank you.

Julio Linares – *Telefónica S.A., COO*

This is Julio Linares. Just to give you some more information at the Group level, our SMS revenues are growing year-on-year, comparison basis, 5%. Our mobile data ARPU is increasing year-on-year basis 9.3%. And then, because total our mobile data revenues are growing at almost 19%. So that's the result that we show today, as you see, quite positive regarding the future. We believe that we will be able to keep good growth based on our current strategy, basically through our tiered pricing and bundling strategy.

Paul Marsch - *Berenberg Bank*

Thank you.

María García-Legaz - Telefónica S.A. – Head of IR

Next question, please.

David Wright - *Deutsche Bank*

Yes, hello, guys, it's David. A couple of questions. First of all, you saw very strong growth in the data and IT revenues in Spain, and I think that offset a lot of the pressure in traditional. I'm just wondering to what extent we should expect that to continue, certainly this quarter, but at that kind of run rate throughout the year. Is that valid?

And then secondly, I guess a question for Matthew. You chose to step away from the High Street in the UK because of the perception of lower activity and a little more competition. Can you just give us an update on, sort of what you're seeing so far in Q2? Is the consumer still standing back, or are you guys still standing back? Thanks.

Guillermo Ansaldo - *Chairman and CEO Telefónica España*

Hi, David, this is Guillermo. Yes, fixed data, I understand you're talking about fixed data. It has some very healthy growth during the first quarter. You have to take into account that this is the fixed business, so part of that activity is linked to sales to mobile operators, and our own mobile operator, so the net is positive, but it's not as impressive, this number, and that is a good trend, but is affected by that intercompany activity.

And in IT, it's an activity that it has a positive growth, but has, as it is, booked projects, and there's a lot of volatility quarter-over-quarter. So we see a positive pipeline, a very healthy pipeline in IT, but you have to take into account that some quarters are higher than others because the way projects are finished and accepted, and booked.

Matthew Key - *Chairman and CEO Telefónica Europe*

Hi, David. As far as the UK High Street is concerned, nothing significantly different, I don't think, in our experience in terms of Q2 versus Q1 to date. I don't think we stepped away completely from the High Street. We stepped away from where we didn't see there was value. Where we think we can drive value, we are still there.

Just to reiterate my point on upgrades, significantly lower upgrades. I'd be worried if I saw our churn increasing, but our postpaid churn is still market leading, as you can see, at 1.1%. Upgrades probably will kick up a little bit at the end of quarter 2, as we start to unwind from the first 24 month contracts that we wrote two years ago.

So the short answer is, no significant change in Q2 trends.

David Wright - *Deutsche Bank*

Okay, very good. Thanks, guys.

María García-Legaz - Telefónica S.A. – Head of IR

Next question, please.

Justin Funnell - *Credit Suisse*

In the UK business, there were quite weak core volumes. Volumes fell about 10% sequentially. I just wondered if Matthew could talk about that. Is that all the economy, or is that some cannibalization of voice by data?

Secondly, can you discuss a bit more smartphone uptake in Latam, outside your Brazil business? Are you starting to enjoy some mass market adoption of smartphones in the wider Latam region? Thank you.

Matthew Key - *Chairman and CEO Telefónica Europe*

Hi, Justin, let me pick up your first one. I think the question was around core volumes, and I guess particularly, minutes of use. The first thing is, just be careful not just to look at prepaid, and look at the consolidated number, because there is still a trend in the market of high end prepaid customers moving to postpaid.

Having said that, when you look at the combined number yes, our minutes of use Q1 on Q1 per customer down about 9%. But I think, as I said to Paul's question, the flip side of that is our SMS per customer Q1 on Q1, is up 16%.

The other thing I would say is, we are seeing some postpaid optimization of bundle usage and the level of minutes outside bundle, and in fact, the level of text outside bundle reducing a little bit in Q1.

If you strip out the minutes of use and strip out the MTRs, and look at customer spend, no significant different variance in the trend, certainly even from Q4 to Q1. Both sort of minus 2.5, minus 2.8, so very little movement on that.

So summary, minutes of use per customer, yes, it's down, SMS more than offsetting it at the moment. There is optimization, but customer spend trends not significantly changing.

José María Álvarez-Pallete - *Chairman and CEO Telefónica Latinoamérica*

Taking your question on the smartphones in Latin America, yes, we are seeing an acceleration, a take-up in the number, and the activity in the market, in terms of the smartphone growth, we have roughly more than 120% increase year-on-year. We have basically reached a level in the neighborhood of 5% smartphone over total volume of total customer. And in fact, we are seeing a significant activity and a significant increase in activity as the prices of the smartphones are heading down. We're already approaching a level close to USD 100, which is where we think the market is going to be accelerating even more.

If you judge upon the impact of all these efforts jointly with dongles in the region, we have been increasing our total broadband accesses in the region by more than 83% year on year, and that is driving up data revenue. Data revenue is posting up very solid 32% year on year growth, and we think this is a very sound trend. And as the prices of the smartphones should be heading down, these trends should accelerate.

And on top of that, trying to link this question with the previous one on non-SMS revenues, 52% of data revenues are coming from non-SMS related. So very solid trend accelerating, and volumes should be very important, very relevant in the next quarters.

Justin Funnell - *Credit Suisse*

Thank you.

María García-Legaz - *Telefónica S.A. - Head of IR*

Next question, please.

Guy Peddy - *Macquarie Research*

Yes, good afternoon, team. Just a quick question on Spain. In the presentation, Santiago, you mentioned that Spanish trends seem to be stabilizing, but you'd like to see a few more quarters before you've got any confirmation of trends. What are you actually looking for to see a more positive environment going forward, and what are the sort of key things you're going to be measuring? Thank you.

Guillermo Ansaldo - *Chairman and CEO Telefónica España*

Hi, Guy, this is Guillermo. I will take this. Yes, as Santiago mentioned, we see a better performance in the top line in this quarter, compared to the last one in several business lines, and in the overall numbers. But looking at consumer trends and the overall dynamics of the market, we believe we need to confirm these trends in following quarters.

Remember, for example, that the third quarter last year was better and the fourth one was weaker. This seems better, so it looks like we are in a situation where quarter by quarter, and also month by month, we have some volatility. There is a moody consumer trend depending on the month, on the news that we have overall, where there are some changes in consumption. And as you know, there's a very intense competitive dynamic in the market. So we need to wait, in our opinion, another quarters to have a clear trends going forward.

María García-Legaz - Telefónica S.A. – Head of IR

Next question, please.

Ivón Leal **-** *BBVA*

Hello. Good afternoon, everybody. A couple of questions on Latin America. The first thing, José María, I don't know if you could explain us what is happening to the MTRs in Mexico. I think there has been a recent ruling which actually will drive the implementation of Cofetel decision to decrease MTRs by 60% between America Móvil and the smaller operators in the market.

I don't know how this is going to affect your MTRs and how it's eventually going to affect, in the long term America Móvil competitive position in the market.

That's the first one. And the second one, I don't know if you could update us on the Telesp/Vivo integration synergies.

José María Alvarez-Pallete **-** *Chairman and CEO Telefónica Latinoamérica*

Okay, thanks, Ivón. On the new interconnection rules in Mexico, the Mexican Supreme Court decided on May 3rd that whether the new interconnection rules are clear through the legal process between the different players, the new rules, the new prices should be applied, which is, in fact, quite surprising.

These new charges represent a radical change on the rules of the game in Mexico in terms of interconnection. Current interconnection prices, in order to give you an idea, in the range of MXN 0.95, 0.85 cents, which is a similar level to most European countries, in spite of a very different penetration level.

The Mexican regulator decided a nominal decrease to MXN 0.39 cents, which is 60% decrease, but on top of that, they decided to change the tariffication from a rounding basis to a minute to a per second basis, which in fact, represent a further decrease because of the length of the calls.

This Supreme Court decision forces all players to apply this change. If, in spite of the different legal processes initiated by both Telcel and ourselves.

As you know, we are a net interconnection revenue company. We have more interconnection revenues than expenses. And our main counterparty is Telmex. We have an agreement in place with Telmex, at the initial prices of MXN0.95 to MXN0.85 cents, and therefore, everything is going to be depending on what is going to be the reaction of Telmex to this new ruling.

In the short run, such a price decrease will have a significant impact on everybody, I would guess, in the country who is a net receiver of interconnection revenues. But it is tough to quantify right now what is going to be the impact because of the pre-existing agreements, and because of the different interests of the different parties involved.

In the long run, I think that even though this decrease is too drastic and too fast, it would set up a new competitive environment, where our net prices are going to be more affordable for the new entrants, for the ones that have a lower market share, including ourselves. So in the long run, we think this is going to be positive, from a competitive standpoint. In the short run, it's going to be tough to identify, because again, the drop is too drastic and too fast.

And taking the Telesp and Vivo question, as we were trying to advance to you in London, after two quarters in a row of being very involved in both units together, we are very positive on the synergies that we are able to achieve. Once the legal process has been completed, and the new organization chart has been announced and communicated, we are really accelerating our plans.

During the first quarter of 2011, we have already accomplished significant insight, and that's why we re-affirm that the EUR2.3 billion, EUR2.7 billion synergies net present value range that we share with you that we announced at the time of the transaction, we think this minimum range. The synergies identify around three main pillars, intents of the offer, joint offer. The first one is a very intensive joint offer in the corporate segment that we are already ready to go, and that we are already sharing with our customers.

We are already analyzing our fixed wireless effort inside and outside Sao Paulo that should help us to accelerate growth in revenues and to be more efficient in terms of deployment of the more traditional products, such as voice.

In terms of platform and efficiency, in the intercompany, you know that we have this long distance code, the 15, that were shared among Vivo and Telesp with zero margin for Telesp. Now we can be much more efficient, because we are, as well, eliminating intercompany indirect taxation.

In network, joint network planning and transmission, again, we are taking advantage of all units inside and outside Sao Paulo. Data center, we are advancing, and we are working very intensively in doing the planned convergence towards Vivo, generating more synergies in terms of commercial expenses and distribution.

We are extending the contracts that we have with Open Telefónica in the remainder part of Latin America to Vivo, and that's why we have been dating some significant success in terms of ringback tones, co-branded cards, and financial services.

I'm trying to quantify a little bit all those efforts, so in order to give you an idea, we have had 27,000 more contracts with small and medium companies. We have been able to generate more than BRL100 million in the first quarter of this year from savings in network and transmission, BRL10 million in terms of hardware maintenance and IT suppliers, more than BRL17 million in new products and services, and just expanding the ringback tones in three weeks in Vivo, we have been able to reach 1.2 million new customers, new services.

So all in all, very optimistic, and that's why we have been accelerating the reorganization effort in Brazil.

Maria Garcia-Legaz - *Telefónica S.A. – Head of IR*

Next question, please.

Will Milner - *Arete*

Thanks very much. I've just got one question on Spain, firstly. The retail broadband revenue trend, obviously, pretty disappointing, going back 10%. Clearly, I guess you're still suffering from competitors offering discounts on DSL to their mobile customers. I guess the question is, if those offers don't change, if they continue to be in place in the market, what will you change in your commercial approach to address this issue? I think you did put a similar offer in place during the quarter. I'm just wondering if there's any positive signs from that, that would arrest the decline in that trend.

And then a second question, just picking up on Matthew's earlier point that he made, what is the percentage of revenues in the UK that come from out of bundle minute usage, and out of bundle SMS usage? And perhaps also, if you have those figures for Spain as well, that would be quite useful. Thanks.

Guillermo Ansaldo - *Chairman and CEO Telefónica España*

Yes, Will, this is Guillermo. Regarding your question in regular broadband, yes, of course, there is, as in previous quarters, very aggressive competition in the fixed broadband market with aggressive promotional offers.

However, on the other side, the last April 7, the increase in the ULL price has been in force, so we have start seeing some moves in the competition that are either increasing some charges, or slowing down some of the promotions. It's too early to see a trend, but we are starting to see some logical reaction to adjust their P&L. So this is not a change in trend, but it's something that is new in the market, and we need to keep an eye on that.

We are more selective on promotions. We have done less promotions in the first quarter than in previous quarters, because we want to understand in a better way, a more deeper way, are we creating value or we are not? So we have been more selective on the other side. We need to see if this increase in the wholesale prices change the shape of the dynamics.

Matthew Key - *Chairman and CEO Telefónica Europe*

Hi, Will, it's Matthew. On your out of bundle question, I think, yes, as I said, customers are certainly optimizing and managing very carefully around their out of bundle percentage, and you will have seen recently we just increased our per minute and per text rate out of bundle. The actual number out of bundle is single digit on both numbers, so both are less than 10% on both out of bundle voice, and out of bundle SMS.

Will Milner - *Arete*

Matthew, sorry, SMS usage, I guess, on ARPU, what's the percentage?

Matthew Key - *Chairman and CEO Telefónica Europe*

I don't know, Will, I don't know. Let us take it offline and come back to you.

Will Milner - *Arete*

Okay, thanks a lot.

Luis Prota - *Morgan Stanley*

Yes, hello, I have two questions. The first one is on Spain. And sorry to come back to the issue of the out of bundle and these things, but in your mobile data tariffs, your structure looks very similar to that of KPN. This is based on add-ons, rather than on data-centric bundles.

So the question is whether you are seeing in Spain any similar trends to those that KPN have mentioned? decline of bundle traffic in Spain, voice cannibalization of data, you've mentioned that you are not seeing this in the UK. But any light on what's happening in Spain, and whether you are planning to move to more data-centric bundles, would be useful, as your peers have already that kind of tariff.

And the second question is regarding your debt position, and I'm hearing some comments from credit rating agencies, kind of suggesting that your rating might be at risk if you don't cut debt substantially. So I would appreciate your thoughts on this, and whether you have any other assets on top of Atento that could be for sale. Thank you.

Guillermo Ansaldo - *Chairman and CEO Telefónica España*

Hi, Luis, this is Guillermo. Obviously, we are tracking cannibalization impacts, as in the past we were tracking fixed mobile and broadband cannibalization, and we have positive news. We are starting to track much closer cannibalization of services like SMS and data.

So far, our data indicates that revenues, there is a positive net impact, meaning that what we estimated could be a decrease in SMS is more than compensated by the revenues that we are generating in data. For example, this quarter, we have 7.6% increase year on year in data to April, so it's something that we know we have to keep track, an eye on that, and I have to track that very frequently. But as in fixed to mobile, so far, we are seeing a positive net impact on our numbers.

Miguel Escrig - *Telefónica S.A.-Chief Financial Officer*

Okay, Luis, this is Miguel, taking your question about our rating. I think that we have made good progress this quarter, just by reducing substantially our leverage ratio just in a quarter. It is true that we have been helped by FX, but also, we have been paying down both principal and accrued interest with the cash that we have been generating.

So we think that we are in line towards the requirements made especially by S&P, but this will take some time until we achieve our targets at year-end.

María García-Legaz - *Telefónica S.A. - Head of IR*

Next question, please.

Torsten Achtmann - *JP Morgan*

Good afternoon. Could you update on your progress on cost cutting in Spain? You already indicated at the presentation that you are negotiating the CPI. Can you say how far you are, and also, on the headcount reduction, have you started negotiations there?

And secondly, on Argentina, the service revenue growth seemed to have slowed down from 25% last quarter to 14% this quarter. So any specific reason for that, or could you give some more clarity around it? Thank you.

Guillermo Ansaldo - *Chairman and CEO Telefónica España*

Hi, Torsten, this is Guillermo. Regarding question in Spain and cost cutting measures in human resources, for the non-union program that we started in the last quarter of last year, that program is going on smoothly, and is hitting the targets. Regarding the union, the unionized efforts, after the Company union elections in Telefónica de España last March, the new Bargaining Committee was created, April 27, I believe. The first meeting of this committee was held on the 11th, two days ago, and in which it was discussed about different issues previously mentioned in the Investor Day in London.

So the negotiations will accelerate and take place in the next few weeks, and we'll keep you posted. But so far, we are moving according to the calendar, but there's no news to report.

José María Álvarez-Pallete - *Chairman and CEO Telefónica Latinoamérica*

Good afternoon, Torsten. Taking your question on Argentina, in fact, in the previous year, we accounted for a very big contract that we have with the government to distribute PCs jointly with our connection, and that has somehow altered the comparison.

Overall, in the first quarter, Argentina, we have a very strong quarter. Revenues in the country were up 16%, 15.8%, compared with 12.9% a year ago, which is the most comparable figure. And OIBDA is up in the country 11% compared to 10.7% a year ago, again, the most comparable figure.

Both units are doing very well. Our wireline business is growing 16% revenues, versus 11% a year ago, and 12% OIBDA versus roughly, 3% a year ago. And the wireless business is growing very nicely, 16% revenue growth, and now roughly 11% OIBDA growth, with trends being sound and very focused on value.

So in fact, in Argentina, we think that we have had a very strong quarter growth both financially and commercially, and if you were to exclude this contract that we had last year, the trends are even better than the previous year.

María García-Legaz - *Telefónica S.A. – Head of IR*

Next question, please.

James Ratzer - *New Street Research*

Yes, good afternoon. I had two questions, please. The first one was regarding your performance in Brazil, clearly, a very strong quarter, and it looks like a lot of acceleration in growth. Vivo is being driven by your changing strategy on DLD calling and using the 15 code. I wonder if you could just talk us through a little bit more what your plans are with regard to this. Are you planning to cut prices more aggressively? To what extent do you see volumes can further grow and help accelerate revenue growth in Brazil? I mean clearly, it's been a boost to TIM. Do you see a similar performance ahead for yourself?

And the second question it's regarding your Spanish broadband business. I'm still struggling a little bit with the revenue outlook on broadband. You think you're not competing fair or, it's harder to compete for new net adds at the moment, which I understand. But at the same time, we're seeing ARPUs on your existing customers actually come down at an accelerating rate.

I mean, is this a customer spinning down and bill optimizing on the fixed line as well? And if it is, could you say how much further you think this has to run from current ARPU levels? Thank you.

José María Álvarez-Pallete - *Chairman and CEO Telefónica Latinoamérica*

Well, taking your question on Brazil, Brazil as a whole posted a very strong quarter, both units performed pretty well, Telesp and Vivo. Telesp has been affected at the level of OIBDA by heavy rains, and therefore, that's what we have been doing to preserve quality and not to increase customer insatisfaction, and in fact, we are one of the very few industries or companies, if not the only one, that has been stepping out of the crisis even stronger, while revenue growth in Telesp has been positive for the third quarter in a row.

So I would say just to focus on Telesp, because in spite of the fact that we have been incurring more costs in order to preserve quality, I think that quality is going to pay back in the short run.

Taking the specific question on Vivo, in fact, Vivo posted a very solid set of results, and now it's focused on the levers that we anticipated in London, that were announced by Vivo conference call, in fact we keep focus on value. We are not fighting just the number of customers, and that's why we have been lagging behind our competitors in terms of the prepay market share in this quarter.

But in fact, we have increased significantly our market share in contract, in these last 12 months. In fact, we already have 35.5% market share in contract in Brazil, which is roughly 5 percentage points above our average market share, 40% of the net adds in the quarter have been based in contract. Therefore, we are pretty focused on gaining the bulk of the value of our Brazilian market.

Traffic is up 13% year on year, with on-net traffic growing much more than that. MOU and ARPM are practically stagnant with a very slight decrease. Service revenues growing in the neighbourhood of 15%. We have seen a great acceleration in recharges with proof that our commercial offer is attractive. And a very consistent growth in data revenues.

This proved that we have the best brand, that we have the best network, and that we are leaders in quality, and those are the levers upon with we are aiming to build on.

And that explains, as well, the difference in margins, because we are pretty focusing on getting the value of the market and the growth of the market where it really matters.

By the way, data revenue has been increasing 47%.

So very, very strong performance in a very strong and dynamic market, and we are very enthusiastic about the future.

James Ratzer - *New Street Research*

Can you talk specifically on the DLD opportunity; I mean to what extent do you think that helps to further growth ahead? Thank you.

José María Álvarez-Pallete - *Chairman and CEO Telefónica Latinoamérica*

Yes. In fact, the DLD, the domestic long distance code that we co-used by Vivo and Telesp, was owned by Telesp and used by, as well as by Vivo, with 0% margin with Telesp. All the different billings between the two companies were quite inefficient in terms of indirect taxation, and on top of, and as well, in terms of bundling their products.

So now that the restructuring process is over, and it's over just from three weeks ago, we are going to be able to compete with our closest competitors in the region in a much more efficient manner in the long distance, domestic long distance market, with less inefficiency as a whole. And therefore, we think that we would be more present on this market with more attractive prices for our customers.

But still not flowing through the P&L, as the restructuring was not over yet.

Guillermo Ansaldo - *Chairman and CEO Telefónica España*

James, this is Guillermo. Regarding your questions about fixed broadband, two things. First, regarding the ARPU variations, there is direct impact of the promotions, but not only the promotion that were put in place this quarter, but the promotions that were put in place in the past.

For example, last year, in the first quarter, we have a lot of activity on our side in promotions, one 12 month promotion, meaning that a customer will sign up for EUR19.90 per month, of fixed broadband, for 12 months, and then the price will, after 12 months, will go up to EUR40. What happens at the end of any promotion, in any company, in any situation is that a percentage of customers remains with the service provider with increased price, and some of the customers churn.

What we have seen in the past, that's why one of the things we are looking more carefully in terms of value, is that the percentage of customers that, after the promotion, the churn is higher. So the value of the promotion is more questionable than in the past.

So that's why we decelerate a little bit in the last months, in terms of putting new promotions in place, because the postmortem numbers are different, because the crisis is shaping, obviously, changing the customer behavior of our customers.

So, that impacts on our number, because we have a lots of promotions that were expiring in the first quarter, and we were not adding new promotion in higher volume to our base.

Looking to the future, besides the fact that the increase on the ULL level, as I mentioned before, remember that we are accelerating and deploying the upgrades in copper that we started last year. This means that, for example, the people that were up to 1 megabit for the same price goes up to 6 megabits, and the people that were in 6 megabits, we are moving them to 10 megabits. This is, we're trying to, for the same price, to give them more and more value, and trying to sustain a lower churn.

So I hope that's to help you to understand the dynamics of this quarter, where again, lower promotion this quarter, and a lot of promotions one year ago with behavior that was not as good as expected as in the past. I think the same is happening in the rest of the market, because we are starting to see some minor movements in the competition of trying to improve a little bit the conditions on their side, not on the customer side, because I guess they are also questioning the economics of the promotions.

María García-Legaz - *Telefónica S.A. – Head of IR*

We have time for the last question

Javier Borrachero - *Kepler Capital Markets*

Yes, good afternoon. I have a question on Germany. One, in terms of the EBITDA margins. On slide 17, you mentioned this progress in restructuring that may deliver more efficiencies in Q2. So maybe if you can comment on, to what extent we can really see EBITDA margin expansion coming from this restructure, or maybe the pressure from this commercial cost may keep them more subdued.

And also, maybe, if you can comment a bit more on the HanseNet, the cross selling opportunities with HanseNet, whether you could expect maybe some top line acceleration in coming quarters in Germany. Thank you.

Matthew Key - *Chairman and CEO Telefónica Europe*

Hi, Javier, it's Matthew. Let me pick up your point. Yes, in Santiago's presentation, he spoke about OIBDA margins. The reason the declared number has gone down is because clearly, we're now consolidating HanseNet, and it's not quite like for like versus last June, the first quarter. Once you strip HanseNet out, it's broadly flat.

The restructuring benefits will start to come through in Q2. They'll ramp up during the year, and by the end of the year, they'll get to about 3 percentage points of margin.

The other key dynamic you should see in the margin is certainly around My Handy, and the increasing proportion of My Handy, which clearly impacts service revenue as well.

From the combination of HanseNet, until we were one statutory company, German law didn't allow us to cross sell products. Now we are one statutory company, we can. So it's a major focus for us in Germany, to exploit the, certainly, the O2 base from a DSL perspective, and the HanseNet base from a mobile perspective. So we're hoping to see some results of that during the second half of the year.

Santiago Fernández Valbuena - Telefónica S.A. - *Chief Strategy Officer*

Okay, with this intervention by Matthew, ladies and gentlemen, I'd like to thank you for having attended these first quarter results from Telefónica. I wish you the best, and have a very nice weekend. We'll be holding the next conference call at the end of July.