

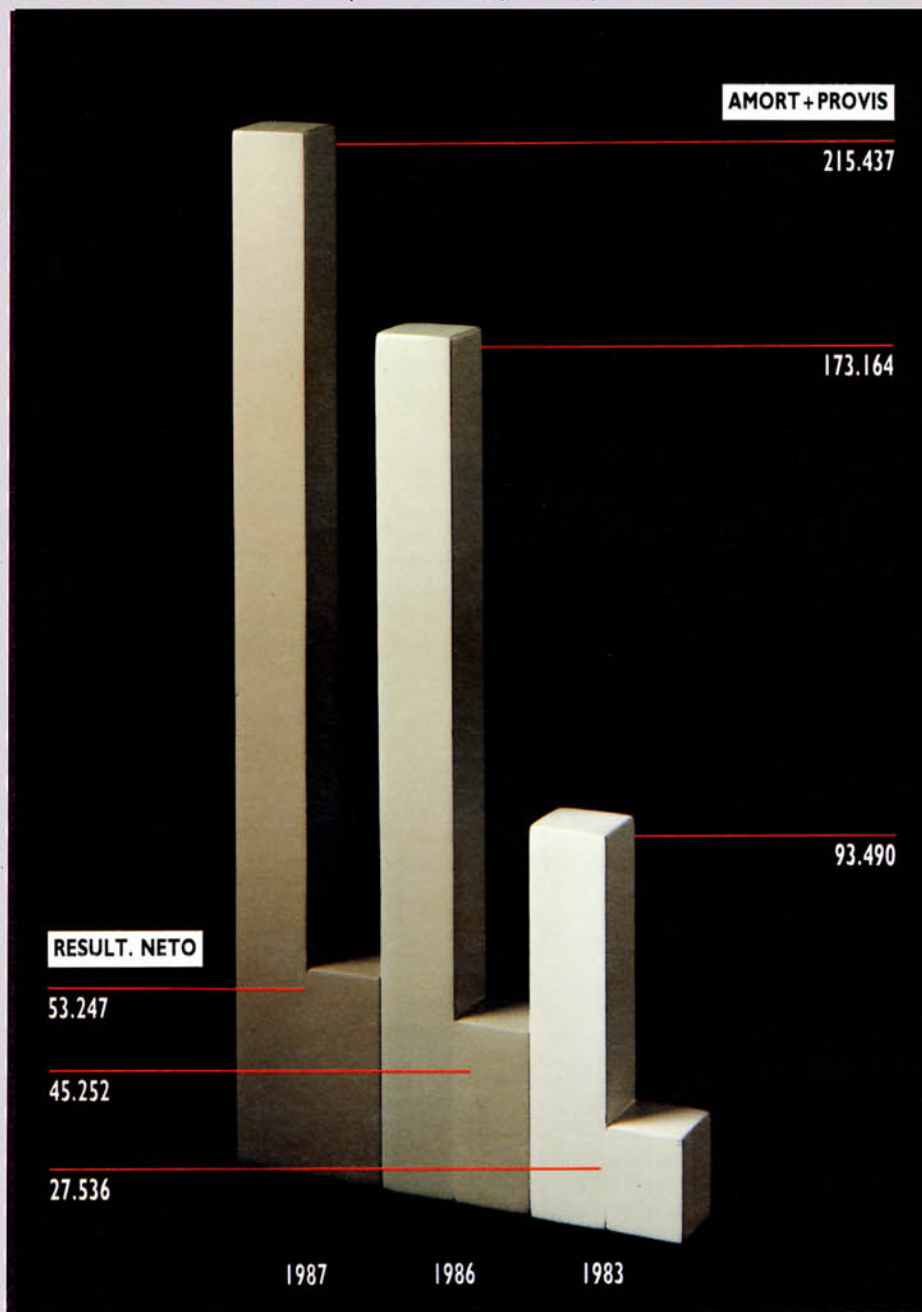


Financial Review



FUNDS GENERATED FROM OPERATIONS

(Millions of pesetas)



Financial Review

CONTENTS

- Selected financial data
- Telefónica and the Spanish economy
- Management's discussion

SELECTED FINANCIAL DATA

(In millions of Ptas., unless otherwise stated)

	1987 (\$)	1987	1986	1985	1984	1983
Operating revenue	4,954.6	540,727	468,011	409,415	363,937	311,469
Operating expenses	1,673.0	182,580	162,837	148,601	133,143	120,897
Financial expenses	770.5	84,094	77,781	77,209	75,817	63,790
Depreciation and amortization	1,506.8	164,442	138,204	116,964	97,866	83,682
Net income	487.9	53,247	45,252	39,149	32,620	27,536
Gross cash flow	2,461.9	268,684	218,416	177,580	149,518	121,026
Share capital	3,806.0	415,368	411,793	360,468	320,416	288,374
Shareholders' equity	11,185.4	1,220,727	1,090,016	947,804	832,543	719,023
Medium and long term debt	6,260.0	683,186	632,056	659,545	636,528	562,994
Capital expenditures	2,384.0	260,183	211,514	188,681	173,642	164,404

Exchange rate (31-12-87): 1 \$ = 109.136 pts.

Telefónica and the Spanish economy

1987 was another prosperous year for Spain's economy with performance notably exceeding EEC and OECD averages. Of particular significance, was the 5.2 % growth in real terms in GDP and the 15.9 % real increase in investment. In addition, there was a promising decline in the rate of inflation to 4.6 % and a reduction in public sector deficit to 3.8 % of GDP. On the exterior front, foreign reserves had risen by year end to 30,000 million dollars. There was a relative rise in the value of the peseta against the major world currencies and Spain became one of the world's creditor nations.

On the whole, the financial performance of Spanish companies showed a strong improvement. There was a rise in the ratio of internally generated funds to capital expenditures and a strengthening of their financial position, both enhanced by productivity gains and labour cost control.

In line with the rise in domestic markets, **Telefónica** registered an 8.2 % boost in average usage per line and a 17.9 % rise in demand for new lines. There was a real increase in **Telefónica's** value added of 11 %, representing 1.57 % of the national total. The substantial 10.7 % rise in labour productivity helped improve **Telefónica's** participation in Spain's gross operating profits from 1.89 % in 1986 to 2.07 %. Finally, the 33.1 % increase in the Company's gross savings enabled us to cover the 23.2 % expansion in capital expenditures over the year, with no significant rise in borrowing.

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

	1987	1986	1985	1984	1983
Gross value added	1,57	1,50	1,51	1,47	1,46
Wages and related benefits	1,18	1,21	1,23	1,22	1,19
Gross operating profit	2,07	1,89	1,85	1,78	1,79
Gross savings	2,72	2,29	2,38	2,19	2,11
Gross capital formation	3,45	3,34	3,47	3,50	3,47

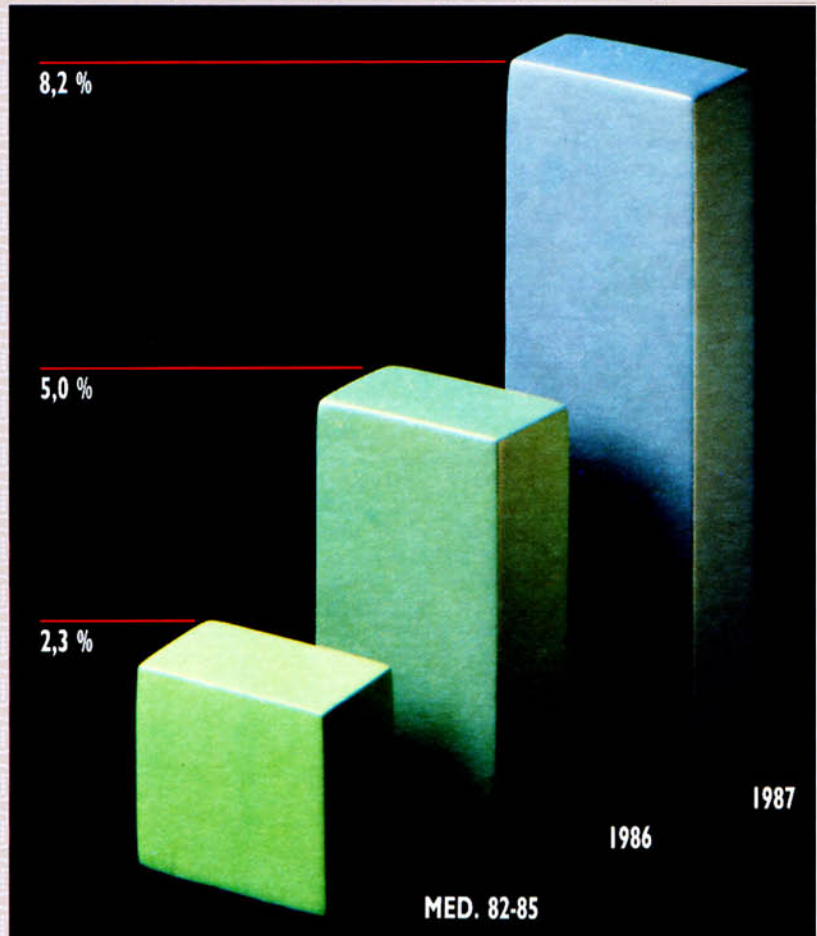
Management's discussion

TELEPHONE USAGE (% Increase in average usage per line)

Fiscal 1987 was a highly successful year for the Company as a whole. The boost in productivity together with enhanced management efficiency brought about a healthy increase in gross cash flow and earnings per share, which in turn has encouraged a vigorous capital expenditure program.

Once again there was an outstanding growth in demand. Over 1,135,000 applications for new lines had been recorded by the end of the fiscal year, representing a 17.9 % increase over 1986, when in turn there was a 27.4 % rise over 1985.

Particularly noteworthy was the sharp 8.2 % rise in average usage per line and the impressive 11.2 % leap in international service usage.

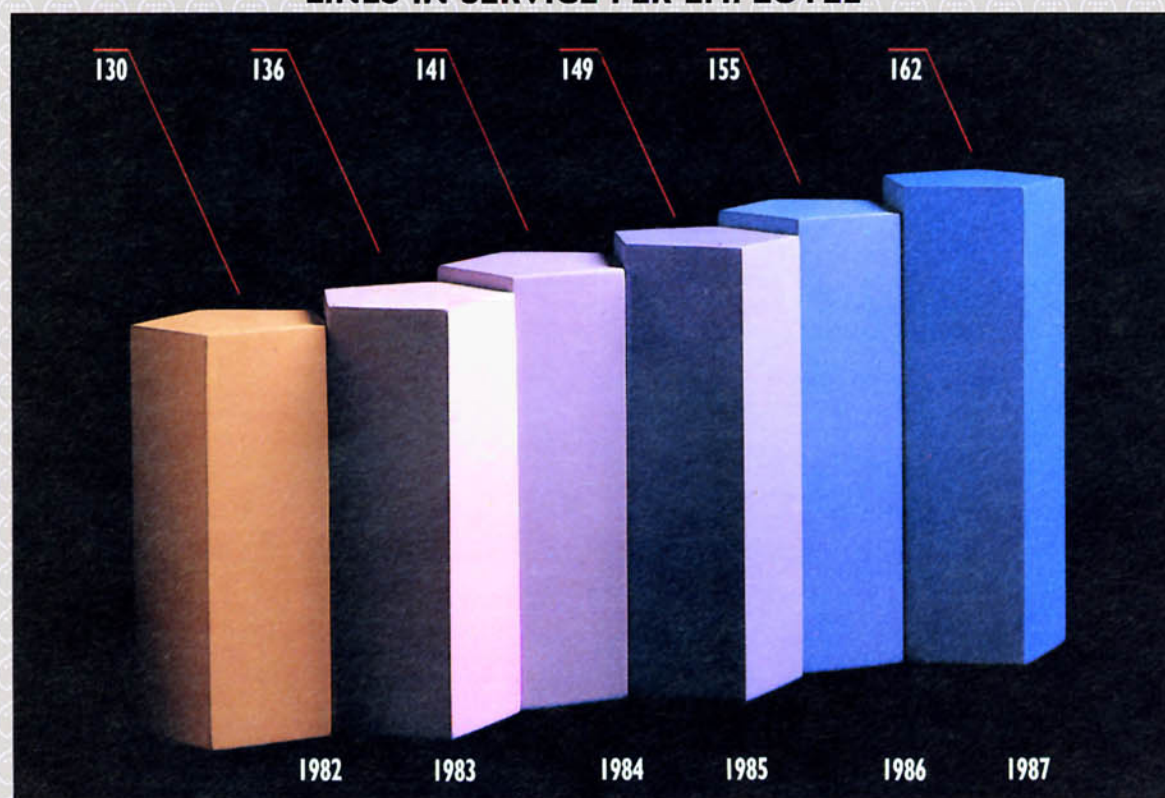


OPERATING REVENUE (In millions of Ptas., unless otherwise stated)

Description	1987 \$ in millions	1987	1986	1985	1984	1983	% Increase	
							over 86	83-87 cum. av.
Subscriber Service Charges	1,439.2	157,073	141,894	126,834	111,086	74,916	10.7	20.3
Data and facsimile transmission	394.5	43,052	35,859	32,252	24,568	21,245	20.1	19.3
Domestic Automatic Service	2,166.9	236,491	196,526	163,063	149,646	148,023	20.3	12.4
Trunk calls through operator	14.6	1,597	1,882	2,186	2,217	2,201	(15.1)	(7.7)
International Service	668.4	72,948	61,787	57,505	51,149	40,299	18.1	16.0
Mobile land and maritime services	15.1	1,646	1,634	1,595	1,437	1,087	0.7	10.9
Directories and yearbooks	69.6	7,598	10,216	10,071	9,123	9,112	(25.6)	(4.4)
REVENUE FROM SERVICES	4,768.3	520,405	449,798	393,506	349,226	296,883	15.7	15.1
Connection fees and other items	186.3	20,322	18,213	15,909	14,711	14,586	11.6	8.6
OPERATING REVENUE	4,954.6	540,727	468,011	409,415	363,937	311,469	15.5	14.8

Exchange rate (31-12-87): 1 \$ = 109.136 ptas.

LINES IN SERVICE PER EMPLOYEE



The upward trend in demand for data transmission services continued, with a 47.2 % increase over 1986. There was an especially heavy demand for the Iberpac network (75.2 %), and for the Telefax and Ibertex data transmission services through the switched telephone network (130.1 %).

Operating revenue grew by 15.5 % against an average 3.99 % increase in service charges. These figures provide firm evidence of the boost in real demand for telephone and datacom services.

The 1987 positive results were reinforced by improved management efficiency to cope with the increase in demand and by a strict cost containment policy.

Although workforce numbers remained stable, there was a notable improvement in productivity. The number of lines in service per employee reached the figure of 161.7, compared to 155.2 the previous year.

The relatively moderate increase in operating expenses led to a rise in the operating margin to 66.2 %, which is a clear reflection of the excellent progress achieved

in productivity and operating efficiency during fiscal 1987.

A prudent financial policy was responsible for keeping down financial costs and further cementing **Telefónica's** solid financial structure.

Consequently, the rate of increase in net financial expenses continued to fall with only a 3.3 % rise registered in 1987, compared to 3.9 % in 1986 and 6.3 % between 1983-85.

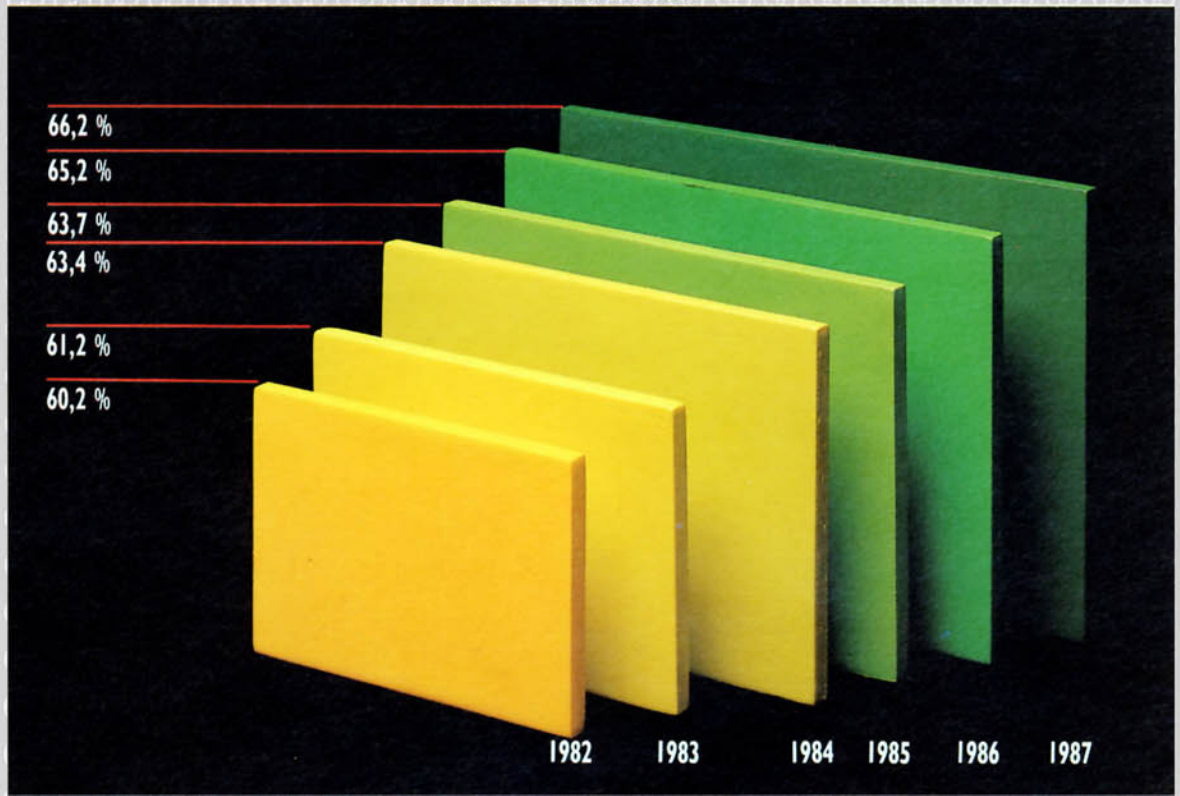
There was also a reduction in the ratio of net financial expenses to operating revenue, which fell by 1.5 points against the previous fiscal year.

We should also mention that during fiscal 1987 financial management strategies led to adjustments and greater flexibility in domestic and foreign debt and general improvements in the Company's term financing structure.

The following are some of the most significant features of fiscal 1987 results:

—Transfer to provisions, in line with a provident poli-

OPERATING MARGIN



cy of maximum prudence, representing 9.4 % of fiscal year revenue. This figure was in spite of the reduction in transfer to exchange losses resulting from the strength of the peseta and the current low level of foreign currency debt.

—Increase in the average annual depreciation rate, which was set at 5.5 % the last financial year, applying replacement cost accounting principles. If the historic cost value of assets is considered, the 153,501 million pesetas represent an 11.25 % average annual rate of depreciation of fixed assets. This figure compares favourably to that of the international telecommunications sector.

—Income before tax rose to 84,322 million pesetas. It is the last time that the 6 % state levy will be applied to gross operating revenue.

From January 1st 1988, the special tax regulations laid down in the State Contract, will cease to exist. Under the new fiscal regulations (Ley de Tributación de **Telefónica**), **Telefónica** will be subject

to general Corporate Tax law and Real Estate local taxation. All other local taxes will be replaced by an annual 2 % levy of gross operating revenue.

The change in fiscal regulations together with the enforcement of the new Telecommunications Bill (LOT) as from January 1st 1988, have encouraged the Company to take certain measures. These in no way affect the income statement but rather aim to anticipate the whole write down of customer premises equipment, thus preparing ourselves to meet the ongoing terminals deregulation process.

These adjustments are reflected in the reconciliation of net income and shareholders' equity to international (IAS) and United States (US GAAP) accounting systems. (See pages 68 and 69).

Further evidence of the positive trend within the Company can be found in the 17.7 % rise in net income to 53,247 million pesetas. Earnings per share grew by 15.1 % over the previous year to 64.2 pesetas.

This successful figure enabled us to meet our target

of offering an 11% dividend over par value to shareholders, with the rest going to the Company's reserves. Consequently, pay-out level was 85.7% as opposed to 99% in past years.

Our strategy, designed to boost productivity and enhance efficiency, together with the steps to control operating and financial expenses, have led to further upgrading in the quality of our assets and a 23% increase in gross cash flow.

Telefónica's excellent 1987 financial results are recorded in the balance sheet ratios where the accomplishments of our active financial managerial approach are faithfully reflected.

There were improvements in the fixed assets coverage ratio (from 59.4% in 1986 to 60.4%) and in the

FINANCIAL RATIOS

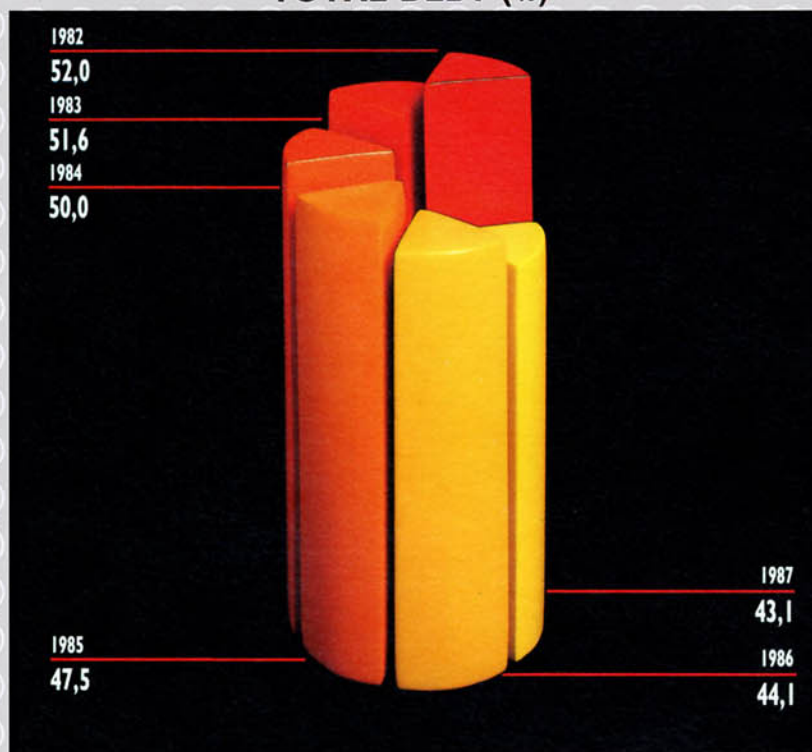
	1987	1986	1983
Operating margin/ operating revenue (%)	66.2	65.2	61.2
Net financial expenses/ operating revenue (%)	12.6	14.1	18.0
Transfer to provisions/ operating revenue (%)	9.4	7.5	3.1
Operating margin/Av. net plant (%)	19.6	18.4	16.2
Fixed assets coverage (%)	60.4	59.4	51.8
Guarantee ratio (%)	64.1	63.3	56.1
Total debt (%)	43.1	44.1	51.6
Debt repayment capacity (years)	2.7	3.1	5.2
Gross cash flow/net financial expenses (years)	3.9	3.3	2.2

RESULTS - PROFIT MARGINS

Description	1987 \$ In millions	1987		1986		1985		Amount
		Amount	% Struct.	Amount	% Struct.	Amount	% Struct.	
+ Revenue from operations	4,954.6	540,727	100.0	468,011	100.0	409,415	100.0	363,937
— Operating expenses	1,673.0	182,580	(33.8)	162,837	(34.8)	148,601	(36.3)	133,143
= Operating margin	3,281.6	358,147	66.2	305,174	65.2	260,814	63.7	230,794
— Net financial expenses	624.2	68,123	(12.6)	65,973	(14.1)	63,474	(15.5)	63,600
— Exchange losses	94.3	10,294	(1.9)	11,050	(2.4)	9,277	(2.2)	14,230
— Depreciation and amortization	1,506.8	164,442	(30.4)	138,204	(29.5)	116,964	(28.6)	97,866
= Gross operating income	1,056.3	115,288	21.3	89,947	19.2	71,099	17.4	55,098
— Other provisions and charges	372.9	40,701	(7.5)	23,910	(5.1)	12,190	(3.0)	4,802
± Net extraordinary items	89.2	9,735	1.8	6,071	1.3	3,675	0.9	3,170
= Income before state levy	772.6	84,322	15.6	72,108	15.4	62,584	15.3	53,466
— State levy	284.7	31,075	(5.7)	26,856	(5.7)	23,435	(5.7)	20,846
= Net income	487.9	53,247	9.9	45,252	9.7	39,149	9.6	32,620
+ Net income	487.9	53,247	9.9	45,252	9.7	39,149	9.6	32,620
+ Depreciation and amortization	1,506.8	164,442	30.4	138,204	29.5	116,964	28.6	97,866
+ Provisions and charges	467.2	50,995	9.4	34,960	7.5	21,467	5.2	19,032
= Gross cash flow (funds generated from operations)	2,461.9	268,684	49.7	218,416	46.7	177,580	43.4	149,518

Exchange rate (31-12-87): 1 \$ = 109.136 ptas.

TOTAL DEBT (%)



guarantee ratio—the relation between shareholders' equity and net capital employed—which reached 64.1 %, an 0.8 % increase over the previous year.

Debt ratios also experienced a positive development.

Total Debt ratio was down from 44.1 % in 1986 to 43.1 %.

On a final note, the fact that gross cash flow was 3.9 times greater than net financial expenses (3.3 in 1986), and total debt only 2.7 times gross cash flow, is a clear indication of the healthy expansion capacity achieved in 1987, which overtook that of the year before.

Two important events accompanied these outstanding financial results:

On 12th June 1987, the international diversification of **Telefónica's** investor base reached a highpoint, marked by the start of the listing of our shares on the New York Stock Exchange.

Almost simultaneously, the U.S. agencies, Standard & Poor's and Moody's, awarded the Company "A-1+" and "P-1" ratings respectively, for our U.S. and European commercial paper program.

These two events provide firm confirmation internationally of both **Telefónica's** performance and future prospects. Furthermore, they clearly show the solid foundations of the Company's financial position and the strong fundamentals of our stock in the eyes of the discerning international investor.

983/1987 (In millions of Ptas.)

% Struct.	1983		Increase	
	Amount	% Struct.	Over 86	83-87 cum. av.
100.0 (36.6)	311,469 120,897	100.0 (38.8)	15.5 12.1	14.8 10.9
63.4 (17.5) (3.9) (26.8)	190,572 56,216 5,330 83,682	61.2 (18.0) (1.7) (26.9)	17.4 3.3 (6.8) 19.0	17.1 4.9 17.9 18.4
15.2 (1.3) 0.8	45,344 4,478 4,348	14.6 (1.5) 1.4	28.2 70.2 60.4	26.3 73.6 22.3
14.7 (5.7)	45,214 17,678	14.5 (5.7)	16.9 15.7	16.9 15.1
9.0	27,536	8.8	17.7	17.9
9.0 26.8 5.2	27,536 83,682 9,808	8.8 26.9 3.2	17.7 19.0 45.9	17.9 18.4 51.0
41.0	121,026	38.9	23.0	22.1

BALANCE SHEETS 1983/1987

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

ITEMS	1987 \$ in millions	1987	1986	1985	1984	1983
Fixed assets	18,514.7	2,020,623	1,835,197	1,703,265	1,540,156	1,388,514
Property, plant and equipment	28,976.6	3,162,385	2,828,586	2,568,812	2,298,083	2,016,193
Depreciation of fixed assets	11,307.4	(1,234,045)	(1,097,404)	(982,606)	(868,250)	(754,311)
Property, plant and equipment - net	17,669.2	1,928,340	1,731,182	1,586,206	1,429,833	1,261,882
Net intangible assets	6.6	718	3,997	5,042	4,803	3,797
Investments	475.2	51,859	38,755	32,987	33,895	37,677
Deferred charges	98.2	10,722	12,424	12,898	13,461	9,186
Unrealised exchange losses	265.5	28,984	48,839	66,132	58,164	75,972
Current assets	1,155.1	126,059	113,596	103,122	124,201	98,081
Consumable inventories	38.0	4,146	5,692	3,699	2,993	2,523
Accounts receivable	1,052.6	114,882	100,010	86,078	78,038	75,155
Cash and banks	25.4	2,772	2,332	7,981	34,297	12,388
Other current assets and prepayments	39.1	4,259	5,562	5,364	8,873	8,015
Assets = Liabilities and shareholders' equity	19,669.8	2,146,682	1,948,793	1,806,387	1,644,357	1,486,595
Shareholders' equity (1)	11,185.4	1,220,727	1,090,016	947,804	832,543	719,023
Paid-in share capital	3,806.0	415,368	411,793	360,468	320,416	288,374
Reserves and provisions	7,379.4	805,359	678,223	587,336	512,127	430,649
Medium and long term debt (2)	6,260.0	683,186	632,056	659,545	636,528	562,994
Debt in pesetas	5,531.6	603,694	532,927	450,717	400,374	369,393
Debt in foreign currencies	728.4	79,492	99,129	208,828	236,154	193,601
Net capital employed (1 + 2)	17,445.4	1,903,913	1,722,072	1,607,349	1,469,071	1,282,017
Current liabilities	2,224.4	242,769	226,721	199,038	195,286	204,578
Short term debt	1,890.5	206,321	187,585	168,171	165,381	180,929
Accruals	333.9	36,448	39,136	30,867	29,905	23,649
Unused credit facilities (In memorandum accounts)	850.2	92,789	97,965	121,300	88,680	53,607

Exchange Rate 31-12-87: 1 \$ = 109.136 Ptas.

STATEMENT OF CHANGES IN FINANCIAL POSITION

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

	1987 \$ en millions	1987	1986	1985	1984	1983
Gross cash flow	2,461.9	268,684	218,416	177,580	149,518	121,026
Reserves	40.7	4,444	2,157	3,369	4,769	4,563
Share capital increases	—	—	36,047	32,084	22,387	33,644
M & L.T. Debt	1,622.1	177,028	204,803	154,267	151,510	105,714
— Domestic	1,518.4	165,710 (a)	168,827	139,370	97,409	72,151
— Foreign	103.7	11,318	35,976	14,897	54,101	33,563
Total sources and applications of funds	4,124.7	450,156	461,423	367,300	328,184	264,947
Capital expenditures and investments	2,609.3	284,773	218,458	195,726	175,549	185,797
— Capital expenditures in fixed assets	2,384.0	260,183	211,514	188,681	173,642	164,404
— Intangible assets	40.3	4,398	1,866	1,778	1,607	1,658
— Investments in affiliates	135.7	14,808	5,051	48	(3,318)	15,386
— Stocks for fixed assets	49.3	5,384	27	5,219	3,618	4,349
Deferred charges	(72.9)	(7,959)	(7,307)	(5,882)	(9,511)	(4,628)
Applications of provisions	611.6	66,752	61,774	55,056	50,770	36,851
Repayment and redemption of M. & L.T. debt	1,011.0	110,335	205,534	147,587	78,642	51,518
— Domestic	822.4	89,758	67,014	86,900	53,032	41,107
— Foreign	188.6	20,577	138,520	60,687	25,610	10,411
Variation in working capital	(34.3)	(3,745)	(17,036)	(25,187)	(32,734)	(4,591)
Variation in unused credit facilities	(50.7)	(5,533)	(16,976)	29,271	22,839	8,760

Exchange rate 31-12-87: 1 \$ = 109.136 ptas.

NOTES

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

Total variation	(3,745)
Increase in 1987 dividends	1,005
TOTAL	(2,740)

(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	632
Promissory Note interest	3,447
TOTAL	4,079

