



# Our Company's forward-looking approach



## Dear Shareholder,

I am very pleased to share with all of you a brief overview of Telefónica's performance and results in 2011, as well as the positive outlook for our company.

Last year was challenging for all of us. In 2011, developed countries continued to display important signs of weakness, especially in the Euro Zone, where economic growth stood at a mere 1.4%. We are clearly witnessing the rise of a new global economic order, in which growth comes primarily from emerging economies such as Asia and Latin America. This fact makes clear, once again, the important competitive advantage that geographic diversification gives to our company.

In a year characterised by a difficult macroeconomic, competitive and regulatory context, our high degree of diversification and our capacity to adapt allowed us to deliver solid results, in line with the targets we had announced; obtain a record free cash flow; and pay our shareholders a remuneration that continues to be differential, not only within our sector but in the markets in general.

Moreover, this was a year in which we took a decisive step forward in the process of transforming our company. This will enable us to better meet the challenges ahead, enhance our growth potential and capture the opportunities that the new digital world offers. A digital world that represents a unique opportunity to consolidate our leadership and contribute to shape a better future for all of our customers.

It is my hope that this letter will provide you with elements that will strengthen your conviction that you are investing in a promising sector and in the company that is best prepared to take advantage of the great opportunities offered by the digitalisation of the economy, even in the current difficult economic context.

### Solid results and diversification

In 2011, we moved forward in our strategy to capture growth in the markets where we are present, thereby strengthening our competitive position. This strategy has led us to increase by 19 million our customer base, which now stands at more than 306 million, allowing us to reach a new milestone in our growth. This boost was driven primarily by the significant growth in the number of mobile and mobile broadband customers.

The expansion of our customer base and the growing contribution of the mobile broadband business have, in turn, spurred the growth of our revenue, which rose by 3.5% in 2011 to €62,837 million.

"We have taken a decisive step forward in the process of transforming our company and enhance our growth potential"

We made remarkable progress in diversifying our business this year, greatly strengthening our position in Latin America. This region now accounts for more than 45% of our revenue and operating cash flow, with almost 55% coming from our European operations.

In Latin America, our revenue increased by more than 13%. Telefónica has the largest contract mobile customer base in the region and is the leader in mobile broadband adoption. We have strengthened our leadership in the key market of the region, Brazil, which has become our major growth engine and yields tremendous potential for the future.

In Europe, the difficult context has not prevented us from continuing to encourage the adoption of new broadband services as a key driver of revenue, in a context of pressure in traditional voice services due to intense competition with adverse regulation. The changes in commercial offerings seen in our main markets have led to a clear improvement in sales, and our efforts to seek efficiency have now begun to pay off.

The sustainability of this growth in coming years is our management priority. For this reason, we invested more than €10,200 million in 2011. The size of this investment reflects the importance that we, at Telefónica, place on having the best network, which differentiates us from our competitors and that will allow us to offer increasingly sophisticated services compatible with all kind of devices. Undoubtedly, this will be essential for future revenue generation and for improving customer satisfaction.

Allow me to finish this brief overview of our results by underscoring our free cash flow generation for the year: €9,270 million. This figure, a record for our company, represents 9.5% growth over 2010 and is equivalent to €2.06 per share. In addition, our free cash flow exceeds that of the vast majority of our peers.

“The fact that Telefónica is offering the highest expected dividend yield makes clear our company’s solid commitment to its shareholders”

### Differential shareholder remuneration

Few companies compare with Telefónica in terms of the historical performance of its shareholder remuneration. In recent years, Telefónica has gradually increased dividend per share, from €0.50 in 2005 to €1.60 in 2011. This continuous increase means that, in these seven years, more than €40,000 million has been paid out in shareholder remuneration.

Regarding 2011 dividend of 1.60 euros per share, a first payment of 0.77 euros per share has already been fulfilled last November. For the remaining amount (0.83 euros per share) the Telefónica's Board of Directors has proposed to the Shareholder Meeting to distribute a cash payment of 0.53 euros per share on next 18th of May, and to offer the possibility to receive the rest of the amount, 0.30 euros per share, in cash or shares of the Company.

In the current environment and considering Telefónica's stock market valuation, the Company has decided to anticipate the flexible shareholder remuneration scheme initially set for 2013. In 2012, we will once again offer a very attractive shareholder remuneration of €1.50 per share, consisting of the payment of a €1.30 per share cash dividend and a share buyback for the remaining amount. Treasury shares acquired will be amortized and the share buyback shall be completed by May 2013.

The remuneration, including dividends and share buyback, announced for 2012 imply a yield of 13.3% at the current share price<sup>1</sup>. The fact that, of the one hundred largest companies in the world by market capitalization, Telefónica is offering the highest expected dividend yield in 2012, makes clear our company's solid commitment to its shareholders.

<sup>1</sup> 11.295 euros as of 25/4/2012

### Bright prospects for the future

Let me highlight the positive prospects for the future of our company. The digital world in which Telefónica operates is growing at a faster rate than the economy overall and, in fact, is expected to grow at an average annual growth rate of 5% over the next four years.

The explanation for these favourable expectations lies in the progressive digitalisation of the real economy—a digitalisation that goes beyond our need to communicate. This means that sectors such as health, public administration, education and entertainment are creating demand for new digital applications and services that will make it possible to achieve higher levels of efficiency and better quality of life.

We can clearly state that we are evolving towards a smart, hyper-connected world, in which nearly every electronic device or equipment will be connected to the Internet. As an example, allow me to mention the gradual emergence of smartcities that use information and communication technologies to connect tens of thousands of sensors that receive information in real-time so as to offer services to citizens, thereby improving their quality of life and facilitating the transition towards an increasingly sustainable society.

This is but one example of the opportunities the digital world offers a company such as Telefónica. I can assure you that we are already taking advantage of these opportunities, and we will continue to do so in the future.

It is very clear to us, at Telefónica, that our company's success is based on customer satisfaction. Consequently, Telefónica's growth strategy for the coming years is centred on improving our customers' experience when they are using our products and services, in order to not merely continue to grow but also to be at the forefront of growth.

To make the most of the opportunities that the digitalisation of the economy offers us and to strengthen our customer relations,

**307 million**  
customers

say a lot about our Company growth in 2011

**In Latin America**  
we have grown **13%**

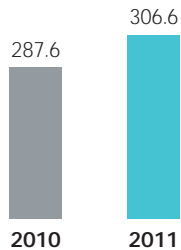
and have the largest contract mobile customer base of the region

**9,270 million**  
Euros of Free Cash Flow

represents 9.5% growth over 2010 and a record for our Company

**Customer evolution**

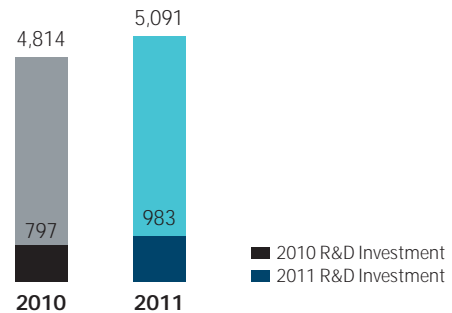
Million Euros

**Revenues**

Million Euros

**Technological innovation**

Million Euros



Telefónica has carried out a deep transformation of the company's organisational structure. We have launched two common units for the Group: Telefónica Digital and Telefónica Global Resources. In addition, we have created two business units, centred on the two large regions in which we operate: Europe and Latin America.

The new Telefónica Digital business unit aims to capture all of the growth opportunities available in the digital world, speeding up innovation, broadening and reinforcing our portfolio of products and services and maximising the advantages of our broad customer base.

The Telefónica Global Resources operating unit was created to boost the profitability and sustainability of our businesses, by leveraging to the greatest extent possible the benefits of our scale. The unit sets up global processes for areas such as procurement, systems, operations and human resources.

The creation of these two new units is in perfect alignment with Telefónica's strategic priorities, improves our positioning in the digital world and accelerates our transformation into a fully global company. In addition, it will allow us to be more agile, that is, to respond in a more straightforward manner, and more quickly, to the opportunities and challenges that are arising.

I can assure you that with the execution of these strategic priorities, we will strengthen our leadership position. Our aspiration is to become the best global communication company in the digital world, leading the distribution and aggregation of digital experiences for our customers.

I would like to reiterate that Telefónica is, in addition, a leader committed to sustainability—that we are involved in and concerned with the economic and social well-being of the countries in which we operate. For this reason, at Telefónica we allocate significant resources both for community work and for cultural endeavours.

I should stress, that through the Telefónica Foundation, we are fostering educational programs to eradicate childhood labour. Besides, Telefónica Foundation promotes access to knowledge and the application of Information and Communication Technologies, and the use of ICTs in collaborative networks.

Telefónica also promotes the use of ICTs among the handicapped in order to narrow the digital divide. Moreover, the Company has focused on foster Corporate Sustainability, in order to reduce the risks and take advantage of the opportunities arising from the economic, social and environmental management in line with the Dow Jones Sustainability Index. Index, in which the Company is present since 2003.

We recently launched several innovation and entrepreneurship programmes. As an example, I would like to highlight Wayra, with which we are operating as an incubator of small businesses that identify ideas with high potential in the digital world. Wayra fosters the development of these businesses and provides them with technology, tools, a work space, and financial resources.

Clearly, we are facing 2012 from a position of strength, thanks both to our important progress in the last decade to consolidate our diversification and to the decisions we have taken to accelerate our transformation process and promote our company's growth.

On behalf of the Board of Directors, I would like to conclude by taking the opportunity to express my gratitude for the support and trust that all of you have shown. And I would like to reiterate my conviction that at Telefónica we have embarked on a new phase that will strengthen our position as a growth-oriented and profitable company and a leader in this new digital world. I hope that you will continue with us in order to celebrate these achievements together in the very near future.

**César Alierta**  
Chairman of Telefónica

**The digitalisation  
of the economy**

offers great growth opportunities to  
our industry