Telefónica January-September 2016 Results Conference Call Transcript

27th October 2016

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Introduction

Pablo Eguirón - *Head of IR*

Good morning, ladies and gentlemen, and welcome to Telefónica's conference call to discuss January-September 2016 results. I am Pablo Eguiron, Head of Investor Relations.

Before proceeding, let me mention that financial information contained in this document related to the first nine months of 2016 has been prepared under international financial reporting standards, as adopted by the European Union. This financial information is unaudited.

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We encourage you to review our publicly available disclosure documents filed with the relevant securities market regulators. If you don't have a copy of the relevant press release and the slides, please contact Telefónica's investor relations team in Madrid by dialing the following telephone number, +34-91-482-8700. Now let me turn the call over to our Chairman & CEO, Mr. José María Álvarez-Pallete.

Presentation

José María Álvarez-Pallete – *Chairman and Chief Executive Officer*

Q3: Sustainable improvements on all fronts

Thank you Pablo. Good morning to all of you. Today with me is Ángel Vilá, Chief Strategy and Finance Officer, and during the Q&A session you will have the opportunity to address us with any questions you may have.

Our transformation process focused on quality differentiation and data-centric strategy is paying off. The next step is to focus on growth acceleration. OpCF growth is set to accelerate as CapEx to Sales peak is left behind and synergies flow.

In the third quarter, Telefónica achieved sustained progress. We are particularly pleased with the organic year-on-year growth acceleration in OIBDA, OpCF, reported EPS and FCF. Forex is looking better nowadays and its negative impact in headlines is clearly easing, as our Q3 reported OIBDA showed almost flat performance year-on-year versus -7.1% in Q2. Leverage is on a downward path thanks to the robust FCF generation improvement in Q3, reducing debt by 2.6 billion euros in the last three months to just below 50 billion euros.

Business sustainability is reflected in improved fundamentals across countries. In Spain, market value is undoubtedly increasing; in Brazil we are posting a stellar evolution, with OpCF growing 38% organically vs. July-September of last year; Profitability in Hispanoamérica is returning to growth; Germany continues to expand margins and UK financials are improving sequentially, consistently outperforming the market.

Deleverage sustainability is also granted with the new financial objectives; the aim is to strengthen the balance sheet, through 1) attractive and market consistent shareholder remuneration, a 2) sustainable organic net debt reduction with growing FCF and 3) portfolio optimisation policy in order to reinforce our strategic positioning.

New financial objectives to ensure sustainable remuneration and consistent deleverage

We are announcing new financial objectives in order to ensure sustainable remuneration, with a pay-out of around 50% with growing FCF and consistent organic deleverage.

As such, we are revisiting our dividend policy for 2016 and 2017. The dividend will now amount to 0.55 euros in 2016 and 0.40 euros in 2017, split into two tranches in both cases.

The first tranche of the 2016 dividend will be payable in the form of voluntary scrip dividend in the coming weeks of 0.35 euros plus 0.20 euros per share in cash, to be paid in the second quarter of 2017. In addition, and in order to complement our shareholder remuneration, we cancelled 1.5% of treasury shares some weeks ago, leaving this position at 2.8%.

The 2017 dividend will consist of two full cash tranches of 0.20 euros per share, with payments to be made in Q4 2017 and Q2 2018.

As a result, in the calendar year 2016 payments will amount to €0.75/sh. while in the calendar year 2017 they will be of €0.4/sh.

Our objective is to maintain a solid investment grade credit rating through organic deleverage, with a view to achieve leverage ratios compatible with a BBB/Baa2 rating.

2016 Outlook

As shown on slide 3 and regarding the operating guidance, in an environment of longer handset life cycles, we expect service revenues to be the key metric going forward and these are growing under guidance criteria at a very strong rate of 4.4%. OIBDA margin and Capex to Sales are on track to meet targets set at the beginning of the year.

Financials in a nutshell

To review Telefónica's financial snapshot, please move to slide number 4.

Organic growth rates are very sound in the quarter as OIBDA accelerated to 3.1% year-on-year organically and OpCF to 10.8%; with stable service revenue growth from previous quarter and margins expanding 1.0 percentage point year-on-year.

Up to September, organic revenue growth was 0.8% year-on-year, but this is much higher when you look at the service revenues and OIBDA increase of 2.2% and 3.1% respectively, while margin expanded 0.7 percentage points. On OpCF, growth reached almost 6% vs. the last year figure.

The reported OIBDA decline of just 1.0% vs. the third quarter of 2015, along with the very solid management of the P&L items below it, drove an EPS of 0.19 euros, 44.8% higher than last year figure.

On the other hand, reported year-on-year evolution continues affected by the negative forex impact; although this has significantly eased in the third quarter. As in previous quarters, this negative FX effect in the first nine months is neutralised at FCF level as OIBDA drag in absolute terms is countered by lower payments of CapEx, Working Capital, Taxes, Spectrum, Interest and others.

Let me mention that the Latam FX impact on the year-on-year variation will diminish in the next quarter as the bulk of the Argentinean peso devaluation took place in the fourth quarter 2015.

Lastly, there was a strong sequential improvement in FCF to €1.5Bn, leading to surpass the €2.3Bn in the first nine months.

Robust FCF generation; improving markedly

As seen in slide 5, FCF generation continued to improve, both sequentially and year-on-year.

In the third quarter, FCF totalled 1.5Bn euros, up 0.8Bn euros quarter-on-quarter, with a stronger performance across the board, despite greater investments and spectrum payments. Excluding spectrum, FCF grew 30.8% year-on-year.

In the first 9 months FCF generation remained robust at 2.3Bn euros, up 1.1Bn euros versus the same period of 2015 on improved Operating Cash Flow and lower interests, taxes and minorities payments, as well as spectrum, despite higher WC consumption still impacted by seasonality.

We expect FCF to improve further in Q4 as operational performance improves and FX and other seasonal factors ease. We estimate full year FCF to exceed €4Bn.

Strong recovery in reported OIBDA

Please move to slide number 6.

In this slide we show the different moving pieces affecting OIBDA evolution; on the one hand organic growth remains and is stronger, as already mentioned; on the other hand FX negative impact is markedly improving.

OIBDA year-on-year evolution improved sequentially more than 250 million euros, as FX drag was reduced to -4.4 p.p. and organic contribution accelerated. I would like to stress that we expect this trend to continue in Q4 on easier FX year-on-year comps.

Steady growth of service revenues

To review the quality of our revenues, please turn to slide 7.

Organic service revenues have once again performed better than total revenues in almost all regions, increasing in Q3 by 1.4% year-on-year, offsetting the continued downward trend in handset sales across the board.

I am particularly pleased with the acceleration that we've seen in both Hispam and Brazil this quarter, with Germany and the UK improving their trends too.

The revenue mix reconfiguration continues to be supported by the growth in Broadband Connectivity and SoC, representing 49% of total sales, 7 percentage points more than a year ago, capturing IoT, cloud and data opportunities, among others.

Accelerating organic OIBDA increase

Slide 8 takes you through our accelerating OIBDA expansion.

Organic OIBDA ramped-up in the quarter, fundamentally due to our disciplined cost management efforts derived from merger synergies and from the global efficiencies and simplification plan. These factors led to a 3.1% year-on-year boost, up 240 basis points vs. the second quarter.

In the first nine months there was OIBDA growth across the board. It's also important to point out that our portfolio diversity is really helping to drive our OIBDA performance.

On the back of what I've just mentioned, we also saw margin, which was 31.9% at Group level, expanding year-on-year across all segments this quarter.

Outstanding OpCF upturn on higher OIBDA growth

As you can see on slide 9, our progress made at OIBDA level is driving a brilliant Operating Cash Flow performance, which grew 10.8% in Q3, 930 basis points more than in Q2, benefitting from CapEx and OpEx optimisation.

Profitability in Brazil and Spain contributed most to the OpCF performance over the quarter.

In July-September, 79% of CapEx was devoted to growth and transformation, as we continue to invest in our networks to provide unrivalled connectivity for our customers. The slight year-on-year dip in CapEx investments reflects phasing effects.

High-value strategy across geographies

Please turn to slide 10.

Once again this quarter we have successfully executed on a substantive high-value strategy across our footprint, focusing on network evolution and setting the stage for further top line growth.

We have driven penetration levels up year-on-year, mainly smartphones, LTE and FTTX + VDSL, propelling higher customer lifetime value. As such, average revenue per access expanded 2.6% vs. January-September 2015 and churn was reduced.

It is also worth highlighting the success of the "More for More" tariffs we are landing and the high-end pricing power achieved with FTTX and 4G bundling strategies.

Significant upside from data consumption

In slide 11, let me highlight data trends and the significant upside opportunity we foresee ahead of us. As shown in the different charts, in recent years we have been experiencing a sustained data traffic explosion, with Q3 year-on-year growth of 65% for mobile data and 45% for fixed.

This rocketing demand requires stronger networks. A good example of this is that in Spain fiber accesses already have 2x higher data consumption over DSL.

While in mobile broadband a comparison with other regions suggests that MBB in Europe can double in the coming years; the conclusion is clear, data growth is unstoppable.

Disruptive data proposals; more recurring revenues

Slide 12 shows the evolution of our data monetisation metrics.

We continue to develop innovative data propositions across the Group to benefit from the data explosion commented before.

In mobile, it is worth mentioning our new "More for More" contract portfolio in Germany and new prepaid data plans for Latam with a focus on integrated recurrent plans.

As a result, the larger smartphone base and the higher data usage, led by LTE customers (up 2.5x year-on-year) and its average consumption uplift of 63%, translated into higher ARPUs and the acceleration of data revenues to 12% vs the third quarter of 2015.

In terms of fixed data, a wider fiber customer base along with offerings focused on bundling content are driving strong traffic expansion, especially around video.

Digital Services: Value accretive initiatives

Turning to slide 13,

With the customer at the centre, Telefónica is becoming a platform where innovation is offered to our customers and integrated in our internal processes. In addition, our increasing number of partnerships with industry leaders reinforces our global positioning.

Digital Services revenues grew 10.7% year-on-year in the quarter mainly driven by video, on the back of our investment to transform ourselves in this new digital era.

I am pleased to highlight that Gartner has once again recognised our efforts in the Managed M2M services space, naming Telefónica as a "Leader" for the third year running.

TGR: Continued technological transformation

On slide 14, TGR continued to expand UBB networks and simplifying operations across its footprint. As a result, 33.7 million premises were passed with fiber already, of which 21.4 are fiber to the home and LTE coverage increased 9 p.p. year-on-year to 58%, with Europe standing at 86%.

Additionally, we continued to progress in network quality and users experience by building a smart wifi home experience and a new set-top platform to enhance HD video.

On network innovation, I would like to highlight milestones such as the successful trial of 4G speeds of up to 800 Mbps and the extension of SON (self organizing networks) automatisation.

A key step towards IT transformation in the quarter includes continued advances in Full Stack, evolution of on-line channel in Spain and system consolidation in Germany.

Lastly, I am pleased just to highlight the strong advance in Big Data platforms, with capacity 4 times higher year-on-year.

Now I hand over to Angel.

Ángel Vilá – *Chief Strategy and Finance Officer*

Spain: Increasing value in customer base
Thank you, José María.

Slide 15 reviews our domestic business.

We are pleased to present the early results of the new convergent portfolio launched in July. The first and most notable was the acceleration in higher quality accesses growth, with UBB and mobile contract net adds posting robust figures. In addition, churn stayed low across services proving the resilience of our customer base.

On the other hand, TV results were impacted by the start of the football season and promotional activity in the market.

Our superior FTTH and LTE networks along with top TV bundles are clearly paying-off and give us plenty of room to upsell in a market where commercial activity is more and more focused on quality.

As such, solid loyalty and increasing convergent ARPU, 11% up year-on-year to 82 euros, translated into a positive evolution of financial results as you will see in the next slide.

Spain: Stable revenue and growing margins

Service revenues continued their upward year-on-year trend, despite tougher comps this quarter (wholesale TV revenue declined and the year-on-year effect of the tariff update in May 2015 faded from May 2016).

The top line increase in consumer and wholesale segments accelerated sequentially and more than offset the IT seasonality in the "Business" segment, which is expected to revert in the next quarter.

Once again, OpEx declined year-on-year through increased efficiencies which accommodated the higher net content costs and led OIBDA to increase 1.8% year-on-year ex-non recurrents with a margin expansion of 0.9 p.p. to 43.3%.

On the bottom of the slide, we'd like to highlight how cash conversion is accelerating, with OpCF growing year-on-year for the second quarter in a row to 7.1%, ex-non recurrents.

Germany: Incremental synergies in H2

To review Telefónica Deutschland, please turn to slide 17.

Good trading momentum was maintained, with strong contract net adds on the dynamism of partners. After the migration of contract customers to O2 Premium brand, we enhanced the commercial offering with "O2 Free" launch in October. The market continued to be highly competitive but with early signs of easing pressure in the non-premium segment.

Additionally, LTE continued to make progress, with average data usage up 15% quarter-on-quarter. As a result, mobile data monetisation continued to flow through to mobile service revenue, and led to an improving quarter-on-quarter trend when excluding regulatory impacts.

Incremental synergies together with a lessening effect of transformation OpEx translated in OIBDA acceleration in Q3 year-on-year to 3.6% and OIBDA margin expansion of 2 percentage points to 24.7%.

UK: Robust performance; market leading loyalty

In the UK, as seen on slide 18, we highlight continued traction in the contract segment driven by market leading levels of churn in contract, thanks to our high customer satisfaction.

LTE is the main growth lever with a penetration of 45%, up 15 percentage points year-on-year and with LTE traffic accounting for 67% of total data traffic, up 23 percentage points vs. Q2 15. CapEx continues to grow as we rollout LTE, with outdoor coverage now at 93%.

Mobile service revenues were up 1.1% excluding "O2 Refresh", reverting from -0.2% in the previous quarter, as customers chose higher tariff bundles and larger data bolt-ons, as can be seen in the 8.2% average subscription per user year-on-year growth.

OIBDA returned to year-on-year growth of +1.6% on revenue flow and cost control. As a result, margin expanded 1.0 percentage point year-on-year to 27.3%.

Brazil: ARPU growth in key services

In Brazil, as shown in slide 19, ARPU growth in key services is the base to our outstanding performance.

In this sense, our positioning in value segments, which was reinforced once again in Q3, drove double-digit ARPU growth in mobile, ultra broadband and Pay TV services.

In mobile, this performance was mainly leveraged on data consumption, with an ongoing increase on 4G adoption, and the improvement on top-ups in prepay.

In fixed, it was driven by the successful cross-selling execution and the gradual development of our fiber reach.

Brazil: Strong margin expansion; OpCF +38%

Turning to slide 20, let me highlight the year-on-year growth acceleration across financial metrics in Q3, driving a very strong operating cash flow generation.

This outstanding performance is built-up on 3 main premises:

First, the consistent service revenue growth acceleration, well above the sector, reaching 3.0% year-on-year in Q3, despite macro headwinds and lower handset sales.

Second, the increased profitability, above 33% this quarter, on efficiency measures and successful execution of operational synergies, already securing 2/3 of the best case scenario with €229m achieved as of September.

And third, on our CapEx execution below initial expectations with strong efforts on optimisation, partly on the clear benefits of big data intelligence at the core of our strategy.

HispAm: Focusing on value growth

In Hispam, as seen on slide 21, commercial activity is focused on value with accesses growing at strong rates despite more intense competition in the last quarters.

In the mobile business, third quarter net adds improved to reach 1.1m new customers with contract accesses up 6% year-on year, reinforcing our leadership in the region.

In fixed, our focus is on improving the quality of service, delivering higher broadband speeds to our customers and bundling new services. As a result, high speed broadband accesses grew by 14% and Pay TV by 7% year-on-year.

HispAm: OIBDA back to growth; improving profitability

Please turn to slide 22 to review the financials of our businesses in Hispanoamérica.

Quarterly revenue growth accelerated to 4.1% year-on-year, with better contribution from Argentina and sustained positive performance from Colombia; resulting in OIBDA returning to growth of more than 6%, with a sequential improvement in all countries except México and Peru.

As such, profitability expanded by 0.6 p.p. to pass the 30% threshold once again this quarter and revert negative year-on-year growth posted up to June.

Organic deleverage based on strong FCF generation

Let me now move to the financial metrics starting on slide 23.

In the third quarter we have made a substantial reduction in our net debt figure, which was reduced by €2.6Bn to just below €50Bn.

Almost 60% of such debt reduction is purely organic. It is explained by the growth in FCF, which reached €1.5Bn in the quarter, up 7% vs. third quarter 2015.

The remaining debt reduction is explained by financial measures, mainly the €1Bn hybrid issue and the partial disposal of our stake in China Unicom.

As a result our leverage ratio goes down to 3.05 times, 0.15 times lower that in June. We expect further deleverage thanks to stronger FCF in the fourth quarter as well as the cash preservation through the voluntary scrip dividend in November.

Attractive financing to reinforce liquidity

On slide 24, we continue to tap different markets at historical low rates, further strengthening our liquidity cushion, currently close to €22Bn, to cover coming years maturities.

Our latest capital market transactions have also increased our average debt life above 6 years, taking into consideration our recent bond issues launched in October.

The effective cost of interest payments in the last 12m stood at 4.31%, 32 basis points lower year-on-year. Europe reduces 72 basis points thanks to debt refinancing at rates below average cost. Interest payments in LatAm increased the cost by 40 basis points mainly due to higher payments in Argentinean pesos, higher cost of Colombia due to interest rates and inflation increase, and other non-recurrent effects in Brazil.

I will now hand back José María to recap.

José María Álvarez-Pallete – *Chairman and Chief Executive Officer*

Summary

Thank you Ángel.

To conclude, please turn to slide 25.

Our strategy has been successfully executed: we are now back to growth thanks to transformation strategy has paid off. Our next step is to accelerate growth, with the CapEx intensity peak already behind us and benefits from synergies.

As you can see from today's presentation, our proof points in Q3 of this year are clear: OIBDA and OpCF ramped-up organically year-on-year in Q3, EPS and FCF also are posting very solid increases and leverage is on a downward path.

Earnings momentum is very positive as all business units are improving fundamentally, reflected in the year-on-year organic growth posted across the board up to September built on best-in class assets, namely spectrum, networks and differential offers.

New targets set today have the objective to be solid investment grade credit rating Company, through 1) an attractive shareholder remuneration, and 2) consistent organic deleverage, linked with growing FCF.

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

Q&A session

Georgios Ierodiaconou – *Citi*

I have two. The first one is on the business revenues in Spain. And I appreciate you have already made a comment around the IT services seasonality but even the connectivity revenues looked to have gone backwards a bit. In the previous quarter, they were down a couple of percent and they were showing improvement. And now they are back to around -5%. So, I was wondering whether there is any specific drivers for the third quarter, or you're seeing any renewed pressure on the business revenues more broadly?

And also, my second question is on the UK. Part of the improvement, from what I understand, maybe I'm getting this wrong from the presentation, comes from roaming and the O2 Travel bolt-ons. So, I'm just wondering given that you're not going to be able to charge for EU roaming next summer, probably you're going also to have to pay for higher volumes when customers travel. Are there any measures you have in place to compensate the impact on EBITDA in the UK? and will that affect churn or do you think you can keep that low also? Thanks.

José María Álvarez-Pallete – *Chairman and Chief Executive Officer*

In terms of your question on Spain, in fact, what we see is that recovery in terms of ARPU expansion is a reality and is happening namely on the residential market. You have several effects out of the revenues in Spain this quarter. First, handset sales have declined 21% year-on-year, and that has affected. Excluding that, service revenue has grown 0.6% year-on-year in organic terms, and it has been pushed by mainly Fusion and the new wholesale services.

It is true that the year-on-year comparison has affected us in terms of different factors. First, our offer upgrades; we had one offer upgrade in July this year. And, therefore, you need also to take into consideration the year-on-year comparison with the previous year.

Secondly and probably more importantly, on the B2B side of our revenues, we have some seasonality effects namely on the IT part of our business, and that has been providing us with a weaker quarter in Q3 that we foresee to improve in the next months.

And in terms of “other revenues”, they are accelerating, they account for 19% of our service revenue. They have accelerated to 8% year-on-year. Those are revenues coming from wholesale. It is true that it's coming from easier comps (we have not had ONO revenues since the third quarter of 2015) and MTRs and also some MVNO revenues.

So, overall, in Spain, we have market dynamics that are going in the right direction. We have some volatility coming out of some seasonality effects on the B2B business. We have the handsets revenue declining sharply. This is across the board. But out of the consumer trends, what we can see is that we are growing the consumer segment 1.3% in the first nine months of this year, with Fusión revenues coming up 23%. So, everything is evolving according to expectations and will have some seasonality effect namely on the B2B business.

In terms of your question around the UK, mobile service revenue have grown 1.1% year-on-year if we were to exclude the “refresh” effect. And therefore, we have returned to growth. And this is mainly due to higher subscription revenues, increased number of data bolt-ons and moving customer to higher tariff bundles and, therefore, out-of-bundle revenues. And those are more than offsetting negative impacts coming from roaming declines and MTR.

So, basically, the effects coming from O2 UK are due to improved trends in terms of higher subscription revenues, and therefore, we think they are recurring. They are sound. So, they are not just coming from one single effect. In terms of the roaming part, roaming revenue has been supported by a strong take-up of the product called "O2 Travel" proposition, approximately 80% of our roaming customers are on "O2 Travel", giving customer confidence in terms of using data abroad. So, overall, we think that if you consider both effects, the fact that the major driving part of the service revenue growth is basically around higher subscription revenues and that we have been able to stabilize roaming revenue through this new tariff, we think that the revenue trends in the UK are sustainable.

Giovanni Montalti - *UBS*

I don't know if you can help us understand better the divergence between the acceleration in net adds from mobile contract and a bit of light in net adds in terms of fixed broadband in Spain.

And also, if you can share a bit more comments with us about deleveraging potential asset disposals?

José María Álvarez-Pallete - *Chairman and Chief Executive Officer*

You know that we have renewed our offer in Spain and therefore, we have included a second line in most of our Fusión packages, and therefore, that has been accelerating mobile net adds. We are right now under a promotion, whose effects are going to be flowing into the last quarter, and therefore, we also have some promotional impact this quarter. The promotion will be expiring in the next weeks and we will see where the customers evolve after the promotion. But our previous experiences are telling us that those promotions in the end are resulting in ARPU accretion.

So, the divergence that you are seeing is coming from these add-ons, out of this bundling strategy of having a second mobile line. And we expect to see the impact of the promotion in the next weeks. We are basically having more mobile add-ons in higher level packs and therefore they will foster portability, as some of our Fusión subscribers are also competitors' subscribers. So that's why we have been willing to add this second line on the Fusión offer.

Ángel Vilá - *Chief Strategy and Finance Officer*

Regarding deleveraging, you've seen that, at the end of September, we stand below €50 billion of debt. We have managed to get a very strong debt reduction in the quarter of €2.6 billion.

We remain committed to maintain a solid investment-grade credit rating, aiming at ratios compatible with BBB/Baa2. So, what we are doing is reiterating our commitment of solvency and liquidity, although reformulating this objective.

With the decision the Board took yesterday to reduce the dividend, we are moving to an objective of organically deleveraging, since we are increasing the retained free cash flow in the business and generating cash in excess of our dividend payments that clearly will be directed towards improving our balance sheet.

On top of this, all inorganic measures that would be thought of remain available to us, if anything de-risked, but we would not want to entertain discussions on those potential measures. We will just execute them when they make strategic sense and they create value.

Giovanni Montalti - *UBS*

What's the biggest risk that you see in your cash flow projections to get you where you want to be in terms of deleverage? What's the biggest risk in your view on this side? And where would you look for more flexibility if things do not go as expected?

José María Álvarez-Pallete - *Chairman and Chief Executive Officer*

Well, let me take that question, if I may. What we are doing right now is that we are betting, we think deleveraging is the right decision, our deleveraging strategy on organic free cash flow generation. During the last three months, we have been working on our business plan for the next three years. And what we see ahead of us is a growing business, mainly in terms of free cash flow, but also in terms of revenue, OIBDA and with a lower CapEx intensity. And that's a vision that is also sustained by the recent performance. Namely, these quarter figures show that we are moving into that direction.

As a result, we are fully confident that we can rely on organic free cash flow generation to be the base for an organically-based accelerated debt reduction. And this is why we think that the most value-creating option for our shareholders is to adapt our dividend policy in order to guarantee that we do not depend on external factors to deleverage. And, remember that we have indicated that the dividend payment is going to be below 50% of free cash flow generation.

So, we think that with the current business trends that we foresee, with the investments that we have been doing in the last four years, in which we have been very strongly investing in our assets, with the fibre positioning that we have in Spain, with the LTE positioning that we have everywhere around, and with the data traffics and data volumes that we are seeing ahead of us and data monetization that we are starting to have (take a look at how data monetization is growing excluding SMS), we think that we can be basing our deleveraging strategy on free cash flow generation.

So, that's what we are betting. That's our view. And what we don't want to have is to be depending on external factors to deleverage, that are out of our control.

Giovanni Montalti - *UBS*

So, let's say the 50% pay-out as a guidance is as important as the absolute amount of the DPS (40 cents). We need to look also the 50% pay-out, that's important for us to understand.

José María Álvarez-Pallete - *Chairman and Chief Executive Officer*

We don't guide on that. We are just indicating what we see ahead of us today and that's where we are in our dividend policy.

Mathieu Robilliard – *Barclays*

If I can follow up on the previous question. If I look at the absolute cash dividend that you will be effectively paying throughout the calendar 2017 and going forward, if I'm doing my math correctly, there's not a big change, and there's almost no change at all compared to the previous policies.

So, I guess, where you're gaining more flexibility is probably if you don't buy back shares as you've done in the past to kind of offset the scrip dividend. So, is my understanding right? That's where you're gaining more flexibility from?

And the second question I have to do is Hispanoamérica. At the Q2 you had flagged that, in a number of countries, the competitive and macro environment had deteriorated and you were not expecting a quick recovery, which is basically what we got in Q3, apart, maybe, from Argentina and Colombia to some extent. Are you becoming a bit more constructive when you look ahead? Are you still thinking there is going to be some tough quarters, on the basis of competition and macro environment? Thank you very much.

Ángel Vilá – *Chief Strategy and Finance Officer*

On the first one. If you compare the €0.75 to the €0.40 to which we are moving, that is 1.9-1.8 billion euros cash savings, depends on the number of shares. In your statement you were assuming that we would have continued with the voluntary scrip dividend partially for the next year, which is something that was not communicated to the market. We are executing now in November the €0.35 voluntary scrip dividend tranche, but it was not approved that that would be the same for the coming years. So, if you look at calendar year 2017, compared to €0.75, going to €0.40 it's €1.8 billion savings. And that is something that arithmetically leads you to less or around 50% pay-out of the free cash flow that we're going to be generating in a year like 2016. And we are for the first time committing to a free cash flow target in our presentation, to show to you our commitment to cash flow generation.

And as José María was saying, we are seeing growth ahead for the coming years. Had we stuck to the scrip dividend, we would have been issuing shares continuously. And at some point, we would have to remunerate those expanded number of shares in cash. So, by stopping to do the scrip dividend, we are stabilizing the cash outflow and the number of shares. So, there is a very significant saving for the coming years in this new remuneration policy.

José María Álvarez-Pallete – *Chairman and Chief Executive Officer*

Taking your second question on Hispam, we have some markets in which we are concerned, namely Mexico, in which the market dynamics are not sound. They started to be not sound in the Christmas campaign last year. And it has continued all over this 2016. It is true that we are seeing some signs of a more rational approach, not in pricing but in terms of the time duration of promotions and bolt-ons. But still very weak to bet on a recovery of the value of that market. We are growing in terms of customers. But there's impact in revenues and in OIBDA, as the asymmetry in terms of interconnection it's being faded away because the interconnection rates are dropping. So, it's not going to be an easy year and still too soon to say that we are seeing any signs of recovery of the Mexican market. So, we think that the Mexican market is going to stay complex for a while.

The other market that you were mentioning; Perú. We have a very sound commercial position there. And what we are doing there is fighting for the value customers. There is a competition being intensified mainly on the low-end but also on the high-end of the market. But in terms of contract and in terms of Pay TV, we are doing pretty well. It is true that we have some impacts in this quarter coming namely, in Peru, from some regulatory effects in terms of MTR declines, and also in the fixed line business coming from less hardware revenues. But it is also true that we are defending very well our market share and the value market share, the value customers. So, we think that in Peru, market dynamics will be back to normal at some point. And in the meantime, we are effectively defending our position.

And by the way, you have two other countries which have been turning around in the positive way which are Argentina and Colombia, which are showing good signs of recovery, namely in Argentina due to tariff re-positioning. And in Colombia, we are starting to get more traction on prepaid.

So, we are seeing a different mix of performance in Latin America. Some of them namely Mexico being concerning. But Mexico weights less on our overall revenues while the other markets, which are weighting more like Peru, Argentina or Colombia are doing better.

We are concerned in terms of the low end of the market, namely on prepaid. Our evolution on prepay in Latin America has not been brilliant in the last quarters, but we have learned how to proceed. And namely in Colombia; we have been testing in Colombia, we will be expanding a new tariff portfolio across the board to improve competitive position in prepaid, and we are starting to see better trends.

And, by the way, efficiency targets of OpEx are paying off. OpEx is growing below inflation everywhere. So, we have a better impression than what you have in terms of Latin American prospects.

Ángel Vilá – *Chief Strategy and Finance Officer*

And to complement my previous answer, you should not expect us to carry any share buybacks in any meaningful way.

Mandeep Singh - *Redburn*

So, first question I really had was on the Spanish business development. You've given a little bit of color on the revenue trends. Can you sort of help us understand how we should expect OIBDA to evolve going forward? Clearly, you've only booked sort of partial quarter of increased content cost, so should we expect a negative development in Q4 from a higher content cost applied to the full quarter and how does sort of work with the revenue dynamics sort of offset that? So, just sort of maybe a little bit of a forward-looking indication or how we could expect the revenue and OIBDA dynamic to evolve in the quarter.

Secondly, and I'm sorry to come back to the balance sheet, but it clearly is a big focus for investors. We notice that the CEO of O2 UK said the IPO is off this year. Do you feel that the organic sort of deleveraging, let's say, it's €2 billion because you generated €4 billion of cash, do you think that's enough to keep the rating agencies away and have you had a constructive discussion with them based on what you've announced today? Thank you.

José María Álvarez-Pallete – *Chairman and Chief Executive Officer*

In terms of Spanish business OIBDA, as you mentioned, we have already had in the third quarter two impacts, so to say, on a quarter-to-quarter comparison. The first impact was the Champions League impact which we did have last year and we started to have from the first quarter of this year. And the second one, as you were mentioning, was the new prices of "La Liga" rights. And they have started to flow during this quarter, as well as less wholesale revenues coming from the packages that we don't own have been affecting our revenues and growth.

So, you have in the third quarter a good proof point of the new kind of revenue structure and OIBDA structure. 2016 margin at the end of the year, we think, will be around 40%[1], although it will be probably lower in the fourth quarter, due to higher net content cost, as you were mentioning. But we have also initiatives to reduce OIBDA tension. Some of them are already flowing and will be progressively flowing like the personnel reduction from the voluntary incentive retirement program. And also, we are seeing some better mix in terms of value and tariff upsell. So, other efficiency, like the distribution channel restructuring that we are currently implementing, will also help. So, at the end of this year, we think we should be above 40%[2] margin and we think that's a sustainable projection.

Ángel Vilá – *Chief Strategy and Finance Officer*

Regarding rating's agencies, of course, we cannot speak for the rating's agencies. Of course, we have frequent contact with them and today's announcement is not a surprise. Those conversations are confidential. But what is obvious is that the revised dividend policy improves our credit quality. It's a step in the right direction towards cash preservation, since more cash is being retained in the business.

In addition, we are seeing a very positive evolution of our free cash flow and a growing trend going forward. So, this will allow us to deleverage organically in a consistent way.

On top of this, any other measures that you could think about remain available. And if anything, they would be de-risked. So, today, we are a better credit than we were yesterday.

José María Álvarez-Pallete – *Chairman and Chief Executive Officer*

I would like to complement on what has been said. What we're doing, means that we are fully confident that we can rely again on organic and growing free cash flow generation to reduce leverage. It also means that we do not need any more to do any divestment in order to meet our deleveraging goals.

[1] See answer to question 11 (Julio Arciniegas)
[2] See answer to question 11 (Julio Arciniegas)

It means that from now on, any such process will be run exclusively according on its strategic and value-creating merits, and it means as well that we are no longer under any rush to proceed with any transaction. Because by doing what we are doing today, we think that we should not be depending anymore on any longer and external factors to deleverage.

James McKenzie - *Fidentiis*

On Spanish cash flow: could you give us an idea of what the change in advanced corporate tax may mean for the cash flow in the fourth quarter? Does it affect the guidance that you gave in the first half conference call where I think you that you gave a lot of guidance on interest cost and tax?

Ángel Vilá - *Chief Strategy and Finance Officer*

We have been managing the situation on the change on the advanced payments that has been put in place by the Spanish government, so that you can still rely on our guidance of less than 20% cash tax rate for year 2016.

James McKenzie - *Fidentiis*

At the first half conference call, you talked about low-teens decline in financing and tax rates. Is that still applicable?

Ángel Vilá - *Chief Strategy and Finance Officer*

Our gross cost of debt now stands at 4.10%. This is a blend of 3.21% in Europe, which continues to go down, and in LatAm currencies 9.25%.

The trend that we see in our financing in European currencies is clearly downward, as you could see in the issuances we did a couple of weeks ago, both in the 4-year tranche and the 15-year tranche: the 15-year tranche was below 2%, and the 4-year tranche was at 0.3%.

So, you should expect us to continue on that declining trend in the current macroeconomic environment.

Keval Khiroya - *Deutsche Bank*

I've got two questions, and basically it's Spain, please. Firstly, you lost 44,000 TV customers in Spain in Q3. I understand this is a quarter when many customers churn, but that level of loss is still almost four times worse than the level last year. Can you talk a little bit more around the dynamics in the TV market versus one year ago?

And then secondly, going back to the revenue profile in Spain, which you have given some color on, I think on the Q2 call you said the most recent price rise in July should help the Q3 and the Q4 trends. Now, looking at the Fusion ARPU, the percent growth is actually a little bit worse than Q2.

As these promotions roll off should we, therefore, expect an acceleration of growth of Fusion ARPU from Q4? Thank you.

José María Álvarez-Pallete - *Chairman and Chief Executive Officer*

Taking the first one on the TV net adds in Spain, they have been impacted by the price update that was included in the basic packs of the revamped Movistar Fusion+ in August, as well as the one made on the pure one-play TV in September, which was upgraded from 22 to 25 euros. There is also, as you were mentioning seasonality and more promotional activity in the market that has also been affected. And we have also included there the disconnection coming from the former satellite platform. So we foresee that process being almost over. So, as a result, those are the major impacts that we have been having in this quarter. The consolidated churn is slightly up, 1.8% versus 1.6%, in the second quarter, as this quarter has been impacted by the football promos in the market. Year on year, the churn is reduced almost 1 percentage point, as last year we had the bulk of the disconnection of DTS customers. So, a mix of effects.

And then, taking your second question and trying to combine it with the ARPU of Fusion, ARPU of Fusion is 81.8 euros and it has been growing, mainly from the tariff increases that we have been doing, but also on the higher value mix. We are moving customers upwards. And that's why today, in this third quarter, we have been also impacted by our own promo, in which we are trying to push customers from the low end part of the Fusion layers into the upper by giving a taste of the higher, high-end products. We should have a better view in the fourth quarter of both two trends. We are slightly optimistic, but too soon to say, as we will have the first customers stepping out of the promotion in the next weeks. So, probably, at the end of the year we'll have a better view.

Let me just highlight one thing, and is that we are, the Fusion customers are up 7.1% year-on-year. And Fusion revenues are up 23% year on year. So we are focused on Fusion, but we are also focused on the non-Fusion customers, and that's where we are driving; and we are also focused on the business segment, in which we need to make sure that we recover the dynamics of the second quarter. So the overall impact in revenues have different colors, different flavors in Spain.

Alberto D'Agnano - *Goldman Sachs*

Just a very quick follow-up on that. So, can you elaborate a bit on your decision to move to a more generic leverage guidance of maintaining the investment grade rating? or whether you have a leverage ratio in mind for that? and whether that change results from the previous target, maybe being dependent on inorganic delevering? Or is it just a case of the stronger organic free cash flow generation that you highlighted a couple of times? Thanks.

Ángel Vilá – *Chief Strategy and Finance Officer*

Yes. We are moving the articulation of our target to a different way, but we want to reaffirm our commitment of having a solid investment grade credit rating. This has not changed. But, we are no longer constricting ourselves to reach a specific leverage target on a specific date because this was creating an environment which was not conductive to potentially taking the right decisions to create value and the right strategic decisions for the business. With the cash flow retention that we are going to have, we can organically reach a leverage ratio of 2.5x Net Debt/OIBDA in the medium term. This is thanks to the cash preservation, the growth in the free cash flow that we are seeing for the business.

But on top of this, any other measures that you could have thought of as potentially executing, all those remain available as well to us. But we are going to focus our deleverage on organic deleverage because we think that it's the sustainable way to go about this and not be dependent on factors which are beyond our control.

David Wright – *Bank of America Merrill Lynch*

I noticed there was no guidance reiteration in the dividend statement or your own report commentary, José María, and I think every other quarter, you very clearly do that. Can you confirm the full-year revenue guidance of over 4%? It does still look a little difficult to achieve, given the nine months of 3%. And I think that Q3 was 1.4% service revenue growth. So, can you fully confirm that target, please?

José María Álvarez-Pallete – *Chairman and Chief Executive Officer*

Thanks for your question. As I have been saying during the presentation, we are focusing now on service revenue because the handset revenue decline is general, is out of our control; and, therefore, we are focusing on service revenue growth and this is growing above 4% on the guidance that we gave of above 4%.

David Wright – *Bank of America Merrill Lynch*

I see. So, the top line revenue growth is no longer expected to be over 4%. Is that correct?

José María Álvarez-Pallete – *Chairman and Chief Executive Officer*

We will see. Again, it will depend on the handset evolution at the last quarter. But again, service revenue, which is the driving force behind the whole P&L, is growing above 4%.

Luis Prota – *Morgan Stanley*

Two questions please. First is on Spain. A follow-up on the revenue trends and with some slowdown in the service revenues growing up 0.6% this quarter, it was 1% in the first half. I understand the lower wholesale revenues. But, what I would like to get some more color is on the dynamics from the new tariffs put in place including the football and whether the dynamics there are more or less in line with your expectations? And more specifically, what I am trying to understand is whether those customers that were paying for old football before and that they are now in the 30 megabits per second product and, therefore, not getting all the football content, whether you see a strong movement of up-selling or trading up to the 300 megabits per second, get all the football and driving higher ARPU, boosting revenues in the next few quarters. So, those dynamics in terms of up-selling there would be great to know.

And secondly, on CapEx, you are mentioning CapEx all the time in the presentation as part of the cash flow growth next few years. We know that this year, guidance is 17% on constant exchange rate. Next year, 15%; but you are, for the nine months, in 15%. You were mentioning some phasing in the third quarter. Do you think that you will still be 17% in 2016 and 15% next year? Or there's any room for lower CapEx guidance coming. Thank you.

José María Álvarez-Pallete – *Chairman and Chief Executive Officer*

In fact, several comments. You know that on the residential, namely Fusión, namely TV and namely football promos, we are combining promotions with up-selling strategies in order to try to add new customers while up-selling the current subscribers. And in this context you should framework the promos on the premium extra TV pack that we have launched, in which we aim to encourage further subscriptions and increase the TV mix after the promotional periods are over by letting customers try the new contents.

During the summer of 2016, we made available to all Fusión+ customers the premium extra package for two months. We have 400,000 subscribers adding to that promo at the 15th of October. The impact in Q3 revenues is negative, although not much significant. And there were some upgrades and downgrades and also some new customers. And still too soon to see subscriber's behavior after promo, because as I was telling you it was just two months, and we will see.

So, I think that we would be very early judging the effect of this promo in the fourth quarter. But as I was saying before, we are slightly optimistic with the first readings, even though it's too soon to say. Remember that we have had record UBB net adds, 159 thousand, at 300 megabit per second, and this is driving higher value customer.

So, we are trying to push revenues up by doing this kind of promotion and by deploying the new products in terms of the attribute of speed and capacity, and we think it's paying off. In Spain, the impact in this quarter is not mainly derived out of that because in fact, as I was saying before, consumer revenues were up 1.3%. The major impact in revenue this quarter is coming from business, which was down and again it has to do with some seasonal effects namely on the IT contract part and we are addressing that for the fourth quarter.

And then, I would also like to say something on the impact of all those impacts in Spain. I also said in the previous conference call that once included everything, the extra content cost, we were aiming at preserving the margins because we thought we would be able to absorb the extra content cost with efficiency measures. And it is being done and it will be done in the fourth quarter as well. And therefore, we are confident that we can preserve this level of margins, which is important for us because it justifies the strategy of betting on those expensive contents. So, the effort that we are doing in efficiency to absorb those content rights is very significant and that's why margin is evolving positively.

And then on CapEx going forward, we are not guiding on that yet. We will wait for the final year results. But, what we see ahead of us, as I have been mentioning all across the conference call, is lower CapEx intensity coming ahead of us because of several factors. I mean, we have deployed during the last four years, for example, in Spain an amazing effort in terms of fiber coverage. You have more fiber in Spain today than in the sum of the UK, Germany, France and Italy together.

And therefore, this effort is done once in lifetime. So, combined with the fact that we are going to be simplifying radically our approach to legacy networks, and also derived from the fact we are using Big Data in order to do a smart deployment of CapEx and that we have learned a lot along the Brazil experience allow us to think that we can do more, or the same, with less CapEx intensity going forward.

James Ratzer – *New Street*

The first question is just regarding Hispanoamérica where you put up a very strong EBITDA performance, +6%. I mean the text in the release does seem to talk quite a bit about lower commercial costs helping to support that in particular in Argentina, Colombia and Peru, so it would be helpful to get a steer on how sustainable that 6% growth is. I mean do you think commercial costs in those markets now can be structurally lower or this is just a timing effect?

And the second question I had also in Latin America was regarding Mexico. I was wondering if you could just talk a little bit more about how you see your longer term strategic dynamic in that market. You mentioned the competitive dynamics weren't sound and I think you spent about €130 million in capex year-to-date. Is this the market you could consider exiting in due course? You know, just to understand what you see as the next step forward in Mexico? Thank you.

José María Álvarez-Pallete - *Chairman and Chief Executive Officer*

In terms of your first question, as I was saying before, the commercial cost evolution in Latin America has different flavours in different countries. We are being more aggressive in places like Peru and we have also been affected in places like Mexico, but we are seing better trends in other places like you were mentioning Colombia or Argentina. So, I think that going forward what you should expect from us is to be betting on the high-end value customer and therefore betting on those and also launching a better targeted prepaid tariffs all across the board with contained commercial cost.

The overall trends that you're seeing in this quarter in Hispam we see them stable, so we are not projecting any major impact. And remember that we have been able to grow all costs in Latin America below inflation, which is a significant proof point of the simplification efforts that we're doing across the board.

And in case of Mexico, our decision is going to be depending on how the market is going to be evolving. We do not see this market as a rational market. We think that something needs to change. Again our exposure to Mexico is limited and there are some factors that might change the market dynamics in the coming weeks. But Mexico is a pending issue for us in terms of turning around the business or transforming our positioning in the market. So I cannot comment further because we are working on different alternatives. But what it is clear is that we are not satisfied with the Mexican situation in our case.

James Ratzer – *New Street*

And you mentioned some other factors in the market in the next weeks, are these things within your control or just for other market effect looking out for?

José María Álvarez-Pallete - *Chairman and Chief Executive Officer*

I was referring to some situations like the "Red Compartida", the share network in auction by the government, the 700 megahertz. Some players might be less aggressive, and these are factors beyond our control. In our case, we are taking our own decision, addressing operationally on our situation for 2017 in order to have a much more targeted approach into the market. So we are building our own case and we think we can improve our own situation. But whether that's going to be enough to turn around the value in the whole market, we are not that relevant in that market.

Julio Arciniegas – *RBC Capital Markets*

The UK market looks like it will become a little bit more active in terms of fixed/mobile convergence. I know that it's not actively price promoted. But, would you consider a change of strategy? Or how would you address it, if the UK market drives to a more active fixed mobile convergence like Spain?

And my second question is regarding the 2.5 mid-term leverage target that you think that you can accomplish. Are the rating agencies happy with this sort of leverage? Thanks.

José María Álvarez-Pallete – *Chairman and Chief Executive Officer*

Let me get back to something that I wanted to emphasize on some previous comments. It seems that there is some confusion around the market reading of our words on the margins in Spain. I want to clarify that we expect margins in the fourth quarter of this year in Spain to be around 40%, so to be comparable and sustainable with the current levels of margins. I mean, I want to stress that we foresee ahead of us in the fourth quarter in Spain similar levels of margins to the ones that we have been seeing so far.

Stepping now directly into your question around the UK convergence. We have several factors that allow us to think that we are well-protected and we have optionality if that was to be the case. We do not see convergence, again being demand-driven, so far. And we do not see any of the players of the market being incentivized to do aggressive discount on the bundling. And therefore, we do not see a massive shift in the strategy in the UK.

But having said that, what is crystal clear, is that we have the best mobile asset in the UK, with the lowest churn, the best quality. And as a result, whatever could happen on that market, we have a very valuable asset. We think that there is room in the current market structure for our pure mobile leading brand player. And the proved point of that, is that as I was mentioning before, we are doing well in terms of subscription revenues and in terms of customer satisfaction index and historically lower levels of churn. So, I think that customers are currently more interested in acquiring best-in-class value services versus a quadruple service from the same provider and we do not see aggressive discounts being promoted.

So, that's why we think that we are in a good situation in the UK with, again, the best mobile asset. And in a market that is not looking like it's going to be significantly changed in the short-term.

Ángel Vilá – *Chief Strategy and Finance Officer*

Regarding the second question, I did not set a target of 2.5x Net Debt/OIBDA in the medium term. I want to be clear about that. What we are committing is to maintain a solid investment grade rating, aiming at ratios that are compatible with a BBB.

And answering to previous question, I wanted to say that since we are in the new dividend scenario and in the free cash flow growing, a scenario that we are, we expect to substantially accelerate net debt reduction organically. And this will take us organically towards 2.5x Net Debt/OIBDA in the medium-term. But on top of this, I also said, we can have financial measures that we have had in the past. And, on top of this, we can also have other inorganic deleveraging measures, but we will not be rushed into those in a way that we may be led to destroy value for our shareholders. But, organically, we are going to move very much into the direction of the target, but on top of the organic deleveraging, all other options are available.

Fabián Lares – *JB Capital Markets*

The first one is with regards to Brazil. There's been a lot of news flow with regards to Oi and how there's likely to be some type of a restructuring there, not only from a financial point of view, but the assets could be up for sale. I know this is a recurring topic, but there's a news flow that has appeared and a number of sources stating that Telefonica's management in Brazil would be interested considering their new free cash flow objectives and deleveraging. Would you still consider to be looking at these assets? And if so, how would you contemplate these type of acquisitions?

With regards to Hispanoamérica, could you let us know whether you, within these objectives, are contemplating, aside from Mexico, any other strategic asset reviews? So, without specifying names, if you are considering any other possibilities of exits and changing your footprint, etc. etc.? Thank you.

Ángel Vilá – *Chief Strategy and Finance Officer*

Regarding potential M&A in Brazil; well, one can never say never, but we are clearly very focused on organic growth. And regarding Mexico, I think that José María already responded that we can be pragmatic in a situation of an unstable market as we see it.

José María Álvarez-Pallete – *Chairman and Chief Executive Officer*

Well, thank you very much for your participation. We certainly do hope that we have provided some useful insights for you. Should you still have further questions, we kindly ask you to contact our investor relations department.