



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

31st July, 2014

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Although we try to accurately reflect speeches delivered, the actual speech as it was delivered may deviate from the script made available on our website

Introduction

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

Good afternoon and welcome to Telefónica's conference call to discuss January-June 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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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 releases 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 over our Chief Financial & Corporate Development Officer, Mr. Ángel Vilá, who will be leading this conference call.

Presentation

Highlights

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

Thank you Pablo. Good afternoon and welcome to Telefónica's first half 2014 results 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 the year.

First, the quarter evidenced a pick-up in commercial activity, with remarkable momentum in net adds, specially Pay TV, mobile contract, smartphones and fiber. We are working on expanding customer value by reducing churn and improving ARPU.

Second, top line grew year-on-year for the fifth consecutive quarter boosted by T. Hispanoamérica, growing at double digit, and mobile data ongoing expansion.

Third, OIBDA was stable year-on-year, balancing increased efforts in commercial expenses with cost savings from efficiencies. As such, OIBDA margin posted a limited decline year-on-year in organic terms, both in the semester and in the quarter.

Fourth, spending for network differentiation continued to accelerate.

Fifth, financial flexibility was sustained, benefiting from a strong FCF of €1.7Bn in the six months to June, while net debt stood at €43Bn, after the sale of Ireland closed in July.

Sixth, EPS posted an outstanding sequential improvement to 0.26 euros per share in Q2.

And finally, let me remark that these results are fully aligned with our expectations and therefore, our guidance and dividend policy are confirmed.

Key figures / Financial summary

Let me now start with a summary of key financials on slide 3.

Reported first half evolution was impacted by negative FX and the deconsolidation of T. C. Republic, although in Q2 both impacts slowed down slightly. The first factor, FX, deducted 10.9 p.p. in the semester and 10.0 p.p. in the second quarter to revenue and OIBDA variation but, at the same time, reduced the payments in euros of CapEx, interests, taxes and minorities. Therefore, FX impact on OIBDA is virtually neutralised at FCF level.

In organic terms, second quarter revenues posted a consistent performance vs. the first quarter, growing 1.3% year-on-year to reach €25.0bn in the first half, while OIBDA topped €8.1Bn and remained flat. OIBDA margin stood at 32.3%, 50 basis points lower than in the first six months of 2013.

Lastly, net debt stood at 43.8 billion euros at the end of June, 6 billion lower than last year figure.

Accelerating commercial activity towards value and quality in Q2 (i)

On slide 4, I would like to stress that commercial activity ramped-up, showing very strong volumes.

This way, total net adds exceeded 2.6 million, growing 40% quarter-on-quarter and posting a better trend in most categories, but specially in high value services (such as mobile contract, pay TV and fiber).

We continued to focus on value and growth levers as I just said, increasing customer loyalty on the back of customer differential propositions. This strategy translated into a sequential improvement of churn levels across the board.

Accelerating commercial activity towards value and quality in Q2 (ii)

Slide 5 shows the remarkable growth of future key drivers, highlighting Pay TV momentum up 32% year-on-year. Connected fiber accesses doubled year-on-year and LTE coverage in Europe reached almost 50% of the population. Smartphone traction continues and penetration expanded 8 percentage points year-on-year to 32%.

As such, the strong investments in customer expansion enabled to improve customer satisfaction and differentiation, setting the stage for further sustainable growth.

Steady organic revenue growth; healthy profitability

Best-in class portfolio diversification by geographies and services underpinned organic revenue growth, as shown in slide number 6.

In H1 14, T. Hispanoamérica and T. Brasil remained as key growth area, more than offsetting lower sales by some of our European businesses. Let me also highlight mobile data revenues, which accelerated revenue growth in Q2 to 9.2% year-on-year and increased their weight over mobile service revenues to 40% (which is 3 p.p. up year-on-year).

Revenue-flow coupled with good progress on cost efficiencies allowed the cumulative OIBDA to remain flat year-on-year, organically. Margin declined 50 basis points year-on-year in the first six months and 60 basis points in the second quarter, reflecting higher customer investments linked to capture future growth.

Solid double digit FCF growth

In slide number 7, FCF generation was robust in the six months to June, reaching 1.7bn euros or exceeding 1.8bn euros before spectrum payments.

I would like to highlight the sound 14.7% year-on-year growth in FCF, levered on improvements in most categories of FCF metrics despite adverse FX effect, CapEx increase and assets sold.

Let me remind you that the first half of the year is traditionally impacted by seasonal effects, therefore FCF should record a better performance in the second half.

TGR: leading technological transformation

We continue to invest strongly to improve quality and capacity and foster growth, as shown on slide 8.

On network, we keep on accelerating UBB deployments, in order to meet steady traffic increases. 4G is increasingly available for customers in key markets, with recent new launch in Costa Rica. On fiber, we have doubled the size of the network, having passed more than 10 million premises.

We are exploiting technology to provide the best data experience, combined with multiple initiatives, which are leveraged on our scale. One example is the global management of roaming traffic already in place in our major markets.

IT is helping businesses transformation according to common principles, such as standardisation, modernisation, reutilisation and automatisisation. To give you some examples, we launched more Business Support projects across T. Hispanoamérica and we are strengthening our digital capabilities for marketing and self-care.

Finally, efforts on simplification and consolidation continue, with more than 6% of physical servers reduced, over 160 applications decommissioned, three additional data centers closed and sustained progression on virtualisation.

Digital Services: Innovative portfolio of digital solutions

Turning to slide number 9, let me go through the main progresses achieved in the digital arena.

In the B2B area, solid year-on-year growth rates are shown in different services. M2M is growing by more than 50% on solid access trend and key deals signed in the first half. Cloud revenue was up 20% and Information Security surpassed 40% increase, with relevant agreements reached this quarter, such as the one with Etisalat.

Regarding the Consumer segment, Video stood as one of the key drivers, with revenues accelerating above 15% year-on-year as we continue to focus on reinforcing our position through exclusive content acquisition.

The global device management is driving the smartphone adoption, with special focus on LTE, as the total volume of LTE devices increased 8-fold year-on-year.

Finally, in Financial services I would like to highlight the launch of “Yaap shopping” in Spain, allowing customers and stores to be connected through discount offers and loyalty programs.

Spain: Starting the recovery; outstanding KPIs

Let me now update you on the progress of our business in Spain, which is showing signs of recovery, driven by an intense commercial performance.

Our new quadruple play offer leveraged on our superior TV and fiber, is a game changer in the Spanish marketplace, as shown by outstanding Q2 net adds, pushed by higher gross adds and specially by churn reduction across services.

Strong traction of the new convergent offer allowed us to reach 1.2 million TV customers and 0.9 million fiber accesses in June, paving the way to build the leading platform for content delivery at home. We have also repositioned 0.7 million “Fusión” customers in the quarter, which implies

resetting the 12 month commitment with the service. While in the mobile business, improved portability trends led contract mobile net adds to turn positive, for the first time since Q2 11.

“Fusión” is not only helping to gain commercial momentum and extend the lifetime of our customers by dramatically reducing churn, but it is also enhancing the value of the base by accelerating the take-up of high value services, as reflected by the fact that close to 80% of new customers are opting for high packages in Q2.

This commercial performance is leveraged on a strong network differentiation, and we keep investing to enlarge this gap. We have already passed 7.4 million premises after increasing by 1.3 million the premises covered in just one quarter.

Spain: Revenues have reached the bottom

Spain’s financial performance is shown on slide 11.

The evolution of revenues in Spain is showing clear progress in recent quarters, which allows us to think that revenues have already reached the bottom. This improvement has been driven by lower re-pricing impact and progressive stabilisation of the customer base. So, the improved commercial performance that we are already noticing should lead revenues to gradually improve year-on-year trends and to grow again in the coming quarters.

In terms of profitability, OIBDA margin decline in the quarter reflected the strong commercial effort devoted to anticipate revenue recovery by capturing the value we see in a market that is finally showing a clear macro turnaround.

UK: Record loyalty on superior customer experience

Please turn to slide 12 for a review of our operation in UK.

From a trading standpoint, commercial momentum picked-up in the second quarter and as part of this, our contract churn improved to a record 1.0%, extending the market leading loyalty.

O2 Refresh continues to be a successful proposition, together with the proactive upgrade of high value customers to LTE, resulting in a contract segment increase of mid single-digit.

Top-line returned to growth in the second quarter despite the negative contribution of “Refresh”, following its anniversary in April-14, and the disposal of fixed business assets. The sequential improvement of revenue trends is the result of non-SMS data revenue acceleration to almost 20% year-on-year.

Lastly, improving business dynamics translated into a stable OIBDA and margin in Q2, when excluding non-recurrent effects.

Germany: Successful data monetisation strategy

In Germany, commercial dynamics reflect the strong traction of new propositions, with both gross adds and contract churn improving their trends. As a result, contract net adds more than doubled the average of last four quarters.

Additionally, we continue to focus on LTE deployment reaching a coverage of 52% at the end of June. LTE consolidated as the main driver of mobile data monetisation in a very competitive market, with 86% of handsets sold in Q2 vs. 40% a year earlier.

In this context, mobile service revenue showed a better year-on-year trend in the second quarter, down only by 2.5% when excluding MTRs, on lower ARPU dilution.

Q2 OIBDA margin was 2.7 p.p. lower year-on-year following the increased commercial investment to enhance trading momentum.

Finally, I would like to remind that we have overcome an important milestone in the acquisition of E+ with the EC conditional approval on July 2nd.

Brazil: Enhancing leadership in high value customers

In Brazil, turning to slide 14, our leadership position in network quality and brand perception led to a strong performance in the most valuable segments of the mobile business. As such, for 4 quarters in a row, we captured more than 60% of the contract net additions, while smartphone penetration almost doubled year-on-year to 32%. As a result, we have expanded our contract market share by 3.4 p.p. year-on-year to 41.3%.

In the fixed business, the execution of our turnaround strategy continues on track, with second quarter net adds of fixed services accelerating. On top of that, fiber uptake stands out after connecting 37 thousand accesses on an accelerated fiber deployment, that already reached 2.9 million premises passed.

Brazil: Improved revenue and OIBDA trend

This operational performance resulted in an improved revenue and OIBDA trend as slide number 15 shows.

Service revenue growth accelerated year-on-year despite the increased negative regulatory effect this quarter. As such, service revenue would be growing above 6% when regulation is excluded.

Also excluding regulatory impacts, mobile service revenue ramped up to 11% in Q2 year-on-year on strong mobile non-SMS data growth, which grew once again 40% year-on-year. Fixed revenues slightly decelerated on lower working days due to the Football World Cup.

At the same time, OIBDA reverted the trend of last quarters, growing 4% year-on-year in Q2 on revenue improvement and on a strict cost discipline, offsetting higher commercial costs incurred to keep improving our market position.

Hispan: Double digit revenue & OIBDA growth

Turning to slide number 16, in T. Hispanoamerica we kept posting a strong revenue & OIBDA growth.

As such, excluding regulation, second quarter revenues grew by 13% year-on-year, or 12% when excluding Venezuela, with solid a performance across the board. This evolution is underpinned by the growing uptake of non-SMS mobile data, posting an increase of 41.5% year-on-year in Q2, along with the higher penetration of fixed broadband and new services, above 18% this quarter.

At the same time, let me remark that this revenue performance is steadily flowing into OIBDA, offsetting higher commercial and network expenses. All countries in the region, with the exception of Uruguay, are growing OIBDA year-on-year, which keeps accelerating and growing double digit even after excluding Venezuela.

Hispan: Strong growth across the board (i)

On a per country overview, let's move to slide number 17.

In Colombia, solid revenue and OIBDA year-on-year growth remained in Q2, underpinned by structural changes implemented by the regulator 1 year ago.

In Argentina, revenue and OIBDA were both growing above 20% vs. Q2 13, with year-on-year erosion in profitability reflecting currency depreciation and inflation driven costs.

In Chile, revenue and OIBDA performance have been highly impacted by the new regulatory framework for mobile and fixed termination rates. Nevertheless, let me highlight the strong year-on-

year increase in OIBDA margin on better commercial comps and despite strong trading in most valuable segments.

Hispan: Strong growth across the board (ii)

To continue with the Latin-American review on page 18.

In Peru, revenue and OIBDA reached double digit growth ex-regulation and the low smartphone penetration provides a huge opportunity onwards to an already strong mobile data growth.

Mexico posted once again this quarter an accelerated trend on mobile service revenue, increasing by almost 8% year-on-year, while profitability improved despite strong trading momentum. Let me also highlight that new regulatory framework will be effective from mid-August, providing additional growth opportunities in a more dynamic and competitive telecom sector.

In Venezuela and Central America, revenue was severely impacted by lower handset sales but mobile service revenue kept increasing at strong rate of above 30% year-on-year. Specially noteworthy is the leading non-SMS growth in the region on a right monetisation strategy.

Year to date net debt reduction to €43bn

Let me now move to the financial side, on slide 19.

Net debt has been reduced to the absolute level of €43Bn. The balance between FCF and dividends have allowed divestments proceeds for €3.1Bn to fully flow into lower debt.

Despite stable OIBDA in organic terms, lower reported OIBDA due to Latam currencies depreciation and divestments has pushed-up the leverage ratio in the year. To offset this effect, we are putting together measures to reduce leverage, among others, the voluntary scrip dividend in November, the recent Mandatory Exchangeable on TI shares or the expected Mandatory Convertible linked to the E-Plus acquisition.

Diversified financing at managing liquidity

Slide 20 shows the ongoing diversification in our funding process while keeping a high liquidity cushion.

In the last quarter we raised €1.25Bn through an 8 year bond yielding 2.24%, we have launched private placement bonds for €0.7Bn with 3 years of average maturity and 67 basis points as average spread to repay more expensive debt with similar maturity, and we have also been granted bank loans at similar spreads.

We keep a liquidity cushion of €2.2Bn, even after the E-Plus acquisition and early debt repayment for €2.2Bn, we will still keep our outstanding liquidity levels while controlling financial costs.

Effective interest cost stays similar to the previous quarter, in the middle of the target range, despite the increase on average cost of debt driven 1) by the reduction held mainly in € and CZK, with lower costs than average and 2) by keeping hedging strategy in Latam currencies with higher costs.

Conclusion

To conclude, let me highlight that we have made further progress in our transformation strategy.

First, we are accelerating commercial momentum, with increased customer appetite for value and quality, translating into lower churn levels.

Second, commercial action and investments led to positive organic growth for the last five quarters, with improved trends quarter-on-quarter in Brazil, UK and Germany. While outstanding commercial trading in Spain anticipates revenue recovery in next quarters.

Third, stable OIBDA performance year-on-year organic and healthy margin of 32.3% in the first half. The year-on-year erosion resulted from higher net adds in Q2 and focused investments to expand 4G coverage and fiber.

And finally, in the first half of the year we posted a strong cash generation, while our financial flexibility is sustained.

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

Q&A session

Georgios Ierodias - Citi

Hello. I have got two questions, please. The first one is around Pay TV margins. I would like to get an idea of how programming costs work and whether you get any unit savings as you grow the base. Particularly, whether there is a threshold at which the programming costs effectively turn to a flat fee and any additions that you make thereafter are on a much higher margin. And perhaps if you could comment whether if successfully when acquiring Digital Plus, if that could have an impact on your per unit programming cost.

And then my second question is on Mexico, and obviously the news we had yesterday. I just wanted to understand whether you see a path to convergence and to some type of fixed line arrangements there, or whether this transaction that you are pursuing is purely focusing on consolidating the mobile market? Thank you.

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

Thanks for your question on the programming cost, namely on the content cost. The way we account for that is the total cost of the contract divided by the number of years, therefore, we accrue each year the proportional part of that and, therefore, it is independent of the number of the customers that we have each year. And as a result, as you were correctly mentioning, the more customers we have, the more profitable this content is going to flow to the Profit and Loss account. But basically, the message is that we are accounting the full amount of the contract divided by the number of years and then the revenues are flowing as we get more customers.

In terms of Digital Plus, you know the transaction is subject to the approval of the relevant authorities. For sure, it will give us more scale because we have more customers and therefore the profitability on a per customer basis, is going to be significantly improved namely in Spain. But most of all, I think that Digital Plus could provide us with a significant know-how and expertise dealing with content negotiations and in terms of dealing with production capabilities that we are lagging at the group level as we speak.

So basically we think that in terms of the scale, and that's why we are accelerating growth recently, the more we accelerate the scale of the group, the more profitable the business will be at the level of the Group and we do think that Digital Plus would significantly accelerate that.

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

Regarding Mexico, our priority continues to be to accelerate the turnaround of the business focusing on quality growth and capturing the mobile broadband opportunity.

We don't see it as a converged market yet.

As you have seen, the first half is already showing a clear acceleration in revenue and OIBDA growth and, furthermore, the new regulatory framework will improve the competitive landscape, creating the conditions for us to capture better market position.

Regarding what was disclosed yesterday, you know that we are firm believers in the benefits of in-market consolidation and we have demonstrated this belief in several opportunities in the last quarters.

In the specific case of Mexico, we already have collaboration agreements in place and we are open to explore deepening them. Conversations are on and off. And, what I can say at this moment is that we can be pragmatic when assessing a potential merger or integration.

Clearly there are several strategic alternatives open to us but no agreement has been reached so far on any front. So, when that may happen we would communicate to the market accordingly.

Giovanni Montalti - UBS

Hello. Good afternoon. Thank you for taking the question. Just an update on Brazil, on the back of the recent events on Portugal Telecom, can you provide us an update on the way you look at consolidation? Thank you.

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

Yes, in Brazil we continue to have very strong position. As I was explaining during the presentation, we continue leading in the mobile market with very strong position in net adds, more than 60% for a fourth quarter in a row. And also looking at the results of our competitors, one can see that Brazil is an attractive market, but one that will require substantial investments going forward, and that would potentially benefit from consolidation.

Having said this, this type of transactions require that the timing and the conditions be right for all parties involved and we will see how the situation evolves in the coming future.

Giovanni Montalti - UBS

Sorry, if I may follow up. Last time we had a conference call with you, you were talking about some stars getting more in line, I mean incrementally how do you see the situation today, if I may ask?

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

I don't know. Maybe we can say that some stars may be losing their shine, but the force of gravity remains strong pulling cosmic bodies together, potentially in the future.

Akhil Dattani – JP Morgan

Yes, hi, good afternoon. Two questions please. Firstly on the Spanish fiber landscape. We've seen from Jazztel in recent days that they have indicated their intentions to expand their fiber rollout from 3 million to 6-7 million. I just wondered if you could comment on whether or not there are any discussions ongoing or whether you should have an interest in partnering with them for that rollout or whether we should assume that theirs is a standalone rollout? With that maybe if you can update us on your own coverage plans for the next few years in case there are any changes or thoughts around that?

Then secondly just on your margin in Spain for the second half of the year, you've talked about how you feel revenues have bottomed in the second quarter. Could you maybe help us understand relative to the 45% margin in Q2 how you think about the cost evolution through the back end of the year and what that might mean for margins? Thanks a lot.

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

Thanks for your questions. First in fiber in Spain, let me first address our own plans and then I will comment a little bit on the market. As was described by Ángel during the conference call we have reached 7.4 million premises in June 2014 which is double the amount that we had a year ago. We have a target to reach 10 million households before year end and also plan to significantly increase to 18 million by 2016, therefore we are not on a wait and see mode.

We are accelerating because we think that with the fiber, and you see the figures of Fusion, we have mid-term competitive advantage based on infrastructure investments and CapEx and therefore we have the agreement that we have with Jazztel which is for 1.5 million each, therefore a total of 3 million premises in 18 months ending in the second half of this year and no other plan is today on top of the table. We are doing our homework and the others are accelerating. The 7.4 million households that we have in June is the target that some of our competitors have for the next few years. Therefore we think that we have a mid-term competitive advantage and we are exploiting that through our Fusion offer.

In terms of the margin in Spain, the margin in Spain has been affected in this second quarter by several factors: namely the commercial effort that we think we need to do in order to capture the value that we see in the market in Spain. Out of the four percentage points of decline, roughly 5.1 percentage points are coming from lower revenues compared with a year ago; 2.6 percentage points are coming from commercial costs, handsets and content as well; and 3.7 percentage points in positive are coming from interconnection and efficiency. That means that there is a mix of effects, some positive and some negative.

The ones that are specifically for this quarter are a little bit more of content but not that much, we are talking about roughly in the neighbourhood of €15 million. More handsets that we have been using tactically to improve the churn and you will have seen that we have posted very significantly improved churn figures and then as I was telling you, the content accounting.

As a result for the remainder of the year we think that the value of the customers that we have been able to capture namely on the contract side, on the mobile side, on the mobile business means that our plans to turn back Spain to revenue growth has been accelerated and therefore what I can also anticipate to you is that in the month of July we have seen much better revenue trends than at the end of June which means that we think that the margin effort that we have done in the second quarter is going to be paying off significantly sooner in terms of getting back revenue stabilisation and soon revenue growth.

We are not guiding as you know on margins but in our view, and we will update you every quarter, we think that this level of margin is sustainable and we are aiming even higher.

Paul Marsch - Berenberg

Thank you very much. Before I ask my question I wonder if I could just ask you about the comment you made at the end there about the level of margin being sustainable. You mean the Q2 level of margin in Spain you think is at least sustainable through the rest of the year? Is that what you meant?

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

Yes, the answer is yes.

Paul Marsch - Berenberg

Thank you. My question is then on the revenue line for Spain and then I have a second question on Fusion ARPU, so on Spanish revenues, you talked of revenues growing again in coming quarters. How long do you think that we have to wait for that? Do you think that's possible to actually get back to growth in 2014, year over year growth I'm talking about in 2015 sorry and when you talk about that, are you talking about the aggregate for Spain, the total revenue for Spain or are you just talking about the wireline business?

Then secondly on Fusion, in the press release you say that Fusion is attracting both new and existing customers to higher value offers, that 79% of gross additions to Movistar TV packages of €60 or more; and you also say that Fusion's customers who repositioned into the new Fusion offers had higher ARPU than before the repositioning, so my question is why did ARPU fall in the second quarter compared to the first quarter? What were the moving parts that actually led to ARPU coming in at €68.8 when it was €70.2 in the prior quarter?

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

Ok. First on the revenues, it's too soon to guide when we are going to be back to growth but certainly we think 2015 is where we should ambition that to happen. We are accelerating that and that's why we are investing significantly on the commercial side.

The factors that are behind that assumption are the following. In terms of Fusion and I will go on to your question about ARPU, we see that 77% of the customers that are coming to Fusion or moving to Fusion for different packages are upselling and therefore we are starting to see a stabilisation of the ARPU of Fusion as we speak.

On the other side just in terms of the absolute amount of customers, just by an arithmetical calculation the effort that we have done on the mobile side means that stopping the bleeding of the contract mobile customers will help us also to go into positive momentum, it's too soon to say when but sooner than what we were anticipating in the first quarter of this year thanks to the commercial effort and the investment that we are doing in this quarter, because we do see value in the market and we do see the Spanish economy moving more and consumption being more attractive for our customers; and that's why we are investing on the market.

In terms of the Fusion in this second quarter, the reason behind no sequential improvement despite the fact that we see positive incremental ARPU from repositions as you were mentioning, is that in order to calculate the ARPU, the revenue corresponds to the billing period. That means that for example in June we are taking revenue from May 18th to June 17th. On top of that, the customers considered for calculating the ARPU of Fusion are stable which means that all that have not changed their tariffs and therefore gross adds or repositions after May 18th have not been taken into account. Therefore it takes a little bit of time for the Fusion ARPU to reflect the change on the mix.

We think that going forward, because of the number of customers that we have on fiber and on TV, and out of that allow me to remind you that in terms of the new gross adds, 79% of the gross adds have come in on the above €60 packages, 17% of Fusion customers have already fiber; and 30% of Fusion customers already have TV, therefore the blended is improving and is moving upwards.

We are becoming more optimistic about the ARPU of Fusion but again allow us to update you on a quarterly basis because this is very sensitive in terms of the arithmetical calculation and it's too soon to say when that will turn into significant revenue growth. But just again to stress the previous point on the revenues in July in Spain, the related reading that we have of July, allows us to think that we are heavily into that direction.

Justin Funnell - *Credit Suisse*

Again, on Spain and then back to Mexico.

On Spain, obviously some good progress. When Fusion was first launched, we had a pretty good run for a few months and then, ultimately, Jazztel and Ono reacted with cheap smaller bundles, which slowed down the momentum, to a degree, of Fusion.

Do you worry about the same thing or do you think this time, because you've added TV, because you've added fiber, you're doing things that can't really be replicated?

You've launched these plans back in April, so you perhaps already have seen enough time to know if competition is going to react or not. How do you see the likely competitive reaction?

Then secondly, in Mexico, can you give us an idea about how the growth trends could improve in the second half, as this regulatory change comes through? Do you think that we can move towards double-digit growth in that business?

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

Allow me to give a little bit of color on the comparison between the first launch of Fusion and this renewal of the offer.

First, now we are two years and a half after the initial launching of Fusion, we have now a learning curve in terms of the customers that were expiring out of the retention clause of Fusion.

Out of that, we have been able to preserve most of them, and even to move them up. And therefore, the churn of Fusion that we are showing in the different chapters is already a good indicator of the trends that we might be anticipating. And as a result, repositions and gross adds do help us to keep the momentum of Fusion.

Most of that, we have a new pillar on the Fusion offer, which is the TV offer, and then the fiber deployment. Therefore, we think that we can keep feeding the Fusion attraction in more geographical areas of Spain with this 100 Mb offer and with the four different content packages or bundles that we have prepared.

Therefore, if you put everything into the equation, and after the learning curve that we have and considering the levels of churn that we have in the different products, namely the most valuable products, which are namely fiber, TV and mobile contracts, we tend to think that the Fusion momentum could be accelerated a little bit or not, but it would be significantly sustained.

As we are repositioning customers, they re-sign a commitment clause of 12 more months. Therefore, all indicators that we have right now look to go into the direction that the trends of Fusion are pretty sustainable.

In terms of Mexico, now that the reform has been approved by the Congress and the Senate, we think that a new commercial momentum starts in Mexico.

Too soon to say, again, what are going to be the legal derivatives of any of the players in terms of the procedural, but we do see better momentum.

Just allow me to remind you that the five major points of the reform are: asymmetry of interconnection, significant asymmetry, even higher than the one that was approved in Colombia; that on-net and off-net tariffs need to converge; exclusivity in retail outlets of phones is banned; and, the obligation of sharing infrastructure, as well as unbundling of the local loop.

All those chapters, each of them separately have significant impact. Therefore, we think that if we keep building momentum, the commercial momentum that we have on top of that, and we are able to exploit the new regulatory framework, we should be able to maintain, or even increase, the trends that we have right now.

In terms of the quality of the network, we need to keep investing. That's why the level of CapEx in Mexico is relevant, because we cannot afford not to take advantage of the opportunity. But we will start seeing some effects out of the next quarter, the third quarter.

Luis Prota - *Morgan Stanley*

Two questions, one on Spain and one on Brazil. On Spain, it would be helpful if you could give us some indication on the impact from, first, the pension contributions, or pension payments that you are going to resume, I think, from the third quarter, a rough order of magnitude.

Also, whether you have already analyzed, and you can share with us, the implications of the tax rate reduction to 28% and then to 25%; whether that is going to give rise to some tax savings in the next few years?

Then the question on Brazil is related to GVT, which is an asset that you were interested in the past, and then you seemed not to be interested any more. But is now coming on the table in some market box; whether you might be interested in this asset again? Thank you.

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

Hi, Luis, thanks for the question. The impact on the pension fund is roughly around €15 million per quarter. Therefore, it's relevant, but it's manageable in terms of the other effort that we are doing in terms of insourcing and so on, so it's pretty limited.

We are developing now, as we speak, other source of savings in the cost structure of Spain. And remind, also, that the commercial effort that we are doing, we will adjust that depending on the market conditions and therefore, the level of OIBDA margin in Spain is going to be depending on how attractive we see the market and how much value we think we can capture.

On the GVT question, I pass it to Ángel Vilá.

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

Before GVT, regarding the impacts of tax changes in Spain, what I can say is that for this year we stick to our guidance of cash tax rate of around 25%. For the coming years, we will give the appropriate guidance, but that should be trending towards a lower figure.

Regarding GVT, in Brazil as you know in the fixed business, we continue on track in our turnaround strategy, with very clear growth in fixed broadband, fiber and pay TV.

It is not, Brazil, a convergent market today, but may evolve in that direction in the future. So we are monitoring all possible scenarios and we are going to get ready to act, potentially, in an expeditious way if needed.

Fabian Lares - *JB Capital Markets*

With regard to the fiber deployment in Spain, you already mentioned that, by 2016, you want to reach 18 million households; that's the totality of Spanish households basically, so you want 100% coverage.

This would imply somehow that you would probably need to consider what the regulator's standpoint would be on you having such a significant lead on everyone else.

Do you have any visibility on how the fiber-to-the-home review is coming along at the regulator? When we should have some kind of ruling on that and how that would affect your plans and rollout? That's my first question.

Second with regards to 4G in Spain, the digital dividend in Spain is coming on January 1st of this coming year. Do you plan to have an extensive rollout, given your limitations in the 1,800 megahertz refarm frequency? So when you receive the 800 megahertz, do you plan to uplift CapEx to do a strong rollout to recover some advantage in 4G? Thanks

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

Thanks for the questions. On your first question, we were not talking about 18 million, we were talking about 18 million premises, not households. It's a metric that our competitors are also using. Therefore, it's a different metric that we were talking about.

In terms of the potential regulation of fixed broadband access or infrastructure, the commission is doing a public consultation, which is expected to happen early fourth quarter of this year. Our position there is as follows.

We think that the traditional broadband and the ultra-broadband should have a different approach. The next-generation network deployed could be deployed under competitive conditions, therefore should not be regulated. They don't want a hinder investment and sustainable contribution.

Cable operators are undoubtedly also under this chapter, next generation and, therefore, they are market leaders, because they have cable network has been updated to DOCSIS 3.0.

There are no entry barriers to the markets, but the bottlenecks have been solved. And alternative operators have access to the essential facilities; civil infrastructure and to in-building fiber infrastructure, therefore have made significant economies of scale and scope.

On top of that, there is a consolidation trend in the market.

As a result of all that, we don't think, and we are working, and we are deploying under the assumption that no major changes are going to be introduced on that framework. Was that not to be the case, then we would reconsider our deployment stance.

In terms of the LTE, our 1800 network will be an overlay network, based on the most efficient multi-mode base station technology and, therefore, offering 3G and 4G overall, the spectrum asset that we have.

As soon as we will have access to the 800 megahertz, then we will deploy also wide LTE 800 network, in order to provide a better indoor experience. But in terms of the technology and the assumptions, we are really working under the model that we will be able to make use and to take advantage of the different band.

David Wright - BofAML

Just one question really; obviously in Spain convergence is your core strategy. You've even mentioned convergence within the framework of your Brazilian outlook.

It does seem like the UK stands out at all. You obviously sold fixed line operations there. And it's a market that could be moving towards convergent products with BT's mobile phone launch at some point this year.

Could you tell us a little bit more about your plan for the UK and why, perhaps, you've looked to invest less on the fixed line infrastructure side? Thanks.

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

Thanks for the question. First, we think that in the UK today, convergence is not a factor.

First of all, the interests of the customers have significantly limited so far. There are different market structures between the wireless and the wireline commercial distribution networks, in terms of retail, direct and indirect. Therefore, the convergence on the commercial side, in terms of distribution, so far, they are significantly limited.

There are already some convergent offers on the market, for example, Virgin is already offering that. And it has, for the time being, limited market demand.

But it is true that BT has announced and has started a significant effort on their content side, and has also announced that it has intention to move to a mobile digital network operator kind of profile into the wireless side of the market.

It is also true that BT tried that previously, and it has proven not to be easy. That's why for the time being, we think that convergence is not the name of the game yet, or today, or still on the UK market.

As you can imagine, we monitor permanently. But if you'll allow me, I think that the UK dynamics today are much more based on the quality and on LTE deployment.

If you go to the numbers net or gross adds in the recent months, you will see that, mainly in this quarter, and according to the figures that have already been published, Everything Everywhere, is the leader in contract, taking advantage of the 4G coverage. But we are immediately after.

On prepaid it's Vodafone the leader; we're immediately after. And we have best in class churn, which means that the loyalty for our customers is significantly higher than the ones of our competitors, based on two factors.

First, we have a pretty solid network and we keep investing for 4G. But most of all, we have been able to provide to our customers experiences, like Priority Moments or Refresh, that allow us to think that we have one of the best distribution networks as well and one of the best value propositions.

As we speak, as of today, as of this quarter, we think this is the name of the game in the UK, but we will monitor for the moment.

Jean-Francois Paren - Credit Agricole

Thank you, Good afternoon. A very quick question. Just want to have thoughts where we are in terms of the process of funding and financing in the acquisition of E-Plus. Have you already started? I understand that 20% to 30% was meant to be financed through a convertible. Is that still the plan? Thank you.

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

The answer is yes. We are planning to issue a mandatory convertible on Telefónica's shares, to complete the financing for E-Plus acquisition. The hybrids were already issued and the debt portion is being accommodated in our balance sheet.

This issuance is still not in the market, but since we would be expecting to get unconditional approval in the coming weeks and Telefónica Deutschland to fulfil the rights issue, then would be the time to see if market conditions are right for such issuance.

Jerry Dellis - Jefferies

Good afternoon, thanks for taking my questions. First question on Spain, please. I just wondered whether I could delve into a little bit more detail in terms of what might drive a faster pace of cost reduction within the domestic business, going forward. I wonder whether there are any new potential initiatives that you have in mind, related perhaps to the personnel cost base.

And alternatively, whether you are intending on perhaps easing up on the level of commercial investment in the second half of the year? And whether you feel comfortable that your strong commercial traction would be capable of being maintained if you were to do that?

And then the second question, please, just on Brazil. Obviously, the cost base has been stabilizing progressively over recent quarters; but in particular against selling expenses, seem to have been particularly flat last quarter. And I just wondered, really, how sustainable you think that is, going forward? Thank you.

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

Thanks for your questions. In Spain, first, we think that the country is going with efficiency measures; and namely, the ones in which we are focus, as we speak, is certification, namely of IT

and network processes; in-sourcing of activities; and focusing on a much more efficient distribution channel. And let me elaborate a little bit on those.

In terms of simplification, Ángel has mentioned the effort that we've been doing in terms of shutting down applications. Every single time that we converge or that we standardize one of the applications, the IT applications that are not providing us with a significant competitive advantage, we significantly save money in terms of storage capacity, processing capacity and, as a result, you will see that the IT effort that we are doing all along the Group and namely in Spain, in terms of radically transforming our systems, will allow us to radically simplify the way we process the information, and therefore should flow immediately into further commercial cost-reduction, in terms of number of calls to our call centers, number of claims.

In terms of the distribution model, we are aiming to reducing by roughly 20% the points of sale that we have, from roughly 2,100 to 1,600, and fostering the online channel. Right now, we have an online activity of 7% at the end of 2013 and we are more than doubling that, to the neighborhood of 20% at the end of this year. And on top of that, we have also been working significantly in terms of the in-sourcing activities. So it's basically not about assuming that we are going to be changing our commercial approach.

Let me also highlight that in this second quarter, and in this summer campaign, so far, and again too soon to conclude, but so far the market is showing more rationality. And therefore, I think that the commercial effort that we are showing is also installing some kind of discipline on the market, being the leader.

So we are not assuming that in the second half of this year we will be saving significantly in terms of our commercial effort, but rather in another initiative.

And in terms of Brazil, what I can tell you is that we are doing most of the things that we did in Spain, we are also applying into Brazil. We think that the effort that we are doing in order to improve, radically improve, the quality of our network, namely the wireline network in Sao Paulo, should flow into better cost-related savings.

And on top of that we are also being much more selective in terms of the subsidies that we use, because we have the best network and therefore, we are significantly trying to rationalize the market. Because, as we speak, we are grabbing more than 60% of the contract market share in Brazil, based on other attributes which are not purely the subsidies.

So on both fronts, on the wireline and the wireless side, we are applying most of the methodology that we applied here in Spain. And on top of that, we have some sustainable competitive advantage, which is for the time being our 3G network.

So I think that yes, we are optimistic of the future of our Brazilian margin.

Nick Brown – Goldman Sachs

Thanks. Two questions, please. Firstly, on Mexico, would you be prepared to dispose of more assets to help fund the expansion in other markets like this? Or do you think you've got enough balance sheet capacity?

And secondly, on Brazil, do you think CADE is still concerned about the conflict of interests of your Telecom Italia stake following the recent exchangeable bond issue?

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

Ok, let me take the questions. In the case of Mexico, one way to think about this is that we would be pragmatic when considering merger or integration scenarios.

So, probably, no divestments elsewhere would be required, would the situation evolve in that market. But, again, I have to say that there is no agreement so far on any front.

Regarding CADE, well, the rulings that CADE issued last December are known by the market; we also have been responding to those. On July 9th we decided to challenge those rulings in court. And we have made some disclosure about this in our results and documentation today.

But in parallel, we have taken two measures to reduce our indirect stake in TI. The first one was to sell our position in the TI mandatory convertible; the one that was issued in November and that we sold around one month ago.

And second, following the start of Telco's demerger process, we have placed a bond, which is mandatory exchangeable in a fraction of our TI shares. And, as a result, we would be reducing our stake eventually in TI, because now we're still shareholders of Telco. We would be reducing that stake below the levels we had prior to September 2013, when we did the capital increase in Telco.

So, these two measures are, clearly, from the financial point, helping us to pre-emptively neutralize about half of the potential debt increase that would come from Telco demerger. But also we are signaling to the regulators our lack of influence on anything regarding Telecom Italia.

Keval Khuroya - Deutsche Bank

Thank you. I've just got two questions on Germany, please. Firstly, obviously your net adds performance has improved materially versus previous quarters. Can you give us a little bit more color in terms of what segments do you think incremental customers have been coming from?

And second, the service revenues excluding MTRs, is still falling around 3% in Germany. To what degree do you think or can you give us some color on how much of the customer base you think still potentially needs to re-price towards the newer tariffs introduced over the past 12 months? Thank you.

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

Well on Germany, first, the performance that we have in terms of the positive net add evolution, in this second quarter we have had in postpaid basically 152,000, which is doubled the size of the average of the last four quarters.

And this is mainly because of two factors, significant traction of two main tariffs. One is the O2 Blue which is devoted to consumers. And, as you know, it's a very simple and straightforward proposition that differentiates between 3G and 4G. And it's pretty simple, pretty straightforward, pretty easy to contact, and is having significant traction on the consumer side.

And namely we're also having significant traction on the SMEs bundle with a tariff called O2 Unite, which has also helped us to gain significant traction.

So, the major traction that we are seeing is basically on both consumers and SMEs, and it's based on repositioning for our commercial proposition that looks to be attractive to the consumers.

In terms of the trend that we have been having in Germany, in terms of the operating revenue, we have been basically stabilizing that at that level of minus 4%.

And, we have had lower declining handset sales, minus 7% compared with minus 33% in the first quarter. Improved performance on managed service revenue, based on those tariffs and based on the effort that we have been doing currently and persistently in the last quarters. Therefore, now, we are just looking at minus 2.5%.

So as a result, what I can tell you is that the repositioning that we are doing in the German market is starting to pay off.

Let me also highlight another two factors. First LTE, right now in Germany, which is literally booming, is just available for the core brands; namely, the MNOs participants. And the effort that

the three of us are doing in terms of coverage is paying off. Thus, for the time being, a competitive advantage in terms of the commercial traction that we are able to have.

Out of the consumer customer base of O2 in Germany, 72% of postpaid and 21% of prepaid are smartphones. But the experience that we have in terms of the data consumption of the LTE consumers, at this stage, is that every LTE customer is basically using 3 times more, higher data usage, than a 3G customer. And basically, it also is showing a significant ARPU uplift.

So we think we are doing the right strategy in Germany, significantly investing in our network, committing to our commercial distribution, simplifying our tariffs. And as a result, we think that the commercial traction should be sustainable in the coming quarters.

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

Thank you very much for your participation and we certainly do hope that we have provided with useful insights for you. Should you still have further questions, we kindly ask you to contact our Investor Relations department. We wish you a very good summer break. Good afternoon.