Telefónica January-June 2010
Results Conference Call Transcript

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Introduction

María García-Legaz - Telefónica S.A. - Head of IR

Good afternoon, ladies and gentlemen, and welcome to Telefónica's conference call to discuss January-June 2010 results. I am María García-Legaz, Head of Investor Relations. Before proceeding, let me mention that this document contains financial information that has been prepared under international financial reporting standards. This financial information is unaudited.

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We encourage you to review our publicly available disclosure documents filed with the relevant securities market regulators. If you don't have a copy of the relevant press release and the slides, please contact Telefónica's Investor Relations team in Madrid by dialing the following telephone number, +34-91-482-8700. Now let me turn the call over to our CFO, Mr. Santiago Fernández Valbuena, who will be leading this conference call.

Presentation

Santiago Fernández Valbuena - Telefónica S.A. - CFO

Good afternoon, ladies and gentlemen, and thank you for joining Telefónica's 2010 first half results conference call. Today with me I have Julio Linares, our Chief Operating Officer, Guillermo Ansaldo, Head of Telefónica España, José María Álvarez-Pallete, Head of Telefónica Latinoamérica, and Matthew Key, Head of Telefónica Europe. During the Q&A session, you will have the opportunity to ask questions directly to any of them.

Continue to execute 2010 priorities

Telefónica has released today a strong set of results, based on execution of the management priorities established for 2010. Our results are consistently improving on a quarterly basis, from top to bottom line, leveraging a solid underlying operating and financial performance and positive impacts from forex. Our wide diversification fully explains our sound results despite challenging conditions in some markets.

Revenue growth in the second quarter picked up noticeably, led by improved trends across all regions on the back of a strong commercial push, focused on expanding the base of high quality customers, and robust growth in wireless data in our markets.

We continue to post robust profitability, with enhanced margins sequentially despite reinvesting efficiency gains to fuel future revenue growth.

Operating cash flow generation remains strong, which is coupled with a solid balance sheet that allows us to face current headwinds from a comfort zone.

Year to date performance is in line with expectations, and we do confirm our 2010 guidance for all metrics, with faster OIBDA growth expected for the second half of the year.

And let me stress that our growing dividend policy is fully reaffirmed.

Growth reacceleration...

Starting with the summary of the P&L on slide 3.

We see that in the second quarter of the year we have posted improved trends sequentially in major metrics, reflecting a ramp up in growth across regions and material currency boost, mainly from the Brazilian real and the Mexican and Colombian pesos, offseting the sharp Venezuelan Bolivar devaluation.

Group sales grew by 5.4% year-on-year to over 29 billion euros up to June, ramping-up 3.7 percentage points quarter-on-quarter. In organic terms revenue rose 2.0% in the first half, 1.1 percentage points more than on the previous quarter.

Six months Operating Income before D&A reached 10.9 billion euros, virtually flat year-on-year in reported terms, which turned into 2.3% decline rate in organic terms, driven mainly by the fast customer growth and the negative impacts from regulatory measures and non recurrent effects.

Operating Cash Flow in the first half exceeded 6.6 billion euros, impacted by the recent 1.4 billion euros investment in spectrum in Germany.

... from top to bottom

Our disciplined management of non-operating results allows top line growth to fully flow into net income, as slide number 4 shows.

January through June net profit topped 3.8 Billion Euros, or 9.4% above last year's figure and 10 percentage points above Operating Income growth.

All things considered, first half 2010 Reported EPS reached 0.83 Euros, equivalent to a 10% year-on-year increase.

Sustained commercial push …

Turning to slide number 5, the strong customer expansion up to June has been a key lever for our sound performance, reflecting our strategy to build the foundations to better capture the economic recovery and set the basis for the new wave of revenue growth.

Good commercial momentum continued in the last three months, leading to net adds in the first half of the year doubling the volume recorded a year earlier. Growth in net adds was powered by higher gross adds as well as churn control across businesses.

I would like to stress the 8.9 million organic mobile net adds recorded in the six months to June, 76% up year-on-year, with a particularly noteworthy performance in the contract segment and mobile broadband connections. More than 56% of the net adds were in contract, well above last year figure, while MBB accesses have already surpassed the 17 million mark, that already account for 8% of our mobile customer base, mainly pushed by the growing traction of smartphones.

Further prepaid to contract migrations and MBB adoption will foster mobile growth in the coming years.

Growth in FBB is also to be highlighted, with first half organic net adds increasing 30% year-on-year, on the back of higher penetration of bundles, which also drove improved trends in the traditional fixed line services.

Our commercial push on value and growth levers led us to reach 278 million accesses at the end of June 2010, or 7% more than a year ago in organic basis, with a 110 basis points improvement sequentially.

…translates into a superior revenue growth

Let's turn to slide number 6 for the review of the top line.

Year-on-year organic growth ramped-up in the second quarter, marking the Company's third consecutive quarter with a sequential improvement, boosted by the sharp growth in accesses.

Excluding the drag from MTRs cuts, first half organic sales growth jumped to 3.3% year-over-year, or 90 basis points up on the first quarter.

The sound diversification of the revenue mix is to be highlighted, with growth driven by our businesses in Latin America and Europe, that already account for over 2/3 of our revenues. By services, growth businesses, namely broadband connectivity, are increasing its weight in our revenue mix.

In addition, global initiatives launched a year ago to fully capture the benefits of our scale in terms of roaming, global procurement and IT are already bearing fruits, with these actions having a direct positive impact in the different businesses in terms of savings or better conditions. Meanwhile, the centralization of procurement in TGS is being reflected at a regional level with an additional positive contribution from services to vendors of 90 million euros Group revenue in the first half of 2010.

In reported terms, revenue growth is benefiting from a positive currency effect during the second quarter and the consolidation of Hansenet and Jajah from the first quarter of the year.

And as I said before, revenue trends are improving simultaneously in our three regions of operations.

Strong profitability despite increased commercial activity

Despite the commercial drive to strengthen our future growth profile, operating profitability remained healthy as outlined in slide number 7.

OIBDA declined 2.3% in organic terms year-on-year affected by non recurrent items and negative regulatory impacts, which dragged growth by 2.7 percentage points.

Also, group operating expenses rose 5.5% in organic terms up to June, mainly driven by higher commercial expenses (+8.1% year-on-year) due to fast customer growth, higher commissions and handsets subsidies. Increased network maintenance and expansion, mainly in Latam, drove higher network costs. On the contrary, interconnection costs remained virtually stable driven by MTR cuts across Europe.

Consolidated OIBDA margin stood at 37.5%, down 1.7 percentage points year-over-year in organic terms, but expanded 80 basis points quarter-on-quarter.

Margin erosion eased in the second quarter on the back of the rebound in sales and the benefits of our scale, with global initiatives contributing with 85 million euros up to June.

Solid cash flow generation

Continued solid cash flow is shown in slide number 8.

Operating cash flow in nominal terms topped 6.6 Billion euros in the first half of 2010, while stripping out the investments in spectrum it would have reached almost 8 Billion Euros, posting a 3.4% drop year-on-year, purely organic.

Operating cash flow increased across Latam and Europe, while España delivered a sound OpCF at 3.5 Billion Euros, down year-on-year.

Efficiency ratio stood at 75.3% for the six months ending June 2010 leveraged on disciplined cost management and focused CapEx.

On track with 2010 full year outlook

Please turn to slide number 9 for an update on guidance.

First half results are fully aligned with year-end targets, with revenue increasing under guidance criteria 3.3% year-on-year and OIBDA still below our annual target but consistent with the anticipated performance along the year.

OIBDA growth for the whole year will be within the outlook range, with a strong boost in the second half of the year as we will have less challenging year-on-year comparisons in Telesp and Colombia fixed, and commercial activity increased from Q3 09 onwards.

We also maintain our CapEx target for the year, with first half figures reflecting CapEx seasonality.

T. España: Gradual recovery and improved profitability

Let's now review our regional performance, starting with Telefónica España on slide 10, where results continue to be constrained by economic weakness in a very competitive market, though the trends show a gradual improvement in both top line and OIBDA.

In comparable terms, revenues delivered a fourth sequential quarterly improvement since we reached the bottom in Q2 09, on the back of a better performance in all businesses driven by the increased commercial push in recent quarters, a mild voice traffic recovery and a good growth in wireless data.

Disciplined execution on OpEx initiatives allowed to support the commercial boost while containing the OIBDA margin erosion to 1.2 percentage points in the first half of the year, on a comparable basis. We continue to post healthy margins, at 47.7% up to June in comparable terms.

Regarding CapEx, the year-on-year rise was driven by increased investment in growing businesses like mobile broadband.

Sound commercial momentum focused on contract

On slide number 11, wireless service revenues in Spain declined by 5.7% year-on-year in the second quarter, an improvement of 1.3 percentage points on the previous quarter, pushed by robust growth in mobile data, strong customer growth and better usage patterns.

Telefónica led the market growth in the quarter, particularly in the contract segment, where we have added close to 450 thousand customers since the beginning of the year, 3.6 times higher than a year ago, reflecting our focus on growth opportunities and allowing us to maintain our superior revenue market share.

The strong growth in contract net adds was driven by a 37% year-on-year rise in gross adds and stable churn. As a result, our customer base was up 7.4% year-on-year, with the contract base already accounting for over 66% of the total.

Voice traffic trends also improved sequentially, with a stable pricing environment vs. previous quarters and continued drag from MTR cuts.

On the very positive side, wireless connectivity revenues continue to grow sharply, 64% year-on-year as of June, on the back of the good traction of our mobile broadband offer. We have already exceeded 3.8 million MBB customers, leveraging our focus on smartphones and data plans.

Revenue recovery, leveraging integrated leadership

On the wireline business, revenues in the quarter also deliver a small improvement in trend, with a 3.8% year-on-year decline in comparable terms in the second quarter, 1 percentage points higher than the previous quarter.

This evolution is mainly driven by the sustained positive contribution from data & IT businesses, the slight recovery in traffic and lower line losses, and the return to growth in broadband.

Commercial efforts focused on the bundling strategy are delivering results, with good gross adds and churn rate coming down across all services.

Let me highlight that retail wireline losses, despite having the lowest ULL prices in Europe, continue to decline both quarter-on-quarter and compared to last year. Additionally, due to growth in wholesale accesses, total wireline accesses limited their year-on-year decrease to 0.9% up to June.

In FBB, with no major changes in our competitors' behaviour, we maintain our leadership in the market with a customer share above 54%, thanks to the 5.4% growth achieved in broadband customers. We continue to focus on quality and service improvements, which have allowed us to almost double net adds year-on-year in the first half. The market competitive intensity continues, with total BB ARPU declining 7.4% year-on-year despite the increased contribution from VAS, especially Imagenio, which reached more than 20% of total BB ARPU.
In Pay TV, we continue to gain market share to over 18% at the end of June, on the back of the sharp reduction in churn, which led to strong net adds in the first half, compared to the net losses posted in the previous year.

In summary, though slowly, year to date we are seeing better trends in Spain, across business, going forward it is too soon to anticipate the potential impact from the government austerity measures and the recent increase in the VAT, that could be an additional challenge on consumption starting in the third quarter.

T. Latam: Revenue and OIBDA growth acceleration

Moving to slide number 13 to review our Latin American properties, I'd like to stress the solid results delivered in the second quarter, highlighted by the improved trends in customer, revenue and OIBDA year-on-year growth in organic terms, benefiting from better economic environments in the region.

Strong commercial momentum was sustained, with 3.8 million net adds in the quarter and 7.5 million in the first half, close to 3 times those of a year earlier, leading to ramp up in accesses growth to exceed the 176 million mark.

Revenues grew a healthy 6.2% in organic terms in the January-June period, ramping up sequentially, on improved growth in most markets.

OIBDA up to June rose close to 4% year-on-year in organic terms, a 0.5 percentage points improvement on the previous quarter, with OIBDA margin reaching 37.2% in the first half, sustaining a very healthy level despite the stronger commercial activity vs. last year and the negative performance at Telesp and Colombia.

As we already anticipated at the beginning of the year, year-on-year comparisons should improve from next quarter on a much better performance from these two operations and more comparable commercial efforts across the region.

On reported terms, OpCF increased by over 7% year-on-year to 3.2 Billion Euros in the first half, despite the Bolivar devaluation.

Wireless business: Strong commercial activity

Let me now spend a few minutes on the performance of our Latin American wireless businesses.

Up to June, year-on-year customer growth ramped up to 12.6% topping 142 million customers, led by the strong performance of the contract segment, which grew over 23% year-on-year.

Our focus to enhance customer value is reflected in the sharp reduction in churn to best-ever levels, the significant increase in prepay to contract migrations and the push in MBB. As of June we had more than doubled our MBB customer base to around 4% of our mobile customers in the region. The growth potential is huge and we are well positioned to capture this opportunity in the region due to our best in class networks.

Let me highlight that 50% of the 7.2 million net adds recorded up to June were in contract from 25% one year ago, beating competition. 19% of our customer base is already in contract, 160 basis points up year-on-year.

The fast customer expansion drove traffic up close to 30% in the first half, which, together with the very strong growth in mobile data allowed ARPU to remain pretty flattish vs. last year in organic terms, underpinned by the 3% advance in outgoing ARPU.

As a result, revenues accelerated across all services, posting double digit growth even on total revenue. Data revenue growth is impressive at close to 50% year-on year.

Wireline business: Stabilizing revenue drivers

In the wireline businesses we are also delivering improved trends.

The broadband business posted an outstanding performance in the quarter, leveraging the bundle strategy and enhanced quality metrics.

In the second quarter BB net adds increased 92% year-on-year and 28% quarter-on-quarter, driven by better gross adds and churn reduction to the lowest levels ever posted.

Particularly remarkable is the evolution of retail fixed accesses, which returned to positive growth after 6 quarters of net losses, adding 56 thousand accesses in the second quarter of 2010.

As I just mentioned, bundles are key, with 57% of our BB connections being part of a duo or trio package while 28% of our fixed line accesses have broadband.

As a result, new revenues from Internet & Pay TV grew double digit, increasing its contribution to total revenues, with an average weight of 22% in the region, up over 1 percentage points on last year figure.

Telesp: Sustained commercial recovery gradually flowing into financials

Let me now cover the performance of Telesp on slide 16.

For a third quarter in a row the company is gaining commercial traction, capitalising on the strong focus on quality, improved customer satisfaction and lower churn levels.

In the traditional business, net adds turned positive for the first quarter since Q1 06, adding 64 thousand accesses in the quarter, leading to accesses growth since December 2009.

Performance in broadband was even more outstanding, with net adds reaching a new record since the launch of the service 10 years ago on strong gross adds and reduced churn.

Better commercial results are starting to flow into financials, though gradually. Year-on year revenue trend improved, being virtually flat in the quarter on better traditional fixed line revenues sequentially and growing contribution from broadband and TV revenues.

Reported OIBDA continued to drop sharply, though in underlying terms the performance improved significantly quarter-on-quarter, with a single digit year-on-year decline in the second quarter and a margin expansion to 36%.

Commercial trends show we are working in the right direction and this should become even more evident in the financial performance in the second half of the year.

Colombia: Turnaround efforts start to pay off

On slide 17, our businesses in Colombia are also showing signs of improvements.

In the wireline business, fixed BB net adds remained strong in the second quarter, growing significantly from a year earlier, while traditional access performance was very solid, virtually flat in the quarter vs. 64 thousand net losses in Q2 09 and still negative figures in the previous quarter.

And the improved trends in operating metrics are gradually translating into better financials as the graph shows.

In the wireless business, net adds continue to post good growth compared with negative figures a year ago, being noteworthy the strong focus on the contract segment, driving 50% of the net additions recorded in the quarter. In addition, ARPU in local currency was 5.6% up year-on-year.

In terms of financials, top line is back to growth, advancing 2.1% in the first half of the year.

Good performance across key operations

Let me now quickly review the other hot topics in Latin America.

In Mexico, we are focusing our efforts on postpay, driving contract customers up 48%. Service revenues grew close to 10% year-on-year, on the back of strong data revenues, with further advances in profitability, not only in terms of margin but OpCF. Mexico continues to be a key growth driver for the Group, and the recent spectrum auction has allowed us to strengthen our position in this market.

In Venezuela, we are still posting sound financials despite the tougher trading conditions and the Bolivar's devaluation. Data services are booming, driving a solid service revenue growth up to June. However, commercial activity is reduced, as we maintain our selective customer acquisition approach and handset availability has became more limited. Though the OIBDA margin is hit by inflation and the devaluation, it is still very sound at 45% level.

Finally, Vivo continues to deliver outstanding commercial and financial results. Vivo outperformed the market, gaining market share for the fourth quarter in a row, with strong focus on contract. Service revenue year-on year growth ramped up in Q2 to double digit growth, boosted by extremely robust data revenues and the boom in on-net traffic. Profitability improved to the 30% levels, despite the strong commercial push.

Becoming the leader in the growing Brazilian market

To finalise with Latin America, let me stress that we are very pleased with the agreement reached yesterday with PT to get full control of Brasilcel. This agreement allows us to become the leader in the telecommunications market in Brazil, while at the same time we are removing an uncertainty that has been impacting our stock price.

We are in a second to none position in the market to capture the significant growth potential of the telco industry in this country. It gives us a quantum leap vs. all the other players.

The entity resulting from a combination of TELESP and VIVO will be not only the largest integrated operator in the growing Brazilian market by operating and financial metrics, but also the most efficient player, with a combined OIBDA margin of 35% in 2009 and further room to improve it as a result of the very significant synergies that will arise from the combination of the two companies.

And more importantly, this transaction is accretive in terms of both net income and FCF from year one.

Telefónica's value proposition is in line with the offer supported by PT's shareholders at the EGM

Moving to slide number 20,the price conditions of the final agreement are substantially identical to the economic value of the offer supported by PT's shareholders at the EGM, which included a cash-payment of €7.15Bn plus other conditions with additional value, and we avoid a long litigation process.

Taking into account that 40% of the priced agreed will be paid to PT in deferred instalments and that PT will not receive Vivo's 2009 accrued dividends, the NPV is equivalent to €7.3Bn, which in turn leads to a €7.1Bn value if you were to exclude the value of the call option on our stake in PT that the previous offer had included.

And all other obligations included in the previous offer disappear or are subject to a non compete conditions in Brazil.

Let me say that on our stake in Portugal Telecom, we are happy holders and we'll benefit from any appreciation of the stock in the near term.

Control price averaged down by tender offer for ONs

Let's now turn to slide number 21 to review the financial metrics of the acquisition.

The €7.3bn NPV of the price we are paying for PT's stake in Brasilcel compares with a DCF valuation of Vivo in the 3.4 to 4.0 Billion Euros range, depending on WACC and g assumptions.

We are firmly committed to generate a minimum value between 3.3-3.9 billion euros, through operating synergies from the combination of Telesp and Vivo, benefits for Vivo from our regional management model, financial and tax synergies. In this sense, it is our intention to merge Brasilcel into a Spanish entity so that direct interest in VIVO is directly held from Spain. From the closing of the deal the Brasilcel structure becomes unnecessary and this could lead to tax synergies significantly higher than initially anticipated.

The round figure of synergies will depend on the different structures and strategies implemented in the integration, but we are committed to give additional details at the closing of the transaction.

We do also reiterate our intention to acquire the remaining ON shares of Vivo, at 80% of the price offered to PT, which will allow us to average down the price to a 10.2x FV/2011 EBITDA multiple ex synergies. Obviously, if we were to use our internal assumptions and synergies, this multiple would be significantly lower.

If you consider the book value of our current stake in Vivo as a proxy of the historical cost of our investments in Vivo, and that as a result of this transaction we will be the leader in Brazil, the equation becomes much more balanced.

And we expect the Brazilian market to be re-rated on the back of the strength of its economy and all the structural reforms made in the past years.

Key dates of the transaction

Finally, let me remark the key dates of the process on slide number 22.
The closing will not take longer than 60 days from the signing of the agreement and therefore we expect to get full control of Brasilcel by the end of September, with the approval of Anatel within the closing period.

Since we will take the control, the maximum period for closing the tender offer for ONs will be 150 days. So the whole process should be finished by the end of February 2011.

To sum-up, a key strategic movement for us that benefits both companies shareholders and positions Telefónica in an unmatchable place in the Brazilian market.

T. Europe: Improving trends, continued momentum

Let's now turn to Europe, in slide number 23.

In Europe, we continued delivering good financial and operating performance in the second quarter of the year, consolidating our solid momentum in the UK and German core markets, and also seeing signs of improvement in the Czech and Irish markets.

The Company continued managing actively its portfolio of assets, as the sale of non-core Manx Telecom demonstrates.

Year-on-year performance across key growth drivers were maintained, with total accesses exceeding 54 million. Improved quality adds is reflected in the 2 percentage points increase in the contract mix over total mobile customer base, at 48% at the end of June, while MBB accesses increased year-on-year by 54% to over 8 million accesses, mainly on smartphones.

To highlight, the strong year-on-year growth in non-P2P SMS data revenue, 32% in the first half of 2010, in organic terms.

As a result, organic revenue growth in the first half of 2010 ramped up to 6.5% year-on-year, excluding the impacts from MTR cuts.

Profitability was remarkable despite the increased commercial activity across countries, with OIBDA margin of 28% in the first half maintained over 2009, in comparable terms. Operating Cash Flow grew 10.3% year-on-year, as well in comparable terms.

T.O2 UK: Steady growth, shaping the business

Telefónica O2 UK continued to deliver steady growth in the second quarter of 2010, with mobile service revenues ramping up to 10.3% year-on-year, excluding the impact from mobile termination rates. The main driver was the 12% year-on-year expansion of the contract customer base to reach 47% of the total base at the end of June. This, combined with its record low 1.1% churn rate reinforces O2' status as the network of choice in the UK market for high value customers.
Underlying ARPU evolution, positive at 2.2% year-on-year in local currency, and excluding regulatory effects, shows our success to drive demand for smartphones, which resulted in robust year-on-year growth in mobile non-P2P SMS data revenues in local currency of 43%, up to June. The recent move to tiered data pricing, to be applied

from October for new customers signing in, is setting the standard for the industry, and it is an important move in order to fully monetise the explosion in data traffic.

Second quarter revenue growth was also positively impacted by improved roaming trends.

Finally, and despite increased commercial activity, O2 increased its OIBDA margin year-on-year to reach 25.9% in the first half of 2010.

T.O2 Germany: Sustained solid momentum and smooth HanseNet integration

Please turn now to slide number 25.

Telefónica O2 Germany made further progress with its strategy to maintain its third position in the market, with HanseNet integration progressing smoothly, the acquisition of additional spectrum in May, setting the basis for future growth, and benefiting from additional scale in the mobile broadband space.

The Company grew its mobile customer base 9% year-on-year up to June, on the back of a solid growth in the contract base and an improved performance in the prepay segment in the quarter due to seasonal promotions launched through partner channels.

Mobile service revenue rose close to 3% year-on-year in the second quarter, driven by the success of "O2o" tariff and sustained progression in MBB, which drove non-P2P SMS data revenues up 35% year-on-year in the first half of the year. Please notice that service revenue growth up to June was dragged by MTR cuts, with a negative 1.4 p.p. hit, and also due to the "My Handy" product, which removes the handset subsidy component from service revenue. The Company also posted a solid increase in fixed services revenues.

OIBDA rose on increased scale and higher efficiencies in most cost areas, growing 9.5% year-on-year in organic terms in the first half of the year, with a reported 23.5% margin, stable over the previous year in organic terms. The higher margin achieved in the second quarter, at 24.4%, was driven by the above-mentioned seasonal campaigns, though was lower year-on-year on different shaping of national roaming costs recognition along the year.

Effective interest rate contained below 5%

Turning to slide 26, you see that our ratio of net financial debt to OIBDA stands at 2.2 times (or 2.3 times when including debt-like cash commitments), the same level as at the end of the first quarter. Euro weakness has added 2.2 Billion Euros extra debt in the year, due to the translation into euros of liabilities denominated in Latam and other foreign currencies.

We have continued reinforcing our liquidity position: our un-drawn committed credit lines have reached 9.1 Billion Euros, 1.8 Billion Euros higher in the year, and we have continued our refinancing in July. After relying in the Euro and US bond markets, we have tapped the bank market and our Latam subsidiaries continue its financing activities in the local credit markets. We have signed an 8 Billion Euros loan including a 3 Billion Euros 5 year- tranche for refinancing future loan maturities, while we raised since last quarter close to 800 million euros in Latam, of which our Mexican subsidiary issued 4 year and 10-year peso bonds for close to 362 million euros equivalent in July. This shows the ability of the Group to diversify its funding sources in a tough credit market.

Our financial results include a FX loss due to commercial debt in US dollars in Venezuela, while our effective interest rate kept the improvement seen in the first quarter, standing again just below 5% of our 47.8 Billion Euros average total debt.

Conclusions

To recap, we are fully exploiting our diversified profile, our scale and our strong execution capabilities to deliver strong earnings, with significant sequential improvements in growth rates across the P&L, despite economic weakness in Spain. The increase in our stake on VIVO will further foster diversification and increase our exposure to the growing Brazilian market.

These solid results are highlighted by our superior organic top line growth, our strong margins and robust Cash Flow generation, even in a context of reinvesting efficiency gains to foster revenue expansion.

A focused commercial push, aimed at not just expanding our customer base but also enhancing customer value through an improved quality base and further BB adoption, and CapEx focused on growth levers like MMB and new spectrum, reflect our strategy to deliver the next wave of growth in our markets.
At the same time, we maintained a robust balance sheet, a key differentiator factor in the current turmoil, we are fully on track to meet 2010 and mid term guidance, and we do confirm our dividends targets for the coming years.

Shareholders remuneration continues to be our first priority for use of FCF, and year to date we have returned substantial cash to shareholders with close to 3 billion euros paid in dividends.

Thank you very much for you attention. Now we are ready to take you questions.

Q&A session

Operator

We would kindly ask you to ask a maximum of two questions per participant. Our first question comes from David George from Credit Suisse. Please go ahead.

David George - *Credit Suisse*

Yes. Thank you. Firstly, just on your M&A strategy, and post the Vivo deal and the expected Telesp merger I mean, what are your remaining areas of focus, if any, and what the implications these deals have for shareholder returns on specifically buy-backs over the next 12 to 18 months?

And secondly, if I could just ask on guidance. Obviously you've reiterated all of your mid-term targets today. But obviously the Vivo deal and the anticipated material synergies from the Telesp merger, does that actually give you scope to raise that mid-term guidance? Or is this more about reassuring on the achievability of the existing guidance?

Santiago Fernández-Valbuena - *Telefónica S.A. - CFO*

Yes, thanks, this is Santiago. Thanks, David, for the question. On M&A strategy, we're just following the path that we set out in October last year in our Investor Conference. We then said that we wanted to finalize our deals in Brazil, with the Vivo transaction, that is pretty much completed. We wanted to buy spectrum in both Germany and Mexico, and this has been completed. And the only pending thing from that list is an increase in our China Unicom investment, up to 10%, but we are under no rush to do so. But eventually it might be completed.

Other than that, our scale diversification and in-market consolidation capabilities have been pretty much fulfilled and we're quite happy that we could do it ahead of the end of the year.

On Brazil, again, we're not going to change guidance until the whole thing changes. Now this is going to be a multiple month's process. The combination of Telesp and Vivo will not be done overnight and we will regularly update you on when and if things change and what kind of an impact that that you should expect. We have certainly said that this combination is going to elicit very significant synergies and we have already committed today to be much more precise after the closing of the deal.

María García-Legaz - *Telefónica S.A.- Head of IR*

Next question, please.

Operator
The following question comes from David Wright from Deutsche Bank. Please go ahead.

David Wright - *Deutsche Bank*

Yes. It's David here. I have a couple of questions. I guess the first one is a very simple follow-on from the previous. When do you think the Telesp transaction could potentially take place within the time line you've given? And just on the Vivo transaction for the moment, when could you give us some guidance on how you will treat goodwill, for instance?

Then my second question is on Spain. You had indicated both yourself, I believe, and also Guillermo there, and to me that from the middle of May or so, you had seen a slow-down in consumer behaviour following the announcement of the austerity measures. Is that what is driving some of the slower minutes of use growth? I also noted there was some pressure on DSL ARPU. Is there a need, perhaps, has there been a need to reduce pricing a little, just to retain some subscribers? Thanks.

Santiago Fernández-Valbuena - *Telefónica S.A. - CFO*

David, Santiago again. On the Telesp-Vivo combination, we should first wait for the closing of the Vivo transaction, then for the execution of the mandatory tender offer for the voting shares.

This is, as I think we said in the presentation, unlikely to happen before the end of February and then we will run as fast as we can and most of the funds are literally already being built. It is not very easy to see that transaction having been completed, I don't know, before the end of the first or maybe the second quarter of next year.

But again, there are some grey areas that we have to work on in the coming weeks and we'll regularly update you on that.

On the goodwill question, by the closing of the transaction, we will know exactly in which way we've finally structured the deal. We now think that having a Spanish entity, buying or merging into the Brasilcel, a Dutch entity might have some beneficial effects and if that is indeed the case, we'll certainly try and maximize them.

Guillermo Ansaldo - *Chairman and CEO Telefónica España*

David, this is Guillermo. Regarding Spain, there are two separate issues. One is the shape of the consumption across the quarter, as you remember very well, and you mentioned, April was a great month for us with decent consumption in traffic and in sales, and since mid-May we started seeing some slowdown and some decrease in the recovery of consumer confidence. We are also seeing some slight recovery by the end of June and July is coming better than May. So there was a slowdown.

And regarding austerity measures, remember they were announced in May. They were not implemented until July, so it's much more the shape of the consumption, much more expectations rather than on real impact. So we have to see, going forward, what happens on the consumption. I'm not that much concerned on our public sector revenues because it's multi-year, flat type of contracts, but the consumption may be affected, for example, in the VAT increase. Prepaid customers tend to be more expense-fixed than other segments.

Regarding ADSL ARPU, it's a different story. We had a 7.4% decrease in total ARPU, in broadband fixed ARPU in Spain. It's a combination of factors. One, last year, in the first quarter, for example, we had in the gross adds a EUR9.9 of promotion, while this year, in the first quarter, we had a EUR19.9. So the first quarter this year looked a little bit less stretched than previous year, but when you look at the second quarter last year, we had EUR29.9 as the promotion, and this year, EUR19.9. So, on the other side on the mathematics works from the other way around.

Also this quarter, in April, we took the decision to decrease the price of our 10 megabits. It's a small portion of our base, but it's a decrease in price. And also, there's a series of small adjustments. So I expect the third quarter evolution of ARPU will be better than the second one, but the ARPU of the ADSL, the shape in the second quarter is much more due to several factors rather than on consumption changes.

What is true, as you mentioned, is that in general, the broadband market was slower in the second quarter than in the first quarter, in general.

David Wright - *Deutsche Bank*

That's very clear. Thank you.

María García-Legaz - *Telefónica S.A.- Head of IR*

Next question, please.

Operator

Our next question comes from Luis Prota from Morgan Stanley. Please go ahead.

Luis Prota - *Morgan Stanley*

Yes, hello. My first question is on the Portugal Telecom shares. You were mentioning something, Santiago, in the presentation that I was missing. Sorry for that. But if you could give us an update on what's the current status? Whether you physically own the shares already or what's this equity swap contract at the moment?

And whether, I think you were mentioning some positive impact in the short term from that. If you could elaborate a bit more on that, and whether there's a book gain as the difference against the book value to be recorded in the, potentially, in the third quarter, I guess. That would be useful.

And then, the second question is on the adjustments you made for hyperinflation in Venezuela. If you could, I've seen that in the first quarter, there was a negative impact of, I think it was 8-9 million euros, but then it was very, very positive, more than 100 million euros in the second quarter. If you could just explain to me the math behind that, it would be useful. Thank you.

Santiago Fernández-Valbuena - *Telefónica S.A. - CFO*

Thank you, Luis. On our PT shares, we hold physically, more than 2%, slightly north of 2% of the shares and we have equity swaps for just about 8%. So we are long PT stock and we are under no obligation to deliver it or we have finally not granted any call to anyone, which means that we are free to trade as we see fit.

That's the only point I was trying to raise in the call. You know, that we are now as any other shareholder interested in PT shares doing well, and we hope that they will certainly do well going forward. If and when, eventually the full sale is done, and that is not something we're contemplating in the short term, it will be the time to record a book gain because we bought the shares so long ago that we're now sitting on a profit here.

On your hyperinflation in Venezuela thing, there is a technicality involved in it, because the devaluation happened on January the 7th. Technically, we have seven days of 2.15 average rate and whatever, 30, 27 days or 17 days of the new regime. That's what makes it confusing.

Actually hyperinflation should be in general small positive for the numbers, but Q1 is the exception because there is a combination of average exchange rates coming from last year and two months and three weeks of the new regime. And that's what is confusing. It's difficult to arrive at an undisputable number that basically takes you from Q1 to Q2 numbers, without any doubt. But you know, we can try and walk you through the details if you so wish.

Luis Prota - *Morgan Stanley*

Okay. Thank you.

María García-Legaz - *Telefónica S.A.- Head of IR*

Next question please.

Operator

The following question comes from James McKenzie from Fidentiis. Please go ahead.

James McKenzie - *Fidentiis*

Hi, good afternoon. A couple of questions. First of all, on the options, 150 million, over 150 million shares that you mentioned in the previous presentation. I was wondering, could you give us any more detail about those options and do you still hold them?

And then, secondly, I think your guidance of interest rates for the year at the year end conference call was 5.5% to 5.75%. In the year-to-date, we're looking at slightly below 5%. Would you be willing to revisit that guidance?

Santiago Fernández-Valbuena - *Telefónica S.A. - CFO*

Thank you, James. On our 150 million calls those are long dated, we still hold them and I'm sure that they will prove their worth in due course. And we have, of course, the intention of keeping them.

James McKenzie - *Fidentiis*

Okay.

Santiago Fernández-Valbuena - *Telefónica S.A. - CFO*

On our interest costs, we guided at the beginning of the year for, I think, it was 5.75%. We have seen improved that thing. It is now more likely than not, that we will end up, say below 5.5%, although the highly volatile marking-to-market of our pension liabilities and some FX movements make it difficult to be more precise. Because, of course, nobody knows what the exact shape of the currency markets will be in Q4. We are highly confident that, you know, better than 5.5% number is going to be achieved by year end.

James McKenzie - *Fidentiis*

Yes. Sure. Okay. Thank you.

María García-Legaz - *Telefónica S.A.- Head of IR*

Next question please.

Operator

The next question is from Tim Body at Goldman Sachs. Please go ahead.

Tim Boddy - *Goldman Sachs*

Yes. Thanks. A question for Matthew, in fact, around the impact of VAT increases in Europe more generally. Obviously you have less color on that, but should we expect those to be passed through or would they have a similar impact to the one we see in Spain and really any color on those type of austerity measures across the European businesses would be very helpful.

Secondly, also, it would be very great to get a better understanding of your strategy in Germany and now you've been successful in the auction for 800. Thank you.

Matthew Key - *Chairman and CEO Telefonica Europe*

Thank you. Let me kick off on the German question. As you know, we had a very clear strategy going into the auction to acquire the 800 spectrum that we wanted and some 2.6 as well. So we came out with the spectrum that we wanted. We're now launching our first commercial trial in 2010 in Munich and Halle, both in Germany.

Going forward, as far as network share and strategy is concerned, what we've done is put ourselves clearly in a very strong position to have choices. In principle, network share is something we would do and that's the case in, certainly, in all the countries in Europe.

What shape that takes, we'll wait and see. But it's clear, with the spectrum base that we've got and the network base that we've got, we've clearly got choices in terms of what we do and who we potentially partner with.

On austerity, I think we're relatively lowly exposed to government expenditure, apart from the Czech Republic and the good news in the Czech Republic is we've clearly now got a government there, whereas previously we had a midterm government and so we expect that spending to return in the Czech Republic, in Germany and the UK relatively lowly exposed.

I guess my only concern would be consumer confidence and that's something that clearly we'll need to see in all the markets. Not overly worried in Germany. Maybe in the UK. From a VAT perspective, we would likely pass it through. Clearly we need to look at market conditions, but I wouldn't expect us to absorb any VAT potential increases.

Tim Boddy - *Goldman Sachs*

Okay. Thanks.

María García-Legaz - *Telefónica S.A. - Head of IR*

Next question please.

Operator

We now have a question from Robin Bienenstock from Sanford Bernstein. Please go ahead.

Robin Bienenstock *- Sanford C. Bernstein & Co.*

Thanks very much. Just two questions. I'm wondering if you can give us any update on Venezuelan cash expatriation. And then really, I'm just curious about your debt. I'm wondering if you can update us on what percentage of your debt is variable and in what currency is its split. And if you did increase in China Unicom, how would you think about doing that? Is that cash or shares? Thanks.

Santiago Fernández Valbuena - *Telefónica S.A. - CFO*

Robin, I didn't pick up your last sentence for the question. Could you please repeat it?

Robin Bienenstock *- Sanford C. Bernstein & Co.*

Yes. Sure. The last question was really about your debt. I'm wondering what percentage is variable and in what currencies is it split? And then also, were you to increase in China Unicom, I'm wondering how you would think about doing that. Is it shares or cash?

Santiago Fernández Valbuena - *Telefónica S.A. - CFO*

Okay. On Venezuelan cash, we are now sitting on roughly US$1.8 billion worth of idle cash there. We have lower expectations for that to be repatriated now than we had at the beginning of the year. Two things have happened there.

The market for the parallel dollars had been shut down. And now dollars are much more difficult to get for any purpose. And the economic environment in there has actually become more difficult and so the environment is now less conducive to the promises or the commitments that we had heard, being able to be honored.

On the debt composition, we have now a 69% of our debt in euros, roughly 16% in Latin American currencies. The British, I mean, sterling is 7%, US dollars trade 4%, the Czech koruna is 4%. So you see not a major change or a slight increase in euro relative to where we were.

Were we to increase our stake in China, it is more likely than not that it will be done through a cash commitment, but that decision will have to be made when and if that opportunity presents itself, which is still not the case.

On variable versus fixed, we have an active management of our maturity profile and we have, if anything, tried to be slightly shorter this year on some currencies. 46% is now fixed, and the other is either bounded or fully floating. Although there are some differences depending on the currency you look at.

Robin Bienenstock *- Sanford C. Bernstein & Co.*

Thanks very much.

María García-Legaz - *Telefonica S.A. - Head of IR*

Next question, please.

Operator

The following question comes from Ivon Leal from BBVA. Please go ahead.

Ivon Leal - *BBVA*

Yes. Hello. Good afternoon. A couple of ones. The first one in Spain, for Guillermo. You say that you've made some efforts in pricing in the broadband prices in the second quarter, but actually if we look at the net share of, the share of net adds in broadband in the last couple of months has decreased very much, why exactly is that? Is increased competition? Or maybe your strategy has changed and you are trying to, you know, sustain prices or I don't know if you could detail a little bit on that and detail if you're going to take any specifical steps to rearrange that? That's the first one.

The second one, in Mexico, I think you've been very successful in the spectrum auctions, which just took place. I don't know if that changes your strategy in the market going forward, in terms of I think that you had a target of share in mobile of 25% going forward. So I don't know if that's going to change a bit your CapEx going forward and your strategy going forward in the Mexican market.

Guillermo Ansaldo - *Chairman and CEO Telefónica España*

Thank you, Ivon. This is Guillermo Ansaldo, I'm going to answer the Spanish questions. First let me clarify what we did in pricing in the second quarter, is we changed the price of one of the services, the 10 megabits, which is a small portion of our base. We reduced this from EUR44.9 to EUR41.9, a 3 euros reduction for our base and only for those people that will have ten megabits connections in our base. The majority, as you know, in Spain is 6 megabits.

Now regarding our performance in net gains, two things. First, it's not churn. Churn, in fact, has been improving from the last three quarters. It's more gross adds and regarding gross adds, you have to see two things. In the second quarter, the market was slower, so the growth of the market was smaller than in the first quarter and obviously in our case, also we have a smaller share of these gross adds.

Basically we have, as you remember, a very strong campaign in the first part of the year. It was very successful. In the second part of the year what we did is, that we changed our brand, so we focused on communication, our advertising on the changes of the brand, bringing Movistar to our fixed portfolio and also trying to build brand values around Movistar.

Also, we see the competition, very, very active competition, for example, Jazztel and Orange, with very, very aggressive promotions ranging from, for example, Jazztel EUR7.95 as a promotion for a few months and also Orange with an EUR11.95 free air promotion for six months.

So, it's a combination of factors, is not churn. It's gross adds. The market was lower and we were much more focused on the second quarter on changing the brand and building our brand values around Movistar.

Ivon Leal - *BBVA*

So you have to assume, so we have to assume that you're going to do something to change that in the coming quarters? I mean, you're not comfortable with that 20% share of net adds that you've been delivering?

Guillermo Ansaldo - *Chairman and CEO Telefónica España*

No. Obviously we prefer to have more share of net adds than less, but we are not going to do any wild move. We will continue with our strategy of trying to extract more value and for us, to reduce churn is a value driver. It's better to get this performance with reduced churn than with more gross adds and more churn. Obviously I'd prefer more share of net adds than less, no? But it's not going to be any sharp change in the short term.

José María Álvarez-Pallete - *Chairman and CEO Telefónica Latinoamérica*

Taking your question on Mexico, it is so, we have been successful in getting a significant part of the spectrum we were looking for, therefore we are very happy about that because we have been looking for a long, long while to get more spectrum and to, therefore to enlarge our data capacity in the country.

In fact, that was part of our strategy already this year. Remember that we have been trying to focus on the contract part of the customer base and we have been able to get 35% of the net adds of the quarter on contract. That was already our strategy.

We needed, to pursue that strategy, more spectrum, namely on the capital city. We have managed to get that spectrum and this spectrum has already been awarded to us, which is means that is already operational. So our traffic is growing, our total traffic is growing. We think that we are on the right track and we will foster our prepaid campaign because we have been a little bit weak on prepaid in the second quarter.

But everything is being developed as we were planning on the budget and the only thing that we were missing was the spectrum and now we have it. So nothing else that I can tell you. Data revenues, by the way, are growing very nicely, almost 20% year-on-year, and they already represent 22% of total revenues. So we are on the right track and now we think we have to push a little bit more on prepaid and to keep going on this data expansion on the contract customer side.

Ivon Leal Macia - *BBVA*

Okay. Thank you very much.

María García-Legaz - *Telefonica S.A. - Head of IR*

Next question, please.

Operator

The following question comes from Jonathan Dann from Barclays Capital. Please go ahead.

Jonathan Dann - *Barclays Capital*

Two questions. One is on the stake in Portugal Telecom. Once, Portugal Telecom has a stake in Oi, would you be allowed, under Brazilian regulations, hold, I guess, stakes in Telecom Italia directly in Vivo, Telesp and also an indirect stake in Portugal Telecom? And then my second question, if you had any thoughts on how the UK spectrum auction might change under the new government?

Santiago Fernández-Valbuena - *Telefónica S.A. - CFO*

Jonathan, let me start with the Portuguese enter. We have owned PT stake for 13 years. We have been together in Vivo for a long time. We in principal see no reason why that you know this new move, which is just an increase in our stake, not a beginning of a new stake, should mean any change. But if there is anything, we will, of course, study it in great detail.

On our Italian end, you know that it took the regulators in Brazil almost two years to clear that absence of conflict and we expect no change from that end. So we don't particularly see any reason why that could be changed.

Matthew Key - *Chairman and CEO Telefónica Europe*

Hi, Jonathan. I'll obviously pick up your UK question. The statutory instrument that the government announced yesterday, I think, was really focusing on creating a digital Britain. We welcomed it. I think the two key moves for us was clearly allowing 3G on

900 megahertz, which is a big thing for us, particularly virtue of all of the smartphones that are coming now have got the in-built to the chip set, so that's a big positive. And also clear the licensing extension on 3G.

As to the structure of the auction, I think the statutory instrument was less clear. It was really thrown over to Ofcom. Clearly what they've got to consider firstly is, what everything, everywhere will have to do with their 1,800 spectrum as a result of their merger and then the second question of Ofcom clearly needs to approach these caps on the 800 spectrum. So we welcome 900 on 3G and the license extension and wait to see what happens on the auction.

Jonathan Dann - *Barclays Capital*

Thank you.

María García-Legaz - *Telefónica S.A.- Head of IR*

Next question, please.

Operator

We have now a question coming from Will Milner from Arete. Please go ahead.

Will Milner - *Arete Research*

Yes, thank you. A couple of questions. Just on the Vivo deal, you said yesterday, I think, you expected the deal to have a positive impact on earnings and cash flow. I just wanted to understand whether you still think the deal would be accretive if mobile termination rates get cut 20% annually, as I think some recent rumors have suggested they might.

Looking at Vivo's results yesterday, I guess interconnect revenues' less interconnect costs are about 20% of revenue and 60% of EBITDA. So it does look like doubling up your mobile exposure into a round of MTR cuts is a risk. So whether the deal is accretive or not.

And then secondly, to Matthew, on mobile data, you mentioned you're ahead of the learning curve in understanding customer behavior and usage patterns. And I just wondered if you could talk a bit more around that? It's quite an interesting topic. Particularly given the decision to drop unlimited data bolt-ons from September? Do you think this is an inevitable shift that all operators will make? And thinking further ahead, do you have envisaged the pricing model for voice and data looking, in say, five years' time? Thanks.

José María Álvarez-Pallete - *Chairman and CEO Telefónica Latinoamérica*

Let me take your question about MTR cuts in Brazil. Let me first say that the numbers that you are running are not the ones that we have in terms of net exposure to OIBDA. The net exposure to interconnection at the level of OIBDA is now below 20%[1], at the level of OIBDA, therefore the exposure is much lower than the one you were contemplating. Now, the question of when and how you can the MTR cut is going to happen is a big uncertainty.

Recent rumours were pointed to a fast decision on that. But now it looks as if it's, again, postponed. We think it's going to happen and we don't know when. But we think it's going to happen progressively rather than a drastic initial cut.

Anyhow, remember that a significant part, the large majority of our traffic is already on net traffic and that the reduction of interconnection exposure to OIBDA has been going down progressively in the last year and as I was telling you before, it is now below the 20% first called at the level of VIVO.

So we will, as you might imagine, keep you posted. But that was already embedded in the business plan that we were running when making the offer that, that was going to come. So it's no surprise when the only question is when and at what pace. So just on that side, we will monitor that and we will let you know.

Matthew Key - *Chairman and CEO Telefónica Europe*

Let me try and pick up your questions. I think it was 3 or 4 in there. On the mobile data usage, clearly we've been through a massive learning curve in the UK, and particularly in London, that we're now using right across the Group from a Telefónica perspective.

I would say there were two key takeouts for us. The first is that I think the interactions with the network did a lot more, what I would call, snacking. So very quick interactions, in and out, the phone polling in the network. Whether it's using Facebook or getting an update on the latest, I don't know, on the latest Tour de France results or whatever. So a lot of small interactions backwards and forwards. Clearly what we've done is with our network partners, learnt a lot from that.

The second one on the mobile data is huge localized peaks and that's been all about getting the right site sharing process, which is why we've done the deal with Vodafone, on one of the deals we've done with Vodafone in the UK, particularly if you use the phone at London Bridge, you'll recognize that there's network problems there because of the availability of sites.

From a data perspective and the amount of our tiering, I think it's inevitable. Any industry needs to match its revenue and its costs and what was happening, I think, in our heavy data markets is that traffic was exploding from a data perspective and

[1] Net exposure to MTRs: (mobile interconnection revenues-mobile interconnection costs)/total revenues

therefore the cost to serve it, but revenue was staying flat because of the effective flat top.

So what we've clearly done is introduced, or will introduce, in October, I think it is, that sort of tiering structure. Why and where? Well, the first thing to say is we've introduced it such that only 3% of our customers will be impacted by it, initially. We've pitched it there, on purpose, to give you a view of those 3% of customers actually use about 65% of the data going through our networks. So a massive strain on the network there. And those customers will really end up paying more or going to another operator, either one is positive for us.

And the key for us is that actually where we've pitched it, people's data expansion or usage is really expanding over the time. Over time, more and more of our customer base will move into that charging area that we've set.

Your third question was on data and voice and how I see it going forward. Clearly what's happening is data is expanding, voice is decreasing with voice competition and Voice-over-IP minutes going off of our network. The real question for the industry is how quickly does data offset that voice decline.

Clearly what we're getting is a lot of access data at the moment and you can see it in our ARPUs and our ARPUs excluding MTRs in the UK are actually going up now and hitting a positive trend and the more data that customers end up paying for, clearly, they're end up in a positive trend overall and it will more than offset the voice decline. So hopefully I've picked up all of your questions in that.

Will Milner - *Arete Research*

Yes. Sorry. Thank you. Thanks a lot.

María García-Legaz - *Telefonica S.A. - Head of IR*

Next question, please.

Operator

Our final question comes from Stanley Martinez from Legal and General Investments. Please go ahead.

Stanley Martinez - *Legal & General Investment Management*

Is there a minimum level of NOLs that can be applied to the Spanish and Dutch entities?

And second, on financing the Brasilcel transaction, on slide 20, you used the 5% discount rate to present value the cash outflows and that's equivalent to Telefonica's effective interest rate. However, Telefonica has EUR6.6 billion in cash and equivalents and I surmised that's perhaps EUR4 million less than what's truly necessary to have cash to run the businesses.

The term facility that you agreed to last night probably has less than a 2% all-in cost including the commitment fees. So especially given the deferred cash payment schedule, is it very conservative to assume a marginal interest expense that's associated with the transaction as EUR7.5 billion at a 5% rate? Or is it more realistic that Telefonica can fund the vast majority of the Brasilcel buy-in, just by using internally generated free cash flows and not having a marginal interest expense?

Santiago Fernández-Valbuena - *Telefónica S.A. - CFO*

Stanley, the connection was pretty bad, so I'm not sure we have picked up every detail. If this is the case, please either interrupt or ask the question fully. If I understand your question correctly, you are asking the appropriate discount rate to be used for discounting and projecting the cash flows to be had from Brasilcel.

The syndicated loan package that we finished last night is a euro loan and therefore on a very competitive terms, that Telefonica, along with some, but not many, borrowers can take. So you may want to use that number. For conversion purposes, for the delayed payment to Portugal Telecom, we have used around 5%. That's not to be confusing, but you can, you may want to use your best guess or your best value for that number. We don't claim that to be the only discount rate possibly applicable there.

Other than that, as I mentioned in the presentation, we strive for a lower than 5.5% overall increase. We have cash, not idle, but actually we earn an interest in many places and if we don't repatriate it earlier, with the exception of Venezuela, it's because it doesn't make sense to do so for tax reasons.

So we try and run as tight a ship as possible. A lot of the cash that sits in some of our subsidiaries gets channeled upstairs through our free cash treasury or cash treasury management programs and instruments. Again, with the exception of Venezuela. And where we don't have idle cash, we bring it home. But again, with the exception of Venezuela, everything we do is for a good reason. Most likely, coming on transaction, I'm sorry, on taxes, on short-term transactions.

María García-Legaz - *Telefónica S.A. - Head of IR*

We have time for one additional question.

Operator

The final question comes from Jesus Romero from Merrill Lynch. Please go ahead.

Jesus Romero - *Bank of America-Merrill Lynch*

Thank you. I have two questions on the Vivo transaction. The first one for Santiago, if you could give us a detail of what level of net debt to OIBDA you expect to see in the next 12 months, in terms of what would be the peak? And then I don't know if you can give us any more detail on the, what percentage of the synergies you've given us are coming from taxes? Thank you

Santiago Fernández Valbuena - *Telefónica S.A. - CFO*

Well, the headline number that we expect in the increase of debt to OIBDA, especially taking into account that a lot of the OIBDA still remains to be generated in the second half is 0.25. So that's the overall increase in the net debt to OIBDA ratio at current exchange rates that we think is sensible to program into the leverage ratios.

How much of that is going to be taxes, and again, remains to be seen. Assuming that closing is a smooth process, which is what we expect, we will then know in which manner the final taking of Brasilcel shares has been done and whether or not a tax synergy can be taken from the transaction level.

Of course we have been very vocal in the process about what the combination process of Telesp and Vivo might entail in the form of agio or goodwill to be generated in Brazil, but that is not likely to come this year, but rather next year. Specifically we'll keep you updated very in full when the transaction closes.

Let me take the opportunity to thank you all for having attending this summer conference call for Telefónica. We certainly hope that the second half of the year will be more benign, in both the economic environment and as balmy as the weather seems to be in most parts in the Northern Hemisphere. All the best to all of you who have still a few days off to go on holidays and we'll see each other or we'll listen to each other in a few months. Thank you.