

Letter to shareholders

José María Álvarez-Pallete
Telefónica's Chairman



Today we are closer to being the company we want to be than the company we proudly once were

Three years ago, we intensified a transformation of Telefónica that we had initiated some time ago. This transformation is turning a historic voice services company into a technology company.

We embarked on this path at a time when few others had seen it. We were pioneers. As Hemingway once said: *"At the most important crossroads in our life there are no signs"*. Telefónica was able to see the technological transformation path of the Company, our Company, and we decided to follow it.

Well, I can assure you that today we are closer to being the company we want to be than the company we proudly once were:

- » We are already a technology company that is at the heart of the digital revolution that we are living because the driving force behind that revolution is the connectivity we provide for our customers; intelligent connectivity on new high-speed, flexible, secure and advanced networks featuring elements of artificial intelligence.
- » We are a technology company because, on this intelligent connectivity, we provide the new digital services that customers demand.
- » We are a technology company that is at the forefront of new technologies, making pioneering use of artificial intelligence in the way it relates to customers, processes and management systems.

- » We are a technological company moving towards an "All Digital" model.

It is always a major challenge to foster change in large organizations with long histories. Despite this, 2018 was the year in which we crossed the equator of Telefónica's transformation process while concurrently:

» **Gaining relevance in the lives of our customers.**

At the end of 2018 we had a total of 356 million customers; customers with whom we have a higher-value relationship and who are increasingly satisfied. We have more broadband customers with fibre or cable than with copper, and post-pay customers already account for half of our mobile customers. Moreover, approximately 50% of our mobile customers are already enjoying 4G technology.

- » **Improving in the main financial figures:** revenue is growing and we have become a data business insofar as data now account for 53% of total sales. Operating income and net income are also rising, the latter for the third consecutive year and by 6.4%, exceeding €3.3 billion and with margins that are a sector-wide benchmark. In addition, free cash flow excluding spectrum continues to grow, exceeding the €5 billion threshold for the second year in a row.

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- » **Maintaining a high level of investment** to reinforce our technological platforms and hence satisfying customers' needs: €82 billion since 2012. And we are achieving this by becoming increasingly digital: 65% of our processes have already been digitized.
- » **Substantially reducing debt** by €12 billion since June 2016, both organically and through divestment of non-strategic company assets.
- » **Maintaining attractive shareholder remuneration**, with a sustainable dividend of €0.40 per share which is comfortably covered.

Frankly, it has not been easy to drive the transformation of Telefónica while also meeting these business targets. We have had to carry out this transformation in an environment that was not favourable to this change (when not adverse) in which different factors converged: on the one hand, turbulence in important markets in Latin America and the United Kingdom and, on the other hand, market doubts about our sector. The negative performance of IBEX companies on the stock market was also a challenge.

Despite all these factors, today Telefónica is considerably stronger than it was 3 years ago and, although we have already seen a recovery in our share price, we are convinced that it still has growth potential to reflect the true value of your Company.

It is true that a transformation project of a company with 95 years of history and the scale of Telefónica requires both effort and time. But, above all, it requires a clear definition of its mission and long-term strategy.

***Our mission: to make
our world more human
by connecting lives***

It is no coincidence that while accelerating our transformation we redefined our **mission**: *"To make our world more human by connecting lives"*. Thus stated, our mission may sound as broad as it is ambitious; and that is true. But this is easier to understand when explained within the context of the digital revolution that is transforming the economy, society and our lives. Telefónica is striving to ensure that people and societies can benefit from this revolution and not be overwhelmed or left behind.

It has rightly been said that the mission of a company cannot be summed up by a simple empty phrase. Its mission statement must be its fundamental reason for existing, i.e. what it does every day to generate value for its stakeholders.

In building this technology company, we have not limited our vision to the next quarter or even to the next two. We are re-shaping the Company for the next 20 or 30 years. And certain requirements must be met when the goal is to generate long-term value.

The first is to create a relationship of trust with all our stakeholders, starting with customers and, and this must be based on satisfaction. In this regard we have reached record levels. We are encouraged to have been recognised by Fortune for the second consecutive year as Europe's most admired Telco and the third most admired worldwide.

That trust, which we must also build with our investors and society as a whole, is achieved through management guided by respect for human values. Protection of privacy and the security of communications or the controlled and ethical use of artificial intelligence are included among these values. At Telefónica we promote a Digital Rights and Obligations because we believe that the new digital world should not lead to a loss of individual or social rights that were already in-place in the analogue world.

We are building this technology company for the next 20 or 30 years

The second requirement is growth. To be precise, inclusive and sustainable growth. Growth that includes the greatest number of people and that is environmentally-friendly.

Our concern for *inclusion* is reflected in numerous initiatives aimed at reducing the digital divide and promoting inclusive connectivity. If any single programme exemplifies this effort, it is "Internet for All" which is already serving 600,000 people in remote areas of Peru.

Our concern for *sustainability* makes the development of services with a positive impact on the environment a priority, as evidenced by double-digit growth in these services over the past year.

The third and final requirement for a company with a long-term vision is efficiency, which implies optimisation of all our capabilities and where digitisation, both of networks and operations, is key. In this area, Telefónica is recognised as a market leader.

We have significantly reduced energy consumption and are increasingly consuming energy from renewable sources, already reaching in 2018 the ambitious goals that we had set for 2020. This has allowed us to successfully issue the first Green Bond in our sector.

Trust, growth and efficiency depend largely on a company's employees. Our teams are increasingly trained with new commercial and technological skills. And their structure increasingly reflects cultural, racial, generational and profile diversity. There is a growing gender balance: 38% of our workforce are women and 23% of our management positions are held by women and we intend to continue increasing this mix.

Overall, no large company is sustainable in the long term if it does not generate benefits for all its stakeholders. Companies whose overarching value does not include contributing to the development of societies are destined to disappear.

I am proud to tell you that your Company contributes to social development in many ways. We have an impact of over €53 billion on the GDP in the countries where we operate, a fiscal contribution to the public budget of more than €10 billion, this is €21 for every €100 invoiced and more than 1.2 million direct and indirect jobs. This gives you an idea of the magnitude of the social contribution that your Company makes.

At Telefónica we are committed to the United Nations Sustainable Development Goals. As a tangible sign of our commitment to the long term and to sustainability, starting this year, the variable remuneration of our entire team will include factors such as *customer trust, trust of society, gender equality and climate change*.

In last year's letter and in my speeches at previous General Shareholders' Meetings, I referred in some detail to the wave of technology that was approaching. The fact that we saw it coming made us pioneers. *"We are living in a unique moment because never before in the history of humankind has technology advanced at this speed ... It brings together virtual and augmented reality, the explosion of connectivity, the Internet of Things, biotechnology, robotics, blockchain, the softwarization of everything and the ramping-up of artificial intelligence..."* were some of the expressions I used.

I also talked about voice and image recognition, the possibilities of 3D printing and deep learning.

Some shareholders celebrated this vision of the future while others expressed their curiosity and surprise at what appeared to be remote. Well, not much time has gone by and we already have self-driving cars on some roads. In just a short span of time, artificial intelligence has become a familiar expression. Today image recognition is increasingly common and is being frequently used.

All these things which seemed like science fiction three years ago, are happening today and are being transported on our networks.

Now it is time to talk about another phenomenon that is already impacting our business: the explosion of cognitive intelligence. Just to give you an idea, the database of Walmart, the number one retailer in North America, generates 40 petabytes of data per year while Facebook generates 4 petabytes a day. Connected cars with all of its sensors will generate 40,000 petabytes a day and very soon there will be 100 billion people and things connected. Data traffic will continue to grow exponentially. All this places infrastructure at the heart of this transformation and speaks to the relevance of our networks.

The digital experience of our customers will change radically over a short period of time. In fixed connectivity, the transition from copper to fibre is producing that quantum leap and the same will happen in mobile connectivity with advanced 4G until 5G is rolled out.

This will require even faster networks that are much more capable, much safer and much simpler; networks with less latency and that are much more intelligent. On top of this we need to consider *edge computing* which requires a network prepared to process the data generated by the



internet of things closer to the point at which they are created. All of this again opens a world of opportunities for our Company.

Telefónica has a very bright future ahead because it is capable of generating long-term value in all the societies where it operates and for all its stakeholders

The history of Telefónica is one of permanent change. Your Company, our Company has been forged to change. And as Stephen Hawking once said: *"Intelligence is the ability to adapt to change"*.

Our Company was created with the mission of deploying fixed infrastructure, and we accomplished that. Our goal was to provide a simple voice service in Spain and those roots are indelibly marked in our name (Tele-Fónica).

At a certain point we realised that this was not enough; that this was going to be a business of scale. And the courageous decision was taken to venture outside of our national borders. Telefónica became a large multinational. We then saw the world of mobile telephony and accepted the challenge of providing both fixed and mobile networks. We saw broadband coming and stayed ahead of the others. Later we saw the world of television and positioned ourselves. We understood that connectivity would be key and we

committed to rolling out fibre. We envisaged the world of platforms and again we stayed ahead of the pack.

The waves of opportunity may again accelerate. Connectivity gives us one of those enormous opportunities to grow by embracing the world of big data, and we are ready. A fourth wave is coming in the wake of cognitive intelligence that will make us even more relevant.

I can assure you that your Company, our Company, will honour its history and will know how to capture all these opportunities thanks to our technological platforms.

Telefónica has a very bright future ahead because it is capable of generating long-term value in all the societies where it operates and for all its stakeholders: shareholders, employees, customers and suppliers.

Thank you for the time you have spent reading this letter. In it I have tried to summarise the most relevant events that have marked the performance of Telefónica over the past year and the ideas that inspire us towards a future full of achievable opportunities. It is, in any case, a letter written with absolute frankness in recognition of the trust you have placed in the managers of your Company.

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