Telefónica January-December 2016 Results Conference Call Transcript

23rd February 2017

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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-December 2016 results. I am Pablo Eguirón, Head of Investor Relations.

Before proceeding, let me mention that financial information contained in this document related to the year 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 87 00. Now let me turn the call over to our Chairman & CEO, Mr. José María Álvarez-Pallete López.

Presentation

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

2016 highlights; positioned to grow sustainably

Thank you Pablo. Good morning and welcome to Telefónica's fourth quarter 2016 results conference call. With me today 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.

We are positioning Telefónica for future sustainable growth after closing out a year in which we performed notably well, with top line, OIBDA, EPS and FCF increasing year-on-year. Thus, we are reaping the benefits of our transformation initiated some years ago. There are many examples of it one is that we have reached the peak in CapEx, having the best infrastructure, which gives more value to FCF expansion.

This is reflected in a strengthened balance sheet reinforced by recent announcement in Telxius and the long term financing raised, thus supporting sustainable shareholder remuneration in 2017.

Consolidation of growth trends

Slide number 4 shows how in 2016 we have consolidated and even accelerated the growth trends initiated two years ago.

Higher revenues plus widened margin drove the robust 24.4% year-on-year increase in FCF, upgrading the performance vs. 2014 and 2015 and being more balanced, despite including significant CapEx efforts.

Again, we have laid very solid foundations for the future.

FY 16: Key financials

Turning to slide 5, we can see the consistent organic growth in service revenues of 2.6% year-on-year, improving to 4.7% in OIBDA and 5.6% to OpCF.

Also, we continue to demonstrate how our fundamentals are steadily improving, as shown by our underlying EPS increase of 5.1% year-on-year to 0.75 euros per share despite FX impact.

Let me mention that we have implemented different restructuring measures to improve efficiency, productivity and cash flows over the coming years, which affected our fourth quarter. Ángel will explain these in detail later.

Performance on 2016 guidance

Turning to slide 6.
Our 2016 performance has been below our 4% guidance on total revenues, but service revenues have performed better, up 4% year-on-year, the gap then is explained by weaker and volatile handset sales, in line with market dynamics.

We exceeded the OIBDA margin target, as it was up 0.9 percentage points versus the guided stabilising trend vs. 2015, while CapEx/Sales ratio was in line at 17%.

We confirm our 2016 dividend, with the second tranche of 0.20 euros per share to be paid in cash in the second quarter of the year.

Superior customer growth & improved retention

Our focus on attracting and retaining quality customers has led to yet another quarter of strong double digit increase in LTE, Fiber and Cable and smartphones.

We've made progress in our upselling strategies in both mobile and fixed, encouraging customer stickiness, which has led to Q4 churn dropping half a percentage point year-on-year.

As a reflection of this, the growth of average revenue per access accelerated in the quarter 280 basis points to 4.4% year-on-year.

Revenues accelerating; improving quality

On slide 8 we highlight the quality of our revenues and how they are transitioning to a more sustainable mix.

Service revenues performed attractively, ramping up 230 basis points on a sequential basis to 3.7% vs. the fourth quarter of 2015 and with all business segments increasing, except Germany. Total revenues returned to growth in the quarter, +2.7% year-on-year.

Meanwhile, sustainability improves as Broadband and Services over Connectivity represent already 47% of total revenues.

Higher speeds and data proposals fuel growth

Slide 9 shows key data points of our data monetisation story.

LTE base continued to grow very rapidly, +77% year-on-year, and continued to push data usage per user up, this quarter by 65%.

LTE adoption is clearly an engine to boost traffic.

On top of that, different pricing strategies such as 'More 4 More' , already in place in six countries, recurrent prepay plans in Latam, or data sharing plans among others, are proven successful tools to drive ARPU up in 4G and a 20% organic increase in non-SMS data sales.

It is also worth highlighting the pricing power and the usage increase seen in Fiber users, driven by its superior quality.

Extensive transformation starting to bear fruits

Over recent years we undertook a bold transformation of the Company with a long-term perspective.

Firstly, we deployed UBB networks to differentiate ourselves and offer the best connectivity for the rocketing data traffic. By 2016, premises passed with fibre and cable expanded significantly to reach 39 million premises passed, and LTE coverage in Europe was extended by 28 percentage points.

Secondly, we paved the way towards E2E digititalisation, a key piece of the transformation that make us more agile, flexible and in the end, more efficient. "Full Stack" projects went live in 6 countries and simplification initiatives were reinforced (turning off applications, consolidating data cantres, and increasing virtualisation). At the same time, since 2014, the total capacity of our Big Data platforms was multiplied by 7 times (to 27 PetaBytes).

Thirdly, we accelerated the change in our revenue mix from traditional services towards connectivity and new services.

TGR: excellent connectivity; further digitalization

Main accomplishments delivered by Global Resources in 2016 are shown on slide 11.

UBB deployment was accelerated to enhance speeds and capacity. On the access side, premises passed with fiber and cable increased significantly in Hispam, Spain and Brazil, and LTE coverage rose to 62%; while in the backbone we transformed the transportation network and managed legacy.

In parallel, we continued to increase efficiency by the enhancement of our digital capabilities.

Initiatives such as VoLTE and VoIP made us advance towards an all-IP Company; our Global Centers designed smarter customer equipment and mobile applications; and innovative software and technologies were introduced in the network. In addition, “Full Stack” projects are being deployed in 9 additional countries and the single online charging system is already available for 59% of our customers.

Lastly, let me stress, that Big Data initiatives are delivering benefits at different levels: network management, Video platform evolution and Real Time decisions.

Digital Services: enlarged growth platform

Moving to slide 12, in Digital Services we continued to grow revenues at double-digit rates, as we bolster our propositions in this space.

Video continues to be the main pillar of this and a proven tool to monetise fixed data. We have built a cutting edge TV service on content, connectivity and customer experience, driving growth in both customers and ARPU.

Adjacent services are increasingly contributing to overall growth, namely Cloud, M2M and Security. I’d like to highlight the launch this quarter of LUCA, our Big Data unit aimed at helping businesses extract value from insights.

2017 outlook & dividend policy

Let me now outline the guidance for this year.

We are targeting for 2017 stable revenues despite negative impact from regulation, of around 1.2 percentage points, growing OIBDA margin up to 1 p.p. and CapEx to Sales ratio around 16% after reaching the peak in 2016.

We confirm our dividend for 2017 of 0.4 euros per share in cash. Let me remind you that the interim payment of 20 euro cents will be payable in the fourth quarter and the final payment of another 20 euro cents will be in the second quarter of 2018.

Our objective for 2017 will allow us to maintain a solid investment grade credit rating through growing cash-flow and organic deleverage.

2017 priorities set on milestones reached

Looking to 2017, we have set clear strategic priorities.

First, growth in main P&L headlines and cash-flow.

Second, as a platform and data-driven Co, we will make targeted investments in UBB and 4G

Third, cash preservation and organic deleverage complemented with a transversal asset review leading to improved balance sheet.

Now, I hand over to Ángel.

Ángel Vilá - *Chief Strategy and Finance Officer*

Q4 summary: Robust results

Thank you José María,

Moving to slide 16:

Fourth quarter results reflected the strength of our business, as Group year-on-year organic trends clearly improved vs. the prior quarter. This is particularly visible in the +6.3 percentage points in OIBDA growth rate, and the easing of the negative FX impact. Hispanoamérica, Spain and UK mainly explained the acceleration in growth, while Brazil and Germany excelled in attaining synergies.

Our growth was reinforced through higher levels of investments, improving the quality of our networks and customer base, driving data monetisation and setting the basis for future differentiation.

Free Cash Flow was very solid, generating €2.1Bn in the last three months and net debt progressively reduced to €48.6Bn at year-end.

Finally, underlying EPS grew threefold vs. Q4 15 to 23 euro cents.

Financials in a nutshell

Turning to slide 17, let me summarise the key financials for the quarter.

Reported P&L figures were significantly impacted by non-cash factors, including restructuring charges, capital gains and goodwill impairments.

In organic terms, revenues and service revenues grew 2.7% and 3.7% respectively vs. October-December 2015, while OIBDA ramped up to 9.4%, margin expanded 2.0 percentage points and OpCF was up 5.4%.

The underlying increase in euro terms ramped-up in the last three months as forex drag faded on the Brazilian real appreciation and easier comps year-on-year. Underlying net income surpassed 1.2 billion euros, 2.5x higher than a year ago.

Reported Q4 affected by several factors

Please turn to slide number 18 to see in more detail the effects impacting the quarter.

These factors deducted OIBDA and Net Income by 1.3 and 1.1 billion euros respectively, with restructuring in Spain accounting for two thirds.

Strong and healthy FCF generation

Moving to slide 19, we have delivered a very strong and healthy FCF of €4.4B in 2016, exceeding our stated objective.

As shown in the first graph, FCF improved throughout the year by 0.9 billion euros on better operating trends and savings in all items and despite a lower contribution from working capital.

As such, our FCF has accelerated, even with record-high CapEx levels, which as we said are expected to be lower starting in 2017.

Outstanding organic OIBDA growth in Q4

As you can see on slide 20, operating leverage has strengthened.

Organic OIBDA posted an outstanding performance in the fourth quarter, accelerating 630 basis points to 9.4%, mainly due to Spain and Hispam. Synergies and savings from different simplification initiatives drove efficiencies across the board.

In addition, in the full year there was OIBDA growth across segments.

Accelerating OIBDA growth; FX easing

Looking at OIBDA in more detail, if you turn to slide 21 you can see that while organic OIBDA trends have accelerated, the impact of FX has faded sequentially on the back of the appreciation of the Brazilian real and despite the depreciation of the sterling pound and Argentinean peso. This led to a positive net impact of both factors of 300 million euros in Q4 year-on-year, improving sequentially vs. the -53 million euros posted in Q3 and vs. the -323 million euros in Q1.

The negative FX effect in 2016 was neutralised at free cash flow level, as can be seen in the graph at the bottom left of the slide.

Looking ahead, at current spot rates, FX should become a tailwind in the first quarter of 2017.

Growing OpCF despite CapEx still increasing in 2016

Moving to slide 22,

CapEx intensity is paying off and has been the driver of our network leadership. Up to December, 79% of total CapEx was devoted to growth & transformation and we are building the future, using Big Data to allocate CapEx and to create a differential experience.

On the back of our OIBDA growth profile, and despite our consistent investments in CapEx to support the network transformation, operating cash-flow is increasing at mid-single digit rate. Spain and Brazil are both contributing almost two thirds of the total and are both growing.

Spain: superior franchise; sustained upselling

In slide 23 we show the performance of the Spanish business.

New steps in the development of the 'More 4 More' strategy continued to deliver positive results in terms of bundling, churn and value mix.

The enhanced "Movistar Fusión", levered on the leading infrastructure in Europe, allowed us to attract more new customers and to foster the existing ones to move towards higher-end bundles. By year end, more than one third of total Fusión base had UBB and more than two thirds contracted TV, a significant improvement vs. the previous year, with significant upside ahead of us.

This positive evolution in the customer mix along with the tariff updates drove a steady rise of 11.5% year-on-year in Fusión ARPU to almost 82 euros.

Spain: growing Service Revenues, OIBDA, OpCF

Turning to slide 24, quarterly service revenues and OIBDA posted a sequential acceleration in their year-on-year growth rate of 1.2 p.p. and 0.8 p.p. respectively, which was especially remarkable given the tougher year-on-year comparison on net content costs.

As a result, 2016 marked an inflection point in domestic financials. The Company recovered its profitable growth profile and proved how operating leverage is starting to work in this new situation.

In 2016, service revenues rose 1.1% while OIBDA increased by 2.2% year-on-year ex-factors, thanks to significant efficiency gains, which also drove a margin expansion of 0.9 p.p. to 41.1%. Finally, and despite higher CapEx, cash generation was back to growth, up 1.8% year-on-year.

In summary, our Spanish franchise, which has invested steadily over the last years, enjoys a high cash conversion and a superior positioning in a constructive market landscape.

Germany: realising synergies; improving profitability

To review our performance in Germany, please turn to slide 25.

Telefónica Deutschland met 2016 outlook and maintained operational momentum in a dynamic fourth quarter, leveraging the successful launch and encouraging customer response to our new premium portfolio “O2 Free”. Additionally, there are signs of easing competitive pressure in non-premium.

Fourth quarter mobile service revenue fell 0.9% year-on-year when excluding regulatory effects, being stable versus the prior quarter.

Quarterly OIBDA accelerated to 3.9% year-on-year and margin expanded 2.5 percentage points to 24.8% leveraged on incremental synergies. It should be noted that we are upgrading our total synergy target from approximately 800 million euros to approx. 900 million euros of operating cash flow synergies in 2019.

UK: consistently outperforming the market

Now to our UK business. As you can see on slide 26, we have been outperforming the market and the fourth quarter is no exception to this, with strong net adds, market-leading customer loyalty, and accelerating ARPU.

All this has led to a solid financial performance in the quarter. Organic revenue growth accelerated to 2.5% year-on-year ex-”O2 Refresh” which, coupled with robust cost control, led to an OIBDA increase of 4.1% year-on-year organic.

CapEx to Sales was 13.6% in 2016 as we continue to invest heavily in our network to further reinforce this outperformance. Thus, our LTE network reached a coverage of 95%, up 16 percentage points year-on-year.

Brazil: focus on value; customer upgrades

In slide 27, we show how our focus on value in Brazil and the superior quality of our assets are delivering successful results.

Thus, in mobile, our leadership in contract and the protection of the growing value in prepay are driving the double-digit ARPU year-on-year growth.

In fixed, the average revenue per access is also growing at solid rates in both fixed broadband and Pay TV, as we are steadily upgrading our customers on our enhanced network quality.

Brazil: robust growth in revenue, OIBDA, OpCF

Let me turn to slide 28 to review the financial performance.

The outstanding commercial results are leading to a robust service revenues increase, up 2.1% year-on-year in Q4, and to a consistent market outperformance, capturing the full incremental market revenue growth along 2016.

In addition, the ongoing execution of efficiency measures and the capture of incremental synergies, drove the expansion of profitability in a context of strong OIBDA and OpCF increase, up by more than 8% and 26% respectively.

Finally, smart CapEx allocation and synergies led to beat initial target for CapEx/Sales.

HispAm: strengthened market positioning

Turning to slide number 29 we review T. Hispanoamerica.

Our focus on value, service bundling and continued network improvement is reflected in the steady increase in quality accesses and ARPU growth.

Thus, mobile contract customers were up 3% year-on-year, smartphones 15% and LTE 86%, pushing ARPU growth to almost 7%.

In fixed, fiber and cable accesses (up 48% year-on-year) explained broadband ARPU expansion of 12% year-on-year; while Pay TV is also growing in both accesses and ARPU, 4% and 6% respectively.

HispAm: revenues and OIBDA y-o-y acceleration

This positioning is driving year-on-year acceleration in revenues and OIBDA, both growing at double-digit rates in Q4, as seen on slide 30.

By countries, Argentina is the main contributor to this performance, combining higher traffic volumes, tariff updates and easier year-on-year commercial comps.

In Chile, top line ramped-up in Q4 while profitability was affected by higher commercial trading, which also applies to Peru, where intense competition and promotional actions drove Q4 lower contribution.

In Mexico, after a tough 2016 on pricing pressures, Q4 is showing some improvements.

Further deleverage on stronger FCF generation

Let me now turn to the financial metrics starting on slide 31.

Since we reconsolidated O2 UK in June, net debt has been reduced by 3.6 billion euros to reach 48.6 billion euros at year end, i.e. 2.95x net debt/OIBDA. The recently announced Telxius transaction will reduce net debt further by 1.3 billion euros bringing leverage ratio closer to 2.85x. A key factor in debt reduction has been strong FCF generation, 4.4 billion euros, up 24% vs 2015, of which 3.6 billion euros were generated in the second half.

This FCF generation is due to growth in adjusted OpCF and decline in financial and tax payments, with a lesser contribution from working capital.

We expect cash-flow growth in 2017.

Strengthening balance sheet with long term financing

We continue progressing in our objective of extending debt maturities while reducing interest cost.
As slide 32 shows, the effective cost of debt in 2016 stood at 3.94%, 102 basis points lower year-on-year. European debt costs were reduced 109 basis points thanks to debt refinancing at rates below average cost, risk management measures and an exposure to short term interest rates, including 5 billion euros of European commercial paper program at rates close to 0%.

We continued to strengthen our balance sheet with long-term financing. In December, we issued a bond with a 35 year tenor, the longest in the Company's history.

We keep on tapping different markets at historically low rates, further strengthening our liquidity cushion, currently close to €23.8bn, clearly exceeding maturities over the next few years.

Our average debt life was 6.35 years at the end of December and it has increased to 6.77 years including the additional refinancing activity of the last two months.

I will now hand back to José María to recap.

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

Closing remarks

Thank you Ángel.

To finish, please move to slide 33 for final conclusions.

2016 was a year of strong execution and growth for Telefónica, one in which our FCF has accelerated.

In the fourth quarter we delivered a promising earnings momentum, while also being strong on infrastructure via our NGN networks, and we have de-risked our balance sheet.

We enter 2017 with confidence, based on further growth, consistent organic deleverage and sustainable shareholder remuneration.

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

Q&A session

Mathieu Robilliard - *Barclays*

First, I had a question with regards to your revenue guidance which you guide for flat for 2017, and I wanted to understand a little bit better what were the drivers.

So I understand that there is a negative impact from regulation, but in 2016, you did deliver 2.6%, which is much higher than 0% plus 1.2 p.p. And I wanted to understand, therefore, where you think there could be a deterioration sequentially, because when I look at Spain, it looks to be in a good position, certainly in Q4. And also, Latin America, it was a nice rebound in Q4.

So maybe not sustainable, but basically I wanted to understand why you're just going for flat in 2017 despite all these positives.

And then second, in Spain, you have a big restructuring charge. Could you maybe elaborate a little bit in terms of the cost savings you expect from this restructuring exercise?

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

In terms of the revenue guidance for this year, for 2017, we are including, as you were mentioning, some significant regulatory impacts, as some of our units have already shared with the market. Both Brazil and Germany, but mainly Germany will have a significant impact in terms of the roaming and termination rates, and that's also affecting other units in our perimeter.

On top of that, we'll have some trends contributing to soften the revenue trends, namely wholesale in some markets. But overall, we do see mobile service revenues net of regulation, and namely in both residential, the B2C, and B2B segments with a strong momentum.

So, it's a mix of effects and the overall of those effects, namely including these trends of regulation, are calling us to guide on those stable revenues.

In the case of the impacts of the restructuring of Spain, and basically, I would refer also to margins in Spain. I think that you should take into consideration several facts. First, the redundancy program has been extended to 2018, that has forced us to include another provision. It's affecting overall 7,000 volunteer employees. The direct cost savings will be at a run rate of 370 million euros in 2017, and the extension will allow us to have another 100 million going on. So far, leaves have been close to 4,000 people. OpEx savings in 2016 have been 207 million and cash flow payments in 2016 have been 156 million.

So, those are the numbers that we can share in terms of the voluntary suspension plan, and allow me to highlight, as well, that there are other cost initiatives in Spain that are allowing us to significantly control margins. I would include the network simplification, the central office closure or the retail distribution simplification as well.

So overall, including the labor force effort that we are doing in Spain, and in spite of a significantly higher impact of content cost, we have been able to perform robustly in terms of OIBDA in Spain. And that means that we are continuously pushing for efficiency in all fronts and that we feel that we can control the impact of a higher content cost.

Mathieu Robilliard - *Barclays*

If I may just follow up on the revenue question, is there , can you give us a sense of where you see Spain revenues moving to that guidance in the sense that do you expect the improvements to continue in 2017? Or your guidance implies that it doesn't move much from where it is now.

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

Well, regarding the Spanish performance, I would like to highlight that again the improved trends that have been showed in 2016 with service revenues growing, OIBDA growing and operating cash flow growing, despite record high CapEx levels. The focus now is on accelerating operating cash flow.

Going back to 2015, most of the questions were about revenue trends and the stability of revenues. Three years later, we can say that revenue trends are solid and we have small ups and downs in quarters affected by year-on-year comparisons because of the calendar of promos, the anniversaries of tariffs repositioning, or other seasonal factors. But with all this, revenue trends are solid and outperforming other European markets.

In 2016, the questions were mostly about our ability to maintain margins in a context of increasing cost, and we have been able to do that and even improve margins.

In 2017, we will focus on all those trends and on top of that to accelerate operating cash flow. So as you know we don't guide on specific guidance per business, but I hope that I give some light to your questions.

Mandeep Singh – *Redburn*

I had a couple of questions, please. One was on the balance sheet.

Can you just give us a little bit more disclosure on the total liabilities, including hybrids and mandatory convertibles, plus also workforce commitments, just to give a better picture of the total indebtedness?

And I notice that you gave some greater disclosure this particular quarter on net derivatives position. Could you just give us a little bit of colour on why you've done that? I don't see it being disclosed before, and it was a EUR3.4 billion positive.

The second question is on the free cash flow. Towards the very end of the presentation, you said free cash flow should grow in 2017. Maybe you could just give us a little bit more colour on some of the moving parts. Whilst I notice that the working capital contribution was significantly lower you say year-over-year, it's still a very important contributor towards your free cash flow; about EUR1.5 billion of your EUR4.3 billion cash flow is working capital. Do you expect to be able to continue working capital to contribute that order of magnitude towards your free cash flow over the medium term? How sustainable is that positive working capital?

Ángel Vilá – *Chief Strategy and Finance Officer*

Net financial debt at the end of 2016 amounts to EUR48.6 billion. This will be reduced inorganically during 2017, at least, with the announced Telxius transaction; and arithmetically, it will be reduced with excess free cash flow over the dividend and over the early retirement payments.

Hybrids, you were asking, we have an outstanding amount of hybrids of EUR6.5 billion, including USD 0.5 billion in Colombia.

Regarding the mandatory convertible, it's EUR1.5 billion. This expires on 25th September of this year. It will be obviously settled in shares, around 3% of outstanding capital, and bear in mind that we have in treasury shares 2.8% already. So, this is not part of our debt.

The payments corresponding to early retirement programmes -these increase debt as they get paid- in the year 2016 have amounted to EUR 738 million. For 2017, we're estimating around EUR 760 million; 2018, EUR 730 million; 2019, EUR 720 million and in 2020, it would go lower to around EUR660 million.

When you aim to do your projections on free cash flow for 2017; first, as per our guidance, with stable revenues and growing OIBDA margin by 1 percentage point, CapEx over revenues 1 percentage point down from 17% to 16%, this translates to operating cash flow growth. Other elements into the free cash flow estimation would be spectrum payments. These have amounted to EUR 345 million in 2016. In 2017, especially if there is a UK auction, this figure would be higher.

Working capital positive contribution in 2016 has been EUR 383 million positive, much lower than what it was in 2015. For 2017, we expect it to be positive as well but lower than 2016, so lower than the EUR 383 million we had this year.

On financial payments, we are aiming to financial cost below 4% and you should expect payments to decline, both on reduction of cost and reduction of the net debt figure.

On taxes, we expect to have a cash tax lower than 20% for 2017. And dividend leakage to minorities would be similar to what we had this year, maybe slightly higher.

So if you do the math, and we don't guide on free cash flow, you can conclude that we will see free cash flow growth, although we expect, especially if there is a UK auction, that the spectrum figure would be higher.

Giovanni Montalti – *UBS*

If I may, just as a very quick follow up on the guidance. The revenue, I guess now you're talking of service revenues flat in 2017. Is it correct, or you are still talking of total revenues?

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

We are talking about total revenues on the guidance.

Giovanni Montalti - *UBS*

Okay. So I guess on service revenues, we should expect a slightly, let's say, stronger trend compared to the total revenues. Is it a correct assumption?

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

We don't open that on the guidance level, so I am afraid I cannot comment on that.

Keval Khiroya – *Deutsche Bank*

I've got two questions, please, both of which are related to LatAm.

Firstly, Argentina was obviously very strong this quarter. Can you talk around the sustainability of that into 2017? And how do you feel around the change in the Nextel asset in terms of ownership, and also spectrum position?

And then secondly, when we look at some of the other LatAm markets, namely Chile, Peru, and Colombia, as you highlighted, some of the EBITDA trends do remain still quite weak there. Do you see any signs of improvement at all in the competitive backdrop, or should we still expect the OIBDA trends to be quite weak in 2017 in those markets?

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

Overall in Argentina, what we see is a healthier competitive environment. We have been having tariff updates from mostly all operators on the mobile side. We have been having positive net additions in contract. We are having as we speak better recharges trend in prepay.

Overall, we see better consumption patterns, and those tariff updates have allowed us to have ARPU growth year-on-year. And on the fixed side, we are basically upselling the customers at higher speeds and, therefore, been able to introduce this 'More 4 More' strategy.

We have been having a very strong acceleration year-on-year in revenues, more than 30%, and even handset sales has been up as well. And that has allowed us, with the tariff update that we have been able to carry out finally in Argentina, to have a significant impact in terms of OIBDA. OpEx is up 15% because inflation is still high, but also on that side the trend is improving because the comps are becoming easier and inflation is heading down. So, as a result of all of that, OIBDA has almost doubled year-on-year; and OBIDA margin has improved 11.5 percentage points.

So we see a better outlook for Argentina, macro economically and also from a market standpoint, and we think that those trends should be sustainable. So overall in Argentina, we are much more confident.

In terms of other markets you were mentioning, for example, Peru. In Peru, we are facing a very tough competitive environment, namely, in mobile. Our contract accesses have been down 1% year- on-year. It is true that we have been having in this quarter positive portability numbers for the first time in the year, and that we are moving our customer base towards more value-added services like LTE, and so on. So, on the mobile side, it's a very tough competitive environment, both in the high end of the market, with one competitor, namely Entel, and with the low-end with another one, Bitel. So we need to focus on Peru in order to improve the overall Hispanoamerica metrics.

We are much more confident on Colombia; and, in fact, we feel stronger because we have better mobile trends in Colombia. So,the effort that we have been doing in Colombia in the last year is starting to pay off.

And also, we see some slightly better trends in Chile, where our operation there is performing better. So overall, we think we are heading for another year of strong growth in HispAm as a whole.

Lastly, Mexico. In Mexico, the trends were very worrying in the first three quarters. We've seen some better signs in the last quarter, and mainly in the first two months of the year. It looks like some of the, I would say, not very rational pricing points are starting to become more rational, and that's having already an impact in the fourth quarter, and it's already having an impact in this first quarter.

So overall, if you ask me in terms of the ranking priorities, I would say Peru should be the first priority to focus; Mexico as well. And then the others are getting better. Overall, we expect a better performance.

And in terms of the spectrum in Argentina, you know that we have some disagreements with the government in terms of the spectrum being refarmed of the requalification for one of our competitors; as well as about the allocation of the spectrum that we bought months ago, quarters ago of the 700 MHz that we need to have as soon as possible. So, we are addressing those issues with the Argentinean government, and we hope we can reach an understanding with them. But as you said, we are not in agreement with those conditions of assuring these kinds of entry levels for a fourth competitor in Argentina.

Georgios Ierodiaconou – *Citi*

My first question is around the net debt and the financial cost. Obviously, we had some of the LatAm currencies appreciated quite materially in recent months. Are you at all tempted perhaps, to shift some of the weight of your leverage away from Euro and spread it more evenly across the different currencies you are exposed to with your asset? And how should we think about the financial expenses if that's the case? I think you mentioned in answer to the first question you expect the financial cost to come down, so I'm wondering if that will come down in spite of raising some debt in LatAm.

And linked to that, actually, if you could comment at all on COLTEL’s financial position and any thoughts of recapitalizing there; whether you could save some financial expenses from doing that.

And then my second question is just on the Business trends in Spain. It's been very volatile during 2016; weak in Q1, better in Q2, worse in Q3, much better in Q4. So, is it possible to give us any indications of what we should expect in 2017?

Ángel Vilá – *Chief Strategy and Finance Officer*

On the financial cost, as you can see on slide 32, we have reduced 102 basis points in 2016. We're already below 4%. Our guidance for Group-wide cost is for 2017 to be below 4%. And all the financial expense and financial payments should decline, not only because of cost reduction, but also due to debt reduction.

In the mix of debt according to currencies, we have a benchmark of 2 times net debt to OIBDA in our European operations. Basically, this would apply to GBP in the UK. And then, 1 time net debt to OIBDA in our LatAm portfolio. And we take a portfolio approach to this because depending on the depth of the markets -of different currencies and different countries- we don't want to be exposed to the volatilities and limits on certain markets. So, we take a portfolio approach; when we look at units like Brazil, Mexico and Colombia, we have more than the benchmark debt in Colombia, that you were asking about, and we have a bit less in Brazil. We are taking a dynamic approach at the position we have of debt in each one of these currencies, taking into account the FX evolution, but also the evolution of interest rates. And Brazil is improving in this sense, we have recently issued some debentures in Brazil and we may do some additional refinancing.

All in all, again, below 4% and declining on the interest cost.

With respect to Colombia, as José María was saying before, it's a very attractive market. The economy, the telco market and our operation which is, as you have seen in our results, performing nicely and has a strong potential. And we are in talks with our partner, the Colombian Government, to implement the best way to finance and strengthen the balance sheet of the Company. These conversations are under way, and when there is a result on those conversations, we would inform accordingly.

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

Taking your question on the Spanish outlook in terms of revenues, again, we do not provide guidance for business lines. I have already commented that we expect 2017 to be a year in which operating cash flow will accelerate. But in order to try to give you more color on expected trend, I can reiterate that we are not expecting big changes in trends versus 2016.

Consumer and Business revenues are expected to perform similarly to what they did in 2016. There might be small ups and downs in terms of specific quarters that might be affected by the basis of comparison, seasonality or others, as we had in 2016. But again, in general terms, in Consumer and Business, improving trends.

In the Others line, which includes mainly wholesale, as you saw already in the Q4 numbers, it is affected by different factors that are dragging the growth in the business, such as lower Pay TV wholesale revenues, regulation, termination, the lower base of ULL accesses, indirect access, and lower revenues from MVNOs. Most of these factors we foresee them to continue in 2017.

Having said this, we remind that some of those factors, wholesale TV or interconnection, do not impact OIBDA, and that's why we are confident and so focused on operating free cash flow for the Spanish business in 2017.

Akhil Dattani - *JPMorgan - Analyst*

So firstly, just on the Spanish pricing environment, I just wondered if you could share some thoughts around the price changes that you've put through year to date, both on the Fusión side and the postpaid side, and I guess specifically, just keen to understand how you think those scale of price changes compare to last year.

And secondly, just in terms of the strategy around that pricing, for example, I see that, if I've understood correctly, you're not putting those price changes through on the back book; it's just on the front book. The way in which you've scaled up data allowances, I think that has also changed.

So, just to really understand your thought process and also how you see your competitive environment in terms of how operators are reacting.

And then the second point, I guess, just following up on a number of the prior questions around the guidance. You've talked about operating leverage and that being a driver of OIBDA and operating cash flow growth. But obviously, in the mix, the revenue guidance is for stable. So, just wondered if you could maybe just clarify a little further around the margins; maybe call out a couple of markets specifically in terms of where you're seeing the upside. And I guess particularly keen on any thoughts around Spain.

José María Álvarez-Pallete López - *Telefonica SA - Chairman & CEO*

In terms of the overall environment in Spain, we foresee a rational market, basically. So, what we are trying to do as the leader of the market is trying to upsell our customer; trying to make sure that the new attributes of the network, like speed or capacity, or the new features like content or technical features on the video platform, we are able to capitalize on them, and our customers are able to appreciate and value those new attributes. And this is namely as well for the whole of the market.

It's precisely because of that that the first number that I would like to stress is the ARPU of Fusión. It has been up significantly over the year. And if you ask me which part of this increasing ARPU is coming from tariff upgrades and which part is coming from upselling customers, customers that have been invited through a promo to enjoy those new attributes and after the promo stays, I would say that roughly 60% is coming in 2016 from tariff upgrades and 40% is coming from upselling our customer base. So that explains why we are running some promos in which we incentivate the customer base that we already have, and also the new customers to enjoy the new features.

Out of the promos, I can share with you that roughly 58% of the customers that have been coming to the new promos were new customers, so they are also helping us to increase the customer base.
So overall, I think that you should expect from the Spanish market first to stay rational, and second to move into this upselling of customers and improving the overall ARPU.

As a summary for 2016, Fusión revenue is up 18% year-on-year, and one third of that is increase in subscriber base, and two-thirds of that is the ARPU increase of 12% year-on-year. So, increased penetration of TV is the next move. Increased penetration of fiber, we keep expanding fiber; increased data usage; increased number of mobile lines per Fusión line; so, those are the features that we are using to drive our revenues in Spain. So, I think that you should expect this market to keep going into that direction. We might be having new features during 2017 that should allow us to keep going into the same direction. So overall, on the B2C business in Spain, the trend is accelerating and we think it's sustainable.

And in terms of the guidance, we don't guide by geographies, but as I have been sharing with you, I think that we will have some significant revenue impact through regulation, namely in Germany, and some of the Latin American territories, some wholesale effects in Spain as we have mentioned.
So that's why we are, and it is hard for us to have a reading of the handset revenues going forward, so that's why we are guiding for stable revenues.

And in terms of the margin, the overall guidance in margin, the simplification efforts are going as we speak all across the board, the digitalization of the business that we have tried to describe during the presentation in terms of basically running a full IP network and switching off legacies and switching off IP platform and, in the case of Spain, we are starting to switch off central switches as well.

And the synergy case in Brazil and Germany; the German case has just been upgraded; the Brazilian synergy case has been upgraded three times. So we are pretty confident that we can keep building on efficiency all over 2017 in all geographies.

Joshua Mills – *Goldman Sachs*

If you just follow-up on the B2B question earlier, actually. So, in your report, you're highlighting that the communications revenue, to which I presume a higher margin, saw a lesser decline this quarter vs. last quarter. Could you give some color on what that is as an absolute figure? Is it a mid-single-digit decline you're seeing on the legacy B2B revenues, or less than that?

And then secondly, just if you can talk a bit about inorganic de-levering opportunities? As in how many towers do you think there are potentially that could still be sold to Telxius? And is there any opportunity to potentially sell assets in LatAm? Are there willing buyers there for some of these assets? Thank you.

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

Taking the one on the B2B trend, it is true that comms are under pressure and, in fact, they are going down like 3%. Basically we expect low single-digit decline going forward. But what we are doing is bundling our comms services in our offers with IT. And IT is growing 10% year-on-year in Q4 and will keep growing. So, what we are trying to do is digitalizing our offers as well. And, at the same time that we foresee a decline in comps, we are having a very strong boost in terms of IT revenues.

And in terms of the margin impact, we are trying to control that by using value-added services on top of IT; like security, cloud, Internet of Things or others that are all growing double-digit. So, those are the trends that I can share with you on the B2B business so far.

Ángel Vilá - *Chief Strategy & Financial Officer*

Regarding your second question, we are very focused on organic cash flow generation, organic deleverage. You saw that our Free Cash Flow is EUR 0.86, above our dividend of EUR 0.40 per share. So, you should expect as we stated in previous quarter and we reiterate now, to continue delivering on organic basis. And we are very committed to maintain a solid investment grade credit rating. You also saw that M&A can play a role in all these efforts. We just announced the Telxius transaction. And M&A, if conditions are right, if it creates value and makes strategic sense, will also play a role in our efforts. But we would rather not discuss specific situations.

Julio Arciniegas – *RBC*

So my question is regarding the competitive environment in Spain. I see that for example, Orange they continue to be very aggressive in the low-end of the market with Jazztel brand. And Vodafone has claimed that they are going to become more active with their low-end brands. Do you see that this is a dynamics that might drag this good momentum of pricing in Spain? That's my first question.

And the second question, you mentioned FTT homes passed in Hispanoamerica; there were an extra 5 million homes. Can you give me some color of which countries did the Company invest in?

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

Overall, in Spain, environment is still rational and, I would say, very focused on upselling customers. Again, all competitors are going on to this 'More 4 More' strategy, and it is true that some of them are making promos, but they are becoming also more rational.

To give you some color; Orange increased convergent prices from 2 to 5 EUR just in February, Jazztel increased EUR 1.65 the fixed-line fee, or Vodafone capitalizing football contents or starting to charge for some services, and even Masmovil is removing some discounts. I can give you a lot of examples in which we think that all competitors are willing to capitalize both technological features of the network, like speed or capacity or content or services. It has taken us a while, all of us in Spain, all the players in Spain, to invest and to transform Spain into the most advanced European market in terms of ultra-broadband. Heavy investment has been made in terms of fiber deployment and LTE coverage. And I think that educating the customers on this 'More 4 More' thing and the customers being able to value speed capacity and value-added services is essential. So, we might have some ups and downs in promos, but I think that those are all promos focused to upsell customers. And again, our reading is that the market is rational and is likely to stay rational in Spain.

And in terms of your question around the fiber deployment in Hispanoamerica. Apart from Brazil, that has already more than 17 million premises passed with fiber and more than 4 million of connected houses, Peru is increasing and we are basically upgrading our cable network. And all across the board, in terms of Chile, Colombia, we are also growing. We are waiting in Argentina. We are not deploying in Argentina because you know that we have been refrained from competing. We have not been able to give 4-play offers in Argentina until next year. So, until we have a clear regulation in front of us, that allows us to have a more accurate calculation of returns on the investment, we will be refraining. So, basically the number is going up in Peru, Chile and Colombia, and stable in Argentina.

Justin Funnell– *Credit Suisse*

Just another follow-up question on the revenue guidance, please. I guess Brazil is still something we're slightly in the dark on. The Company didn't provide an awful lot of guidance on its revenue outlook. Your business is growing about 2% at the moment; regulatory effects of 1% going into this year. So there's a 1% underlying slowdown you're implying. Is Brazil part of that trend as well? Are we expecting Brazil to slow down?

And then secondly, when you look back at the UK and Germany, obviously, they're performing reasonably well, but seem to be trailing a bit on network on some measures. Vodafone seems to be pushing harder in the UK, but is there a concern O2 is falling behind a bit? And have you thought about a project spring type of strategy for the UK and Germany now that you've hit peak CapEx in Spain?

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

In fact, in Brazil, we feel pretty strong and pretty solid in our performance in 2016, and we think that we will keep going into that direction. So, we do not expect major weakness in Brazil revenues in 2017. We have the best network, the best distribution network and the best brand. We have been able to grab 100% of the growth of the market in 2016, and we have no indication that our positioning is weakening. And in fact, we are also accelerating in LTE coverage, so you should not read out of the guidance any weakness in Brazil.

Again, I am stressing that we are just including the impact of the regulatory effects, mainly in Germany and also in the UK because of the roaming regulation in Europe and termination rates in other countries. But overall, underlying trends, we feel pretty confident.

So, please do not read any weakness in Brazil through the guidance. In fact, in Brazil, we expect double-digit growth, for example, in mobile data, and digital and fixed ultra broadband revenues. So, we do not foresee any major change in trends in Brazil.

In terms of the UK, we have the lowest churn of the industry and the best quality network perception. So, our target for 2017 in the UK is the spectrum auction, making sure that we have the right share of the spectrum. And we are actively participating in the consultation period with Ofcom and government officials, and we have a clear view what should be the framework of that spectrum auction.

So, if you ask me our priority in the UK for 2017, it's making sure that we have the same trends in terms of customer quality, the lowest churn levels of the industry, and making sure that the spectrum auction is structured in a way that is fair for UK PLC. So, we do not feel the need of accelerating; and, in fact, we have the network sharing with Vodafone, which is in good shape, that contract is in place. So, we do not expect any major change in network investments in the UK, apart from the spectrum.

And in Germany, on networks our strategy has not changed. We think, and as Markus was sharing with the market yesterday, that we have all the ingredients to achieve the best customer experience in urban and suburban areas. We have the best spectrum and we have the most dense network. And I think that the integration effort that has been carried out in 2016 and the effort that we are doing in 2017 is not just allowing us to have greater synergy case, but it's also allowing us to have or to build the best mobile network in Germany in urban and suburban areas. So, we are not lagging behind and we think that we can achieve the best network in the next two years.

Fernando Cordero - *Santander*

Also related with the Spanish market, and particularly with the mobile-only business, although I recognize that the vast majority of your retail business is only converging, but discussing on the recent offer update, where you are increasing data allowances while maintaining the prices. I would like to know what is your view at what extent that limits the future mobile data growth monetization. And also to get a clear view on the dynamics of these kind of offers.

And looking into the costs, at which extent these efforts of simplification and the digitalization of the business are being translated into the cost, or the unitary cost per giga or per unit of data related with mobile business. Also trying to understand if these new offers, even maintaining prices, are margin accretive or not.

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

The revamped portfolio that we have done in mobile has two tranches, I would say. It has a first tranche in which we've 'More 4 More' in the low-end, so we are trying to raise the value per giga at the entry level and more on the same in mid and high. So, it has been structured in two tranches. And in fact, it had a very good performance in Q4.

As we are expanding our LTE coverage, and we have now 96% geographical coverage under competitors' criteria, and we have more than 6 million LTE customers in Spain, and more than 81% is smartphone penetration, we are able to capitalize this investment effort through those tariffs. But again, keep in mind that we are trying to do several things at the same time: upgrading the offer by giving 'More 4 More', and trying to give the perception for the customer that the speed and quality are attributes that should be valued.

We have been increasing our entry level by two years, and at the mid and high, we have been giving basically "more for the same amount of money".

As a result of all of that, we have been having record highs in contract mobile net adds, and we are having more loyalty, which again sticking to the fact that your calculation should include the churn effect of those offers and not just the extra giga that we are giving to those extra layers of customers.

Overall, the numbers that we are running allow us to say that we are able to capitalize the investment effort that we are doing in network, but again, read through the promotions or through these offer upgrades, the two tranches, and read the churn target that we are pursuing.