Telefónica January-June 2011 Results Conference Call Transcript

28th July, 2011

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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 2011 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.

This presentation may contain announcements that constitute forward-looking statements, which are not guarantees of future performance and involve risks and uncertainties, and that certain results may differ materially from those in the forward-looking statements as a result of various factors. We invite you to read the complete disclaimer included in the first page of the presentation, which you will find on our website.

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 Chief Strategy Officer, Mr. Santiago Fernández Valbuena, who will be leading this conference call.

Presentation

Santiago Fernández Valbuena - *Telefónica S.A. - Chief Strategy Officer*

Good afternoon, ladies and gentlemen, and thank you for attending Telefónica's 2011 first half results conference call. Today I have with me Julio Linares, Chief Operating Officer, Guillermo Ansaldo, head of Telefónica España, José María Alvarez-Pallete, head of Telefónica Latinoamérica, Matthew Key, head of Telefónica Europe and Miguel Escrig, our Chief Financial Officer.

During the Q&A session you will have the opportunity to ask questions directly to any of them.

H1 11 Highlights

Telefónica has released today a set of strong earnings despite economic challenges and headwinds from regulation.

First half business trends are consistent with 2011 targets and therefore we confirm our full year guidance.

We have posted strong top line growth, driven by the robust performance at T. Latam, excluding Mexico, and solid mobile data growth.

We continued to deliver benchmark profitability, expanding margins quarter-on-quarter, and limiting OIBDA year-on-year decline in Spain to levels similar to those of the first quarter.

Latin America already accounts for over 45% of consolidated figures, from revenue to OpCF, driven by the stellar performance of Brazil and shows the benefits of our high diversification.

I'd also like to highlight the significant progress made in several areas since our last call, in May, which proves Telefónica's strong execution skills: we have reached a new social agreement with the unions in Spain, we are announcing higher than anticipated integration synergies in Brazil and we have launched our "Partnership Program", which proves scale is a differential and valuable asset. All these initiatives will have a positive impact in cash generation.

Finally, let me stress that we fully reaffirm our dividend commitments.

Key financials

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

Reported year-on-year growth rates were positively impacted by the full consolidation of Vivo since October 2010.

Revenue increased 6.3% year-on-year in nominal terms to almost 31 billion euros and grew by close to 1% purely organic.

Six months OIBDA topped 11 Billion euros, up close to 4% in reported terms and declining around 2% in organic terms. Profitability remained robust, with OIBDA margin up sequentially to 36.6% in H1 11 and limited year-on-year erosion.

As a proxy to cash flow generation, Operating Cash Flow ended at close to 7.5 billion euros, which is equivalent to a 6% organic decline compared to 2010 first half figure.

Net income mainly affected by a non-recurrent effect

Our first half net income exceeded the 3 Billion euros mark, with second quarter profit negatively impacted by Telco SpA's revision of the value of its stake in Telecom Italia, which reduced net income by 353 million euros. Please notice that this is a non-cash item.

In addition, cumulative D&A grew at double digit driven by the full consolidation of Vivo and the amortization of Vivo's purchase price allocation, leading to a 9% year-on-year increase in total PPAs.

Profit attributable to minority interests continued to drag net profit as a result of the change of consolidation of Vivo and higher earnings from this Company.

All things considered, EPS stood at 0.70 euros, but stripping out the impact from PPAs and the revision of value of Telco's stake in TI, EPS would reach 0.88 euros.

Building consistent "value over volume" commercial strategy

Slide 5 shows the results from our "value over volume" commercial strategy, being mobile contract and mobile data our key focused areas.

Our total access base grew 6% year-on-year to 295 million, with superior growth in the mobile contract segment, which already represents more than 30% of our mobile customer base. Contract net adds were strong across regions, accounting for 47% of mobile net adds in the first half, and over 100% at T. España and T. Europe.
At the same time, demand for smartphones and other data devices continued to be strong, driving up MBB penetration across all markets. By region, MBB penetration reached 28% in Europe and 23% in Spain, while the still low figure for Latam shows the huge opportunity going forward.

Strong mobile data momentum, fast revenue growth

The rapid expansion of MBB and our tiered data rates, launched across all markets, led to an outstanding 19% year-on-year organic increase in mobile data revenues, with a ramp-up in growth in Q2 in most markets.

Mobile data revenue already account for 30% of mobile service revenue, up 4 p.p. versus H1 10, with the contribution ranging from roughly 25% in Spain and Latin America to 41% in Europe.

The fact that non-P2P SMS data revenues accounts for the majority of data sales in each region and continue posting very solid growth rates, along with our right pricing schemes, including bundles, limit the cannibalization risk from new services and applications.

And please notice that P2P SMS revenues continue to grow.

Increasingly capturing growth opportunities

In slide number 7 we detail Telefónica's evolution of revenue mix.

T. Latam emerges another quarter as the key contributor to growth, accounting together with T. Europe for over 2/3 of consolidated sales, offsetting headwinds in Spain.

Broadband and Services beyond connectivity already account for 26% of revenues, compensating the lower contribution from access and voice sales.

Healthy profitability sustained

Let's turn to slide number 8 to talk about business's profitability.

Despite the commercial drive to boost smartphone and contract penetration, along with increased network costs on higher traffic volumes and impact from inflation in some countries, operating profitability remained solid thanks to higher efficiencies derived from our scale, scope and global initiatives.

OpEx year-on-year growth rate slowed down for the second consecutive quarter, reflecting continuous focus on efficiency improvements.
As a result, consolidated OIBDA margin stood at 36.6% in the first half, a limited erosion year-on-year, but expanded 50 basis points quarter-on-quarter.

On track to meet full year outlook

Regarding our full year guidance, on slide number 9, we do reiterate the outlook announced in February.

In the second half we expect T. Latam to continue delivering a robust performance, capitalising the synergies potential in Brazil, and despite the negative impact from the unexpected change in regulation in Mexico.

In T. España we are not expecting a further deterioration in OIBDA year-on-year change, on the back of sustained growth in mobile data, further costs savings and the sale of non-core assets, as we announced in our last Investor Conference.

In T. Europe, we expect a steady performance in the second half of the year.

Let me now walk you through the operating and financial performance of the three regions, starting with T. España.

T. España: Contained OIBDA decline in a challenging environment

Despite challenging conditions, shaped by weak consumer confidence and strong price competition, OIBDA in the second quarter showed a similar year-on-year performance as in the previous quarter, as we further deployed costs cutting initiatives, with all OpEx items except labour costs declining.

We maintained our commercial strategy, prioritizing "value over volume" and we increased the commercial resources devoted to customer loyalty, driving lower churn rates sequentially across all our services.

As a result, and despite the sustained loss of high margin revenues, OIBDA margin increased sequentially more than 1 percentage points to over 45% in Q2.

And we continue to expand the coverage and capacity of our fixed and MBB networks, as reflected in the higher CapEx year-on-year.

Sustained solid momentum in mobile data

Slide 11 provides additional colour on the mobile business, where commercial activity was focused on expanding MBB penetration and fostering data usage.

MSR declined 8.1% year-on-year in the second quarter, or 6.1% excluding MTR cuts. Voice revenues continued to be impacted by volatile usage trends and intense price competition, as reflected in voice ARPU, though price erosion slightly eased in the quarter.

On the other hand, data revenues were strong, up 13% in the quarter and showed a ramp-up in year-on-year growth rates, on the back of the over 26% increase in non-P2P SMS revenues. The fact that these revenues already account for 73% of our total data revenues implies that SMS cannibalisation risk from new applications is relatively lower. And let me stress that SMS revenues have recorded a similar performance than in previous quarters, with double digit growth declines mainly explained by the current economic weakness.

Continued pressure in fixed line, more rational FBB market

On the wireline business, usage optimisation and a lower access base weighted down on voice revenues, while fixed broadband revenues remained pressured by the ARPU decline in a broadly stable customer base.

However, it is important to notice that price competition in the quarter was more rational, as most of the competitors have transferred to their customers the ULL price increase.

We maintained our value oriented strategy, with more selective promotions on broadband leading to a slowdown in the ARPU year-on-year decline. On top of that, churn improved quarter-on-quarter.

At the same time, IT revenues continued to grow nicely by 15% to June, on the back of our differential capabilities to target the Corporate segment.

New Social Agreement will lead to higher flexibility and efficiency gains

Let's move to slide number 13. Despite market scepticism about our ability to further reduce costs in a very difficult environment, we have reached a 3 years Social Agreement with the unions in less than 2 months since we started negotiations. This agreement will reinforce significantly our flexibility to manage our costs base, leading to further efficiencies gains.

On top of the new Collective Agreement that links, for the first time, salaries to OIBDA targets of the Company, rather than exclusively to CPI, the Social agreement includes a new workforce redundancy plan in the wireline business, already approved by the labour authorities, involving up to 6,500 employees until 2013.

The resulting cost per employee is estimated at 415,000 euros, in net present value terms, including the unemployment benefits, which were covered by the Social Security in previous plans. Regarding the financial impacts:

At the P&L level, we will account for a provision representing the net present value of payments to employees joining the Plan until they reach the retirement age. The provision will be booked as non-recurrent personnel expenses in the second half of the year for an amount of roughly 2.7 billion euros. As benefits, we will save personnel and G&A expenses, with positive impact in net income from 2012.

In cash terms, yearly payments to pre-retirees are offset by the benefits related to lower personnel and G&A expenses, and therefore the Plan is cash-flow positive since year 1.

Overall, we estimate the Plan will generate around 1.4 bilion euros of excess cash for the Group.

In terms of leverage, our committed payments will gradually increase in the coming 3 years, as employees join the Plan.

T.Latam: Strong commercial momentum and robust profitability

Moving to slide number 14 to review our LatAm operations.

In Q2 we had a strong commercial momentum, with sequential increases in net adds across all services.

On top of volume, it is remarkable the increased quality of the customer base, with a growing weight of contract and smartphones in mobile, and bundles in wireline.

Top line growth remained strong at similar levels than in Q1, despite a weaker performance in Mexico. Excluding Mexico, revenue growth would ramp-up from the previous quarter to 7% year-on-year.

This solid performance was reached without jeopardising our robust profitability, posting an OIBDA growth pretty in line with sales expansion if we exclude Mexico. Organic OIBDA margin declined by just 0.5 percentage points year-on-year to 37% in H1.

Please notice that growth rates are negatively affected in 2011 by a lower contribution from regional projects compared to 2010, as our priority this year is to deliver on the projects already in place rather than launching new ones.

T.Latam: Data revenues drive growth across businesses

The next slide shows a solid data and broadband revenue performance, driving robust growth both in mobile and wireline.

Increased MBB penetration, on top of the healthy expansion of voice sales, boosted outgoing mobile service revenue, up 12.3% year-on-year in organic terms. The differential profile of our mobile customer base is reflected in the year-on-year growth in ARPU.
Wireline revenues ramped-up in the quarter, on the back of a growing contribution of Internet and Pay TV revenues.

As of today, new services like data in mobile and internet and pay TV services in wireline already account for roughly 25% of each businesses sales.

Brazil: Perfect balance, sequential growth with higher profitability

Let's now review the brilliant performance of our businesses in Brazil.

In the second quarter we reinforced our leading position in the market, with increased net adds quarter-on-quarter in all services.

Specially remarkable are the results achieved in mobile, where we continue to increase market share in the contract segment, now at 36%, leading ARPU to grow year-on-year, as we leverage our leadership in the MBB space.

ARPU growth and customer expansion led mobile service revenues up 15% year-on-year in the first half, with growth accelerating again in the quarter.

Wireline revenue growth also ramped-up in Q2, mainly due to a better performance of new businesses and the full consolidation of TVA.

As a result, total organic revenue growth in Brazil posted the 8th consecutive quarter acceleration. More importantly, this robust performance was achieved while profitability improved, as showed by the 2 percentage points margin expansion in the first half and the solid 13% increase in OIBDA.

Brazil: operating synergies target upgraded by over 16%

Let me now to spend a few minutes in updating you on our synergy program in Brazil.

Only 3 quarters after closing the deal there are clear evidences that synergies are flowing faster than expected and that benefits will be larger than originally anticipated.

As a result, we are increasing the total net present value of operating synergies by 16% to a range of 2.7-3.1 billion euros, 60% of them derived from OpEx savings and the remaining 40% equally split between higher revenues and lower CapEx.

On top of these, we maintain our targets of 1-1.5 billion euros from financial and fiscal synergies.

The results just explained show that the fixed and mobile businesses, combined, are better and stronger, and the performance will improve, as we partially reinvest integration benefits to further reinforce our position in a market with significant growth potential.
In 2011 operating synergies will have a positive impact in OpCF of over 120 million euros, rising in coming years to a 400 million euros run rate from 2014.

We feel very comfortable with these targets, as our execution skills are delivering tangible results.

Brazil: faster than anticipated synergies execution path

Slide 18 provides more colour on the initiatives supporting these goals. I will rapidly summarise them.

In terms of the offer, business integration is allowing us to be more competitive in the Corporate and SMEs segments, and to improve our reach, as we will leverage our wireless national footprint to offer fixed services outside Sao Paulo, where we expect to launch an integrated offer in the second half of the year.

In platforms and efficiency, initiatives such as rationalization, unification, aggregation and optimization from core network to data centers or customer care related activities are leading to material savings.

While in terms of new services, we are leveraging the global scale of Telefónica to further innovate and expand customer spending.

So, to sum-up, our businesses in Brazil have posted a stellar performance, clearly outperforming peers, and we are in a process that may be the start of a virtuous and self-powered circle, as some of the synergies are reinvested into the business to continue strengthening our market leadership.

Mexico: improving operating KPIs, sharp MTRs cuts

Turning now to slide number 19, I will explain the recent developments in Mexico.

The good news is that operating KPIs are improving quarter-on-quarter, with increased volumes of gross adds, good traction of our MBB offer, and a drastic change in outgoing traffic trends. These improvements are not yet reflected in the financials metrics, but give us comfort on the initiatives launched to turn the business around.

The bad news are the major change in the regulatory framework, with significant cuts in termination rates, which in the short term are having and will have a painful impact on our business, as you can see on the slide.

Please notice that these impacts are maximum impacts, as they do not include any elasticity effect.

On the other hand, this drastic change could erode in the mid to long term some competitive advantages of the dominant player, improving our market positioning.

In our view the regulatory review is incomplete and therefore we expect the regulatory framework to continue evolving to tackle different positioning in the market with the different regulatory rules.

Solid performance in other key operations

And to finish with Latin America, just two comments.

The Southern region performance remained very robust, while in Venezuela we have made a remarkable progress in our commercial proposition, allowing us to post strong top line growth and very solid margins.

T.Europe: growing value from mobile data

Let's now turn to slide number 21 to talk about T.Europe.

T. Europe continued the execution of its "value over volume" strategy, delivering a good financial performance despite challenging environments and severe regulation.

Fast growth in MBB penetration, together with successful tiered data pricing led to a solid mobile data revenue growth of 12% year-on-year, leveraging outstanding 32% non-P2P SMS sales. Smartphone penetration will further increase in the second half of the year leveraging on sub-100 euros handsets availability.

OIBDA increased over 3% organically in the first half, as increased investment in acquiring and retaining the best value customers and negative impact from regulation were offset by efficiencies from business restructuring and additional scale from network/platforms sharing. As a result, OIBDA margin slightly expanded to 27% up to June.

The group also continued to actively invest in new business areas, such as the Financial services and O2 Media, which are now beginning to have a noticeable impact mainly on increased customer satisfaction.

T. UK: driving a profitable MBB ecosystem

Telefónica UK, as slide 22 shows, continued building a profitable MBB ecosystem.

Strong demand for smartphones from new and existing customers drove penetration up to 35%, with 55% of contract smartphone users in the consumer segment already based on tiered data plans. To highlight is the fact that most of these customers are taking the upper tier range of the tariffs, limiting the cannibalisation risk from IP Voice and messaging Apps. As a result, customer spend was broadly stable over the previous quarter.

Six months revenue continued to be fuelled by non-P2P SMS data that were up 32% year-on-year in the first half. In Q2 sales performance was sharply impacted by MTR cuts from April by 4 p.p. and by the progressive change in the Company's commercial relationship model with some distributors until the second quarter of 2010. Please notice, this effect will not affect year-on-year comparisons in the second half of the year.

OIBDA performance remained strong, driven by a muted commercial activity and ongoing cost efficiencies. The steep quarter-on-quarter slowdown was mainly due to different MTR cuts timing in the UK market, explaining close to 8 p.p. of the deceleration.

T. Germany: continued strong momentum in the market

Let's now review our operations in Germany, where we continue to enjoy a strong commercial momentum in mobile.

The good traction of tariffs like O2 Blue and fast adoption of smartphones, strongly supported by the "My Handy" distribution model led to close to 460 thousand contract net adds up to June, accounting for two thirds of the total, driven by the strong traction in the consumer and business segments.

The Company is already showing tangible benefits in customer loyalty as reflected in contract churn declining trend.

Non-P2P SMS revenue continued to post solid growth, at 65% year-on-year in Q2, accelerating sequentially and leading to a quarter-on-quarter ramp-up in MSR growth to over 7%, ex-MTRs.

OIBDA rose close to 2% and the margin remained flattish at 23% in the first half, as we reinvested the benefits from restructuring and business integration to foster commercial activity.

We also launched LTE in several rural areas in Germany, with a limited impact in CapEx, as most sites are located within current 2G 900 Mhz grid.

Containing financial expenses despite debt increase

Turning to slide 24, I would like to mention that we maintained net interest expenses pretty stable year-on-year. They stayed below 1.2 billion euros in the first half, despite the fact that the average total debt has been 17% higher.

The debt increase has led our leverage ratio (total net debt + commitments over OIBDA) slightly above the upper part of our target range. The excess debt over 2.50x would have been offset if working capital consumption had been within the target range communicated at our Investor Conference. We are working to beat our goal of working capital consumption in 2011.

I want also to highlight our solid liquidity position, with close to 8 billion euros of unused committed credit lines as of June 2011, most of them long term, on top of 2 billion euros for pending payment to PT for Brasilcel.

Conclusions

To sum-up:
We have posted a solid set of numbers amid difficult trading conditions, including severe mobile termination rate cuts.

Revenue trends continue to be strong while profitability was stable to improving quarter-on-quarter.

Our unique footprint in Latin America is boosting growth.

We are leading the MBB opportunity, monetising it through tiered data rates.

We continue to prove our strong execution skills, with significant progress in key strategic areas in two months.

Finally, I'd like to reiterate our confidence to deliver our commitments. We are well on track to meet 2011 guidance. Despite operating challenges, FCF generation will be ahead of our initial estimates by year-end, as we leverage on capital discipline and further initiatives to improve working capital. No doubt, we will meet our dividends targets for the next years.

Thank you very much and now we are ready to take your questions.

Q&A session

Tim Boddy *- Goldman Sachs*

Yes, thanks, I had a clarification and a question. The clarification was just around what you were saying about guidance. You said last quarter that you expected growth to accelerate through the year. That statement hasn't been repeated, so it would just be helpful to understand how you see the sort of sequential momentum.

And also, when you mentioned asset sales in Spain as preventing any further deterioration in the EBITDA growth year on year, could you try and quantify that? That would be really helpful.

And then, the question really I had was around the UK market, where, again, I didn't understand the comments around the change in distribution model. Also, I was surprised to see the very sharp slowdown in traffic growth, so if you could comment on those factors and the causes, that would be helpful.

Julio Linares - *Telefónica S.A. – COO*

This is Julio Linares. Let me take your first question. We are expecting a better performance along the year, but our results are being weighed down by a few operations like Spain, where recovery is getting longer than we expected, and Mexico, where we have the impact of MTR cuts.

And because of that, because the turnaround is being slower than we expected, now we don't think that we can talk anymore about it expected to be a year with a back-end loaded in our results. But we do confirm our guidance, both on revenues and OIBDA margin. So, we confirm that our expected growth will be up to 2% on revenues, and we are expecting limited year-on-year erosion of our EBITDA margin.

Matthew Key – C*hairman and CEO Telefónica Europe*

Hi, Tim, it's Matthew. Just to pick up your two points on the UK, first up, we made a change in Q2, 2010, where with distribution channels, we moved from sort of a revenue share model to a more traditional SAC model, which would have boosted Q2 2010 revenue and therefore obviously it reduced the year-on-year growth Q2 10 to Q2 11.

On the traffic growth point in the UK, Q2 voice was down 8%. Traffic SMS, up 18%. If behind your question, do we see any significant impact from OTT products?, no, we don't.

Interestingly, customer spend deterioration didn't accelerate, so it was about minus 3% in Q1 and about minus 3% in Q2. That's customer spend, and the good news is that the subscriptions, which are becoming more and more important of our overall revenue, remained stable, so the fact that customer spend went down was largely driven by out-of-bundle minutes, which was driven by the voice reducing, but no overall significant impact from OTT products.

Tim Boddy - *Goldman Sachs*

That's great. Thanks.

Fabián Lares - *JB Capital Markets*

Hi, good afternoon, I would like to address the first question to Mr. Linares regarding the slowdown in Spain, and perhaps Mr. Ansaldo can also step in. Do you see that this is more of a secular shift happening on the market on pricing, both in mobile and in fixed-line broadband? And if that's the case, is your strategy of value over volume truly rightly directed because basically we are heading more towards a price-driven model in the market? And does the headcount reduction specifically give you that flexibility to become more competitive in the future? And that would be my first question.

And the second question is regarding the Atento IPO that was cancelled. I would like to know whether you still have plans to float it again anytime this year. I know that the market situation is poor, but, and if not, could you give some visibility whether that would even be a priority anymore or not, or should we maybe considering that in our cash flow estimates?. Thank you.

Guillermo Ansaldo - *Chairman and CEO Telefónica España*

This is Guillermo Ansaldo. I will take the questions regarding Spain.

The first part of your first question regarding the slowdown in Spain, it's both in fixed and mobile. When you compare second quarter with the first quarter, it's an acceleration of the decline. It's both pricing and consumption. Maybe in mobile will see the combination of both, of pricing and consumption. In the fixed, maybe the more recent news is that despite the deceleration in consumption and the slower growth in fixed broadband market, we've seen some more rational behaviour on the pricing side as the different competitors are adjusting their tariffs to the new ULL prices.

We will continue with our value over volume strategy, we will continue focusing on quality of service and commercial efficiency. And, obviously, if we see opportunities to attract and protect customers with high value, we will go for it. The proof of that is that we continue focusing on contract mobile, and obviously, for example, what we're doing in data in mobile and also in IT in the Corporates.

And also on that side, we changed our organization to have on the commercial side, a geographical closer approach to our customers, so we can have direct decision-making processes on the commercial side on that field. And that will help us to be more precise in targeting customers or situations which we believe that we can create more value.

Obviously, the headcount reduction will, in the next three years -this year and the next two years- improve our profitability and that will give us flexibility to reinforce our strategy and to be more effective on the market.

Santiago Fernández Valbuena - Telefónica S.A. - *Chief Strategy Officer*

This is Santiago on Atento. If you read again the communique that we produced, the word we used, and we used it carefully, was we suspend the IPO process, so it has not been cancelled.

We continue to think that it is the right thing to do with Atento. And the reasons why we couldn't complete it are related to the weak state of the markets. If the markets, as we expect, should improve, we would look at it heavily again. So the current plan continues to wait for market conditions to improve, and if that is the case, we will take it again to the public market.

Fabián Lares - *JB Capital Markets*

Okay, thank you.

Jesús Romero - *BofAML*

I had two questions. The first one on the UK. I don't know if, Matthew, you could explain the contract ARPU that dropped quite a bit in the quarter. I don't know if you can give us a bit more detail on what drove that, and perhaps talk about the outlook for the second part of the year in the UK.

And then, the second question on the net debt/OIBDA of 2.56x. If I look at the second part of the year, you have EUR3.5 billion of dividend commitments, a spectrum auction in Spain, a EUR2.7 billion restructuring charge, and potentially FX adjustments to your Venezuela cash position. What can you tell us about net debt/OIBDA, or what do you think will be for the end of the year? Do you think you'll be under the 2.5x range?

Matthew Key - C*hairman and CEO Telefónica Europe*

Jesus, let me pick up your point on, I think it was contract ARPU rather than blended ARPU, was it?

Jesus Romero - *Merrill Lynch*

That's right.

Matthew Key - C*hairman and CEO Telefónica Europe*

Yes. If you look at contract ARPU, if you look at it from two angles really, one which is a customer usage profile and one was a spend profile. Clearly, the main thing that drove the ARPU reduction was the MTR cut. Overall, we've been probably heavier impacted by the MTR cut than the other operators.

From a MSR perspective, it's probably reduced our revenue by about 4.6 percentage points in the quarter, which will continue through the rest of the year. I just think we've got a higher element of prepaid subs than the other operators.

But on postpaid ARPU, when you look into what's happening, voice is coming down. SMS is coming down. But data is going up quite significantly, and the good news on data is we are getting a higher data ARPU per user across the total base, but also the customers that are taking a data bolt-on are increasing their spend as well, and that's not just a UK phenomenon. That is a cross-Europe phenomenon as well, which I think is good news.

The other way of looking at it is between subscriptions and out of bundle. As I said earlier on, subscriptions actually are broadly flat, so we're holding our subscriptions level, effectively the access fee, at a level which is really important for future tariffying from a product bundling perspective. The element that's going down is the out of the bundle, and that's largely because of the minutes reduction that I answered to Tim's question earlier on.

Miguel Escrig - *Telefónica S.A.-Chief Financial Officer*

Jesus, taking your question on the leverage ratio, we really expect at year-end to be below the 2.50x complying with our commitment.

There are several factors that make us confident on achieving that goal. On the first hand, we have cash flow generation which is going to accelerate across the year, especially due to working capital management. If you see, we have been paying this quarter or this semester a high amount of CapEx, well beyond what has been accrued, and this is not going to happen in the second half of the year, rather the opposite.

Also, some of the payments we have in the second half, such as the spectrum in Spain, can be split in two tranches. So, roughly 50% of that will be paid later in 2012.

And regarding the impact of the new provision from the ERE, taking into account that they are non-cash and that we are going to recognize as debt, really, which we owe to creditors, so the portion that is going to be signed with employees will become actual creditors of the Company this year, and that could be a little bit above one-third of the total provision.

And on top of that, as you know, our guidance on the leverage reduces that amount by the tax savings associated to these commitments, which is a difference in comparison with the normal debt which has not a tax shield on the principal.

Georgios Ierodiaconou - *Citi*

Good afternoon. Perhaps if I could extend the previous question one year forward, so as you add more employees and therefore you recognize more commitments, obviously it will benefit EBITDA, but that takes longer.

If you do exit your target of 2.5 times, is it something you have to be firmly within by year-end, or is it something you wish to be around that level in the next two or three years? Therefore, even if temporarily you move beyond that, it wouldn't necessarily change the way you do things?

And can you please clarify again regarding the tax impact, whether this year or next year the provisions you'll take will benefit the cash tax?

And my second question is, again, regarding the agreement and the part where you've changed the way salaries are linked to EBITDA targets rather than on CPI. Could you give us an idea what the impact could be to numbers? Is it possible to tell us, for instance, how much it would have reduced OpEx, how it has been implemented so far this year? Thank you.

Miguel Escrig - *Telefónica S.A.-Chief Financial Officer*

Okay, our leverage commitment is a commitment to be respected certainly at year-end, is not for the medium term. Although there may be temporary deviations, let's just say we have had this semester, and we have to work to correct them. And as I told you before, we feel confident that we will do in the near future.

Regarding the implications on tax of the commitments, we will recognize this next quarter EUR2.7 billion of charge. This will have an impact on accrued tax, not on cash taxes. The cash tax savings will appear when we pay, and we will start making payments next year, and then we will save the 30% in taxes of every yearly payment.

Guillermo Ansaldo - *Chairman and CEO Telefónica España*

This is Guillermo. Regarding the agreement with the unions for Telefónica de España, first a clarification. This is only for the fixed business, where is the majority of the employees, as you know.

In the past, the salary increases were linked to CPI, it was clear. Now, what we have is a scale that, depending on the achievement of the OIBDA targets in this specific company, the salary increase will move from 1% in any case, that's the floor, or to CPI as a ceiling and an additional non-consolidated amount if we go through, for example, 103%, 105% of achievement.

So, the impact on the accounts, well, it depends on how the business goes. If we hit our targets, there was no comparable impact because we will give CPI in any case. If we're under our targets in this Company, we would have an increase which is lower than the one we have been giving in the past. So, this gives us more alignment of our expenses with our OIBDA.

So if we are having a great year, over-achieving targets, it will be similar. If we are under, we are gaining flexibility in terms of the increase. And this is an increase that goes forever. So, basically, it's a more variable, if you want to call it, structure.

Luis Prota – *Morgan Stanley*

I would like to confirm. You just mentioned that in 2011, the provision from the social plan should be around one-third of total provision. So, wondering whether that means that one-third of the employees are supposed to sign up for the plan this year, whether you can give us any light on whether this is going to be in the last part of the year, or any savings should be accrued this year, or it's pretty much going to come next year. This is the first question.

And the second question is on your EBITDA guidance of margin having limited erosion relative to last year. In the first half, you are putting a tick in that box. This first half, it has been 36%. It was a 1 p.p. compression. But for the full year, the reference you gave is 38% in 2010.

So, I'm wondering whether if you stay around 36% for the second half, and this is a 2 percentage points compression, this is still considered as a limited erosion. Thank you.

Miguel Escrig - *Telefónica S.A.-Chief Financial Officer*

Luis, this is Miguel. Taking your question, your first question, let me stress we are going to book the full accounting provision in the third quarter, roughly 2.7 billion euros. From the leverage ratio point of view, we have always been avoiding double-counting. This means that we are not including in the OIBDA this provision, but rather we are adding up to our debt the equivalent debt commitments.

And we will have just debt equivalent commitments when we have actual creditors. This means that we will recognize the amount of debt corresponding to people actually signing this year. We estimate that this could exceed one-third of the total base we are targeting.

Guillermo Ansaldo – *Chairman and CEO Telefónica España*

This is Guillermo. Just to complement Miguel's comments regarding savings, since we are going to start the program in September this year, the impact on OIBDA will be very limited. So, almost all the majority of the impact will be in 2012 and in 2013 and going forward.

Julio Linares - *Telefónica S.A. – COO*

This is Julio Linares. Regarding your question on OIBDA margin erosion, yes, 36% will be the maximum limited margin erosion.

Torsten Achtmann – *JP Morgan*

Two questions, please. On Spain, we've seen revenue slowdown year-on-year, but that's also a tough comparison. Can you give us some idea on the outlook going forward? You've seen competitors reducing prices. The consumer is still impacted. How do you see Spain will develop in the second half from competitive and revenue-generating environments?

And the other one is back to the UK and the impact of the change in distribution agreement. Can you give us some idea how much of the non-MTR slowdown we can put towards the distribution agreements, i.e., one-off, and how much is the consumer trying to get its spending in order?. Thank you.

Guillermo Ansaldo - *Chairman and CEO Telefónica España*

Torsten, this is Guillermo. Regarding the outlook for the rest of the year, what we are seeing now and for example in July is similar trends as we've seen in the second quarter. That means consumption contraction, and obviously price competition more intense in the mobile recently, as I mentioned before.

So, we don't see a major change in the future. Maybe by the end of the year we can see some signs. But, to be honest, July looks similar to the second quarter. And there's a lot of volatility. So we expect a similar scenario. We have several initiatives on the cost side to balance on the OIBDA side. And that's why we are saying that we see no further deterioration on the OIBDA year-over-year change now. So there's a decrease, but not more than we see up to now.

Matthew Key – C*hairman and CEO Telefónica Europe*

Torsten, just to pick up your question on the UK, I've sort of got a mental model where I sort of reconcile between Q1 growth and Q2 growth. So, if Q1 was plus 4%, take out 4.5% for MTRs, and if Q2 is minus 4%, you've got another 3 percentage points to go, which is roughly, very roughly, split by, one-third the accounting classification point, one-third lower base growth, and one-third customer spending. So that's the broad split.

As we've said, the third from the accounting classification distribution element doesn't continue. Base growth, we will have some more momentum in the second half. We probably won't recover to the levels we were at last year. And the spending is very much a consumer confidence question, I think, for the UK.

Matthew Robilliard - *Exane BNP Paribas*

First a question on Brazil. Very strong revenue growth on mobile and fixed. Now, a part of that is washed out to the intercompany elimination, and I wanted to see if it's possible to get a little bit of clarity through what kind of revenues are disappearing. Where do they come from, essentially? Is it essentially corporate? Is it retail, I mean, residential?.

The second question has to do with the working capital. You highlight that typically H2, you intend to recover some of the working capital investment that you do in H1. In fact, that's what happened in the last few years.

The only question was, in 2010, you actually had a very positive working capital impact of $2.6 billion or $2.7 billion, which helped, obviously. And I was wondering, therefore, if we should expect in 2011 a real recovery in working capital, as we typically are, because maybe some of the things that were passed in 2010, and I'm thinking about, for example, Brazilian spectrum or Mexican spectrum. Those things will actually not revert in 2011. Thank you.

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

Taking your question on Brazil and the revenue growth, the consolidated revenue growth and the impact of interrelation between both companies, wireline and wireless, I can tell you that you have the effect on the elimination part of our disclosure.

You can have an idea there of what's the impact of traffic interrelated between both businesses that has significantly increased due to the promotion of our domestic long-distance products through the mobile. Now that we are in control of both businesses, we have become more aggressive, commercially speaking. And, therefore, we have been able to be more present on the market and be more competitive, namely against TIM Brazil.

But in order to give you an idea of how the underlying trends in revenue are going in the different business, both wireline and wireless, excluding that effect, let me tell you that the line losses, traditional line losses have been further limited in this second quarter, remember that in the first quarter we have heavy rains, so we are losing 1.2% of our lines. But the second quarter has been much better than the first one. And 70% of our lines are bundled.

Broadband is growing; on the wireline side is growing more than 17% and TV is growing 45%. It is true that it includes the TVA customers, but excluding that effect, it will be growing in the neighbourhood of 10%. And the side of VIVO, the underlying growth of our service revenue is growing 14%, almost 15%. But data ARPU is already 22% of total, data revenues growing 42%, non-SMS data revenue is growing 42.5%. The data ARPU itself is growing almost 22%, and total customer base is growing 14%.

So all underlying metrics, even excluding the effect of these interconnection tariff charges, are very, very strong. We can be more detailed in further explanation. And if you want to have any specific idea of the underlying trends, you have on the elimination part of our statements the interrelation between both companies.

Miguel Escrig - Telefónica S.A. - *Chief Financial Officer*

This is Miguel. Well, it is true that this year we are not going to have some extraordinary items improving the working capital, which are mainly related to year-end provisions in 2010, which had not any cash payment that year. But this is not what I understand managing the working capital.

We have started this year a program, as we communicated in our Investor Day, to improve the working capital, working with suppliers in the CapEx area and also standardizing throughout the Group the payment terms in OpEx and improving the collection. And we feel pretty confident that this is going to till fruits. It's starting to do it right now and will accelerate in the second half of the year.

Also, in the CapEx trend, is quite clear. And we will still have one extraordinary effect, as I have mentioned before, due to the delayed payment of the Spanish spectrum auction. All in all, we expect to beat the target we communicated in our Investor Day of 2% to 5% consumption in working capital over operating cash flow. We are confident in being better than that.

Ivón Leal - *BBVA*

A couple of questions. The first one in Mexico. It would be very helpful if you could give us further detail on the new tariffs that you've launched in July and how that will compare with America Móvil tariffs, and eventually if you have any kind of internal targets in terms of the timing to stabilize Mexico, OIBDA in Mexico. That's about Mexico.

And the second one, in Spain, again, I don't know if you could update us on the fibre and VDSL rollout and how that is affecting your share of net adds in those regions where you are rolling out the new network.

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

Jose Maria Alvarez-Pallete speaking. Well, in Mexico, in terms of the tariffs that we have launched pretty recently, it's a reaction of the new interconnection, of the new MTR scenario in Mexico. We have launched a tariff that includes all destination, including that is all networks, in order to try to take advantage of this reduction in the entry barrier to be mainly to the Telcel community.

The competitor has reacted immediately, but I think it is one of the effects, of the potential positive effects of the interconnection reduction. And we want to foster that as soon as possible.

Having said that, we are in open conversations with the regulator because we think that this drop has been too severe and too immediate. And therefore, we have conversations because we disagree on some of the calculation they have used in order to reach this level of MTRs. I think that those conversations are open, and we think that the competitive environment in Mexico is still, from a regulatory standpoint, it is still not closed.

In terms of the situation in Mexico, it's a weak quarter from a financial standpoint, very weak quarter because of the year-on-year comparison, with revenues down 13% and OIBDA dropping 30%. It is true that because of the deterioration from a financial standpoint that started in the third and most importantly in the fourth quarter of the previous year, the year-on-year comparison is going to be better, because at the end of the day the underlying operating metrics are getting better.

We are intensifying our CapEx deployment, namely in 3G. We are basically doubling the amount of our base stations in the country. Data revenue is growing 11% versus namely, almost flattish in the first quarter. Non-SMS data revenue is growing, is almost tripling. Mobile broadband net adds is growing 180%. The total customer base is growing almost 13% and contract customers 21%. The traffic is growing 4.7% for the first time in the last few quarters, on net traffic growing 7%. MOU has a limited decline. So, in summary, we see some turnaround in operational metrics that should start to be reflected from here till year end.

Guillermo Ansaldo - *Chairman and CEO Telefónica España*

This is Guillermo regarding your questions about fiber. What you can infer from the CMT data is that the fibre numbers, its quantity, is very limited. It's less than, in our case, less than 2% of our total broadband plant.
We are focusing in this stage on improving the processes, the quality of installation, the customer experience, and also on the commercial side, how to sell these services in the places where we have footprint. This is very early stages. We are learning, and it has no material impact at all on our overall numbers.

John Keith – *Stanford Bernstein*

Two questions, please. Firstly, if you had to choose at the year-end between three of your stated targets, that is paying the full dividend, keeping debt to EBITDA under 2.5 times, and paying the dividend out of organic cash flow rather than debt, how would you prioritize among those?

And then the second question is, how would you rate the probability of a significantly worse MTR cut in Brazil occurring? Thank you.

Santiago Fernández Valbuena - *Telefónica S.A. - Chief Strategy Officer*

Hi John, this is Santiago. When we get to the year end, I am convinced 100% that we will have been able to show that the commitments that we set for ourselves are fully doable. So, I would not engage in a hypothetical discussion as to what comes first, because all three are realizable.

We are going to meet all three. And when we produce those numbers, we think we accommodated a sufficient cushion, a sufficient degree of leeway, so that we are comfortably going to meet our growth, our margins, and our dividend commitments without any further swing.

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

And regarding the question of MTRs in Brazil, no news on that front yet. The conversation or the rumours or the noise that we are hearing from the market is that it's going into the direction of a progressive cut or a glide path scenario rather than a drastic initial cut. But no further news so far.

Jonathan Dann – *Barclays Capital*

Could you do two things, please? Could you clarify the dividend language around the 2013 and onward dividend? And secondly, could you just sort of let us know what sort of magnitude of cash flow are you expecting to repatriate from Latin America annually?

Santiago Fernández Valbuena - *Telefónica S.A. - Chief Strategy Officer*

This is Santiago. On the dividend language, let me be again specific. What we have said is that we are going to pay a full dividend in cash out of the results to be generated in 2012 of EUR1.75 per share. Starting 2013, that is to be paid in late 2013 and early 2014, so the calendar goes, we left the window open not to change the amount, but to be open, that is optional, towards the content of that payment. So, we could at that time ask around and see whether a buyback would be more interesting as a partial commitment, as we have done in the past, and the full cash. But no decision has been done. We don't have any strong preference for either. We will have enough time from now until the end of 2012 to ask around and see what the investment community feels, if there is a majority feeling.

Jonathan Dann – *Barclays Capital*

Would you rule out a scrip dividend?

Santiago Fernández Valbuena - *Telefónica S.A. - Chief Strategy Officer*

When the time comes, we will get there. What we have said is at these low valuation levels, it would not make much sense from our perspective to increase the share count.

So, it will not be used a scrip dividend in the sense of issuing those shares is not something that is in our arsenal yet.

Miguel Escrig - *Telefónica S.A.-Chief Financial Officer*

This is Miguel. Regarding the repatriation from Latam, year to date we have repatriated close to EUR1.4 billion, and we plan to more than double that in the full year.

Stanley Martínez - *Legal & General Investment*

Good afternoon to Maria and Santiago and thank you for taking my call. I just have two questions today. Both concern Telefonica's leverage target and evolution there, and following into Jesus and Georgios' questions. Miguel, I did not see a reiteration of Telefonica's 2.0x to 2.5x leverage target in the slides or in the detailed reports text. Now, is that because the social agreement, which is NPV positive in the long term, and it has a slightly leveraging effect, was not included in previous guidance? Or is that fully offset by the additional tax synergies in Brazil, which was also not included? And, if not, is deleveraging now a longer-term ambition, perhaps for 2013 or beyond? Or is Telefonica's new central tendency around 2.5 times gearing, and if so, increasing rather than a stable to declining growth stat?

Miguel Escrig - *Telefónica S.A.-Chief Financial Officer*

Okay. Our leverage target has been set in a way that we are going to be able to comply, whatever we do. And we consider any movement we do with its impact in the leverage. Really, the recent provisions in Spain are going to increase, obviously, our commitments. But as I have told you, this could be one, around one-third of what we have been commenting. And this will be offset by cash flow generation, because we have not just the ambition of generating cash flow to pay the dividend, but to have some leeway for other purposes and including this debt cancellation. Obviously, in the equation and we're looking forward, we take into account everything, and we take into account the tax savings in Brazil, as we take the tax savings in Spain or in other countries or the cash flow generation from the business. But we will continue moving towards the medium part of the range in the coming years.