

# Letter from the Chairman

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Executive Chairman, Telefónica, S.A.



## Dear Shareholder,

I have always considered the Annual Report published on the occasion of the Annual General Meeting of Shareholders to be a highlight in the communications policy of any company, not just for its shareholders but also for all other stakeholders. The Annual Report that we are presenting today outlines the results of our management strategy over the course of 2009; these results are even more important than usual given the recession that has hit the economy, which is the most serious since the Great Depression of the 1920s with the largest drop in economic activity since the Second World War. Without doubt, overcoming the challenges posed by these unfavourable economic conditions has severely tested the management skills of most companies.

I am pleased to be able to tell you that our efforts in Telefónica to transform the business in recent years have enabled us, not just to withstand these conditions, but also to continue growing; once again –for the seventh consecutive year– we have met the objectives we committed to with the financial community, with a total return for shareholders which sets us apart not just in the sector, but also in the markets in general.

In 2010, emerging markets in Latin America and Asia are leading the economic recovery, and this is now starting to be noticed in the rest of the markets. The worst is over, and Telefónica is perfectly placed to take full advantage of its global positioning and diversity in order to move further ahead of the rest of the industry.

The global ICT sector also grows and a new social and economic paradigm is becoming evident around the new information and communication technologies. Telefónica is committed to playing a leading role in this new digital world, as I shall be outlining in this letter.

# Nobody is better positioned than Telefónica to tackle the challenges of the future

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## Expansion despite the recession

In spite of the complex situation faced by the sector throughout 2009, the diversification of Telefónica's operations enabled it to achieve turnover of 56,731 million euros, an increase of 0.2% on 2008.

The Company's intensive commercial activity has enabled it to increase its customer base by 5.1% in comparable terms over 2008, and we now have 265 million customers all over the world. This increase in Telefónica's customer base is mainly the result of a 7.4% rise in the mobile phone business, an increase of 8.2% in broadband landline services and a 9.8% growth in pay television. Mobile phone accesses have increased to 202 million, with a significant increase in mobile broadband accesses, which totalled 15 million by the end of 2009.

From a financial perspective, the Company's aim during 2009 was to guarantee cash flow at all times, meaning that there was a substantial emphasis on improving efficiency and fully exploiting economies of scale. This is reflected in operating income before depreciation and amortisation (OIBDA), which rose to 22,603 million euros, an overall increase of 0.9%, with an OIBDA margin of 39.8%.

Operating cash flow (OIBDA-Capex) stood at 15,346 million euros, overall year-on-year growth of 8%. There was an acceleration in conversion of revenue into operating cash flow, reflecting Telefónica's success in combining strong commercial activity with highly positive cash flow generation.

Telefónica's net 2009 profits increased by 2.4% to stand at 7,776 million euros, with basic net profit per share rising to 1.71 euros per share, 4.5% above the 2008 figure.

## Our first priority is always shareholder remuneration

In 2009 we set aside 61% of free cash flow for shareholder remuneration, through a combination of dividend payments and the repurchase of company stock. The positive results obtained in 2009 will enable us to continue with our shareholder remuneration policy in the future through increasing dividends, from 1.40 euros per share in 2010 to a minimum of 1.75 euros per share in 2012.

Telefónica's share price climbed by 23.2% in 2009, in excess of the largest increase by any comparable European or American company, and exceeding the annual increase in the Dow Jones Telco Index which is the worldwide reference for the sector. In 2009 Telefónica achieved the highest total return rate to its shareholder of any comparable European or American company, 29.5%.

Telefónica is currently offering the highest profitability to shareholders in terms of expected 2010 dividends of any of the fifty largest companies in the world by market capitalisation. However, our objective is not only to offer good dividends, but also to maximise value for Telefónica shareholders through continued growth. To this end, our constant objective is to expand more than our competitors and to be the market leaders.

## Solid corporate strength ensuring a unique profile

In last year's letter I stated that no other company is in a better position than Telefónica to tackle the challenges of the future. In a difficult situation, Telefónica has not only been able to post solid results but also to further strengthen its position, as can be seen in this Annual Report.

Telefónica is characterised by sustained profitability and growth. Since 2000 its revenue has doubled whilst its customers have quadrupled. This has resulted in Telefónica growing into the world's fifth largest operator in terms of accesses; this has been accompanied by extensive diversification in operations, both from a geographical and a business perspective, with almost 65% of company turnover coming from outside Telefónica's original market.

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Our profile as a global operator has been further strengthened by a series of strategic and industrial alliances with China Unicom and Telecom Italia, which together have a joint customer base of over 658 million people 10% of the world's population.

Telefónica's efficiency, which continues to set a benchmark within the sector, and its financial robustness, both of which were maintained throughout 2009, with a debt ratio measured in terms of net debt over OIBDA of 1.9, all make Telefónica a low-risk option in a highly promising industry.

We should also highlight the leadership of our brands; Telefónica's firm commitment to society, which was recognised internationally with the first place for our sector in the Dow Jones Sustainability Index; and the commitment of our executives and the whole Telefónica team, whose professionalism is recognised both within the sector and beyond.

We face 2010 therefore on a firm footing, in an unbeatable position from which to take full advantage of the great opportunities for growth that the sector affords us.

### **Growth in a sector which is crucial for the future**

Today, the most respected analysts agree that the worst of the difficult economic situation that we have been going through is now behind us. As we foresaw a year ago, the world of telecommunications has continued to undergo one of the most significant periods of development and transformation which any industry has ever experienced. The new decade begins with 4.4 billion mobile phone customers and over 1.2 billion landline and mobile broadband users.

The multiplying impact of telecommunications and ICTs in general is an essential part of a new cycle of sustainable growth. Studies indicate that broadband contributes growth of around 5% in productivity within the industrial sector, and 10% in the service sector; other reports suggest that the application of ICTs might reduce world CO<sub>2</sub> emissions by 15% by 2020. Broadband connectivity is the most efficient way of driving this sustainable growth, and this is clearly demonstrated by worldwide productivity gains; plans to stimulate economic growth, and the digital agendas being pursued by governments.

High-capacity broadband will be at the centre of all new value proposals. It is easy to appreciate the ever-increasing importance of the digital contribution to commerce, leisure, health, education and governmental administration. Companies need ICTs in order to open up new ways of doing business and ensure ever-better experiences for their customers. It is also true to say that ordinary people are the driving force behind change, living 24 hour-a-day lives that are increasingly digital. This is demonstrated by sales of more than 175 million smartphones in 2009, with increasing revenue from digital applications and content. Customers are the real drivers behind this process, constantly defining and redefining a demand-led marketplace.

Nobody is closer to these new digital customers than telecommunications operators, as can be seen from the amount of spending on communications increasing from 2.6% in 2000 to a forecast 4.2% in 2015. It is clear that there is a great opportunity in our industry for global, flexible operators with the size to adapt to the needs of their customers to offer the perfect channel for access to all the innovation and creativity in the digital world, simultaneously offering a comprehensive, high-quality, customised, personal experience.