Telefónica January-March 2017 Results Conference Call Transcript

11th May 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-March 2017 results. I am Pablo Eguirón, Head of Investor Relations.

Before proceeding, let me mention that financial information contained in this document related to the first quarter of 2017 has been prepared under international financial reporting standards, as adopted by the European Union. This financial information is unaudited.

This conference-call webcast (including the Q&A session) may contain forward-looking statements and information relating to the Telefónica Group or otherwise. These Statements may include financial or operating forecasts and estimates based on assumptions or statements regarding plans, objectives and expectations that make reference to different matters, such as the customer base and its evolution, growth of the different business lines and of the global business, market share, possible acquisitions, divestitures or other transactions, Company results and other aspects related to the activity and situation of the Company. All forward-looking statements, in involve risks, uncertainties and contingencies, many of which are beyond the Company's control and all of which may cause actual results, plans, objectives or expectations to differ materially from those expressed or implied herein.

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*

Sustainable business model; differential quality

Thank you Pablo. Good morning and welcome to Telefónica's first quarter 2017 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.

I'd like to begin this presentation by highlighting the continued execution of our strategic goals:

First, business sustainability is reflected in the solid growth delivered both in reported and organic terms, namely OpCF, which accelerated across the board. Also, our focus on capturing high quality accesses and the encouraging response from "More4More" tariffs across markets is the basis for the expansion in customer life time value. Moreover, headlines in euros benefited from FX effect and earning per share grew very robustly by 49%.

Secondly, our transformation process results are visible in terms of cost reductions and synergies. In addition, with the introduction of Aura we are adding a new type of relationship with our customers based on cognitive intelligence.

And finally, we are strengthening our balance sheet, through extending average debt life with financing at historical low rates and reducing leverage with our growing free cash flow generation and including the sale of the announced Telxius stake.

Q1 performance fully consistent with FY outlook

As shown on slide 3, we are on track to meet 2017 guidance as our Q1 figures are in line with expectations.

With regards to shareholder remuneration, the second tranche of 2016 dividend, 0.2 euros per share in cash, will be paid on the 16th of June. And for 2017 we confirm the 0.4 euros per share in cash, with the first tranche to be paid on the 14th of December and the second one in June 2018.

These two factors, and the organic deleverage through growing free cash flow will allow us to maintain a solid investment grade rating.

Financials in a nutshell

To review Telefónica key financials, please turn to slide number 4.

Consolidated revenues topped 13.1Bn€, up 5% nominally or 1.5% organically year-on-year. Underlying OIBDA grew 6.5% to just above 4.1Bn€, while margin remained flat at 30.6%. Operating Cash Flow accelerated reported growth to 12.1%, 8.9% in organic terms.

Please note the positive contribution of forex for the first time since Q1 15, adding between 4 and 5 percentage points to Revenues and OIBDA performances, respectively.

Reported growth accelerating at net income level

Moving to slide 5.

Growth ramped-up from top to bottom thanks to our management of non-operating results. As such, January to March net income reached almost 800m, up 42% on last year's figure, while reported earnings per share were up 49%.

Underlying EPS reached 0.18 euros per share.

Accelerating free cash flow generation in Q1

On slide 6, free cash flow generation reached almost 600 million euros, 530 million euros higher than in January-March 2016. As shown in the graph on the top right of the slide, operating cash flow growth explained 50% of the increase, while the working capital improvement and savings in financial payments and others more than compensated the higher cash taxes.

This cash generation is reflected in the lower net debt increase compared with the last two years that traditionally occurred during the first quarter of the year.

Let me mention that Q1 is traditionally impacted by seasonal impacts, so for the rest of the year we expect FCF to improve.

Significant recovery in reported trends

Please move to slide number 7.

In the first quarter of the year we have noted a significant recovery in reported trends in revenues, returning to growth. In underlying OIBDA, we have accelerated the year-on-year variation by 0.5 percentage points and in OpCF a stellar 11.2 percentage points.

Organic performance and FX driving growth

Please turn to slide number 8 to see the different moving pieces affecting OIBDA evolution, above all the marked change in FX contribution, which this year added €191m and last year detracted €553m.

So, the currency impact is clearly fueling growth this quarter, contributing 5.0 percentage points to the OIBDA increase, mainly coming from the Brazilian real. Looking to the next quarter and taking into account current rates, FX will continue to be a tailwind in Q2.

However, it's important to remember the positive organic delivery in markets such as Brazil, Argentina, Germany and UK.

Steady organic growth of Revenues & OIBDA

Moving to slide 9, quality of revenues is delivered again this quarter with growth of 1.7% of service revenues in organic terms, 26 basis points higher than total revenues and despite the negative effect of 110 basis points from regulation.

By region, Hispanoamérica continued to be the main growth driver and by services, broadband and Services beyond connectivity.

Global efficiencies and merger synergies drove the Group organic OIBDA growth. Margin was stable vs. January-March 2016 reflecting expansion in Brazil and Germany, stability in Spain and erosion in UK and Hispam.

Boosting OpCF growth; high cash conversion

On slide number 10, you can see the high cash conversion achieved, led by strengthened operating leverage and lower CapEx intensity.

Absolute OpCF level reached almost 2.5Bn€ and posted a very solid organic growth of 9%, balancing more than 20% in Hispam and Brazil, respectively, with high single digit in Spain and Germany and a decline in UK. I'd like to highlight the sequential acceleration in the year-on-year trends in all segments.

Enhanced network and offer fostering data growth

Slide 11 shows the visible results of data monetisation.

LTE customer base increased 72% vs. Mar-16 and data usage by 58% driving an ARPU uplift of around 11%.

In Latam, increasing prepaid smartphone penetration up to 45% and the successful implementation of recurrent data plans continue to boost data prepay ARPU, delivering a 20% uplift in Q1.

As a consequence, mobile data revenues grew 13.5% year-on-year, representing 58% of mobile service revenues.

On the other hand, data volumes continued to post high growth rates in both fixed and mobile networks, showing a huge monetisation potential.

A new wave of data monetisation opportunities

On slide 12, you have our view on the promising growth expected from data monetisation.

In the speed & capacity wave, we are successfully capturing growth thanks to the differential networks we have, with fiber price premium vs DSL and higher ARPU uplift from LTE across the Group as leading examples.

This ARPU uplift then continues by adding Services Beyond Connectivity, with TV being a clear driver. There are several initiatives to exploit this second wave across our markets.

And finally, we are starting to work on what we see as the third wave, cognitive intelligence, which will further optimise customer experience, enhance operational efficiency and open us up to new optionality.

In this context, we have new opportunities to expand our strategy reflected in the higher value and loyalty of our customers.

Digital Services: Distinctive model

In Digital Services, on page 13, we continue to implement a distinctive approach.

On the one hand, in Video, the best premium content across our geographies continues to drive revenue growth.

In addition, the recent contracts signed in Q1 for the international distribution of some of our original productions, proves their high quality and our ambition to reach a wide audience, as well as providing a new way to monetise our investment.

On the other hand, in adjacent services, we have once again strengthened our partnerships with key players in Security, reinforced our Cloud offering for SMEs and begun to rollout several flagship M2M projects.

TGR: UBB deployment and E2E Digitalisation

In Telefónica Global Resources, we continued to work towards offering excellent connectivity leveraged on our enhanced network, our main differential asset. In fact, our fiber and cable coverage of 40 million premises passed, is one of the largest UBB networks worldwide, while our LTE coverage has reached 64% on average across our footprint.

In parallel, we remain committed to the evolution of our network and the digitalisation of our processes and systems, leading to innovation, increased efficiencies and agility, thus improving customer experience.

Telxius: Solid performance

On slide 15 we show the solid performance of Telxius, with strong revenue growth, up 5.4% year-on-year, and OIBDA margin reaching 48.9%.

With nearly 16,000 telecommunications towers in five countries and a leading network of fiber optic cables that is being extended with the deployment of two new cables, Telxius is in an excellent position to capture the exponential growth in data traffic foreseen for the coming years.

Now, I hand over to Ángel.

Ángel Vilá - *Chief Strategy and Finance Officer*

Spain: Trading skewed to high value

Thank you José María, let's move to slide 16.

Q1 trading in Spain shows positive results tending towards high value as the mix of "Fusión" subscribers continues to improve: 21% of the customer base is already in high-value packages (Fusión+2 or above), 5 percentage points more than in December.

It is also worth highlighting that the mobile base shows a robust positive growth of 5% and TV performance improved.

These constructive dynamics prove a successful "More4More" strategy based on smart bundling combined with leading coverage and content.

As such, Fusión ARPU remained stable quarter-on-quarter at 82 euros, and its pace of growth was 4.4% year-on-year due to the different timing of tariff upgrades and promotions.

Spain: Zoom on revenue evolution

On slide 17, we include a zoom on the main drivers behind service revenue performance in Spain.

The decline in Q1 year-on-year amounts to 46 million euros. It is mainly explained by lower wholesale revenues, which declined 7.1% year-on-year (or 35 million euros) impacted by lower football and a gradual loss of MVNO contracts; both factors were already well flagged in the past.

In addition, Consumer revenues paused their year-on-year growth this quarter because of a slower pace of improvement of "Fusión" revenues. The reason behind this is the different phasing of tariff upgrades applied to the bulk of the "Fusión" base (Feb-16 vs. Apr-17).

Therefore, note that service revenue trend should rebalance from Q2 based on a more comparable tariff calendar; and again from Q3 once the wholesale football revenue impact has passed.

In addition, I would like to highlight that the low levels of wholesale fibre penetration suggest a relevant upside in the wholesale business in the medium term.

Spain: Accelerating operating cash flow growth

Turning to slide 18.

Telefónica España starts the year delivering strong profitability and cash conversion; with both quarterly organic OIBDA and OpCF margins expanding year-on-year to 40% and 29%, respectively.

The consistent capture of efficiency gains along with a material lower capital intensity, leads to an impressive 8.3% growth in operating cash flow generation, despite a temporary tougher comparison of service revenues in Q1 as we explained before.

Germany: Executing on synergies; improving quality

Telefónica Deutschland, on slide number 19, maintained solid operational momentum in a dynamic environment focusing on stimulating data usage, while price pressure in non-premium showed further signs of easing.

Strong growth in LTE customer base, usage and data traffic continued, with our unique positioning of O2 Free allowing to multiply data usage by 1.5 times vs. prior tariff portfolio.

On financials, Mobile Service Revenue trend continued its sequential improvement, when excluding regulatory effects. OIBDA posted a steady growth in Q1 with further margin expansion, balancing successful synergy capture, approx. €35m of incremental savings, compensating commercial efforts.

Finally, it is worth to highlight the OpCF increase of 7.7% vs. Q1 16.

UK: customer brand of choice

Turning to slide 20,

The UK business shows growth in value accesses while at the same time customers continue to move towards higher tariffs leading to greater data consumption and LTE penetration.

As such, total revenues grew 2.1% year-on-year, reflecting higher average subscriptions and out-of-bundle spend, growing MVNO contribution and an increase in value customer base.

This revenue performance coupled with ongoing costs efficiencies drove OIBDA up 0.6%. On the other hand, Operating Cash Flow fell 21% due to a 31% increase in CapEx as we accelerate towards completing our LTE rollout.

Brazil: Growing & expanding margins; OpCF +21.6%

Moving to slide 21, our performance in Brazil shows we continue steadily growing and expanding profitability.

High-value commercial activity is driving both solid accesses growth and sustained ARPU increase.

Service revenues grew 2.1% year-on year, with mobile service revenues up 5.1%. This performance and the reduction in OpEx on the successful execution of synergies, drove the OIBDA and OpCF increase, up by 7.5% and 21.6% respectively.

Currency evolution is very positive this quarter and growth in reported figures is 30 percentage points higher than in organic terms.

HispAm: Focus on quality growth

In Hispanoamérica, moving to slide 22, we continued to focus on quality growth. As such, mobile contract accesses growth and increased penetration of smartphones and LTE translated into double-digit mobile ARPU increase.

At the same time, fixed accesses with fibre and cable connections grew by 53% year-on-year enabling further uptake of higher quality fixed broadband and Pay TV services with higher ARPU for both services.

HispAm: Solid revenues, OIBDA and OpCF growth

Turning to slide 23, we show how these commercial trends are driving solid revenue and OIBDA growth, up by more than 9% and 6% respectively, and, how our OpCF is growing by 23.6%.

This widespread growth is mainly driven by countries like Argentina, where tariff upgrades & growing volumes underpinned an outstanding performance, or Colombia, where our solid commercial activity is consistently delivering positive results.

On the other hand, in countries like Mexico and Perú, intense competition continues to drive negative year-on-year changes. However, we saw some signs of improvement, with ARPU trends stabilizing or even improving in both countries.

Leverage reduced on better operating performance

Let me now turn to the financial metrics starting on slide 24.

We continued to reduce our Net Debt/OIBDA ratio down to 2.91x as of March 2017, mainly explained by healthy FCF generation in the quarter. Including the Telxius stake sale, Net Debt/OIBDA ratio declined to 2.84x.

Our cash flow generation reflects improved operational performance despite seasonal impact on working capital. All in all, FCF has been multiplied by 8.7 times compared to first quarter last year.

We expect further deleverage progress throughout 2017 as we continue to deliver across our operations on top of inorganic measures.

Average debt life above 8 years

On slide 25, Telefonica continues reinforcing its balance sheet by issuing close to €7bn year to-date, with an average debt life above 16 years for new debt at an average cost of 3.3%. As a result:

We have extended our average debt life above 2 years in the 3 last months to reach 8.3 years;

We have built a healthier liquidity position, at €24.6bn, which allows us to cover debt maturities for over the next 2 years, and

We have taken advantage of historical low refinancing rates that together with the exposure to short-term interest rates, reduced interest payments cost 128 basis points year-on-year to 3.48%.

I will now hand back to José María to recap.

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

Summary

Thank you Ángel.

To recap.

Today's strong set of results allows us to advance in the execution of our sustainable growth strategy.

As such, our distinctive operating cash flow, growing strongly both on reported and organic bases and fuelled the year-on year-expansion of free cash flow.

Furthermore, we retained a benchmark profitability and our EPS grew very solidly.

Finally, we continued to reinforce our balance sheet and we reiterate all our commitments.

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

Q&A session

Akhil Dattani - *JPMorgan - Analyst*

Just to start with Spanish revenue performance. As you'd already highlighted over the last couple of months, there was an expectation that the comps into Q1 would be tougher given the phasing of price increases. And obviously, you've discussed that on the call so far this morning. You've mentioned that Q2 would improve as price increases kick-in, in Q3 a bit further as the wholesale revenues improve too. But could you maybe help us quantify how we should think about that? Can we think about revenue growth returning back to where you exited at, in terms of service growth at the end of last year, or are there any other factors within that that we need to think about, that might either make it better or worse than that level of performance?

And then, secondly, in staying with Spain, we've seen in the press over the last couple of weeks various comments that you, as a company, may look to launch a low cost brand. I just wondered if you could comment both in terms of the broader competitive environment and in terms of those specific comments, whether that is something you're looking at, and how you think about, I guess, more broadly your KPI momentum in Spain going forward.

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

In the revenues of Spain, let me try to explain a little bit further the evolution on this first quarter. This first quarter is highly conditioned by the wholesale revenues and that should progressively fade away. If you review page 17 on the presentation, you will notice that B2C revenues were basically stable year-on-year in spite of a much tougher comparison, as we have not had "Fusión" offer upgrades this quarter, but we did have them in the first quarter of 2016. Therefore, this should be improving along the year as we have already been putting in place a first upgrade of the offer in April. And remember that B2C accounts for 54% of total revenues.

B2B was also stable. And, as we have been able to compensate declines in communications services with a double-digit increase in IT services, we expect B2B to be broadly stable along the year with some phasing events in some quarters, due to specific contract renewal or signing. And remember that B2B accounts for 28% of total revenues in Spain.

Wholesale revenues were down year-on-year in the quarter mainly due to the lack of football right resale of the "La Liga" right that we owned in 2016 and that we do not own anymore, and therefore, we do not resell it in 2017. And also the Yoigo contract is having some impact. Out of the total wholesale revenues, MVNOs and football represent just 18% of total wholesale revenues while transport, interconnection, roaming and FBB represent 82%. We expect the football rights' effect to be progressively diluted along the year -namely from August onwards- and therefore, progressively, this wholesale revenue impact should be neutralized. In any case, remember that "wholesale & other" revenue accounts for 18% of total service revenue.

As a result of all of that, we foresee a progressive recovery along the year. We do not guide on a specific yield, and certainly we do not guide on a quarter-by-quarter basis. But we do foresee progressive recovery, progressive improvement along the year.

And on your second question, we cannot confirm a second brand launching still. We analyze all alternatives, of course. And we have second brands in some OBs, for example, giffgaff in the UK, or others in Latin America. However, we foresee that we are very strong on the bundle strategy on the mid and high-end, and we think that we should gain some traction on the low-end. And therefore, we are certainly rethinking our strategy on the low-end "Fusión" customer base.

David Wright - *BofAML*

By the end of year, should we be expecting sort of revenue growth back to those 2016 levels in Spain, so for around the full year? Just trying to get a little more comfort there.

And then just secondly, in the UK, that CapEx spend is high again. As you mentioned you are getting towards the end of your LTE rollout, should we start to see CapEx levels come down again in the UK, or is there an effort to continue to improve that network quality, potentially ahead of any kind of IPO or even a minority stake sale?

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

Again, allow me to reiterate that we don't guide on regions. But, having said that, let me make a few reflexions around the Spanish market. The market consolidation of the market and the "More4More" strategy is basically driving into upselling of the different customer bases of the different players.

In this first quarter and the second quarter of this year, we are upgrading again all our services and, therefore, what we can extract out of all that, is that this is a very rational environment. We think we have differential assets. We have the largest fibre network in Europe and the strongest 4G coverage in Spain. And we think we have the best TV proposition as we are focused on value. And therefore, we also think that the fibre wholesale agreement will drive even more rationality into the market. So overall, we think that all the trends that were valid at the end of 2016 are still here, in spite of the fact that we have been having this impact of wholesale revenues in Spain.

And remember again that B2C and B2B accounts for basically more than 80% of the revenues in Spain. And we see solid trends on that part of the business. So we are pretty comfortable with the market environment. We are working in order to improve the current trends. And we think that all the reasons that were behind the market in 2016 are still valid today.

And in terms of CapEx in the UK, we foresee a quite similar CapEx to Sales ratio in the UK in 2017 compared with 2016. We are improving our network significantly and that's why we have decided to accelerate some CapEx deployment in the UK this quarter. We have reshaped our Beacon agreement with Vodafone in order to make it more flexible and both of us to have more agility. So you should expect a similar level of CapEx over Sales ratio in the UK this year compared with the previous year.

Mathieu Robilliard - *Barclays*

My first question is on Spain. Sorry if I come back to that. Just looking at the KPIs, I understand there is some upselling there, but clearly there's been a bit of deterioration in some of the broadband and line loss trends, and I was wondering if we should relate that to some sort of consumer fatigue about the price increases.

So, the question would be, are you comfortable you can continue to do "More4More" initiatives without having a negative impact on KPIs going forward?

My second question has to do with Brazil. Very strong numbers in Brazil published yesterday. We're not seeing a big recovery in top line, but obviously very strong synergies. I was wondering if you're expecting the macro to play a role for the rest of the year and to enable further acceleration. Are the numbers you see in Brazil already benefitting from the easier macro? The question really is, can revenues accelerate in Brazil?

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

In terms of trading in Spain this quarter, first, allow me to mention something that is important for us: our outstanding mobile contract this quarter. We have had record gross adds this quarter and we have improved sequentially the quarter-on-quarter TV performance on a better IPTV. And we have had some solid growth on ultra-broadband.

It is true that we have been having the impact of tariff upgrades and promo calendar. But, overall, if you ask me: which is the most significant indicator around the potential fatigue that you were mentioning, in our customers in Spain? Allow me to say that, in spite of these price upgrades, churn levels remain significantly low. Churn level in mobile is 1.6% in contract; on fixed telephony, it's 1.4%; on fixed broadband, it's 1.6%; on fiber, it's 1.3%; on ultra-broadband fibre, it's 1.2%; and on "Fusión", it's 1.4%.

And allow me to say that those levels of churn which are, I would say, relatively positive compared to the benchmark of the industry and the sector, namely in Europe, we have been having all those indicators at the same time that we have been having an expansion of "Fusión" ARPU of roughly 4%, which is significant in spite of the fact that we have not been having any tariff upgrades in this first quarter. And that means that the "Fusión" composition base, which is the most significant contributor to B2C revenues, has also been improving. We have been able to upsell our customers.

And now, you have that the high-end customers of "Fusión" accounts for 21%, which is 5 p.p. more than in the previous year, and the basic has declined this 5 p.p. with the low-end remaining stable, basically. And that means that we have been able to upsell our customers. In this quarter, ARPU growth, this upselling, has been diluted by the promo effect. But once the promo effect is diluting progressively, you will see that fostering ARPU growth.

So, overall, we think that this rational strategy that we are following in the Spanish market, so far we have been able to execute it at the same time as controlling the churn effects and having significantly low levels of churn.

And in terms of Brazil, the macroeconomic scenario in Brazil is certainly recovering on the back of much more rational economic measures. The market consensus estimate for GDP expansion for this year is 0.4%, but we are already seeing some reports of some macroeconomic analysts showing a 3% to 4% GDP growth in 2018. And this upward trend is started to be perceived in our revenue trends, and namely on commercial activity, and certainly on the bad debt levels.

So, overall, yes, we see macro recovery already being a fact in Brazil. Yes, we do think that that should be translated into a much better customer environment, commercial environment. And as we have the best network in Brazil and we have the best brand and the best distribution network, we feel that we should be able to capture this extra boost coming from the macroeconomic environment.

And finally, allow me to tell you that as the economy improves, we could see a better evaluation on the prepaid segment in Brazil, which is still underperforming year-on-year and also on the B2B business for us. So, we see some further room for improvement in Brazil.

And finally, just to conclude, this macroeconomic recovery, we think it is solid, it is here to stay. We have been the only telecommunications company that has been able to grow, even in the times when the GDP was declining 3%. So, we feel that we are prepared to take advantage of this better macroeconomic environment.

Mandeep Singh – *Redburn*

I want to come back to Spain. I appreciate you don't give specific country or regional annual guidance, but we've had multiple moments in the past where, returning Spain to revenue growth and sustainable 40% margins was a sort of watershed moment. And it's been expressed by management on calls as an ambition, as a sustainable trend. I mean, your message on that appears to be a softer. I mean, how should we think about Spain? Is this a business where revenues will grow sustainably and where 40% margins are sustainable? So if you could just, sort of just, give us a little bit more in terms of what's the ambition around the Spanish business and the sustainability thereof.

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

In terms of revenues, we expect recovery along the year with service revenue progressing toward stabilisation. Handset sales will not follow linear trends, I mean, in general terms they are decreasing.

Consumer trends will continue increasing. We have already executed a tariff upgrade of “Fusión” in April, and the preliminary figures that we have out of April and this first week of May, allow us to say revenue trends are back into the right direction. In terms of SMEs, rising competition is also eroding some part of the trend but as we launched “Fusión” business last year, we have been able to stabilise that part of the business. And in the corporate segment, we are growing double-digit in IT, more than compensating the communication services. As I have mentioned already, wholesale revenues are suffering in the first quarter and will be starting to ease away in the third and fourth quarter.

Overall, again, competitive environment is rational, the "More4More" strategy is sustainable, we have the best network and we think we have the best brand and, therefore, all the trends that we were highlighting in the previous quarters should be here to stay.

Mandeep Singh – *Redburn*

Can I just follow-up briefly on margins, if you don't mind, please?

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

In terms of margin, we have been able to absorb a 10% increase in the content cost year-on-year with stable margins, thanks to the voluntary retirement plan that we put in place last year, efficiency in distribution channels and, also, we should start to notice some effect in the next quarters, but mainly in the next years, of the central office decommissioning.

So, in terms of margins, what we can tell you is that we have been able to absorb the extra content cost with efficiencies in other chapters, namely in labour force. But we are also working on the distribution channel, and we are also working on the network side because for the time we are running two networks, the analogical, the copper one and the fibre, we will be progressively decommissioning central switches. So we feel that margin's levels in Spain should be sustainable.

Keval Khiroya - *Deutsche Bank.*

So just on Spain when we look at the non-"Fusión" revenues, they're still falling around 15%, and the KPI's are quite weak within that. Obviously, some of this is driven by the migration to "Fusión", but the "Fusión" adds themselves are perhaps a little bit lower than just over one year ago. So, how should we think about the direction of non-"Fusión" revenues? Do you have any drivers to improve this trend or is this 15% decline quite realistic for what we see for what we should see for the rest of the year?

And then, secondly, when we look at LatAm, we've noticed some positive developments but, as you highlighted, Perú and Chile do remain a little bit mixed. When do you expect Perú to improve? Is Entel still being very aggressive? Are there any signs of improvement at all, beyond the quarter in terms of competitive backdrop in Chile and Perú?

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

Thanks for your questions. You're right, non-"Fusión" revenues declined 15.0% this quarter while "Fusión" revenues increased by 9.3%. And remember that, basically, "Fusión" revenues are twice larger than non-"Fusión" revenues. We have been having this quarter price upgrades on the non-"Fusión" revenues and, therefore, this effect should start to be reflected in the coming quarter.

And we have been, also, improving our plans on the contract side, on the mobile side. So, yes, we are working on stabilising or improving the trend on the non-“Fusión” revenues, and it is also true that we keep migrating customers from non-“Fusión” into “Fusión”.

Also, allow me to mention that in the non-“Fusión” revenues, you have the DTS one-play revenues, and, therefore, the migration of customers from pure satellite into “Fusión”, and also the migration of customers to other platforms should be easing away in the next quarters. So we expect that to improve in the next months.

And in terms of Chile and Perú, those are different scenarios.

In Chile, we have been focusing on high-value segments, and we have been having growth in contract and in fibre to the home, despite very intense competition. We have a relatively strong position, and we are improving on the high-end, on the value customer side, and we are suffering on the low-end, with the entrance of some new players. In terms of fixed, we have been having a solid performance of Pay TV; we have been growing 2%. And on the FTTx, we have been increasing by 22% (we have already in Chile around 1.2 million premises passed with fibre), which account for 30% of fixed broadband accesses, and fixed broadband ARPU has been growing. So, even though revenues have decelerated and have fell slightly due to decreasing prepay and regulation, ex-regulation revenues in Chile would have increased.

And then, OIBDA is down 10% because we have been having more commercial cost and some higher network expenses. So, overall in Chile, we see trends solid in the high-end of the market. We keep expanding our fibre and LTE network, and therefore, we think that we need to hold on to our commercial position, but the overall underlying trends of the company are getting better.

In Perú, the situation is different. In Perú, the situation is we have a strong competition on both, the high-end and the low-end of the market. It's a very highly competitive environment, specifically in mobile, while we have a positive traction on the fixed line. And we do not foresee that commercial intensity on the mobile side to be relieved in this year, neither in prepaid or in postpay. So, in Perú it will take us longer to turnaround the business on the mobile side. And, allow me just to point out the evolution on the fixed business, which is growing, and we are also expanding significantly our ultra-broadband capabilities in Perú.

So, different scenarios: In Chile, we think we can hold-on and somehow improve our trends. In Perú, it's going to take us longer.

Giovanni Montalti - *UBS*

If I can, on the cost base in Spain, looking at service revenues so, excluding the mobile handset portion, and, let's say, subtracting OIBDA before one-off. It looks like your cost base in Spain, let's say, the one linked to the recurring business is down around 1%.

I understand and I do respect the fact you don't want to give indications on a regional basis, but is it reasonable to assume that the improvement that you have been indicating in terms of top line for the coming quarters will, let's say, be followed also by the OpEx base? Shall we expect the evolution of the OpEx base to continue to be on the downside, as it was in Q1, and eventually to improve this decline, as well?

And on the wholesale revenues, if I may, you again have been guiding for an improvement going forward. When do you think it could be reasonable to start thinking about the wholesale revenues as a potential source of growth, not just stabilization? I mean, once you get rid of the content portion of the revenues, once you get rid of the impact from the loss of the MVNOs contracts, the agreements you have reached with Vodafone and the improvement in the price mix that should derive from the fiber connections could make a different source of growth, actually. Is this something you would share some comments with us? Thank you.

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

Well, thanks for your questions. On the cost basis of Spain and the way going forward, allow me just to focus for the time being in three chapters, although we are working on some others.

In terms of the voluntary retirement plan, as you know, we booked a provision in 2015, the extension of the plan in 2016. We have been booked an extra provision this quarter because we have been having more people subscribing to the plan that we were anticipating at the end of the year. That means that the acceptance so far is roughly more than 4,200, of which 228 left in this first quarter, which means basically that the run-rate of those savings should be around €480 million since 2019, and therefore, we have still some effect to flow through the organic P&L of Telefónica España. We think the level of this should be in the neighborhood of more than €350 million in 2017; approximately another €100 million in 2019, and an extra €8 million coming from the higher acceptance. So, still a way to go to have more impact on efficiency on the labor force in Spain.

And then on the distribution channels, we have been closing stores for the last years. We have been closing basically close to 400 stores namely 383, if I remember it correctly. 41 shops were closed in this first quarter. And our online sales are also growing. So, in terms of distribution channel, we should have also some positive effects flowing through the P&L in the next quarters.

And then finally, on central office closure, we are the first company in the world to shut down 38 central switches. And we target to close more than 2,000 in the next years. You know that according to regulation, we need to give a one year pre-notice in places where we don't have unbundling of the local access. And we have already announced more than 200 central offices closure. And therefore, we should expect more efficiency growth. And in terms of the places where we have unbundling of the local access, we need to have a pre-advice of five years. Now we have already preannounced more than 30 central switches. So you will see that, us, also acting very heavily on the network side of the cost in Spain going forward.

And then, we are also trying to land down to earth the cognitive intelligence impacts on the cost basis out of AURA. We will try to give you more color out of that in the next quarters.

And then on your wholesale revenues question, we should have negative effects coming from this TV thing that should be fading away in the third and fourth quarter, then we will have the migration of the Pepephone and Yoigo into the new owners' network which would be in 2017 and 2018. But, allow me to say that MVNOs and TV represent just 18% of wholesale revenues while other wholesale revenues, namely the ones coming from the network, represent the bulk of wholesale revenues. And out of that, we have the unbundling of the local access of the traditional copper lines that progressively would be somehow migrated into fiber accesses, and the rental access of fiber is significantly higher than the rental access of the copper line. And then, we are also ready and having conversation with different players to extend wholesale agreements into our fiber network.

So, allow me not to be very specific because we don't guide on the different countries and certainly not on the different segments, but we think that there is room to significantly improve the wholesale trends because of the strong network that we own in Spain.

Joshua A. Mills – *Goldman Sachs*

First on Hispam. So, first is Q1 vs. last year, obviously, the CapEx-to-sales ratio has come down, and I see in part actually due to help from the FX effect. So my question is, what level of CapEx to sales do you see as sustainable longer term, assuming a kind of stable FX rate in that HispAm region ex-Brazil?

And secondly, coming back to Spain. We're talking about “More4More” and strategies from the main operators, but you are seeing some extension of commercial periods, and I'm looking here at Orange, Jazztel and MásMóvil are still being quite competitive. So, have you seen any change in competitive intensity over the last quarter or is the slowdown in net adds really due to a slightly larger price increase versus this time last year?

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

If we do see signs of fatigue again on the “More4More” strategy? The answer is; so far no. Certainly, not on the mid to high-end. We see some intensity on the low end because of mainly the MásMóvil moves. But, again, because of MásMóvil capital structure, the room for significantly deteriorating the current environment in Spain is, in our opinion, limited.

So, it is true that we have some slight more intensity in these last months. But it is also true that it is certainly below the levels that could be anticipated. So, on the low-end of the market, a little bit of more tension. We are rethinking our strategy there. But certainly, on the high and mid-end, we think that the “More4More” strategy is pretty solid. So, overall, I think that in our opinion, you should not expect the Spanish competitive environment to deteriorate in the next quarter.

And in terms of CapEx over the sales in Hispam, it is roughly around 1 p.p. lower than in 2016, which is in line with the group guidance on CapEx over the sales which would be roughly 1 p.p. down compared with the previous year. We are already covering 56% of the total Latin American territory with LTE, and we have already done significant improvements in our ultra-broadband networks in the countries in which we have wireline operations. So, we feel comfortable with the levels of quality that we have in Hispam. We do not see significant increase. And in the mid to long-term, CapEx intensity in the whole of the group should be heading down.

Julio Arciniegas – *RBC*

Coming back to Spain, it's true that the high-end proportion of customers has increased this quarter to 21%, right? But I can also see that the proportion of the low-end customers has also increased. Do you see some risk that the upside from higher-end customers could be reduced by the increase in low-end customers now that you are actually thinking in pushing maybe further the low-end of the market?

And my second question is regarding Latin America. From the 5 million home passed in Hispam, do you include in the figure VDSL technology and if you do, approximately, roughly, what is that figure? And additionally, some of your competitors, they have been saying that for example, the deployment on both cable and fiber, let's say, in Colombia which is a big market, it's roughly $100 USD. Why doesn't Telefónica, considering that the cost is actually similar to Spain, decide to basically move from a copper network to a cable or fiber network in Colombia? Thank you.

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

Out of the "Fusión" total customer base, the high-end has increased 5 p.p.; the mid-end has decreased 5 p.p. And then, the low-end has increased 1 p.p. because we are also doing some promos, and therefore, we are also incorporating some new customers, which is the way going forward because once we have incorporated new customers, we try to upsell them and to encourage them again through promos to move upwards on the chain.

So, we are not detecting a significantly downward trend on the customer base of "Fusión", rather, I would say, the opposite. We are upselling our customers and through the different promos we are also been able to increase their average ARPU. And you should expect us to keep doing the same and, if something, to be a little bit more active on the low-end.

And in terms of HispAm, we are pretty pragmatical with the technological evolution. In some places where it is more effective and where the foreseeable average ARPU of the different customer layers in some regions could not justify deploying fiber, we are increasing our copper capabilities with Fiber-to-the-Cabinet. And, therefore, we are mixing technologies in Latin America.

The reasons for moving from one deployment to other; that is really depending on the foreseeable ARPU that we foresee out of the customers and the data needs that are foreseeable in the different regions.

So, you should expect us to keep going into that direction. And remember that we have the largest ultra-broadband network in Latin America, overall.

And then, just to focus on Colombia, we are advancing significantly, manly in fiber deployment. We have connected more than 33k homes this quarter. And we have passed 360k homes in Colombia. So, pretty active. I'm sorry but we do not disclose the average cost per connection.

Julio Arciniegas – *RBC*

May I follow up? Are these homes in Colombia VDSL or fibre?

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

Again, it's a mix of both.

Justin Funnell– *Credit Suisse*

In Mexico, there's a plan to roll out a national wireless network backed by the government, and there seems to be a similar plan in Argentina, although it's less developed. I just wondered what your thinking was about these. I mean, could you actually shift towards perhaps being an MVNO in these markets and perhaps invest less capital, but make better returns?

And then secondly, in Spain again, the regulators made a few comments, have made it clear that they've got a few concerns about the level to which prices have risen in Spain. Is that going to affect your strategy on how you put through price increases going forward?

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

On the first one, allow me to make a more general reflexion on the environment in Latin America. I would say that all the players in Latin America, including ourselves, are certainly much more open to network sharing, and therefore, you will see it. And in fact, we have already been doing some network sharing, I would say bold network sharing agreements namely with Millicom in Colombia, and we're analysing network sharing agreements, I would say, significant network sharing agreements with different players, with all the players in Latin America. So, I think that all of us being much more rational in terms of CapEx deployment is something that you should score into your models.

Again, it's similar to the thing that we have done in Spain with the fibre network with Vodafone. So, we will analyse every single possibility of taking advantage of other deployments, but we will need to run the different numbers. About the "Red Compartida" in Mexico, I would not comment because it's on an earlier stage. But we see opportunities of doing different things with different players in Mexico, not just with "Red Compartida". As I was mentioning before, all the players are now open much more open-minded to that. So, the answer is, should you consider us running in some regions of Latin America on other's network? That's perfectly possible.

In terms of Spain. Well, the regulator, in terms of the "More4More" strategy, that does not imply unitary price increases. In fact, if you divide the prices of Spain per gig or per megabit per second, including the TV content, price per unit keeps declining in Spain. So, I don't think that this should be a concern going forward, especially at a time that Spain has become the leading country in Europe in terms of ultra-broadband deployment. There is more fiber in Spain than in the sum of the UK, Germany, France and Italy together. And this is something that should be protected, because we can go even further. There is a roughly a 65% household coverage penetration of fiber in Spain, this is far beyond any other country in Europe. So, we think that this "More4More" strategy is providing significant value to our customers. In fact, churn levels are low and have not been significantly impacted by these price upgrades. So, we do not feel that there is any need to be concerned around that in Spain going forward, but of course, we will monitor. Another factor that should be taken into consideration is the prices that are going to be proposed by the regulator in Spain for the local NEBA, which is also going to be conditioning our further deployments of fiber in Spain.

Luis Prota – *Morgan Stanley*

First is a follow-up on the wholesale revenues; on the agreement with Vodafone. I would like you to elaborate, if you don't mind, on the rationale and the benefits for Telefónica of giving access to Vodafone to the non-regulated and regulated areas. And also, I would like to get your thoughts on the potential for Orange to join this agreement -they have just announced accelerating their fiber deployment- but whether you think that they eventually will join this wholesale deal.

And the second question is on whether you have any update on how to recapitalize Telefónica Colombia.

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

On the wholesale agreement with Vodafone, the rationale behind that. Well, you know that there is a geographical segmentation in Spain. Therefore, in non-regulated areas, the price of the NEBA access is liberalized, so to say. And in regulated areas, it's going to be liberalized. We think that reaching an agreement with Vodafone allow us to set the standard for those two benchmarks. And I think that it makes little sense not to take advantage of the fact that we can have extra revenues coming from this very intensive capital deployment effort in Spain, at a time that in some of the regions, that would not be a competitive advantage, and in other regions, in the regulated regions, we will have to give them access anyhow. So, we think it's better to negotiate that directly on commercial terms with them and, therefore, setting the level of the precedent and, therefore, giving some sign of rationalization also on CapEx deployment in the Spanish market. So, you should include that on the capital optimization of the different players, but also, think of it on strategic terms.

Are we ready to take others on board? The answer is yes. This is not an exclusive agreement, it couldn't be. And, therefore, yes, and we are having conversations with other players.

Ángel Vilá – *Chief Strategy and Finance Officer*

With respect to the recapitalization of Telefónica Colombia, we are making progress with the Colombian government. They need to go through a very specific process that includes some government action. Advisors have to be hired; which they have been. And, we are making progress in those talks, which would lead to a potential recapitalization of the company and repayment of this type of liability.