

# Financial Review

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\* In this financial information all financial accounts are expressed in Spanish pesetas (ptas.). In certain cases, for convenience only, amounts are also expressed in United State dollars (U.S. \$).

All dollar amounts expressed herein have been translated at the rate of pesetas 132.40 to one U.S. dollar, Bank of Spain fixing exchange rate as of December 30, 1986.

## SELECTED FINANCIAL AND OPERATING DATA

(In millions of Ptas., unless otherwise stated)

	1986 \$ in millions	1986	1985	1984	1983	1982
Operating revenue	\$ 3,535	468,011	409,415	363,937	311,469	259,501
Operating expenses	1,230	162,837	148,601	133,143	120,897	103,407
Financial expenses	588	77,781	77,209	75,817	63,790	52,708
Net income	342	45,252	39,149	32,620	27,536	26,547
Gross cash flow	1,650	218,416	177,580	149,518	121,026	99,388
Property, plant and equipment-net	13,075	1,731,182	1,586,206	1,429,833	1,261,882	1,094,642
Medium and long term debt	4,774	632,056	659,545	636,528	562,994	483,543
Shareholders' equity	8,233	1,090,016	947,804	832,543	719,023	599,694
Total assets	14,719	1,948,793	1,806,387	1,664,357	1,486,595	1,250,643
Capital expenditures	1,598	211,514	188,681	173,642	164,404	150,704
Weighted average shares outstanding (thousands)	808,258	808,258	702,720	585,702	493,001	480,623
Book value per share at year end (ptas.)	\$ 9.88	1,308.4	1,297.0	1,278.5	1,231.0	1,231.5
Market price per share (ptas., year end)	6.61	875	637.5	465	350	322.5
Employees in active service at year end	63,021	63,021	62,790	62,817	62,823	61,670
Lines in service at year end (thousands)	9,780.0	9,780.0	9,340.5	8,881.7	8,453.7	8,017.7



# Telefónica and the Spanish economy

The major real increase of 5.7% in domestic demand helped boost GDP by 3%. This growth rate exceeded EEC and OECD averages and is the highest recorded in Spain since 1977. The healthy economic performance together with the recovery of the labour market and a reduction in public sector deficit relative to GDP, reflect the Spanish economy's expanding margins for non-inflationary growth over the coming years. Furthermore, if one considers a current account surplus of some \$5,000 million and a \$6,900 million reduction in Spain's net indebtedness, the overall picture is one which highlights Spain's solvency abroad and the encouraging prospects for the future.

In line with the macro-economic environment, the 1986 positive economic climate led to a surge in demand for telecommunications services. There was a 27.4% increase in demand for telephone lines and average consumption per line rose by 5%. The 7.4% real increase in **Telefónica's** gross value added, led to significantly higher labour productivity figures than the national average and boosted gross operating profit by 17%. The slowdown in financial expenses resulted in a 25.9% growth in the company's gross savings and hence considerably reduced the need to turn to capital markets. By the end of 1986, **Telefónica's** gross savings represented 2.18% of Spain's gross savings, compared to 1.71% in 1982.

**Telefónica AND THE SPANISH ECONOMY** (Telefónica as a % of the national total)

	1986	1985	1984	1983	1982
Gross value added	1.50	1.50	1.47	1.45	1.39
Gross capital formation	3.19	3.44	3.56	3.65	3.51
Gross operating profit	1.88	1.84	1.76	1.77	1.64
Gross savings	2.18	2.11	1.81	1.93	1.71
Employment	0.84	0.88	0.87	0.84	0.81



# Management's discussion

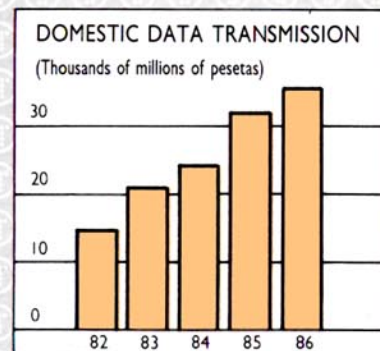
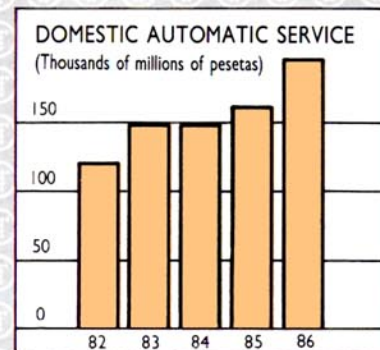
From a financial standpoint, 1986 was a highly successful year.

This was primarily due to the outstanding growth in demand, which far surpassed rates of previous years. Demand for new lines, at 963,037, was a record in the history of the company and marked a sharp increase over 1985. Even more significant as far as results, was the rate of growth in consumption of services. Measured in terms of traffic per line, the 5% rise was again a record for recent years.

Telephone services revenue, which represent 86% of total operating revenue, went up by 15% compared to 1985. Particularly noteworthy was the impressive 20.5% rise in domestic automatic service and the steady upward trend in domestic data transmission services.

The latter have grown at a cumulative annual average rate of 24.9%, over the period 1982-1986 and now account for 8% of total service revenue.

The overall effect of this growth has been a 14.3% increase in operating revenue over 1985, which is more than 7% in real terms.



## OPERATING REVENUE (In millions of Ptas., unless otherwise stated)

Description	1986	1986	1985	1984	1983	1982	% Increase	
							over 85	82-86 cum. av.
Subscriber Service Charges	\$ 1,072	141,894	126,834	111,086	74,916	65,337	11.9	21.4
Domestic Automatic Service	1,484	196,526	163,063	149,646	148,023	122,054	20.5	12.6
Trunk Calls through operator	14	1,882	2,186	2,217	2,201	2,554	(13.9)	(7.3)
International service	467	61,787	57,505	51,149	40,299	32,620	7.4	17.3
Domestic Data Transmission	271	35,859	32,252	24,568	21,245	14,722	11.2	24.9
Mobile land and maritime services	12	1,634	1,595	1,437	1,087	983	2.4	13.5
Directories and yearbooks	77	10,216	10,071	9,123	9,112	6,655	1.4	11.3
<b>REVENUE FROM SERVICES</b>	<b>\$ 3,397</b>	<b>449,798</b>	<b>393,506</b>	<b>349,226</b>	<b>296,883</b>	<b>244,925</b>	<b>14.3</b>	<b>16.4</b>
Connection fees and other items	138	18,213	15,909	14,711	14,586	14,576	14.5	5.7
<b>OPERATING REVENUE</b>	<b>\$ 3,535</b>	<b>468,011</b>	<b>409,415</b>	<b>363,937</b>	<b>311,469</b>	<b>259,501</b>	<b>14.3</b>	<b>15.9</b>



Another contributing factor to our 1986 financial performance was **Telefónica's** continuing rigorous cost containment policy and productivity boosting measures.

These had a positive effect on margins and results in general and further cemented the solid financial structure built up by the company over recent years. Operating expenses rose by merely 9.6% and hence the operating margin increased 17% compared to 1985.

The company maintained its policy of strengthening and diversifying its financial structure. This resulted in a negligible increase in financial expenses, which rose by 0.7% over 1985.

There was a 23% growth in gross cash flow or funds generated from operations, which allowed the policy of maximum transfers to depreciation and provisions to proceed ahead. Operating on prudent and conservative accounting criteria, the company continued to improve capital recovery, thus further enhancing the quality of **Telefónica's** earnings and assets.

It is worth mentioning here that for the first time in the annual report we are including, for the benefit of shareholders, the adjusted figures obtained after reconciling net income and shareholders' equity in accordance with International Accounting Standards —IAS— and United States Generally Accepted Accounting Principles —US GAAP— (see pages 70 and 71). This is required for our current listing in a number of foreign stock exchanges and for the New York Stock Exchange, where we shortly expect to be listed. As indicated by these adjusted figures, **Telefónica's** earnings, according to International Accounting Standards and particularly to US GAAP, are significantly greater than those shown in the attached audited financial statements.

Although these fundamental differences are due to the accounting criteria applied in each case, they are also an indication of the company's sound accounting approach.

The aforementioned enhanced operating margins and results, together with our financial program,

Description	1986	Amount
+ Revenue from operations	\$ 3,535	468,011
— Operating expenses	1,230	162,837
= Operating margin	\$ 2,305	305,174
— Financial expenses net of financial income	498	65,973
— Exchange losses	83	11,050
— Depreciation and amortization	1,044	138,204
= Gross operating income	\$ 680	89,947
— Other provisions and charges	181	23,910
± Net extraordinary items	46	6,071
= Income before state levy	\$ 545	72,108
— State levy	203	26,856
= Net income	\$ 342	45,252
+ Depreciation and amortization	1,044	138,204
+ Provisions and charges	264	34,960
= Gross cash flow (funds generated from operations)	\$ 1,650	218,416



have had a positive effect on **Telefónica's** financial position. To wit: a reduction in debt, improved fixed assets coverage and increased expansion capacity.

However, as stated in previous years, if one is to get a broad view of **Telefónica's** ongoing

achievements these trends and management strategies need to be analysed over longer than merely one financial year. As in former years, we have therefore included the main financial figures for the period 1982-86 in order to facilitate overall appraisal and analysis.

## RESULTS-PROFIT MARGINS 1982/1986

(In millions of Ptas., unless otherwise stated)

1986		1985		1984		1983		1982		Increase	
% Struct.	Amount	% Struct.	Amount	% Struct.	Amount	% Struct.	Amount	% Struct.	Over 85	82-86	
100.0 (34.8)	409,415 148,601	100.0 (36.3)	363,937 133,143	100.0 (36.6)	311,469 120,897	100.0 (38.8)	259,501 103,407	100.0 (39.8)	14.3 9.6	15.9 12.0	
65.2	260,814	63.7	230,794	63.4	190,572	61.2	156,094	60.2	17.0	18.2	
(14.1)	63,474	(15.5)	63,600	(17.5)	56,216	(18.0)	46,086	(17.7)	3.9	9.4	
(2.4)	9,277	(2.2)	14,230	(3.9)	5,330	(1.7)	3,000	(1.2)	19.1	38.5	
(29.5)	116,964	(28.6)	97,866	(26.8)	83,682	(26.9)	68,935	(26.6)	18.2	19.0	
19.2	71,099	17.4	55,098	15.2	45,344	14.6	38,073	14.7	26.5	24.0	
(5.1)	12,190	(3.0)	4,802	(1.3)	4,478	(1.5)	906	(0.4)	96.1	126.7	
1.3	3,675	0.9	3,170	0.8	4,348	1.4	4,075	1.6	65.2	10.5	
15.4	62,584	15.3	53,466	14.7	45,214	14.5	41,242	15.9	15.2	15.0	
(5.7)	23,435	(5.7)	20,846	(5.7)	17,678	(5.7)	14,695	(5.7)	14.6	16.3	
9.7	39,149	9.6	32,620	9.0	27,536	8.8	26,547	10.2	15.6	14.3	
29.5	116,964	28.6	97,866	26.8	83,682	26.9	68,935	26.6	18.2	19.0	
7.5	21,467	5.2	19,032	5.2	9,808	3.2	3,906	1.6	62.9	73.0	
46.7	177,580	43.3	149,518	41.0	121,026	38.9	99,388	38.4	23.0	21.8	



\* 1982-1986

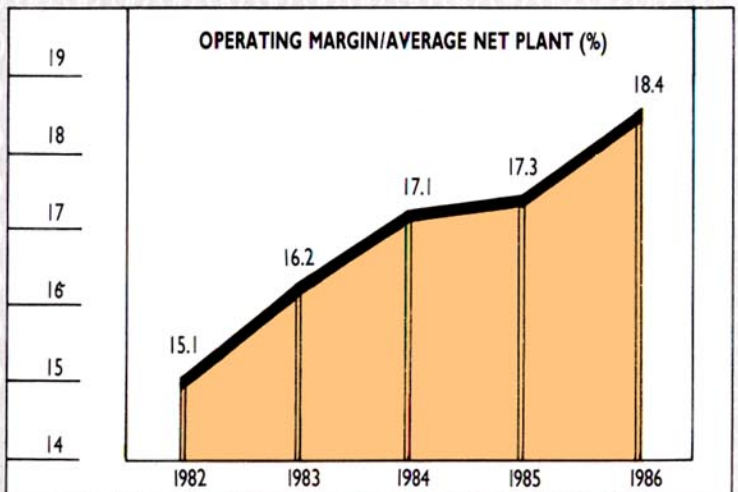
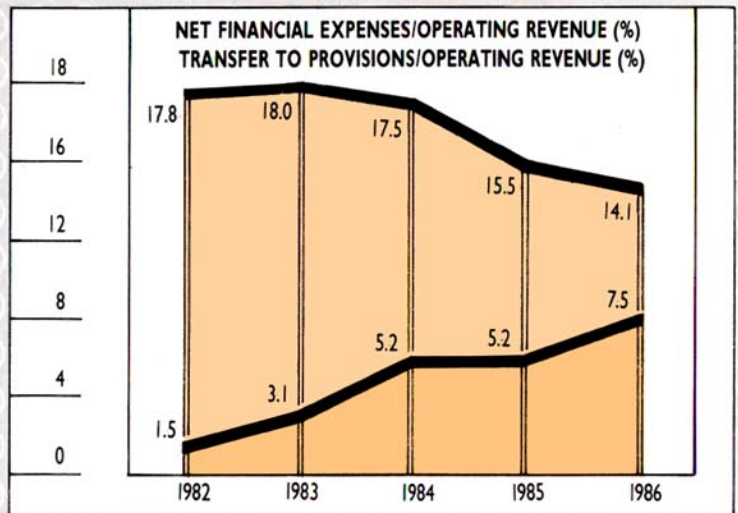
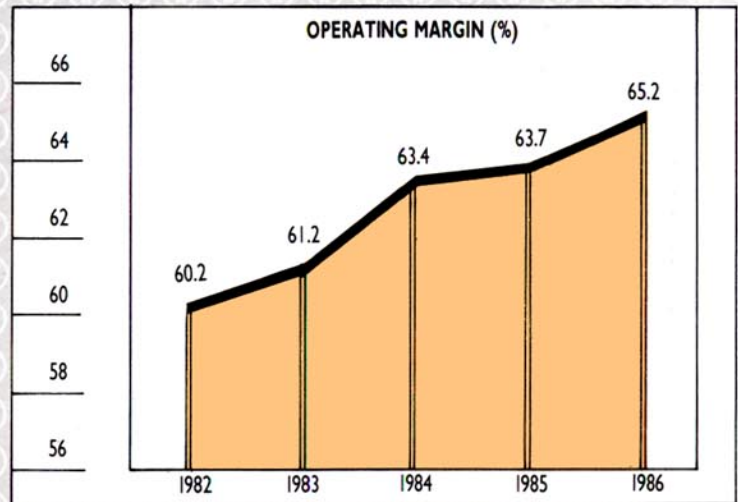
As mentioned previously, **Telefónica's** financial strategy for this period was based on two main criteria:

- Strict cost control coupled with increased productivity, in order to increase operating margins and internally generated funds.
- Strengthening the financial structure, boosting shareholders' equity and diversifying sources of finance to optimise borrowings and reduce debt servicing risks, with the aim of reducing the ratio of financial expenses.

This policy of austerity has radically improved the Company's financial situation, as revealed by the main parameters for 1982-1986:

- The cost control measures and increased productivity have reduced the ratio of operating expenses to operating revenue by five points, thus raising the operating margin from 60.2% to 65.2%.
- The financial policy pursued has stabilised financial expenses, which grew by 1.8% in 1985 and by only 0.7% in 1986, compared to average growth of 20% per year for 1982-1984. If one considers financial expenses net of financial income, the ratio to operating revenue has been cut back by 3.7 points over this period.
- As a consequence of the above, internally generated funds rose substantially from 38.4% to 46.7% of operating revenue, when measured by gross cash flow. This has led to:

- \* Improvements in operating profitability, measured by the ratio of the operating margin to average net plant, which rose from 15.1% to 18.4%.
- \* Substantial transfers to provisions, in line with a provident policy of maximum prudence (from 3,906 million pesetas in 1982 to 34,960 million pesetas in 1986).
- \* Recording all the necessary depreciation charges, which have increased at a cumulative annual average rate of 19%. The average rate of depreciation of fixed assets has risen from 4.9% in 1982 to 5.5% in 1986, involving a 13% reduction in the estimated service lives of telephone plant in service over this period. These figures are particularly significant when calculated on the historic cost value of assets rather than the replacement cost, which **Telefónica** records in the balance sheets;





applying this criteria, the 1986 depreciation rate would mean an estimated average service life of between 9 and 10 years, which compares very favourably with international practice in the telecommunications service sector.

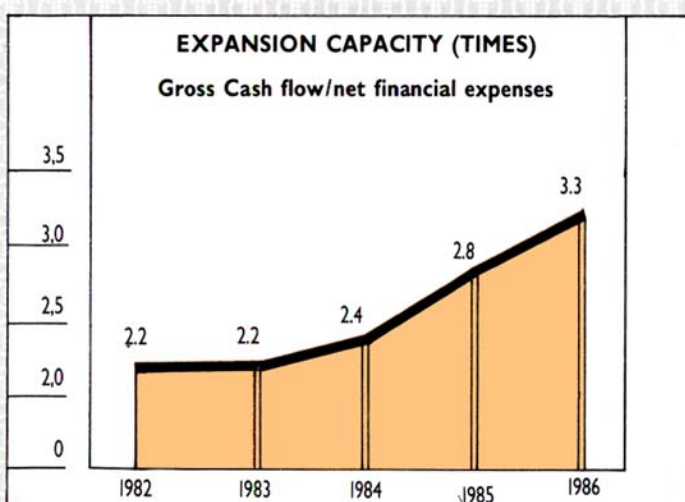
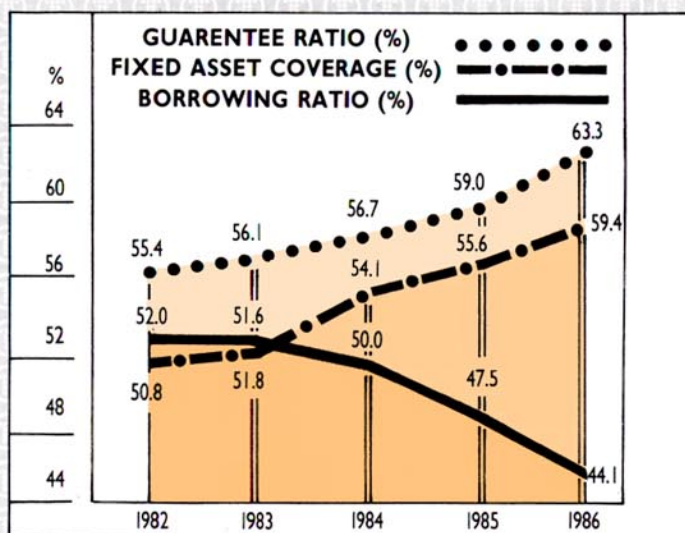
These measures have resulted in the following changes in financial structure over the period 1982-1986:

- Shareholders' equity has increased at an annual cumulative rate of 16.1%, whereas medium and long term debt rose by only 6.9%. The ratio of shareholders' equity to total liabilities and shareholders' equity has risen from 47.9% to 55.9%.
- Due to our active refinancing program, aimed at lowering the company's overall financing costs, the medium and long term debt ratio has fallen by 6.3 points to 32.4% while foreign currency debt has dropped from 11.7% to 5.1% of total liabilities and shareholders' equity.
- The financial diversification policy is reflected in the fact that by the end of 1986, 25% of total debt was in new financial instruments and markets, thus improving **Telefónica's** financing flexibility.

The overall result is a substantial boosting of **Telefónica's** expansion capacity. The funds generated in 1986 were 3.3 times net financial expenses, as compared to 2.2 times in 1982. Furthermore, debt servicing capacity in 1982-1986, measured as the ratio of total debt to gross cash flow, has improved from 5.6 years to only 3.1 years.

To conclude, **Telefónica's** financial structure is now solidly grounded, due to the policies of financial prudence applied. Thus, the company is well prepared to carry out its ambitious expansion plans for the coming years, which are essential if we are to meet the demand for services and exploit market opportunities as they arise.

These trends have also been positively reflected in the company's stock market performance. Pages 76 and 77 provide more detailed information in this respect. The above comments clearly indicate that **Telefónica** will continue to be of prime interest to domestic and international investors, as has indeed been the case over this period. We are firmly committed to ensuring that our shareholders at home and abroad continue to earn a competitive return on their investment in **Telefónica**.



#### Financial ratios

	1986	1982
Operating margin/Operating revenue	65.2	60.2
Net financial expenses/Operating revenue	14.1	17.8
Transfer to provisions/Operating revenue	7.5	1.5
Operating margin/Av. net plant	18.4	15.1
Fixed assets coverage	59.4	50.8
Guarantee ratio	63.3	55.4
Borrowing ratio	44.1	52.0
Expansion capacity	3.3	2.2



## BALANCE SHEETS 1982/1986

(After profit distribution, in millions of Ptas., unless otherwise stated)

ITEMS	1986	1986	1985	1984	1983	1982
Fixed assets	\$ 13,861	1,835,197	1,703,265	1,540,156	1,388,514	1,181,214
Property, plant and equipment	21,364	2,828,586	2,568,812	2,298,083	2,016,193	1,754,272
Depreciation of fixed assets	8,289	(1,097,404)	(982,606)	(868,250)	(754,311)	(659,630)
Property, plant and equipment - net	13,075	1,731,182	1,586,206	1,429,833	1,261,882	1,094,642
Net intangible assets	30	3,997	5,042	4,803	3,797	2,256
Investments	293	38,755	32,987	33,895	37,677	22,054
Deferred charges	94	12,424	12,898	13,461	9,186	7,884
Unrealised exchange losses	369	48,839	66,132	58,164	75,972	54,378
Current assets	\$ 858	113,596	103,122	124,201	98,081	69,429
Consumable inventories	43	5,692	3,699	2,993	2,523	2,051
Accounts receivable	755	100,010	86,078	78,038	75,155	59,138
Cash and banks	18	2,332	7,981	34,297	12,388	2,592
Other current assets and prepayments	42	5,562	5,364	8,873	8,015	5,648
Assets = Liabilities and shareholders' equity	\$ 14,719	1,948,793	1,806,387	1,664,357	1,486,595	1,250,643
Shareholders' equity (1)	\$ 8,233	1,090,016	947,804	832,543	719,023	599,694
Paid-in share capital	3,110	411,793	360,468	320,416	288,374	240,312
Reserves and provisions	5,123	678,223	587,336	512,127	430,649	359,382
Medium and long term debt (2)	\$ 4,774	632,056	659,545	636,528	562,994	483,543
Debt in pesetas	4,025	532,927	450,717	400,374	369,393	337,195
Debt in foreign currencies	749	99,129	208,828	236,154	193,601	146,348
Net capital employed (1 + 2)	\$ 13,007	1,722,072	1,607,349	1,469,071	1,282,017	1,083,237
Current liabilities	\$ 1,712	226,721	199,038	195,286	204,578	167,406
Short term debt	1,417	187,585	168,171	165,381	180,929	146,708
Accruals	295	39,136	30,867	29,905	23,649	20,698
Unused credit facilities (in memorandum accounts)	\$ 740	97,965	121,300	88,680	53,607	35,329



## STATEMENT OF CHANGES IN FINANCIAL POSITION

(After profit distribution, in millions of Ptas., unless otherwise stated)

	1986	1986	1985	1984	1983	1982
Gross cash flow	\$ 1,650	218,416	177,580	149,518	121,026	99,388
Reserves	16	2,157	3,369	4,769	4,563	5,109
Share capital increases	272	36,047	32,084	22,387	33,644	—
M. & L.T. Debt	1,547	204,803	154,267	151,510	105,714	86,070
— Domestic	1,275	168,827(a)	139,370	97,409	72,151	62,693
— Foreign	272	35,976	14,897	54,101	33,563	23,377
Total sources and applications of funds	\$ 3,485	461,423	367,300	328,184	264,947	190,567
Capital expenditures and investments	\$ 1,650	218,458	195,726	175,549	185,797	155,375
— Capital expenditures in fixed assets	1,598	211,514	188,681	173,642	164,404	150,704
— Intangible assets	14	1,866	1,778	1,607	1,658	1,515
— Investments in affiliates	38	5,051	48	(3,318)	15,386	844
— Stocks for fixed assets	—	27	5,219	3,618	4,349	2,312
Deferred charges	(55)	(7,307)	(5,882)	(9,511)	(4,628)	(420)
Applications of provisions	467	61,774	55,056	50,770	36,851	28,858
Repayment and redemption of M. & L.T. debt	\$ 1,552	205,534	147,587	78,642	51,518	37,114
— Domestic	506	67,014	86,900	53,032	41,107	30,859
— Foreign	1,046	138,520	60,687	25,610	10,411	6,255
Variation in working capital	\$ (129)	(17,036)	(25,187)	32,734	(4,591)	(30,360)
Variation in unused credit facilities	\$ (128)	(16,976)	29,271	22,839	8,760	6,570

### NOTES

The difference between the Variation in Working Capital indicated in this table and that audited is as follows:

Total variation .....	(17,036)
Increase in 1986 dividends .....	5,989
<b>TOTAL .....</b>	<b>(11,047)</b>

(a) This amount includes time period adjustments for Promissory Notes and Zero Coupon Bonds, that figure in the audited statement of changes in financial position as self-financing, in accordance with the following breakdown:

Debenture interest .....	548
Promissory Note Interest .....	4,569
<b>TOTAL .....</b>	<b>5,117</b>



