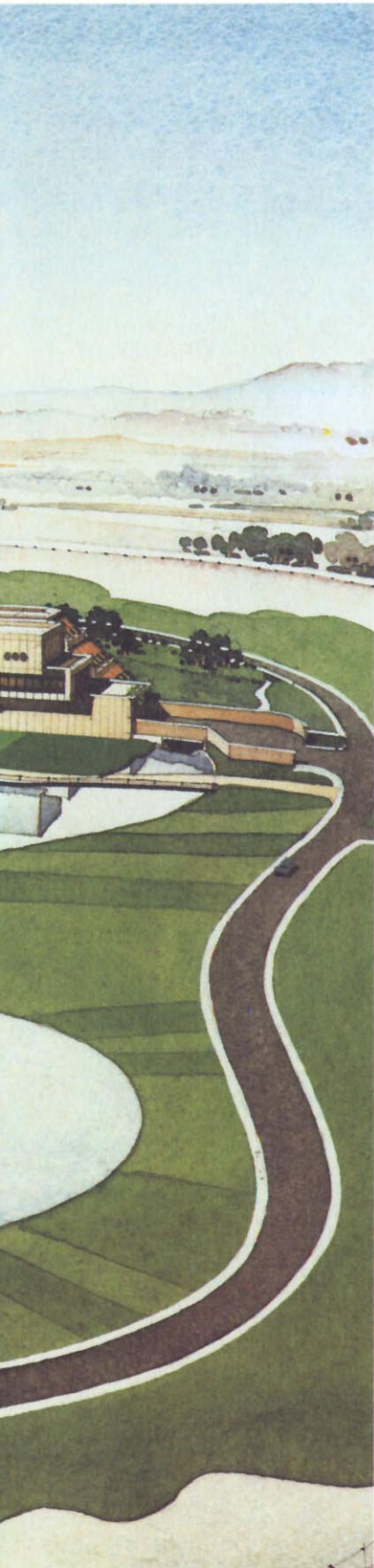
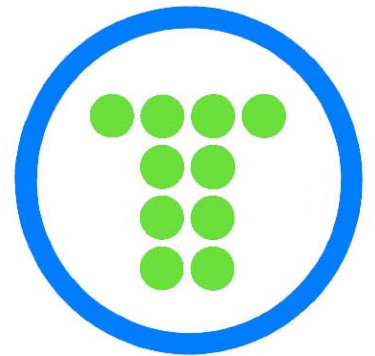


THE TELEFONICA GROUP



The Telefónica-AT&T agreement was signed in Madrid during December 1985. The foundation stone of the factory being built near Madrid, shown in the picture, was laid in April 1986.

END OF AN ERA

1985

has seen the end of an era in the industrial policy that **Telefónica** used to implement. The achievements are basically a more homogeneous group of companies in profit for the second year running, more solid from the industrial and technological point of view and, finally, less dependent on purchases from **Telefónica** itself; i.e. with a more diversified activity structure.

Consequently, **Telefónica** maintains the objective of proper industrial procurement planning that, on being agreed with the suppliers, provides a platform allowing improved orientation of resources, investments and efforts towards other market segments, eliminating uncertainties.

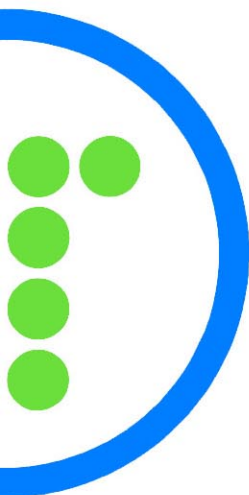
This progressive consolidation of the companies has in turn allowed **Telefónica** to open up the firm's supplies policy to the sector overall, favouring greater competitiveness in both developments and supplies.

In this way, the restructuring effect of industrial policy widens its scope to the sector overall and directly benefits **Telefónica's** procurement.

Business projects created in 1984 and directed to preexisting market gaps have commenced operations in 1985. This has happened with **Indelec**, having **Philips** as the technological partner and dedicated to mobile communications; with **THM**, specialised in electronic security systems, and **Telefónica y Datos**, as the second supplier of **Tesys** and advanced voice/data communication systems.

The appearance of new companies and the restructuring and development of existing ones has led to another series of initiatives aimed at coordinating activity between Group Companies, allowing the Group to make maximum use of existing synergy and complementary aspects. These actions, some of which are already implemented and others in the pipeline, include:

- **Telefónica Internacional, S. A.**, a company orientated to promotion abroad, complementing individual Company activities. It is basically directed at complex projects, coordinating global proposals from several companies, essentially in the area of Spanish-patented products.
- **Telefónica Sistemas, S. A.**, a systems and networks engineering company, specialising in large-scale complex projects, and contributing the value added of advanced design, multidisciplinary complexity and corporate coordination. Its objective is the domestic market outside the scope of **Telefónica: Advanced Business Communications, Defence, Institutional Sector**. Furthermore, as a consulting and engineering company, it provides technical backup to **Telefónica Internacional**.
- **Research and Development Centre**, at the service of **Telefónica** and the sector as a whole, basically in applied research and prospective development areas. The new technology policy is aimed at maximizing Spanish-patented products adapted to market requirements, while allowing a condition-free supply of exports. The **Research and Development Centre** construction agreement was signed in December with the company **Pacific Telesis**.
- **Cosesa-Telyco (Marketing Networks)**. The object is to create new modern distribution networks, which are the key for access to freely competitive markets. The maturity process of **Telefónica's** industrial companies runs parallel to that of conquering new markets for its prod-



ucts. Activities presently in progress and others scheduled for the near future in an international context and with respect to the liberalization of equipment and terminals offer tremendous potential with an adequate commercial policy. **Cosesa y Telyco** offer the possibility of a combined commercial policy on the basis of a solid coherent strategy.

NEW AGREEMENTS

In order to make up for capacities that the country lacks, although being of fundamental importance for guaranteeing and updating service quality, **Telefónica** has concluded a series of agreements in 1985 of transcendental importance for the future of the sector.

The outline of the negotiations has essentially been as follows:

- a) Fluid technology transfer without limitations but with guarantees of permanent updating. For this it has been necessary to negotiate R&D activities in Spain, implied in the global strategy of the R&D partner.
- b) An unrenounceable presence in international markets, with the double aim of achieving the critical mass necessary for business success (taking the small domestic market into account) and for an international comparison of competitiveness.
- c) A prospect of specialization towards production centre arrangements which, on generating mutual interdependence, provides a better guarantee of reciprocal commitments and technical and economic project viability.



ATT MICROELECTRONICA ESPAÑA, S. A.

Deregulation of **ATT** in 1982 made this company turn to foreign markets, commencing a joint venture policy with international partners. In this context, **Telefónica** made the initial contacts in October 1983. From the beginning, the project with **Telefónica** was approached as a launching platform for **ATT's** new international strategy, essentially in relation to Spain and Europe. This allowed 80 or 90% of overall output from the future production facility to be scheduled for export, implying the possibility of achieving the economies of scale necessary to overcome the critical break-even point of the project.

The basic Agreement reached in July 1984 was defined in detail throughout 1985, signing the final Agreement on December 17, after fulfilling all official requirements for foreign investments in the country, aids scheduled for the new facility, etc.

Construction work has already started on the factory (located in Tres Cantos, in Madrid's Urgent Reindustrialization Zone) and production is planned to start in 1988.

The Company will have a share capital of 65 million dollars, 20% **Telefónica** and 80% **ATT**, and will specialise in manufacturing integrated circuits employing the most up-to-date technology available. Apart from producing one of the elements whose strategic value is increasingly more important, such as chips, and with high market growth forecasts, the most important aspect of this project is the local design capacity. It is an investment in training personnel to assimilate new technologies in our society and industry.

FUJITSU ESPAÑA-SECOINSA

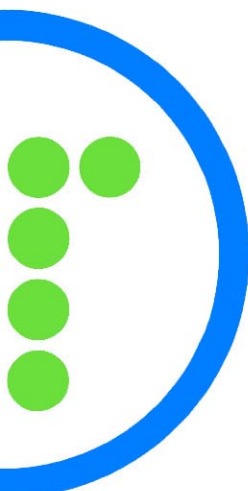
Secoinsa, with a majority INI and minority **Telefónica** and **Fujitsu** shareholding, had become the country's leading information technology company. The project, launched in 1974, basically rested on **TESYS** (which the firm helped develop). However, penetration in the information technology market was insufficient and, at the end of 1983, the accumulated losses made it necessary to strengthen the technology base.

Secoinsa owned a high quality factory in Málaga, had a wide based commercial structure and a certain market presence.

These factors were behind the negotiations with **Fujitsu**; on the one hand, **Telefónica** purchased the INI shareholding in **Secoinsa** and started to negotiate an increased commitment by **Fujitsu** in the Spanish project. **Fujitsu** is one of the world's leading manufacturers with an extensive range of large computers and has leading technology in semi-conductors and telecommunications, guaranteeing its presence in the professional electronics sector.

The negotiation has focussed on the following points: a) incorporation of the wide **Fujitsu** main-frame computer range into the new company; b) real technology transfer, both in systems engineering and manufacture, know-how and staff training; c) exports to enable the critical mass of the company to be overcome, opening up new markets; d) overall response to existing demand in the information technology, automated office and telematics sectors. The new factory will be the beachhead of **Fujitsu** products in Europe and Latin America.

The Company, formed with the name of **Fujitsu España**, is the result of the merger between **Fujitsu España** and **Secoinsa**. **Telefónica** will control 40% of the share capital of the new **Fujitsu España**, while **Fujitsu** will have a 60% interest. The share capital in 1986 is 6,000 million pesetas.



COMPañIA DE FIBRA OPTICA TELCOR, S. A.

EUROPEAN SILICON STRUCTURES (ES2)

Optical fibres undoubtedly already comprise the new future transmission medium, given their power, transmission quality and price. They offer a greater communications capacity at much lower cost than coaxial systems. This has led to a major increase in the manufacture of fibre and optical fibre cables, making spectacular progress in world markets: from 400 million dollars in 1982 to 4,500 million dollars forecast for 1990.

Telefónica logically plans to introduce this new material in its network. The first optical fibre cables were installed in 1985 and installation is scheduled in 1986 for the large local networks (Madrid, Barcelona), continuing to expand this type of installation up to subscriber networks in 1990.

As a result, a survey was carried out in 1984 for potential technological partners for joint optical fibre manufacture in Spain, with these efforts resulting in a memorandum of understanding with **Corning Glass** in January 1985.

A basic agreement was reached in December 1985, covering the following points:

- Transfer of leading OVD technology with a guarantee of creating and permanently updating the necessary R&D capacity in Spain.
- Repurchase and export commitments of around 35% of the total installed capacity.
- A **Corning Glass** shareholding of 65% and a **Telefónica** interest of 35%.
- Manufacturing capacity of around 100,000 kilometres per year of optical fibre.
- Investment of around 25 million dollars, employing 100 to 150 persons and a two-year implementation period.

ES2 is a completely European project involving major EEC industrial partners, the object of which is the design and manufacture of custom integrated circuits with exceptionally short design and prototype production times in short production runs.

This serves to orientate the sector within the semi-conductor market that will enjoy strongest growth in the coming years: custom circuits.

Telefónica, together with a Spanish banking group, has a 3 million dollars interest, approximately equivalent to 5% of share capital. It will act as a broker for a group of 20 industrial companies, selected from the most suitable firms for this type of requirement. The main consequence is to facilitate access for small innovative companies to high technology custom circuits and the incorporation of a certain design capacity, all with a minimum response time at competitive prices.

This will basically facilitate greater price competitiveness in the industrial sector and an alignment with European trends relating to the incorporation of new technological designs.



RESEARCH AND DEVELOPMENT CENTRE

A collaboration project was signed in December 1985 for building this Centre with **Pacific Telesis** (one of the companies formed on the breaking up of **AT & T**), an agreement that not only included the construction of the building, but also the installations, equipment and commissioning services.

The new building, involving a 6,400 million peseta investment, will cover 20,600 m². This new infrastructure will allow the present **R&D** capacity to be doubled and, above all, will strengthen it.

The new Centre has the following basic objectives:

- Firstly, to achieve domestic products with in-house technology.
- To develop exploratory systems or equipment, i.e. to analyse the feasibility of new concepts or to define future trends.
- Applied research in collaboration with other centres to create and/or assimilate new technologies.

This Centre, in particular, will offer the Telecommunications sector world standard facilities and organization, with the aim of providing orientation in the field of new technologies.

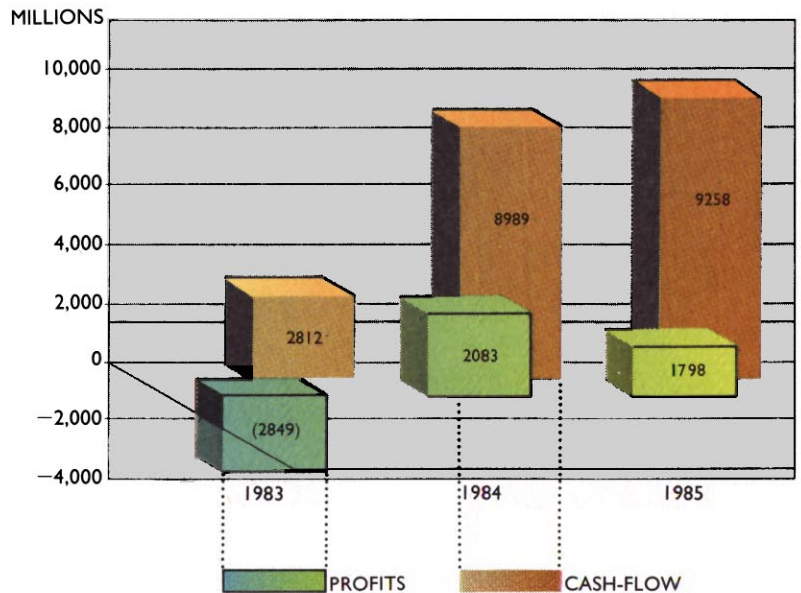
DIGITAL MAPPING COMPANY, MAPTEL, S. A.

A memorandum of understanding was reached with the Norwegian Company **SysScan** in December. The aim is to create a digital mapping company providing general engineering and consultancy on graphics systems. This is a relatively unexplored area in our country, so that the Company's growth prospects and potential for a major market share are promising.

On the other hand, the mapping of the **Telefónica** network will allow for a major improvement in network management. The project is also aimed at other important markets: electrical, gas and water utilities, municipalities, land registry, etc.

The technological partner **SysScan** will have a minority interest (around 30%), with the rest corresponding to **Entel** (software) and qualified users.

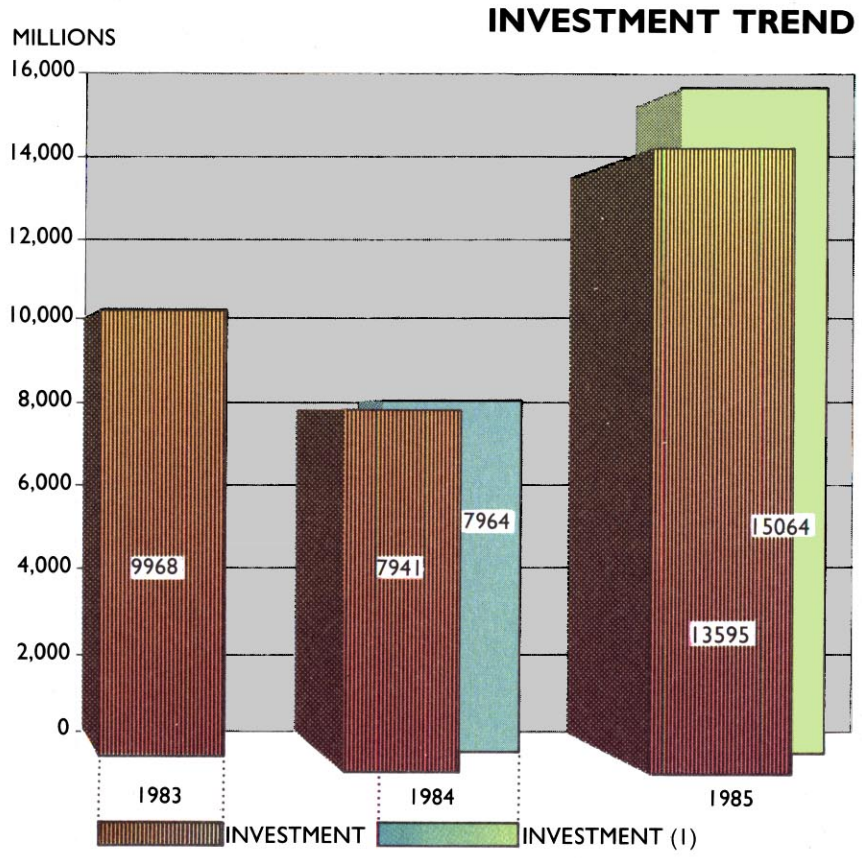
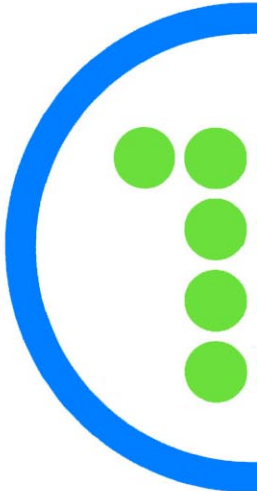
PROFIT TREND



TELEFONICA GROUP PROMOTION ACTIVITIES ABROAD

Telefónica's projection into international markets has been instrumented by forming **Telefónica Internacional de España, S. A.**, in 1985, to consolidate the Spanish telecommunications present world-wide, on three fronts:

- a) Consultancy to international Administrations employing experience acquired by us in the specific field of telecommunications.
- b) Promotion of **Telefónica Group** products. In 1985, **Telefónica** signed an important collaboration agreement with the Academy of Science of the Ministry of Post and Telecommunications in the Popular Republic of China, to supply Spanish-made products and technology, ranging from the complete installation of a telephone factory to the supply of rural multi-access networks and digital electronic exchanges.



Telefónica Group

Furthermore, negotiations are in progress to supply engineering services to Panama, Argentina and Ecuador.

TESYS equipment has been sold on a turnkey basis for packet switching data networks in Canada, U.S.A., U.K., Colombia and Tunisia and proposals have been submitted in a further ten countries that are under negotiation.

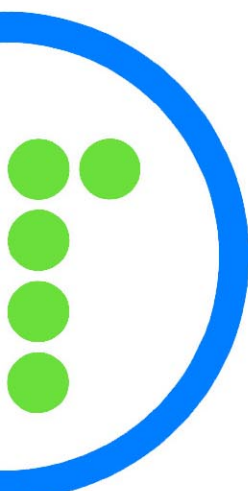
Firm contacts have also been made to supply telephone systems and equipment to a total of twelve countries, including the U.S.S.R., China, Kuwait and Portugal.

c) Creation of companies abroad.

The creation of **Telefónica Hispanoamericana, S. A.**, in Puerto Rico, in October—in which **Telefónica** has a 30% interest, **Compañía de Teléfonos de Puerto Rico** a 50% share holding and with the remainder distributed between three Spanish banks—marks the start of an activity that should become normal practice in the future. This factory, that presently repairs telephones, will be manufacturing with Spanish technology tomorrow.

Negotiations are now in progress with several countries on four continents to form other companies and export Spanish technology.

Culminating several contracts for operation and development and for the industrialization of a data-over-voice communications system signed by **Telefónica** with the American Company, **Barry Young**, a small shareholding was taken in that firm, equivalent to 4% of the shares issued. This will not only make it possible to manufacture the products that the system requires in Spain, but also to participate in international marketing of this system.



	AMPER	ATT Micro- electrónica	CCSA	ELASA	ENTEL
Communication exchanges	Telephony				
	data				
Switchboards and multilines	☎				
Concentrators	Telephony				
	Data				
Transmission equipment					
Modems	☎				
Subscriber equipment	Telephones	☎		☎	
	Telematic terminals	☎			
	Piscifoneas subscriber equipment	☎			
Cables			☎		
Components	☎	☎			
Local area networks					
Operation aid systems	☎			☎	
Computer equipment	Computers				
	Peripherals	☎			
Office automation equipment					
Data processing and telematic applications					☎
Mobile telephony					
Rural telephony					
Navigational aid systems					
Electronic security					
Power supply systems					
Installations and civil work			☎		
Systems engineering					☎

■ SUBSIDIARY COMPANIES
■ ASSOCIATED COMPANIES

INDUSTRIAL AND ENGINEERING COMPANIES

FUJITSU ESPAÑA/ SECOINSA	HRM	INDELEC	INTELSA	SESA	SINTEL	TELEFONICA HISPANO-AMERICANA	TELEFONICA SISTEMAS*	TELETTRA ESPAÑOLA	TEMASA	THM	T y D
			☐	☐							
☐			☐	☐							☐
			☐	☐							
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* Its activities represent a global offer of products and services of the Telefónica Group, with the added value conferred by its own Systems Engineering.

INDUSTRIAL GROUP HIGHLIGHTS

Telefónica has a major interest in a total of 29 companies, without including the new high technology projects that have recently been signed. In 21 of these companies **Telefónica** has an interest exceeding 20% of capital, whereas it has an indirect interest in the other eight.

Given the importance of these firms and the breadth of activity diversification, ranging from circuit design and manufacture (printed, hybrid and integrated circuits), telematics and telephone terminals, packet switching and rural telephone systems to the manufacture of radio and transmission equipment, telephone exchanges, etc., the **Telefónica Group** comprises a major industrial conglomerate placing it among the leaders of our country's economic structure and undoubtedly occupying first place in the telecommunications sector.

Suffice it to say that total Group sales in 1985 amounted to 146,115 million pesetas; that, of the Group of Companies, five (**Standard, Sintel, Secoinsa, Intelsa** and **Telettra**) each had a turnover exceeding 10,000 million pesetas and, all of these plus **Amper**, figure amongst the 500 largest Spanish companies.

From an economic point of view, efforts made in recent years to improve the Group's development potential have been directed in the first place to restructure some companies (e.g. **H.R.M.** and **Standard**) and, in second place, to planning products and markets. The continuation of this policy in 1985 has been reflected in the main economic highlights, which demonstrate the three fundamental aspects that define Group evolution: growth, profit consolidation and an increasing investment effort.

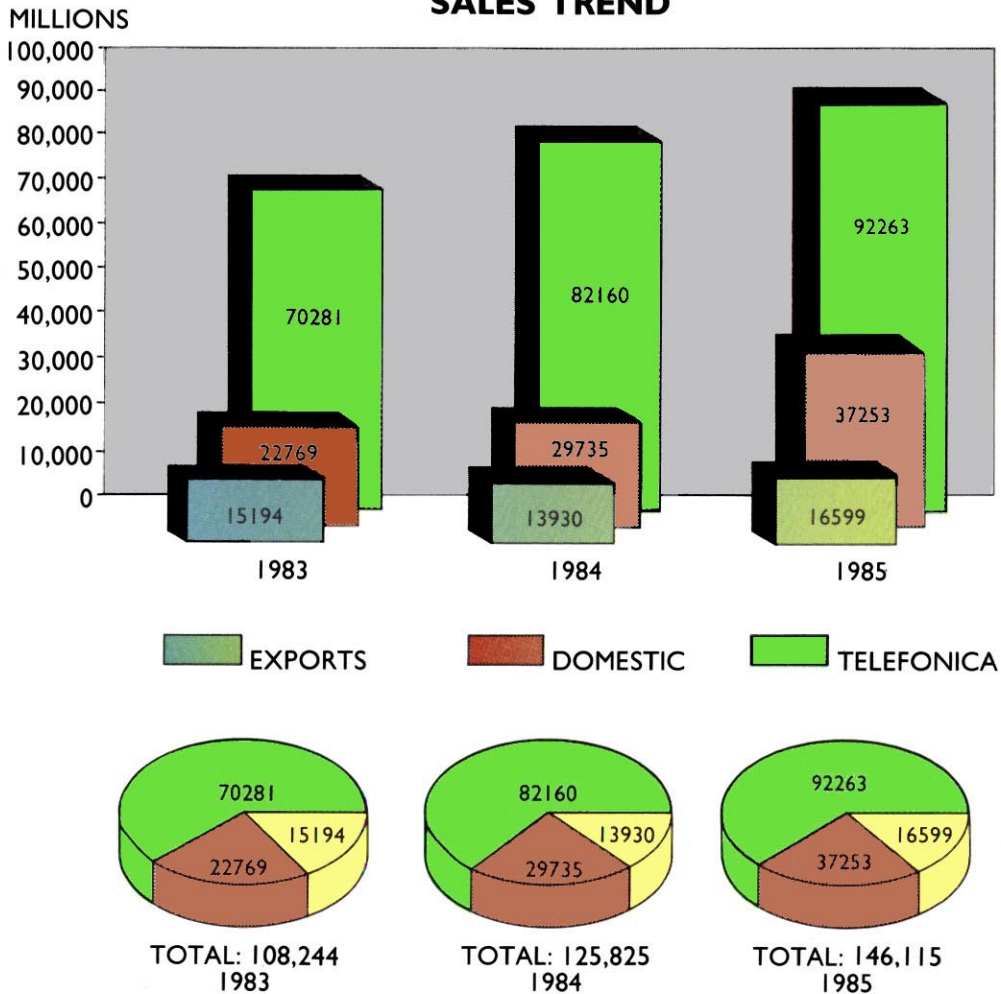
Growth

Average annual sales growth was 16% over the last three years. But although this figure is significant, there are other important aspects that should be emphasized. Group Companies generally supply products and services to **Telefónica** but, thanks to becoming increasingly dynamic, they are increasing their specific weight in other domestic and international markets. Exports are growing at a rate of 19% and sales to the domestic market (other than **Telefónica**) are increasing by 24%.

COMMERCIAL SERVICES, FINANCE AND OTHER COMPANIES

	Advertising	Marketing of Equipment and Systems	Publication of Telephone Directories	Civil Protection	Financial	Real Estate Activities
CETESA	●●●●		●●●●			
COSESA		●●●●				
GRAFIBUR			●●●●			
TELEFONICA INTERNACIONAL		●●●●				
TELFISA					●●●●	
TELYCO		●●●●				
TPSA				●●●●		
URBANA IBERICA						●●●●

SALES TREND



Continued Profits

The profits obtained by the Companies overall, without taking the new Companies formed after 1984 into account, amount to 1,798 million pesetas.

Although this profit figure is less than in 1984, it should be taken into account that the policy has been to transfer a total of 1,301 million pesetas to technological innovation provisions.

When this fact is taken into consideration, the real cash-flow of the Group overall was 9,258 million pesetas, 3% higher than in 1984 and triple that obtained in 1983. In this sense, the profits undoubtedly can be considered to have been consolidated in 1985.

Increased Investment Effort

The investment effort in 1985 has been much greater than in previous years: 90% more than in 1984 and 50% higher than in 1983.

This effort is not only due to the formation of new companies over the last two years, to which 1,469 million pesetas have been destined, but mainly to the other companies already operating as a result of the technological consolidation policy put into effect. In this major technological updating process, the following main industrial companies stand out: **Standard** (7,858 million), **Intelsa** (931 million), **Secoinsa** (909 million), **Amper** (720 million) and **Telettra** (643 million).

TELEFONICA GROUP COMPANIES

DIRECT SHAREHOLDINGS

COMPANY	SHARE CAPITAL (MILL. PTAS.)	% TELEFONICA	1985 PROFITS (MILL. PTAS.)	EMPLOYEES AT 31-12-1985
AMPER, S. A.	2,400	84.375	391	987
CABLES DE COMUNICACIONES, S. A.	782	49	(109)	395
CETESA	434	100 (1)	61	879
COSESA	700	100 (2)	(442)	385
ELASA	300	100	87	494
ENTEL, S. A.	350	100	157	718
GRAFIBUR, S. A.	325	100	(6)	104
H. R. M.	500	100	31	315
INDELEC	300	30	(86)	46
INTELSA	2,600	49	729 (4)	2,225
SECOINSA	3,125	92.857 (5)	307	1,133
SESA	17,604	20.99	138	15,127
SINTEL, S. A.	1,100	100	457	3,121
TELEFONICA INTERNACIONAL DE ESPAÑA, S. A.	200	100	1	3
TELEFONICA SISTEMAS, S. A.	100	100	(5)	22
TELETTRA ESPAÑOLA, S. A.	2,800	51	30	1,764
TEMASA (3)	600	100	—	2
TEPESA	100	63 (6)	(18)	31
T. H. M.	200	51.5 (6)	(68)	27
T. Y. D.	225	100	(78)	120
URBANA IBERICA, S. A. (4)	330	100	(33)	1

(1) A 2.67% shareholding through COSESA.

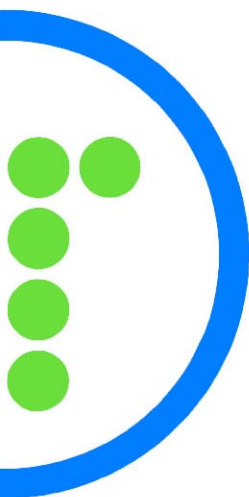
(2) A 0.86% shareholding through CETESA.

(3) Will not commence operations until the middle of 1987

(4) The profits shown do not include the effect of deferred corporation tax

(5) Includes direct and indirect interest (TELFISA)

(6) Of paid-in share capital



INDIRECT SHAREHOLDINGS

COMPANY	SHARE CAPITAL	% TELEFONICA (Indirect interest)
CETESA TELYCO	50 mill. ptas.	100
COSESA SAPEC	40 mill. ptas.	33
ENTEL, S. A. IBERMATICA, S. A.	210 mill. ptas.	35
SADIEL, S. A.	56 mill. ptas.	9.8
SINTEL, S. A. TECNITEL CORPORATION (Miami)	US \$ 10,000	100
SECOINSA SADIEL, S. A.	56 mill. ptas.	9.8
T. I. TELEFONICA INTERNACIONAL DE ESPAÑA, S. A. TELEFONICA INTERNATIONAL	1,750,000 D.M.	100
(1) COMPANIA FINANCIERA DE LA TELEFONICA ESPAÑOLA, B. V.	25,000 florins	100
(1) TELEFONICA HISPANO-AMERICANA	US \$ 600,000	30

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(1) A direct shareholding of TELEFONICA INTERNATIONAL

COMPANIES IN THE PROCESS OF FORMATION

COMPANY	SHARE CAPITAL	% TELEFONICA
ATT MICROELECTRONICA ESPAÑA	US \$ 65 mill. (1)	20
TELCOR, S. A.	US \$ 6 mill. (1)	35
DIGITAL MAPPING, MAPTEL, S. A.	300 mill. ptas.	70

(1) Forecast share capital on completing the implementation period

