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Letter from the Chairman

Dear Shareholders,

I am very pleased to be writing to you again in Telefónica's Annual Report for 2003. I would like to start by saying that I am very optimistic about the outlook for Telefónica in the telecommunications industry. The sector is beginning to show unmistakable signs of recovery, thanks to the careful management that companies like Telefónica have displayed in recent years.

This turn-around is the result not only of the significant improvement in the debt levels and quality of assets in the industry, but also the renewed growth prospects for the businesses based on fixed and mobile broadband infrastructures, where management is focusing once again on the core telecommunications businesses.

In this context, the capital markets have begun to recognize the work that has been done in our industry, as reflected by the sector indices such as the DJ Stoxx 600, which gained 42.6% in 2003, well above the rise experienced by such general indices as the S&P 500, DJ Euro Stoxx 50 and Ibex 35, which rose during the same period by 26.4%, 15.7% and 28.2% respectively. In 2003 our share price rose more than the main indices, achieving a price increase of 43.2%, in line with the trend followed by telecommunications industry indexes.

The past fiscal year saw the anxiously awaited change in world economic growth. The preliminary figures seem to indicate a global pace of growth near 3% in 2003 that could pick up speed to reach a rate close to 4% in 2004, a growth level that has not been seen for the past four years. In Latin America, the faultless management exercised by Brazil's new government and the beginnings of economic recovery in Argentina have been the catalysts for the notable improvement in expectations for this fiscal year in the region, where we project a growth of 3.5% in 2004.

Spain has continued to show a stable growth rate close to 2.5%, and was not adversely affected by the overall slow growth in Europe over the past year of 0.4%. The projections for this year are optimistic with an expected growth of around 2%.

In this macroeconomic context, Telefónica achieved good operating results for the year 2003. Our operating revenues amounted to 28,399.8 million euros, a similar level to that recorded in 2002. If you take out effects of exchange rates and changes of consolidation for accounting and consolidation, revenues would have grown by 6.0%. Our operating expenses reached 16,617.8 million euros, which was 5.1% less than in the previous year in current euros.

The achievements mentioned, both in organic growth and in operating efficiencies, enabled us to attain a gross operating profit before interest, tax, depreciation and amortization (EBITDA) for the Telefónica Group in 2003 of 12,602.1 million euros, which is 7.5% higher than the figure obtained in 2002. After discounting the effects of exchange rates and the changes of consolidation, the Group's EBITDA would have grown by 12.5% over the fiscal year 2002.

Especially significant has been the strong net income growth we enjoyed in fiscal 2003: 2,203.6 million euros. This result benefited from the strong growth of all the non-operating items in the profit and loss account after the write-offs carried out in 2002. But perhaps the most outstanding financial achievement is Telefónica's cash flow generation in 2003, amounting to 8,875.0 million euros, an increase of 11.8% on 2002.

Our extraordinary free cash flow allowed us to establish the most clearly articulated dividend policy, and the only one in the medium term among the integrated operating companies in Europe, with a minimum annual dividend of 0.4 euros per share for the 2004-2006 period. This policy was reinforced by the commitment we made in October 2003 to repurchase and redeem the company's own shares for a minimum value of 4,000 million euros over the three-year period from 2003 to 2006.

In addition, I would like to emphasize that the process we put in place for the mandatory divestment in Antena 3 was also undertaken with Telefónica shareholders in mind. Our shareholders were rewarded with a paid-in-kind dividend consisting of one Antena 3 share for every 295.6 shares of



Telefónica. I am pleased to say that the initial theoretical value has improved thanks to the successful public offering of Antena 3.

In 2003, our management inevitably focused on our customers, as it will continue to do in the years ahead. During the past fiscal year we reached a milestone well ahead of our most conservative forecast: our total client base grew to some 100 million customers who honour us with their trust by using our services and products. Of these clients, more than half are users of our mobile telecommunications services. I would also like to say how proud I am to manage a multinational company that has a truly local focus. Nearly 60 million of our customers, out of the total of around 100 million, live outside Spain.

Furthermore, we achieved this organic growth in our client base during a period in which we made a number of crucial decisions, such as setting up a new strategic agreement between Terra and Telefónica, and the subsequent public bid for 100% of the share capital of Terra-Lycos. During the past year, we also completed the integration, at an operating level, of the companies of the Telefónica Data Group into our fixed telecommunications operating companies. This allowed us to refocus the role and name of Telefónica Data from a formerly product-oriented company to Telefónica Empresas, which is a customer-focused company.

Also in line with our goal of strengthening our position and focusing on our key businesses, we decided to sell our communications media assets. Therefore, to comply with legal requirements, we decided to divest ourselves of Antena 3 TV and centre our efforts on the agreement to merge Vía Digital with Sogecable. This put us in a privileged position in Spain's strongest, market leading pay TV platform, Digital +, which had 1.8 million customers as of the close of the 2003 fiscal year.

During the fiscal year 2003 our operations in Latin America were successful. In fact, our four fixed operating companies in Brazil, Argentina, Chile and Peru have, as a group, increased their operating revenues by 8.4% over 2002, and Telefónica Latin America's cash flow generation (2,474.5 million euros) grew 13.9% in constant currency terms over the previous fiscal year.

Clear proof of Telefónica's potential in Latin America is the success and credibility achieved by Telefónica Móviles in Mexico. As a newcomer to the market, Telefonica Moviles has attracted a sufficiently large number of clients to enable us to finish the 2003 fiscal year with more than three million customers. I should further point out, also in the mobile telephony area, the first important outcome of our joint venture with Portugal Telecom in Brazil. Our joint brand, Vivo, finished the year, thanks to the integration of TCO into Brasilcel, as Brazil's leading mobile operator, with over 20 million customers and a market share approaching 60% in the areas in which it operates. Vivo has more mobile telecommunications customers and a larger market share than we had in Spain as at December 31, 2003.

Our focus on Telefónica's key businesses during 2003 also enabled us to consolidate our leadership in the broadband access area, which, without question, will be one of our company's growth drivers in the medium term. We finished the year with 2,656,656 ADSL connections worldwide. The effects of our efforts in this area have been especially outstanding in Spain, where we achieved a 73.5% increase in the number of ADSL connections in 2002, closing the 2003 fiscal year with 1,660,450 broadband lines. It's also worth highlighting the growth in our ADSL lines in Latin America. At the close of fiscal 2003 these access points totalled 769,680, 69% more than at the end of 2002. Sixty-three per cent of Telefónica Latin America's ADSL customers belong to Telesp, our Brazilian operator in the State of Sao Paulo.

In mobile telecommunications in Spain, Telefónica Móviles' sales efforts and increase in market share are outstanding achievements. In point of fact, our operator finished fiscal 2003 with nearly 20 million customers, close to 7% more than at the end of 2002. That's a very good result in a country like Spain where the penetration of mobile telephony is above the European Union average (88% compared with 83% in Europe).

All in all, the fiscal year 2003 was a crucial period for Telefónica with the culmination of the restructuring of both our balance sheet and our business model, and also in terms of significant business growth during the expansion phase, such as

broadband ADSL and mobile telephony. Both aspects are complementary and are necessary to fulfil our shareholders' short-term expectations, which are focused on receiving a suitable reward for their investment. At the same time they will help prepare Telefónica to face the start of worldwide expansion that is predicted for the telecommunications industry with some guarantee of success.

Looking now towards the future, we must be aware that a structural change is taking place in the telecommunications sector, a change that will no doubt have a strong impact on the business. This change is evident in new customers' needs, in the evolution of the competitive and technological framework, as well as in the key economic parameters for managing the business.

First, clients have new and more sophisticated needs linked to the digital world, a situation that opens up new business opportunities for us and, therefore, opportunities for growth in all client segments: households, individuals, SMEs, professionals and large corporations.

Secondly, the competitive framework is also changing in significant ways. We are witnessing increasing market maturity, rising competitive intensity and the extension of the industry value chain, all of which forces us to transform and strengthen Telefónica's sales activity so that we can continue to grow.

Thirdly, innovation and the spread of the new technologies allow us to put a more flexible, efficient business model into practice, with less need for investment and resources.

Finally, this dynamic environment is affecting the basic economic parameters of our business, including the demand by the securities markets that we give greater visibility in the short term to our profits and cash generation.

In summary, the change that is under way in our industry is structural and demands a transformation of our business model. The only way to adapt ourselves successfully to this change is to make the customer the centre of our strategy and

our management. We must offer our clients innovative, differentiated solutions that respond to their needs:

For households: in addition to voice communications, digital services, multimedia entertainment and domotic applications.

For individuals: broadband services with mobility, and new premium services.

For SMEs: multimedia services and packages of solutions adapted to their businesses.

For large corporations and government bodies: advanced solutions based on new technologies and outsourcing schemes for their ICT activities.

Therefore, Telefónica's transformation is inevitable if we want to achieve our two major strategic objectives: to maintain sustained free cash flow growth and to improve the return on invested capital.

To this end, we have defined two main lines of action that are closely interrelated: the first is aimed at increasing our sales, and the second is intended to transform Telefónica into a more commercial organization, a more flexible and lean company, that will be able to attain the desired growth and obtain the maximum return on that growth.

Telefónica has an extraordinary opportunity to capture the growth that will occur in the coming years in the natural businesses of fixed broadband, mobile telecommunications and fixed telecommunications in Latin America.

In fixed broadband, Telefónica has been one of the pioneering operators in the massive deployment of ADSL, and we will continue developing this market until we make it a mass consumer market.

We are also pursuing the maximization of the future growth of mobile telephony by unlocking all the remaining potential in the mobile voice business in the short-term, and, by increasing

growth in the new data services in the medium term, which in Spain will be driven by the commercial launching throughout 2004 of services based on UMTS technology.

This growth will not come only from Spain, but also from Latin America, a region to which we are transferring the best practices of Telefónica Móviles España. Brazil and Mexico are two key markets in Telefónica Móviles' growth strategy. The combination of still low penetration levels with the latent growth potential in these countries' economies will enable us to grow at rates that are no longer seen in mature markets such as Europe.

In Latin America we also expect the fixed telecommunications business to grow. We intend to ensure this growth, retaining and expanding our client base by increasing market penetration at all levels with innovative, customized offerings for all types of clients (traffic packages, flat rates, added-value services, etc.).

To capture all this growth, we must continue, with even greater determination, with the transformation of Telefónica into a more sales-oriented company by developing our marketing and sales excellence to ensure growth and by radically refocusing the Group's operations towards commercial activities. This transformation will have to be compatible with our attainment of new goals in our evolution towards a leaner, more dynamic business model, based not only on more efficient operations, but also on less capital intensity supported by investment optimisation and greater asset turnover.

All these efforts should enable us to achieve our targets of generating more than 27,000 million euros in free cash flow over the four-year period from 2003 to 2006, and to raise the return on invested capital to double-digit figures from 2005 onward.

All in all, I think that Telefónica is in a perfect situation to take the greatest advantage of future developments while meeting its shareholders' short-term expectations. We have the financial resources needed to accomplish these goals, as reflected in the

strength and health of our balance sheet and in our high capacity for generating cash flow. We also have the best human capital in our industry, both in our home market, Spain, whose economic growth potential continues to outstrip the European Union average, and in our natural markets in Latin America, which are showing signs of recovery.

This is our commitment to our customers, to our employees, to the societies in which we are present and where we are a key part in their corporate world, and, of course, to you, the shareholders who honour us with your trust: the return on investment in Telefónica, both in the short and long term.

But immediate return, even if indispensable, is not enough for Telefónica. To us, the ability to generate sustainable confidence and trust over the long term is extremely important. And that is precisely the Telefónica Group's vision of the future: to become the trusted telecommunications company in all the Spanish and Portuguese-speaking markets. This is our goal and the long road that we have been working on for some time now. It has become our *raison d'être*, and demands ever-greater levels of rigour and fulfilment of our commitments.

On behalf of the Board of Directors of Telefónica, I thank you for the trust you have placed in the company, and I encourage you to continue to maintain that trust in this future that opens new and promising opportunities for growth and profits.



César Alierta
*Chairman of the Board
and Chief Executive Officer of Telefónica S.A.*