

# TELEFÓNICA

TELECOMMUNICATION SERVICES

STUDENT: MANUEL NUNES

# COMPANY REPORT

04 JUNE 2012

## Debt matters

### *Risk averse investors spree away from debt*

- After an aggressive acquisitions strategy to consolidate its position in Latin America and Europe outside of Spain, Telefónica is now hard pressed to look into ways of reducing debt from current highs of €59.6 Billion net financial debt in order to avoid further cuts in its current debt rating of BBB. There is increased pressure due to Spain's and overall Eurozone sovereign debt situation which is still far from a safe resolution and the fact that its shareholders have faced a negative return of 45.5% for the past year.
- Telefónica has thus reduced shareholder's remuneration commitment for 2012 from €1.75 to €1.5 per share with €0.9 being delivered through a scrip dividend. Simultaneously it is actively pursuing the sale of non-core assets and announced on May 30<sup>th</sup> the beginning of preparations for an IPO of Telefónica Germany.
- Faced with extremely negative conditions in its home market Telefónica decides to effectively focus on the markets with higher growth potential<sup>1</sup>, specifically in Latin America. At the same time it is relying on the consistency and stability of results that it has gradually obtained in European markets<sup>2</sup>, with the objective of growing organically by taking advantage of the strong position it has in many if not all its markets.<sup>3</sup>

<sup>1</sup> Average market penetration in Telefónica's Latin American markets was 110.4% at the end of 2011 significantly below average in its European markets of 132.1%. Additionally according to IMF's "World economic Outlook" released in April 2012 real GDP growth for Advanced Europe is forecasted to be -0.1% and 1.1% in 2012 and 2013, respectively while for Latin America and the Caribbean it is forecasted at 3.7% and 4.1%.

<sup>2</sup> In 2011 the company had an organic annual growth in revenues of -7.6% in Spain, -1.6% in Europe and +3.5% in Latin America.

<sup>3</sup> Of Telefónica's 15 main markets the company is the market leader in mobile accesses in 5 and is in second place in 7. Additionally it offers quadruple play services in 7 markets and three services (including mobile) in 5.

**Recommendation:** BUY

*Vs Previous Recommendation* N/A

**Price Target FY12:** 15.66 €

*Vs Previous Price Target* N/A

**Price (as of 4-Jun-12)** 9.00 €

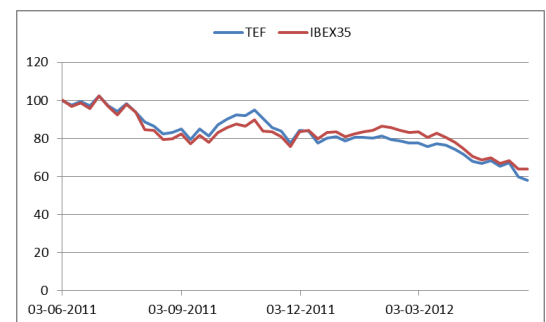
Reuters: TEF.MC, Bloomberg: TEF:SM

52-week range (€) 8.81-17.05

Market Cap (€m) 4,1417.43

Outstanding Shares (m) 4599.89

Source: Bloomberg



Source: Bloomberg

| (Values in € millions) | 2011   | 2012E  | 2013F  |
|------------------------|--------|--------|--------|
| Revenues               | 62,837 | 62,713 | 62,786 |
| OIBDA                  | 20,210 | 21,127 | 21,092 |
| Net Profit             | 6,188  | 4,787  | 5,156  |
| EPS                    | 1.12   | 0.92   | 1.00   |
| P/E                    | 8.07   | 9.79   | 9.02   |
| Debt/OIBDA             | 3.28   | 2.9    | 2.97   |
| Net debt/OIBDA         | 2.95   | 2.65   | 2.72   |
| EV/OIBDA               | 6.8    | 6.5    | 6.5    |

Source: Bloomberg and analyst estimates

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## Executive summary

We value Telefónica using a Sum of the Parts (SOP) approach, with an explicit Discounted Cash Flow (DCF) valuation for Brazil’s operations, based on available information. For each country’s unit we forecast Key Performance Indicators (KPI’s) as well as revenues and Operating Income Before Depreciation and Amortization (OIBDA) in local currencies, which are then converted in euros using forecasted exchange rates or market forward exchange rates and summed in three regional units: Spain, Latin America and Europe. These are then integrated in a global valuation. For Brazil we computed FCF in reais converting to euros the equity value directly, using market forward rate for the end of 2012. We look at the main regulatory frameworks as well as current trends in the industry. Finally we also look very carefully at the debt level evolution in order to understand the effectiveness of proposed decisions while also analysing other means at the company’s disposal to avoid further downward pressure in its credit rating.

## Valuation

According to our valuation Telefónica is worth €15.66, which is significantly above current price of €9.00, representing a potential shareholder gain of 73.93%. We believe the market has been especially negative on the company’s stock effectively explaining the loss in value seen in the past year and the underperformance relative to peers and the IBEX 35. We see the strong debt aversion now present in all Europe due to increasing concerns associated with sovereign debt as an explanation for the behavior of Telefónica share price as the company debt increased to above average levels at the worst possible time.

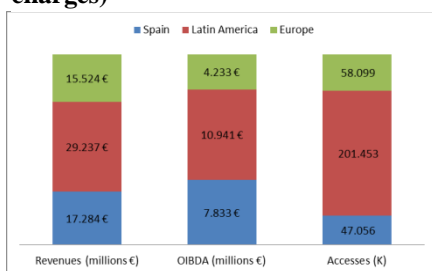
### Spanish Market

*The valuation of Vivo independently through DCF allows us to look more carefully into the potential for value creation with Vivo.*

*Besides the announced IPO for Telefónica Germany there are other means at the company’s disposal to address concerns surrounding its debt level.*

*For the past year not only did Telefónica underperform relative to peers with a negative return of 45.5% compared with an average of -13.06% among comparables and 41.03% for IBEX 35*

**Figure 1 - Financial and Operational data in 2011 (excl. restructuring charges)**

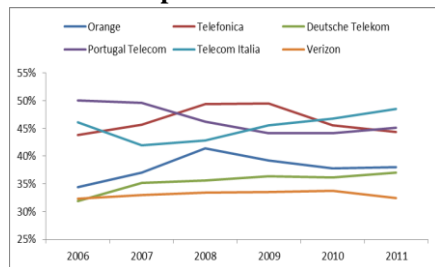


Source: Company Report

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Home market operations are greatly affected by the current macroeconomic conditions that Spain is going through as a result of both 2008's financial crisis and the current sovereign debt crisis. Still the country continues to represent a very significant fraction of the company's cash flow creation (27.5% of Revenues and 33.76% of 2011 Group OIBDA, excluding workforce restructuring plan charges). As the incumbent operator Telefónica has been able to take advantage of its brand recognition and network quality to continuously present the highest OIBDA margins in the country and among the highest between comparable companies in their home countries. However stronger competition and a depressed economy has led Telefónica's revenues to present a negative CAGR (Constant Annual Growth Rate) in the past three years of 6%. For the first time ever in 2011 the company presented negative growth year over year (y-o-y) in accesses of its three main segments (fixed and mobile telephony and internet services). According to our estimates the company's revenues will show almost no growth as MTR cuts and decreased market share (significantly in fixed line segments) are not compensated by increased data ARPU (0.1% CAGR 2012-2021) while OIBDA will increase at double that rate (0.2% CAGR 2012-2021) as the company takes advantage of its efficiency measures, namely: the workforce reduction program that we expect will reduce in 2012 personnel expenses as % of revenues by 1.3%; and the T-Global Resources division that is concentrating company's efforts regarding procurement and which the company predicts will allow a €1 billion benefit in 2012. In 2021 Spain is forecasted to represent 22.6% of revenues and 28.2% of OIBDA due to above average OIBDA margin.

**Figure 2 - OIBDA margins of telecom companies in their home**



Source: Companies' Reports

***In Europe Germany has presented the best prospects being Telefónica's only market in Europe presenting growth organically in 2011. This might be an explanation as to why Telefónica while looking for a chance to monetize its assets chose Germany. Otherwise the depressing European landscape might have made the IPO very hard to fulfil.***

### European Market (Excluding Spain)

Here the company has been able to somewhat stabilize its results with continuous growth in accesses - 3.2% growth in overall accesses for 2011 - while revenues have been down for all countries in both local currency and Euros, except Germany that presented a healthy 4.4% growth in 2011. Overall the revenues were down with a reported 1.3% in 2011, mostly as a result of the competitive landscape, the depressing Irish landscape where revenues were down 14.6%, but also cuts in MTR<sup>4</sup> in Czech Republic, the UK, Germany as well as Ireland. OIBDA was up 3.8% for the year, though it is exaggerated by a restructuring charge in Germany in 2010 of €202 million. Without this effect OIBDA would have been down 1.2%. We expect to see growth in revenues starting next year and

<sup>4</sup> Mobile Termination Rate – In the European case it is the cost that calling operator has to pay receiving operator to terminate the call (Calling Party Pays)

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forecast 2.17% CAGR from 2012-2021. OIBDA CARG is expected to be 3.37% for the same period driven by a more established position in Germany where the acquisition of HanseNet has allowed Telefónica to be quadruple-play player and in the UK where Telefonica already offers three services. We predict that supply costs as a % of revenues in the region will gradually decline from 2011 levels of 44.3%, compared to 22.3% in Spain or 25.8% in Latin America, being the main contributor to growth in OIBDA. Additionally this effect in OIBDA can be explained by the fact that we estimate 2012 not to be a very good year or that today Telefónica lags in what concerns OIBDA margins, and with the effect already mentioned of T-Global Resources and lower competition and customer acquisition costs, OIBDA can reach higher levels. In 2021 this region shall represent around 25% of Revenues and 20.6% of OIBDA up from 23.6% and 18.3%, respectively.

## Latin America

This region is where Telefónica has been showing increasingly better results, driven by growth in accesses with the region representing 45.9% and 47.5% of Revenues and OIBDA respectively and a huge 65.7% of accesses. Total accesses have shown tremendous momentum with 9.6% growth in the 2011, with growth from all segments excluding fixed telephony (-1.8%) with 63.5% of new accesses coming from Brazil, that overall already represents 43.3% of accesses. In 2011 revenues grew a reported 13.5% or 5% organically<sup>5</sup>, this growth was also affected by the massive MTR cut in Mexico. For the period from 2012-2021 we expect revenues to increase at a CAGR of 1.55% and 1.85% for OIBDA or 3.89% and 4.12% respectively in local currencies. The main reason for the discrepancy is related with Exchange rate expectations that in most countries are predicted to increase as the inflation differential between the Eurozone and Latin American countries is maintained, however we do not expect this inflation to be totally reflected in ARPU as competitive pressure and MTR cuts from increased regulatory oversee drive down ARPU. Consequently the region shall represent in 2021 47.4% of revenues and 49.5% of OIBDA.

In relation to Brazilian operations we value their equity at \$56.325 million Brazilian reais or €22,203 million at current exchange rates which is more than half Telefónica's current market capitalization despite the fact that it is estimated to represent only 22.9% of 2012 Group revenues or 24.3% of 2012 Group OIBDA. Our valuation is 6.22% above current market capitalization and implies a

***In May 2011 Mexican telecommunications regulator Cofetel decided to reduce MTR rates from 95 Mexican cents to 39.***

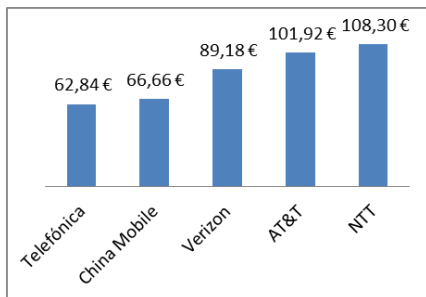
***Negative forecasted evolution for exchange rates in some markets, Increase in competition and the fact that regulators in Latin America are increasingly showing signs of more active regulation in the form of cuts to MTR's shall prevent a stronger evolution in Latin America***

<sup>5</sup> In the first 9 months of 2010 Telefónica did not fully consolidate Vivo's operations.

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€26.6 billion Enterprise Value. Being mobile segment (previous Vivo) currently around 60% of Brazilian operations, which would imply around €13.3 billion of overall equity, at first glance the 22.4% stake of Vivo, Telefónica bought from Portugal Telecom in 2010 for €7.5 Billion, represented a very significant premium over the €3.0 billion fair value that these simple computations would suggest. However if we take into account potential losses on fixed operations that indeed were losing ground to competitors we can better justify the premium paid. Telesp, the fixed arm of Telefónica in Brazil had very low awareness (as a result of being restricted until recently only to the São Paulo state) and consequently we created a scenario where market share and ARPU in fixed operations decreased from the levels at which under the more well renowned Vivo brand we believe they will be. This also has to do with the fact that Telesp’s customer satisfaction had suffered some issues in regulator indicators. Under this more drastic scenario valuation for Vivo’s equity would be 49,682 BRL. This means a loss 6,643 million BRL with a loss at Telefónica’s stake of €2,120 million, still below €4.5 billion premium paid but indicating Vivo’s purchase will allow Telefónica to be a more robust operator.

**Figure 3 – 2011 Revenues in billions of euros**

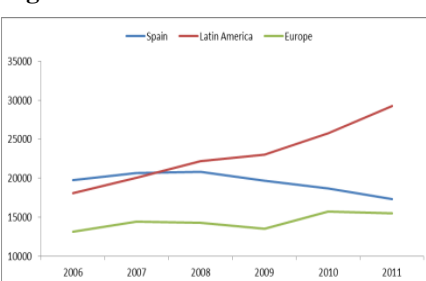


Source: Companies’ Reports

## Company overview

Telefónica is a Spanish integrated telecommunications company, providing services all over the world. The company, state-owned until 1999, ranks amongst the top telecommunication companies in the world regarding number of accesses (309.4 million as of March 2012), which is number 4 worldwide behind Vodafone, China Unicom and China Telecom; market capitalization number 7 worldwide; as well as revenues.

**Figure 4 - Revenues (millions €) per region over time**



Source: Company Reports

## Company description

Telefónica provides mobile and fixed telephony, Broadband, Pay-Tv and customer relation management services in over 23 countries.<sup>6</sup> Additionally the company also offers wholesale telecommunication services, by taking advantage of its international fiber network. Telefónica is also present in two more countries through significant equity stakes that it holds in Telecom Itália and China Unicom with both full-fledged strategic partnerships.

<sup>6</sup> Besides Morocco, the USA and France where Telefónica offers exclusively customer relation management services, the remaining countries where it offers telecommunication services are: Spain, UK, Ireland, Germany, Czech Republic and Slovakia in Europe and Mexico, Brazil, Argentina, Chile, Peru, Colombia, Venezuela, Uruguay, Ecuador, Panama, Nicaragua, Guatemala, El Salvador and Costa Rica.

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In its home market, Spain, Telefónica's services are supplied using the Movistar brand and the company, which is the incumbent operator, is the market leader in fixed telephony, broadband services and mobile telephony with market share respectively of 62.6%, 51.5% and 41.0%<sup>7</sup> at the end of 2011. Here the company's revenues have been decreasing with an increasing percentage coming from Latin America.

Telefónica's most significant market outside Spain is Brazil where the company has consolidated its operations after the acquisition of PT's stake of Vivo in 2010 for €7.5 billion and subsequent merger of its fixed and mobile segments under the Vivo brand where the company now has a stake of 73.9%. Vivo is the mobile market leader with market share of 29.8% by the end of 1<sup>st</sup> Quarter (Q) 2012 and 74.784 million accesses<sup>8</sup>. In the remaining significant Latin American countries, from a revenue perspective, specifically Argentina, Chile, Peru and Venezuela, Telefónica is the market leader in Chile and Peru, 2<sup>nd</sup> player in Venezuela and 3<sup>rd</sup> in Argentina. In Europe (except Spain) Telefónica works under the O2 brand that holds strong market shares in key countries such as Germany and the UK. It is important to mention that Telefónica only holds 69.4% of Telefónica Republica Checa.

In September 2011 the company announced an organizational structure revamp with three main outcomes:

- The integration of Spanish operations under the European region, therefore creating only two geographical blocks – Europe and Latin America. The fact that operations in Spain have deteriorated for the past quarters due to very negative macroeconomic conditions, with unemployment above 24.4%, as well as fierce competition, justifies the company's decision to move its home market operations under the European umbrella in an attempt to solidify its position and image as an international company. Another perspective is the desire for the company to stray from its incumbent role associated with Spanish operations.
- The creation of a new business unit designated Telefónica Digital that consolidates Telefónica's operations in the innovation and digital development areas by merging the company's current resources. This new business unit will be responsible to create an environment prone to fostering innovative ideas. Two important services it will be responsible for are cloud

***With the merger between Vivo and Telesp finalized in September 2011, Telefónica started using exclusively the Vivo brand for all its commercial services in Brazil in April 2012 with Telesp stores becoming Vivo stores and bundling in product offers.***

***With only two regions Telefónica is also looking into drifting from incumbent image sometimes associated to a slower and less driven company. However in practical terms we do not perceive significant value creation (or destruction) from such a move.***

***Gilli Coston, head of M2M at Telefónica expects M2M to grow 25% per year driven mostly by the utilities and automotive sectors.***

<sup>7</sup> According to Spanish telecommunications' regulator CMT.

<sup>8</sup> Company reports and information from Brazilian telecommunications' regulator Anatel

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computing and machine-to-machine (M2M), that are seen as potential growth drivers in the near future with the first expected to generate revenues of €35 billion in Europe by 2014<sup>9</sup>, while the latter is expected to represent €900 billion in revenues for mobile operators in 2020<sup>10</sup>. However, due to lack of information and the deployment of these technologies still in their early stages it is not easy to predict their impact in terms of revenue per operators.

- And the creation of a Global Resources unit to take advantage of the company’s leverage in a global scale. This, according to Telefónica, is expected to allow through economies of scale significant savings from the acquisition of devices. Specifically in 2012 the company predicts that it could lead to benefits of 1 billion euros.

### Shareholder structure

Telefónica currently does not have very significant shareholders except BBVA and La Caixa that hold respectively 6.279% (of which 6.273% is a direct stake) and 5.05% (of which 5.025% is an indirect stake). Those shareholders are otherwise the only ones with a total shareholding above 5%, besides these companies other stakes worth mentioning are Blackrock, Inc with 3.884% and China Unicom with 1.37%. Telefónica Board of Directors (BoD) has 5 directors appointed at the proposal of its shareholders, 2 from BBVA, 2 from La Caixa and 1 from China Unicom that started its functions only in May of 2011.

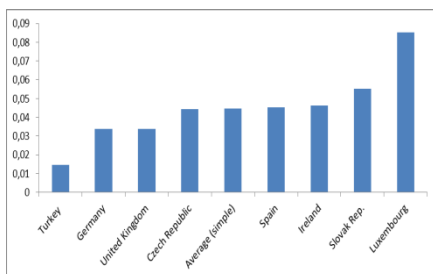
*The cross-shareholding and board seats shared between Telefónica and China Unicom are a clear indicator of the strategic partnership that both parties are seeking. The stability of significant shareholders can also be seen in the fact that the La Caixa board members are the ones with an older date of first appointment of 1994 and 1995.*

## Europe

### EC Regulation

The ICT market in Europe has been subject to increased scrutiny from regulators as they find that the industry is an essential determinant to increased productivity and a sustainable economic growth. Although until the last decade of the 20<sup>th</sup> century most countries had a state-owned monopoly telecommunication company, the regulation started to change and become increasingly pro-competition leading to the privatization of these so called incumbent and the openness of the industry to new entrants.

Figure 5 - MTR rates in Euros



Source: BEREC “MTR Benchmark Snapshot”

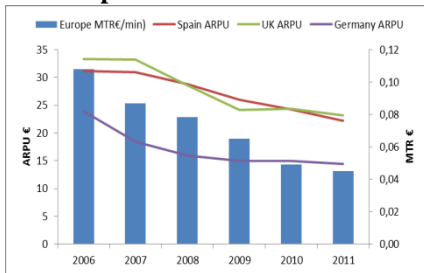
<sup>9</sup> According to EC’s estimates: <http://europa.eu/rapid/pressReleasesAction.do?reference=IP/11/575&format=HTML&aged=0&language=EN&guiLanguage=en>  
<sup>10</sup> According to a panel of industry executives from AT&T, Vodafone, among others gathered by the GSM Association.

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**The French communication's regulator ARCEP goes even further estimating efficient mobile termination rates (the ones that increase the economy's utility by the most) at around 1 and 2 euro cents per minute.**

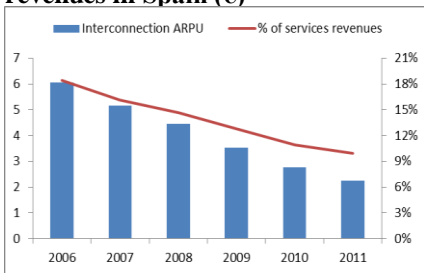
In Europe the more common approach to MTR is Calling Party Pays, in other words, the network from which the call is made has to pay the interconnection rate. Consequently, EC established in May 7<sup>th</sup> 2009 a guidance that national regulators have to take “the utmost account” of. They recommend that interconnection rates should be based on real costs (the general approach is the LRIC<sup>11</sup>) so that customers utility is increased and companies have the motivation to be more efficient in their operations. Termination rates should according to the EC recommendation reach a value between 1.5 and 3 eurocents per minute in 2012. Additionally they recommend that NRA's<sup>12</sup> should eliminate asymmetries between mobile and fixed networks termination services. Currently there is still a lot of variability in what concerns MTR's in the EU.

**Figure 7 - Average MTR and ARPU in Europe**



Source: BEREC and companies financial reports

**Figure 6 - Interconnection revenues in Spain (€)**



Source: Telefonica financial reports

We thus expect to continue seeing in all Telefónica's European markets decreases in MTR's negatively affecting ARPU and thus mobile revenues following recent trends. However it is important to take into account that the weight of interconnection revenues in ARPU is gradually decreasing and thus continued decreases in this source of revenues will undoubtedly become less and less significant. Despite the effect in revenues, MTR's decrease also positively affects telecommunication companies' cost structure, by decreasing interconnection costs. Consequently depending on the number of off-net and on-net calls made and received by its customers MTR cuts can even have a positive or neutral effect on OIBDA. For Telefónica we forecast that ARPU will be affected by MTR cuts and consequently revenues however the increased importance of mobile data and inflation to some degree shall in most markets revert the decreasing ARPU trend midway through our forecast period. OIBDA on the other hand will face different effects depending on the market and the company's competitive position. New entrants or the smaller operators will face two opposing effects, while on one hand they will have to pay lower interconnection rates, allowing them to charge less for off-net calls, they will not be able to take advantage of asymmetric MTR's where higher MTR's are imposed for these smaller companies thus in a way subsidizing their operations because these are being abolished by regulators.

<sup>11</sup> Long-Run incremental cost – A method to determine what is the incremental cost to a company of providing a service, similar to marginal cost but avoids issues related with the fact that marginal costs can be very different depending on whether usage is close or far from installed capacity, in which case marginal cost would be very high or very low respectively. LRIC measures the long-term increment taking into account that long-term costs can be both fixed and variable in the short-run.

<sup>12</sup> National Regulatory agency

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**Table 1 - Roaming Prices in Europe end of 2011**

|                      | Average | Price Cap |
|----------------------|---------|-----------|
| Making Call €/min    | 0,32    | 0,35      |
| Receiving Call €/min | 0,10    | 0,11      |
| SMS sent €/SMS       | 0,10    | 0,11      |
| Wholesale data €/MB  | 0,21    | 0,5       |
| Retail Data €/MB     | 1,60    | N/A       |

Source: BEREC

**The updated EC regulation on roaming will require “network operators from other Member States to give MVNO’s access to their network at regulated wholesale prices”;**

**While increased competition will drive ARPU from roaming down we expect to see traffic increase especially in the data segment. Consequently roaming ARPU shall revert decreasing trend after the more significant decreases in price caps happen.**

Another significant source of regulation for Telefónica (and telecommunication’s industry in general) are roaming rates. The reason for the need of regulation according to EC is that there is lack of competition in roaming services thus if left unregulated will lead to asymmetries and loss in well-being for the economy. According to a report published in 2010 the EC has the goal of having the difference between roaming and national tariffs approach zero by 2015. The regulation takes the form of price caps both at wholesale and retail level. Table 1 shows that currently the average Eurotariff<sup>13</sup> is very near the regulated cap in most EU member states, except for wholesale data. This empirical evidence shows that the regulation has not been able to create the structural changes desired and increase competition which would be reflected in further decreases in roaming prices below the price caps’ levels. On the basis of such arguments the EC has proposed new regulation to be effective on June 2012<sup>14</sup>, while continuing with price caps. The proposal plans to increase competition through two main venues: first by making it easier for MVNOs<sup>15</sup> to enter roaming markets; second by letting customers choose an alternative provider for roaming services, independently of their national operator and without the requirement to change their SIM mobile card.

In relation to the price caps we do not believe they will have a very significant effect on Telefónica’s ARPU. For example roaming revenues in Spanish operations represented less than 2% of mobile service revenues in 2011. On the other hand the increased competition resulting from the two proposals will force some of the prices down and we expect to see a faster approach of retail data prices to the wholesale caps. However we believe that as the goal of roaming prices equal to domestic prices is fulfilled traffic will significantly increase with data roaming becoming increasingly significant. Thus we forecast only a minor decrease in roaming ARPU in the short-term and in the long-term we expect it to rise fueled by the still more expensive data roaming and increased traffic.

## Spain

In order to try to reverse the negative trend in accesses while minimizing the effect of commercial efforts on OIBDA Telefónica has put into place a new

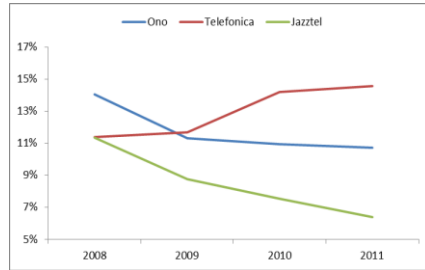
<sup>13</sup> Eurotariff is the regulated tariff to which the EC price caps apply. Operators are able to offer different tariffs though they are forced to also offer the Eurotariff.

<sup>14</sup> The new regulation proposed in July 2011 will continue with the current approach of price caps (until 2016) for the same services though it will introduce a new price cap on retail data, which was not previously covered to prevent situations where users pay €1.6 per megabyte while operators pay, according to latest available data around €21 cents.

<sup>15</sup> (mobile virtual network operators those that use other operator’s network to offer their services

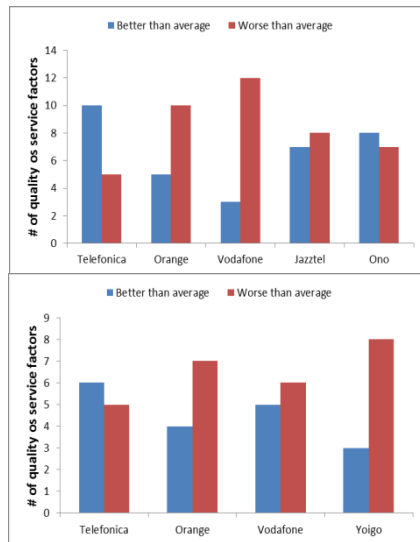
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**Figure 8 Personnel expenses % of Revenues for Spanish Players**



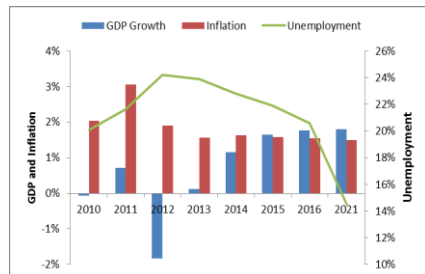
Source: Companies Reports

**Figure 9 - Quality of service report on Fixed (up) and Mobile (down) Telecommunications**



Source: Ministerio de Industria, Energía Y Turismo

**Figure 10 – Spanish Macroeconomic indicators**



Source: IMF and analyst estimates

workforce reduction program. The company proposed the lay-off of 6500 employees of its Spanish division. The cost per worker was estimated at around €415000 which means a total cost of 2.671 billion euros which were accounted as a personnel expense in 3Q 2011. The company expects to start benefitting from the program starting in 2012 through 2013 with around 3,149 thousand employees already out by the end of Q1 2012. Additionally the company committed to the creation of 650 new jobs in Spain from 2011 to 13. Using an average cost per worker in Spain of €66772<sup>16</sup> per year, associated with the fact that workers that entered into the redundancy program were generally older with (average age of 55) which means 12 years of savings we value the benefit from this program at €1.99 billion. Yearly if the company maintains current level of employees the reduction will have a positive effect in OIBDA margin, allowing a decrease of personnel expenses from current levels of 14.6% to 12% of revenues when the program is completed. This decision comes on the heels of the increased weight of personnel expenses on costs mostly as a result of the fact that they have not followed the decrease observed in revenues. However, faced with increased competition from companies with less cumbersome cost structures<sup>17</sup> Telefonica can use the lower personnel costs to increase its commercial efforts, to more effectively compete, while also offering lower prices without hurting OIBDA, in an effort to reduce churn and turn around the decrease in accesses. Simultaneously the company is focused on maintaining high customer satisfaction levels. According to government demanded publication on quality of service for fixed and mobile telecommunications, Telefonica has been able to present better quality of service among its peers for key issues<sup>18</sup>.

Our forecasts for the Spanish market (as well as any other market) are greatly influenced by the evolution of the economy for which we use three main macroeconomic factors: GDP growth, inflation and unemployment.

### Wireline Business

In the wireline business Spain has gradually seen a decline in fixed retail lines and market penetration as well as a decrease in prices. On the other hand fixed broadband (FBB) accesses have consistently grown albeit gradually at a slower

<sup>16</sup> Based on Spanish personnel costs for fiscal year 2011.

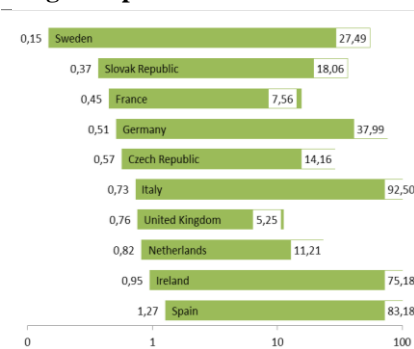
<sup>17</sup> Though Ono is faced in a somewhat similar position in terms of negative growth in its cable related operations Jazztel is however facing significant growth which justify the rapid decrease in personnel expenses as % of revenues.

<sup>18</sup> For both publications issues looked into are: time to restore service; percentage of breakdowns per line; time to repair breakdown; frequency of complaints; time to resolve complaints; percentage of failed calls; time to establish calls among others.

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rate. We expect that over our explicit time-frame market penetration per 100 people for FBB will reach 30.8% of by 2021 a middle value between the current highest market penetration rates (in Denmark and Netherlands) and the current EU average. This target might seem too pessimistic though it can be explained from two perspectives: first that historically Spain has presented some of the highest broadband prices in OECD countries which, though we expect to decline with competition, they will remain high and maybe drive off some of the adoption; second and probably the more important factor has to do with mobile broadband which is picking up in most countries and in Spain already presents a 7.5% market penetration, which will offset some of the growth in fixed broadband. Despite being above the EU average of 6% Spain’s mobile broadband market is still significantly below Finland levels of 21.4% so there is still a lot of room to grow at a rapid pace.

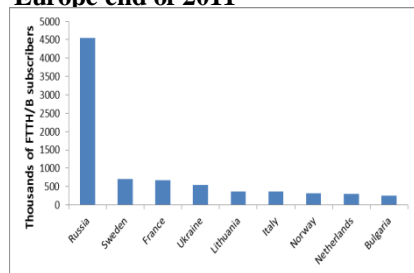
**Figure 12 - Broadband prices per megabits per second 09/11 - USD**



Source: OECD

**According to the CMT study on FBB and MBB, the internet connection characteristics that increase users utility more are prices while velocity is not as significant.**

**Figure 11 – FTTH/B market in Europe end of 2011**



Source: FTTH Council Europe

According to a study conducted by the Spanish telecommunication regulator (CMT) on the substitution effect between fixed and mobile broadband 76.4% of the people with a mobile broadband (MBB) connection did not have previously a fixed connection which supports the fact that up to this point a significant majority of MBB users were not stolen from FBB. However with increased MBB throughput rates<sup>19</sup>, even if always below fixed ones, FBB users may start finding MBB more attractive and consequently there might be a transition. With LTE<sup>20</sup> development in Spain still in its first stages and due to spectrum shortages, MBB prices are not expected to decrease to FBB levels, so this transition effect may take some time to happen<sup>21</sup>. Consequently in the long-run, even if small, the differences in prices and speed won’t lead to a full transition between mobile to fixed broadband supporting our 30.8% market penetration.

Fibre to the home in Spain is not very developed yet, when compared with other European countries with accesses still below 200 thousand accesses and thus not making the European ranking composed of 20 countries that have at least 1% of households as FTTH/B subscribers. It is however important to mention that in the 2<sup>nd</sup> half of 2011 Spain added 70 thousand new FTTH accesses closing in

<sup>19</sup> Speed of data transmission. LTE technology is expected in its first stages to reach 30 Mbps but can reach 100/150 Mbps. FTTH on the other hand while initially expected to reach around 100 Mbps has already speed of 1Gbps commercialized.

<sup>20</sup> Long Term Evolution – Mobile 4<sup>th</sup> Generation

<sup>21</sup> While 4G services are not yet commercialized in Spain current mobile broadband packages for 2Gb are selling for €25 per month with speed up to 7.2Mbps. FBB are offering services without download caps that go from €20 for 30Mbps to €40 for speeds of 50Mbps or 100Mbps in cases where the customer is also a mobile client for the company. In Portugal where LTE is already available prices go for €25, representing a 50% discount with no traffic limit and speeds up to 100Mbps.

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on 171 thousand. With a little over 1 million houses passed Spain presents a take-up rate of 17.1% in line with EU 27 average of 17.5%. Telefónica's fibre to the home (FTTH) deployment started in 2008 by the end of 2011 coverage reach approximately 1 million homes with 163 thousand accesses. Right now in Spain 74.5% of internet users have speeds below 10 Mbps which are easily achieved with ADSL or cable technologies. Consequently there is no incentive for Telefónica to invest heavily in the very short term in FTTH instead of in a gradual way as the take up rate increases. Additionally the fact that the two other significant Spanish fixed operators Ono and Jazztel, as almost exclusively Spanish operators, are facing a difficult environment mostly competing through prices, in our view does not bode well for the chances that they will try to launch any large scale FTTH investments. They will probably be focusing on local deployments or buying Telefónica's wholesale services. FTTH deployment is not expected to be pursued by multinational operators Orange and Vodafone due to the very low margins they have consistently presented in this segment.

**With Spanish internet users still favoring speed below 10Mbps FTTH is not a good value proposition in the difficult environment Spanish people are going through.**

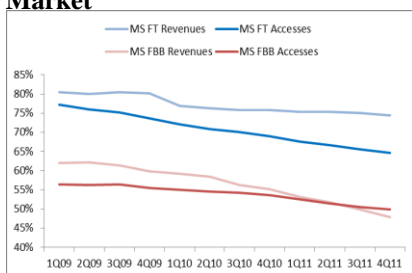
**European average of Pay-TV market penetration is incredibly inflated by huge penetration rates in Belgium and Netherlands of around 90%.**

Regarding Pay-TV, CMT predicts that by 2023 there will be 8.3 million accesses representing 46% of households. For 2021 we estimate that there will be 7.7 million accesses. This would mean an increase of 3.3 million accesses (or a CAGR of 5.8%). Even though this value is below current European average of around 50% we have to take into account that free and state TV in Spain are still very much relevant.

Telefónica maintains a strong foothold in both fixed telephony (FT) and broadband with market shares, according to CMT of 51.5% in broadband and 62.6% for fixed lines. Figure 9 shows the evolution of Telefónica's market share (MS) of accesses and total revenues in both segments. We can see that since March 2010 both market shares have declined. However it is still interesting to see that even though MS in terms of fixed telephony accesses and traffic is 66.7% and 55.4% respectively revenues MS (in the retail segment) is above 75.3%. This can imply either that Telefónica's competitors are offering more attractive and cheaper offers that allow users to have unlimited minutes at small flat rates thus explaining the more rapid decrease in traffic market share then in revenues or that customers are acquiring competitors bundled broadband offers. Both justify the increased market share for all competitors.

Regarding internet accesses Telefónica's revenues are more in line with accesses and the decline in market share of 4% over the last year came at the expense of increase market shares for Vodafone and Jazztel. Once again the

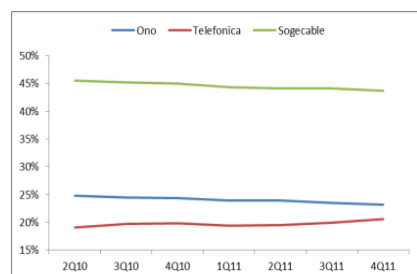
**Figure 13 - Telefónica FBB and FT Market**



Source: CMT

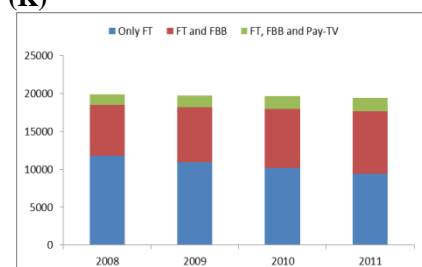
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**Figure 15 - Pay-Tv market shares**



Source: CMT

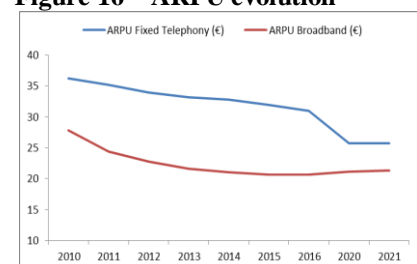
**Figure 14 - Bundled offers in Spain (K)**



Source: CMT

**CMT announced that for 2012 the Wholesale Prices exercised by Telefonía for ADSL will decline by 14%.**

**Figure 16 – ARPU evolution**



Source: Company Reports and Analyst Estimates

decline can be attributed to price concerned customers that were able to find in Jazztel or Vodafone for the same or even higher speeds a lower tariff. However it is worth mentioning that the decrease in market share of revenues more significantly implies that Telefonía has already reduced its prices, which associated with the fact that Telefonía will be able to start to take advantage of its fibre optic network with higher quality and speeds will lead to a stabilization of market share for the medium to long-term.

The pay-tv market is stabilized in regards to the major players: Ono, Sogecable and Telefonía excluding Pay-Tv offers from digital tv<sup>22</sup>. Figure 15 shows the evolution of this segment, which is the only place where Telefonía has been able to continue growing. We expect Telefonía to be able to increase its market share as FTTH services are rolled-out throughout Spain and triple-play bundles become increasingly popular.

Table 2 gives our estimations financial indicators related with fixed telephony broadband and pay-tv where we anticipate that Telefonía in the short term to keep up with competition will have to lower prices, thus reducing ARPU in both fixed lines and broadband. This will also be the result of the negative GDP growth in 2012 and the high unemployment rates Spain is expected to continue facing. Fixed Line ARPU is expected to present continuous declines as traditional accesses revenues and voice services revenues lag from increased usage of mobile telephones and the lower perceived value of holding a fixed line that will make people less prone to pay a monthly fee to have it. Broadband ARPU will prove more resilient as the FTTH rollout is consolidated. Data and IT services revenues should continue growing as a result of higher demand for cloud computing or e-health services. We expect to see Telefonía’s market share decrease to 55% in fixed telephony and to 43% in broadband while increasing to 21% for pay-tv at the end of our forecast period. Table 2 - Fixed Line Operating and Financial Data (Revenues in millions of euros)

**Table 2 – Spanish Fixed Line Operating and Financial Data (€ millions)**

|                             | 2010   | 2011   | 2012E  | 2013E  | 2014E | 2015E | 2016E | 2021E | CAGR  |
|-----------------------------|--------|--------|--------|--------|-------|-------|-------|-------|-------|
| Traditional Access          | 2.426  | 2.170  | 1.965  | 1.869  | 1.792 | 1.676 | 1.559 | 1.200 | -6,2% |
| Traditional Voice Services  | 3.549  | 3.230  | 2.976  | 2.863  | 2.725 | 2.536 | 2.396 | 1.680 | -6,6% |
| Internet Broadband Services | 5.421  | 5.231  | 5.275  | 5.369  | 5.480 | 5.474 | 5.644 | 6.353 | 1,5%  |
| Broadband                   | 2.914  | 2.766  | 2.721  | 2.712  | 2.781 | 2.820 | 2.898 | 3.287 | 1,1%  |
| Data and IT Services        | 2.507  | 2.465  | 2.554  | 2.657  | 2.699 | 2.654 | 2.745 | 3.065 | 1,8%  |
| Total operating revenues    | 11.396 | 10.631 | 10.216 | 10.101 | 9.997 | 9.685 | 9.599 | 9.233 | -1,9% |

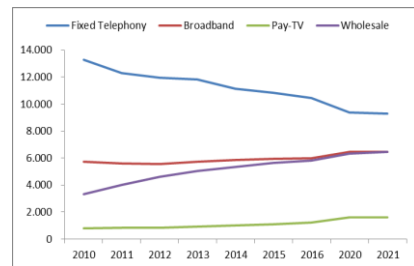
Source: Company Reports and Analyst Estimates

<sup>22</sup> GolTV is a sports channel that is available as a payed channel directly from digital tv without the requirement to contract services from a Pay-tv provider.

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With reduced market share in broadband, wholesale accesses are also expected to increase as other operators use Telefónica’s network either through local loop unbundling or bitstream access service<sup>23</sup>, which should drive growth in this segment. Overall nominal fixed line revenues (as are any other revenue in this report unless otherwise stated) are expected to invert growth in 2016 and to be down from 2010 at the end of our forecast period though due to stabilization in the decline of revenues from traditional access and voice services we forecast a mild terminal growth of 0.3% in fixed line services driven by data and IT services and inflation to some degree.

**Figure 17 – Fixed Accesses (K)**

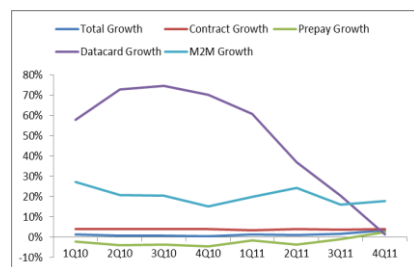


Source: Company Reports and Analyst Estimates

**Wireless Business**

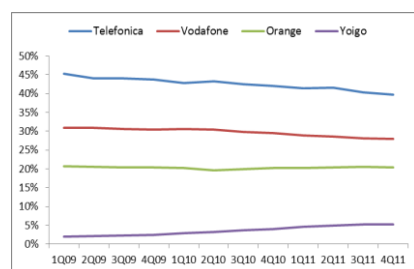
In Spain wireless telephony is already reaching maturity with year over year growth over the past 8 quarters between 0.5% and 2% except in 4Q 2011 where it was significantly above those levels at 3.5%. This growth is mainly driven by growth in the contract segment which already accounts more than 61% of all customers. In prepay there has been some quarters with declines for the same timeframe. However in the wireless segment in general there are two main sources of growth: datacards, associated with mobile broadband and M2M lines. These have been growing heavily and are expected to be the main drivers of future growth in wireless accesses in Spain. At The end of our explicit period market penetration is expected to be around 149.1% from today’s 147.8% in line with the highest current mobile penetration rates in Luxembourg or Portugal. This happens as the result of people having more than one SIM card even if from the same operator for mobile broadband with datacards or tablets.

**Figure 18 - Mobile Accesses Growth**



Source: CMT

**Figure 19 - Mobile Accesses Market Share**



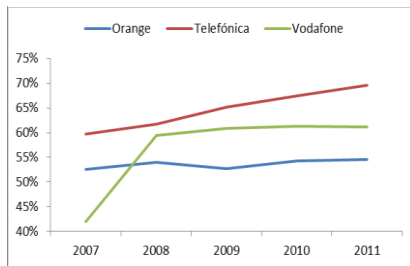
Source: CMT

Telefónica has maintained a strategy of directing its efforts to contract customers that have on average higher ARPU and lower churn rates. Even though from an OIBDA perspective it has contributed to the company being able to achieve high OIBDA margins over the years as discussed, under current economic conditions Telefónica’s market share has decreased. Not only Telefónica but also Vodafone (the two market leaders) have lost market share mostly at the expense of Yoigo and to a lesser extent Orange. Here we are once again faced with a situation where the 45.3% revenues market share in 2011 is higher than the 38.8% traffic

<sup>23</sup> With local loop unbundling (LLU) operators install their physical equipment on telephone exchanges and then rent from Telefónica the local loops (the physical wire connection that runs between the local exchange and the customer). With wholesale bitstream access service the competitors do not need to install their own equipment and instead rent Telefónica’s own product, this was mainly used in rural areas where the investment of unbundling local loops was not feasible.

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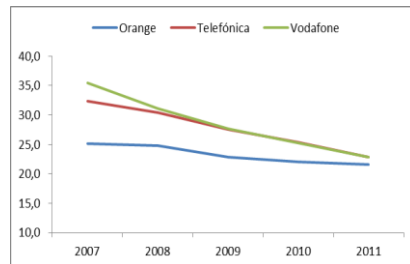
**Figure 20 – % of Contract Customers**



Source: Companies' Reports

**MTR's will decline from €4cents to €3.42 cents in April 2012, to €3.16 cents in October 2012, to €2.76 cents in March 2012 and to €1.09 cents in July 2012.**

**Figure 21 – ARPU €**



Source: Companies' Reports

market share or the accesses market share that was between 41.4% and 39.7% in 2011. In relation to datacards Telefónica has had a pretty stable 40% market share over the past year and a half. Telefónica will be able to take advantage of its 3G network coverage that will drive smartphone and datacard adoption, which associated with the deployment of the LTE<sup>24</sup> mobile generation will lead to further increases in mobile data consumption and contribute positively to ARPU. The fact that Telefónica has always pushed for the acquisition of higher end customers will pay-off as mobile data consumption continues to increase taking into account that it is this type of customer that will continue driving growth in data related revenues. Additionally the increased smartphone adoption, reaching in European operations 30% of mobile accesses in the first quarter of 2012, bodes well for the growth of data that is done mostly in these devices as well as tablets.

On the other end pushing ARPU further down are MTR rates regulation. According to a proposal issued by CMT on March 30th the regulator proposes to continue imposing a glide path on mobile termination rates that would lead to a decrease in price cap from the current €4 cents to €1.09 cents in July 2013. Additionally it plans to eliminate the current asymmetry that exists in favor of Yoigo who is able to demand a higher charge for terminating calls due to its very low market share. This proposal would put Spain in compliance with EC recommendations regarding lower and more symmetric (in relation to fixed rates) MTR's. With MTR charges currently representing 8% of mobile ARPU in the last quarter of 2011 after the last decrease, this glide path should depress our expected ARPU by 1.78% for 2012, 3.18% for 2013 and 2.9% for 2014.<sup>25</sup> After this period and at the 1.09 eurocents per minute level we do not expect MTR's to continue decreasing.

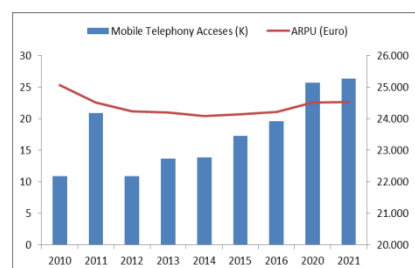
We expect in general that market share will continue decreasing for the next two years though with better macroeconomic conditions in Spain in terms of GDP and gradual reduction of unemployment we expect market share to stabilize at 35% and ARPU recuperating in 2014, after the effect from decrease in MTR's has already been totally incorporated. ARPU should grow mostly driven by data. We do not expect however ARPU to get back to levels above 2010 which were

<sup>24</sup> Long-term Evolution (4th generation)

<sup>25</sup> Taking into account the current level of interconnection revenues (around 8% of total) that should be maintained if there were no changes in MTR's we conclude that in the first year our expected ARPU of €27 would decrease to €26.59 with the decrease in MTR's from 4 cents to an average of 3.57 for the 2012 with interconnection charges decreasing to only 7.1% of mobile revenues. The process was repeated on the expected adjusted (by the decrease that had already happened) ARPU's for 2013 and 2014.

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**Figure 22 - Accesses and ARPU**



Source: Company Reports and Analyst Estimates

**Table 3 – Spanish Mobile Financial Data (€ millions)**

|                            | 2010  | 2011  | 2012E | 2013E | 2014E | 2015E | 2016E | 2021E | CAGR   |
|----------------------------|-------|-------|-------|-------|-------|-------|-------|-------|--------|
| Mobile Operations Revenues | 8.551 | 7.748 | 6.805 | 6.556 | 6.514 | 6.688 | 6.932 | 7.860 | -0,7%  |
| Service Revenues           | 7.271 | 6.548 | 5.895 | 5.651 | 5.571 | 5.741 | 5.975 | 6.773 | -0,6%  |
| Customer Revenues          | 6.226 | 5.686 | 5.200 | 5.174 | 5.243 | 5.409 | 5.629 | 6.394 | 0,3%   |
| Interconnection            | 792   | 652   | 500   | 294   | 150   | 153   | 156   | 165   | -13,2% |
| Other                      | 253   | 211   | 195   | 183   | 177   | 180   | 190   | 213   | -1,6%  |
| Handsets Sales Revenues    | 1.280 | 1.200 | 910   | 905   | 944   | 946   | 957   | 1.087 | -1,4%  |

Source: Company Reports and Analyst estimates

**Spain is one of several countries that have already auctioned 4G spectrum. In Germany where Telefónica was one of the successful bidders LTE deployment has already started.**

**In Spain the increase in mobile Capex for 2012 should be around 3% as the efforts of deployment should only peak in 2013 based on the current mobile environment.**

inflated by higher MTR's and higher costs per minute that we do not forecast will reverse its decreasing trend. Additionally we forecast growth in Minutes of Use (MOU) per month from increased relevance of plans of minutes at fixed rates.

Regarding wholesale accesses we expect them to continue to increase as competition intensifies and Telefónica loses market share to other operators that require the usage of Telefónica's network to service their customers. In mobile this is the case of MVNO's whose market share though small almost doubled in the past year from 3.46% in September 2010 to 6.1%.

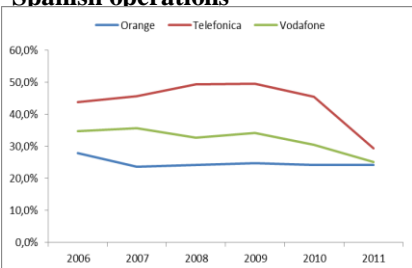
Revenues are expected to grow in mobile starting in 2015 after Spain's economy reaches a trough and MTR effects are internalized. Interconnection is predicted to be the main negative contributor to growth while customer revenues driven by mobile broadband should grow at the same pace as the economy. We forecast for mobile operations a terminal growth of close to 0.9% growing below the economy due to the maturity of the market already reached in 2021.

Another important aspect is related with 4<sup>th</sup> generation services. On June 2011 there was the auction in Spain for the Digital Dividend (DD) spectrum<sup>26</sup> in which only the three main operators (Telefónica, Vodafone and Orange) had successful bids. This means that Yoigo was left out and it will create difficulties for the small operator to deploy LTE in its own network probably requiring the usage of the others operators' networks. From Germany's experience of LTE deployment we do not expect a very significant impact in Capex from LTE due to a gradual approach to the deployment. Y-o-Y growth in Germany's capex was down 17.8% in 2011, even excluding the effect of the spectrum acquisition (that happened in 2010). Additionally in the USA, the country with higher LTE subscriptions, AT&T last year at the peak of LTE deployment saw an uptick in Capital expenditure of 7.3% in the first 3 quarters of the year (\$14.7B compared with \$13.7B).

<sup>26</sup> The Digital Dividend spectrum is the radio spectrum that was used for TV broadcasting and becomes available with the switchover from analogue to digital TV. This spectrum in the 800 MHz band due to its specific characteristics is ideal for LTE services, with lower costs than deploying LTE in other bands.

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**Figure 23 - OIBDA margin in Spanish operations**



Source: Companies' Reports

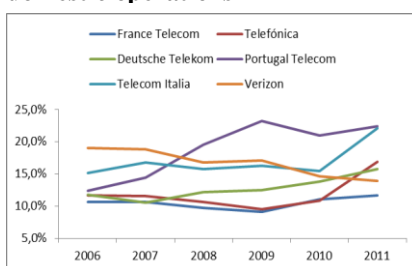
Overall revenues for Spain should be down from 2010 levels due in great part to the negative pressure from fixed revenues. OIBDA margin is expected to get worse in 2012 and 2013 due to high competition and low prices, however it should then increase with economic recovery though it should stabilize at 43.0% below historical levels. Specifically we forecast supplies and personal expenses to present lower growth than revenues and subcontracts to grow above revenues due to competition staying high and Telefónica's lower market share and power in Spain.

**Table 4 – Movistar Spain Financial Data (€ millions)**

|                            | 2010    | 2011    | 2012E  | 2013E  | 2014E  | 2015E  | 2016E  | 2021E  | CAGR  |
|----------------------------|---------|---------|--------|--------|--------|--------|--------|--------|-------|
| Revenues                   | 18.712  | 17284   | 16014  | 15673  | 15536  | 15405  | 15554  | 15861  | -1,3% |
| Intragroup adjs            | -1.235  | -1.095  | -1.006 | -984   | -976   | -967   | -977   | -996   | -1,8% |
| Revenues Fixed             | 11.396  | 10.631  | 10.216 | 10.101 | 9.997  | 9.685  | 9.599  | 8.997  | -1,9% |
| Revenues Mobile            | 8.551   | 7.748   | 6.805  | 6.556  | 6.514  | 6.688  | 6.932  | 7.860  | -0,7% |
| Operating Expenses         | -10.489 | -12.622 | -9.464 | -9.265 | -8.995 | -8.920 | -9.006 | -9.310 | -0,9% |
| Supplies                   | -4.185  | -3.938  | -3.683 | -3.605 | -3.542 | -3.435 | -3.469 | -3.473 | -1,5% |
| Personnel expenses         | -2.658  | -5.109  | -2.161 | -2.040 | -1.942 | -1.926 | -1.944 | -2.014 | -2,3% |
| Subcontracts               | -3.017  | -3.009  | -3.123 | -3.056 | -2.952 | -3.004 | -3.033 | -3.251 | 0,8%  |
| Other Operating Expenses   | -629    | -566    | -496   | -564   | -559   | -555   | -560   | -571   | -0,7% |
| Other net income (expense) | 298     | 410     | 272    | 267    | 264    | 262    | 265    | 270    | -0,7% |
| OIBDA                      | 8.520   | 5.072   | 6.823  | 6.674  | 6.805  | 6.748  | 6.813  | 6.820  | -1,8% |
| OIBDA Margin               | 45,5%   | 29,3%   | 42,6%  | 42,6%  | 43,8%  | 43,8%  | 43,8%  | 43,0%  |       |
| Total Capex                | 2.021   | 2.914   | 2.322  | 2.351  | 2.097  | 1.879  | 1.898  | 1.983  | 0,0%  |

Source: Company Reports and Analyst estimates

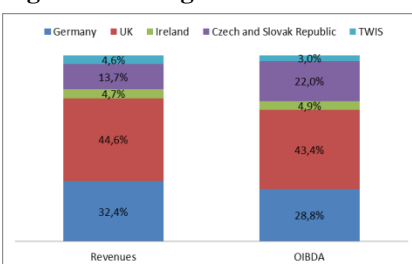
**Figure 24 - Capex % revenues in domestic operations**



Source: Companies' Reports

Capex is expected to be significantly higher than average in 2012 and 2013 (2011 is inflated by the cost of spectrum acquisition of €669 million) due to FTTH and LTE rollout though the company will probably even out Capex to avoid having the bulk of it in 2012 at the same time as it faces debt restrictions. Capex as % of revenues is close to average of comparable companies in similar positions; specifically Portugal Telecom and Deutsche Telekom have both LTE and FTTH deployments underway.

**Figure 25 - Weight Revenue/OIBDA**



Source: Company Report 2011

### Rest of Europe

Telefónica has operations in 5 more countries in Europe: Germany, UK, Ireland, Czech Republic and Slovakia. Additionally operations in Europe also include TIWS<sup>27</sup>, which are the wholesale services Telefónica provides outside of Spain. The two more significant are the UK and Germany both in terms of Revenues as well as OIBDA. ARPU has been decreasing as a result of fierce competition in all markets and has been driven further down by constant and gradual decreases in

<sup>27</sup> Telefónica International Wholesale Services

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**The macroeconomic indicators for European markets show signs that consumers will either spend more or stabilize their telecommunication consumption**

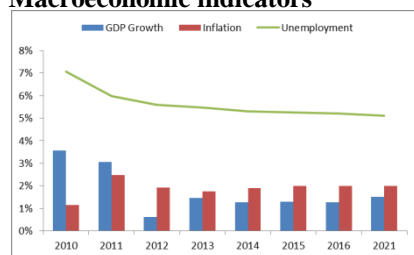
MTR’s with double digit declines in Telefónica’s markets.<sup>28</sup> Additional cuts are anticipated as the current MTR’s are still above EC’s recommendation in all countries. On the other hand data traffic explosion has helped to smooth some of the decline in ARPU especially in Germany where data ARPU has taken advantage of LTE rollout.

**Germany**

In Germany, where macroeconomic indicators paint a very stable and low growth picture, Telefónica uses O2 brand and has operations in all segments: fixed and mobile telephony, internet and pay-tv and represented 8% of total revenues and 5.3% of OIBDA in 2011. The fixed telephony market in Germany is stagnant, as generally seen in most countries nowadays, with decreases y-o-y of around 0.5%, and we expect number of subscribers to stabilize based on triple play offers. O2 has a 4.6% market share at the end of 2011 and has seen accesses grow in the previous year at a significant rate of 7.2% that increased to 20.2% in the first quarter of 2012 taking advantage of the acquisition of Hansenet<sup>29</sup>. We see this strong momentum as indicator that O2 will continue to gain market share driven by adoption of its fixed broadband offers though growth should slow down in the short to medium term until accesses stabilize at an 8.5% market share. Fixed broadband services should be the main drivers of adoption of not only fixed telephony but also pay-tv with increased bundling by operators. We expect an increase in broadband market share from the current 9.7% to around 11.5% at the end of our explicit period mainly driven by the lower prices offered compared to competition in the short term. Right now O2 is offering DSL services at significantly lower rates than Deutsche Telekom with €14.99 offer for basic DSL and fixed telephone if made with a contract of 24 months otherwise for €24.99. Deutsche Telekom (DT) on the other hand is offering similar service for €29.99, which gives an idea of the price competition Telefónica is pursuing and might explain the low OIBDA margin seen in the market.

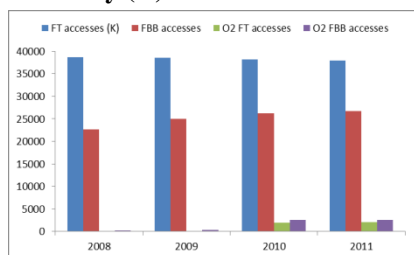
In the mobile business Germany currently presents a high market penetration of 138.9% and growth in accesses of 4.8% for 2011. We expect this growth to gradually decrease leading to market penetration of 165.1% by 2021 driven by the adoption of broadband offers. Regarding O2 that held at the end of 1<sup>st</sup> quarter 2012 16.4% market share from 12.9% in 2006 is expected to continue increasing its market share from rival KPN (E-Plus) who was the operator left out in the

**Figure 26 – German Macroeconomic indicators**



Source: IMF and analyst estimates

**Figure 27 - FT and FBB accesses in Germany (K)**



Source: Bundesnetzagentur

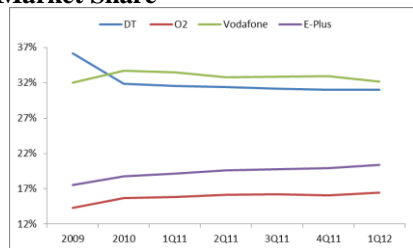
**Growth in broadband market share shall not be more significant as Deutsche Telekom FTTH infrastructure quality starts allowing the incumbent operator to price above competitors.**

<sup>28</sup> Over the last 2 years MTR showed double digit declines between 15.4% in Slovak Republic and 50.2% in Germany.

<sup>29</sup> Hansenet was a fixed line German operator acquired by Telefónica in 2010.

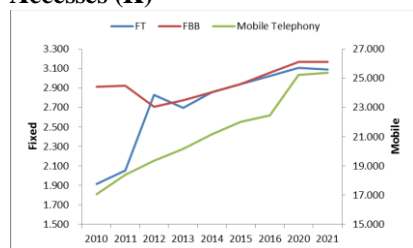
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**Figure 28 - Mobile Telephony Market Share**



Source: Bundesnetzagentur

**Figure 29 – Fixed and Mobile Accesses (K)**



Source: Company Reports and Analyst estimates

**We expect German MTR's that currently stand at €0.0337 to decrease as the German regulator adopts a glide path system similarly to other regulators such as CMT and Ofcom (the UK regulator).**

Digital Dividend spectrum auction last year. Even if E-Plus rents capacity from competitors or reforms the current spectrum it has, the LTE benefits for the company will probably decrease due to higher costs. The forecasted evolution in mobile as well as fixed accesses is displayed in Figure 29.

Regarding ARPU there are many opposing forces in action. From one side we believe that the fact that O2 customer base is comprised of 51.2% contract customers (while market leader Vodafone and E-Plus have 42.5% and 32.9% respectively) will allow ARPU to increase fomented by data consumption and LTE enabled smartphones growth. Evidence of this growth besides Data ARPU that has grown a very healthy 15.4% y-o-y in the 1Q of 2012 is the percentage of non-SMS over data revenues that increased to 53.9% in 1Q12 from 47.5% the year before. Additionally the fact that the O2 brand is the network operator with the most satisfied customers according to a survey in 2011, also complements Telefónica's strategy in the market. On the other hand the company has to make sure it will be able to deal with the explosion in demand for mobile broadband<sup>30</sup>. On the other side there are the commercial costs related with the competitive landscape, where operators to gain market share are mainly competing on prices and the negative pressure from further MTR cuts which we will happen starting at the end of this year or at the beginning of next year. Consequently we expect ARPU to further decrease in 2012 and 2013 and recuperate afterwards slowly. MOU is expected to continue increasing though only slightly as lower MTR's drive cost per minute down. Table 9 shows our forecasts for the main KPI's and accesses in Germany as well as financial data.

**Table 5 – O2 Germany Financial Data**

|                              | 2010  | 2011  | 2012E | 2013E | 2014E | 2015E | 2016E | 2021E | CAGR  |
|------------------------------|-------|-------|-------|-------|-------|-------|-------|-------|-------|
| ARPU (€)                     | 21,3  | 18,5  | 17,5  | 17,0  | 17,2  | 17,3  | 17,3  | 18,1  | -1,5% |
| % non-SMS over data revenues | 41,9% | 50,4% | 56,9% | 62,9% | 68,4% | 73,4% | 76,4% | 82,4% |       |
| Revenues (€ millions)        | 4.826 | 5.036 | 5.085 | 5.175 | 5.444 | 5.709 | 5.881 | 6.892 | 3,3%  |
| OIBDA                        | 944   | 1.219 | 1.236 | 1.294 | 1.394 | 1.496 | 1.588 | 1.895 | 6,5%  |
| OIBDA Margin                 | 19,6% | 24,2% | 24,3% | 25,0% | 25,6% | 26,2% | 27,0% | 27,5% |       |
| Capex                        | 2.057 | 557   | 661   | 750   | 762   | 799   | 794   | 965   | -6,7% |

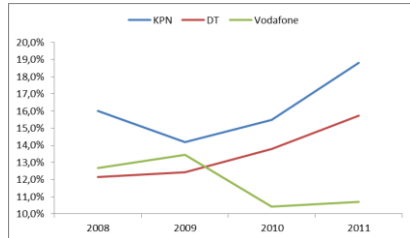
Source: Company Reports and Analyst estimates

Revenues driven by accesses and ARPU are expected to grow at a CAGR of 3.2% in 2011-2021 period reaching €6.892 billion, while OIBDA with some recuperation in margins to levels closer to its competitors (Vodafone and DT

<sup>30</sup> In November 2011 Telefónica O2 Germany admitted that its mobile network was being overloaded by smartphone mobile traffic in Germany's biggest cities. There had been 6000 complaints from customers that their calls had been interrupted.

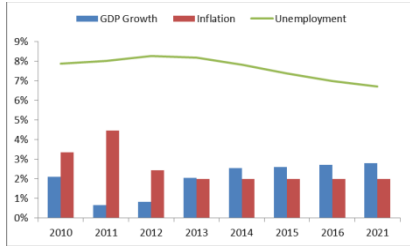
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**Figure 30 – Capex % Revenues in Germany**



Source: Companies Reports

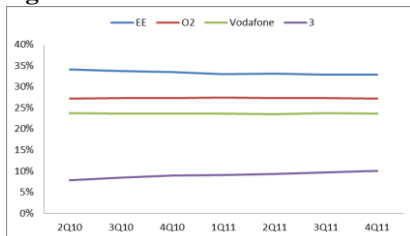
**Figure 31 – UK Macroeconomic indicators**



Source: IMF and analyst estimates

**Despite a somewhat lower mobile penetration compensated by a higher fixed telephony penetration the UK is overall a similar market to Germany. Thus we forecast similar market evolution**

**Figure 32 – Mobile Market Share**



Source: Ofcom

have consistently been able to maintain OIBDA margins above 35% compared with a maximum margin of 26.1% in 4Q11 for Telefónica) is expected to present a higher CAGR of 4.51% for the same period reaching €1.9 billion in 2021.

Capex to better deal with data traffic is expected to increase from current levels. However due to debt restriction in 2012 O2 Telefónica is expected to refrain from increasing Capex significantly. We nevertheless see the bet on fixed operations to lead Capex to levels above what historically was seen even after adjusting for network sharing agreement between O2 and Deutsche Telekom where DT’s infrastructure will connect to O2’s German fibre points. Thus we forecast Capex % revenues at the levels observable in competitors and a little below historical average of 14.7%. Finally we forecast nominal terminal growth for the region at 0.9%.

### United Kingdom

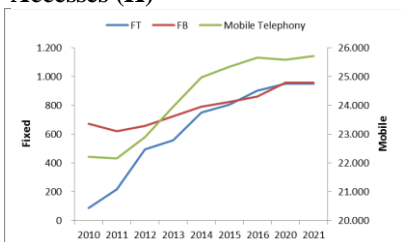
UK’s operations represented 11% of revenues and 8% of OIBDA in Telefónica’s 2011 results. O2 here offers services in three segments: mobile and fixed telephony and fixed broadband. The UK is in a similar position in terms of its telecommunications’ market when compared with Germany. Nevertheless while on Germany we have seen growth of 2.4% y-o-y in 1Q12 in the UK there was a significant decline in revenues of 6.1%. Regarding Wireline operations we expect Telefónica to increase only marginally its small market share in fixed broadband from current 3% to around 4%, due to the fact that there is not a lot of momentum behind broadband for O2 and its offers are somewhat limited when compared with incumbent BT. Additionally O2 offers are not better than the ones offered by BT in terms of price and it lacks coverage for most of UK and does not have a pay-tv option.

Regarding Mobile operations the company has more or less maintained its market share around 27% for the past two years after an increase from 25% in 2006 and maintains the second position in the market only behind Everything Everywhere (the joint venture of Orange and Deutsche Telekom in the UK) and remains comfortably ahead of Vodafone. Additionally it has shown resilience while both other operators lost market share to 3 the operator with highest growth in the previous year. O2 UK reflects the company’s approach to contract based customers in order to reduce churn with increasing percentage of contract customers, though it still lags Vodafone and 3 in this area. Additionally smartphone adoption has increased as well as the percentage of non-SMS over data revenues from 37.6% to 43.6% in the last year. This has not been totally

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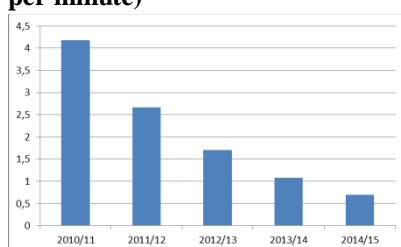
reflected in blended or data ARPU with the first decreasing 8% and the second only growing 1.4% y-o-y. This can however be explained by the fact that MOU have decrease in the past year when compared with its main competitors and that in April 2011 there were steep cuts in MTR's by Ofcom. Consequently and in an effort to keep customers the company has introduced new tariffs that even though it led to a reduction in ARPU have allowed it to present growth in accesses. These tariffs should also lead to at least stabilization in MOU. We expect the mobile market in the UK to continue to grow driven by the same factors as the ones present in Spain and Germany reaching a market penetration of 150.1%. For O2 we expect it to be able to maintain its market share mostly stable at 26%. Figure 33 reflects the forecasted evolution of O2's accesses based on the analysis done regarding market penetration and O2 market share.

**Figure 33 – Fixed and Mobile Accesses (K)**



Source: Company Reports and Analyst estimates

**Figure 34 – MTR in the UK (pence per minute)**



Source: Ofcom

Ofcom has introduced new regulation at the end of March 2011 according to which the regulator would continue to limit MTR's, as previous regulation would expire at that time. Consequently based on the Ofcom's analysis of the market and consultation, and using an LRIC approach following EC's recommendation, the regulator imposed a new glide path that would last until 2015 and bring prices down gradually at the beginning of April of each year from 0.0418 to 0.0065 pounds in 2014. This would also eliminate the asymmetry that previously existed in favor of 3. Taking this measure into account and that the main cut in prices happened in April 2011 we expect ARPU to decrease for the next 3 years and start recovering in 2015.

**Table 6 – O2 UK Financial data and KPI's (GBP unless stated otherwise)**

|                              | 2010  | 2011  | 2012E | 2013E | 2014E | 2015E | 2016E | 2021E | CAGR  |
|------------------------------|-------|-------|-------|-------|-------|-------|-------|-------|-------|
| ARPU (GBP)                   | 22,9  | 21,8  | 20,7  | 19,7  | 18,9  | 19,0  | 19,3  | 20,2  | -1,1% |
| % non-SMS over data revenues | 32,8% | 40,5% | 46,0% | 52,9% | 58,9% | 63,9% | 68,1% | 80,0% |       |
| MOU                          | 224   | 196   | 193   | 195   | 205   | 210   | 220   | 250   | 1,0%  |
| Exchange Rates (GBP/€)       | 0,86  | 0,87  | 0,83  | 0,83  | 0,83  | 0,83  | 0,82  | 0,81  |       |
| Revenues (€ millions)        | 7.201 | 6.927 | 6.999 | 6.989 | 7.072 | 7.390 | 7.681 | 8.246 | 1,2%  |
| Revenues (millions)          | 6.171 | 6.013 | 5.843 | 5.824 | 5.867 | 6.097 | 6.299 | 6.680 | 0,7%  |
| OIBDA                        | 1.568 | 1.594 | 1.315 | 1.357 | 1.484 | 1.463 | 1.531 | 1.770 | 1,1%  |
| OIBDA Margin                 | 25,4% | 26,5% | 22,5% | 23,3% | 25,3% | 24,0% | 24,3% | 26,5% |       |
| Capex                        | 614   | 635   | 1.068 | 786   | 792   | 854   | 945   | 1.002 | 4,5%  |

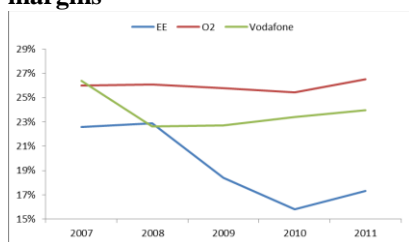
Source: Company Report and analyst estimates and Bloomberg and IMF for Forward Exchange rates

We expect Capex for next year to increase significantly driven by the Digital Dividend spectrum auction that is supposed to happen in the second half of

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**The auctions in Germany, Sweden, Switzerland, France, Portugal and Spain have shown generally three successful bidders however in the UK we expect 4 successful bidders based on Ofcom’s stance in the matter.**

**Figure 35 – Historical OIBDA margins**



Source: Companies’ Reports

2012<sup>31</sup>. Taking into account the spectrum auctions that already happened we can try to predict the amount that will be spent by O2 in the UK auction. We forecast Ofcom will receive in total around €3,075 billion<sup>32</sup> with the auction where Telefónica may end up paying around €750 million based on our belief that there will still be 4 successful bidders.

Revenues are expected to decline in local currency in 2012 and 2013 after which they should gradually increase. In euros, growth is higher due to the forecasted appreciation of the British pound in the short/medium term. O2 UK has been able to present an OIBDA margin consistently above that of its competitors and we believe this is mostly associated with management and not with prices that are fairly the same between operators. However company’s OIBDA margin shall decline in 2012 continuing 1<sup>st</sup> quarter trend as a result of intense competition and lower ARPU and afterwards recuperating as the market stabilizes and commercial activity is reduced. Terminal growth rate is forecasted at 1%.

**Table 7 – Europe Other than Spain Accesses and Financial Data**

|                              | 2010    | 2011    | 2012E   | 2013E   | 2014E   | 2015E   | 2016E   | 2021E   | CAGR  |
|------------------------------|---------|---------|---------|---------|---------|---------|---------|---------|-------|
| Fixed telephony accesses (K) | 3.672   | 3.853   | 4.855   | 4.800   | 5.158   | 5.297   | 5.454   | 5.528   | 3,8%  |
| Internet and data accesses   | 4.496   | 4.537   | 4.726   | 4.866   | 4.988   | 5.047   | 5.180   | 5.341   | 1,6%  |
| Mobile accesses              | 46.676  | 48.277  | 50.193  | 52.220  | 54.190  | 55.363  | 56.101  | 59.433  | 2,2%  |
| Pay TV                       | 206     | 219     | 235     | 249     | 260     | 269     | 278     | 332     | 4,4%  |
| Wholesale Accesses           | 1.248   | 1.213   | 1.215   | 1.189   | 1.190   | 1.181   | 1.188   | 1.193   | -0,4% |
| Revenues (€ millions)        | 15.724  | 15.524  | 15.181  | 15.268  | 15.588  | 16.178  | 16.645  | 18.424  | 1,5%  |
| Operating expenses           | -11.912 | -11.503 | -11.600 | -11.599 | -11.709 | -12.199 | -12.478 | -13.569 | 1,2%  |
| Supplies                     | -6.900  | -6.873  | -6.756  | -6.672  | -6.578  | -6.875  | -7.024  | -7.609  | 0,9%  |
| Personnel expenses           | -1.691  | -1.391  | -1.504  | -1.710  | -1.858  | -1.930  | -1.963  | -2.091  | 1,9%  |
| Subcontracts                 | -3.106  | -3.067  | -3.188  | -3.065  | -3.118  | -3.231  | -3.325  | -3.685  | 1,6%  |
| Other Operating Expenses     | -215    | -173    | -152    | -153    | -156    | -162    | -166    | -185    | -1,4% |
| Other net income (expense)   | 268     | 213     | 213     | 214     | 218     | 226     | 233     | 258     | -0,3% |
| OIBDA                        | 4.080   | 4.233   | 3.794   | 3.883   | 4.097   | 4.205   | 4.400   | 5.112   | 2,1%  |
| OIBDA margin                 | 25,9%   | 27,3%   | 25,0%   | 25,4%   | 26,3%   | 26,0%   | 26,4%   | 27,7%   |       |

Source: Company Report and analyst estimates

<sup>31</sup> The proposed calendar was not fulfilled due to the fact that O2 has categorized the auction as illegal under current conditions due to the fact that Ofcom pretends to ensure that a part of the 800 mhz spectrum will forcibly go to an operator other than O2 and Vodafone on the basis that these operators already holding spectrum in the 900mhz band. However O2 defends that the two frequencies are not comparable and that the auction as it is goes against EU law representing a state aid as these floors would allow Everything Everywhere and 3 to buy the spectrum at lower prices. Ofcom has revamped their proposal excluding such clause and thus clearing the way to the advancement of 4G auction.

<sup>32</sup> The Digital Dividend spectrum auctions in Germany, Spain, Sweden, Switzerland, Portugal and France led to total amounts paid of €3.57B, €1.3B, €225M, €841M, €372M and €3.45B million respectively. These values imply a per capita expenditure of €43.4 in Germany, €28.2 in Spain, €24 in Sweden, €109 in Switzerland, €35 in Portugal and €55 in France. By simplifying and using an average the per capita charge we predict in the UK is €49 which leads to total spending of €3075 million.

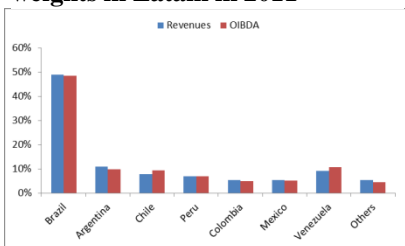
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Following trend displayed in the UK and Germany European (outside of Spain) shall present healthy growth in both Revenues as well as OIBDA.

## Latin America

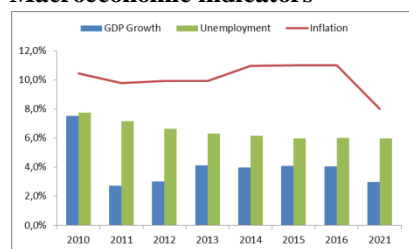
Latin America markets are currently the main driver of growth for the company. The area already represents more 66.6% of total accesses though revenues and OIBDA shares are smaller. The main contributor to growth is Brazil with net adds of over 3.2 million in the last quarter. There are however some other countries that have shown good growth prospects namely Peru (10.7% growth in accesses and 5.8% in revenues), Colombia (15.8% growth in accesses and 7% in revenues), Chile (6.4% in accesses and 4.9% in revenues), Ecuador (4.6% in accesses and 8.5% in revenues) and Uruguay (4.9% in accesses and 5.6% in revenues)<sup>33</sup>. These results that compare very positively with European countries have however one main issue, which is the forecasted depreciation against the euro of their exchange rate in some markets mainly driven by much higher inflation and interest rates fueled by high economic growth. However due to the current European conditions we have seen a trend of appreciation regarding the euro which however we believe to be short-lived. Telefónica is very well positioned in Latin America with its presence in all main markets which are also markets that are expected to present very favorable economic growth<sup>34</sup>.

**Figure 36 – Revenues and OIBDA weights in Latam in 2011**



Source: Company Report

**Figure 37 – Brazilian Macroeconomic indicators**



Source: IMF and analyst estimates

### Brazil

Brazil presents some mixed macroeconomic indicators. On one hand growth is expected to remain high with unemployment in check. However Inflation is also expected to stay at levels much above those seen in Europe thus supporting the idea that the Brazilian Real (BRL) will depreciate against the Euro.

Brazilian fixed telecommunications’ market is divided into three areas. Areas I and II that represent around 77.5% of the population and 63% of GDP have as the main incumbent Oi<sup>35</sup>, while for region III (São Paulo state) the incumbent is Telesp<sup>36</sup>. Additionally Embratel, currently controlled by América Móvil, is the incumbent operator for long distance calls (between states) in all regions. This

<sup>33</sup> Revenue growth in local currencies

<sup>34</sup> According to IMF and analyst projections for the period between 2012-2021 GDP growth is expected to increase at a simple average of 3.89% over the different countries or by 3.64% if using an average weighted by each country’s contribution to Sales.

<sup>35</sup> Oi was initially the incumbent operator of region I but acquired Brasil Telecom in 2008, the incumbent in region II.

<sup>36</sup> Telesp was Telefónica’s fixed telephony company in Brazil until the merger of fixed and mobile arms under the Vivo.

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**Vivo now holds both fixed and mobile offers taking advantage of strong recognition all over Brazil, opposite to Telesp's predominance in the São Paulo area.**

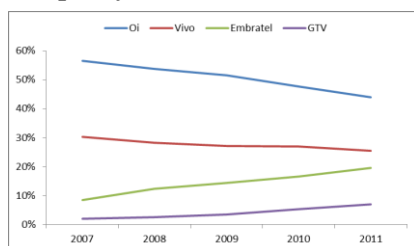
gives somewhat the competitive picture in Brazil, because these three operators offer services in all segments: América Móvil (AMX) uses the brand Claro that started as the mobile telephony and has become the overall brand though it is still in a transition phase. Also the company holds 49% of Net which offers fixed line services though it has different coverage; Oi offers all its quadruple play offers under the same brand; Telefónica offers all its services under the Vivo brand umbrella with the transition related with the merger between fixed (Telesp) and mobile (Vivo) operations completed. The other big player is TIM that currently only offers mobile services<sup>37</sup>. The benefits from this integration are the possibility of cross selling products and introduce bundles that more effectively allow an operator to manage customer satisfaction and churn rate. Telefónica has already merged the companies legally and commercially as Vivo.

**Wireline**

Brazil's fixed telephony market penetration akin to most Latin America countries never reached high levels of market penetration and with the increase in popularity of mobile telephony it started to stagnate. In Brazil from 2005 to 2010 market penetration has not deviated from the interval between 21% to 22%. Additionally though there have been changes in the competitive landscape each player is still in the same place as it was 5 years ago. We do however believe that future changes in fixed telephony will be the result of broadband adoption, thus Oi and Telefónica shall continue to lose market share in fixed telephony if others' 2-play and 3-play bundles are preferred, and specifically those from Claro that has increased its market share at the expense of both. Regarding fixed broadband the main losers over the previous year in relation to market share are Telefónica and Oi, with NET and GVT increasing their market share. Market penetration is still low at 8.39% and we believe the market will continue to grow with great momentum as growth was 19.57% in 2011. Narrowband accesses should continue to decrease and become an insignificant amount of accesses. Market penetration at the end of explicit period is assumed to be 21.1% as a similar effect to the one presented in fixed telephony might happen where mobile broadband will end up cannibalizing fixed accesses.

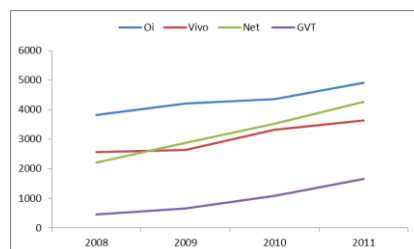
In relation to Pay-TV we expect the market to continue growing. Pay-TV has become extremely popular in Brazil with growth above 30% during 2011 and a total of 12.7 million accesses compared with 16.5 million in fixed broadband

**Figure 38 – Market Shares in Fixed Telephony**



Source: Anatel

**Figure 39 - Accesses in fixed broadband (K)**

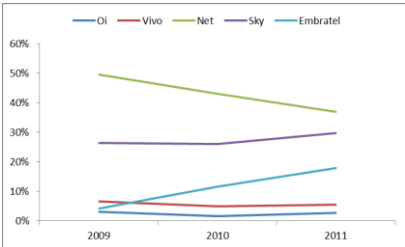


Source: Anatel

<sup>37</sup> TIM has purchased AES Atimus an optic fiber network that covers Rio de Janeiro and São Paulo and will start offering fixed broadband services in the near future.

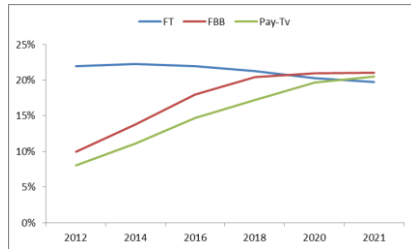
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**Figure 43 - Pay-tv Market Shares**



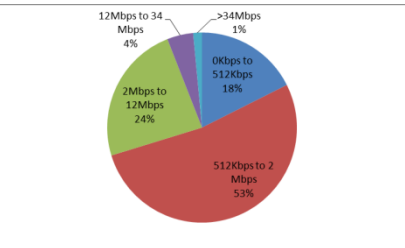
Source: Anatel

**Figure 42 - Market Penetration in Fixed Operations**



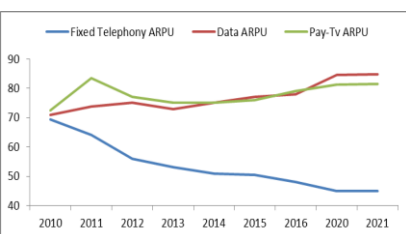
Source: Analyst estimates

**Figure 41 - Distribution of FBB by speeds**



Source: Teleco

**Figure 40 – ARPU evolution in reais**



Source: Company Reports and Analyst estimates

which implies a rate of 0.772 pay-TV subscription per broadband access. This rate of Pay-TV per broadband access has been increasing and this should be the result of operators heavily pushing for triple play offers and in some cases even quadruple play offers. Additionally Sky, that has been increasing its market share is a pay-tv company only which might imply that the number of households with pay-tv without other fixed line services is growing. We expect to see the Pay-TV growing at a faster rate than broadband with all three landline segments very close at the end of our explicit period. Similarly to other landline services Telefónica has lost market share in Pay-TV services in detriment to Sky and Embratel (excluding TVA accesses)<sup>38</sup>. This reduction of market share in all fronts can be attributed first and foremost to limited coverage of Telefónica’s services outside the São Paulo area not being able to effectively compete in some states on fixed services and second to the lack of awareness for Telesp the brand the company still used until March of 2012. However we do believe that integration of all services under the Vivo umbrella will bring higher customer awareness and drive demand. Simultaneously efforts to increase coverage outside of São Paulo and the roll-out of its fiber network in São Paulo area should be important factors to revert this trend. Still, right now there are probably two reasons why this increased coverage in optic fibre services has not yet contributed heavily to growth in landline services: first the still very limited coverage and second the fact that the main benefits of optic fiber are still not very much relevant in Brazil. Looking at the average internet connection speed in Brazil of 1.9 Mbps (3rd Q 2011) and the market share of broadband speeds we can easily see that right now the increase in utility from optic fibre services is still very much limited for most of Brazil’s population. Nevertheless the company has reiterated its goal of increasing FTTH subscribers with the goal of having 1 million subscribers by 2015 up from around 70,000 at the end of 2011.

Following these trends we forecast a decrease market share for Telefónica in all fixed and broadband services (the addition of 150 thousand TVA customers will lead to increased market share in Pay-TV) for the short-term, while having positive net adds as a result of the high growth in the market. However we do believe activity for the company will start picking-up at the end of 2012 (when services commercial integration is done) and starting in 2013 we already expect market share to increase. Regarding ARPU we expect to see declines for all

<sup>38</sup> Telefónica increase its ownership of TVA from 19.9% to 49% in May 2011, after Anatel approved the operation that was under analysis since 2007 and was only possible due to legal changes that previously did not allow foreign companies acquiring controlling stakes in cable companies.

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segments except data following recent trends as competition intensifies, with all operators looking to increase their market share and offering the same integrated services. Prices for Data and Pay-tv should start picking up in 2014 as inflation starts pushing them up, though the growth in prices should remain below inflation reflecting what has historically happened. Regarding Fixed-telephony ARPU we expect to see it continue to decrease due to decreases in the demand for fixed telephony as mobile telephony continues growing.

**Table 8 - Vivo's Fixed Financial Data (BRL millions)**

|                 | 2010   | 2011   | 2012E  | 2013E  | 2014E  | 2015E  | 2016E  | 2021E  | CAGR  |
|-----------------|--------|--------|--------|--------|--------|--------|--------|--------|-------|
| Fixed Revenues  | 13.742 | 13.574 | 12.567 | 12.712 | 13.788 | 15.306 | 16.554 | 20.934 | 3,9%  |
| Fixed Telephony | 10.217 | 9.478  | 8.084  | 7.676  | 7.734  | 8.003  | 7.826  | 7.654  | -2,6% |
| Data            | 3.113  | 3.448  | 3.792  | 4.222  | 5.044  | 6.050  | 7.152  | 10.381 | 11,6% |
| Pay-Tv          | 412    | 647    | 691    | 814    | 1.009  | 1.253  | 1.575  | 2.899  | 19,4% |

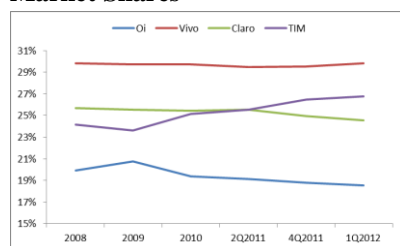
Source: Company Reports, IMF, Bloomberg and Analyst estimates

Fixed line revenues are expected to increase at a CAGR of 3.9% from 2010-2021 though growth varies a lot in different segments. While Fixed Telephony revenues are expected to decrease, data and Pay-tv revenues should present big growth driven by increasing access numbers and growing ARPU.

**Wireless**

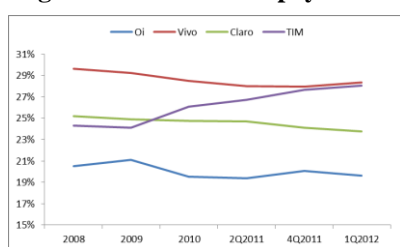
Mobile telephony in Brazil has grown over the past two years at a minimum 15% growth y-o-y with 19.2% growth in 1Q12. Additionally 3G and datacard accesses have intensified and already represent 17.3% and 3.4% of total accesses, which shows that Brazil's mobile telephony market is becoming increasingly sophisticated. Market penetration has grown very much in the past years and stood in 1Q12 at 126.72%. We expect it to reach market penetration of 170.3% above what is generally seen right now in developed economies but it should reflect the competitive environment in Brazil, where high off-net minute costs leads to a larger number of people holding more than one mobile account.

**Figure 44 – Mobile Telephony Market Shares**



Source: Teleco

**Figure 45 – Mobile Prepay MS**



Source: Teleco

The mobile market is far from defined or stable with a lot of commercial activity and aggressive competition. Currently Vivo continues to be market leader with stable market share. TIM is now second after overcoming Claro and Oi has shed some market share though not very significantly. Though Vivo continues to be market leader its strategy is distinct from those of other operators and has led to a focus in high-end customers (part of Telefónica's strategy) consequently market share of contract customers was 36.5% in 1Q12, significantly above its overall market share of 29.8% and of second place in this segment Claro with

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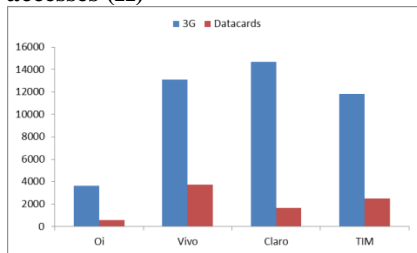
28.2%. On the other hand TIM has focused in prepay customers which continue to predominate and have allowed the company to get very close of Vivo's market share in prepay (28.3% vs 28.0%). However, future growth will come mainly from contract customers as has been visible for the past year (21.5% growth vs 18.64% in contract and prepay respectively). In the short-term Vivo is expected to lose leadership in the prepay segment.

There are two main factors that lead us to believe Vivo is going to continue in a market leading position overall and they are related with the company's capacity to deliver on the main driver of mobile growth: mobile broadband. First is the company's 3G coverage in Brazil. The company has undertaken a financial effort to create and sustain the best 3G coverage in Brazil. By the end of 2011 Vivo had 3G coverage in 2727 municipals representing 84.3% of Brazil's population while Claro, the second operator with highest coverage, only reached 877 cities (65.5% population)<sup>39</sup>. In spite of it the higher coverage is not totally reflected on number of 3G accesses, as Claro still leads here even if it shows much lower datacard market share. However as income per household continues to grow even outside of the big cities Vivo is predicted to have an advantage.

The second factor is related with performance in dealing with customers complaints.<sup>40</sup> As can be seen Vivo has consistently outperformed its peers in the IDA and also in complaints<sup>41</sup>. We expect Vivo to maintain leadership reaching a 29% market share overall and 38% in contract customers which imply a percentage of contract customers to total customers of 47.4%.

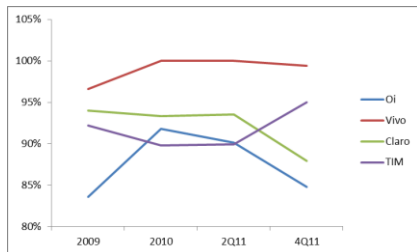
Regarding ARPU we have to take into account two opposing forces. On one side there is pressure for ARPU to continue increasing because though competition is fierce the fact that Vivo has a strong percentage of contract customers it should be more protected from the volatility in prepay ARPU. Additionally increased 3G adoption and with it, data traffic increase is expected thus driving Data ARPU up and creating a positive pressure on overall ARPU. This is what is actually happening now. Vivo's ARPU decreased 5.7% in the 1st quarter of 2012 with a decrease of 10.9% in Voice ARPU and increase of 12.2% in Data ARPU. Additionally traffic is expected to continue increasing as contract customer base increases as well as tariffs that contribute to higher traffic usage leading to MOU

**Figure 47 – 3G and Datacard accesses (K)**



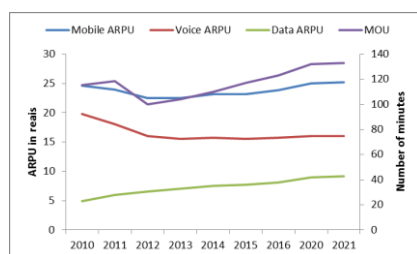
Source: Teleco

**Figure 46 – IDA index**



Source: Teleco

**Figure 48 – ARPU evolution and MOU**



Source: Company Reports and Analyst estimates

<sup>39</sup> Oi and TIM had coverage of 50.3% and 43.7% of Brazil's population respectively.

<sup>40</sup> This index called IDA determines whether Operators meet targets demanded by Anatel. If all targets are met the operator has 100%.

<sup>41</sup> Vivo had an average of 0.221 complaints per 1000 customers in 2011 compared with 0.420, 0.355 and 0.388 for Oi, Claro and TIM respectively.

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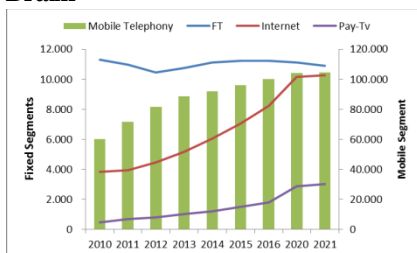
increases. Finally we expect a very positive impact from 2014 and 2016 sports events (FIFA World Cup and the Olympics) driving traffic up as well as roaming revenues.

Besides very fierce competition, there is another negative pressure on ARPU. Even though Anatel does not regulate directly mobile termination rates due to classifying it as part of private services, it does regulate fixed to mobile termination rates. In February 24th interconnection rates from fixed to mobile decreased by 10.78%<sup>42</sup>, thus reducing the amount of money mobile operators will receive from calls received from fixed telephony users. This regulatory decision has already affected 1st quarter of 2012 ARPU and should continue negatively affecting voice ARPU.

Anatel will hold this year an auction for mobile spectrum in the 2.5 GHz band which can be used for 4th generation applications. This because band on the 800 MHz band is not yet available with the switch off in analog television only expected to happen starting in 2014. Telefónica has already stated that it finds that the auction comes too soon on the heels of a still incomplete coverage and adoption of 3rd generation services (whose auction occurred only 5 years ago in 2007). However this is one of those situations where not entering the auction will put Vivo in a very difficult situation going forward even if it means more capital expenditure. Consequently we believe that Telefónica will indeed bid in the auction and based on Digital Dividend auctions in Europe and the fact that in 2007 the total amount paid for the 3G licenses were 5.3 billion reais, we believe that Vivo will acquire one of the 4 band for auction spending around 1.19 billion reais for it<sup>43</sup>. The deployment of 4G networks simultaneously with increasing coverage of 3G will certainly drive Capex up. Additionally Telefónica has stated that it expects to invest in capital expenditures in Brazil 24.3 billion reais in the 2011-2014 period which we expect to be the one with highest capex fomented by 4G and FTTH after which it should slow down as percentage of sales.

**The proposed reduction of interconnection rates was supposed to be higher however Anatel determined that a slow decrease would allow operators to adjust and be able to participate in mobile spectrum auctions that will should start in June 2012**

**Figure 49 – Evolution of Accesses in Brazil**



Source: Company Reports and Analyst estimates

<sup>42</sup> Fixed to mobile rates will decrease from current \$0.546 reais to \$0.487 a 10.78% reduction in 2012 with similar reduction projected for 2013 and 2014. Additionally the idea is to introduce a cost based approach to fixed-mobile interconnection rates in 2014. With the introduction of this approach further cuts may occur.

<sup>43</sup> Using the average paid in Europe the per capita expected expenditure in reais would be 79.31. However if we take into account the 3G auction in 2007 where the per capita expenditure was just 27.92 reais it would lead us to believe that the European average does not apply. Not only because 3G network did not yet have time to be fully taken advantage of with operators still focused on 3G services that present strong growth perspectives but also because the 2.5 Ghz band is not as good as the 800 Mhz with shorter range and capacity so we predict total amount paid below 3G spectrum at 4.77 billion reais (a 10% discount) above 3.75 billion of minimum price target.

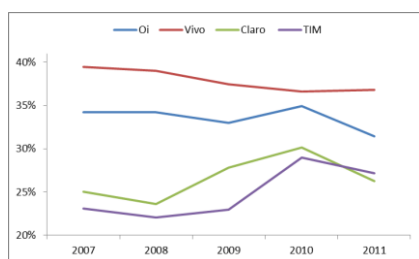
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**Table 9 – Telefónica Brazil Financial Data (BRL)**

|                                      | 2010    | 2011    | 2012E   | 2013E   | 2014E   | 2015E   | 2016E   | 2021E   | CAGR  |
|--------------------------------------|---------|---------|---------|---------|---------|---------|---------|---------|-------|
| Forward Exchange rate BRL/€          | 2,33    | 2,33    | 2,42    | 2,57    | 2,62    | 2,67    | 2,72    | 3,00    |       |
| Revenues (millions)                  | 31.471  | 33.172  | 34.031  | 36.717  | 40.225  | 42.933  | 46.100  | 53.890  | 5,0%  |
| Mobile                               | 17.729  | 19.598  | 21.464  | 24.005  | 26.438  | 27.627  | 29.546  | 32.956  | 5,8%  |
| Fixed                                | 13.742  | 13.574  | 12.567  | 12.712  | 13.788  | 15.306  | 16.554  | 20.934  | 3,9%  |
| Expenses                             | -20.458 | -21.540 | -22.535 | -24.203 | -26.315 | -27.657 | -29.927 | -34.993 | 5,0%  |
| Personnel                            | -2.164  | -2.272  | -2.921  | -3.152  | -3.453  | -3.685  | -3.957  | -4.904  | 7,7%  |
| Supplies                             | -6.324  | -6.313  | -6.057  | -6.425  | -6.838  | -6.869  | -7.606  | -8.622  | 2,9%  |
| Subcontracts                         | -8.080  | -8.706  | -9.132  | -9.853  | -10.794 | -11.521 | -12.371 | -14.461 | 5,4%  |
| Others                               | -3.890  | -4.249  | -4.424  | -4.773  | -5.229  | -5.581  | -5.993  | -7.006  | 5,5%  |
| Other net operating income (expense) | 298     | 403     | 681     | 734     | 805     | 859     | 922     | 1.078   | 12,4% |
| OIBDA                                | 11.311  | 12.035  | 12.177  | 13.248  | 14.715  | 16.135  | 17.094  | 19.974  | 5,3%  |
| OIBDA margin                         | 35,9%   | 36,3%   | 35,8%   | 36,1%   | 36,6%   | 37,6%   | 37,1%   | 37,1%   |       |
| Depreciation and Amortization        | -4.695  | -5.132  | -5.140  | -5.536  | -5.793  | -6.101  | -6.468  | -7.778  | 4,7%  |
| Capex                                | 4.181   | 5.740   | 6.808   | 6.058   | 6.637   | 7.299   | 7.606   | 8.083   | 6,2%  |

Source: Company Reports and Analyst Estimates

**Figure 50 – Historical OIBDA margins in Brazil**



Source: Company Reports

OIBDA margin should remain a little below 2011 levels due to strong competition in both mobile and fixed operations. Compared with the main operators it should present a margin rate in line with Oi and above Claro’s and Tim’s margins as has historically happened and Oi best compares with Telefónica as an incumbent operator while both Claro and Tim started or still are mainly mobile operators.

### Latam Operations

Latam operations are expected to present significant growth in accesses all around, except in fixed telephony. Regarding revenues CAGR between 2011 and 2021 is predicted to be around 1.62% while OIBDA should face a 1.13% CAGR for the same time-period. The lower growth in OIBDA reflects competition levels significantly above historical levels and personnel expenses that are the expenses that will face the highest growth as a result of the high inflation expected to be seen in some countries. On the other hand, supplies which should increasingly be negotiated at a corporate level from Telefónica Global Resources should face growth below revenues. It is important to mention that both Revenues and OIBDA in 2010 are not directly comparable with other years because they do not take into account full consolidation of Vivo and they include a €4.1B gain due to revaluation of Vivo’s stake. Capex should remain above

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European levels specifically FTTH and 4G, is done in most countries some sooner than others.

**Table 10 – Latam Countries Operating and Financial Data**

|                              | 2010    | 2011    | 2012E   | 2013E   | 2014E   | 2015E   | 2016E   | 2021E   | CAGR   |
|------------------------------|---------|---------|---------|---------|---------|---------|---------|---------|--------|
| Fixed telephony accesses (K) | 24.404  | 23.961  | 23.485  | 23.761  | 24.191  | 24.393  | 24.438  | 24.123  | -0,1%  |
| Internet and data accesses   | 8.235   | 8.886   | 9.842   | 11.007  | 12.418  | 13.899  | 15.425  | 18.104  | 7,4%   |
| Mobile accesses              | 149.255 | 166.298 | 183.342 | 196.481 | 204.164 | 213.313 | 221.007 | 238.916 | 4,4%   |
| Pay TV                       | 1.793   | 2.258   | 2.568   | 2.959   | 3.368   | 3.860   | 4.294   | 6.012   | 11,6%  |
| Wholesale Accesses           | 56      | 51      | 41      | 45      | 48      | 53      | 56      | 60      | 0,6%   |
| Revenues (€ millions)        | 25.756  | 29.237  | 29.875  | 30.108  | 31.084  | 31.693  | 32.411  | 34.320  | 2,6%   |
| Operating expenses           | -16.749 | -19.311 | -20.339 | -20.554 | -21.213 | -21.414 | -21.935 | -23.038 | 2,9%   |
| Supplies                     | -6.718  | -7.519  | -7.767  | -7.828  | -8.020  | -8.082  | -8.135  | -8.305  | 1,9%   |
| Personnel expenses           | -2.344  | -2.644  | -2.803  | -3.061  | -3.184  | -3.159  | -3.395  | -3.892  | 4,7%   |
| Subcontracts                 | -6.503  | -7.826  | -8.365  | -8.280  | -8.579  | -8.716  | -8.913  | -9.266  | 3,3%   |
| Other Operating Expenses     | -1.183  | -1.322  | -1.404  | -1.385  | -1.430  | -1.458  | -1.491  | -1.574  | 2,6%   |
| Other net operating income   | 4.705   | 1.014   | 839     | 834     | 870     | 884     | 904     | 957     | -13,5% |
| OIBDA                        | 13.714  | 10.941  | 10.375  | 10.388  | 10.742  | 11.162  | 11.381  | 12.239  | -1,0%  |
| OIBDA margin                 | 53,2%   | 37,4%   | 34,7%   | 34,5%   | 34,6%   | 35,2%   | 35,1%   | 35,7%   | -3,6%  |
| Capex                        | 5.455   | 5.299   | 5.320   | 5.132   | 5.435   | 5.745   | 5.765   | 5.764   | 0,5%   |

Source: Company Reports and analyst estimates

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## Valuation

Our assumptions for the DCF model are shown in table 13.

**Table 11 – DCF assumptions**

|                                     | Group  | Brazil |
|-------------------------------------|--------|--------|
| Risk-free <sup>44</sup>             | 3,00%  | 10,07% |
| Cost of debt <sup>45</sup>          | 6,7%   | 4,89%  |
| Return on equity <sup>46</sup>      | 10,91% | 13,68% |
| Market Premium <sup>47</sup>        | 7,28%  | 8,63%  |
| Levered beta <sup>48</sup>          | 0,94   | 0,42   |
| Debt/enterprise value <sup>49</sup> | 45,00% | 9,60%  |
| Tax rate <sup>50</sup>              | 28,50% | 30,00% |
| WACC                                | 8,15%  | 12,70% |
| g <sup>51</sup>                     | 1,13%  | 1,50%  |

In the scenario with the highest probability of occurring for which we presented financial and operational data, or clean scenario, we value Telefónica at 15.66€ a significant premium over current price of €9. We value Brazilian operations at an Equity value of 56,325 million BRL a 6.22% premium over current market capitalization. These represent respectively an EV/OIBDA12 of 6.5 for the whole group and 4.9 for Vivo. It is interesting to notice that if Brazil's operations had the same Debt/EV as the Group operations then valuation per EV/OIBDA multiple would increase to 7.4 due to WACC reaching 9.07% (excluding any probable effect on cost of debt).

<sup>44</sup> 5-year average of 10 year German Government bonds, due to current historical low levels. For Brazil the rate is adjusted by the inflation forecasted differential (2% EU and 9% Brazil).

<sup>45</sup> Computed using cost of debt equation  $(1 + rd) = (1 + y) * (1 - PD) + PD * RR$  where rd is the cost of debt, y is the market yield on 10 year bonds (7.28% for Telefónica and 5.46% for Vivo); PD is probability of default assumed to be 1% due to high coverage ratio for Telefónica (4.1%) and Vivo (12.21%); RR is recovery rate assumed for both at 48%, according to average observed in "Moody's Investors Service, 2010, Corporate Default and Recovery Rates, 1920-2010".

<sup>46</sup> Using CAPM.

<sup>47</sup> Damodaran 2012

<sup>48</sup> Computed using 2-years weekly data on the MSCI World index and adjusting by 1/3 of the unit.

<sup>49</sup> Current debt to enterprise value for Vivo. For Telefónica due to current very high D/EV and anticipated debt reduction we used a target D/EV value of 45% which is in line with a somewhat stable historical average.

<sup>50</sup> For Vivo Brazil's marginal rate, for Telefónica used average effective rate after adjusted for non-recurrent effects

<sup>51</sup> For Telefónica terminal growth rate is weighted average of predicted terminal growth rates in different markets.

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**Table 12 – Millions € for Telefónica and BRL for Vivo except Prices in units**

|   | Telefónica | Vivo   |
|---|------------|--------|
| PV  | 64.814     | 35.339 |
| Terminal Value                              | 71.800     | 24.558 |
| %   | 53%        | 41%    |
| Enterprise Value                            | 136.614    | 59.897 |
| Net Debt 2011 + unfunded pension plan       | 63.267     | 3.573  |
| Minority Stakes held <sup>52</sup>          | 3.903      | N/A    |
| Telecom Italia                              | 1.313      | N/A    |
| PT  | 57         | N/A    |
| China Unicom                                | 2.316      | N/A    |
| BBVA  | 217        | N/A    |
| Vivo Minority Stake (26,1%)                 | -6.082     | N/A    |
| Czech Minority Stake (30,59%) <sup>53</sup> | -1.455     | N/A    |
| Number of shares outstanding                | 4.841      | 1.126  |
| Equity Value                                | 71.168     | 56.325 |
| Price per share                             | 14,7       | 50,0   |

We performed sensitivity analysis on our valuation in regards to WACC and terminal growth for Telefónica and Vivo, where we can see that both are highly sensible to changes in those two parameters. Still for Telefónica there is no situation would we be below market price.

**Table 13 – Sensitivity analysis on Telefónica’s valuation parameters (Prices in €)**

|        |       | WACC  |       |       |       |       |
|--------|-------|-------|-------|-------|-------|-------|
|        |       | -1,0% | 0,5%  | 0,0%  | 0,5%  | 1,0%  |
| Growth | -1,0% | 17,41 | 15,35 | 13,55 | 11,97 | 10,56 |
|        | -0,5% | 18,81 | 16,52 | 14,54 | 12,8  | 11,27 |
|        | 0,0%  | 20,43 | 17,86 | 15,66 | 13,75 | 12,08 |
|        | 0,5%  | 22,36 | 19,43 | 16,96 | 14,83 | 13    |
|        | 1,0%  | 24,66 | 21,28 | 18,47 | 16,08 | 14,04 |

**Table 14 - Sensitivity analysis on Telefónica’s valuation parameters (Prices in BRL)**

|        |       | WACC  |       |       |       |       |
|--------|-------|-------|-------|-------|-------|-------|
|        |       | -1,0% | 0,5%  | 0,0%  | 0,5%  | 1,0%  |
| Growth | -1,0% | 52,84 | 50,34 | 48,05 | 45,95 | 44,02 |
|        | -0,5% | 54,05 | 51,41 | 49    | 46,8  | 44,77 |
|        | 0,0%  | 55,39 | 52,89 | 50,04 | 47,72 | 45,59 |
|        | 0,5%  | 56,86 | 53,87 | 51,17 | 48,72 | 46,47 |
|        | 1,0%  | 58,49 | 55,29 | 52,41 | 49,81 | 47,44 |

For Vivo the effect was also significant and because our valuation’s premium is much lower than that present in the overall Telefónica group we can see that

<sup>52</sup> Using Market Prices.

<sup>53</sup> Valued according to market prices.

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more negative growth or higher WACC can turn the valuation below market prices.

## Comparables

**Table 15 – Telefónicas main comparables and competitors**

|                  | 1 Yr Retur | P/E ratio | Net debt/EBITDA | EV/EBITDA | Price/Sales | Div Yield |
|------------------|------------|-----------|-----------------|-----------|-------------|-----------|
| Telefonica       | -40.62%    | 7,66      | 3,00            | 5.64      | 0,64        | 14,6%     |
| Deutsche Telekom | -23.05%    | 10.27     | 2,22            | 4.01      | 0,65        | 8,8%      |
| KPN              | -24.74%    | 8,93      | 2,36            | 4.66      | 0,86        | 11,1%     |
| Telecom Italia   | -30.72%    | N/A       | 2,76            | 4.06      | 0,44        | 5,2%      |
| France Telecom   | -35.57%    | 6,93      | 2,02            | 3.94      | 0,59        | 13,8%     |
| America Movil    | 14.08%     | 13,22     | 1,29            | 6.16      | 1,84        | 1,1%      |
| Vodafone         | 9.62%      | 12,31     | 0,93            | 4,06      | 1,89        | 6,1%      |
| Average          |            | 9.89      | 2,08            | 4.65      | 0,99        | 8,7%      |

Source: Bloomberg

Looking at the table with Telefónica's main comparables and competitors it becomes apparent that European incumbent operators are seeing very negative market performance of their shares. All of these trade at similar multiples and there is a relationship one can make between the very negative 1 year returns and Net debt/EBITDA levels. On the other hand Vodafone despite being also an European company has the lowest Net debt/EBITDA of the sample and presents multiples above average and positive 1 year growth. The same can be said of America Móvil. In conclusion investors seem to be divesting in the more leverage companies which is analogous to European sovereign debt situation and consequently has led to such a low current average. Additionally despite only representing 1 quarter of Telefónica value, the company is still very much connected with Spain and thus the uncertainty surrounding the country's capacity to overcome its debt situation without a bail-out and the impact it may have on Spanish economy and the Eurozone. Investors who put a lot of probability in a much worse scenario than the one presented by us, will reach a much lower valuation and avoid the stock at previous valuations.

## Debt

Debt as mentioned before is one of the elements Telefónica is most concerned about, already deciding to take specific actions. We believe that German Enterprise value €7.9 billion and equity value of €6.4 billion using EV/OIBDA and P/E of 7.4 and 14.87, respectively, which are those implied in our Group valuation. Taking into account the comparables average, EV would be €5.7 billion

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and equity at €4.2 billion. We thus build three scenarios to assess evolution of debt. A, with the company as is, B with the spin-off of German operations at an average EV of €6.8 billion and C with additional measures such as another scrip dividend next year for 1 out of 1.3 dividend and the sale of Atento, which based on comparables is evaluated at €1.25 billion.

**Table 16 - Net Debt/OIBDA scenarios**

|   | 2011 | 2012E | 2013E | 2014E | 2015E | 2016E | 2021E |
|---|------|-------|-------|-------|-------|-------|-------|
| A | 2,95 | 2,65  | 2,72  | 2,68  | 2,67  | 2,64  | 2,58  |
| B | 2,95 | 2,37  | 2,66  | 2,64  | 2,65  | 2,64  | 2,72  |
| C | 2,95 | 2,26  | 2,40  | 2,38  | 2,39  | 2,38  | 2,45  |

*Source: Analyst Estimates*

As we can see according to our projections the scrip dividend this year plus the sale of Germany’s operations (besides this we also take into account sales of other non-core assets) is not enough to reduce Net debt/OIBDA below the desired 2.35. Additionally as we did not adjust dividend below scenario A levels, because FCF generated by Germany’s operations will no longer be available there will be continued increases in the variable. Consequently we believe Telefónica should also look into other ways so that debt reduction is more significant.

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## Appendix

| Income Statement Euros (millions)       | 2010       | 2011       | 2012E      | 2013E      | 2014E      | 2015E      | 2016E      | 2021E      | CAGR       |
|---|------------|------------|------------|------------|------------|------------|------------|------------|------------|
| Revenues                                | 60.737     | 62.837     | 62.713     | 62.786     | 64.035     | 65.192     | 66.590     | 71.621     | 1,5%       |
| Spain                                   | 18.712     | 17.284     | 16.014     | 15.673     | 15.536     | 15.405     | 15.554     | 16.152     | -1,3%      |
| LATAM                                   | 25.756     | 29.237     | 29.875     | 30.108     | 31.084     | 31.693     | 32.411     | 34.320     | 2,6%       |
| Rest of Europe                          | 15.724     | 15.524     | 15.181     | 15.268     | 15.588     | 16.178     | 16.645     | 18.424     | 1,5%       |
| Others                                  | 545        | 792        | 1.642      | 1.738      | 1.827      | 1.916      | 1.979      | 2.725      | 15,8%      |
| Own work capitalized                    | 737        | 739        | 563        | 545        | 557        | 560        | 570        | 577        | -2,2%      |
| Expenses                                | -40.374    | -44.501    | -42.954    | -43.046    | -43.618    | -44.306    | -45.243    | -48.414    | 1,7%       |
| Supplies                                | -17.606    | -18.256    | -18.264    | -18.169    | -18.213    | -18.475    | -18.717    | -19.607    | 1,0%       |
| Personnel expenses                      | -8.409     | -11.080    | -7.956     | -8.341     | -8.537     | -8.594     | -8.898     | -9.472     | 1,1%       |
| Subcontracts                            | -12.228    | -13.019    | -14.656    | -14.413    | -14.702    | -15.044    | -15.394    | -16.991    | 3,0%       |
| Change in trade provisions              | -852       | -818       | -883       | -870       | -890       | -904       | -923       | -970       | 1,2%       |
| Taxes                                   | -1.279     | -1.328     | -1.195     | -1.254     | -1.276     | -1.289     | -1.312     | -1.373     | 0,6%       |
| Other operating income (expenses)       | 494        | 317        | 449        | 451        | 462        | 469        | 478        | 480        | -0,3%      |
| Gain (loss) on sale of fixed assets     | 4.149      | 823        | 356        | 357        | 366        | 371        | 378        | 379        | -19,6%     |
| Impairment of goodwill and other assets | 35         | -5         | 0          | 0          | 0          | 0          | 0          | 0          |            |
| Operating income before D&A (OIBDA)     | 25.777     | 20.210     | 21.127     | 21.092     | 21.801     | 22.285     | 22.772     | 24.642     | -0,4%      |
| <b>OIBDA Margin</b>                     | <b>42%</b> | <b>32%</b> | <b>34%</b> | <b>34%</b> | <b>34%</b> | <b>34%</b> | <b>34%</b> | <b>34%</b> | <b>-2%</b> |
| Depreciation and amortization           | -9.303     | -10.146    | -10.349    | -10.377    | -10.311    | -10.265    | -10.263    | -10.447    | 1,1%       |
| Depreciation                            | -6.159     | -6.670     | -6.739     | -6.841     | -6.860     | -6.882     | -6.929     | -7.213     | 1,4%       |
| Amortization                            | -3.144     | -3.476     | -3.610     | -3.536     | -3.452     | -3.383     | -3.333     | -3.234     | 0,3%       |
| Operating income (OI)                   | 16.474     | 10.065     | 10.778     | 10.715     | 11.490     | 12.020     | 12.509     | 14.195     | -1,3%      |
| Profit from associated companies        | 76         | -635       | -627       | -188       | 0          | 65         | 133        | 143        | 5,9%       |
| Net financial income (expense)          | -2.649     | -2.941     | -3.456     | -3.315     | -3.436     | -3.499     | -3.546     | -3.749     | 3,2%       |
| Finance Income                          | 760        | 809        | 565        | 464        | 373        | 376        | 379        | 392        | -5,8%      |
| Interest expenses                       | -2.514     | -2.671     | -3.507     | -3.408     | -3.482     | -3.546     | -3.593     | -3.798     | 3,8%       |
| Other Finance Costs                     | -783       | -920       | -514       | -371       | -326       | -329       | -331       | -343       | -7,2%      |
| Exchange rate profit (loss)             | -112       | -159       | 0          | 0          | 0          | 0          | 0          | 0          | -100,0%    |
| Income before taxes                     | 13.901     | 6.489      | 6.695      | 7.212      | 8.054      | 8.587      | 9.097      | 10.589     | -2,4%      |
| Income taxes                            | -3.829     | -301       | -1.908     | -2.055     | -2.825     | -2.447     | -2.593     | -3.018     | -2,1%      |
| Income from continuing operations       | 10.072     | 6.188      | 4.787      | 5.156      | 5.759      | 6.139      | 6.504      | 7.571      | -2,6%      |
| Minority interests                      | 95         | -784       | -607       | -622       | -686       | -748       | -772       | -801       | -221,4%    |
| Profit for the year                     | 10.167     | 5.404      | 4.180      | 4.534      | 5.072      | 5.391      | 5.732      | 6.770      | -3,6%      |
| Other comprehensive income              | 628        | -1.774     | 0          | 0          | 0          | 0          | 0          | 0          |            |
| Total Comprehensive income for the year | 10.700     | 4.414      | 4.787      | 5.156      | 5.759      | 6.139      | 6.504      | 7.571      | -3,1%      |

| Balance Sheet                                   | 2010          | 2011          | 2012E         | 2013E         | 2014E         | 2015E         | 2016E         | 2021E         | CAGR         |
|---|---------------|---------------|---------------|---------------|---------------|---------------|---------------|---------------|--------------|
| Cash and equivalents                            | 4220          | 4135          | 3136          | 3139          | 3202          | 3260          | 3330          | 3581          | -1,5%        |
| Current Financial Assets                        | 1574          | 2625          | 2107          | 2149          | 2192          | 2236          | 2281          | 2518          | 4,4%         |
| Accounts receivable                             | 12426         | 11331         | 10996         | 10837         | 11053         | 11252         | 11311         | 12166         | -0,2%        |
| Inventories                                     | 1028          | 1164          | 1186          | 1204          | 1193          | 1161          | 1186          | 1275          | 2,0%         |
| Current Tax Receivables                         | 1331          | 1567          | 1290          | 1313          | 1369          | 1410          | 1454          | 1599          | 1,7%         |
| Intangible assets                               | 25026         | 24064         | 23573         | 23010         | 22550         | 22223         | 21992         | 21557         | -1,3%        |
| Goodwill  | 29582         | 29107         | 29107         | 29107         | 29107         | 29107         | 29107         | 29107         | -0,1%        |
| Tangible assets                                 | 35802         | 35469         | 36006         | 36104         | 36224         | 36471         | 36781         | 38292         | 0,6%         |
| Others  | 18786         | 20161         | 17388         | 17073         | 16770         | 16525         | 16302         | 15734         | -1,6%        |
| <b>Total Assets</b>                             | <b>129775</b> | <b>129623</b> | <b>124788</b> | <b>123936</b> | <b>123659</b> | <b>123644</b> | <b>123743</b> | <b>125828</b> | <b>-0,3%</b> |
| Accounts Payable                                | 21555         | 19947         | 20124         | 20049         | 20196         | 20393         | 20824         | 22284         | 0,3%         |
| Provisions                                      | 5424          | 7584          | 6434          | 5805          | 5223          | 4638          | 4062          | 2886          | -5,6%        |
| Current Tax Payables                            | 2822          | 2568          | 2451          | 2512          | 2622          | 2699          | 2790          | 3065          | 0,8%         |
| Gross Debt                                      | 61100         | 66311         | 61214         | 62710         | 63916         | 65015         | 65652         | 69658         | 1,2%         |
| Post retirement liability                       | 1116          | 1091          | 1113          | 1135          | 1158          | 1181          | 1187          | 1221          | 0,8%         |
| Other liabilities                               | 6074          | 4739          | 4862          | 4791          | 4748          | 4723          | 4714          | 4740          | -2,2%        |
| <b>Total Liabilities</b>                        | <b>98091</b>  | <b>102240</b> | <b>96197</b>  | <b>97002</b>  | <b>97864</b>  | <b>98649</b>  | <b>99230</b>  | <b>103854</b> | <b>0,5%</b>  |
| Equity attributable to equity holders of the p. | 24452         | 21636         | 22615         | 20856         | 19635         | 18733         | 18172         | 15618         | -4,0%        |
| Non-controlling interests                       | 7232          | 5747          | 5977          | 6078          | 6160          | 6262          | 6341          | 6356          | -1,2%        |
| Equity  | 31684         | 27383         | 28592         | 26934         | 25795         | 24995         | 24514         | 21974         | -3,3%        |
| <b>Total Liabilities + Equity</b>               | <b>129775</b> | <b>129623</b> | <b>124788</b> | <b>123936</b> | <b>123659</b> | <b>123644</b> | <b>123743</b> | <b>125828</b> | <b>-0,3%</b> |

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| Cash Flow                                       | 2010        | 2011        | 2012E        | 2013E        | 2014E        | 2015E        | 2016E        | 2021E        | CAGR    |
|---|-------------|-------------|--------------|--------------|--------------|--------------|--------------|--------------|---------|
| Operating profit                                | 16474       | 10065       | 10778        | 10715        | 11490        | 12020        | 12509        | 14195        | -1,3%   |
| Net financial income (loss)                     | -59         | -905        | -576         | -96          | 47           | 112          | 180          | 192          | -211,3% |
| EBIT adjusted                                   | 16415       | 9160        | 10202        | 10620        | 11536        | 12132        | 12690        | 14387        | -1,2%   |
| Adjusted income taxes                           | -4583       | -1102       | -2960        | -3078        | -3340        | -3511        | -3671        | -4157        | -0,9%   |
| NOPLAT  | 11832       | 8058        | 7242         | 7542         | 8196         | 8621         | 9019         | 10230        | -1,3%   |
| Other Comprehensive Income (after tax)          | 628         | -1774       | 0            | 0            | 0            | 0            | 0            | 0            | -100,0% |
| Depreciation and Amortization                   | 9303        | 10146       | 10349        | 10377        | 10311        | 10265        | 10263        | 10447        | 1,1%    |
| Gross Cash Flow                                 | 21763       | 16429       | 17591        | 17919        | 18507        | 18886        | 19282        | 20677        | -0,5%   |
| Net Working Capital                             | -9592       | -8453       | -9103        | -9206        | -9204        | -9269        | -9662        | -10309       | 0,7%    |
| Var in NWC                                      | -4356       | 1139        | -650         | -104         | 3            | -65          | -394         | -162         | -25,9%  |
| Capital Expenditures                            | 9958        | 6337        | 7276         | 6939         | 6980         | 7129         | 7240         | 7541         | -2,5%   |
| Investment in Goodwill and Acquired Intangibles | 22340       | 2039        | 3118         | 2974         | 2991         | 3055         | 3103         | 3232         | -16,1%  |
| Gain (loss) from financial investments          | 2086        | -1601       | 2263         | -426         | -365         | -409         | -407         | 30           | -31,9%  |
| FCF   | -4093       | 5313        | 10110        | 7684         | 8168         | 8358         | 8927         | 10097        | 6,0%    |
| Interest on debt                                | 2514        | 2671        | 3507         | 3408         | 3482         | 3546         | 3593         | 3798         | 3,8%    |
| tax shield                                      | 754         | 801         | 1052         | 1022         | 1045         | 1064         | 1078         | 1139         | 3,8%    |
| Var Net Financial debt                          | -9202       | -5296       | 4098         | -1493        | -1144        | -1041        | -567         | -1155        | -17,2%  |
| Var Employment Provisions                       | 60          | 25          | -22          | -22          | -23          | -23          | -6           | -7           |         |
| Dividends paid                                  | 6312        | 7728        | 1936         | 6293         | 6293         | 6293         | 6293         | 7745         | 1,9%    |
| Repurchases                                     | 849         | 777         | 968          | 0            | 0            | 0            | 0            | 0            |         |
| Other movements                                 | -3870       | 209         | 297          | 0            | 0            | 0            | 0            | 0            |         |
| Minority Interests                              | 0           | 0           | 377          | 521          | 604          | 647          | 692          | 855          |         |
| Cash flow available to investors                | -4091       | 5313        | 10110        | 7684         | 8168         | 8358         | 8927         | 10097        | 6,0%    |
| <b>Operational Indicators</b>                   | <b>2010</b> | <b>2011</b> | <b>2012E</b> | <b>2013E</b> | <b>2014E</b> | <b>2015E</b> | <b>2016E</b> | <b>2021E</b> |         |
| Invested Capital                                | 87375       | 88558       | 85664        | 85517        | 85517        | 85746        | 85792        | 86884        | -0,2%   |
| Invested Capital without goodwill               | 57793       | 59451       | 56557        | 56410        | 56410        | 56639        | 56685        | 57777        | -0,3%   |
| ROIC  | 14,9%       | 9,2%        | 8,3%         | 8,8%         | 9,6%         | 10,1%        | 10,5%        | 11,8%        | 2,3%    |
| ROIC without Goodwill                           | 18,2%       | 13,7%       | 12,5%        | 13,4%        | 14,5%        | 15,3%        | 15,9%        | 17,7%        | 2,3%    |
| Coverage Ratio EBIT                             | 6,6         | 3,8         | 4,1          | 4,2          | 4,3          | 4,3          | 4,4          | 4,6          | 1,8%    |
| Coverage Ratio (EBITDA)                         | 10,3        | 7,6         | 6,0          | 6,2          | 6,3          | 6,3          | 6,3          | 6,5          | -1,4%   |
| Debt/EBITDA                                     | 2,4         | 3,3         | 2,9          | 3,0          | 2,9          | 2,9          | 2,9          | 2,8          | -1,3%   |
| Net Financial Debt                              | 55306       | 59551       | 55971        | 57422        | 58523        | 59519        | 60042        | 63559        | 0,6%    |
| Net Financial debt/EBITDA                       | 2,1         | 2,9         | 2,6          | 2,7          | 2,7          | 2,7          | 2,6          | 2,6          | -1,2%   |
| Net Financial debt+ commitments/EBITDA          | 2,2         | 3,0         | 2,7          | 2,8          | 2,7          | 2,7          | 2,7          | 2,6          | -1,2%   |

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|             |  |
|-------------|--|
| <b>Buy</b>  | Expected total return (including dividends) of more than 15% over a 12-month period.   |
| <b>Hold</b> | Expected total return (including dividends) between 0% and 15% over a 12-month period. |
| <b>Sell</b> | Expected negative total return (including dividends) over a 12-month period.           |

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