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Results Conference Call Transcript

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In October 2015, the European Securities Markets Authority (ESMA) published guidelines on Alternative Performance Measures (APM), applicable to the regulated information published from July 3, 2016. Information and disclosure related to APM used in this presentation are included in the Appendix. Recipients of this document are invited to read our condensed consolidated interim financial statements and consolidated interim management report for 2017 submitted to the Spanish National Securities Market Commission.

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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-June 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 second 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*

Q2: Executing on strategy; structural quality

Thank you Pablo. Good morning and welcome to Telefónica's first half results conference call. I would like to take this opportunity to highlight the changes to our organizational structure announced last Tuesday to accelerate the pace of business growth, facilitate the achievements of new goals and promote the new values that will shape corporate governance in the coming years. I would like also to congratulate Ángel Vilá, as Chief Operating Officer and Laura Abasolo, as Chief Finance and Control Officer. With me today is Ángel and during the Q&A session you will have the opportunities to address us with any questions you may have.

I'd like to begin by highlighting the acceleration in organic growth this quarter across revenues, OIBDA and OpCF, thanks to the successful implementation of our strategy.

Our focused approach is paving the way for our ongoing transformation with efficiencies, synergies and digital agenda. Our business is more efficient, with OIBDA margin expanding to 32.1%, an increase of 1.2 percentage points year-on-year in organic terms. Moreover, higher quality assets drive our strong competitive position in main markets. This progress results from targeted investments towards UBB, fostering digitalisation, Cognitive Intelligence and differential value proposition to our customers.

Our balance sheet continues to get stronger, with Net Debt down 3.7 billion euros year-on-year and a robust free cash flow in a context of lower cash interest costs and longer average maturities.

So, to sum up; we are accelerating growth; with organic revenue growth of 4.1% ex-regulation, then margin expansion is fueling organic OIBDA growth to +7.2%, which accelerates again at OpCF level to +17.5% thanks to lower CapEx; and in addition we are reducing net debt by 5 billion year-on-year when including Telxius closing.

So, we are in the right direction, as reflects the upgrade of our 2017 guidance while we reiterate our dividend.

Financial Summary

Turning to slide 3, let me summarise the key financials.

Second quarter revenues increased 1.9% in nominal terms to reach almost 13 billion euros and 3.1% in organic terms. OIBDA topped 4.2 billion euros, up 6.1% or 7.2% in organic terms. OpCF ex spectrum totalled 2.3 billion euros, with very robust double-digit growth both in reported and organic terms.

I would qualify these as a strong set of Group financials.

Upgrading full year guidance

The upgrade of 2017 guidance is best outlined in slide number 4.

In H1 revenues have clearly beat guidance growing by 2.3% vs a guidance of stable. We think that better trends posted in the second quarter, in addition to profitable growth expected for the second half of the year allow us to increase this guidance to a growth of above 1.5%, maintaining 1.2 percentage points of negative impact from regulation.

This higher revenue growth is not expected at the cost of other variables as we maintain our guidance for the rest of the metrics; we continue guiding for margin expansion and lower CapEx intensity.

Regarding the dividend, we paid the second tranche of 2016 dividend of 0.2 euros per share in cash the last 16th of June. In addition, we confirm the 0.4 euros per share in cash for 2017.

Finally, we reiterate our aim to maintain a solid investment grade rating.

OIBDA growth from top to bottom

Moving to slide 5, H1 reported OIBDA growth of 5.5% flowed directly to net income increase of 28.9% reaching 1.6 Billion euros in the first half of the year, driven by sound management of non-operating results.

Underlying EPS totalled 0.38 euros, up 32.3% year-on-year.

Let me mention that we have adopted a synthetic FX in Venezuela. This has had a negative impact in revenues and OIBDA, with this Venezuela's contribution to total Group being reduced to 0.3% in revenues and 0.2% in OIBDA.

Robust FCF generation; improvement y-o-y and q-o-q

On slide 6, you can see very robust FCF dynamics in the graph on the top left of the slide, accelerating sequentially and year-on-year, surpassing the 1.6 billion euros mark in the first half, an increase of 98.6% versus one year ago.

Of this increase as seen on the right, 70% came from operating cash flow, while interest payments and working capital more than offset the drag from taxes & others.

For the second half of the year, we expect FCF to improve further.

Let me mention that net debt decreased in the second quarter year-on-year despite seasonality and dividend payments, in contrast to trends in previous years.

Accelerating OIBDA growth

On slide 7, we show the breakdown of OIBDA growth looking at organic trends and FX.

In the second quarter OIBDA increased by 234 million euros compared with 2016. It is worth highlighting that the organic contribution was 285 million in the quarter, vs. 52m in the first quarter, so growth has higher quality.

FX deducted 51 million euros year-on-year as the Venezuelan bolivar was devaluated, but if we exclude this, exchange rates continues to add 70 million euros this quarter mainly coming from the appreciation of the Brazilian real against the euro.

Strengthening organic trends; sustainable growth

Turning to slide number 8, we review the composition of this growth, with the strength that organic figures have shown.

Total Revenues grew a solid 3.1% vs. the second quarter of 2016 or 4.1%, excluding regulation.

Service Revenues and OIBDA accelerated vs. first quarter by 120 and 590 basis points respectively, with a generalized improvement across regions, in both service revenues and OIBDA.

OIBDA expansion and CapEx decline explained the 860 basis points sequential acceleration in OpCF, with all segments growing year-on-year.

Thus, I would like to highlight that operating leverage improved returns.

Gaining momentum in data monetisation

Data monetisation continued to contribute to revenue acceleration as you can see on slide 9.

LTE customer base increase 63% vs. Jun-16 and average data per user was 59% up, resulting in booming traffic that is threefold compared to last year.

The consistent growth in volumes is fostered and further monetised by the development of integrated data offers, that follow a “more for more” approach and increase “value for money”.

The benefits of this strategy is a clear ARPU accretion, translating into a ramp-up in mobile data revenue growth to 17.8% year-on-year, representing already 60% of mobile service revenues.

On the fixed business, data volumes continued to post high growth, showing a huge monetisation potential. As an example, fiber traffic per customer in Spain continued expanding and is now 2.5 times higher than average DSL traffic.

New wave of value creation opportunities

On slide 10, we show the value creation opportunities we have ahead of us, as we evolve through:

First, speed & connectivity is our core competitive advantage allowing us to monetise the UBB networks deployed.

Second, services beyond connectivity offer our customers differential services besides the traditional ones, and TV is the main driver.

Third, cognitive intelligence will add more value to our customers, building loyalty, improving efficiency and opening new optionality. We are currently working to launch Aura in several markets in the next few quarters.

Digital Services: progress in the new ecosystem

On slide 11, we show our progress in the digital ecosystem.

Video continues to be a key pillar of growth now and in the future, accelerating revenue growth in the quarter to 4.8% year-on-year, as we consolidate our leading position in Spain and Latam as one of the main distributors of content in the Spanish language.

This success is built on our TV platform and differential bundling strategy.

In other digital services, we are integrating solutions to strengthen our B2B offering and become an increasingly relevant player, with progress made across Cloud, Security and M2M.

Global Resources: Progress on technology evolution

Turning to slide 12, we show progress in Telefónica Global Resources to adapt our network to traffic growth, as well as to provide greater flexibility and foster E2E capabilities.

Our fiber and cable coverage surpass 41 million premises, while our LTE coverage reach 68% on average across our footprint, 89% in Europe.

Regarding virtualisation, we are currently implementing in 4 countries our UNICA program providing the support needed to smoothly adopt and deploy virtualized solutions, enabling the transformation to software-driven networks.

In parallel, E2E digitalisation, mainly on the back of Full stack projects, increasingly delivers efficiency and agility.

Telxius: Consolidating solid results

Now please turn to slide number 13. Telxius posted a solid set of results in the second quarter with strong organic revenue growth of 11.4% and robust OIBDA margin of 47.9%

Regarding its business performance, towers tenancy ratio of the quarter improved to 1.3 times, while cable IP traffic grew 31% and capacity bandwidth 62%

It's also worth mentioning that marine deployment of MAREA and BRUSA continued as expected.

Now I'll hand over to Ángel.

Ángel Vilá - *Chief Operating Officer*

Spain: Improved trading, ongoing upselling

Thank you José María. On to slide 14.

Spain showed a clear improvement of commercial trends and positive momentum in our upselling strategy.

Our focus on value and churn reduction allowed us to achieve sound commercial results, as follows:

The mix of "Fusión" subscribers continued to improve, with high-value packages increasing to 24%; while Fusión ARPU grew quarter-on-quarter to almost 85 euros, up 6.4% year-on-year.

TV returned to positive net adds on a widespread take-up of a new "Fusion" bundle.

FBB gained traction gradually since March, heading in the right direction.

And, mobile contract base posted very solid growth of 5% with a better portability balance.

Furthermore, we continue to strengthen our positioning with market segmentation. As such, the new convergent "entry level" offer with differential TV content (launched in July) will foster trading dynamics in the coming months.

Spain: Revenues trending upwards, solid cash flow

Continuing with Spain on slide 15.

Service revenues year-on-year trend posted a sequential improvement of 0.8 percentage points driven by Consumer revenues growth and a lesser decline in "Other revenues".

Revenue is on the right path as service revenues have already stabilised year-on-year, excluding the lower TV wholesale of "La Liga", an impact that will disappear from mid-August onwards.

Despite tougher comps of personnel savings, ongoing cost reduction led to a 0.9 percentage points improvement in OIBDA trend and margin reaching 40.6%, up 0.8 p.p. sequentially.

Moreover, I'd like to draw your attention to the falling CapEx (-21% year-on-year in the first half) that comes from our early build of NGN and translates into a superior cash flow conversion, as shown in the 8% of year-on-year growth delivered in OpCF.

In short, strong cash flow generation is here to stay.

Germany: Solid momentum; realisation of synergies

Moving to slide number 16, T. Deutschland is driving solid momentum in a market shifting to stimulating data growth.

O2 Free and O2 brand 15-year anniversary promotions accelerated net additions to 197 thousand in contract and 322 thousand in prepay in the quarter.

A robust LTE increase sustained traffic and data usage growth, with impressive early statistics from "O2 Free 15" customers, with data usage >3GB.

On financials, MSR trend continued to improve in the second quarter to -0.4% year-on-year excluding regulation. OIBDA growth rate accelerated to 3.8% year-on-year and OIBDA margin expanded 1.9 percentage points leveraging on incremental savings of €40m, despite commercial investments.

In January-June OpCF growth remained strong at 4.0%, leveraging synergies and transformation initiatives.

UK: Customer focus delivers robust performance

Over now to the UK on slide 17, where we have once again leveraged on our strong customer focus, resulting in a positive performance across metrics.

We continued to grow our quality customer base, as contract was up 2% year-on-year, maintaining market-leading loyalty levels, and LTE penetration reached 58%.

This led to acceleration in financials this quarter: revenues were up 2.6% year-on-year, OIBDA 3.9% and Operating Cash Flow 5.3%, despite the fact that our accelerating LTE rollout is driving an increase in CapEx.

Brazil: Accelerating profitable growth

Moving on to Brazil now, on slide 18, we have posted another set of strong results this quarter, accelerating profitable growth.

In mobile, our best-in-class service quality, significantly increasing our 4G and 4G+ coverage, drove stronger adoption of data services and, as a result, mid-single digit ARPU growth. On top of that, it also allowed us to capture almost 60% of new contract customers in a context of more intense competition.

In fixed, we continued to focus on fiber deployment, passing new cities and complying with our plan to expand our reach. Thus, we achieved new record-high FTTH and IPTV net adds and ARPU is reflecting the shift to upgraded networks.

Brazil: Sustained benchmark performance

On slide 19, you can see how this strategy is flowing into the P&L, with results, once again, well ahead of the market.

Top line service revenue was 2.3% up year-on-year with solid mid-single digit MSR growth and fixed revenues recovering momentum.

Moreover, consistent cost control coupled with continued capture of synergies are reflected in the improved profitability, with OIBDA increasing by 7% in Q2 and OpCF by 17% in the first half of the year.

HispAm: Focus on value driving ARPU acceleration

In Hispanoamérica, as shown on slide 20, customer upgrade to higher value services is the main driver behind ARPU growth. Thus, in mobile, ARPU growth jumped to +21.1% year-on-year in the second quarter, with positive trends both in prepay and contract.

In the fixed business, fibre and cable connections grew 46%, driving FBB and Pay TV ARPU to increase by more than 9% and 12% respectively.

The continued expansion of our 4G and fiber networks coupled with the relatively low penetration levels, represent a strong support to continue maintaining this quality growth.

HispAm: Growth acceleration across the board

Moving to slide 21, we can see how these positive trends are reflected in revenue and OIBDA growth, ramping-up to 15.5% and 20.9% respectively, and flowing into a 43.2% OpCF growth in the first half of the year.

These positive trends illustrate the outstanding performance in Argentina, the steady positive contribution from Colombia, the recovery in Mexico and some signs of improvement in Peru and Chile against a backdrop of intense competition.

And let me also remark that positive growth rates are visible in both organic and reported terms, despite the devaluation in the exchange rate of the Venezuelan currency this quarter.

Deleverage on strong organic FCF and disposals

Let's move now to the financial metrics on slide 22.

We keep on steadily lowering our Net Debt/OIBDA ratio down to 2.86 times as of June 2017, which would be further reduced to 2.78 times including Telxius stake sale. Strong organic FCF generation is the key driver of this leverage improvement. Including the Telxius deal, net debt is 5 billion euros down year-on-year, a 9.5% decline.

We expect further deleverage until year-end thanks to stronger FCF in the second half of the year.

Solid and diversified liquidity

On slide 23, let me highlight the strong liquidity position, above the 21 billion euros mark, built to face comfortably next two years of maturities.

The effective cost of debt in June 2017 stood at 3.22%, 72 basis points lower than at the end of 2016.

I will now hand it 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 number 24 for our final conclusions.

Today's strong set of results demonstrates our excellent position for delivering sustainable long-term growth.

As such, our organic growth is accelerating across the board on sustained commercial momentum, with a focus on high-quality connections and more-for-more actions. This allowed us to strengthen our differentiation based on 2 key pillars: network leadership and quality assets, thanks to upfront CapEx efforts made in previous years.

Furthermore, our EPS is growing very nicely and the FCF profile is clearly improving, driving a remarkable organic debt reduction.

Finally, we are upgrading our guidance for the year.

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

Q&A session

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

Ángel Vilá - *Chief Operating Officer*

Georgios Ierodiaconou - Citi

In Spain, you showed the mix of the customers in Fusión between the 3 different tiers. And obviously, it looks like the low-end is the one that is losing weight. I just wanted to see if it's possible to get an idea of the churn levels you are seeing between the different tiers and whether there is a big difference between the low-end and the other 2 tiers; and then secondly, whether you are seeing some down trading as you continue to offer "More for More" on one side and then have some promotions in the market on the other side.

And then my question around Peru is, as I can see, the margin is now in the mid 20's. And we all know it's a very competitive mobile market, and indeed you still seem to be losing a lot of contract customers, but I'm under the impression that competition in fixed is more balanced, so I was wondering how low could these margins fall given that around half of your revenues come from the fixed line services. And is it a point we've reached now where in mobile effectively the margins are at very low levels?

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

Thanks for your questions. In terms of churn levels in the different segments of the Fusión customer base, what I can tell you, is that in the mid-to-high-end, churn in the second quarter is 70% of the total churn on the lower levels, which means that churn is much lower in the high and mid than in the low segments, which is natural. And we think that, that will keep improving going forward. That would put more value in the equation.

And in terms of your question around Peru, the evolution of Peru has different performance in the mobile and in the fixed.

In mobile, competition remains very high. And also, this quarter, we had the effects of the El Niño and some flood effects. Prepaid is under a significant amount of pressure, and also postpaid. You know that we have launched very recently a repositioning of our prepaid offer. And we are starting to have some positive signs of recovery, mainly in terms of the level of recharges, which is the level of active customer base that you have. So we are starting to see some signs of improvement.

On the fixed line side, commercial trading remains very robust. Service bundling with pay TVs accesses have been growing 5% year-on-year. And TV ARPU, to give you an example, is up 3% year-on-year. Fixed broadband accesses are 2% up year-on-year and we have been having positive net adds of 15,000. So that means that we are seeing a robust trend on wireline and some signs of improvement on the wireless side. It is true that OIBDA is significantly down year-on-year. And the margin has been falling significantly, but if we are able to stabilize the prepaid segment and we keep working on the postpaid segment, we should be able to have a better performance in the second half of the year. Please bear in mind that, in the second quarter of 2016, we've recorded a positive impact from the reversion of a tax provision, and that has been now impacting the year-on-year comparison in OIBDA.

Finally, in terms of the down trading in Spain, promotions, namely the last one that we launched on the low-end, are starting to foster gross adds. And then we are also following the value strategy, which means that we are improving the mix from standalone to convergence. And the upselling convergence from low to mid, high segments keeps also working. So we are not seeing, so far, it is early times, because of the recent promotion, different levels of migration on the chain. So we don't have signs to be concerned on that side so far.

Georgios Ierodiaconou - Citi

And if I could ask a very quick follow-up. I know it's only been a few weeks, but since you launched the new promotions, have you seen a broadband improvement? Or are you still losing broadband customers?

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

We have seen an improvement, but again, it's early days. It's just 2 weeks away from the promotion, but yes, we have been seeing an improvement.

Luis Prota - Morgan Stanley

My first question is on Spain. And I would like to get some more color on the market dynamics and how these could evolve going into the second half. I've seen that Fusión customers have come down quarter-on-quarter 4,000, which is first-time happening; and also declining broadband net additions, lower growth in fiber. Are you really seeing a lot of competition? Were you just stepping back from the market? Or also, revenues were growing a bit less than expected in the consumer segment, so I wonder whether this counts. So, if you can elaborate a bit on the dynamics this quarter and how these could progress into the second half, it could be useful.

And the second question is on the potential IPO of assets like Colombia and Argentina that have been coming out in the press. I don't know whether you have plans for that. And also the recapitalization of Colombia, whether there are any news on that.

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

In terms of Spain, let me start by saying that we are seeing a sequential improvement in revenue evolution. And we are seeing better commercial trends, with a few exceptions; and also, which is also very important, churn reduction in almost all segments. Remember that Fusión is already a highly penetrated product in our base, which means that 85% of broadband customer are under Fusión, 84% of TV customer and 77% of contract customers. And it's also growing in value. Ultra-broadband fiber is up 38% year-on-year, TV 70% year-on-year and high-value packages 24% year-on-year. Also worth highlighting that Fusión ARPU is up 6.4% year-on-year to almost EUR 85 in average. And churn is down; Fusión churn is down to 1.3%. I will also like to highlight the mobile accesses evolution; it's the best performance we have had since the third quarter of 2010, with net adds of almost 70,000, excluding M2M and churn down to 1.3%.

What I'm trying to tell you is that the market environment is helping us with this “More for More” strategy. We think that the B2C improvement that we have seen in this quarter should keep growing in the next quarters. And we also aim to keep improving on the B2B segments.

The wholesale impact will be fading away progressively, as the year-on-year comparison will ease away, and therefore we think that we will keep improving. And we'll keep evolving towards service revenue stabilization, in Spain. And also, it is worth highlighting that handset revenues are significantly down, as it took us a while to eliminate the structural subsidies out of the equation in the Spanish market, as hardware revenues gives very low margin, we will not push much on that side.

So we have better and more positive outlook this quarter in revenues, and we think that evolution could keep going for the next quarters.

Ángel Vilá - *Chief Operating Officer*

Luis, regarding Argentina, first. In Q2 17, Telefónica's Argentina revenue, OIBDA and operating cash flow growth accelerated due to increased consumption and better regulatory environment. We believe our business in Argentina is currently undervalued and the opportunities that the market offers are not priced-in, as valuations applied in the sum-of-the-parts are very low, despite the fact that performance is very good and we are already repatriating cash from the country. Having said this, we do not comment on market rumors regarding any potential IPO there.

Regarding Colombia recapitalization, the process of recapitalization of Coltel continued progressing on recent months. The government continued advancing. On June 30th, a law was approved by the Colombian Congress to allow the government to subscribe the capital increase in order to prepay the obligations with the Parapat in accordance with their shareholding. The next steps in the process are the approval of a Decree and other internal government approvals. Once that Decree is approved, a shareholder meeting can be held in order to approve the capital increase.

However, there has been recent news, a result of an arbitration initiated by the Ministry of Information and Communication Technologies in connection with the potential reversibility of certain assets under former mobile concessions. We believe that this arbitration is not conducive to investments in the telecommunications sector in Colombia. We are analyzing the implications of that arbitration award and the legal measures available to us at both local and international levels. And obviously, yesterday news could potentially affect the process, although it's too early to say what would be the potential impacts.

Akhil Dattani - *JPMorgan*

Firstly, just on the new EUR 45 Fusión offer that you've launched; and I guess, is just as a follow-up to the prior question on this. If I look at the slides that you've provided on the mix of customers, it looks like it's about 27% of the base your low-end. I guess it would just be useful to get some color in terms of how you're thinking of what the impact of this is, both in terms of down trading from the current EUR 55 plan to the EUR 45, and how you think that kind of drives your add mix? And when we think about the move to that, obviously there's been a lot of emphasis in the market around Másmovil, should we think about that as having been a relevant factor for you driving this change in pricing? Or do you think there were other factors behind why you've done that?

And then, the second question is really around your "other and wholesale" segment. You mentioned earlier in the call that we should expect a decent recovery through Q3 and Q4 as the wholesale TV drag washes out. Could you just remind us of some of the bigger ticket items that are likely to impact as we look at the next couple of years? And I guess what I'm mindful of is you've got on the negative side the Yoigo contract washing out, but again offsetting that, you've got the new wholesale contracts on fiber you've signed with Vodafone.

So I guess it's a really broad question as to how do you think, post this year, that "other and wholesale" revenue stream develops?

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

Regarding the first one, around the new tariff that was launched three weeks ago, our main target was to reactivate the gross adds at that level because we are having good results in upselling our customer base. And therefore, if you compare the quality of the Fusión customer base this quarter versus a year ago, you will see that it has improved, but we see the opportunity of having an upgraded and competitive low-end offer in the new environment. And that's why we have launched this EUR 45 tariff, which allows us to fight and capture some activity on the low-end. Certainly as there are new actors, as Másmovil which you mentioned, I think that we can be competitive because remember that we have the best network, the best content and the best distribution channel in Spain.

So, we think that we can reactivate the low-end activity for Telefónica without triggering a down trading in our customer base. And the proof of that is that, in the first three weeks, and again, it's too soon to conclude, but in the first three weeks of launching that tariff, we are not seeing major activity on customers moving from the EUR 55 into the EUR 45 offer. Again, three weeks is not a good sample, but we think that, so far, it proves that we can be more active on the low-end segment without triggering significant down selling in our customer base.

In terms of Másmovil, it has been certainly a disruptive element in the market. It is focused on low cost instead of value, so we don't see immediate risk to market evolution in the mid to high-end. It's capturing market share but not that much revenue share. And it's also facing several challenges in the current market structure: the market is oriented to value with differential assets, and remember that Másmovil has no TV; subscribers are more loyal on the back of convergence and totalization, with lower churn; and they have a smaller market growth in fixed broadband and mobile. Within that, by revamping our entry-level portfolio, we will have significant possibilities going forward to reactivate our growth in Fusión without affecting the quality of the base.

In terms of the wholesale revenues, we include there, as you know, the TV and the MVNOs part. I was mentioning before that the football impact that has been affecting us, because we have no revenues from “La Liga” since the third quarter of 2016, will be progressively fading away. But remember that we are having also right now not just the Vodafone contract, which is affecting positively, but also good performance in NEBA and roaming revenues. So we think that we could have a relevant upside coming from the NEBA growth in the mid term. It's going to be progressively and that will be compensating progressively the decline in the traditional unbundling of the local access.

So we will give you more color in the next quarter of this change of mix in the wholesale revenues, but we think that the bulk of the impact coming from the football rights will start to fade away, starting in August, and therefore we should have an easier comparison year-on-year in the next quarters.

David Wright - *BofAML*

I just wondered whether I could get a little more granularity on wholesale fiber, because it seems like that is one of the big opportunities to drive cash flows on next year.

The agreement with Vodafone, please, when exactly does that kick-in, in terms of the new rates being offered to them? And how are you expecting the actual fiber wholesale rate to evolve over time? My understanding is the DSL unbundling is around EUR 9. What should we expect the fiber level to be, please? And when could we really expect he Vodafone agreement to catalyze an acceleration? Is that the right way to read it?

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

Thanks for your question. I will try to give a little bit more of color. Yes, in the wholesale segment NEBA is growing very fast, it is 2.6x more important now than a year ago. The growth is accelerating, but it is just 14% of the total amount of wholesale accesses. The Vodafone agreement, as you know, is a 5-year commercial agreement and it will give them access to our fiber network. It's already starting and it will be accelerating progressively, but it's still very low figures included in this quarter. In terms of the mobile side of the wholesale revenues coming from MVNOs, Másmovil is still with Telefónica in 2017 because it will be migrating progressively. And as a final piece of color, let me tell you that, excluding “La Liga”, “Others revenue” will be flat year-on-year. So I think that, going forward, we should see a better performance of the wholesale segment.

And with respect of the price of the unbundling of the local loop and the EUR 9 at the copper line; the price for fiber wholesale will be settled in, I think, in the first quarter of next year. And the expectation that we have and is it should be significantly higher than the 9 EUR, but it is still unclear when the price of the local NEBA is going to be established.

So overall, with the new rates coming from the fiber access, the progressive improvement coming from the Vodafone agreement and the softening of the impact of the football rights, we should expect a better performance of the wholesale revenues going forward.

Julio Arciniegas - *RBC*

Regarding the mix of customers. If you have the mix of the low-end has decreased from 29 to 27%. Can you give us some color of the dynamics? If this mix reducing due to higher churn in the low- end? How should we think going forward after basically the company has launched some attractive offers in the low-end spinning down? That's my first question.

The second question is that by looking at the results of your main competitors in terms of broadband KPIs, they have grown but they haven't been great, the rate of growth has been lower. Do you see any risk that they are going to become a little bit more active, more aggressive in the low-end to try to boost growth again?

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

I would try to give you a little bit more of color. So first, taking the quality base for Fusión, we see it improving, and in fact, we keep working on that. So the target that we have launched is mainly devoted to attracting customer where we see value on the low-end. Not to preserve our consisting customer base. And in the proof of that is that again too soon to say but in the first 3 weeks of the offer, we haven't seen major change of dynamics in customers migrating downwards. So, we think that we should be able to keep building on the quality base of Fusión going forward. And the proof of that is the ARPU expansion.

Again, let me try to give you a little bit of color on the ARPU expansion main levers. Out of the 6.4% increase year-on-year, which is roughly EUR 5.1, on the positive side, we have the tariff upgrades, the More for More strategy; the upselling to higher value packs; but we also have some diluted effects from promos and are mainly devoted to offer customer to taste superior product and then a significant part of them stay on the higher packages. And then we also have some diluting effect from the old mobile adds and that should progressively fading away.

So just to tell you as a result that we keep working on improving the quality base, and that links perfectly with the second part of your questions. It is true that we are seeing some less mostly gross adds in some of our competitors but it's also true that all of them and the bulk of them are also based on upgrading their customer base, on improving their customer base. And I think that's a positive sign of rationality in the market. So, we do not see major changes in the market dynamics in Spain. And it's something probably to watch more rationalization. But again, we'll keep you posted on the reaction of our own customer base and the market to our recently launched tariff.

Giovanni Montalti – *UBS*

On towers, would you consider as an option the contribution of additional towers to Telxius? I mean, this was one of the strategic pillars of the time of the IPO. I was wondering if this could be still a lever for you.

On South America, is there any progress, are you more optimistic about the possibility to reach some more, let's say, extensive sharing agreements, especially with your top competitor there?

And on wholesale volumes, I see that disconnections from your fixed network in Spain are improving materially, both quarter-on-quarter and year-on-year. Should we expect this trend to continue? Obviously, also thanks to the Vodafone share agreement. And is there any room to reach some similar, comparable agreement at least in some parts of the country with Orange?

Ángel Vilá - *Chief Operating Officer*

Regarding Telxius, on the one hand, we are progressing very well in the process to close the transaction with KKR. We've got all but one of the approvals that we needed, and we're expecting to do the first closing in Q3 or very early Q4 and the second closing in Q4. So that's progressing well.

The strategy, of course, is to grow the vehicle by contributing more towers. Telxius is already increasing its tower perimeter. It is working a lot in build-to-suit towers for Telefónica units and other parties. And also, we are contemplating contributing some of our portfolios of towers into Telxius. So, yes you should expect it to grow its number of towers. And, as José María said during the presentation, we're progressing in the layout of the new submarine cable systems.

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

Taking your question on network sharing agreements in Hispam and in Brazil, the answer is yes. We have already some very interesting agreements in place, like in Colombia with Millicom.

But we think that this is a feeling which we can do much more. In places where infrastructure deployment is not going to be a competitive advantage, I think it makes total sense to share elements of the network in order to accelerate deployments and I think that the interests of everybody are aligned. The customer, society and the different players.

So yes, as we speak, we are having different conversations, including with our largest competitor in the region. We don't have concrete news to share with you at this stage. But yes, we are open and we think it makes total sense.

And in terms of the wholesale volumes, the reading that you have is correct, and also remember that, out of the total number of wholesale accesses, which is 4.4 million, just less than 600,000 are coming from fiber. So, we do see a significant opportunity, again in place in which makes total sense to offer this kind of agreements, to extend those kind of agreements to other players. So the answer is yes, we are open to extending those agreements to other players.

Mandeep Singh – *Redburn*

I think in the presentation you said that service revenues were growing at plus 0.2%, excluding the impact of wholesale drags or the TV drags rather. Just sort of I think Akhil asked about this earlier as well. Once you move into Q3 and Q4, obviously that diminishes, but Yoigo, Pepephone grow. I mean, is +0.2%, i.e. something north of positive, a reliable indicator for what service revenues could look like in the second half of the year, bearing in mind the various moving parts? Are we on an underlying basis back to positive?

If you could perhaps give us a little bit more color on the sort of hybrid call dates for next year and the strategy around hybrids, please?

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

Thanks. I'll answer your question on the expected evolution of revenues in Spain. Well, let me reiterate we do not provide guidance on the different business divisions, but having said this, we expect revenue trends in Spain to continue improving in the next quarters. We remind that total revenue will continue to be affected by lower handset sales and, as you know, those have very little impact on OIBDA. But if you ask me about service revenues evolution, the message is that service revenues would already be stable in the second quarter when you exclude the negative impact from the lower wholesale sales of "La Liga" rights, as I mentioned before. And that, this negative impact, will disappear from August. For the next 2 quarters, we expect that service revenues should continue to improve and will remain relatively stable in year-on-year terms. And we will give you more color in the third quarter, when we see the actual result of the €45 tariff.

Ángel Vilá - *Chief Operating Officer*

Regarding hybrids, we have an outstanding amount of €6.5 billion equivalent, recorded as equity, accounting wise. This amount includes the USD 500 million issuance in Colombia. The first date of first call will be in September of next year. Of course, we cannot make a definitive or irrevocable commitment to redeem the notes at the first call date. It should be noted that at the first date, the securities are expected to lose their entire equity credit from S&P, which is a strong incentive to replace them with an instrument of similar seniority or equity. So we would be focusing on a replacement to keep the equity component.

Dhananjay Mirchandani - *Bernstein*

My question is on consumer revenues in Spain, which account for about half of Spanish revenues. Now, the Fusión revenues, which are about 2/3 of consumer revenues, grew by 10%, and yet the segment posted a moderate 1% revenue growth year-over-year. So, it's rather obvious that the decline is coming from the non-Fusión revenues, 1/3 roughly, which were declining at 13%.

Could you please help us understand how voice line loss trends in the consumer segment are evolving; and, more importantly, where these customers are going to?

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

You are right, 54% of service revenues is in the B2C segment, and out of that, the bulk is Fusión. The main drivers of the growth of Fusión is 1/3 subscriber growth and 2/3 the ARPU increase. And in the non-Fusión, they are declining 13% year-on-year, which is smoothing its evolution compared with the previous quarter.

But, they have also been affected on the non-Fusión side, by revenues from former Digital Plus customers, for which the year-on-year comparison should be easing in the next quarters.

So, it's not just the traditional lines. It's also the former Digital Plus customers. Those contracts are either migrating into the fiber product, or even going to some fiber offers from the competition. I don't have here the exact number of how many those customers are and their percentage, but I guess that we are trying to attract most of them to our fiber offer.

So, to summarize: The non-Fusión are declining - 13%, a softer decline than a quarter ago. It is not just the traditional lines; it includes also the Digital Plus customers whose bundling is also progressing and, therefore, should be fading away in the next quarters. And, out of the traditional lines, part are coming to our fiber offer and other parts are going to the competitors.

Dhananjay Mirchandani - *Bernstein*

Orange today announced its average revenue per converged account of about €58. Your Fusión ARPU, which arguably is a similar indicator, was about €85 for the quarter, so that's a 45% premium.

How do you explain the spread or justify this premium? And what are you doing to address what looks, at face value, like a pretty disproportionate exposure to a potential repricing risk in the market?

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

Well, the explanation that we have for the quality of our Fusión base is, first, we have the best fiber network in Europe. There is no country in Europe that has a similar fiber network that the one that we have been building in the last years.

And by the way, keep an eye on operating free cash flow generation in Spain because, as we are reaching a significant coverage of fiber in Spain, CapEx intensity should be progressively going down.

But the price premium is justified because we have the best network.

We have the best platform, in terms of functionalities (cloud DVR). We have the best contents. None of our competitors have a similar level of contents that the one that we have, in spite of regulation that forces us to offer premium content to our competitors. And also, we think we have the best distribution channels.

And we have started first to upsell our customers. So I guess that, in the case of the competitor that you mentioned, you are including all the customers that they have, including the Jazztel customers. And therefore, I would not be surprised that they will start to offer upsell offers to their customer base. And therefore, their ARPU could expand and shorten that differential.

So, I think that there is a mix of effects. And if you ask us if we are concerned, let me point out that churn in Fusión customers is significantly controlled. So for the time being, we think that this is a sustainable market evolution. We think that there is significant incentive for our competitors to upgrade their customer base by offering their customer better products through their network.

And then finally, let me highlight that, again, churn in the different levels of Fusión is highly controlled. Fusión churn overall is 1.3%. It's down 0.1 percentage points year-on-year. Postpay churn on the mobile side is 1.3%. It's down. TV churn is also down. So, for the time being, it looks like competitors and customers are appreciating that we have a significant competitive advantage in terms of all the different features that I mentioned before.

Keval Khiroya - *Deutsche Bank*

I've got one question on Spain and one question on Brazil, please.

The second half of last year, you did have another price increase in return for giving free football included in some of the bundles. And do you see much of a drag on Fusión ARPU in the second half as this price rise annualizes? Or did it not have much of a net benefit given some TV customers would have no longer paid for the football?

And then secondly, on Brazil, just 4 years ago, I think we were starting to get excited about potential consolidation in the Brazilian wireless market. Do you expect Brazilian consolidation to return on the agenda at all? And would you be in favour of it if it were to happen?

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

In terms of your first question on the packages and the football, we are not seeing major changes in the composition of the packages going forward. So I will try to understand better your question off-line and give you some colour through the IR because we have not seen major changes on the football side.

We have launched “Fusión Ocio” to try to differentiate ourselves through our movies and series as an alternative, and our customers are reacting well to that, but we are not seeing major changes in the composition or the appetite of customer based on the football.

And in terms of consolidation, on the consolidation agenda in Brazil, I will hand it to Ángel to give you a little bit of colour, but we think it makes all the sense if that was to happen.

Angel Vilá - *Chief Operating Officer*

Thank you, José María. Again, in Q2, Brazil maintained a very healthy revenue and OIBDA growth trends, with margin expansion; posted double-digit operating cash flow growth, which increased synergies generation. We've had a sound share of mobile net adds, especially in contract.

So we are delivering very nicely. We do not see the need for inorganic movements. However, as always, we would analyze in-market consolidation opportunities if they make sense and they create value.

Keval Khiroya - *Deutsche Bank*

My question really related to the price increase you put through in July of last year where you included football in some of the TV packages. And obviously, this will then start to annualize in Q3 of 2017. Will there be much of a drag on the second half Fusión ARPU from the annualization of this move you did in the second half of last year, or is it not too much of an issue?

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

Let me try to give you a little bit of colour. It is true that we have a price move that we mentioned last year, but it is also true that we have been having other offer upgrades this year in April, in February and also recently in August. So, the evolution going forward will be a mix of all of those, and the year-on-year comparison is going to be negatively affected by the prices that were done in the second half of the previous year, but they will be positively affected by the price uplift that we have done so far this year. And we see still room for this “More for More” strategy going forward, before the year-end.

Joshua Andrew Mills - *Goldman Sachs*

Two questions on Spain, please. So, first is just on the trade-off between offering customers speed and content within your Fusión base. If you look at the Fusión subscribers taking 100 or 300 Mbps broadband packages, there's been a big step-down in the net adds growth this quarter. My question is, is that because people are sacrificing a bit of speed, maybe churning down to 50 Mbps, in order to keep onto content, much more if discounted before and now isn't? And in that context, how do you think about Sky's announcement this morning that they'll be looking to do an OTT service in Spain?

The second question is just on CapEx. Now I know it's difficult to read too much into phasing, but Spanish CapEx is down 20% year-on-year in the first half. Do you think that there's scope to deliver a greater than

1% CapEx/Sales saving in the domestic market? And the 1% reduction in CapEx itself is obviously what you're guiding to at group level. And what's driving that lower CapEx effectively?

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

Well, taking your question on the mix of features that we put in play in order to build this “More for More” strategy. You are right. It's a mix of speed on the fiber network capacity; number of mobiles included in the bundle; certainly content and also the technological features of the platform. So we try to build different attributes, speed and capacity on the wireline and wireless side; number of mobile lines included; technological features of the platform, like cloud DVR or latest seven days recording or access. So it's a mix of those. And the customer chooses between the different features, so the more we build into that, the more versatility of the offer we have, but again a proof of that is the mix of the customer base. If we put more value, it might be a different combination, but the result of that needs to be that we keep upgrading our customer base. And that has been happening in the last year.

I mean our customer base has better quality this quarter than a year ago, and there is a mix of effects out of that. And we will keep building that. And remember that the network capacity that we have and the network speed that we can offer to our customer is just starting. And we just deployed the fiber network, so we have significant room to grow in terms of the capacity and the speed of the network.

And now your question about a potential over-the-top player's offer in Spain. We have already here the largest players. And we see that more as an opportunity than anything because that would increase the usage of our fiber network.

So we think that there is room for our customer to choose between different options. But finally, let me get back to the previous question; we have the best fiber network in Europe. We have the best platform, and therefore we should be able to offer our customer a very attractive proposition going forward.

So in order to give you a summary: I think that you are right. Speed is one of the elements. Capacity on the mobile side is another, as we keep deploying LTE. Content and the features of the platform should allow us to keep upselling our customer base.

And in terms of the CapEx, we are already reaching levels of penetration of fiber in Spain that are 8x or 10x than the ones that you could see in the U.K. or Germany. So Spain has become the best country in Europe. And I think it's the third in the OECD in terms of ultra-broadband network expansion. And therefore, CapEx intensity should keep going down in the future. And that's why I was trying to drive your attention into the free cash flow generation in Spain, not just revenues, which are very important and will be a significant focus for us going forward. But free cash flow generation of Spain because that will be a key lever for the group going forward.

Sam McHugh - *Exane BNP Paribas*

I just wanted to follow up on that last question of actually on Netflix and they obviously launched at the end of last year. Sky said that they're launching in the second half of this year. And we've had nearly a year of Netflix post launch. Have you seen any impact from Netflix? And how do you factor in this growing OTT availability into your thinking around the low-end bundles? Is there a greater risk of people taking just a Fusion #0 offer, with more OTT video?

And then just more broadly, can you remind us of your plans for original content, kind of whether the cost is OpEx or whether it's being capitalized?

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

Well, thanks, Sam, for the question. We have already, as you were mentioning, Netflix and other over-the-top players in Spain and we are not seeing a major shift in the evolution of our customer base, so far. And remember that Netflix is already very active for a year now in Spain. And our Fusión customer base keeps improving.

So I think that over-the-top players are seen, so far, in Spain by consumer as a complementary service to the bundled TV. And remember that we have today a significantly better catalogue in terms of series and movies than any over-the-top in Spain. So, I think that we still have a better offer than any of them. And as a result, I think that our customer base are seeing them as a complementary product, rather than a replacing product. In terms of the ned adds in Fusion in the second quarter, we are seeing just the opposite. Even though with Netflix already here, net adds in high and mid-end are up 6x year-on-year. So, we do not see that cannibalization, namely on the high-end or mid-end customer base. And in terms of content, it is all flowing through the OpEx side, so we are not capitalizing any content element in Spain. So it's fully reflected at OIBDA level.