RESULTS
January – March 2021
Conference Call Transcript

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Introduction

Adrián Zunzunegui – *Global Director of Investor Relations*

Good morning, and welcome to Telefónica's conference call to discuss January-March 2021 results. I am Adrián Zunzunegui, Global Director of Investor Relations.

Before proceeding, let me mention that the financial information contained in this document related to the first quarter 2021 has been prepared under international financial reporting standards, as adopted by the European Union. This financial information is unaudited.

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We encourage you to review our publicly available disclosure documents filed with the relevant securities market regulators. If you don't have a copy of the relevant press release and the slides, please contact Telefónica's Investor Relations team in Madrid or London. Now let me turn the call over to our Chief Operating Officer, Ángel Vilá.

Ángel Vilá – *Chief Operating Officer*

Presentation

Q1 21 Results

1. A strong start to 2021; improving growth outlook

Thank you Adrián. Good morning and welcome to Telefónica's first quarter conference call. With me today is Laura Abasolo, our Chief Financial, Control and Corp. Development Officer & Head of T. Hispam. As usual, we will first walk you through the slides and we will then be happy to take any questions.

First, I would like to briefly go through our Q1 results:

- It has been a strong start to 2021 on the commercial front. Our customer base grew 2% year-on-year, and group NPS improved to 27%, a record high, and 9 percentage points higher than in Q1 2020.
- It has been a strong start also on the financials; momentum quarter-on-quarter improvement seen in Q4 was maintained in Q1 21, with sequential improvements in both revenue and OIBDA trends. Despite Q1 facing the toughest year-on-year comparison in the whole 2021, once comparison base eases as from this Q2, we should see a gradual improvement along the year.
- Cash conversion improved, on higher operating leverage paying off, with growing operating cash flow and margins.
- FCF ex-spectrum payments grew by 200% year-on year, while net debt will soon be reduced further.
- We posted a stellar EPS year-on-year growth of 158%.

Secondly, we see growth gaining momentum; March already showed year-on-year growth in terms of revenues, OIBDA and OIBDA-CapEx. And we are generating the strongest growth from our strategic priorities, our new Tech businesses, UBB, particularly FTTH, and in high-value and converged services in our four core markets. Moreover, B2B revenues continued to improve sequentially, +2.8 percentage points, above total revenues, showing we are best placed to grow.

Also worth noting the return of growth comes whilst managing capital intensity, as we remain focused on smarter capital allocation, aimed at enlarging growth opportunities while capturing efficiencies to increase returns. In this respect, spectrum acquisition in the UK at much lower prices than benchmark is a clear win.

And third, we continue making progress on our strategy.

- We advance towards completion of our UK JV, which received preliminary CMA approval, and the most likely approval of Telxius towers deal in Q2. These two should allow to book capital gains in Q2 of more than €6bn and reduce net debt by approximately €9bn.
- We also launched our joint FibreCo in Germany, with the Brazilian and Chilean operational launches underway.
- In Hispam, we continue to optimise our operating model and increasing leverage in local currencies.
- T. Tech continues to grow strongly, with revenues increasing by over 25% year-on-year. We continue to streamline our operations with close to 80% digitised processes and OPEN RAN solution progressing to plan.
- Finally, all the above happens whilst ESG recognition continues to excel, showing it is an integrated element in our strategy.

2. Financial performance

Moving to slide number 2 for the review of our financial performance.

Our reported results continued to reflect FX impacts and COVID-19, but less pronounced than in the previous quarter, as you can see in the charts on the slide. We continue managing FX, and headwinds are largely neutralised at the FCF level.

In organic terms, it is the 3rd consecutive quarter of sequential improvement in revenue and OIBDA, with revenues declining 1.3% but both OIBDA and OIBDA minus CapEx already showing year-on-year organic growth. We continue to focus on efficiencies and smart capital allocation: CapEx was almost flat year-on-year organic in the quarter, with NGN related activities representing close to 50% of total. OIBDA and cash flow margin expanded 0.6 and 0.3 percentage points organically year-on-year respectively.

Free cash flow of 33 million euros reflects spectrum payments of close to €700m, FCF ex-spectrum payments grew by 200%. Net debt grew slightly from the previous quarter for the same spectrum reason, but declined compared to March 2020 by 6.4%. Furthermore, and as stated, we expect net debt reduction by approximately €9bn in Q2 due to the completion of the Telxius towers and UK deals.

3. Spain | Continued recovery in revenue and OIBDA

On slide 3 we review the performance of our Spanish operation.

Our commercial performance was muted as we continue bringing rationalisation to the competitive environment, this being a long-term strategy. In any case, NPS surpassed 30% for the first time in 3 years, a 5 percentage point increase from Q4 last year, and 14 percentage points higher year-on-year. NPS GAP versus competition also increased to 16 percentage points (that’s 4 percentage points higher y-o-y), showing customer perception is gaining strong momentum. Network quality and demand for speed, bandwidth and superior content rank higher in consumer considerations. On this strong satisfaction scores, we are optimistic on our future commercial performance, despite sticking to our plan to cool down competition.

Financial performance again showed a sequential improvement in both revenues and OIBDA. Top line improved its trend by as much as 2 percentage points from Q4 last year, with record growth, again, in IT sales, accelerating 7 percentage points versus Q4 2020. Convergent ARPU widened its gap vs our closest competitor, thanks to our superior offer and a growing contribution from new businesses. As an example, Movistar Prosegur Alarmas gross adds in the quarter being 4 times higher than in Q1 2020. Moreover, wholesale revenues continued to perform steadily. Profitability remains benchmark as well, despite growing CapEx into next generation networks. Again, network quality is the pillar behind our record customer satisfaction.

4. Germany | Solid operational and financial performance

Moving to slide 4.

Telefónica Deutschland posted good operational and financial performance despite continued COVID-19-related headwinds.

It is worth highlighting the solid OIBDA performance, up 5.7% year-on-year in Q1, mainly driven by revenue performance (+0.2% year-on-year) and effective COVID-19 cost measures. As such, OIBDA-CapEx improved by 8.5% year-on-year.

The O2 Free portfolio continues to be well-received and drives trading performance and ARPU-uplift (ex roaming). Churn remained at historic low levels supported by improved network quality.

In April, T. Deutschland was awarded a 'good' rating in the CHIP magazine fixed network test, a significant improvement vs last year's rating.

5. UK | Record Q1 OIBDA, successful spectrum acquisition

Moving to the UK on slide 5, where we continued to deliver market leading NPS and churn, resulting in a 5% growth in mobile accesses to reach 36.6 million, the highest base in O2 UK's history.

In a quarter where the UK was under strict lockdown, versus just two weeks in the prior year, revenue was down 9.4% year-on-year, but OIBDA grew by 7.6% year-on-year on the back of strong cost control and commissions savings, driving a record performance for the Company in Q1.

It's also worth highlighting that Telefonica UK secured a significant share in the latest spectrum auction at considerably lower prices than European benchmarks. As part of the negotiation period in April, the Company also agreed a trade to create a contiguous block of 80Mhz in the 3.4-3.8 GHz band, which makes this spectrum even more valuable.

And of course, as I mentioned earlier, we received provisional approval for the JV between O2 and Virgin Media from the CMA in April, and we continue to work constructively with the CMA to achieve a positive outcome.

6. Brazil | Outstanding value growth led improvement on financials

In Brazil, as can be seen on slide 6, we accelerated value growth reaching the highest contract net adds since Q4 17, that reinforces VIVO's leadership with more than 33% market share in the Brazilian mobile market. This takes place at the same time contract churn reached historic low levels, at close to 1%, which is an indication of the quality of our customer base. We also managed to increase FTTH up-take to 23% and continue progressing on the development of one of Brazil's largest digital ecosystems.

So, top-line growth is back this quarter, with our core businesses (which are 88% of the total revenue base) growing by as much as 5% year-on-year, and with legacy drag becoming less and less evident, as shown by fixed revenues annual drop of just 1.4%, some 6 percentage points better than in the previous quarter.

These, coupled with continue efficiencies, mainly due to digitalisation, allowed Vivo to also post better year-on-year OIBDA trends, with OIBDA margin reaching a remarkable 42.7%.

7. Tech | Growth acceleration for trusted digitalisation partner

On slide 7 we show latest developments from our fastest-growing unit, Telefónica Tech.

Top-line growth accelerates in the quarter to 25.1% year-on-year, leveraging the reinforced proposition of our Cloud & Cyber unit, which grew its high value revenue (namely managed, professional and platforms services which make for more than half of this division) by 33% year-on-year. Relevant deals in public administration and the financial sector have been signed throughout the quarter, adding visibility to the pipeline. Digitalisation is becoming mandatory for businesses of all sizes.

IoT & Big Data continues to be impacted by COVID-19, with certain projects being interrupted (mostly in retail) and lower sales of IoT/Big Data Solutions. However, we see a commercial recovery from previous quarters, whilst IoT Connectivity continues showing healthy growth.

Telefónica Tech current perimeter gathers all those services identified as a priority in a first phase, and additional transfer of businesses is still expected along 2021.

8. Infra | Top infrastructure portfolio manager

Moving to slide 8.

T. Infra, our infrastructure portfolio manager, continued to focus on pursuing value creation opportunities. Telxius' towers sale to American Tower Corporation, at a record 30.5x multiple, was a clear example. The transaction is expected to close most likely in Q2.

As we announced, Telefónica's strong footprint in fibre is further expanding through sharing agreements and fibre vehicles. In this respect, our German fibreCo UGG has secured financing for its first three years, whilst FiBrasil was already approved by CADE, pending only ANATEL's green light.

Additionally, Telxius' subsea cable has expanded its state-of-the-art portfolio in Q1, reaching almost 94,000 km of subsea fibre. Its premium and unique infrastructure, together with high top line and cash flow visibility from the renewed contract with Telefónica and growing share of third-party revenues, and scalable growth platform, gives us full optionality with respect to this asset.

Finally, the announcement of the acquisition of a 20% stake in Nabiax in exchange for the contribution of four data centres into the company also allows value crystallisation while Telefónica keeps strategic and operational flexibility.

I now hand over to Laura for a review of the financial position, our Hispam operations and ESG progress.

Laura Abasolo - *Chief Financial, Control and Corp. Development Officer & Head of T. Hispam*

Hispam | Reducing exposure without jeopardising growth

Thank you Ángel and we will now go through the Hispam main highlights on slide 9.

During the quarter we continued to reduce our exposure to the region, as demonstrated by the launch of a fibre vehicle in Chile, which is pending regulatory approval, and the recent sale of our wholesale DTH business, a move aligned with our commercial strategy of prioritising investments in growth, and which will bring savings at both the OpEx and CapEx levels.

Along these lines, we continued to add debt in local currencies and aligning the region's leverage with that of the Telefonica Group. At the same time, we efficiently managed investments in the region, with CapEx to sales at 11% in the first quarter. All in all, we continue to reduce capital employed in the region.

This strategy to modulate our exposure is happening without jeopardising growth; contract net adds grew 54% from the previous quarter, as much as 1 million improvement vs Q1 last year, whilst we multiplied FTTH net adds by 3 times.

Ongoing value growth and continued OpEx & CapEx efficiencies led to more than 2 percentage points sequential improvement in revenue performance to flat year-on-year growth, and as much as 31.5% annual growth in OIBDA-CapEx. A remarkable achievement.

Continued balance sheet optimisation

On slide 10 you can see that despite a slight increase in net debt in March by approximately €500m, once you include the proceeds from inorganic transactions approved, namely Telxius towers in Europe and the second tranche of T. Deutschland towers, net financial debt decreases already to €31.8bn. Furthermore, it will stand at approximately €26bn with the additional inorganic initiatives announced.

We maintain a proactive and innovative approach to financing in 2021, raising €3.1bn in total, including €1.7bn related to the Allianz and Telefónica Group deal financing. Similarly than in 2020, we have been at the forefront of sustainable financing.

We have maintained our average debt life above 10 years, while maintaining a robust liquidity cushion of 19.7 billion euros, which comfortably accommodates upcoming maturities over the next 2 years.

All this financing activity has been executed at historically low interest rates, enabling us to reduce our effective interest cost to 2.96% as of March 2021.

Achieved significant endorsement of our ESG commitments

The first quarter has further consolidated our commitment to sustainability in each of the three pillars in which we work:

- To highlight the issuance of the first sustainability hybrid bond of the telecommunication sector, which joins the two green bonds we had already issued in the past. This new €1bn bond brings in both environmental and social impact projects, such as the broadband connectivity deployment in rural areas and support for SMEs and entrepreneurship. The bond achieved the lowest hybrid coupon in the history of Telefonica with demand exceeding €7bn. The bond has become a catalyst to fostering digital inclusion by deploying connectivity infrastructure and supporting entrepreneurship. For example, our Wayra initiative that has just celebrated its 10 years has driven the creation during this period of more than 10,000 skilled jobs in Europe and LATAM.
- In addition, we have renewed our targets associated with remuneration, increasing the weight of our environmental objectives, while maintaining commitments to gender equality, customers and society. We have also defined long-term targets for reducing CO2 emissions and remain committed to achieving Net Zero Emissions in our four key markets by 2025.
- Precisely, this net zero emissions goal has enabled us to join the European Green Digital Coalition, which is a combined initiative between the European Commission and leading ICT companies to drive digital solutions to create an innovative and sustainable economy. All this effort is being widely recognised by the market. Recently, Telefónica has been recognized by S&P Global Ratings Agency for our sound management of environment, social and governance risk, and we run top global telco in the ranking digital rights 2020.

I will now hand back to Angel to wrap up.

Ángel Vilá – *Chief Operating Officer*

Well on track for 2021 guidance

Thank you Laura.

Moving to slide 12, let me tell you that despite challenges and an uncertain environment due to COVID-19, we feel very confident to meet our financial guidance for the full year.

Q1 results are in line with our expectations, and we are already close to our full year guidance of revenue stabilisation despite Q1 being the toughest in terms of comparison base. OIBDA is already stabilised, and CapEx should be accelerating throughout the year to the guided normalised level of up to 15% over revenues.

In fact, once comparison base eases as from this second quarter, we should see a gradual recovery along the year.

On shareholder remuneration, we cancelled 83 own million shares, and we will be paying €0.2/share, the second tranche of 2020 dividend, through a voluntary scrip dividend next June. As for the 2021 dividend, €0.15/share will be payable in December 2021 and another €0.15/share in June 2022, both through voluntary scrip dividend.

Summary

To wrap up, on slide 13.

We continue to execute on our strategy and significant progress has been made in this respect over the last three months. We are only weeks away from large capital gains and net debt reductions being booked, once Telxius towers and the UK JV obtain final approvals.

It has been a strong start to 2021. Whilst year-on-year trends inevitably reflect the continuing impacts of COVID-19 against a largely unaffected first quarter last year, the momentum of month-on-month and quarter-on-quarter improvement seen at the end of last year was maintained in Q1. We would also like to highlight the stellar growth in EPS and FCF ex spectrum we delivered this quarter.

We are firmly on track to fulfil 2021 guidance; with a more evident recovery from this Q2 once the comparison base eases.

Smart capital allocation continues to drive our strategy; 50% of CapEx in our core four markets continues to be devoted to next generation networks. This quarter we also managed to acquire spectrum in the UK at prices significantly below market expectations. Through the reassignment process the value of such spectrum increased even further.

Thank you very much for listening. We are now ready to take your questions.

Q&A Session

Mathieu Robilliard – *Barclays*

I had a question on Spain first with regards to the trajectory of the convergent ARPU. I understand that you increased some prices during Q1, but we still saw a decline in the ARPU year-on-year. I was wondering what was behind that? Is it largely related to the impact of the pandemic on some of the revenue lines? Or are you seeing downspin between the different packages? Or is it just a mix of the 2? So if you could give us a bit of colour on that, that would be very helpful.

And then with regards to your disposal program, as you show in your slides, I think the total is €9bn. Can you remind us the big blocks that constitute the €9bn? And whether there is some impact also on the leases that wouldn't be captured by the €9bn, which, as I understand, are excluding these impacts?

Ángel Vilá – *Chief Operating Officer*

Thank you, Mathieu. I'll take the first question, and Laura will deal with the second one. With respect to the ARPU of our converged product, there is indeed a decrease in the absolute amount, although there is an increase with respect to the gap versus our competitors. The reasons behind this ARPU decrease in the first quarter: first, there is a value mix erosion due to COVID-19. We have seen some of our customers reposition in some downgrades. There has been also a higher base with promotions, and this had its peak in Q1 because we are deliberately moving our promotions to far less intensity. So, this would be a non recurrent impact. We also are seeing some increase in the options with just connectivity, having more penetration, such as O2 and Movistar Conecta Max, and lower out-of-bundle consumption.

On the other hand, on the positive side, what we see is the tariff upgrade that we've put in place in the first quarter that will be having more effect in the quarters to come. And, we have also repositioned our Fusion product to include handsets going forward that will bring an ARPU uplift. And we are also seeing, and we will see more of the contribution of new digital services in the ARPU. I would like to emphasise that the gap that our ARPU has versus the next competitor has widened by 9% when comparing the first quarter of this year versus the first quarter of last year.

Laura Abasolo - *Chief Financial, Control and Corp. Development Officer & Head of T. Hispam*

Mathieu, with regards to the €9bn, the majority of that, as you may imagine, will be the Telxius Towers deal and also the proceeds from the O2 JV with Virgin Media deal in the UK, which by the way, as we commented, is going to be approved in a few weeks, and the towers in Europe have already been approved, and Telefónica Deutschland towers were also approved. So much of it is going to flow through already in the net debt reduction. And you also have to take into account the strengthening in the balance sheet that it will occur not only because of the net debt reduction, also because of the capital gains attached to these 2 projects.

On top of that, you do have the Costa Rica proceeds. We have fulfilled all the regulatory information requirements, and we should be expecting regulatory approval in the coming months. We will also have proceeds from the FibreCo in Chile which includes brownfield, as you know. On the opposite direction, we need to include the Oi mobile assets that we are acquiring. We also have the FibreCo in Brazil, which in the short term, has no significant impact from a net debt perspective.

You are right, the €9bn does not include the leases. The UK transaction, for instance, is going to be more beneficial once you include the leases because we are going to deconsolidate the leases we have at present from O2 UK. On the other hand, Telxius will have a reduction in the impact because we will have to recognise the additional leases. Oi and Costa Rica have a rather small impact from leases. But all in all, and you know these numbers could change, the €9bn would be around €1bn less because of leases coming basically from the towers.

David Wright - *BoAML*

Just firstly, on the guidance. Given the progressive recovery expected through the rest of the year, I can clearly see the logic for the revenue guidance that started a little bit light but then recovers. But based on that recovery and the fact that EBITDA has started positively, could we not be looking at a better EBITDA performance than the guidance? Or is it maybe just a little too early to commit?

And then secondly, just on the U.K. I noticed the much better EBITDA. And I'm trying to understand how much of that margin increase is due to just the pure commercial activity being lower. Or whether that's a more sustainable margin increase even as the U.K. comes out of lockdown?

Ángel Vilá – *Chief Operating Officer*

Thank you, David, for your questions. With respect to guidance, we reiterate our 2021 guidance of stabilisation in revenues and OIBDA. You saw that in Q1, which was a COVID quarter that compared to a non-COVID quarter 1 year ago, we already got the OIBDA stabilised, and the revenue trend was improving. Also, what we see is that once the comparison base eases, we should see a gradual recovery along the year.

Here, what we see is that there are tailwinds that should be supportive of our revenue line, such as the macro environment with vaccinations gaining pace in Europe. You may have seen that the European Commission raised its forecast for GDP growth in Spain yesterday, to almost 6% this year and close to 7% next year. At some point, the European reconstruction funds will also be a tailwind, and very relevant to both digitalisation and connectivity in those programs. Germany and U.K. are lifting gradually the restrictions. We continue to see strong momentum in our B2B and Tech businesses…

So, we think that there are tailwinds, but it's difficult to assess the timing. For instance, will roaming come back in June, July, August? It's difficult to say. On your question on OIBDA, recovery of roaming would be quite determinant for OIBDA improvement. Also, we see that some of the revenue growth that we're seeing comes on those lines that have relatively lower margin, like handsets with a gradual recovery of stores, and some of the Tech and IT products. So, we believe that we need to see some of those tailwinds to start materialising before making any move to our guidance.

Last year taught us to be prepared for the unexpected. So at least, for the time being, we prefer to stick to the current guidance, with which we feel very comfortable.

David Wright - *BoAML*

If I could just jump in before maybe the second question. If revenues are set to recover, I don't see why the OIBDA would go backwards. It feels to me like stabilisation is very cautious. It should seem like the EBITDA goes back to growth.

Ángel Vilá – *Chief Operating Officer*

We have seen in this quarter with, for instance, the shop lockdown in places like the U.K. or Germany, that some commercial costs were not incurred. And this clearly came to highlight the OIBDA performance in those 2 geographies in the first quarter. Some of these costs will normalise or will go back to usual evolution now that retail is being opened again. Again, we need to see high-margin revenue lines like roaming starting to reactivate. So, at this stage, we prefer to stick to the current guidance, maybe conservatively. But we want to state that we feel very confident with this guidance.

And then regarding your question on the UK. UK had a very positive evolution of OIBDA of +7.6% this quarter. There are a number of moving parts in this strong growth in the UK, the most relevant being that we moved our distribution model away from Dixons Carphone 1 year ago. This implies some tension on the revenue line, as you saw, but at the same time, significant commission savings which have continued to build on a cumulative basis since the second quarter of last year. We also have a number of phasing-related cost savings in the quarter in marketing and sponsorship, a portion of which should pick up as the economy starts to open up. Again, we also have had some commercial settlements, although for not high material figures.

And especially, I would like to highlight the great work done by the U.K. team on cost control. They have been managing the cost base very effectively in the U.K. while delivering a market-leading NPS, market-leading churn and growing the mobile base by 5% to its highest level in history of O2, to 36.6 million customers.

Keval Khiroya – *Deutsche Bank*

I've got 2 questions, both of which on Spain. So firstly, you've obviously highlighted that you wanted to cool down the Spanish competitive environment, and you have seen the indication in Q1 on your subscriber trends. Do you think you've been successful with that strategy such that we should expect those subscriber losses to now moderate? And then second, just following on from the previous question. You've successfully shown an improvement in the Spanish service revenue trend for the past 3 quarters, but the organic EBITDA decline has been relatively similar over those 3 quarters. So can you talk about -- I know you don't go divisionally, but can you talk about how we should think about the EBITDA trends domestically as those Spanish revenue trends also improve?

Ángel Vilá – *Chief Operating Officer*

As I said in my speech, we continued, as we had done in the fourth quarter of last year, we continued cooling down the market in Q1. This has been hitting our B2C commercial KPIs on several factors. We had promotional expiration concentrating in Q1 because of 6-months' promotions from half year before and 3-months' promotions from the previous quarter were expiring in Q1. We also applied more-for-more price increase in January. These are Q1-related effects, not necessarily structural ones.

But at the same time, this is bringing benefits such as a reduction in the churn in convergence. We have also seen the market becoming more rational with some of our competitors or most of our competitors following more for more actions, and consolidation of low-end brands. We have seen in-market consolidation between Masmovil and Euskaltel. So, all of these are trends that are bringing rationality to the Spanish market. And in this process, we have been achieving a record high NPS, growing the gap versus our competitors. We think that this is a strategy that is bearing fruit with respect to cooling down the market.

The market continues to be polarised between the high and low-value segments of the market, and we continue to increase our performance in the higher end of the market. The gross adds in Fusion have been coming with higher ARPU. The high-value TV base continues to grow. It was around 50% 1 year ago versus two thirds now. And in convergence, high-speed fibre and O2 customers continue to grow. So, it's a strategy that we continue to implement.

With respect to the OIBDA trends in Spain. What I should say is that in this first quarter, the sequential improvement has been lower than what we have seen in revenues. We have got 2 percentage points improvement in revenues from the trend in the previous quarter to this quarter. And this brings some increased revenues, for instance, in handsets, which have lower margin than the overall margin. We also have IT and tech growth at record levels, 7 percentage points higher than the previous quarter. And this also comes with lower margin. And we have not had any benefit from roaming this quarter, which is a high-margin activity. So, this would be the elements that mostly explain the evolution of OIBDA versus the revenue evolution in our Spanish operation.

Mandeep Singh – *Redburn*

I have a couple of questions, please. So just coming back to the U.K. on service revenues, your margins are now 46%. I mean, in the history of U.K. Mobile, I don't ever recall these types of margins being delivered. So I'd like a little bit more colour on the sort of sustainability of that high level of margin in the U.K..

And then the second question is also in the U.K. I think there's a lot of interest in, the JV is now complete, so I'm sure you've given this some thought. What you think about U.K. network expansion when it comes to fibre? What are your attitudes towards wholesaling fibre to other people like Sky or anybody else for that matter, off balance sheet vehicles or funding that expansion? Just thoughts around sort of fibre strategy and wholesaling of that in the U.K.

Ángel Vilá – *Chief Operating Officer*

Thank you, Mandeep, for your questions. Let me try to give some more colour on the U.K. margins. Again, we have had a very high profitability performance in the U.K. with some factors that are to continue going forward and some factors that probably have been more specific to the first quarter. Among the factors that are going to be more recurrent is the better margin that we have from having moved from indirect distribution to direct distribution. This is here to stay. We have had a cumulative impact from commission savings since we moved away from DCP. Here, we did not incur in a one-time payment to DCP in order to improve the margins. Later on, we continue in this DCP model to pay existing commissions, but given the different volumes on each one of these channels, this figure will continue to be helping our profitability.

Also, the recurrent type of efforts, we have very strong cost control in the U.K. It's in the management remit to continue to do so. Of course, with the joint venture going forward, you should expect this to be also incorporated with the synergies that will be derived from the transaction.

On the elements which are less recurrent from this high profitability in the UK would be those related to all the COVID impacts from the first quarter. We had a full lockdown in the UK in the first quarter, and the country is moving away from that situation. So, you should expect a portion of that marketing and sponsorship costs to recover again. An example also could be in the smart metering program, where we were not able to do installations during the lockdown. This will be reactivating as the economy reopens. So, this would be the moving pieces of this margin. You are looking in this quarter at a record high-margin for our UK operation.

Then with respect to the U.K. network, of course, we need to first close the transaction. We have a preliminary approval, and we continue very constructively in talks with the CMA for an expeditious move ahead with the transaction. Virgin Media already has 15 million premises passed through different technologies in the UK. Virgin Media has plans to move ahead with at least 1 million premises passed in addition. And as Mike was explaining in his Liberty Global conference call one week ago, there is an opportunity to continue to upgrade and expand the network in the UK, potentially aiming at an additional 7 million premises passed above the previous figures. This could be done by accessing highly efficient sources of funding and potential partnerships. As soon as we close the joint venture, we would be taking those decisions together, along with our partners. Here, we have proven that we are extremely positive and focused in growing fixed ultrabroadband fibre in all our footprint. And the U.K. would not be different from that. But for specific plans on this front, we would need first to close the joint venture and then reach agreement with our partners.

Michael Bishop – *Goldman Sachs*

Just a question on free cash flow. You've had a good start to the year on an underlying basis, excluding spectrum. And I remember, I think I asked the same question at Q4. You said there was quite a few moving parts. So it was a bit difficult to give sort of verbal guide on cash flow like you gave in 2020 as the year progressed. But I was just wondering whether you've got any more updated thoughts on where we could be thinking about free cash flow landing for the year, and in particular, any sort of moving parts below operating cash flow.

Laura Abasolo - *Chief Financial, Control and Corp. Development Officer & Head of T. Hispam*

Thank you, Michael, for the question. Let me focus first on the Q1 free cash flow because I think it shows our solid performance and capabilities to generate a strong free cash flow. It's been indeed impacted by the spectrum paid, which is being U.K., Chile and also part of Spain. We are very happy about the successful execution of those 3 spectrum auctions, removing a lot of uncertainty. And in the case of U.K., it was well below benchmark expectations. But the €727m, excluding spectrum, reflects regular seasonality of the first quarter. This year will not be an exception. Free cash flow generation is generally back-end loaded.

If we go through the expectations for the year, I'm afraid, Michael, I have to give you a similar answer to the one I gave you a few months ago. We do not guide on free cash flow, but we remain very focused on delivering a very robust free cash flow. It's an absolute priority. It's going to comfortably exceed dividend payments, labour commitments and hybrid coupons, and it's going to be a sustainable driver for continuing deleveraging on top of the very sizable inorganic deals.

Operating cash flow, it will flow through the guidance we gave you, which is OIBDA stabilisation and CapEx moving to normalised levels of 15%. Below operating cash flow, as you asked, working capital will be business as usual. You can also expect that we are going to continue optimising our financial payments. That's something which is structural, and it's all flowing through P&L and free cash flow. Tax payments, very much affected by refunds and so on, but we have a midterm guidance of around 20% with the unavoidable volatility of payments in advance and refunds.

Spectrum, we still have Spain and Brazil to come. But I think the uncertainty removed around U.K., is crucial for the free cash flow generation of the year. Minorities in line, so a lot of management in every single line. Uncertainty is still there, so we are not comfortable with giving any guidance on free cash flow as we did last year. We did it much well advanced in the year, not so early. But be safe that we are focused and we are going to manage resources aligned with results and aligned with revenues as we did. Again, let me emphasise that that resource prioritisation, as you can see, it has not been at the expense of growth. And we are able to deliver this free cash flow and at the same time, posting a strong solid commercial results.

Jakob Bluestone – *Credit Suisse*

Firstly, on Spain, you mentioned earlier the sort of slight disconnect, between service revenue trends that are improving, but EBITDA growth is still sort of stuck at minus 5. And you alluded to the fact that there's a bit of a mix shift happening within your revenues. So if you look a few years out, what do you actually think will happen to margins in Spain? Do you think they can go up, stay stable? Or do you think they could fall because of this mix shift?

And then just secondly, if you can maybe just give an update on how the disposal for Hispam is getting on what are sort of the key milestones to come.

Ángel Vilá – *Chief Operating Officer*

Thank you, Jacob. When we look at margins in Spain, I would like to reiterate what I stated in the previous conference call after Q4. We still see OIBDA margins around 40%. In this quarter, the margin was 39.2%, and we see for the year margins around 40%, which are sustained margins compared to last year. These are made of evolution of different lines in the revenue evolution and evolution on different cost lines. So, for instance, in this first quarter personnel cost has had a slight decline, and a more significant decline in commercial costs. Content costs have been decreasing year-on-year. We have had an increase in supply costs, especially those related to IT and hardware supplies that come with some of our tech and IT businesses.

But when we look ahead (and we don't guide over years, and only guide for the Group), we continue to believe that a margin of 40% or around 40% for our Spanish operation is where we are aiming.

Laura Abasolo - *Chief Financial, Control and Corp. Development Officer & Head of T. Hispam*

Hispam is progressing with the strategy of strengthening our assets while reducing capital employed. We have completed operations, a legal carve-out and have a fully dedicated team working at Hispam. So we have all the optionality. We are prepared. We continue to modulate our exposure in the region with the agreement such as the FibreCo in Chile or the wholesale DTH sale now. We are prioritising investments in growth, and that will be accompanied by savings on OpEx and CapEx as we digitise those operations more and we go to a much leaner operating model. All this, without jeopardising growth. You saw it in the slide, revenue and OIBDA trends are improving to virtually stable, contract net adds of over 600,000; we multiplied fibre net adds by 3x year-on-year; efficiency accelerating, operating cash flow growing more than 30%. And all of that's whilst improving customer satisfaction. And we have leading NPS in 5 markets.

We are continuing de-risking our balance sheet by adding debt in local currencies and aligning the region's leverage with that of Telefónica Group. Precisely this quarter, we have refinanced bank financing in Chile and we have already issued a bond denominated in Chilean pesos in April. So that's all working and on track. We continue, of course, exploring and working in different M&A alternatives. There are different routes. Optionality is there as we continue improving those assets. I think we have gained ourselves with the successful execution of various landmark transactions in the past months, the flexibility to choose the right timing to make the right and value-accretive decisions. But we will continue posting solid results. We will continue showing that we are modulating exposure in many different ways and improving the return on capital in this region.

Ángel Vilá – *Chief Operating Officer*

Let me complement my previous comment on margins. When one looks at the first quarter in Spain and you compare it to the previous year, last year we reported some capital gains from sale of real estate and other assets in our figures. In Q1 '21, there are no material or substantial comparable situations.

And the other thing I would like to add is that CapEx to revenue in Spain will continue to be best-in-class. We are aiming this year for something below 12%. So, the operating cash flow margin for Spanish operation is benchmark in Europe.

Luigi Minerva – *HSBC*

Can I ask you about the point you make in the presentation about exploring more fibre optionality in Europe? We've seen some initiatives in Germany, obviously, and Spain has so far been off the table. I was wondering if there is any change in view there?

And secondly, if you could share your views on the way the recovery fund may have a positive impact on the Spanish operation? My understanding is that these are public money that will help investments where private capital is not available. It would be helpful to hear your views.

Ángel Vilá – *Chief Operating Officer*

Thank you, Luigi. With respect to fibre, we are constantly looking for alternatives to accelerate fibre expansion because we think that there is, and even more in this post-pandemic world, there is growing demand for high-quality ultra-broadband in different countries now. So, in Germany, we established this 50/50 JV with Allianz. It's already up and running. We have permits in several municipalities to start building, and we have already started building in a number of those municipalities. We expect to sign up the first customer already in the month of May. In Brazil, we also, in addition to our own development in the first tier of towns and cities in Brazil, which is done 100% by Vivo with our own CapEx, we are launching FiBrasil, which is a 50-50 JV with CDPQ. This would be new cities. So, it would be incremental to our existing footprint. And we also have wholesale agreements, and we have franchises. The target in Brazil is to reach 24 million premises passed by 2024.

In the U.K., I commented before, the strategy will be linked to first, closing the JV, and then agreeing with our partners. But we are, across all of our footprint, supportive for alternatives to accelerate fibre. in Spain, we have the most developed fibre deployment in the whole of Europe. It's a strategic asset, which is probably not reflected in our valuation. And it's one that could give us optionality in the future. But we declare it as a strategic asset. And you should expect us to continue exploring efficient ways to deploy fibre across our footprint.

With respect to the next-generation funds or the recovery funds from the European Union: Out of the €750bn European Union wide, €140bn is the amount allocated to Spain. 50% of the €140bn being direct subsidies or transfers and the other half being loans. At the moment, the Spanish government is focusing on the direct transfers in an initial phase, and has axes which are relevant for Telefonica, which are digitalisation and environmental. A big part of that amount of money is to digitalisation, about 20%; and to environment around 35%. Environment is relevant because deployments such as fibre are qualifying for environmental improvement processes. So Telefónica has designed what we call Telefónica Next Generation program, which has 3 major priorities.

- One is around connectivity. We want to provide the best connectivity, secure and efficient for everyone, and there will be funds allocated to this such as fixed broadband in rural areas or 5G coverage in rural areas.
- The second axis in our plan is to improve competitiveness of the Spanish environment, giving SMEs accesses to technology. 5G, for instance, in Industry 4.0, smart cities, connected mobility, cultural industry support.
- And the third axis is linked to strengthening the pillars of well-being or welfare in society, meaning digital education, health care, digital administration and ecological transition.

So Telefónica is already submitting a proposal of projects along these lines. Spain as a country already has sent its proposal of national recovery and resilience plan to the European Union, joined with a program of reforms that need to be implemented to qualify for those funds. And we believe that this is going to be a competitive program. It's going to have public-private collaboration, probably will be done in ecosystem with partners. Telefonica is perfectly qualified to make these funds effective and accelerate the economy and digitalisation. We think that this is one of the tailwinds that I was talking about at the beginning of the call that should be helping (we don't know exactly in which quarter but later in the year) the revenue trend of Telefonica.

Thank you very much, and we hope that we have provided some useful insights. Should you still have further questions, we kindly ask you to contact our Investor Relations department. Thank you.