
Letter from the Chairman



Dear Shareholders,

2004 was a milestone year in Telefónica's history in terms of management and economic-financial results, which I would like to summarize in this letter, and at the same time reiterate the optimism I expressed last year regarding our Company's growth and profitability outlook. This year we have managed to simultaneously achieve progress in growth, profitability and leadership, placing us in an unbeatable competitive position for capitalizing on the new growth opportunities offered by the telecommunications sector.

In 2004, the world economy consolidated the recovery that began in 2003, growing at a rate of 5%, the strongest pace of growth in the last three decades, accompanied by a solid increase of 10% in world trade. For the tenth year running, Spain, with a 2.7% increase in GDP, enjoyed the strongest growth of all the large countries in the European Union. The economy of Latin America, a geographical region of special importance for Telefónica's business, grew by 5.5%, the highest rate of growth in 24 years, enabling an increase in per capita income of almost 4%, and reversing the sluggish trend in PCI growth in the previous 5 years. I firmly believe that the region has laid the necessary foundations for developing certain incipient structural improvements that will bring medium-term stability and capitalize on the next economic cycle, the outlook for which is extremely positive, with average growth in the next three years forecast at over 3%.

In this global scenario, the quality of the results obtained by Telefónica in 2004, its shareholder remuneration policy and the renewed expectations of growth have been decisive in the performance of the Company's shares. In fact, last year Telefónica's shares were revalued 19.1%, bettering both its main competitors and the international telecommunications indexes of reference, such as the DJ Stoxx 600, which gained 11.9%, and general stock market indexes such as the S&P 500, DJ Euro Stoxx 50 and Ibex 35, which rose during the same period by 9.0%, 6.9% and 17.4%, respectively. It is therefore clear that Telefónica's strategy has been endorsed by the financial markets, where the Company has become a reference in the sector, an achievement without precedent in Telefónica's history, and also, in terms of stock market value, as the world's

second integrated telecommunications company and the third in the overall sector at the end of the first quarter of 2005, a substantial improvement on its fifteenth place in the ranking at the end of 1999.

I cannot think of a better way to celebrate our Company's 80th birthday. Today, Telefónica's business leadership spans beyond the limits of the sector in which it operates and, as the Chairman of this Company, allow me to share with you the feeling of enormous responsibility and pride in being part of this great business group.

2004 has undoubtedly been a memorable year for Telefónica, due to both the significant growth of the main variables in our income statement and our response to the challenges currently facing the telecommunications sector in relation to growth, innovation and commercial transformation. In this respect, Telefónica's net profit in 2004 reached the historic figure of 2,877.3 million euros, up 30.6% on 2003. This achievement acquires greater relevance if we consider that it was based not only on operative efficiency as in previous years, but also, and more importantly, on the return to growth in sales. Operating revenues increased by 6.8% from the previous year to 30,321.9 million euros. In a similar comparison excluding the exchange rate effect and the variation in the consolidation perimeter, revenues would reflect an inter-annual increase of 8.3%. The performance of this variable, which has made our results stand out from those of the other main European operators, has been based firmly on the expansion of our customer base and on the intensification of commercial initiatives. At the same time, improved operative efficiency in 2004 has enabled us to achieve the best efficiency ratios in the entire sector, with an EBITDA (gross earnings before interest, tax, depreciation and amortization) ratio to revenues of 43.6%.

These results respond exactly to Telefónica's strategic objective of generating profitable and sustainable growth, and are the result of our efforts to, firstly, improve our commercial capacities in order to expand our business and, secondly, gear our investments to growth opportunities. In fact, in 2004 more than 55% of the 3,772 billion euros corresponding to our

investments was channeled into growth projects such as the broadband business, the mobile telephony business in Latin America or UMTS technology in Spain.

The true excellence of these financial results is revealed by Telefónica's capacity to use them to generate free cash flows and boost returns on invested capital. Free cash flows increased in 2004 by 6.4% to 9,443.5 million euros, equivalent to a revenue-to-cash conversion rate of 31%. Similarly, the return on invested capital was over 12%, up by more than 4.5 percentage points on 2002. This means that we have achieved the double-figure percentage targeted for 2005 one year ahead of schedule.

The strong pace of cash generation in 2004 has enabled us to allocate 3,995 billion euros to shareholder remuneration through dividends and share buy-backs, 2.3 times the amount set aside for this purpose in 2003. This distribution of dividends, coupled with the revaluation of our shares during the year, has given Telefónica shareholders a total return of 22.5%, making the Company the best option in terms of the combination of growth and return for shareholders in the European telecommunications sector.

Today, Telefónica is much stronger than it was in the past and the excellent prospects for 2005 give us a great deal of confidence to continue developing our shareholder remuneration policy, which, from a long-term standpoint, is one of the most attractive and explicit in the sector. As a result, Telefónica's Board of Directors has proposed increasing the dividend payable in 2005 by 25%, to 0.50 euros per share and it intends to maintain this minimum dividend in the following year. It has also proposed distributing treasury stock, representing 4% of capital stock, in the proportion of one share for every twenty-five shares, in line with the treasury stock buy-back program announced in October 2003 for the 2003-2006 period.

One of the main achievements of the Company's management in 2004 was the simultaneous acquisition of BellSouth's ten mobile operators in Latin America. This operation has enabled us to incorporate more than 14.7 million new customers and further strengthen our future growth profile and scale. In this

way, Telefónica has consolidated its leadership in Latin America and has become an obligatory reference in the global mobile telephony market, since it is now the world's second mobile telephony multinational with more than 74 million customers at the end of 2004.

Telefónica's long experience has shown that leadership and growth go hand in hand in this sector. Our leading position has enabled us to strive towards our growth target with notable success, since we increased our customer base by 26.4% in 2004. This growth was mainly fuelled by the strong organic growth of Telefónica Móviles, as well as by the incorporation of the BellSouth operators. If we include BellSouth's customers in Chile and Argentina, following the acquisition of the company's operators in January 2005, the total number of customers managed by Telefónica reached 121.9 million, distributed evenly both geographically, in markets with strong growth potential, and from a business standpoint. As a result, 68% of our customers are outside of Spain and 64% correspond to the mobile telephony business.

As in previous years, I would like to draw your attention to our intense activity in Broadband business which has enabled our ADLS accesses to grow substantially this year, with the combined total for Spain and Latin America reaching 3.9 million lines, 61% more than at year-end 2003. This represents a business opportunity with clear potential for development. Its limits are hard to predict but it will transform many dimensions of Telefónica's current corporate profile: customers, products and services, operative processes, dedicated assets and, of course, financial results.

To summarize, growth, profitability and leadership have marked a key year for the Company, putting us in an optimum position to capitalize fully on the new situation in the Information and Communications Technologies (ICT) sector.

The European Union has identified the ICT sector as the main motor driving economic growth, productivity and social development, enabling it to lead the Information Society forward and achieve the new goals established in the Lisbon

Agenda. Telefónica's record in R&D and innovation is perfectly in tune with these objectives. The Company increased its investment in R&D and innovation in 2004 by 26% to 2.398 billion euros. In Spain alone, Telefónica's investment in innovation in 2004 accounted for 24% of total innovation-related investment in the ICT sector, making it the business group with the largest investment in innovation.

Telefónica has all the necessary assets to continue developing this solid growth. We have the technologies and the customers. We are leaders in our markets. We hold key positions in the new structure of the value chain in the sector. We have optimized our investments and operations. Our sound balance sheets and financial strength give us greater strategic flexibility. We have mobilized our resources and capacities around our customers. And most importantly, we have been working on our transformation for some time, anticipating the rest of the sector, because it is essential we achieve the target to which we are committed: "Being the best and biggest integrated telecommunications group in the world".

Being "the best" must respond to our leadership in the industry in terms of customer orientation, innovation, operative excellence, commitment and professionalism. Being "the biggest" means that our profitable growth and shareholder remuneration policy will make us the world's best valued operator offering integrated solutions to each customer segment.

We will continue to work hard on all these mutually supportive management priorities. In this new project, our financial stability and geographical and business deployment are no more important than our professionals, who are the best in the sector.

I would like to end by reiterating Telefónica's commitment to its customers, employees and companies, and to you, our shareholders, because you are the ones who enable us to fulfil our vision. We continue to strive to make our commitments a reality and thus justify, in the short and long term, the trust and confidence you have placed in us. We will do this by applying the best practices of Corporate Governance in everything we do, as Telefónica has always done, acting through the Board of

Directors and Control Committees, precisely as described in our Annual Report on Corporate Governance.

On behalf of the Board of Directors of Telefónica, I would like to thank you for your trust and confidence and encourage you to accompany us in this project of future growth and profitability that we are building.



César Alierta

*Chairman of the Board and
Chief Executive Officer of Telefonica, S.A.*