

CHAIRMAN'S LETTER

Dear shareholders,

Thanks to the efforts of employees and the savings of the shareholders, it has been possible to restructure the Company after several difficult years and it can now be stated that the results of these efforts are beginning to gather. Today, **Telefónica** is a financially stable, industrially active and innovative Company, providing the new services and demands of a modern country with a greater presence in the world than ever before. Statement of Profit and Loss and Balance Sheet trends, the progress of the Company's shares on the Stock Exchange and the number of telephones and new services in our country, are proof that the targets set by the present Company Management when appointed are being achieved.

We also have data showing that the general economy of our country is reflecting its improved situation on the telecommunications world; at the present time, telephone demand is much higher than in recent years. I should like the shareholders to know that **Telefónica** is presently ready for a new leap forward in its performance as a Company and in its efficiency as a public service.

A few figures will allow you to briefly understand why we can face up to the future with optimism, on the basis of the solid foundation that we have laid during these three years.

By the end of 1985 the number of telephones and lines was 14,258,928 and 9,340,458, respectively, as opposed to 12,820,190 and 8,017,695 in 1982. The number of telephones per 100 inhabitants rose from 34 to 36.6.

But qualitative changes have taken place, apart from purely quantitative developments. The degree of automation is 99.5%; there are 787,800 semielectronic and 184,320 electronic lines, not only improving quality but allowing new services to be offered, such as detailed billing, call waiting, three-way calling and a long list of other facilities.

Telematic services are spreading: point-to-point data transmission, transmission over the switched telephone network, coded alarms, telefax, teletex, dataphone, etc. with an increasing growth rate for the IBERPAC and X-25 public data transmission network, while business communications services and the IBERCOM multi-services and multi-user network are being defined.

At the same time, electronic exchanges and lines are becoming commonplace, optical fibre is starting to make an appearance for both trunk lines and submarine cables. There are presently 93 kilometres of overland optical fibre cable and over 125 kilometres of submarine cable, with the particularity that OPTICAN, laid between the two large Canary Islands, is the world's first submarine cable with repeaters in very deep water.

The appearance of optical fibre and satellites make it possible to transmit voice, data and video over the same channel and initiate a new stage with tremendous possibilities in the world of telecommunications.

Telefónica owns the world's third largest submarine cable network covering 31,000 Km. In 1984, Meridian was inaugurated and negotiations are in progress for the optical fibre submarine network to interconnect the Mediterranean and Atlantic submarine systems, for construction in the period 1990-92.

However, **Telefónica**, apart from being a utility company, is also the head of an industrial group. One consequence of this policy is the creation of joint ventures with AT&T to design and manufacture 1.75 micron custom chips, with Corning Glass to produce optical fibre, with Fujitsu to develop and manufacture computers; with SyScam, for digital mapping and with Philips, for mobile telephony.

Similarly, **Telefónica** is participating in the European Silicon Structures (ES 2) project, which will design and manufacture short production runs of custom integrated circuits.

Despite being the head of a major group of commercial and services companies, **Telefónica** has no ambition as an industrial holding company. The first sign of this policy took place with the offer of shares in AMPER to **Telefónica** shareholders at a price of 150%, together with the subsequent tender of a further package of shares on the Madrid Stock Exchange, at which shares were awarded to applications priced between 315% and 500%, with the resulting average price of 343.9%.

Telefónica is having major international successes with products employing national technology and some Group Companies are marketing Spanish patented products on international markets. This is the case of Tesys, the packet switching equipment, which has been sold in Argentina, Canada, U.S.A., U.K. and Tunisia, has been selected by the IBI and is being offered in various European tenders.

In order to be able to make its service, industry and technology policy a reality, the new **Telefónica** Management adopted strict financial restructuring measures, that can basically be summarised as follows:

- Cost restraint.
- Active financial policy, based on successive capital increases and debt diversification.
- Adaptation of depreciation rates to telephone plant life.
- Strong growth in the ratio of self-financing to investment, that will continue to increase in the future.

The improvement obtained in the latter demonstrates

the major effort made, rising from 50.9% in 1982 to 66.6% in 1985.

The result of this important growth in self-financing, together with the policy of successive capital increases has been that major repayments have enabled debt structure to be improved and working capital to be reorganised.

In order to reduce the effort requested of its shareholders and national savings and to transform debt into equity, **Telefónica** obtained listings on foreign Stock Exchanges in 1985, after complying with the strict controls on the external auditors and the Stock Exchanges themselves. **Telefónica** shares are presently listed on the Stock Exchanges of London, Tokyo, Frankfurt and Paris, with excellent turnover levels that in some cases even exceed turnover on the Spanish Stock Exchanges.

But I will not cease to emphasize that **Telefónica** has achieved these successes because its employees have made the effort, although many controversies remain

that are common to times of crisis, and shareholders have been capable of maintaining **Telefónica** investment activity with their savings. To all of them, now that the end of the long tunnel of the Spanish economic crisis is visible, I should like to express my gratitude and absolute confidence that the coming years will witness new successes for our Company and even greater improvements in our internal organization and presence in the world.



Luis Solana

Chairman of the Board of Directors
of the **Compañía Telefónica**
Nacional de España

HIGHLIGHTS

ITEMS	1984	1985	% 85/84
Number of telephones	13,825,459	14,258,928	3.1
Telephones per 100 inhabitants	35.8	36.6	2.2
Lines in service	8,881,727	9,340,458	5.2
Applications pending	266,979	252,762	-5.3
Trunk calls (thousands of units)	2,565,816	2,819,679	9.9
Trunk calls per subscriber	288.7	301.9	4.6
Automatic trunk calls (%)	98.8	99.1	0.3
Outgoing international calls (thousands of units)	78,402	87,220	12.5
Automatic international calls (%)	97.2	97.4	0.2
Number of permanent staff	66,781	66,661	-0.18
Investment in fixed assets for the year (millions of pesetas)	175,417	187,881	7.1
Value of telephone equipment and installations (millions of pesetas)	2,258,886	2,525,314	11.8
Share capital (millions of pesetas)	320,416	360,468	12.5
Revenue from services (millions of pesetas)	349,226	393,506	12.7