



**Telefónica January-March 2014
Results Conference Call Transcript**

9th May, 2014

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Introduction

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

Good afternoon and welcome to Telefónica's conference call to discuss January-March 2014 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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Now let me turn the call to Mr. Ángel Vilá, who will be leading this conference call.

Presentation

Q1 14 Highlights

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

Thank you Pablo. Good afternoon and welcome to Telefónica's first quarter 2014 conference call.

Today with me is José María Álvarez-Pallete, Chief Operating Officer, so during the Q&A session you will have the opportunity to address to us any questions you may have.

Telefónica has released today a strong set of results, based on the execution of the management priorities established for 2014.

Top line delivered positive year-on-year organic growth for the fourth quarter in a row, and efforts to improve cost structure allowed to consolidate organic OIBDA stabilisation vs the first quarter of 2013.

Customer value continued to progress in the right direction, with significant increase in smartphones, fiber and LTE. This is supported by investments focused on growth and transformation areas, leading to accelerated network modernisation and setting the basis for further revenue opportunities.

FCF generation reached the best figure in a first quarter since 2011 despite higher CapEx, asset disposals and FX effects.

Debt reduction of 2.7 billion euros in the quarter, allowed for a significant improvement of leverage metrics to 2.3x net debt to OIBDA, despite the seasonality effect on FCF and forex.

In summary, I would like to highlight that Q1 results are fully aligned with our internal expectations and, therefore, we reiterate our full year outlook, dividend included.

Key financials

Please now turn to slide 3 for a quick review of our financial performance.

Reported year-on-year change reflected a negative forex impact (mainly due to implicit Venezuelan devaluation to 10.70 VEF per USD, Argentinian peso and Brazilian real depreciations vs. the euro) along with the deconsolidation of T. Czech Republic since the 1st of January, 2014. Let me highlight that FX factor dragged revenue by 11.8 p.p. year-on-year and OIBDA by 11.7 p.p., but at the same time it reduced CapEx, interest, tax and minorities payments in euros. As such, the FX impact on OIBDA is neutralised at FCF level.

Net income totalled 692 million euros with an EPS of 0.15 euros per share.

In organic terms, sales were up 1.5% year-on-year and reached over 12.2 billion euros while OIBDA grew 0.5% year-on-year and exceeded 3.9 billion euros with a margin of 32.1%.

Finally, net debt was reduced to 42.7 billion euros at the end of March or 41.9 billion euros including post-closing events.

Strongest Q1 FCF since 2011, despite CapEx and FX

In the next slide, let me stress again that FCF generation has been the strongest for a first quarter in the last three years, achieving 339 million euros or 433 million euros before spectrum payments.

Let me also remark the positive absolute year-on-year change in FCF of 800 million euros in the quarter, continuing the improved trend initiated in Q1 13. This performance is based on improvements in every category of FCF metrics in spite of adverse FX impact, CapEx growth and asset disposals.

Lastly, FCF will be recording a better evolution throughout the year as the first quarter is traditionally impacted by seasonal effects.

Selective commercial approach; increasing customer value

Turning to slide number 5, we continue to focus on increasing the value of our customer base through the ongoing launch of differential propositions, based on customer insights in each market and with a common approach of tiered pricing.

Mobile contract base maintained the high single-digit growth rate posted in December 2013 driven by the performance of smartphone net adds, doubling those of Q1 13 and leading to a penetration of 30% (up 9 p.p. year-on-year), clearly advancing in data monetisation strategy.

The momentum of LTE, Fiber and Pay TV improved during the quarter, resulting on a remarkable 81% year-on-year increase of homes passed, a 90% growth of connected homes and a high single-digit growth of pay TV accesses. All these, along with low prepaid smartphone penetration, represent a massive opportunity for future growth.

Revenue & OIBDA growing organically

In slide 6, I would like to show the improved organic performance year-on-year from top line to OIBDA.

Group revenues were consistently accelerating, 80 basis points vs full year 2013 on the back of our differential diversification. Hispam, Hispanoamerica was the main contributor to growth and Spain eased its pace of decline. Our sales mix is evolving towards data as it is explained by the strong performance of mobile data, increasing the weight of non-SMS by 8 p.p. year-on-year to 71% over mobile data.

Good progress on cost management transformation and scale efficiencies is reflected in the lowest OpEx year-on-year increase in the last four quarters which resulted in an OIBDA growth of 0.5% vs. January-March 2013.

Organic OIBDA margin erosion was limited at 0.3 p.p. year-on-year, balancing mainly higher network costs coming from increased investments and lower commercial expenses.

Let me stress that if we exclude the negative impact from regulation, our revenues would have grown 3.4% and OIBDA 1.9% year-on-year.

TGR: speeding up technological transformation in network, IT and operations

Global Resources is consistently contributing to network transformation, IT simplification and higher efficiencies.

In networks, we are accelerating the deployment of UBB infrastructure in main markets, with 69% of investments devoted to growth & transformation, which resulted in approximately 2x the number of homes passed with fiber year-on-year and 10x more LTE sites in service than a year earlier. Let me also highlight that more than 80% of 3G and/or 4G mobile sites are already connected with UBB technology.

In IT, simplification of our operating model is delivering results while we continue to progress in infrastructure consolidation. In this sense, I would like just to mention that we decommissioned approximately 80 applications this quarter and more than 35% of our servers are virtualised at the end of March.

Digital Services: Advancing across different P&S

Moving to slide number 8, let me highlight the progresses made in digital services.

Regarding the Consumer area, we are gaining market share in the Pay TV businesses in our main markets, reinforcing our positioning in Spain with exclusive content acquired.

The area of Global Device Management is supporting a rapid adoption of smartphones, with 65% of total devices purchased in the quarter being smartphones.

We also announced “Yaap”, the brand of the digital financial services to be launched in the coming months in Spain by the JV established with CaixaBank and Santander.

In the B2B area, Telefónica signed a M2M deal with JCDecaux to bring urban connectivity in Europe and Latin America, and was chosen as partner in Europe by Tesla, an industry-leader of in-car telematics.

Finally, we also made strategic investments, creating “Axonix”, the first mobile advertising exchange platform owned and powered by a mobile operator, and acquiring “eyeOS”, that enables Telefónica to offer an open-source desktop virtualisation service.

Spain: Unique assets driving quality trading

Moving on to Spain in slide number 9.

Our convergent offer “Movistar Fusión” continued to gain momentum, reaching 3.2 million customers as of March, with a higher weight of new/upselling customers (71% in the first quarter), driving solid trading in a market with increasing customer’s preference for quality services.

Fiber net adds marked a new record in the quarter with 108 thousand, maintaining a 17% uptake despite the accelerated pace of deployment. Pay TV accesses posted 11% year-on-year growth, and contract mobile net loss was significantly reduced, both sequentially and year-on-year.

Specially worth mentioning is the benefit of the high penetration of “Fusión” towards a more sustainable revenue model, through the continued improvement in our services’ lifetime thanks to “Fusión” churn, which is notably lower compared to standalone services.

At the end of April, underpinned by our differential assets we further increased the value of our offer and revamped “Fusión” packages, including “Movistar TV” high quality contents in all packages, with no price increase.

As such, leveraging the “Fusión” enhanced portfolio and the continued acceleration of the deployment of fiber and LTE networks, we expect to foster further commercial activity in the coming months.

Spain: Revenue improvement trend accelerates

Turning to slide number 10, we review Telefónica España financials.

Revenue recovery trend accelerated in the quarter, with year-on-year decline easing sequentially 370 basis points. This performance is explained by improved commercial momentum, lower back book impact linked to the high penetration of new tariffs, and higher handset sales driven by intensified commercial effort.

Profitability remained solid with OIBDA margin at 46.9% in a very competitive market, supported by ongoing efficiency gains, and despite increased commercial costs, reflected in higher gross adds and handsets sold.

UK: Growing contract customer value

Slide 11 shows a quick review of our operation in UK.

We continued to gain high value customers and to maintain market leading contract churn. Key initiatives supporting our performance include the success of “O2 Refresh” proposition or the proactive upgrade of our customers to LTE.

I would also like to highlight that 4G services monetisation, based on increasing data consumption (2x vs 3G), led to high single digit ARPU uplift.

Underlying mobile service revenue trend stabilised year-on-year driven by solid non-SMS revenue growth of 13.9%.

In terms of profitability, OIBDA margin grew 3.5 p.p. year-on-year benefitting from “O2 Refresh” and a one-off contribution from the true-up of past commissions in the quarter amounting to 24 million euros.

Germany: Investing in opportunities around LTE

To review Telefónica Deutschland, please turn to slide 12.

LTE continues to gain traction in the market. We keep on seeing very positive signs of LTE adoption, with 78% of devices sold being LTE enabled, thus increasing the value of our customer base.

With this, and the fast roll-out of the LTE network with 50% coverage in April, we are improving our position to capture the data monetisation opportunity. As a result, and to further promote customer growth, we introduced a refreshed “O2 Blue all-in” portfolio for consumers as well as “O2 Unite” for business.

MSR year-on-year performance stabilised, though affected by a combination of lower SMS volumes, tariff renewals and weaker prepaid dynamics. I would like to highlight the lower weight of SMS over data revenues: up to March, these represented 28% of data revenues (9 p.p. lower than a year ago).

At the same time, OIBDA and OIBDA margin evolution reflect intensified commercial activities around LTE.

Brazil: Reinforcing leadership in high value customers

In Brazil, moving to slide 13, we continue outperforming the mobile market, capturing more than 60% of the new contract customers for the third quarter in a row, driven by our superior network and better service quality. This strategy allows us to be in the best position to capture the new wave of data growth. Let me also remark the success of “Vivo Tudo”, capturing 4 million customers in just 2 months.

In the fixed business, our turnaround strategy continues focused firstly on a highly segmented approach, with quality growth through accelerated fiber deployment as a clear priority, and secondly, on increased coverage of the fixed wireless technology, with growing net adds volumes outside Sao Paulo.

Brazil: Solid financial performance

Slide 14 shows our solid Brazilian financial performance.

Services revenue year-on-year growth accelerated to 3.8%, excluding the higher regulatory effect this quarter, and amid a more balanced contribution of our fixed and mobile businesses.

As such, it is worth to highlight the evolution of fixed business, the best in almost 3 years, and the increased contribution on non-SMS data sales, growing by 42% year-on-year.

Finally, profitability showed limited erosion year-on-year thanks to strong cost discipline and despite more intense commercial activity.

Hispam: Strong revenue & OIBDA growth

Turning to slide number 15 let me summarise our operations in Hispanoamerica, with strong revenue and OIBDA growth in a balanced country contribution as the main highlight this quarter. The region is accelerating its revenue and OIBDA growth even excluding Venezuela.

Specially noteworthy is the higher contribution of countries like Mexico, Colombia and Chile, posting all of them a strong revenue year-on-year acceleration.

During the quarter, T. Hispanoamerica recorded a healthy revenue expansion on new revenue sources, with Non-SMS data revenue, up 43% year-on-year, as the main growth driver. In the fixed business, transformation process to capture increased growth opportunities is also delivering results, with FBB and new services up 17% year-on-year and gradually increasing their revenue weight.

And finally, despite higher network and commercial expenses, OIBDA posted a solid year-on-year growth leading to a slight improvement in profitability on strict cost control and efficiency efforts.

Hispam: Consolidating growth across the board (I)

On a per country overview, in slide number 16, Colombia reinforced its market positioning, consolidating double digit growth in both revenue and OIBDA.

At the same time, Argentina posted solid revenue increase while increased profitability year-on-year.

In Chile, let me highlight that, excluding regulatory effects, year-on-year growth has been the highest in the last four years, delivering the benefits of better commercial volumes captured in recent quarters.

Hispam: Consolidating growth across the board (II)

Moving to slide 17.

In Peru, revenue and OIBDA year-on-year growth trend remained strong, with increased profitability year-on-year.

In Mexico, we posted an outstanding acceleration in revenue year-on-year performance this quarter, taking the benefits of our strong network and the reshaped commercial portfolio, that is progressively gaining traction. Let me remark, that this results do not include yet any positive impact from the improved regulatory framework expected from Q2.

And finally, in Venezuela and Central America, increased volumes remained as the main growth driver with data and voice traffic strongly up year-on-year.

Ongoing net debt reduction & leverage improvement

Let me now move to the financial side, on slide 18.

Once again, in the first quarter we have demonstrated our deleverage capabilities by reducing our net debt figure by close to €4Bn, after Venezuelan bolivar FX impact, or €5Bn when factoring in post-closing events. These efforts translate into a reported net debt figure below €43Bn and leverage ratio at 2.3x, both within the target range.

In achieving such figures, we have offset the negative effect of Venezuelan bolivar implicit devaluation with a new hybrid issuance, the closing of T. Czech Republic disposal and a growing FCF.

Broad financing while maintaining ample liquidity

Slide 19 shows our steady and diversified access to different pockets of liquidity across our footprint, with close to €6bn raised year-to-date.

In parallel, we are smoothing our maturity profile by prepaying €2.3Bn of higher coupon financings at Holding level, mainly maturing in 2015.

On top of that, we maintain an ample liquidity cushion, at €22Bn, which allows us to comfortably address the maturities going forward.

Effective interest cost fits in the middle of the target range despite the increase on average cost of debt driven by (i) keeping hedging strategy in Latam currencies with higher cost and (ii) reduction held mainly in € and CZK, with lower costs than average, within the deleveraging process.

Conclusion

To recap,

We had a strong start of 2014; increasing customer value and network differentiation while improving financials.

Our organic top line and OIBDA accelerated year-on-year, with profitability almost flat.

At the same time, we posted a very solid FCF generation, the strongest Q1 since 2011.

Finally, we made a step forward in debt reduction, strengthening our balance sheet and improving the leverage ratio.

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

Q&A session**Georgios Ierodionou - Citi**

I have two questions, both on leverage. When I look on slide 18 on the net debt to OIBDA ratios that you show, I believe that the nominator of around €18.5 billion includes Irish and Czech OIBDA and Venezuela at the CADIVI rate for 9 and a half out of the 12 months, so that number is likely to come down materially in the coming quarters.

And at the same time you are already in the process of acquiring Digital Plus and E-Plus and you have also been linked with other acquisitions including a very chunk one in Brazil, so my first question is whether the 2.35 times ceiling is a firm target or a medium term aspiration that you may deviate from for a couple of years?

And my second question is around your funding options. Based on comments last quarter I believe you can issue another €3 billion of hybrid at most. So is there a firm commitment to maintain the 40 cent cash dividend and which you are allowed using your equity as a source of funding for M&A?

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

Hi Georgios, thank you for the question, this is Ángel. The ratio of 2.30 times net debt to OIBDA is calculated as in our tradition with a 12 months rolling OIBDA. This excludes the Telefónica Czech Republic OIBDA because the company was deconsolidated from beginning of this year but for the ratio calculation we have done going backwards adjustment and we have taken Telefónica Czech Republic out of this calculation.

Going forward, we have a few pending impacts on debt. On the one hand, we have the sale of Ireland which we are expecting to close in the second quarter and this would reduce debt in €780 million. This does not include deferred payment in addition of €70 million.

And then, at the time of closing the E-Plus acquisition, we would have, as Telefónica, to pay €4.1 billion. This is including both our share of the rights issue in Telefónica Deutschland and second acquiring a stake of Telefónica Deutschland from KPN. This €4.1 billion would increase our debt, but as we announced when we announced the transaction, we are going to issue a mandatory convertible for around one third of such figure.

So if we were to do the proforma from the €42.7 that we have closed in the quarter, we exclude Ireland, we include the acquisition of E-Plus and then the issuance of the mandatory convertible, the figure would be around 44.5 and would be clearly below the 2.35 times net debt to OIBDA once you include the E-Plus OIBDA that we would consolidate.

With this, we maintain our target of less than 2.35 times net debt to OIBDA and below €43 billion for year end. And we still have plenty of options non-organically but also we expect to generate substantial free cash flow between now and the end of the year.

With respect to the hybrids. I think it was your second question. We have now outstanding €4.2 billion. Our issuance of hybrids is motivated by two reasons: one is to support the strategic decisions, like M&A or like increasing investments, as we are seeing this year; or to protect from negative non-organic events as we have seen with the Venezuelan devaluation.

There would be a limit from ratings agencies up to €7 billion; we have outstanding 4.2 billion and at this stage in the short term we are not planning any further issuance. I would like to highlight though, that the last issuance of hybrids, the cost of such have been within the range that we have for senior debt in spite of these instruments being two notches rated below senior.

Giovanni Montalti - UBS

Could you share with us some thoughts about your view on the potential consolidation of the Spanish market following the acquisition of Ono by Voda? And do you expect an improvement from the mobile market dynamics coming from this deal?

And secondly, if you can share with us any update regarding the regulatory review of the fixed access market in Spain?

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

Taking your first question about the transaction being announced by Vodafone acquiring Ono, we do think that we are especially well prepared for a potential market consolidation. We think it's always positive, I think it's part of the business game. I think that in the longer term a market with bigger players, integrated players, like could be the case of Vodafone plus Ono, should evolve in a healthier competition because of the infrastructure base, and therefore, margins are going to be similar and therefore, the average blended ARPU of the customers is going to be convergent and therefore, I think it's going to be more sustainable.

I think that those transactions or these transactions specifically explains part of the aggressiveness of the market in terms of Ono in the last month, because they were very eager to increase their size before this potential acquisition.

And we do not think this market consolidation is over, therefore, I think that we should be prepared for potentially more in-market consolidation, not just in Spain but all over Europe because we think that there are too many networks, too many players in Europe and therefore it makes total sense.

I think that this is part of our strategy, that we are prepared for that, that we have been preparing our company for that mainly in Spain, and I think that in the long run this should drive to a healthier competition and to a more sustainable market and to better commercial prospects based on infrastructure products for the consumers.

Your second question was about the fixed regulation in Spain but I didn't understand basically to which you were referring? Were you referring to the bitstream or to the unbundling? I didn't catch your question.

Giovanni Montalti - UBS

The review by the telecom authorities in Spain for the wholesale access market, if I remember what should be market number two, if I remember well they should publish a public consultation before the beginning of the December and I just want to understand what are your expectations?

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

Ok, understood. I think that you are referring to the pre-consultation on the markets in Spain, number four and number five.

We think that the pre-consultation period has clarified the fact that mobile exerts competitive pressure on fixed as well, and therefore with enough conditions in different areas, and therefore with enough different alternative players and operators, and cable operators. So the integration should explain part of that evolution as well. This new infrastructure competition, which should not start to be regulated, we think, is the only way to generate growth and competition in the future so we have reasons to believe that the new rules should go into the right direction.

It's too soon to say. We expect this new final decision by the end of the year and I think this is not going to be affecting 2014 yet, but we think it's going to the right direction.

Mandeep Singh - Redburn

My question is really about Spanish revenue and margin dynamics. Obviously we've seen this quarter an improvement in the rate of decline in Spanish revenues, strong commercial activity so can you sort of talk to us about the improvement in revenue trends that consensus forecasts and how sustainable that is or how consistent that is with high 40s margins if the cost of better revenues going to be lower margins?

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

Yes sure, thanks for the question. I think that you have the two effects that you were mentioning in this quarter.

First of all we have an OIBDA margin that is 46.9% or 45.3% excluding one-offs, namely the towers one-off. If you compare that with the first quarter of the previous year where the margin was 47%, we have a drop of excluding one-offs of 1.6 percentage points. The explanation of that drop, which I think is more comparable first quarter versus first quarter, is explained by several factors.

First, we have a better performance on revenues, and therefore that has a positive effect on OIBDA which is in the neighborhood, including fixed and mobile of 2.9 percentage points. Then, you have that we have been more aggressively investing in the commercial effort, and that ranges 4.4 percentage points of the evolution of the margin. Therefore, the impact of the margin should be judged upon the more aggressive commercial efforts that we have been doing.

The next question would be: why are you being more aggressive now and not a year ago? First, because we see the macroeconomic situation of Spain improving. We see now value in the market. We see now value that is worth to be captured, and that explains why we have been having in this quarter some record figures of commercial activity, namely TV gross adds for example, have been multiplied almost by three times, mobile contract has increased by 9%, fibre gross adds have increased by 75% and handset upgrades 12%.

Next question should be what's the impact on revenues? We have been improving the rate of decline of revenues to 8.2%, compared with 11.9% at the end of last year, but if you were to exclude handsets and regulation the impact will be that our current revenues will be down 7.1% compared with 9.6%.

So, we are trying to accelerate the revenue trends in Spain because now we see value. This is having an impact on OIBDA, but I think that now that these new customers are going to be flowing to our accounts, this impact should be more limited because we keep working on the efficiency initiatives, namely in Spain, but also at the level of the Group, and therefore we think that this level of revenues at the Group level, but namely in Spain, is much more sustainable this quarter than a year ago.

So, we will keep going. We think that you will have seen that in Spain we launched a new Fusión proposition for the existing customers in April. As we speak, we are having record numbers of sales in terms of TV adds, and we are basically getting back to the figures of Fusión when we launched Fusión initially, so we have reasons to believe that the market on the integrated player, and namely on our TV and fibre proposition is paying off, so we will keep going, and we think it's the right thing to do.

Mathieu Robillard - Exane

Yes, good afternoon. A question on Brazil, on fixed actually. I am intrigued by your product fixed wireless, that you launched a few quarters ago and seem to be doing quite well. And I wonder, is that just an add-on to your mobile strategy in Brazil or is that the beginning of something a bit bigger where you want to be more present in the fixed business in regions outside of São Paulo.

Clearly in a world where convergence is going to increase even though it's not there yet in Brazil but also where you could have some synergies from a network point of view. I guess the question is what is your fixed line strategy in Brazil apart from São Paulo and is this product the beginning of something?

Then the second question about the spectrum auction also in Brazil, it seems that the regulator and the government is quite intent on having that go through in August and I just wanted to know what was your view on the spectrum auction? Thank you.

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

Thanks for your questions. On the fixed wireless proposition outside São Paulo in Brazil, it's a standalone strategy, so we are not just bundling that with a mobile product, and therefore it needs to make the numbers in terms of margin by itself so we are not just subsidising or cross-subsidising one product to the other. We are monitoring that very closely in terms of churn and in terms of subscriber acquisition costs and it's paying off. We are taking advantage of the commercial capillarity distribution that we have in Brazil and also the brand outside São Paulo, so it makes sense. It's generating good results but we need to judge this strategy not together or jointly with the mobile strategy but by itself for the time being, so it's not a bundled product so far.

And in terms of the spectrum auction in Brazil, it's too soon to say. We are monitoring that very closely so if you were to ask us if we need that for 4G this year, the answer is no. We are developing and launching aggressively our 4G proposition in Brazil in the spectrum that we have. But we need to be very careful. The final rules are expected for July with minimum prices included and also there are some uncertainties about what are going to be the costs of the clean-up of the migration of TV customers in some of those cities, so it's still too soon to say. There's still too much uncertainty but as you might imagine we are monitoring very closely.

Justin Funnell - Credit Suisse

Just on Fusión, I think you mentioned the ARPU is €70 and that's flat. I'm not sure, can you tell us what the ARPU on Fusión had been doing year-on-year in prior quarters? Had it been falling year-on-year and is now essentially the year-on-year trends are improving? Or was it the other way around? Had ARPU been growing and it has come down to flat? I presume it's the first but if you could clarify.

And secondly in Brazil, I think the break-up of Telco that may be coming in June gives you an opportunity to go back and have discussions with CADE about your stake in TI. Have you got any thoughts at this stage as to whether you will be able to retain the 15% or is it simply way too early?

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

Hi Justin, this is Ángel. I will take the second question regarding the Telco de-merger in June. The de-merger is a possibility that is contemplated in the shareholders agreement and this can be requested by any shareholder. We have not taken, as Telefónica, any decision in this respect although we have seen that some of our partners have been making some statements, but they have not made any formal indication to us on this.

The Brazilian CADE rulings, which are public on their webpage and we have also made some public statements on them, could be somehow or partially facilitated by a de-merger but, again, I want to stress that we have not taken any decision on this.

For the time being of course we would have no problem to maintain our 14.8% stake. We have no presence on the board of Telecom Italia and we have never had any influence on Brazilian matters when it comes to Telecom Italia.

Attractions of such a potential consolidation remain the same. We have very good performance and as I was saying before in the presentation we continue to grab more than 60% market share of the net adds quarter after quarter in Brazil. The market is clearly attractive, both our competitors have been presenting the results recently and one can see that the market is doing nicely. We continue to be strong believers in in-market consolidation benefits for the market and for the citizens in the markets where that could take place. And, if anything, I was saying in the previous conference call that lots of stars need to get aligned, maybe some stars are starting to align but still many things would still have to happen for a consolidation to take place.

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

Taking your question about the ARPU of Fusión, we are tracking that quarter-over-quarter. Fusión is still a very young product but so far the ARPU is pretty stable and we are starting to have the first layers of Fusión customers with their contract maturing.

The churn of those customers is significantly lower than the churn of the customers that have one single product. So from both sides, I think that we can already say that a year and a half after the launching of Fusión, that this has been a successful product, in terms of ARPU stability, in terms of churn reduction and in terms of value creation.

The customer mix of the Fusión customers continued to improve. 71% of the recent gross adds are new or upselling customers, it used to be 64% a quarter ago and it's significantly protecting our customer base because the lifetime of a Fusión customer is much longer, so from any metric, ARPU or churn or subscriber acquisition cost, Fusión is a good product. It's helping us to significantly anchor the value of our revenues in Spain.

And with the new value proposition, let me stress again that the figures that we have on April are pretty promising, so with the new TV offer I think it's going to be even better. It's also helping us on the mobile side. We are, as of April figures, getting much closer to stability on our customer base, in the contract mobile customer base, so in all metrics Fusión is helping us significantly.

Luis Protá - Morgan Stanley

Two questions, please. The first is on Mexico. I wonder if you could give us some figures on the impact from the lower termination rates applied to América Móvil. How that will benefit Telefónica from second quarter and also when these termination rates go to zero with the new legislation, what is the upside there, not just from a direct impact but also from the indirect implications in terms of your potential increase in market share?

And the second question is on Venezuela and the exchange rate you are using to consolidate earnings from that country and cash flows. You are now moving to Sicad I, but we are already seeing a bunch of companies that have moved to Sicad II closer to VEF50 per dollar. What are your thoughts there? Is there any need to move there? Is there liquidity enough in either Sicad I or Sicad II or what are your plans?

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

Hello Luis, this is Ángel. I will take the question on Venezuela. In Venezuela, we have currently three exchange rate systems. One is called CENCOEX, which is the old CADIVI at VEF6.3 per dollar. The second one is Sicad I, which is the one that we are using for our accounts, which has periodic auctions and at the end of March it was at VEF10.7 per dollar, which is how we have accounted. And then the third system is called Sicad II, which it also has several periodic auctions and this, at this stage, is closer to VEF40 something or VEF50.

The volumes that the authorities have been telling publicly that they would expect to go through the systems; the first system which is the old CADIVI, the CENCOEX, is supposed to be around two-thirds to 70% of the volume of transactions. This we cannot access. It is for basic items like medicines, food, education, and very basic services and products. The second one which has been explicitly stated that is the one to apply to industries like telecoms, the Sicad I, the VEF10.70 at this moment, is going to have a volume of around 25% to 30% of the transactions. And then, the Sicad II has very little liquidity and is going to be something around 5% to 8% of the total volume. This one has been, for instance, according to Venezuelan regulation, the one to apply to consumer goods companies like the ones that you must be thinking that have been recently reporting on Sicad II.

So, first, regarding the volume that these different systems have and, second, regarding the regulation that we have in Venezuela, we are reporting in full agreement with our auditor, which, by the way, it is an agreement between the big four auditing firms for all the companies operating in Venezuela, we are operating at Sicad I.

Also, as you would imagine given the situation and the evolution of the country, we continue to explore potential alternatives to invest our liquidity and protect it from inflation. And some of those alternatives that we are looking would be closer to Sicad I than to Sicad II and hopefully we may be able to reach some success on these in the future, but we are still not there.

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

Luis, taking your question about Mexico, first two things. Since the reform was announced initially as several things started to happen, the most recent events are that Telcel, América Móvil has been declared preponderant players and, therefore, they are subject to significant asymmetry.

The levels of asymmetry is the thing that is currently under discussion and also other elements of the regulation. This regulation has been submitted to the Senate and to the Congress in Mexico and, therefore, is going to be debated in the very, very short run. The level of asymmetry that has been announced initially is significant and could allow, if those were finally the levels to be applied, to significantly have an impact on the on-net tariffs of the Mexican market, which again could create a significant movement towards opening some closed ecosystems of customers, like namely the ones of Telcel, because we could become competitive in terms of the interconnection cost compared with the on-net tariffs.

Too soon to say because this detailed regulation is going to be under discussion in Mexico in the next few weeks we hope, but potentially very relevant for the Mexican market. The results that we are getting so far in this first quarter from our Mexican units have no impact on that yet and, therefore, is totally depending on the evolution of our own effort with the current regulation. But we think that if this regulation was to crystallize, there is a significant upside because competition will significantly be enhanced in the Mexican market.

Ivón Leal - BBVA

Just two on Spain for my part. I don't know if you could share with us the cost of your new commercial strategy in Spain, that is the content cost of your Pay TV in your subscriber base and maybe also the cost of the CapEx of migrating all of your Fusión subscribers to fiber.

And maybe the second one is: what is the reason behind not extending the fiber agreement with Jazztel and just going to those 13 million homes in the long term by your own?

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

In terms of commercial cost, we will not detail the cost of the commercial strategy in terms of the content because it's sensitive commercial information. I tried to advance in a previous question that this represents 4.4 percentage points of OIBDA reconciliation, so to say. But we cannot go further than that, namely on the content side, because it's a pretty sensitive issue, as you know.

And in terms of the cost of migrating customers to fiber customers, again too detailed information is not the thing we should do. But let me tell you, that if we were able to migrate entirely our copper customers in one specific central switch to the fiber customers, the cost of maintaining a fiber network is significantly lower than the ones of maintaining a copper one. So we're going to try to accelerate that as much as we can. It is true that in the meantime you have an overlapping effects, but it is more than compensated by the fact that churn on fiber is significantly, significantly lower than churn on ADSL.

And in terms of the fiber agreement with Jazztel, it's open to commercial discussion, as you might imagine, but we are accelerating. We cannot wait for others and therefore we will keep going. Our aim is to double the homes passed this year and we are executing, so who knows what's going to happen in the Spanish market. In the meantime, we cannot wait; we need to keep going.

Frederic Boulan - Nomura

Hi, Good afternoon. Thanks for the question. Firstly, if you could elaborate, just to follow up on the question on ONO initially, could it make you revisit your current stance on fiber wholesale, especially with Orange? And do you think Vodafone-ONO could emerge as a competitor on high-speed broadband wholesale access?

And secondly, on Fusión, you now have two-thirds of the base, broadband base, upgraded. What do you think is the plan from here, defining it is harder to grow from current levels, hence the April

product Refresh? And how do you think competitors what they will do, if you manage to push this to the majority of your broadband base?

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

Thanks for the question. On the ONO implications for the overall market and mainly for some of our competitors, I mean is too soon to say. We think that is going to take a while for this transaction to be completed and in the meantime a lot of things are happening in the Spanish market. Some of our competitors are trying to accelerate to our convergent products. Others are more worried and might consider alternatives of selling or merging. So too soon to say what's going to be the response of other players. Believe me, too soon to say.

Are we open to partnerships? For sure, but we don't know what's going to be the strategic options that other players are going to be considering in Spain.

And in terms of Fusión, we think that again the fact that we have now 71% of the customers that are coming to Fusión that are either an upsell or are new customers indicates that there's still room to go. And namely on the TV effort that we are doing. Just by launching this new Fusión with TV included for the existing customers and migrating some of those customers from the existing product to fiber is creating us an amazing impact, commercially speaking, in the last two weeks. We intend to keep going. You should expect from us another commercial move in the coming weeks in order to try to accelerate and to incentivize the markets also in other segments of the market. So we still think that through Fusión and through adding more value on the converged product we still have significant room to go. And we think that this could contribute significantly to revenue stabilization, to finally revenue stabilization for Telefónica in Spain. So we have significant expectation for the next months, around Fusión and around Spanish revenues.

Nick Brown - Goldman Sachs

Thanks, two questions, please. Firstly, how should we think about your priorities for non-organic strategic options now? Do you think you need more content, more fixed line presence, or do you think there's further opportunities to participate in mobile consolidation in some of your other markets like Brazil?

Secondly, assuming the E-plus deal is approved, how can you respond to the increased threat from rival convergence bundles in Germany? Do you think wholesaling fiber will be enough? Thanks.

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

With respect to the first question, our priorities for non-organic growth; we are happy with the scale that we have, so we have no ambitions to go beyond the current footprint where we are present.

And, yes, we have been, we continue to be acting on two fronts. One is to be looking for stronger positions in the markets where we operate and this clearly we are trying to achieve via in-market consolidation. This in-market consolidation can be mobile consolidation, can also be fixed to mobile conversion consolidation, or can include content components as we have seen with the recently announced offer that we made for Digital Plus in Spain that was accepted by Prisa. And the second line that we continue to work is on optimizing our portfolio of assets in those markets where we may deem it interesting to be consolidated like what we did in Ireland.

We may contemplate those options if there is interest for some of our assets.

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

Taking your question about the German market, first let me state that we are not seeing in the German market, as we speak today, a move towards total convergent proposition for the customers and, therefore, with the transaction that is currently subject to approval, with the E-plus transaction, and the agreement that we have in place for wireline and for VDSL, that warrants us technological evolution, and therefore, we can be competitive and in fact we are starting to get some traction on the wireline revenues in Germany as well. We think that for the time being we are

prepared to face the situation on that market. In fact, I think that the E-plus transaction being approved, we will become a significant player on the German market. So, so far the answer is we are not seeing that trend happening in Germany. We will monitor that, but for the time being the convergent strategy is depending on what the leader is doing in each one of the markets and we don't see the leader of the German market so far now moving aggressively towards a total 4P product. So for the time being, we don't feel this is a need.

Jerry Dellis - Jefferies

The first question is just on Spain, if I may. On a cleaned-up basis it looks as though in Spain net costs are sort of down 5% year on year this quarter. In previous quarters that trend has been of the order of minus 20%. Obviously, we understand how there was a ramp-up in commercial investments but obviously, going forward content costs could be running at higher levels as well. So, how should we think about the progression in the net cost base going forward? Is minus 5%, for example, the sort of level that you would deem acceptable going forward?

And then secondly, related to Brazil, if I may. Obviously there was a very heavy commercial investment there as well this quarter. But broadband net adds were negative, albeit very fractionally negative, and I think local management commented that competition was pretty fierce in the last quarter. So, I wonder whether you could please just describe what's going on in the Brazilian fixed broadband market and how we might expect that to evolve going forward?

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

Taking the first one on the Spanish cost evolution and the trend of cost reduction; year-on-year the comparison is harder because some of the initiatives that we started to put in place three years ago, like the voluntary employee retirement plan and the handset subsidy reduction and others, the year-on-year comparison start to fade away. Therefore, basically those are there to stay, but in order to improve we need more.

And now we need to face this situation in which we do see value in investing more commercially and, therefore, for the next few quarters, if we see this on top of the table, we will do the same. We will keep investing in the market because we see value there and, therefore, the commercial cost is also going to be there to stay probably, namely on the content side.

So what we are doing is we are preparing the second wave of cost reduction in Spain, which includes our channel optimization. We are reviewing the number of stores that we have, the ones that are more efficient than the others. We are investing in the most efficient ones. We are going to be trying to close some of the others and we aim to reduce in the neighborhood of 10% to 15% of points of sale that we have.

And on top of that, we are significantly increasing the activity through our online channel and, therefore, that should also help to increase productivity.

On top of that, we are in-sourcing all the activities that we can and this is going to have another impact in terms of margins.

Finally, remember that we have put in place at the level of the group a EUR1.5 billion initiative in terms of basically generating savings at the level of the group, both in OpEx and CapEx. And Spain, being one of the largest units, is going to be one of the most favored units as well.

So, basically summarizing, some of the bulk of the initiatives that we started to take three years ago are there to stay and, therefore, that provides a cushion in terms of the sustainability of existing margins. The commercial cost will keep going if we keep seeing value and we do see value for the time being. And we are already working on the second wave of optimization in Spain that allows us to think that this 5% should be improved. How much? we don't guide.

Then, on the Brazilian situation; it's true that we have been having slight negative net adds in the broadband market, but the commercial costs overall are related to the overall of the market and we have been posting a huge, a significant performance in terms of contract net adds, and also, the

launch of Vivo Tudo, which commercially required significant effort. The weak performance on fixed broadband is due to seasonal effects. We have lower number of business days and the summer vacation period as well.

But nevertheless, you should also take into consideration the fact that now we are running São Paulo as an integrated region, which means that for every demand that we have for every customer in terms of a broadband access, depending on where he is sitting, we serve him through a 4G, or through a 3G increased proposition, or through fiber or through ADSL. And that's why you should start measuring the total amount of broadband customers that we have in São Paulo, because now we are treating the region as a whole, independent of the nature of the access that we are providing the customer with.

Will Milner - Arete

In the UK market, obviously the accounting for the handset sales there looks like you're still having quite a big impact on the reported growth trends. I just wondered if you could clarify if there are any other markets where you are accounting for handsets in the same way. I guess I have probably got half an eye on Spain and the big reversal in equipment sales which have been falling but are now growing healthily again. So that's the first one.

Then, secondly, just on the Digital Plus acquisition that you announced yesterday or early this week. Could you just sort of walk us through why you are confident that deal should get clearance from the various regulatory and competitive bodies? It does sort of seem to leave you a very high share of Pay TV in the Spanish market.

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

The first one, on which other markets we are accounting in a similar way to the O2 Refresh is in Germany, in which the My Handy product is accounted in a similar way to the O2 Refresh. This is the only one that I am able to remember right now. But if there is any other, I will keep you posted. But I think that the only that I can remember now is in Germany with the My Handy proposition.

And in terms of the Digital Plus offer that we have put on top of the table, we do think several things. First, the level of competition on the Pay TV market now needs to be judged not just on the Pay TV market itself, but also on who is competing for content. And who is competing for content right now taking into consideration the nature of the Spanish market, in which free-to-air TV has a significant market share and on top of that it is a significantly content consumer. I think that the market shares in terms of who is going to be able to compete for content should be judged more extensively. And on top of that, now you have other sources of competition, namely through the over-the-top players and also some other competitors in Spain that are integrating themselves.

So, our proposal is that we think that the nature of the Spanish market is changing structurally, that the nature of the video market globally worldwide is changing as well as structurally. And this is a trend; look at what is going on in the US market and in other markets in Europe.

So, we do think that we have reasons to believe that the level of competition in the Spanish market is going to be preserved or even increased. But again, too soon to say. This is a process that is just starting. It is going to take long; it is going to take approximately at least 12 months, we think. So too soon to say what is going to happen.

We intend to collaborate intensively with the antitrust authorities, and we will see. But we think that we have strong arguments to put on top of the table.

James Ratzer - New Street

Good afternoon. Thank you very much indeed for taking the questions. Two questions for you.

First one, was just regarding the statement you made about the Spanish business where you are saying the back book repricing is now largely digested. I'm just trying to kind of cross check that against your Fusión ARPU, which you say is about EUR70, which I think would be about EUR85

including sales tax, which seems higher than most of your headline Fusión price points. So if you could help me to match those two statements that would be helpful.

And, then the second question was regarding the strategic outlook for your UK business. British Telecom yesterday made a more formal announcement about their move into offering mobile services and saying they hope to offer a kind of a compelling proposition in the consumer segment. Do you think you might need to follow suit and do something to maybe reverse your sale of the fixed line business? Would you even consider actually selling O2 UK?

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

With regard to the UK operation, I have to state that our UK operations are core. The UK mobile market is improving and O2 UK has a strong position and a positive momentum in the market. We are not contemplating divesting our UK operation.

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

In terms of your question about the ARPU at Fusión and how to reconcile that with the current offer, we are not providing detailed information on that, but I would strongly suggest you to include the fact that some of our customers in Fusión have add-ons.

So the way to reconcile that, the nominal ARPU of the offer is considering the add-ons and a significant increasing number of the customers that we are seeing now in the Spanish market are going not just to the basic offer, but with at least one of the add-ons, which proves that the Spanish recovery is starting to flow somehow through our commercial offer. And on top of that, that Fusión is not just the nominal offer but potentially the services that consumers are adding on top of the basic offer.

Sasu Ristimaki - BofAML

What is your current net cash balance in Venezuela and to what extent have you been able to repatriate funds at the Sicad I rate that you applied to the situation at the moment?

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

1.7 bn euros equivalent accounted at VEF10.70 per dollar. And we have not been able to repatriate at this rate.

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

Thank you very much and thank you for your participation. We certainly do hope that we have provided with useful insights for you. So if you still have further questions, we kindly ask you to contact our Investor Relations department in Madrid. Thank you very much.