

Telefonica

Telefónica January-September 2018 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 regulated information published from July 3, 2016. Information related to APM used in this presentation are included in our condensed consolidated interim financial statements and consolidated interim management report for the six-month period ended Jun 30, 2018 submitted to the Spanish National Securities Market Commission (CNMV), in Note 2, page 13 of the .pdf filed. Recipients of this document are invited to read it.

Neither this document nor the Q&A session nor any of their contents constitute an offer to purchase, sale or exchange any security, a solicitation of any offer to purchase, sale or exchange any security, or a recommendation or advice regarding any security.

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Introduction

Pablo Eguirón – *Global Director of Investor Relations*

Good morning, and welcome to Telefónica's conference call to discuss January-September 2018 results. I am Pablo Eguirón, Global Director of Investor Relations.

Before proceeding, let me mention that financial information contained in this document related to the third quarter 2018 has been prepared under international financial reporting standards, as adopted by the European Union. From the first of January 2018 we implemented IFRS 15 & 9, and all financial information in this presentation is based on this new standard. In organic terms, the effects of the accounting change to IFRS 15 are excluded in 2018. 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. 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. All forward-looking statements, involve risks, uncertainties and contingencies, many of which are beyond the Company's control.

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 or London. Now let me turn the call over to our Chief Operating Officer, Mr. Ángel Vilá.

Ángel Vilá – *Chief Operating Officer*

Q3 Highlights | Executing on strategy

Thank you Pablo. Good morning and welcome to Telefónica's third quarter results conference call. With me today is Laura Abasolo, Chief Financial and Control Officer. Following our presentation we will host a Q&A session and invite you to ask any questions you may have.

I am pleased to show in slide number 2 the good progress in the execution of Strategic Priorities in the quarter:

First, improved positive momentum on capturing high-value customers, with strong net adds in mobile contract, LTE, UBB and Pay TV, while extending our fibre coverage to 49 million premises passed and LTE coverage to 75% of population. As a result, average revenue per user grew by a steady 3.5% and our customers' loyalty is reinforced by stable churn level.

Second and by business lines; we highlight that Spain posted its best commercial KPIs in 10 years. Brazil marked the 7th straight quarter of margin expansion, with record net adds in fibre. Germany maintained MSR growth stable ex-regulation. The UK registered another quarter of stellar performance. In South Hispam, revenue growth improved sequentially on strong UBB and mobile contract. And in North Hispam, Colombia and Central America are performing very well while Mexico remains affected by negative regulation.

Third, with the aim of a sustainable digital future, we continued to evolve towards smart networks, we advanced in our digitalisation program (already yielding efficiencies) and made AURA available in Spain through "Movistar Home" from mid-November.

Overall, we are delivering strong results, with better organic year-on-year trends in revenues, OIBDA and Operating Cash Flow. FCF expanded to 3.6 billion euros excluding spectrum acquisition, and for the sixth



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straight quarter net financial debt has been reduced. All these allow us to upgrade our full year outlook to revenue growth around 2% from our previous guidance of around 1%.

Key Financials

Turning to slide 3, let me summarise key financials.

Reported figures were impacted in the quarter by forex, regulation, hyperinflation in Argentina and other non-recurrent effects. Isolating these factors, year-on-year organic growth remained very solid, ranging from +2.7% in revenues, to +4.1% in OIBDA and +4.0% in OpCF.

Strong earnings performance is translated into a 35.8% annual increase in net income in the quarter, surpassing the 1.1 billion euros mark, or 0.21 euros per share, almost 40% up.

Year-on-year net debt decline of 9.7% to 42.6 billion euros reflects our relentless focus on deleverage.

Upgraded full-year guidance

The uplift of our 2018 guidance is best outlined in slide number 4.

In the first nine months of the year revenues grew by 2.2% year-on-year, clearly beating guidance of around 1% annual growth. The improving trends seen in the quarter and the foreseeable growth for the fourth quarter allow us to increase our guidance for organic revenue growth to around 2% and again despite the drag from regulation of -0.9 percentage points.

We maintain the remaining guidance metrics unchanged, with margin expansion of around 0.5 percentage points and CapEx to Sales ex-spectrum at around 15%.

We remain committed to additional deleveraging and to improving ROCE.

Regarding dividends, we confirm the 0.4 euros per share in cash for 2018, with the first tranche of 0.2 euros to be paid this December and the second tranche in June 2019.

Improved earnings momentum driven by Europe

Turning to slide number 5, earnings momentum improved during the quarter driven by our operations in Europe, which are accelerating top line growth by 40 basis points sequentially, highlighting their positive operating momentum. As such, organic growth was +2.7% in revenues, with Europe growing +1.6% year-on-year and Latam 3.2%.

OIBDA maintained its trend vs. the second quarter with 4.1% year-on-year organic increase and expansion in margin of 40 basis points. We would like to highlight margin increase of more than 200 basis points in Brasil, 50 basis points in UK or 30 basis points in Germany, while Spain continued to surpass the 40% margin level.

Operating Cash Flow up to September had an outstanding performance, growing organically by 2.9% year-on-year or 2.2% reported to 7.0 billion euros despite higher levels of investment, positioning us well for future growth.

Solid FCF generation

On slide 6, you can see the solid FCF generation in the first nine months of the year, reaching close to 3 billion euros. Excluding spectrum the FCF would be 3.6 billion euros, with 0.9% annual growth reflecting the very strong operating performance, lower CapEx intensity and reduced financial payments and taxes. This performance also shows that the impact of FX in revenues and OIBDA is significantly lower at the FCF level.

FCF generation is the main driver of the 1 billion euros net debt reduction during the quarter (or 1.6 billion euros decrease since December 2017).



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Digital transformation framework across our platforms

In slide 7, we show our advances in the digital transformation across our 4 platforms aiming for a differential customer experience and a leaner business model.

Starting from the bottom of the slide, we are committed to guarantee excellent connectivity. We continue to virtualise the network through our UNICA global solution, now available in 11 countries, and install state-of-the-art customers equipment over an enlarged NGN network, that covers 81 m premises with UBB and 75% population with LTE.

Regarding Systems & IT transformation, our second platform, 27% of the total customer base has migrated to Full Stack and 63% of the processes are managed in real time.

With the third platform, our products & services enhance our growth profile, with digital services delivering almost 5 billion euros digital revenues year-to-date, up 25%.

Finally, on our fourth platform the use of artificial intelligence positions us a step ahead. "Movistar Home" smart device will be available from mid-November in Spain through Aura, reinventing the experience for users who will enjoy the possibility of managing by voice the contents of Movistar+, as well as communications and home connectivity.

Data monetisation | Compelling proposals

In slide 8, we show how we capture the value of connectivity with our enriched offers.

In the consumer segment, we keep innovating our proposal including: new flexible tariffs in postpaid, both in Brasil and UK, customised to satisfy different customers' needs; a comprehensive OTT video service, "Movistar Play", already available in most of Latinoamerica, and new tariffs based on "M4M" strategy in Brazil, Colombia and Germany.

At the same time, recurrent data in prepaid plans increases its weight up to 43% in Latam; a new "Fusión+" portfolio is launched in Spain leveraging premium content and fibre, and third parties services, such as Netflix are being integrated already in Chile, Colombia, Ecuador and the UK.

In the corporate segment we focus to drive digital transformation to our clients, through multicloud, security, and Big Data solutions enhanced with strategic agreements, all leveraging on our strong global capabilities. B2B revenues in the 9 months period increased by 3% year-on-year organically.

Video at the core

In slide 9, video is at the core of our strategy of offering the best Pay TV and is driving ARPU uplift and customer stickiness and, therefore, data monetisation.

In addition, video is the main contributor to Digital Services revenues at 44% and reached 2.1 billion euros in the first nine months of the year, with a customer base reaching almost 10 million TV customers (9 million Pay TV subscribers plus 1.0 million OTT active customers in Latam) across Spain, Brazil and Hispam.

Our differential capabilities strengthen our Video business. First, powerful video platforms; leveraged in unique fibre assets in Spain and unified platform in Latam. Second, scale and distribution power, with Movistar Series being an excellent example for own-produced content then re-sold to Latam and new partner-based bundled offerings, as Netflix. And third, our superior content and functionalities which make our proposition differential.

All these allow us to consolidate our leading position and to capture new growth opportunities. We have enriched our content portfolio and platforms and we are the leading video distributor in Spain and the best positioned to capture the large OTT video opportunity in Latinoamerica.



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B2B | Exploiting the digitalisation opportunity

In slide 10, we make a deep-dive in the B2B area.

This is a relevant segment with a 4 million customer portfolio, gaining traction across Telefonica's footprint and delivering above-average performance in key markets. B2B enhances our growth profile, with 60% of its revenues backed by a strong demand of Advanced Data Communications and Digital Services, which are offered in bundled and tailored propositions. B2B is becoming more relevant and, as an example, Spain improved its digital ranking becoming the 3rd IT provider, according to Gartner.

As a global ICT & Cloud Communications provider, we leverage on key capabilities to lead corporates' digitalisation. With presence in 17 operations with 12 thousand specialised salesforce, our customer centric value proposal relies on three main pillars: Consumption Based, Softwarisation, All as a Service. All this together with our network transformation, enabled the delivery of new B2B services, such as Bandwidth on Demand, Access Anywhere, and Near Real-Time among others.

All in all, we are a reference to our customers in their digital transformation, IoT and Big Data.

Successful focus on value customers; providing sustainability

Moving to slide number 11,

We continue focusing on high-value customers, the pillar of our business' sustainability. It is an evidence-based strategy with longer customer lifetimes: with mobile contract in the UK standing at 8 years, 6 years for Spain's Fusion customers, 5 years for mobile contract in Brazil and 3 years for fibre in Brazil.

This is the result of having undertaken a deep business transformation. We continue building state of the art networks, leading towards a customer-centric business model through softwarisation, data analytics and artificial intelligence as well as confirming process automation with full stack deployment and efficient sales, among others.

In addition, this transformation is the lever for a truly differentiated customer experience. As such, this has enabled us to gain velocity to scale innovations, reducing complexity and posting better time to market. Starting from our core connectivity, we have created a global digital ecosystem around the customer (including features such as Novum, Smart Wifi, Consumer IoT or Movistar Play).

Digital Transformation | Optimising customer relationship

In slide 12, we show the tangible progress made on our Digitalisation priorities.

In Spain, Fusion sales in digital channels increased 73% vs Q3 17 and users of Movistar App were up by 43%. On the other hand, self-managed technical incidents were up 21%, and more than 50 use cases of advanced analytics were implemented.

At the same time, in Brazil, users of "Meu VIVO" app were up by 46%, prepaid digital top-ups increased by 20%, and e-billing customers rose by 41% year-on-year, all contributing to 30% reduced calls to the call center.

We keep progressing well towards the target savings of more than €300m in 2018. Furthermore, we are working on other initiatives like Robotic Process Automation, Cognitive Contact Center and Blockchain that will have relevant impacts going forward.

And now, I hand over to Laura to take you through a detailed review of our business units.

Laura Abasolo – Chief Financial and Control Officer

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Spain | Record commercial activity in a reshaped market place

Thank you Ángel.

On to slide 13, we go into detail about the excellent KPIs performance delivered by Telefonica España in the quarter, that posted the best commercial activity in the last 10 years delivering proof points of our content strategy and commercial push focused on high-value convergence.

Despite an intense promotional activity from our competitors, our compelling and rich “Fusion” offer boosted gross adds, while churn was contained, resulting into remarkable net adds. These include best-ever seen fixed and mobile portability, largest FBB net adds since the launch of Fusion in 2012, and the best mobile contract net adds of the last ten years.

Fusión ARPU continued to grow year-on-year, although seasonality on calendar effects explained its lower pace of growth vs the previous quarter. The new customers’ leading quality is noteworthy, as 40% of “Fusión” gross adds subscribed high-value bundles adding incremental value to the base.

At the same time, T.España’s fibre network continue improving returns, both at the retail and wholesale layers, as proved by the more than 1.2m customers connected in the last 12 months.

In a nutshell, our superior assets and unrivalled offering make the difference in terms of value share gain.

Spain | Sustained profitability despite commercial pick-up

Moving on to slide 14, we show how T. España delivers solid financial results and preserves profitability, while strong commercial boost increases business future visibility and proves its differential customer proposition.

Service revenues year-on-year growth remains at similar levels as the previous quarter in spite of the mentioned negative calendar impact on “Fusión”; the loss of wholesale stream from MásMóvil (which impact is larger than in Q2) and MTR cuts.

Excluding the loss of wholesale stream from MásMóvil and MTR cuts, service revenues year-on-year growth remained at 1.4% on the back of higher IT and football wholesale revenues.

At the cost level, efficiencies mostly offset the increase in net content costs since mid-August, when the new football season started, and OpEx posted a narrow increase of €32M vs Q3 17, leading to a quarterly 40.5% OIBDA margin, improved on 40.0% achieved in H1.

All this translated into a robust cash flow generation of 2.6 billion euros in 9M, stable year-on-year, despite higher CapEx (due to phasing) in the period.

Germany | On-track to complete network integration

Moving to slide 15, Telefónica Deutschland maintained strong commercial momentum in the third quarter. The updated O₂ Free tariffs continued to be well received, driving data growth and our ARPU-up strategy.

During the quarter, the Company registered 233 thousand contract net additions. LTE customers amounted to 17.2 million up 9.4% year-on-year. Average monthly data usage of O₂ contract LTE customers was up by 65% year-on-year to 3.9GB per month.

With regards to financial highlights in the quarter, MSR ex-regulation stood flat year-on-year and margin expanded by 0.3 percentage points on the back of successful synergy capture of 25 million euros and focus on profitable growth.

In the first nine months, CapEx increased by 7.6% year-on-year driven by the final stage of our network consolidation and ongoing LTE rollout, while we continue to capture incremental synergies of 35 million euros.

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UK | Customer focus drives further growth

Turning to slide 16,

Telefónica UK continues being the largest UK mobile operator with 32.3 million accesses and leading loyalty with contract churn stable at 1%. The launch of “Custom plans” with an industry-first proposition, provide flexibility and choice allowing customers to select contract terms of up to 36 months. We continued to invest in our award winning network, for example, through rapid deployment of the recently awarded spectrum.

Telefónica UK’s robust financial performance delivers the 9th consecutive quarter of MSR growth and was up 3.6% year-on-year.

OIBDA accelerated its growth to 9.8% year-on-year in the quarter with the margin expanding by 0.5 percentage points, benefitting from lower Annual Licence Fee payments and a commercial settlement. Excluding the commercial settlement, OIBDA grew 5.5% year-on-year.

Operating Cash Flow ex-spectrum strongly improved by 12.8% year-on-year in the first nine months.

Brazil | Irreplicable position in key segments

Moving to slide 17,

Vivo continued widening its quality gap after accelerating its 4G roll-out and already covering 87% of the population, while expanding 4G+ technology across the country with 850 cities already covered.

Simultaneously, Vivo continued to expand its fibre footprint, reaching a total of 230 cities, 104 of them with FTTH and sustaining the leadership with the largest fibre network in Latin America.

Additionally, and once again, we delivered a strong set of commercial results:

- In mobile, leading mobile contract net adds in the market over the last 4 months, with ARPU and churn stable year-on-year in the quarter despite macro and more intense competition.
- In fixed, we enjoy outstanding results in cities passed with fibre since 2017, with an average take-up ratio of 42%, allowing FBB & Pay TV ARPU to increase by 10% and 4% year-on-year, respectively, in the first nine months of the year.

Brazil | Strong margin improvement & cash generation

Moving to slide 18,

Revenues in Q3 decreased by 1% year-on-year affected by a weaker performance in prepaid, due to the macro environment and stronger competition, and a decline in fixed voice. We would expect some future macro stabilisation post the recent elections.

On the other hand, and as a result of our value growth strategy, premium revenues continued posting outstanding progression: +8% in contract, +30% in fibre and +47% in IPTV. These are all quite sustainable revenue sources.

Furthermore, digitalisation and simplification initiatives continue to drive the 3.4% decline in OpEx year-on-year in Q3, and include savings from initiatives in call centers, back office and billing.

As a result, organic OIBDA margin increased year-on-year for the seventh consecutive quarter to 37.2%, which coupled with strict financial discipline, and despite higher capital intensity as well as FX headwinds, led Telefonica Brasil FCF to already surpass 1 billion euros in the first nine months of the year.

South Hispam | Value growth in a challenging environment

With regards to Hispam Sur, it again showed strong commercial trends, helped by further differentiation in our commercial offers now including Movistar Play, and in spite of the tougher competitive environment mainly seen in Peru.



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Moreover, fibre already reached more than 2.3m connections with an outstanding 51% year-on-year increase.

Revenue and OIBDA posted a sound growth thanks to the increase in value accesses, progressive tariff updates in Argentina and the benefits of efficiency measures, which more than offset the increase in commercial costs.

North Hispam | Colombia speeds-up; Mexico hit by regulation

Moving to slide 20, North Hispam continued to post a sound commercial performance, with positive net adds in high-value accesses, including contract, FBB, and Pay TV, namely leveraging on very good performance in Colombia and Central America.

On the one hand, financials continued to be strongly affected by weak performance in Mexico, as a result of both, regulation and the deterioration of the competitive environment. Ex-regulation, revenues in Mexico would be close to stable at -0.9%. On the other hand, there is an outstanding performance in Colombia, that posted an acceleration in revenue and OIBDA year-on-year growth and OpFC grew by 53% in the first nine months of the year.

Telxius | Value adding growth

On slide 21, during the quarter BRUSA cable came into service, becoming the highest capacity cable connecting the Americas (US, Puerto Rico and Brazil) with 11,000km and a capacity of 138TB.

The tower portfolio continued to increase with 101 new towers built in the quarter, and the tenancy ratio rose to 1.35x.

On the financial side, revenues and OIBDA increased by 33.6% and by 30.9% year-o-year respectively, positively impacted by the sale of exceptional capacity in BRUSA in a multi-year agreement. Excluding this impact top-line would grow by 5.3% year-on-year and OIBDA by 6.5%.

On the other hand, CapEx started to decline after the completion of the new cables that came into service this year, driving operating cash flow up by 18.9% year-on-year.

It is also worth mentioning, the sale of 9.99% Telxius share capital to Pontegadea for 379m euros this quarter.

Q3 non-recurrents impacting OIBDA and net income

On slide number 22, you can see the non-recurrent factors impacting third quarter OIBDA and net income, which added +100 million euros to reported OIBDA and deducted 10 million euros at the net income level.

In detail, non-recurrent effects were: 1) In Brasil, the favorable outcome of a judicial decision plus contingencies; 2) hyperinflation accounting in Argentina, 3) Restructuring provisions, mainly in T. Deutschland, T. Peru and T. Argentina; 4) Others, including mainly capital gains on digital companies and tower sales.

Net income up +11.6%, EPS +6.1%

Moving to slide 23, reported net income increased by 11.6% from the same period in the previous year to 2.7 billion euros, and Earnings per Share grew 6.1% annually to 0.46 euros per share.

Management of non-operating results continue paving the way for bottom line growth, as the 6.0% increase at the operating income level ramped up 5.6 percentage points to net income.

FX impacts in P&L, FCF and net debt

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Moving to slide number 24, swings in LatAm markets currencies, in particular the depreciation vs the euro of the Brazilian real and the Argentinian peso are dragging down reported growth in the January-September period.

At the Revenue level, FX (excluding hyperinflation adjustment in Argentina) deducted 3.3 billion euros year-on-year in the first nine months of the year. This negative impact decreased to 1.2 billion euros at the OIBDA level, and was further mitigated at the FCF level, with a negative impact of 330 million euros. On the contrary, forex has lowered net financial debt by 106 million euros year-to-date.

Organic contribution to headline figures continue to be very solid and consistent.

Net debt reduction on strong FCF

Let's move now to the financial metrics on slide 25.

We keep on reducing our net debt figure which stands at 42.6 billion euros, as of September, -1.6 billion euros vs. December 2017, backed by strong cash flow generation.

In terms of our net debt to OIBDA ratio, we ended September at 2.68x.

Strong liquidity thanks to attractive long-term financing

Slide 26 shows how Telefonica has successfully approached capital markets taking advantage of benign market conditions early in the year and raising 12.4 billion euros year to date. Our average debt life remains high at 9.2 years, an increase relative to 9 years in June 2018 and 8.1 years in December 2017.

We have increased our liquidity cushion by 1.5 billion euros relative to June 18, maintaining a liquidity position of 20.4 billion euros, comfortably exceeding our next two years of maturities.

I will now hand back to Ángel.

Ángel Vilá – *Chief Operating Officer*

Summary

Thank you Laura.

To conclude, let me highlight first that our quarterly results show the continuous progress on strategic positioning, the delivery on profitable results and the commitment on financial discipline.

Second, the sound results achieved till September allowed us to increase our revenue growth guidance for the full year to around 2%.

Summing up, we remain focused on long-term value creation, delivering sustainable growth through business excellence and aiming for FCF accretion.

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Q&A session

Georgios Ierodiconou – Citi

The first one is around your leverage. In the past, you expressed perhaps an interest in increasing your debt in Brazilian reais should the exchange rate and the funding costs be reasonable at the time and there has been a sharp, obviously, appreciation of the currency in the past few weeks. So, I was wondering if this is something you are considering doing at this point.

And the second question is on Spain and Fusion's ARPU. You mentioned that there are tougher comps because of the price increases you implemented last year. Correct me if I'm wrong, you are not planning any similar tariff rebalancing this year. So, I was wondering whether the mix of customers you've seen coming through in Q3 is such that gives you confidence this will come through regardless of any tariff rebalancing.

Laura Abasolo – Chief Financial and Control Officer

On net debt and debt in local currency, particularly in Brazil to your question. As you know, the first thing we always emphasize is that the FX impact diminishes quite substantially until we go to the free cash flow level, and our main objective is to protect solvency. So, whenever there is a reduction on free cash flow due to FX, we have a similar reduction or even larger in net debt.

In the first 9 months of the year, the EUR 330 million reduction in FX goes along with a net debt reduction of EUR 106 million, which is lower. However, if you look at this historically, and we have shared this information with you in the past, you can see that, usually, the net debt reduction is higher than the free cash flow reduction, and therefore, the solvency is protected.

Having said that, we continuously look, as you said, whether the depreciation of the FX could be useful to increase debt in local currency. We have a benchmark of 1x in LatAm and 2x in Europe. And we monitor the economic profit analysis. So if we issue debt in Brazilian reais, we have immediately a higher cost of carry due to hedging of that debt that will flow through free cash flow with higher interest payments. And we may have or not a reduction of net debt depending on the FX evolution.

If we do the economic profit analysis today after the elections and the Brazilian reais ramp up, the economic profit would be negative. So, if we had issued Brazilian debt at the beginning of the year at that 1x benchmark of OIBDA, we would have had a loss.

So, you can be sure that we continue monitoring and doing that analysis of the cost of carry versus the FX evolution. However, the cost of carry is a certain, and it would be lowering cash flow while the FX evolution is really dependent on FX movements. And as of today, it would have been the wrong decision to issue more debt in Brazilian reais at the beginning of the year according to that 1x OIBDA to debt ratio in Brazil.

Ángel Vilá – Chief Operating Officer

And regarding Fusión and the ARPU, let me comment first generally on Fusión KPIs, and then I will detail on the ARPU.

The commercial performance of Fusión is measured by several KPIs. All of them have had positive performance this quarter: the customer base, the mix of the base, the churn and the ARPU. Fusión customer base is up quarter-on-quarter and year-on-year, +4.1%. The mix, as you can see on Slide #13, is attractive. 40% of the gross adds we had in the quarter were in the high-end segment. And this high-end segment is moving from 27% to 29%. The churn of Fusión is stable, both year-on-year and quarter-on-quarter.

And finally, to your question, Fusión ARPU is up again year-on-year, reaches EUR 89.2, with a growth of 1.8% year-on-year. To explain this year-on-year improvement of Fusión, we have had a positive impact from tariff upgrades. The impact from upselling this quarter has been neutral as increasing in high-end but also increasing in low-end have compensated each other. And we have had some dilutive effect from promos and from mobile add-ons migrating to Fusión multi-line packs. What we see is that the quality of the customers that we have captured in the third quarter and the good value mix of those customers will impact positively



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on ARPU and also on B2C revenues already in Q4. So, we are expecting positive net adds and ARPU growth in Fusión in Q4.

Guy Peddy – Macquarie Research

Firstly, on Spanish pay TV, you only added 100k customers. Did you have any problems registering people in the quarter? And should we expect a continued strong development in Q4 if there is a bit of that time lag?

And secondly, can you talk about what is commercially going on in the U.K.? With strong revenue growth and EBITDA growth, but also net adds, it looks like it's quite a positive dynamic, and I just wondered whether you felt that the U.K. market was pretty well structured currently.

Ángel Vilá – Chief Operating Officer

We believe that the net adds in pay TV in Spain in the third quarter have been actually very strong. We had above 100,000 net adds in the quarter. These net adds have come in the higher end, so these are very valuable customers that have brought not only their TV subscription, but all their services to Telefónica. If you compare this to the second quarter of this year, that figure was 8,000. So, now we have in the third quarter more than 100k, and we have seen a performance that has not been seen many times in the past. So, we feel very good on this front. This has exceeded our expectations. We expect to continue to see traction. And this has taken us a very long way in compensating the loss of wholesale revenues to other parties.

In the U.K., the performance is very strong. We continue to be the favourite mobile network in the U.K. We continue to have customer growth. We have had the highest contract additions for 8 quarters. It's the ninth consecutive quarter of MSR growth, and this comes with continued revenue and OIBDA growth. We are launching to the market very innovative propositions. We launched the Custom Plans, which are very flexible for our customers in order to tailor what type of usage they want to do, both on the device side and on the consumption side. We continue to have the “yo-yo” flexible tariffs. We have been launching family plans, which give discounts for family members. All of this are allowing to have a consistent ARPU growth. So, the performance and the traction and the momentum in our U.K. business continue to be very strong, and we see no reason for this trend not to continue along the year.

Jakob Bluestone – Credit Suisse

Firstly, on Spain, can you maybe help us understand in terms of where you are getting the incremental customers from? Clearly, a big part of it is going to be from Vodafone. I mean, is this acceleration really just purely driven by getting more Vodafone football customers, or are you seeing a sort of broader “halo effect”? So, a broader pick up where you're getting customers from the other operators as well.

And then, secondly, there were some press articles a few weeks ago talking about a potential disposal of Mexico and Central America. I was just wondering if you can maybe share any thoughts on that. And perhaps also more broadly, any other sort of non-core disposals, what your sort of current thinking is on that?

Ángel Vilá – Chief Operating Officer

With respect to the commercial performance in Spain, I should say that (as we said in the Q2 results call), we were ready to propose to a market compelling offers, including football, that were aimed to attract customers that were interested in that type of content that were not satisfied by their provider offer. So we moved very dynamically and decisively from August to make attractive offers to our customers. One has to take into account that Q3 is always a very strong promotional quarter with the back-to-school campaigns and the start of the football season, so not so atypical, maybe this year a bit more intense. And we wanted to move forward decisively, because, of course, both ourselves and Orange would have that content, and we wanted to grab a significant part of customers that we're looking for a provider with that type of content. So as I said in the presentation, we've had the best commercial performance in 10 years. We have had record number of



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portabilities. We have positive net adds in all segments, in Fusión, in fixed broadband, in fibre, in TV, in mobile contract and these have not come at the expense of our increased presence in wholesale “NEBA” fibre. So we have grown both in retail, but also in wholesale fibre. So probably when one looks at the portability numbers, you can see the trends of every player, how all of us are performing, but it goes beyond just the name that you said.

With respect to speculations on Mexico and Central America, as you know, we look at our portfolio of assets looking to improve the return on capital employed. We are managing our assets in order to move in this direction. Mexico is still suffering from the impact of regulation. Central America, which you saw on slide #20, is posting a very, very good performance. It's a small region, but it's doing very nicely. We have noticed press speculation about potential interested parties on those assets, but we prefer not to comment on such rumours.

Akhil Dattani – JP Morgan

Firstly, just to stick on Spain, I guess just a couple of clarifications. We've had quite a lot of promotional activity in the quarter. So I guess I'm quite keen to understand to what extent or not that's been impacting the ARPU dynamics that you've talked about. And as you are talking about Q4, if I understood correctly, you're saying that the momentum will improve. So does that mean that you're expecting the consumer revenue performance to improve, or I'm maybe reading that a little bit wrong?

And I guess maybe just sticking with Spain as a follow up. I guess next year, the La Liga dynamics between yourselves and Vodafone will change, unless Vodafone will stop making payment. Can you maybe help us understand how you think about what that means to your EBITDA into next year?

And then the second thing was just on leverage and spectrum. I guess yesterday, Telefónica Deutschland talked about IFRS 16 and the impact that they were expecting from that accounting change next year. I guess I'd be interested to understand how you're thinking about that. And linked to that, just any comments around what spectrum auctions you're expecting next year would be useful too.

Ángel Vilá – Chief Operating Officer

Again, on Spain and the evolution in the third quarter. As I said before, Q3 is always a quarter that sees significant promotions. This year maybe a bit more intense. We added customers in the second part of the quarter, because you know football campaign is mostly in August and September, so the impact of those customers was not in all the quarter, but in the last part of the quarter. This will be seen in Q4 already. We got a number of those customers through promotions, as those promotions end you will see also the revenues coming from this new subscriber base to start adding revenue growth already in Q4 and gradually have a larger impact over the next months as those promotions expire. So we have good visibility and we have confidence in seeing a growth acceleration in B2C in Spain in the Q4.

Regarding the content cost of La Liga, we said already in the previous conference call that the content costs will peak in Q4 this year, will stay the same in Q1, Q2 next year, and will start declining from Q3 onwards. These will be reflected in our accounts. But as you saw in Q3, we already had a step-up in content costs because it's the third season of the previous La Liga cycle which had cost inflation versus the second season. And we have been able through efficiencies to absorb that extra content cost, and we have actually achieved 40.5% OIBDA margin, which is higher than the 40% that we were having in the first half of the year. So, yes, we will see some incremental content cost in Q4 this year and in the first half of next year. We will continue working to mitigate that extra content cost with efficiency measures, as we have been doing up to now.

Laura Abasolo – Chief Financial and Control Officer

With regards to IFRS 16, the group is currently assessing the effect of the application of this standard that will have an impact in the reported financial information, but not an impact on our economic position or free cash flow. We are not in a position at the moment to give you further visibility. The information is under analysis. As you know, there will be an increase in net debt, but OIBDA will also improve. And it's important to notice that credit rating agencies are already taking into account for all leases within the ratios, so it won't



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be an increase in that regard. But we are working on the analysis. There's a significant work around it, and we will be in a position to give you further visibility at the time we announce results at the end of the year.

Akhil Dattani – *JP Morgan*

Great thank you. Any colour around spectrum auctions you're expecting next year?

Ángel Vilá – *Chief Operating Officer*

For next year, we think that there could be spectrum auctions in Germany, potentially a 700 MHz in Spain as well. Those would be the most significant, although it's not 100% sure they will take place in 2019, some of them could move to 2020.

Keval Khuroya – *Deutsche Bank*

I have 2 questions, one on Brazil and one on Peru. We have seen sort of mobile service revenue trend being a bit weaker in Brazil in Q3 given competition and macro, as you mentioned. You have repositioned your tariffs now. Should we therefore expect the service revenue trends to improve in Q4? And whilst the top line is still a little bit weaker than what we saw at the start of the year, do you still see the current rate of EBITDA growth as sustainable? And second, in Peru obviously quite a bit of a deterioration with EBITDA growth in particular given the competitive environment, looking on Q3 and in terms of what you've seen in Q4, has the market remained competitive or has it improved at all?

Ángel Vilá – *Chief Operating Officer*

On Brazil, which presented results yesterday and had a very nice performance in the market, we have had a mix of items that affect our revenue evolution.

On the one hand, we continue to be very strong in contract. We have a good performance, with the churn stable, we are leading net adds in the market, and we have been able to apply some M4M price increases in pure postpaid in September. And you should expect for hybrids contracts as well some M4M moves. On the other hand, in prepaid, we have seen weakness due to macro performance and more aggressiveness in the market coming from some competitors. We have made a new launch in prepaid in September. And the new prepaid offer is focused on acquisition and then migrating to hybrids. So as a result, and as was expressed by my colleagues in Brazil yesterday, we expect better trends in revenues in Q4 and a more rational competitive environment. On the fixed side, what we see is the decline in the traditional voice, and we see double-digit increase in fibre and pay TV. So these would be the trends. All in all, we think we have seen the bottom. And in the fourth quarter, we would see better trends.

And this comes with a focus on efficiency in Brazil. We have had 11 consecutive quarters of decline in OpEx, so we are increasing OIBDA margins, we're expanding margins in Brazil. And yes, we have CapEx intensity because we see an opportunity to grow in fibre in Brazil, but still, a very good performance in operating cash flow, and combined with tax impacts and so on, a very good performance in free cash flow.

In Peru, we have been working in the turnaround. Commercial activity is improving. We continue to have strong performance in fixed. However, the market is quite competitive. And we need to continue working and improving the operations and the performance in our Peruvian asset. We have a strong base of assets in Peru, and we think that we can improve the operation, but Q3 clearly was a point of competitive intensity that maybe slowed us down a bit on our turnaround trajectory. We are working to try to post revenue growth in Q4 in Peru.

Mathieu Robilliard – *Barclays*

First, in Colombia, you had a very strong performance, clearly doing better than your competitors there. And I was wondering if you could give a bit of colour as to what is behind that and how sustainable that is. And



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second, coming back to Spain and focusing on the O2 brand. Can you give a bit of colour in terms of where you are in the launch process? And what are the initial reactions? And generally, how is the competitive environment in that segment of the market?

Ángel Vilá – Chief Operating Officer

Colombia, we are very happy with the performance. We have a solid commercial performance, which is leading to strong financial results. Both revenues and OIBDA growth are accelerating. In mobile, we had an increase of 8% year-on-year in accesses. This is driven by contract which rose 2%, prepaid 10%, LTE is up 47%, smartphones 14%. And in fixed, from a lower base, but we are growing fixed broadband 27% year-on-year in accesses and pay TV, 6%. So we think that the market is a good market. Once we left behind the recapitalisation of the company, we said that we were ready to go to capture profitable growth in Colombia, and we think that our results are proving this to be the case.

The launch of the O2 brand, which we launched on beta mode in July, has now in October been made in full-fledge. We have been designing the proposition under accretive criteria. And we want to segment the offer in such a way that we provide to different type of customers appealing and competitive products. O2 is complementing both our premium offering that we offer through Movistar and Fusión and the low-cost that we offer through Tuenti. So we try to fill a commercial space in between, targeting customers that demand plain, but competitive quality propositions with easy product portfolio structures and innovative and frictionless customer care, what we call 'premium simple'. So the attributes that we are looking for in this brand are quality, easy price structure, only communications and name recognition. We use the O2 brand, by the way, because it's a very well-recognised brand, and at the same time, provides us with very cost-efficient way for this launch. It will be competitive, but it will be rational, so it should not trigger disruption in this segment of the market. It's still early days. We have done the full launch now in October, but I can already say that we are having very good sensations.

Mandeep Singh - Redburn Europe Limited

My main question really is on Spain again.

The first component of the question is the sort of 1.4% service revenue growth, you're suggesting ex MásMóvil and ex MTRs. Is that a sort of good proxy for where you are seeing the real underlying health of the business? And if these effects lapse next year, other things being equal, is that the growth trajectory we will see something in the positive 1%, 1% to 2% range? I know you don't give guidance, but just to get a feel of sort of underlying trend. So that's a first question.

And related to Spain, I noticed that IT services was like a 25% growth. Can you just give us a little bit more on what's driving that? Is there anything one-off, anything lumpy in there? Is it seasonal contracts? And what's the margin dynamic of the IT services type of business relative to the base of the business?

Ángel Vilá – Chief Operating Officer

Talking about the service revenue growth, let me go through the components, the trends that we see to try to give you some visibility and try to convey to you why we feel confident.

There are three components to service revenue: B2C, 55% of service revenue; B2B, 27% of service revenue; and "wholesale and others", which is 18%.

On B2C, what we see is that the increases in both volume and ARPU and the commercial performance in Q3 should, if anything, accelerate the trends that we have seen so far in the year.

B2B (and this includes your second question which is IT) in the Q3 is growing 1.5%, the second quarter consecutively of B2B growing. This has two components: the traditional communications revenue declined 1.6% in Q3 and IT in the quarter grew 13.3%. And this is not lumpy, you'll have seen in the previous quarters that IT revenues have been either mitigating (which was the case in Q1), or more than compensating (which was the case in Q2 and Q3) the decline in communications. So, we have a good positioning in IT. During my



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presentation, I was saying how Gartner is recognizing our Spanish operation in its IT proposition. So, the revenues and composition of B2B revenues are improving, and the trend is there.

And then wholesale, because we have been flagging that ex- MásMóvil and regulation, our service revenue would be growing 1.4%.

In wholesale, you have several components. One is the MVNO loss, which will annualize and fade probably from Q2 19 onwards, so that headwind will disappear in due course. Then, we have the wholesale of “NEBA” fibre and the migration from copper, which is value accretive. And then, now that we have more content than we used to have, the TV wholesale revenue line will increase.

So, what we have been seeing in 2018 as a headwind from the third component of service revenues, which is “wholesale and others”, should change sign going forward. So again, we cannot guide. It's too early to guide for 2019, but we see good visibility that gives us confidence.

Nicolas Didio – Berenberg

One question is regarding the content. You haven't yet, I think, launched the kind of partnership with Netflix in Spain. Just relating to the content and negotiations of the rights. With Netflix, as an OTT player growing, and you have on the other side a traditional pay TV with the output deals, can you kind of renegotiate with lower tariffs the output deals with the majors in the U.S. or the rise of Netflix is not impacting anything there?

And with Netflix, is it kind of you provide them content and you will get a favourable access to their offer in terms of billing? Or is it a pure you resell revenues and you will have a kind of normal relationship with Netflix? That's the first question.

The second is regarding Latam M&A.

We have seen Millicom doing a 1 billion deal in Panama. I mean Latam is very fragmented, you have a focus on deleverage. Is this focus on deleverage preventing you to do bolt-on deals or the fact that there are no deals on your side, it's just the conclusion that deleverage is key for you?

And maybe a follow-up on content, just to understand what you're saying on absorbing higher football cost next year. So far until Q2 19 Vodafone has the 8 “Liga” games. Do you assume in your latest Fusión price change and in your 2019 budgets that Vodafone will not pay you for the 8 games and stop completely football? Just to have a view on that.

Ángel Vilá – Chief Operating Officer

Regarding content, I think Netflix and majors are different items. We, as they expire, we will aim to renegotiate the contracts with majors. And we think that our competitive position and customer base, which achieved record high in the Spanish market in Pay TV, will allow us to have a proper negotiating position at the table when we get to negotiate contracts.

Regarding Netflix, it's a different item. It's our strategy of integrating OTTs in our platforms. We have reached a global agreement with Netflix to integrate their content with our pay TV platforms. In Latin America, this takes the format of revenue share. Carrier billing in such geographies is something that is very much appreciated by OTT players, and we're integrating not only Netflix, but some others. And this is a very cost efficient, no commitments, revenue share type of approach, which is very valued by our customers.

The agreement in Spain, which we are planning to launch by the end of this year: we will resell Netflix contents to our Fusión customers who choose to include it in the package. This will provide our customers an enhanced customer experience because we will offer Netflix through IPTV, not over-the-top as other deals in the market, and it will be fully integrated within our platform and equipment. The search will be integrated, there will be integrated capabilities in our systems to recommend contents to the customers and really improve quality, thanks to our 4K descos. So Fusión customers will be able to enjoy a better customer experience with Netflix through their integration with us. And Fusión customers will receive a unified bill from Movistar, including the Netflix, so it will make their life simpler. This is a win-win proposition for both Netflix and us.

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You added a question regarding Vodafone and the football. If Vodafone wishes to reconsider and acquire the football, of course, they have all the right, and we would welcome them to do so. We will continue in spite of that decision (that you have to ask them if they want to reconsider), but we are quite confident with our strategy and performance in Q3 which has shown that our strategy has proven right.

On your question on Latam M&A, we are driven in our decisions by ROCE. We look at our operations. We are in the process of approving our 3-year strategic plan, our 3-year business plan. We are requesting from all our units to improve on this metric. And our portfolio management decision is also linked to this kind of metric.

Every time that there is an opportunity for in-market consolidation, which we continue to believe that it's probably the type of M&A activity that adds more value, we have a duty to monitor and analyse those opportunities. And we have proven in the past that we are not only open, but we have been very active in in-market consolidation in certain markets. We analyse those, but we only move when we think that the opportunity makes sense for us.

So, I don't know if this responds to your question. We are driven by return on capital employed, and we will analyse the in-market consolidation opportunities and move if they have merits according to our financial criteria and value-creation criteria.

David Wright – *Bank of America Merrill Lynch*

I think the first question may have been beaten to death, but I'm just trying to understand the discount rates on a lot of the commercial activity in that 100,000 or so TV adds and the very strong underlying Fusión. Should we be thinking that the kind of incremental ARPU from those guys has kind of come in at a sort of circa 50% or so discount? Is that the kind of discount you guys are running? I'm just trying to get a feel of how we should be factoring that in, but I know that question's been asked many times.

My second question was just on Brazil actually and some of the tax rebates of the court cases that you guys have recently won, another one announced yesterday, I think it was BRL 2.4bn. How are you guys accounting for that? Is that just coming straight into net debt as a potential receivable? Or is that just going to come in as effectively lower tax paid over time? How should we think about accounting for those numbers given they are really quite material?

Ángel Vilá – *Chief Operating Officer*

Let me say something. The average ARPU of the adds that we have had in the Q3 is higher than the average ARPU of the adds that we had in the first half of the year. As you can see, in slide #13, 40% of the gross adds have come in the high-end segment of Fusión. So, even if we have been attracting customers with promotions, which I insist, we always see promotional activity at the beginning of the football season every year, the customers, when the promos finish, will provide ARPU accretion and will provide revenue growth in these customer segments.

So, higher number of customers that have come at ARPUs higher than what we were capturing before Q3 that are in the high end of the profile of the customer base. So, this will be ARPU and revenue accretive from Q4 onwards.

Laura Abasolo – *Chief Financial and Control Officer*

David, regarding the judicial decision in Brazil. As you said, we had a second recognition this quarter and there are still 3 potential more to come of a smaller size, but there is still potential for more coming in Brazil accounts and group accounts. Accounting-wise, for the long-term portion, this is accounted as "financial assets and other non-current assets", and for the short-term portion, as "tax receivables".

In our net debt, we are accounting for the full amount of BIC as this is a monetary asset that generates interests. So therefore, in the net debt amount of June, you could see the first part of the judicial and now in the September, you can also see the additional of the second decision. Going forward, the free cash flow is

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going to reflect as well that cash inflow, because we are going to be mostly compensated for the PIS/Cofins, so for other indirect taxes in Brazil.

So, you will also see that tax coming through the free cash flow, and it's already been the case in September. In September, we have about €150m Brazil free cash flow in the group free cash flow. But that won't impact net debt, because in the net debt is being accounted upfront. So when we have the recognition of the asset, we are accounting for the reduction on net debt.

And you've seen that in June and also in September and going forward, we are going to see a reduction of taxes in Brazil and in the group, mostly indirect taxes, and that's going to flow through free cash flow, but won't reduce net debt because we accounted it upfront as the judicial revision decision has taken place.

Fernando Cordero – Santander

The first one is coming back to Spain, and digging a little bit more on B2C segment, and particularly on the non-Fusión revenues, which for the first time in the last 10 quarters have been growing q-o-q. And I would like to know if you have seen or you're starting to see a stabilization on that business line, particularly in terms of volumes.

And, the second question, regarding the U.K., given the strong performance there, I would like to get a view on what are the great of the two main drivers probably on this performance, on one side, the retail or the end-user activity is driving the growth in EBITDA. And what is the contribution of the wholesale business in this EBITDA growth in the U.K.?

Ángel Vilá – Chief Operating Officer

On your first question around the non-Fusión revenues in the B2C segment in Spain, the trend is, as you said, is improving. This trend is due to lower 1P TV decline. We still have customers in single play TV, which have been migrating towards IPTV and Fusión, and this decline is lower in the quarter and also is impacted by the different calendar of tariff upgrades.

With regards to the U.K., OIBDA, what we have is a continued strong growth in subscriptions, we have seen the RPI increases and we see customers continuing to choose higher value tariffs. MVNO growth is also there. We have had a little bit more of commercial costs, on the other hand, which partially has been mitigated by a reduction in functional costs, the reduction in the annual license fee, and we had the commercial settlement in the quarter.

The OIBDA performance in the U.K. was very high in the quarter, growing 9.8%. But even if you exclude this commercial settlement, it's growing at 5.5%, which we think it's a spectacular performance with benchmark margins for the U.K. market and margin expansion.

Joshua Mills – Goldman Sachs

The first is a point of clarification on slide #13. How exactly do you define high, medium and low-end customers? Is it based on the price point on which they are brought into the bundles, or is it based on the content they receive? And if the latter, how is this going to be affected by the new range of football tariffs you've set up with access to football at lower price point than previously?

And the second was just around co-investment schemes we've seen announced in the Spanish market with Vodafone, Másmovil, Euskaltel. Would you consider participating in any kind of co-investment scheme in some regions where you haven't already rolled out your own fibre?

And then finally, if I can ask a quick one. The hedging and kind of free cash flow drop through some FX impacts you show on slide #24 is quite encouraging. But I just want to understand, why it is that the free cash flow impact is so low when presumably quite a lot of the CapEx you spend is in hard currency for equipment in Latam, and I'd also expect the hedging of your interest expense comes at a cost as well?

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Ángel Vilá – Chief Operating Officer

Regarding how we define high-, medium- and low-end. In the high-end, we have Fusión Total, Fusión Total Plus, Fusión Total Plus with 4 mobile lines. So these are packages that with a fibre of 600 Mbps have prices of EUR 130 and above. Low-end are packages that we call Fusión 0 and Fusión Base, although we call them low-end, the price with the 600 Mbps fibre ranges between EUR 55 and EUR 72, and the mid-end is the point in between.

Regarding your second question, on Vodafone and Másmovil, we think it's a limited agreement that does not entail enlargement of the footprint. We have entered into wholesale agreements with Vodafone, with Orange. And of course, the market is regulated. So, we think that we can provide economically efficient wholesale access to fibre to any player in the Spanish market. We have seen good traction in the wholesale 'NEBA' and the accretion between the migration from copper to fibre, and this should see no need for overbuild in the Spanish market.

Laura Abasolo – Chief Financial and Control Officer

With regards to the page in which we saw the free cash flow impact from FX, you have to take into account that this is not only being diminished because of CapEx, it's also taxes, minorities, financial payments. So, there is a whole flow of things reducing the impact. I also have to say the c.330 million euros has been very much affected by the Brazilian reais, and that situation is turning. We saw a big appreciation already in the month of October. So we should expect that Brazilian impact getting reduced going forward. Also, on the CapEx in hard currency, first, as part of our operational hedging strategy, we do hedge for invoices in hard currency FX. But you have to take into account a lot of the CapEx we have also is in local currency, particularly with FTTH and FTTx deployment, there's a lot of outsourcing with local companies, so the hard currency piece is not as big as you can imagine.

