



César Alierta
C.E.O. Telefónica S.A.

Dear shareholder:

Telefónica has always been noted for maintaining a high degree of transparency in its communications with its shareholders. The Annual Report is, undoubtedly, the most important document in the relationship of the company with its shareholders and with society in general, and, in such complex times as these, it is the basic instrument for a proper understanding of the management results, which in 2002, evolved in a very unfavorable environment.

Therefore, in this Annual Report 2002, we have tried to make a special effort, not only to present the necessary aspects that permit one to evaluate the results obtained, but also, to go one step beyond the requirements of current legislation as regards providing information about the Company. In this manner, for the first time, we have included specific details regarding our progress in implementing Good Government practices and activities related to the exercise of Corporate Responsibility. Thus, Telefónica intends to reinforce its position as a stock market leader, in terms of both its size and the quality and transparency of the information it provides.

Fiscal year 2002 has been a difficult one. The year was characterized by a high degree of uncertainty in the global socio-political situation, and by a severe economic slowdown, especially in the European Union, where GDP rose just 0.8%, and in Latin America, which posted loss in GDP of 0.3%, the worst results in the past twenty years - an environment which includes the serious crisis facing Argentina.

In addition to the factors above, there were others that specifically affected our sector, such as the difficulties encountered by some major companies in dealing with their high debt levels; credit rating downgrades; the uncertainty about the future demand for fixed and mobile telephone services and, consequently, the perceived absence of catalysts for growth in our sector; and finally, the delay in the development of third-generation mobile technology.

In this context, capital markets have suffered from a lack of liquidity and a greater aversion to risk, which has led to extremely volatile stock prices and, ultimately, a deepening of the widespread stock market crisis which began some time ago and, especially, in the Telecommunications sector. For example, the general stock market indexes such as the S& P 500 and DJ Euro Stoxx 50 fell 23.4 % and 37.3 % respectively in 2002, whereas the Telecom sector benchmark indexes such as the DJ Stoxx 600 Telecom and the NASDAQ Telecom fell 27.4 % and 54.0 %, respectively.

2002 Results

During 2002, Telefónica was especially vulnerable to the Latin American markets: consequently, it was affected by the economic, political and social crisis in Argentina, while at the same time it felt the effects of the uncertainty surrounding the political changes in Brazil and its possible economic consequences. In both cases, the loss in value of their respective currencies (Argentine peso and Brazilian real) substantially affected Telefónica's results in the past fiscal year, given the strong weight of both countries in the Company's business. Thus, in this fiscal year 2002, operating income fell to 28,411.3 million euros, in other words, a year-over-year decline of 8.5%. Using a homogeneous comparison, excluding the effect of the exchange rate and the variations of the consolidation perimeter, income would have risen 5.3%. To compensate for this reduced income, a great cost reduction effort has been made in all business lines, despite the difficult economic environment. Likewise, a successful policy to control late payments has been implemented throughout the fiscal year, which allowed us to end the year with a bad debt provision to income ratio of 2.3%, versus 3.3% in December 2001. Operating expenses totaled 17,512.5 million euros in the twelve months of the year, 9% less than in the same period the previous year.

The described evolution in income and expenses have left Grupo Telefónica's earnings before interest, income tax and depreciation allowances (EBITDA) in the year 2002 at 11,724.2 million euros, 8.4% less than the figure for 2001. However, discounting the effects of the exchange rate and the consolidation perimeter, EBITDA would have grown 5.4% over fiscal year 2001.

Given the described scenario, and with the prospects for our sector and the markets in which we operated during fiscal year 2002, we decided to apply the stock market's valuation of our Company's to the Group's accounts, with strategic actions that – although, in the short run, have led to the sacrifice of accounting results – when combined with a strict financial discipline and measures to prioritize cash flow and improve the return on invested capital in all our business lines, will give Telefónica a relative advantage to unconditionally make the most of the clear possibilities of future organic growth provided by the sector in certain businesses and geographical markets.

These decisions were positively valued not just by the stock markets, who stressed their resolve and realism, but also by the main European operators, who, subsequently, moved in the same direction. This shows, yet again, Telefónica's skill at anticipating the trends in the sector, even if this requires adopting difficult measures that affect short-term results.

Within the framework of the strategic decisions I will describe below, the most important one, due to its distinction and its repercussion on the European market, was the freezing of all sales activity and the write-off of third-generation Mobile Telephone operations outside Spain. This asset write-off, plus the expenses of restructuring the UMTS business in Germany, Austria, Italy and Switzerland, has led us to allocate extraordinary negative net results of 4,958.2 million euros. Likewise, Terra-Lycos made some net write-offs, that in accordance with prudent accounting criteria, had a 420.7 million euro impact on our accounts as a result of the continuous review of the retrievability of goodwill,

Altogether, during the past fiscal year, there has been an asset write-off in the net amount of 6,325.8 million euros, write-offs that without causing any cash outflows or any changes in the Company's credit rating, caused a net accounting loss of 5,576.8 million euros in 2002.

Without the impact of all the net extraordinary results of the corresponding tax effects, and the effect of the Argentinean crisis, the Group's net profit would have come to 1,916.2 million euros.

The write-offs taken have reinforced the quality of Grupo Telefónica's balance sheet. The percentage of intangible assets to total assets as of December 2002 has dropped from 31.9% to 22.5%. Telefónica currently has, without a doubt, the most solid balance sheet in the European telecom sector, which guarantees the flexibility required to capitalize on the recovery of the sector and business in our core markets without restrictions.

Profitable Growth Strategy

To explain these results in detail, we must keep in mind that 2002 has been a year in which Telefónica executed key strategic initiatives. These initiatives, which have faithfully incorporated with the strategic vision we presented at the General Shareholders' Meeting in 2001, has focused on three approaches.

The first is the *strengthening of our competitive position in our key businesses and our core markets*.

As a result, in Spain we have consolidated our leadership in two businesses that are key for the future development of Telefónica. On one hand, the Broadband access business, with almost one million active ADSL lines at year-end. The high degree of Broadband penetration in Spanish homes, estimated at around 7 % in December 2002, mostly based on the deployment of Telefónica de España's ADSL access lines, places us among Europe's leading countries, together with Germany. Furthermore, thanks to our investment efforts in Broadband access, we have managed to re-establish the Group's leading role in the Internet traffic market.

At the same time, in 2002 we maintained our position as the leader in the Mobile Telephone business in Spain, with over 18 million customers at year-end, which raises our estimated domestic market share to 55%. Nevertheless, our traffic share is even greater, which proves that we have achieved a significant increase in the quality of our customer base in Spain.

On the other hand, in Brazil, we are beginning to obtain the first results of the accelerated growth strategy which allowed us to meet the fixed infrastructure deployment «goals» ahead of time in the State of Sao Paulo that had been established by ANATEL, the Brazilian regulatory agency; this achievement therefore opened, also ahead of schedule, the door to the fixed telephone long-distance interstate and international business. Thus, our Telesp subsidiary, in its first year operating this long-distance business, has already obtained a 36% share of the domestic long-distance market, and 32% of the international long-distance market. Furthermore, Telesp is now the leading provider of Broadband access in Latin America, with more than 330,000 active ADSL connections in late 2002.

In addition, in 2002 Telefónica Móviles has taken a decisive step to improve its competitive position in Brazil, by formalizing its strategic alliance with our partner Portugal Telecom. As a result, that year in this country, our Companies achieved operational integration with PT's companies, thus creating Brasilcel. The coordination of our strategies through this new operator allowed us, in January of this year, to sign an agreement to purchase Tele Centro Oeste, making our subsidiary the leading mobile operator in Brazil, with almost 17 million customers, a market share in excess of 50%, and almost nationwide coverage, with access to a number of States that account for 80% of Brazil's GDP.

In Mexico, the acquisition of Pegaso and its integration into our existing operations in that country, has allowed Telefónica Móviles to become the second-ranked mobile operator in Mexico, with 2.4 million customers.

The second sphere of activity on which our strategic initiatives focused in 2002 *was the restructuring of businesses that were not providing adequate results*.

In addition to freezing our operations and writing off assets and restructuring expenses for the UMTS Mobile Telephone business in Germany, Austria, Italy and Switzerland, in 2002, Telefónica took a series of decisions that improve the strategic and operational coordination between its businesses. Thus, in 2002, it has changed the approach and reordered the management priorities at Terra-Lycos. As a culmination of this process, in February 2003, Telefónica and Terra-Lycos signed a long-term strategic alliance that boosts their joint leadership in Internet and Broadband. This alliance defines a new type of relation between the Companies, which makes better use of their respective capacities and boosts the growth potential of both companies in the Internet business.

Elsewhere, in 2002 we have continued to work on refocusing our Telefónica Data business by increasing the integration between Telefónica Data Operators and Fixed Telephone Operators in those countries in which we are the leading operator, and, at the same time, we have launched a new approach for this subsidiary in markets where we are new entrants in the fixed telephone and data business, since such markets are not considered strategic in the medium term. By applying this strategy in 2002, we have divested Telefónica Data's operations in Austria (European Telecom International) and Uruguay.

The reorganization of our Media business is also part of this restructuring of businesses not providing adequate returns, and the merger agreement between Vía Digital and Sogecable, launched in first quarter of the year, is currently in an advanced execution phase. The merger of the two Companies will give birth to the leading pay-TV platform in Spain, with more than 2.5 million customer homes, and an aggregate income in 2002 of over 1,300 million euros. The agreement will contribute decisively to the development of the Spanish audiovisual market.

Finally, the third front of our strategic actions in 2002 has been the reinforcement of our financial management to preserve our Company's flexibility.

In this regard, during 2002 we have insisted on a strict financial policy of prudence and profitable growth. Consequently, in the past year we have enhanced the generation of operating cash flow, which, after making the investments required to maintain our competitive position in the business, has increased by 62.6% in year-over-year terms, to 7,935.2 million euros. Our Company's financial strength, quite outstanding in the sector, has allowed us to make the major strategic decisions we have described in the previous point, and simultaneously reduce Grupo Telefónica's net debt by 22%, to 22,533.1 million euros at the end of 2002, in other words, 6,408.5 million euros less than the debt at the end of 2001.

This greater generation of cash flow not only strengthens Telefónica's financial position, but also increases the Company's capacity to improve its shareholder return policy. Thus, Telefónica's Board of Directors approved, at its meeting in December, a proposal to the General Shareholders' Meeting for re-establishing dividend payments, specifically a gross dividend of 0.25 euros per share against freely distributable reserves, as well as the repurchasing of up to 2% of equity, and the Board's proposal to the General Shareholders' Meeting for canceling those shares.

The execution during the year 2002 of the strategic initiatives that I have described to you has provided our Company a financial solidity and strategic flexibility that will allow us to enjoy a privileged position to take advantage of the organic growth opportunities in our sector in services such as Broadband, fixed, and mobile, and the development of Telefónica's core markets, in which we have reinforced our position this year. After the write-offs we have made in our balance sheet, and the measures we have taken to manage both the Argentinean crisis and the general risk of the Latin American region, I can

transmit to you my conviction that Telefónica has emerged clearly reinforced from the crisis that affects our sector, with well-defined management priorities and strategic objectives, and a financial health that is unique among our European counterparts.

Sector prospects

Although our sector, like other sectors, is currently affected by a stock market environment that is buffeted by uncertainty and the consequent investor nervousness, the value of the Telecom sector has in general terms returned to the levels prior to the so-called «Technology Bubble», and its overall profitability is starting to recover. Thanks to this, the capital markets, previously very restrictive, have begun to reopen for telecom companies that have survived the crisis and are demonstrating that they know how to adapt to the new environment.

I believe that our optimism regarding the future is justified, since the hopes that were pinned on our sector, as an essential base for achieving that economic and social development stage we have decided to call the Knowledge and Information Society, were indeed real hopes that are now tangible in many daily aspects of our lives.

As a result, in the field of Fixed Telecommunications, all the best-known experts in the sector agree that future growth in this business is based on the success of Broadband Services, and we can already see in our offices and homes tangible examples of the potential of applications and content delivered through accesses such as ADSL.

During the year 2002, we have witnessed the generalization of Broadband as the high-performance Internet access medium. ADSL is becoming a great success in all the major markets in which Telefónica is present: during the past fiscal year, we have increased the number of active connections by almost 800,000, and the Group currently has 1.4 million ADSL customers around the world. But, in addition, we have seen how Broadband users have moved massively into the use of interpersonal communications on the Internet, and there has been a spectacular increase of direct exchanges of personal content among Internet users (music, videos, games, etc.).

Currently, the value of the Broadband business resides, almost exclusively, in connectivity. In the future, we believe the Broadband connectivity business will multiply, growing as a complement to the applications, content and multimedia value-added services that are provided precisely over that connection. There is a great growth potential in both businesses (Broadband connectivity and value-added services) if fixed telecom operators and service providers jointly develop new business models, which will be really innovative and profitable for both parties.

In Mobile Telecommunications, although voice will continue to be for a long time the main source of income for this sector, we can detect an increase in the consumption of other communication alternatives, mostly written, such as e-mail, instant messaging, multimedia messages and short videos (10-20 sec.). These services will demand, as they grow, increasingly efficient technologies for using available resources. This will be especially important in mobile telephony, where the available spectrum is limited. Technologies such as the current GPRS, EDGE or UMTS are valuable in this context of increased service demands. The year 2002 has been especially fruitful in the deployment of new mobile technologies. Thus, there are currently over 100 networks around the world that supply multimedia messaging (MMS), something that was unknown just a few months ago, and the transmission of images and photos between users of mobile terminals is starting to become widespread.

These tangible examples show that consumer habits in fixed and mobile telecommunications have begun to change, and that consumers accept the new possibilities that technology can provide to improve certain specific aspects of their personal and professional lives. This fact is a source of promising opportunities for companies working, as we do, to materialize ever more efficiently the new services that potential users are already demanding.

Telefónica, and all the companies in the Group, have a clear advantage when facing this new transformation of the sector. First of all, we have a well-defined strategic vision of the steps we must take, and of our capabilities for undertaking them. Secondly, we have a solid financial position, which allows us to use resources flexibly without endangering the future of the Company. Thirdly, and perhaps most importantly, we have access to 90 million customers, with whom we relate every day through our access routes (fixed and mobile) and sales networks.

In this way, we are one of the companies best prepared to support and obtain benefits from the effective development of the Information Society in all the markets in which we are present. For the latter objective, we must count on the commitment of all the agents involved in this project: users, infrastructure and platform providers, content and application providers, and society in general, especially the Regulatory Agencies and Competition Authorities, who have an important role in guaranteeing the existence of a stable and predictable legal framework which does not discourage the capital needed to bring this common Information Society project to completion.

Telefónica: an integrated Group

We will continue to pursue this ambitious objective because we are convinced that we are a Corporate Group united by a set of proprietary corporate values. Our values guide us in the effort to fulfill the commitment that we have acquired with our shareholders, our customers, our employees, and Society. In this regard, Telefónica has an internal corporate reputation project, which represents an integrated management of the main values that affect the Group's good name: ethics, values, vision, corporate governance, corporate responsibility, identity and culture.

Telefónica has acquired a firm commitment to loyalty and transparency with its shareholders, and wishes to be at the forefront in adopting good government practices. In this regard, in 2002 we approved new Internal Conduct Regulations regarding stock markets, there are new members on the control committees of the Board of Directors, and they have been given new competences. Telefónica's *Annual Report on Corporate Governance* details these and other similar initiatives that have been implemented by the Company during this year.

Additional proof of the Company's commitment to transparency is the issue, for the first time this year, of the *Annual Report on Corporate Responsibility*, whose aim is to identify, measure and communicate to everyone - customers, employees, shareholders, investors, the society... - Grupo Telefónica's intangible/non-financial assets. Both reports demonstrate Telefónica's efforts to bring to light the Company's full value.

In sum, Telefónica wants to become the Company of Confidence for all the agents it comes into contact with. And generating confidence means doing what we say: meeting our commitments. With this confidence-based culture that guides our everyday actions, we want everyone to perceive clearly that Telefónica is an honest, well-managed company with a great future, reports in a transparent manner, is safe for its investors, and is close to and intertwined with the social fabric. Telefónica wants to be «more

than just a company»; an institution that contributes actively to the development of the countries in which we are present.

And finally, I wish to transmit to you, as a Telefónica shareholder, the message that the entire Company is focused on improving return, and that all of our businesses will contribute to that end.

On behalf of Telefónica's Board of Directors, I thank you for the confidence you have shown in the Company, and I urge you to continue to join us in this future full of promising prospects which we have before us, a future of which we are ready to take advantage.

A handwritten signature in black ink, consisting of several loops and a long horizontal stroke at the bottom.

César Alierta
Chairman and C.E.O.
Telefónica S.A.