Telefónica January-June 2013 Results Conference Call Transcript

25th July, 2013

Introduction

Pablo Eguirón - *Telefónica S.A. - Head of IR*

Good afternoon, ladies and gentlemen, and welcome to Telefónica's conference call to discuss January-June 2013 results. I am Pablo Eguirón, 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 dialling the following telephone number, +34-91-482-8700.

Now let me turn the call to our Chief Financial and Corporate Development Officer Mr. Ángel Vilá, who will be leading this conference call.

Presentation

Ángel Vilá - *Telefónica S.A. - Chief Financial and Corporate Development Officer*

Highlights

Thank you Pablo.

Good afternoon ladies and gentlemen and welcome to Telefónica's first half 2013 results conference call. Today with me are the members of the Executive Committee, so during the Q&A session you will have the opportunity to address to them any questions you may have.

Telefónica has released today a strong set of results, based on the execution of the management priorities established for 2013.

Revenue picked up notably in the second quarter, returning to positive growth year-on-year, led by a significant improvement in T. Latin America and mobile data. Our profitability continues to progress in the right direction, reflecting a limited year-on-year margin erosion and reflecting cost savings from efficiencies, offsetting higher trading around smartphones.

In the last 12 months we have reduced our net debt figure by close to 10 billion euros, demonstrating our focus on deleverage. As a result, net debt declined to 48.6 billion euros, including announced divestments pending closing.

Our FCF posted an outstanding improvement in the second quarter to almost €2 billion and also EPS improved sequentially to 25 euro cents.

The transaction announced two days ago, will allow us to crystalise value in the German market as it will further enhance our growth profile, diversification, scale and cash flow without increasing our leverage ratios.

Financial Summary

Let me now start with a summary of key financials on slide 4.

Reported year-on-year performance is negatively impacted by forex effect and changes in the perimeter of consolidation. FX deducted around 5.5 percentage points to revenues & OIBDA in both periods.

Revenues showed in the second quarter an acceleration from first quarter year-on-year performance of 2.1 percentage points to reach 14.4 billion euros. OIBDA reached 4.9 billion euros, 0.7% lower year-on-year in organic terms.

Operating Cash Flow keeps growing in the first six months exceeding 6.3 billion euros, 3.4% higher than a year ago organically, while net income surpassed 2 billion euros in the first half, roughly stable year-on-year.

Year to date results are fully aligned with our internal expectations, so we do reiterate our outlook for the full year.

Strong cash flow generation

On the next slide, FCF generation posted a very solid performance in the second quarter and grew 16% year-on-year, topping 1.9 billion euros. As a result, FCF in the first half improved to almost 1.5 billion. Let me mention, that first half figures includes payments from spectrum acquisition of 1.1 billion euros. So, isolating this effect, FCF would have reached 2.6 billion euros, posting a remarkable growth of 19% year-on-year.

EPS also improved on a sequential basis and reached 0.25 euros in the period April to June and 0.46 euros in January to June.

Intense commercial activity boosted by smartphones

In slide 6, you can see how commercial activity is intensifying.

In the second quarter we have intensified our commercial efforts in every category to further focus on value and sustainable growth. As such, we have recorded a strong acceleration in mobile contract net adds, that reached 2.1 million, the highest since Q3 2011.

Specially worth mentioning is the rapid expansion of the smartphone base, with record net adds in the quarter and with penetration increasing 8 percentage points year-on-year to 24%.

At the same time, FBB and fixed line improved momentum, especially in Latin America.

Finally, we continue with the selective deployment of ultra-broadband services; 30% of our fixed accesses are currently ready for these services and out of them 10% are already connected.

Recovering revenue growth

Let's turn to slide number 7 for the review of top line growth re-acceleration.

In the second quarter we have returned to organic revenue growth year-on-year. Revenue trend is 210 basis points better than in the first quarter, improving simultaneously in our two regions of operations. It is worth mentioning that T. Latin America performance accelerated its year-on-year growth rate to 10.4% (+360 basis points higher vs. Q1), highlighting once again the benefits of our best-in class diversification.

Excluding the drag from MTR cuts, first half organic increase would be 1.0%, turning also to positive growth.

By services, mobile data revenues, continued to enjoy strong momentum, with a 10% year-on-year organic growth and already accounting for over one third of mobile service revenues. Non-SMS sales drive this performance on the back of a profitable data monetisation.

Gaining efficiency & reinvesting in growth

Turning to profitability in slide number 8, I would like to stress the ongoing efficiency improvements delivered from key transformational initiatives in the commercial and operational model.

These savings drove to flattish OIBDA margin vs. the first half of 2012 to 33%, offsetting higher commercial spend in T. Latam during the quarter in order to capture market growth opportunities and transforming towards a more sustainable model. As such, OIBDA margin in the second quarter stood at 33.7%, declining 0.4 percentage points year-on-year, organically.

T. Global Resources: Execution of priority projects

T. Global Resources on slide number 9 is consistently contributing to higher efficiencies, cost reduction and transformation driven by further execution of priority projects.

In networks & operations, we are driving the deployment of LTE sites and we are launching the pilot test of our network virtualization in Brazil.

In IT, simplification of our operative model is delivering results while we continue to progress in infrastructure consolidation.

In devices, we are advancing to a more balanced vendor map through strategic agreements with several industry players. Let me highlight that T. España was first worldwide to launch worldwide Firefox OS device.

Finally, on procurement and thanks to our scale our savings are on-track.

T. Digital: Innovation at the forefront of our strategy

Next, I'd like to talk about a few highlights of Telefónica Digital's during the quarter, demonstrating Telefónica's innovation as a Digital Telco.

Firstly, there were Financial Services developments in Latam and Europe. In Brazil we've launched Zuum, a JV with Mastercard that provides banking services for the unbanked. We've also agreed to create a JV with Santander and Caixabank that will become a pioneering alliance between financial institutions and a telco to create new digital services.

Secondly, Telefónica Digital is investing in new information security capabilities. We've set up Eleven Paths, which will act as a hothouse driving radical innovation in security for Telefónica's clients.

In M2M, Telefónica signed an agreement with Dell to deliver "Dell Net Ready", a pay-as-you-go mobile broadband service for notebooks and tablets.

Finally, the first Firefox OS handset was launched in Spain on July 2nd for €69. Next launches of Firefox handsets will take place in Colombia and Venezuela along the third quarter of 2013.

T. Latam: Top line accelerating to double digit growth

Please turn now to slide number 11 to review our operations in Latin America, where our strategy based on capturing the most valuable customers is delivering very positive results.

We keep committed to our long term growth strategy, as proven by the outstanding commercial activity in the second quarter. We reached a record high in contract gross adds, reinforcing our regional leadership in this segment. At the same time, we improved our performance in the fixed business with positive net adds in all services.

Thus, top line strongly accelerated in the second quarter exceeding 10% year-on-year, showing a widespread ramp-up across the region and across services. Booming mobile data is the main growth driver and fixed businesses are recovering and returning to positive growth this quarter.

OIBDA growth of almost 3% year-on-year in organic terms lacks revenue growth, mainly due to the higher commercial effort done in the quarter as we are capturing value clients that have higher upfront costs but make revenues more sustainable longer term.

Brazil: Strong commercial momentum across the board

In Brazil, turning to slide number 12, commercial activity has been impressive in the most valuable mobile segments. Vivo captured almost 60% of the contract net adds in the market this quarter, mainly due to the explosion of smartphones demand, as customers can find in Vivo's network quality a differential service proposition.

Let me remark that Vivo keeps working in maintaining this quality gap as shown by the recent launch of 4G in 22 cities.

The higher quality of our customer base can also be seen in the prepaid performance. Our stricter disconnection policy is driving prepaid base down by 5% year-on-year; while on the other hand, top ups grew at a healthy 12% rate year-on-year.

In the fixed business, our turnaround plan is on track. Broadband net adds benefitted from the segmented approach of our strategy and doubled year-on-year, with enhanced quality in our DSL services and with Vivo fiber starting to gain traction.

Brazil: Commercial activity starting to flow into revenues

As a result, the success of our commercial strategy is starting to flow into revenues, as shown in slide 13.

Excluding regulatory impacts, revenue accelerated to almost 5% year-on-year in the second quarter, maintaining the solid growth in the mobile business while significantly improving revenue trend in the fixed business as operational KPIs started to recover.

On the other hand, profitability declined year-on-year this quarter by mainly two factors: the strong commercial momentum and the impact of some one-offs that positively affected Q2 last year.

Moreover, let me remind that, following the roadmap of the integration of mobile and fixed businesses, the final step of the Corporate restructuring has already been approved. This will lead us to capture additional synergies that will flow to the bottom line onwards.

T. Latam: Widespread revenue acceleration on outstanding commercial activity (I/II)

Please turn to slide number 14, to review other businesses in Latin America.

In Peru, revenue and OIBDA continued accelerating while strong commercial activity remained, reaching a record high in contract gross adds this quarter.

In Argentina, top line continued posting a solid pace, while pressure on profitability was mainly coming from the strong commercial momentum and the inflation driven costs.

Chile posted a significant improvement versus the first quarter as new commercial proposals launched in April started to gain traction. Revenue accelerated by almost 6 percentage points to 3% year-on-year, while OIBDA grew on the back of efficiency efforts.

T. Latam: Widespread revenue acceleration on outstanding commercial activity (II/II)

In Colombia, turning to slide 15, revenues reverted their trend and grew 2.6% year-on-year this quarter driven by solid commercial activity. In addition, OIBDA margin improved year-on-year as the benefits stemming from the fixed and mobile integration, offset the higher commercial costs.

In Mexico, the new "Telecommunications law", already signed, will provide higher dynamism to the market and we will be an active part of that process. In the meantime, revenue slightly recovered while we continued our operational transformation.

Lastly in Venezuela, the impressive operating performance remains. It is relevant to highlight that the main drivers for revenue growing at almost 50% are growing volumes; contract base is increasing by 32% year-on-year, smartphones by 37%, while rising ARPU is driven by data traffic explosion and by voice traffic, which grew by more than 20%. The reason is that value customers demand quality of service and there, our service is the market reference.

T. Europe: Executing transformation for a more sustainable model

Turning to slide 16 we will review our operations in Europe.

Amid a challenging environment, T. Europe continues executing its transformation strategy towards a more sustainable model to strengthen its market position and profitability.

Contract mobile net adds increased over two-fold quarter-on-quarter and smartphone adoption continued to expand, reflecting the value for money of our renewed simple and transparent portfolio built around increasing data usage.

In terms of financials, top line performance improved sequentially and margin expanded year-on-year for a third consecutive quarter driven by further efficiencies.

Specially worth mentioning is that despite the expansion of LTE and fiber networks, operating cash flow up to June was stable year-on-year, leveraging targeted CapEx allocation.

Spain: Leading the convergent market

Slide 17 provides more colour on the Spanish business.

Movistar Fusión's commercial traction remained solid, reaching 2.2 million customers as of June, which means that almost 40% of consumer FBB accesses in Spain are already in Fusión.

It is also good news the sustained improvement in the mix of new customers & upselling, to 56% in the second quarter, 9 p.p. more than the previous quarter. In addition, Movistar Fusión continues fostering strong fibre uptake and sound increase in additional mobile lines. On the impact of lower value packages (Fusión Cero), let me mention that more than 70% of Fusión quarterly gross adds chose higher value packages.

I would like to highlight the higher rationality seen in the market with focus on tariffs rather than on handsets subsidies. In this context, new mobile tariffs launched in April led to a significant reduction in the contract net loss in Q2, although aggressive convergent offers continued impacting portability trend.

Finally, convergence is also allowing us to continue improving churn levels and customer satisfaction across services.

Spain: Massive improvement in operating leverage

On slide 18, we can see the details of financial performance in Spain.

Revenue ex-handset sales improved sequentially its y-o-y trend as in the previous two quarters.

Specially remarkable is the continued improvement achieved in profitability driven by the on-going benefits of the new operating model coming from disruptive initiatives. As such, along with progressive new savings, OIBDA margin in Q2 stood at 48.4%, expanding 3.6 p.p. year-on-year. Let me remark that this is the fourth consecutive quarter with margins above 47% and significant margin expansion year on year.

Operating cash flow in the first half of the year remained flat y-o-y, with CapEx focus on fiber roll out acceleration, which ensures our commitment to capture a new wave of growth.

In a nutshell, T. España Q2 results evidence the sustainable benefits of our transformation strategy, which led to a meaningful improvement in the Company's operating leverage.

UK: Strong momentum while transforming the business

Please turn to slide 19 for a review of our operation in UK.

From a trading standpoint, strong momentum continued in the second quarter, with contract churn maintained at historical low levels and healthy contract net adds.

O2 Refresh proved to be a successful proposition, with a 20% uptake among contract trading despite it is only available through the direct channel and for high-end devices.

The benefits of this commercial approach are starting to be re-directed towards a more sustainable distribution model based on increasing the direct mix. Even though the upfront cost of transactions through the direct channel has a negative impact in the short time, lifetime value of the customer is significantly higher making the model more sustainable.

It should be highlighted that mobile service revenues improved their year-on-year performance for a third consecutive quarter.

Lastly, let me give some detail on the impact of O2 Refresh. In the second quarter, it has contributed with 5.5 p.p. to revenue growth, with no relevant negative impact in mobile service revenues. Part of this positive contribution has been offset by the higher upfront costs of increasing activity in direct channel, and as a result the net positive impact in OIBDA margin was 2.3 p.p.

Germany: transition to data-centric market

In Germany, commercial dynamics reflect accelerated market transformation towards data monetisation, with practically all handset sales being smartphones.

As such, the new O2 Blue offers position us in this direction and we continue to focus on LTE deployment to address the upselling opportunity. LTE is starting to get traction representing 40% of handsets sold in Q2 and two times the ones in the first quarter.

In this context, mobile service revenue continued decelerating, as growth in data services does not offset yet the pressure of tariff renewals, lower SMS traffic and the lower base growth.

The positive trends in data are resulting into non-SMS revenue growth of 25% year-on-year in the second quarter, which already represent 65% of data revenues. We are seeing increasing evidences of LTE monetisation with more than 60% of customers showing higher data usage after migrating to this technology.

Revenue pressure is partially mitigated by the Company's focus on efficiency measures, with OIBDA margin at 25.5% in the second quarter.

The recently announced transaction will provide us with the opportunity to further generate synergies, and to be able to face from a much stronger platform the market transformation towards data.

Creating a Leading Digital Telco in Germany (I)

Now, in slide 21, let me briefly summarise the offer we have launched for E-Plus for creating a leading digital telco in Germany. Total consideration for the acquisition is 5 billion euros and a final stake in the enlarged entity of 17.6%. The structure of the payment is composed of two consecutive steps:

First, the rights issue of Telefónica Deutschland of 3.7 billion euros and a stake in the combined entity of 24.9% and then Telefónica will then acquire a 7.3% stake to KPN for 1.3 billion euros.

Telefónica will commit 4.1 billion euros for this transaction: 2.84 billion euros to subscribe the right issue, plus 1.3 billion euros to acquire the additional stake.

Creating a Leading Digital Telco in Germany (II)

The strategic rationale for this transaction is compelling:

- Combining a bright past with a brighter future, due to strong potential to capture data growth.
- Capturing significant value from synergies with a NPV in the range of 5.0 to 5.5 billion euros.
- Enhancing profitability and FCF metrics and creating a platform to deliver a superior customer experience, to over 43 million customers.

Creating a Leading Digital Telco in Germany (III)

In slide 23, let me remark the better scale and diversified profile, with Telefónica becoming the second largest European mobile operator by customers. In terms of revenues, Germany will end up representing 13% of Group sales, up 5 p.p. on 2012 proforma, improving our geographical diversification.

All of this will be financed without increasing leverage: of the required 4.1 billion euros, 50 to 65% will be financed through Hybrid instruments, 20 to 30% through a Mandatory Convertible, and therefore there will only be incremental debt of 10 to 20%

of the required amount. The incremental debt plus the debt component of the hybrid is estimated to be around 2 times the incremental OIBDA from E-Plus.

Finally, let me wrap-up the key value creation points for our shareholders. The announced transaction:

- Will unlock significant synergies for Telefónica.
- Will better position us to capture future growth.
- It will reinforce geographical diversification, increasing exposure to an attractive market.
- It will have a positive impact on Telefónica's cash flow generation profile.
- It will be EPS and FCF accretive from year 1.
- And it will be credit friendly, with a financing structure designed for leverage ratios to improve.

Deleveraging towards target on debt reduction

Let me now move to the financial side, on slide 24.

Telefónica is making substantial progress on its deleveraging process by taking decisive actions. Net debt including post-closing events decreases by more than €3.5bn compared to December 2012 net debt adjusted by the devaluation of Venezuela. If we look backwards one year we have made remarkable progress in debt reduction for around €10bn.

Positive FCF pre-spectrum has contributed with 2.6 billion euros. This has been complemented with additional portfolio management initiatives such as the sale of our Irish business, 40% of Central America and our stake in Inversis.

Again, we reiterate our target to reduce our net debt below 47 billion euros in 2013.

Over 2 years maturities covered on strengthened liquidity

On slide 25, I would like to highlight how efforts to strengthen liquidity lead us to show recurring maturity coverage in excess of 24 months.

Telefónica's financing activity has been intense during the first half of the year through bond and loan markets. Several long term financing operations have allowed us to raise nearly €8bn year-to-date and to increase our average debt life, while smoothing the maturities profile.

This successful financing has contributed to an additional improvement in our liquidity position, reaching €21.7bn as of June, above the level of March 2013.

It is also worth mentioning the decreasing effective interest cost during the last twelve months, almost 25 bps to 5.23%, close to the bottom of the range of our guidance and despite the strong liquidity position.

Closing remarks

To wrap-up: We are returning to revenue growth leveraging diversification and strong commercial push.

We are exploiting our strong execution and transformation capabilities to deliver targeted efficiencies and reinvesting them in increasing customer lifetime value, allowing us to maintain cumulative OIBDA year-on-year trend practically stable.

We have posted a very solid FCF generation in the second quarter, leading to a sequential improvement of both FCFS and EPS.

We made a significant step forward in debt reduction, decreasing 10 billion euros since June 2012.

We have announced two days ago a transaction that will allow us to crystalise value in the German market.

So, all in all, we are progressing in our transformation strategy.

Q&A session

Paul Marsch - *Berenberg*

Yes. Thank you very much. I think your domestic OpEx fell by EUR 500 million in Q1 and I think it was EUR 400 million in Q2 compared to the previous year, but as I understand it the comp gets tougher into the second half. So, do you think you can sustain that run rate of cost reduction in the range of EUR 400 million to EUR 500 million per quarter through the second half? And, if not, can you give some indication as to what level of OpEx reduction we can expect to see through the second half?

And then secondly, just while your contract churn fell in Spain, it looks like you still churned about 815,000 contract subscribers in Q2. That's a similar level to Q4, when you launched the Fusion product. So it looks like you still need to do a lot more on contract churn and gross additions. What more can you do and have you actually got the cost flexibility to do it? Thanks.

Eva Castillo - *CEO Telefónica Europe*

Thank you, Paul. I think that, on your first question, as we have stated in the last few quarters, we are confident we can maintain similar levels of cost reductions and moreover to sustain our current margin levels. We feel confident we continue with our simplification, in-sourcing and other many projects in the Telefónica España operation.

Secondly, with regard to the contract churn, we agreed with the investor community that we needed to continue working on that. We believe we have set up the right tariffs and we are covering all the segments perfectly well now. And just to say that what we have noticed is more equilibrium in the market, so that we are looking more into both the fixed and the mobile as opposed to just looking at the mobile. We have seen some improvement on contract net adds and obviously we will continue working on this part of the business.

Mandeep Singh - *Redburn Partners*

Thank you. I've got two questions, please. First of all, just a quick one on your position regarding Telecom Italia. A couple of your partners in Telco SpA have indicated they want to exit Telecom Italia, so I wanted to understand if you're willing to take up their shares, or what your future intentions were regarding Telecom Italia. That's the first question.

And the second question is really about your full year EBITDA. I appreciate you guide on an organic basis, but you've done EUR 9.4 billion of EBITDA in the first half and market expectations are about EUR 19.7 billion for the full year. That requires significantly more than doubling your first-half EBITDA. Are you comfortable with market expectations? Or, if you can't answer that question, what do you think could actually drive an absolute increase in H2 EBITDA versus H1 EBITDA?

Ángel Vilá - *Telefónica S.A. - Chief Financial and Corporate Development Officer*

Thank you. This is Ángel Vilá, with the first question regarding Telecom Italia. We believe that there is value in keeping the investment in Telecom Italia under a joint vehicle that has a substantial stake, which has significant influence in a major European telecom operator. So, we are talking to our partners about the merits of preserving this ownership structure, and that is still an ongoing dialogue. So we are not contemplating taking full control of Telco, but we are talking to our partners to convince them on the merits of extending such structure.

José María Álvarez-Pallete - *Telefónica S.A. - Chief Operating Officer*

Taking your question on OIBDA for the full of the year, as you know, we have not been guiding on OIBDA; we have been guiding on OIBDA margin and we have guided on revenue growth. So I will focus my answer on revenue growth and on margin, if you don't mind.

Revenue growth, we announced that will be improving sequentially throughout the year, as we have seen quarter-on-quarter. The second quarter has been better than the first one. We think that, according to the trend that we are seeing internally, this is going to be the case in the third and fourth quarter, namely in Latin America, with very strong commercial activity in contract that will allow us to see better trends in terms of ARPU. And therefore we feel comfortable that the challenging profile of growth that we have in our own budget and that we have shared with the market is going to be met.

And in Europe it's been a bad year, as you know, overall, namely in Spain, but we are seeing progressively a stabilization of the growth, of the rate of growth, and a slight improvement in some cases. So, overall, in revenues we feel comfortable with the trends that we have seen.

On top of that, in the places where revenues have been weaker than we expected, the cost contention has been higher because we are significantly matching both things, revenue growth and subscriber acquisition costs. And therefore the overall thing is that we feel comfortable and we reiterate our guidance of revenue growth and a better performance of OIBDA margin for the full year.

Luis Prota - *Morgan Stanley*

Yes. Thank you. I have two questions, please. The first is on fiber regulation in Spain, where I've heard about a public consultation regarding a potential mandatory wholesale offer for fiber based on competitive levels by region. So I don't know whether you could elaborate a bit on what's going on, give us an update in this regard and what could be the potential outcome.

And the second question is on Argentina and what's your current cash position in the country and whether you have any kind of hedge ahead of a potential currency devaluation in the country. Thank you.

Eva Castillo - *CEO Telefónica Europe*

Thank you, Luis. With regard to your first question, I do believe you are referring to a pre-consultation, a process that it was before analysis of the market, but we cannot give you more information as such.

Ángel Vilá - *Telefónica S.A. - Chief Financial and Corporate Development Officer*

Hello, Luis. This is Ángel. Regarding our cash position in Argentina, the net cash is around EUR 100 million equivalent. It's remunerated at 15.5% and we don't have special hedges on that position. What we have is a positive cash position in solid currencies and some debt position in local currencies.

Eva Castillo - *CEO Telefónica Europe*

If I may add on my previous question, just to clarify that our deployment of fiber in Spain is currently related to the current regulation. So if there's any other regulation or new regulation, we will adapt to it.

Georgios Ierodiaconou - *Citi*

Hello. I've got two questions, please. First one is around leverage. Your target for the full year is to go below EUR 47 billion of net debt, and you're currently on reported numbers around EUR 3 billion short of that and there is an interim dividend which is just in excess of EUR 1 billion, so you more or less need to generate around EUR 4 billion in the second half to deleverage to that level. So, I'm not sure if Ireland will close in time for that. So, my question is to clarify whether the target is for the reported net debt or the one with the post-closing events is the one which we should be focusing on. And perhaps, if it's the reported number linked to that, if you'd give us any color as to how you expect to deliver that target.

My second question is on consolidation. With the announcement of Ireland last quarter and Germany this week, there is limited room for consolidation in Europe, at least with your direct involvement, but I wanted to extend perhaps the discussion about Latin America. Are there any markets in the region where you believe returns need to improve for investment to be viable and sustainable and where the market structure is currently suboptimal? And do you believe it is feasible for consolidation to be delivered or are there any barriers which could prevent that? Thank you.

Ángel Vilá - *Telefónica S.A. - Chief Financial and Corporate Development Officer*

Hello, Georgios. With respect to leverage, our net debt at the end of June stands at EUR 49.8 billion. If you were to include the transactions that we have already signed, some of them, like Central America, already all the conditions to closing have been fulfilled, so it is going to be closed around August 2. And we are aiming to close Ireland, ideally, in the last quarter of this year, maybe in the first quarter of next year. So with these divestments, we would be at EUR 48.6 billion.

We have a target of EUR 47 billion net debt by year end and, as you rightly say, we are going to pay a dividend in November which is around EUR 1.6 billion. So we are estimating that with the free cash flow that we are going to generate in the second half plus the closing of these transactions, we should be reaching that objective.

Having said this, you should expect us to continue being active in our strategy of active portfolio management, not so much here to achieving this debt figure by year end but because we believe it makes sense. Our approach has been, all along this year, to try to strengthen the operations in the markets where we are present. We have been very pragmatic. So in some places like Ireland, we have allowed ourselves to be consolidated, while in other places such as Germany we are aiming to be the consolidator.

This type of approach to the markets, trying to get a better position in those markets, be it in market share, be it in potential to create value, will continue. And we will explore opportunities for doing so in each one of the markets where we operate and potentially also in Latin America.

José María Alvarez Pallete - *Telefónica S.A. - Chief Operating Officer*

If I may complement the answer, I would say that for us consolidation is not just corporate deals, but also about network sharing. We think it doesn't make sense, the amount of network that we have in some places. Namely in Europe we think that having 60 players is not the right number so, I think that consolidation is going to happen. We have already shared our network in the UK. We are doing network sharing deals in Germany, in the Czech Republic and here in Spain. We are doing exactly the same in Latin America.

So, for us, it's becoming much more pragmatic in terms of allocating our capital and in terms of looking for other sources of differentiation, namely on the business intelligence and customer insight and products and services. So, yes, you should expect from us to be very active on this kind of consolidation and in this kind of making sure that we set up the right competitive differential points in our value chain.

Tim Boddy - *Goldman Sachs*

It's been another quarter with a lot of volatility in currencies, obviously later in the quarter so you haven't yet felt the full impact in EBITDA. I guess the question on that is: have you thought any more about your ability to reduce your exposure to LatAm currencies? Obviously, given your debt is nominated mainly in euros, is there anything you can do? I appreciate hedging costs are very high, but anything structurally you can do to change that?

And then, related to that as well, do you still have in mind a target leverage goal for the Group, because obviously, while the deleveraging has been very strong, the net debt to EBITDA ratio hasn't materially reduced?

Second, I just wanted to ask a bit about the timing in Germany, and obviously this is a transaction that's made sense for very many years. What changed which made you think that this was the right time to take on that transaction? Thank you.

Ángel Vilá - *Telefónica S.A. - Chief Financial and Corporate Development Officer*

Hi,Tim. With respect to our ability to reduce exposure to LatAm currencies, we have a hedging policy which is for LatAm currencies 2 times free cash flow pre-interest on those currencies. Our aim is not to have a specific percentage of debt within different geographies, but to protect the solvency, so reducing the sensitivity of leverage ratios to FX movements. So, for instance, some of the weakness that we have seen in the Brazilian real translating into our OIBDA is offset by the reduction of the exposure of the Brazilian debt in our balance sheet. So our hedging policy is aimed to protect solvency, reducing the sensitivity on leverage ratios.

With respect to a target ratio, if you look at slide number 24, at the end of June we're at 2.4 times net debt to OIBDA. If you were to contemplate the figure after divestments announced still pending closing, you will see that the ratio is 2.36 times, which is closer to the target that we have for the year.

With respect to the timing on Germany, I'll pass to José María.

José María Alvarez Pallete - *Telefónica S.A. - Chief Operating Officer*

Why now is the right timing even though this idea or this potential transaction has been on top of the table for several quarters, so to say. Well, first of all, right now there are some elements that are brand-new and that has aligned the elements to make this transaction doable right now. First thing is that commercial momentum is heading into the right direction. Second, we have an asset that is differential like the spectrum that we have in Germany, the 800 MHz for LTE purpose. Third, I would mention the IPO that we did of our German business last quarter of last year allowed us to have another currency, an attractive currency and attractive platform to develop this transaction.

So, overall, I think that today, right now, we can present to all shareholders, KPN and Telefónica and Telefónica Deutschland shareholders, but mostly to the customers of Germany, a very appealing proposal. And therefore, I think that right now we have all the elements aligned to make a very sound and robust case for this transaction to go through.

Tim Boddy - *Goldman Sachs*

And just a quick follow-up, if I may. Could you remind me on your long-term leverage target for the Group?

Ángel Vilá - *Telefónica S.A. - Chief Financial and Corporate Development Officer*

We have a target of leverage by year-end of 2.35 times. We have not moved the year target, but you should assume that our aim is going to be to continue deleveraging both pre and post-closing the announced transaction.

Ivón Leal - *BBVA Research*

Hello. Good afternoon, everybody. I have two questions. The first one is I don't know if you could help us to try to figure out how mobile ARPUs are going to perform in Spain in the second half and 2014, I guess, despite of the re-pricing of the base and lower prices coming from Movistar Fusión on the subscriber base. I don't know if you have some numbers on the third quarter which can help us to try to see if that is decelerating or not. And on that sense, it would be very interesting if you could give us an idea of what kind of mobile ARPU you're getting on the Movistar Fusión Cero contract, which I guess is where the risk of mobile voice cannibalization is more evident. That's the first one in Spain.

And the second one, in Brazil, you're blaming the margin pressure on two issues, one which I guess is more temporary, which is postpaid growth. And the second one, which I guess is maybe more structural, which is re-addressing your fixed line business. So, I don't know if you could give us a figure on, you know, how long can it take to readdress that fixed line operation and what cost it may have in terms of EBITDA margin in the country.

Eva Castillo - *CEO Telefónica Europe*

Thank you, Ivón. I think that with regard to Spain and in particular what is going on with ARPUs there, what, I think that I have stated earlier some new situation. First of all, the market is moving more towards a more balanced fixed and mobile market model. So the convergence seems to be the key driver in fixed business and in mobile business. So that is moving more toward a SIM only model.

We are seeing stabilization in revenues ex-handset sales. And I have to say that we believe we are moving towards improvement at the end of the year. So we will see some improvement in the second half but more at the end of the year. And we believe that will continue being part of the commercial traction coming from Fusión and the new mobile portfolio, despite or considering the negative impact of the MTRs drop in July.

With regards to your question around Fusión Cero, what I have to say is that something that Angel mentioned earlier in his presentation is that despite having that lower level, at that lower possibilities through Fusión Cero, most of the take-ups in Fusión go to the higher value package. So, more than 70% are moving into that direction, without being able to be more specific. I think that is a very good trend for Fusión.

Ivón Leal - *BBVA Research*

Okay. And the improvement that you're mentioning is already visible on July trends?

Eva Castillo - *CEO Telefónica Europe*

I think that we will see more towards the second half of the year, as I mentioned earlier, but we are seeing the right trends in the take-up.

Ivón Leal - *BBVA Research*

Okay. Thanks, Eva.

Santiago Fernández Valbuena - *Telefónica S.A. - CEO Telefónica Latinoamérica*

Ivón, this is Santiago. On Brazilian margins two statements. One is that we're happy we're making the progress we saw we could make on capturing data growth and upgrading customers from prepaid to contract. Our share of net adds is about 10 points or so better than our market share, so this is working.

The second thing that is working, as you mentioned, is the improvement in fixed line. It's still not enough. It's still not out of the water. But certainly it is pointing in the right direction. We have great confidence that slowly but surely this will be the trend over the coming couple of quarters.

And about the stability of margins or long-term numbers, we certainly do not have one, but we think we continue to have benchmark numbers for the industry in Brazil. And to the extent that the industry consolidates, stabilizes or stops growing, which it is not showing any sign of doing, maybe cost could be managed differently. But we think that the sign of the times today is capture that growth, the growth that there is, rather than be very aggressive on cost management. Of course there is always a balance, but at this point we think that capturing the growth is the priority.

Giovanni Montalti – *UBS*

Hello. Good morning. Just, two questions. There's been some acceleration in the line losses in Spain. I just was wondering if you could give us the trends behind this and what you expect for the coming quarters.

And on Brazil, I mean, I don't know how much can you answer to this, but looking at the political and regulatory environment, would you see feasible, let's say, a breakup of one of the four mobile operators among the three ones that would remain? Thank you.

Pablo Eguirón - *Telefónica S.A. - Head of IR*

Giovanni, sorry, could you repeat the last part of your second question?

Giovanni Montalti - *UBS*

Yes. Again, just assuming a breakup of one of the four operators in Brazil among the three that would remain, would you see this as a feasible scenario considering, I mean, the regulatory view, government view about the evolution of the industry? Just wanted to understand what's your opinion about how the regulator will see such scenario. Thank you

Eva Castillo - *CEO Telefónica Europe*

Thank you, Giovanni. I think that with regards to your question on the fixed line business in Spain, it's true the net loss has increased during the month of April specifically because it was affected by the connection fee increase. That was specifically 2.9%. That increase was finally postponed to June, which impacted in lower gross adds.

Santiago Fernández Valbuena - *CEO Telefónica Latinoamérica*

Giovanni, in terms of what the future shape of Brazilian telecoms will be, all the options can possibly be open. We, of course, have a few views, but let me say just one thing. It will not require a change in regulation but a change in the rules that the government has set up to control and direct the industry to attack a thing like the one you mentioned. And I think it is of no use that we share our views.

But certainly we have seen in other geographies that things can change. We're trying to do just that in Germany, but that is not necessarily a lead on what would be good for Brazil. So I think you're probably as well placed as any of us to have a view on what can and what cannot happen. But it is not only a regulatory issue. It is a highly charged political and industry shape view.

Giovanni Montalti - *UBS*

Sorry, if I may, just a very quick follow-up. Would you consider the current framework as, let's say, favorable providing some ground? Would you see some margin for this to happen, I don't know, over the next two years, let's say over the short, medium term, let's say? Or do you see that there's still too much that has to happen?

Santiago Fernández Valbuena - *CEO Telefónica Latinoamérica*

Look, there is still growth and there's a lot of growth coming from the segments that I mentioned, contract, upgrade and data. But Brazil is a large market and all of us have reasonably close market shares. It is highly competitive and so there's no obvious need for it, you know, to disappear as many other smaller markets might be. We have large markets with two or three players and very small markets with five players, and this is the shape of the industry that's morphing. We don't have a strong view about what is best. We should tell you we'll try to adapt to whatever the conditions are.

James McKenzie - *Fidentiis*

Hi. Good afternoon. Just two very quick questions. Firstly, there's been a lot of press comment about an agreement with Yoigo in Spain. I don't know if you could give us any detail on that or if there is any negotiation going on.

And then secondly, I wonder if, Santiago, could give us your view of what the new telecoms law could mean for you in Mexico.

Eva Castillo - *CEO Telefónica Europe*

Thank you. I think that if we look into what is going or what's happening in the press, what I'd like to say and to clarify, as we said in other moments, is that we are quite open minded to reach agreements in sharing infrastructure. We've done it everywhere in Europe and we have done it in Spain, so we will maintain that open minded objective. I think that if it is a rational movement that improves the market economics and optimizes capital investment, it's always good to look at it.

When we look at LTE specifically, we believe that the massive or the potential massive launch will depend first, on market demand, on technological maturity and on spectrum availability. As we have mentioned in other occasions, the usage of the 1800 MHz spectrum and the 2600 MHz spectrum bands definitely provide service in a temporary measure until the 800 MHz is available. So, for us, really the band in which we will focus the quality and the attention will be on that one, when it is released in Spain. So we will have to offer quality and we will have to offer the best service to our clients, and that will be our goal.

Santiago Fernández Valbuena - *CEO Telefónica Latinoamérica*

James, and in terms of the Mexican law, you know that the most interesting things are still to be written. The by-laws and secondary laws are in the process of being put together and those will show the details. The highlights are, however, very well known.

The highlight is that the Government of Mexico wants and has written in the constitution to limit market shares down to 50%. It's obvious that some of the dominant players or predominant players are way above that, and so there a number of known ways to get from where they are to the neighborhood of 50%. That includes asymmetric pricing that includes caps, that includes other things, which are going to be in the details. We think this is going to be healthy for the Mexican market and we will try to take advantage of whatever opportunities present themselves to do that.

There are no longer going to be any restrictions about the ownership. That's the second feature. We think there is a third line that is the strengthening of Ifetel, the new regulator, that is likely to have an impact on how fast any dispute is resolved and how easy, or rather how difficult, will it be to bring it to the legal courts, which has been a feature of the Mexican market, slowing down quite dramatically the thing.

So the most interesting things are still to come, but limited market share through any of the known means and strengthening the regulatory power, the regulatory body powers, and the lifting of all restrictions, we think are going to be quite healthy and interesting for the Mexican market.

James McKenzie - *Fidentiis*

Okay. Any idea of a timeframe for when you might start to benefit from this?

Santiago Fernández Valbuena - *CEO Telefónica Latinoamérica*

We think that the interesting details will be known before the end of this year and it will be somewhat in effect, and this is just a guess, in the first half of 2014. But of course we will all be updating the market on the like of this, as the Mexican government will be doing.

Jerry Dellis - *Jefferies*

Hi, yes. Good afternoon. Thank you for taking my questions. First question has to do with capital intensity. You noted in the slides how capital investment in Spain was heavily reduced this quarter. In general terms, CapEx across the European footprint seems to be trending at around about two-thirds of D&A, and I wonder to what extent that might be sustainable going forward. How should we think about that, please?

And then secondly, just in terms of Spanish mobile, you alluded earlier to the onset of how 1 cent termination rates in Spain from July. Obviously, in other markets such as Italy that has been the precursor to quite aggressive pricing activity at the retail level by competitors. I wondered if you're seeing any evidence of that and what initiatives you have in place to prepare the way and defend yourself in the event of any competitor activity. Thank you.

Eva Castillo - *CEO Telefónica Europe*

Thank you very much. I think that with regard to the CapEx question, to clarify, we are accelerating definitely our fiber investments and obviously the LTE across Europe. So what you might have seen is just some trends, towards the end of the year we will adjust to those targets so, nothing strange there. Moreover, the opposite because we are targeting fiber and LTE very importantly. So capital allocation and making sure that we do the right thing on prioritization is being key, but maintaining targets and maintaining definitely our objectives in all across Europe and in Spain as well.

The second question, I'm not sure if I understood it all together. I didn't hear the whole thing. But with regard to the mobile business and with regard to specifically what is going on in the market, I think that there is an MTR effect that we will see in July more specifically. And secondly, what we want is to make sure is that we focus on data monetization, and that data monetization should be the focus for us in all across Europe. In the case of Spain even more so, as convergence is also helping us to focus on it. We are seeing that coming also from other of our competitors, but what we wouldn't like to see is other competitors jeopardizing these data opportunities, these data monetization opportunities.

Will Milner – *Arete Research*

Thanks. Just had a question on Telefónica Deutschland and the acquisition of E-Plus. Would you expect, going forward, I mean assuming the merger completes, an increase in the Telefónica Deutschland dividend that would cover the incremental interest costs on the EUR 4 billion of debt that you're taking on to finance that deal?

And the second question is on Spanish mobile. I think this quarter you'll lap the launching of Fusión last year, and as a result you'll annualize the benefits of lower loyalty point discounts, which I think looks like quite a headwind in the third quarter.

Should we expect the mobile service revenue trend in Spain to deteriorate as a result of lapping lower loyalty point discounts, or are you confident, as you seemed to suggest earlier, that the service revenue trend will accelerate and improve in Spain?

Ángel Vilá - *Telefónica S.A. - Chief Financial and Corporate Development Officer*

With respect to the first question on the dividend of Telefónica Deutschland, first thing I have to say is that this is a matter that corresponds to Telefónica Deutschland and its governing bodies. But what I can comment is that there are two stages. One is pre-closing of the deal and the other one is post-closing of the deal.

So, pre-closing of the deal, the 2013 dividend that should be paid in early 2014, this should be fully aligned with what is stated in the IPO prospectus and in line with the dividend that has already been distributed recently. And then, after closing, the structure that we have designed will result in Telefónica Deutschland being a very well capitalized company. So, as such, it would make sense that it should have a very high free cash flow payout of dividend and Telefónica will continue to hold at least 65% of that company, and as such we would be a major beneficiary of those dividends.

Eva Castillo - *CEO Telefónica Europe*

Going into your second question, I think in Spain now and going forward the market is moving towards a more balanced fixed and mobile market model. So convergence as a key driver in both fixed and mobile businesses is going to be the key for our focus.

And as stated in previous call, the positive impact of the loyalty program, it will be fading off and it's already fading off. In the second quarter, the impact is lower than in the previous quarter and will be even more diluted towards the end of the full year 2013, when you will have a more like-for-like, more homogenous comparison basis because subsidies in mobile come from March 2012 and will be fully in place also for retention from third quarter 2012. And then the negative impact the subsidies removal had on the ARPU will also fade off going forward, so you will have a more like-for-like and more homogenous comparison. I think that's basically what I have to answer.

Fabián Lares - *JB Capital Markets*

Hi. Good afternoon. Two questions, please. With regard to the Irish deal, considering that this is a transaction that reduces the number of players, do you believe that there could be any difficulties in getting regulatory approval? And if so, could this somehow compromise your objective of reaching the EUR 47 billion by year end, as you seem to be counting with the cash in from this transaction already, even though officially it hasn't closed? So perhaps maybe some visibility on the kind of timeline you believe this may have.

And then second, on the E-Plus KPN deal, I was keen to know your thoughts over the statements made already in the press by people from the German antitrust regulator and other authorities seem to point to a rather negative stance on the transaction. Thanks.

José María Alvarez Pallete - *Telefónica S.A. - Chief Operating Officer*

Thanks for your question. First of all, on the Irish deal, we think that the proposal that we're making in Ireland by the sale of our business is very solid and attractive for the Irish market as a whole. I think that the level of competition in the Irish market is high enough to make sure that in spite of this transaction there is significant tension. And in fact, we will be an even more robust third player and therefore to offer much more attractive offers to customers in the different segments. So we do think that the proposal to the customers and to the Irish market is solid enough to justify the transaction, so we are not expecting major hurdles on that.

And taking your question on the German transaction, it's very similar. Let me make a very bold statement in terms of saying that again it doesn't make sense. There are too many players in Europe. If Europe as a whole, as a region, wants to play its scale, it needs to consolidate. That consolidation is going to be in the interest of European consumers and therefore it needs to happen. We think that we have already a strong and compelling case in the case of our German business. Let me try to detail that a little bit better.

First, on an infrastructure point of view, competition is going to accelerate because right now you have a third and fourth player that because of our entry has been later and the other two we are lagging behind, and therefore we are struggling to be competitive against two very strong players. So the consolidation of the third and fourth should create an infrastructure based player that is going to accelerate competition. And therefore we think we have a solid case in terms of adding competition into that market through this transaction.

But if then we approach this transaction through the eyes of the customer, having a stronger player would allow us, in our case namely, by the combination of O2 Germany and E-Plus, to have a much more competitive offer to some segments to which we have not been able to be competitive today in the German market, like the corporate segment.

So, whatever you approach the transaction is going to create more intensity and a better proposal to both the consumers and the society as a whole because it will accelerate investment, CapEx, and it will accelerate more attractive offers to the customers. So in both cases we think that we have a compelling case.

Let me finalize by saying that even at the end of the transaction, if the transaction was to be completed, we still have more than 100 brands in Germany because we have more than 100 MVNOs through the German market. So I don't think this is going to reduce significantly the competition, rather the opposite. It will help us to be much more competitive.

Jonathan Dann - *Barclays*

Hi there. Two questions. One, have you begun to think about partners for fiber beyond 3 million homes?

And then secondly, in Latin America, apart from Brazil, are there any other low frequency spectrum auctions coming up in the next two years?

Eva Castillo - *CEO Telefónica Europe*

Thank you, Jonathan. I think that our aim is to continue accelerating our fiber deployment, and as such we have the Jazztel agreement. And to remind you that our objective is quite aggressive already and it's to reach 8 million households passed by 2015. We are seeing good traction and the most important here demand is there, so that we are seeing demand coming from our customers especially to Fusión. So we believe we're well positioned, we have the right partners and we're signing the right agreements.

Santiago Fernández Valbuena - *CEO Telefónica Latinoamérica*

Yes. Jonathan, in terms of the upcoming spectrum auctions on low frequencies, understanding 700 MHz by that, the upcoming Chilean auction in Q3 is the one we expect. There is strong talks that Brazil, Colombia, maybe Ecuador, even Peru, might do something next year. This is more talk. You know that these frequencies tend to be heavily occupied and very noisy and so it's not easy to clean them up, but they might come in 2014. No strict plans that we know of are there yet. Then Mexico and probably Uruguay will come sometime in 2015. Those are more expectations than plans.

Jonathan Dann - *Barclays*

Does an auction in Brazil mean open up the scope for consolidation? I guess there isn't enough for all five players.

Santiago Fernández Valbuena - *CEO Telefónica Latinoamérica*

It's difficult to answer, because the rural part is still pending and the full deployment of LTE and the upcoming sporting events are likely to concentrate the regulatory and industry auction for the next year.

Ángel Vilá - *Telefónica S.A. - Chief Financial and Corporate Development Officer*

Thank you very much for your participation. We certainly hope that we have provided some useful insights for you. Should you still have further questions, we kindly ask you to contact our Investor Relations department. Good afternoon. Thank you.