

TELEFONICA

TELECOMMUNICATION SERVICES

STUDENT: DIOGO CALDAS SILVA

COMPANY REPORT

7 JANUARY 2013

Hopes for a Strong Latin America
while Deleveraging*Drop in Spain and high Debt levels spree away investors*

- **We value Telefonica at a price of €13.78 per share**, which represents a capital gain, over the current price, of 31.4% that can ascend to 38.6% if we consider the predicted 2013 dividend of €0.75 per share.
- **Currently, the company is involved in a deleveraging strategy.** After a period when the major focus of the firm strategy was growth through acquisitions, Telefonica is now selling some of its non-strategic assets to face increasing liquidity needs and the high levels of debt that mature in a short-term horizon.
- **Telefonica's operations are being affected by the deterioration of its domestic market.** The sovereign debt crisis and the consequent austerity measures imposed by the Spanish Government are affecting consumption and consumer confidence. The Telecommunications sector is one of the most affected, especially Telefonica that saw its revenues decrease 4.4% YoY.
- **Growth of LatAm operations contrast with the stagnation of the European ones.** The European financial distress is affecting Telefonica's operations, however the technological growth and increasing potential of Latin America have prevented further degradation of the company's operations.
- **Telefonica is currently considering doing an IPO of its Latin America Operations.** The objective is to protect the firm's most valuable operations from an aggravation in the European conundrum and improve the company's financial position.

Recommendation: BUY

Vs Previous Recommendation N/A

Price Target FY13: 13.78 €

Vs Previous Price Target N/A

Price (as of 6-Jan-13) 10.48 €

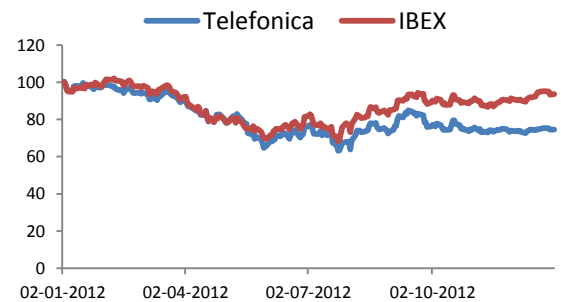
Reuters: TEF.MC, Bloomberg: TEF:SM

52-week range (€) 13.46-7.90

Market Cap (€m) 47,694.7

Outstanding Shares (m) 4,551

Source: Bloomberg



Source: Bloomberg

(Values in € millions)	2011	2012E	2013F
Revenues	62.837	62.553	61.690
OIBDA	20.210	21.637	22.825
Net Profit	5.403	4.997	6.047
EPS	1.20	1.10	1.30
P/E	11.18	9.27	10.60
Debt/OIBDA	3.28	2.91	2.50
Net Debt/OIBDA	2.95	2.43	2.13
ROIC	8.43%	8,70%	8.54%

Source: Bloomberg and Analysts estimates

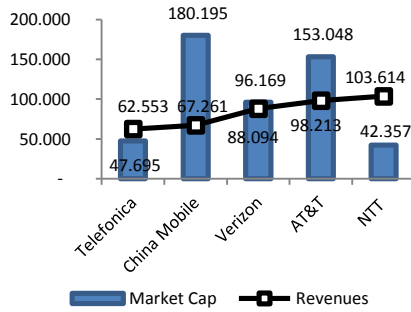
THIS REPORT WAS PREPARED BY DIOGO CALDAS SILVA, A MASTERS IN FINANCE STUDENT OF THE NOVA SCHOOL OF BUSINESS AND ECONOMICS, EXCLUSIVELY FOR ACADEMIC PURPOSES. THIS REPORT WAS SUPERVISED BY ROSÁRIO ANDRÉ WHO REVIEWED THE VALUATION METHODOLOGY AND THE FINANCIAL MODEL. (SEE DISCLOSURES AND DISCLAIMERS AT END OF DOCUMENT)

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Company overview

Figure 1 – Revenues & Market Caps (€Million)

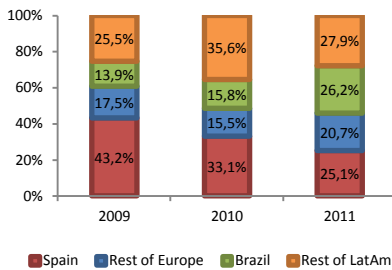


Source: Company Reports, Analyst Estimates and Bloomberg

Telefonica is a telecommunications service provider of Spanish origin, managing currently more than 300 Million subscribers. The company was created in 1924 with the name Compañía Telefonica Nacional de España and was state-owned until 1999. Telefonica is a worldwide firm and one of the most important of its sector, being the 5th in terms of revenues, only surpassed by China Mobile, Verizon, AT&T and the Japanese company NTT. In terms of market capitalization, Telefonica ranks 4th worldwide¹. Nowadays, the firm is managed by the Chairman and CEO Cesar Alierta Izuel.

Company description

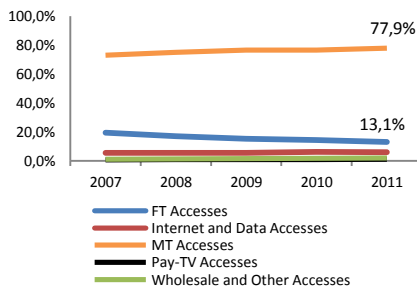
Figure 2 – Telefonica’s OIBDA % per region



Source: Company Reports

In April 2012 Telefonica integrated all Brazilian Telecommunications Services under the Vivo’s name.

Figure 3 – Telefonica’s Operations



Source: Company Reports

Telefonica is a global telecommunications company, present in 23 countries spread throughout Europe and Latin America². Telefonica’s main sector is wireless services, from which should be highlighted the mobile telephony and mobile broadband. However, the firm also provides several wireline services like fixed telephony, fixed broadband and paid television. Besides these, the company also offers wholesale telecommunication services, taking advantage of its international and well developed fiber network³.

Telefonica operates in these different environments through different brands, in order to benefit from brand recognition and customer loyalty. In Europe, its main brands are Movistar, that serves the Spanish operations of the company, and O2, that supplies telecommunications services for the rest of Telefonica’s European operations. In Brazil, Telefonica’s telecommunication services are provided by both the brands Vivo and, formerly, Telesp. In the rest of Latin America, Telefonica’s operations are supplied in a similar way as in Spain, by Movistar, although in this market the brand Telefonica is also implemented to supply some telecommunications services like fixed telephony or fixed broadband.

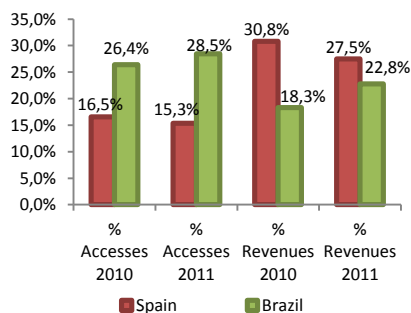
Telefonica has two main markets that weight a great portion in their global operations. The first is the Spanish market where the company works as the incumbent, being market leader in almost all of the services it supplies. Its main operation, mobile telephony and broadband, presents a market share of 39.9%. Considering the remaining operations, fixed telephony, fixed broadband and pay-

¹ We considered the industry of Telecom Services where Telefonica is surpassed by AT&T (€153.047,54B), Verizon (€96.168,81B) and NTT DOCOMO Inc (€47.928,25B). However if we add the wireless telecommunications industry, where Telefonica also has operations, its rank would decrease to 7th behind China Mobile (€180.195,36), Vodafone (€96.569,32) and America Moviles (€69.747,87B).

² In Europe Telefonica has a presence in Spain, its domestic market, United Kingdom, Germany, Ireland, Czech Republic and Slovakia. In Latin America Telefonica has a presence in Brazil, Argentina, Chile, Peru, Mexico, Colombia, Venezuela, Ecuador, Uruguay, Costa Rica, Guatemala, Nicaragua and Panama. In the United States, France and Morocco the company only offers customer relation management services. In Italia and China, Telefonica is present through stakes in Telecom Italia (10.46%) and China Unicom (5.01%).

³ Telefonica fiber operations are one of the best in Latina America, being one of the few companies that has developed both fiber-to-the-home and fiber-to-the-building operations. In Europe the company is in a similar level as it competitors. Source: Company reports

Figure 4 – Spain’s and Brazil’s Operations and Financials

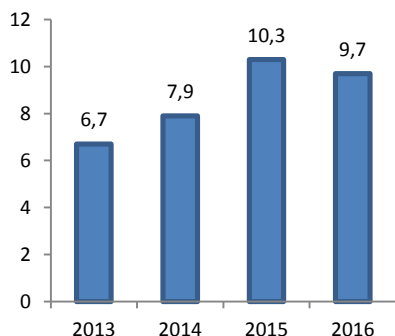


Source: Company Reports

TV, Telefonica presents market shares of 62.7%, 49.3 % and 18.6%, respectively⁴. The second market is Brazil, where Telefonica acquired the Brazilian company Telesp and initiated a partnership with the Portuguese telecommunications company Portugal Telecom (PT), creating the mobile company Vivo. In 2010, Telefonica acquired PT’s stake in Vivo for €7.5 Million Euros⁵ and currently holds a stake of 73.9% in the entity. In this market Telefonica is leader only in the mobile segment with a market share of 29.7%⁶. In the remaining markets we should refer the strong presence of the company in the rest of LatAm, threatening the dominance of America Moviles, and the increasing presence in the European market (outside Spain), especially in Germany and UK.

After a period of time when the company’s strategic actions were focused in growth through acquisitions, the world’s economic conditions threaten such plan. The subprime crisis, followed by the European sovereign debt crisis associated with the company’s increasing levels of debt and with some rating downgrades, thus hindering the access to markets, led the company to change some of the short/medium term views. Currently, we believe that Telefonica has three main objectives that can be classified as financial, operational and structural:

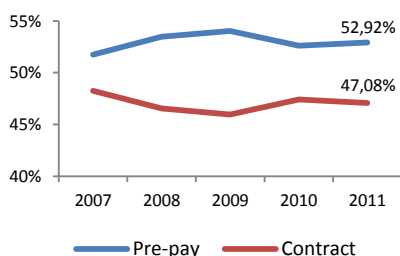
Figure 5 – Telefonica’s Maturity Schedule



Source: Company Reports and Bloomberg

- Financial Objective: Telefonica has to decrease its high levels of debt, in order to face the company’s liquidity constraints (Telefonica has €14.6 billion of debt that matures in 2014 and an additional €10.3 billion that matures in 2015). In order to fulfill this objective the company has been adopting some deleveraging measures, like selling non-strategic fixed assets, selling participations in other companies or raising capital through IPO movements. We would like to highlight that on the 29th of October Telefonica listed 23% of their German subsidiary, Telefonica Deutschland, raising nearly €1.45 billion, the biggest IPO in Europe since July 2011. The IPO was very well received by the market, although investors appear to have demanded a discount due to Telefonica’s position as a forced seller.

Figure 6 – Telefonica’s Operations



Source: Company Reports

- Operational Objective: Telefonica is putting great efforts in reducing the churn rate in all of its operations. This implies giving a greater importance to their contract subscriptions, with the launch, in the market, of several promotion packages like the “Movistar Fusion” in Spain, the “Surf S” in Germany and the “2x1”, “Vivo Fixo” and “Vivo Box” in Brazil, aiming at increasing their subscriber network, but especially at reducing their pre-pay clients over their contract ones. However, the deterioration of financial conditions, especially in Europe, is hampering the accomplishment of this objective.

⁴ The data presented above refers to the 3rd quarter for mobile telephony and 2nd quarter for the remaining sectors. Source: Company reports and Spanish telecommunications’ regulator CMT.

⁵ This implicitly valued the company in €25.423,73 Billion, which having into account our valuation of Vivo – to be presented subsequently – represents a premium of 16.11% paid to Portugal Telecom.

⁶ The data presented above refers to the 3rd quarter. Source: Company reports and Brazilian telecommunications’ regulator Anatel.

According with the European Commission and GSM Association, cloud computing is expected to generate revenues of €35 billion by 2014 and M2M €900 billion by 2020.

- Structural Objective: Telefonica has the objective of becoming a Digital telecommunications company. As such, Telefonica wants to offer all the telecommunications services available in all markets. In order to attain the objective, the company created a new business unit, Telefonica Digital, to foster the development and creation of new and innovative ideas and study the impact of each one in the market environment. Some important services this new business unit has under control are the cloud computing, mobile advertising, eHealth and machine-to-machine (M2M) devices that are expected to generate an increase in revenues per operator⁷. Regarding M2M, Telefonica already launched the service in key industries such as Technological, Utilities and Automotive and is expecting a yearly growth of 25%.

Shareholder structure

Telefonica does not have a very significant shareholder base and is composed mainly by financial institutions. Only two shareholders have a stake in Telefonica above 5%, Banco Bilbao Vizcaya Argentaria (BBVA) and La Caixa with 5.67% (5.65% with direct stake) and 5.43%, respectively. From the remaining shareholders we can highlight Blackrock Investment Management with 3.89% or BNP Paribas with 2.8%. Currently, Telefonica has 18 board members, 5 of them appointed at the proposal of their shareholders⁸. Although considering the distress situation that financial institutions in Europe are undergoing, we believe that Telefonica's shareholder structure is a stable one. Their main shareholders, especially the Spanish ones, believe it corresponds to one of the most valuable assets in Spain and a position in such asset gives them an advantageous spot. This is verified by the fact that Telefonica's main shareholders have maintained a relatively constant position in the company over the years.

The Board Members appointed by the shareholders are the same for several years being another sign of a stable shareholder structure. The BBVA board members since 1995 and the La Caixa ones since 2007.

Valuation

According to our valuation Telefonica is worth €13.78 per share, well above the current price of €10.48, representing a potential shareholder gain of 38.6%⁹. We believe that the current negative stock performance the company has been revealing in the financial markets does not reflect its fair value and is a consequence of the effects of the sub-prime crisis and currently the European sovereign debt crisis, which is negatively affecting Telefonica's domestic market. Alongside this are the high levels of debt that Telefonica has in its Balance Sheet and the small time horizon that the company has to refinance itself. These factors,

⁷ Since most of these technologies are only in the first stages of development and there is a lack of information regarding those, currently it is very difficult to predict the impact of each one in each operator.

⁸ Those 5 shareholders are composed by 2 appointed by BBVA and La Caixa and 1 by China Unicom.

⁹ We considered the closing price of January 4th and the expected dividend of €0.75. Without the dividend effect the upside is 31.5%.

in times of strong debt aversion, are being looked at with distrust by investors that are currently attributing a lower probability to our best scenario and a higher probability to the worst one¹⁰. This symbolizes investor’s doubts regarding the company’s situation upon a default of some Euro country or even the end of the Euro. To sum-up we believe that Telefonica is undervalued and this report will try to demonstrate our point view in the several segments of Telefonica’s operations.

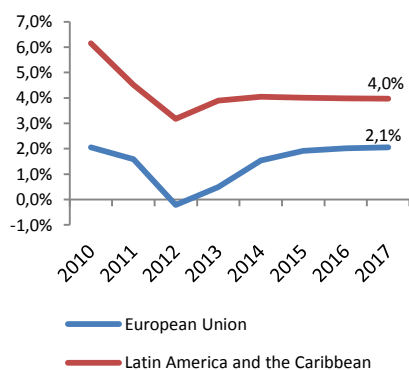
The Telecom Sector and Telefonica’s Operations

Worldwide Telecommunications Market

The worldwide telecom market is currently being affected by some factors that will change the market conditions and alter the relationship between the different operators in the different markets. Those factors can be related with the economic conditions, which are currently influencing the world commerce and consumption or trends that are changing the face of telecoms, demanding further investments. Finally regulations that Governments and telecom regulators are pushing in the market with the goal of increasing competition and, in that way, improve the consumer side.

Regarding economic conditions, we can observe two distinct realities. On the one hand we can assist to the degradation of the European economic conditions caused by the high levels of public debt and the inherent ability to face its financial compromises. Until recently only two countries were severely affected by the sovereign debt crisis, Greece and Portugal¹¹. However, strong economies like Italy or Spain are already feeling the impact and ramifications of this financial distress, which has put a lot of pressure in the stability of the European currency, the Euro. On the other hand, we have the high growth prospects in Southeast Asia and, especially, in Latina America, which bodes well for Telefonica’s operations. The growth, fuelled in its majority by the high levels of exports from North America, China and Europe, is increasing the region’s economic capacity, which led to considerable investments in the most diverse industries, where telecommunications occupy a prominent place. Nevertheless, the European sovereign debt crisis, the uncertainty regarding the US fiscal package that in the short term is under control, but in the long run can still impose damaging effects to the economy, are definitely factors that can delay and, in some cases, prevent the growth predicted to the region.

Figure 7 – GDP growth in the EU and LatAm

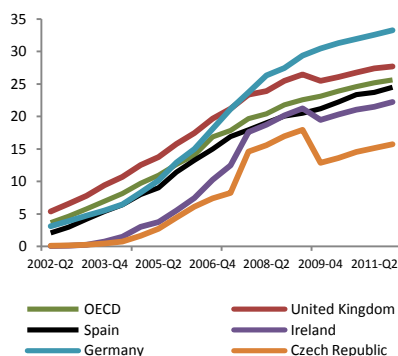


Source: IMF

¹⁰ Our scenarios will be presented in the section “Valuation Assumptions & Financials”, subsection “Scenario Analysis”.

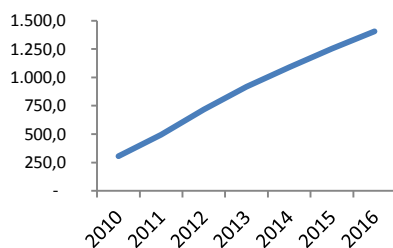
¹¹ We can also consider Ireland, however we believe that the basis for the Irish financial crisis were in the health and sustainability of its banking system, nevertheless its recovery is being severely affected by the European Sovereign Debt Crisis.

Figure 8 – Broadband Penetrations (%) in the OECD



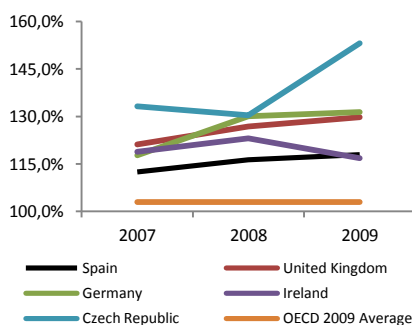
Source: OECD

Figure 9 – Worldwide Smartphone Shipments



Source: International Data Corporation and Statista

Figure 10 – Mobile Telephony Penetrations in the OECD (%)



Source: OECD

Another factor that also affects the telecom market, and as well closely linked to the economic environment, is consumer trends. Consumers are now demanding low cost services in Europe, due to the deterioration of economic conditions, and in Latin America, as the high growth prospects are not reflected in the population wealth and the region is still a scenario of high poverty and income disparity. In response to these consumer demands, the telecom operators launched in the market bundles of telecom services that, if bought alone, would require extra costs¹². These packages of double, triple and four-play services can combine fixed and mobile telephony, fixed broadband and pay television. In the telecom market, the offer of these bundles has led to the slowdown of the decreasing rate of penetration of fixed telephony, to the increase popularity of pay-TV, especially when the domestic market or the state TV is not well developed, and to the development of fixed broadband operations, which is the main driver for this package offers. The fixed broadband operations will have a greater impact with the worldwide development of the Fiber-to-the-Home (FTTH¹³) network that will increase data speeds for every fixed operation and will lead to a greater popularity of the telecom packages. This rise in subscribers has, however, a disadvantage - the reduction of the Average Revenue per User (ARPU). Another trend is the development of mobile broadband, which appears to be the main driver of growth in the telecom market. The increasing demand for smartphones, tablets and other similar devices brought by the current developments in 3G and Long-Term-Evolution (LTE¹⁴) technology oblige operators to further investments, since, besides increasing the number of mobile subscribers, mobile broadband appears to be the only segment where ARPUs can sustainably increase.

The last factor that, in our opinion, could have a decisive weight in the evolution of the telecommunications market is the rising regulation that this industry has been subjected in the past years and that is projected for the future. With the main goal of increasing competition and reducing the incumbent's power in the market – decreasing the number of monopolies in the industry - Governments and regulatory agencies have imposed measures/regulations and high fines for the ones that do not oblige to them. Most of the measures are of economic nature and focus on the mobile termination and roaming rates. In Europe, the decline of MRTs¹⁵ has been the weapon of choice by the regulators to eliminate both the asymmetries between operators and between termination services, fixed

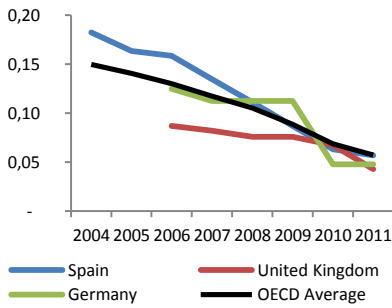
¹² With the adoption of these packages, consumers have the perception of paying less, which is true in the beginning, as they benefit from discounts and lower tariffs. However it is also true that in the future they also end up consuming other associated services. This is in line with the conclusions of the paper “The Dynamic effects of triple play bundling in telecommunications” by Jeffrey Prince that says that bundling offers are positively correlated with income and education, factors that currently present an increasing trend.

¹³ FTTH is a form of fiber-optic communication delivery that reaches the subscriber living or working space.

¹⁴ LTE, marketed as 4G LTE, is a standard for wireless communication of high-speed data for mobile phones and data terminals.

¹⁵ Mobile Termination Rates are the cost that the calling operator has to pay to the receiving operator to terminate the call.

Figure 11 – MTR in the OECD (USD)

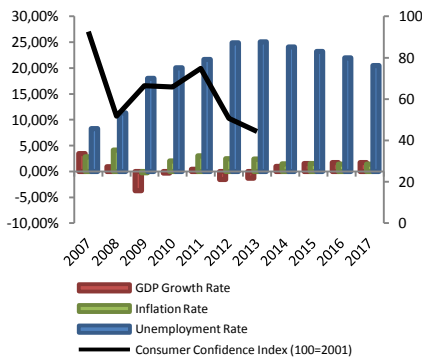


Source: OECD

In 2010 the EC published a document in which expressed the goal of having no differences between roaming and national tariffs by 2015. In 2012 The EC recommendation for the MTR is between 1.5 and 3 cent.

and mobile. Since most of MRTs in Europe are in line with OECD average that has been exhibiting a decreasing trend, we forecast further decreases for the future. In Latin America, we expect similar practices since they are already reducing rates, which are still well above the ones practiced in Europe. This drop will have a negative impact in the operators' ARPUs, though it can also have positive effects in the operators' cost structure as it contributes to the reduction of interconnection costs - normally the negative effect surpasses the positive one. In terms of the roaming rates, the outcome is the same, to reduce competition, although the effects can be somewhat different. At the beginning, ARPUs are also negatively affected by the fall in roaming rates, especially the data ones. However, and after the significant decrease happens, the fact that roaming rates are structured through price caps will revert the tendency and increase ARPUs. Thus, for Telefonica we forecast a small decrease in the short term roaming ARPUs, followed by the rise of the long term ones.

Figure 12 – Spain's Macro Indicators



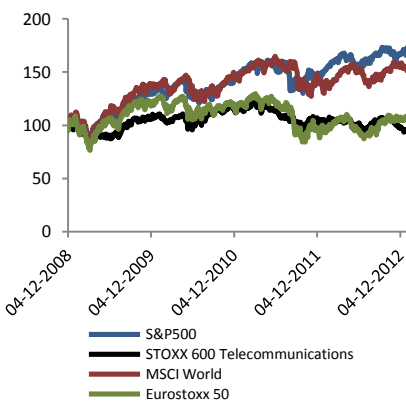
Source: IMF, Instituto de Credito Oficial and Analyst Estimates

In mid 2012 the Eurozone stepped in to fund Spanish banks with €30B, while the overall banking assistance has reached €100B.

Spain

The current operating environment for Telefonica's domestic market, Spain, is extremely difficult, following years of high economic wealth as a result of high taxation revenue from the housing bubble that allowed for an increasing spending without the accumulation of debt. The international economic institutions predict a negative outlook for the country, with the economy in a recessive position at least until 2014 and with very high rates of unemployment. It is predicted for 2012 a decrease in GDP of 1.5% and unemployment rates around 25%. The sovereign debt crisis and the consequent bailouts of the Greek and Portuguese economies left severe marks in the Spanish economy. The country's financial system has been among the most affected by the overall European predicament and in order to meet the conditions for European aid, the newly appointed Spanish Government has put in motion a new round of austerity measures with the objective of cutting €65 Billion in the state budget by 2015. Austerity measures are never popular, though in Spain their effect appears to be destructive with a decrease of 20% in consumer index and a decrease of 11% in the general retail trade index.

Figure 13 – Economic and Telecom Indexes



Source: Bloomberg

These economic conditions are especially damaging for the telecommunications sector, whose characteristics make it extremely dependent on the economic outlook, consumer wealth and confidence prospectus. The Spanish Telecommunications market is one of the largest in Europe, accounting for approximately 4% of the country's GDP¹⁶. The Spanish Telecom market has been gaining greater relevance in the overall economy; however the burst of the

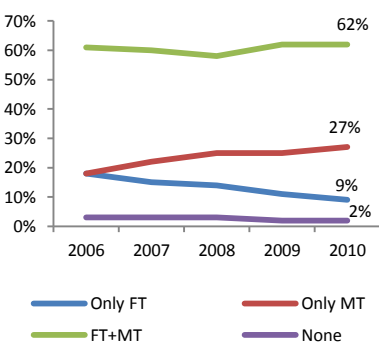
¹⁶ Source: Banco de España and Instituto Nacional de Estadística.

housing bubble in 2007 led to a contraction in the market and to a decline of the industry revenues¹⁷. The most important firm in this market is Telefonica, which is the incumbent providing all the Telecom services available, fixed and mobile telephony, fixed broadband and pay-TV, the company works through the brand Movistar. The market is clearly dominated by the incumbent, as it is the market leader in the first three sectors mentioned, although it has been steadily losing importance. The other telecom companies are Vodafone, Orange and Yoigo, whose key operations are mobile telephony, and Jazztel and ONO that mainly operate on fixed segments. In Spain, the Government and regulators have been introducing procedures to stimulate competition and encourage investments in telecommunications infrastructures despite the current market conditions. Among the most important ones, we highlight the cuts in mobile termination rates, increasing regulation in mobile portability and changes in the wholesale prices for broadband and unbundling of the copper pair. Such measures have been advantageous for alternative operators that by benefiting from the new regulation, specially the one regarding the wholesale rates, have been able to increase their presence outside of the large cities and densely populated areas. This has been accomplished by offering very competitive prices, which meet customer needs in times of financial distress. Although they are considered as important steps for a more develop telecommunications market, the newly elected Government is being pressured to further revitalize the sector by implementing additional policies to encourage investors and ensure a well-developed telecom infrastructure. However, this might be delayed, as the country main concerns revolve around decreasing public debt and avoid a full European bailout.

We have observed a deterioration of Telefonica’s domestic operations with the reduction in the overall subscribers, pressure on prices and lower consumption, mainly due to the adverse competitive scenario and economic environment.

In 2012 CMT cut mobile termination rates from 4ct/min to 3.42ct/min and then to 3.14ct/min. For 2013 are predicted two more cuts, to 2.7ct/min in March 2013 and to 1.09ct/min in July 2013.

Figure 14 – Evolution of Mobile and Fixed Telephony per household in the OECD



Source: BEREC and E-communications

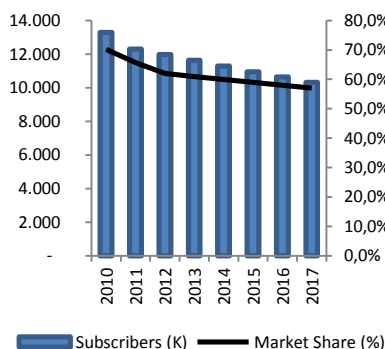
Wireline Business

The Spanish wireline operations have been following the global telecom trends, in which we include the substitution of fixed telephony for its mobile equivalent and the growing popularity of fixed broadband and pay-TV. However, economic conditions and market singularities have been affecting the industry trends in this country. Regarding the fixed telephony market, we have assisted to a constant decline in the levels of penetration, as the popularity of mobile devices kept increasing. For the period 2007-2011 we can observe a CAGR¹⁸ of -1.7%. We expect that the fixed telephony market will continue to struggle and the levels of

¹⁷ In 2009 the Telecom market worth €40 Billion and in 2011 only reached €37.3 Billion. Source: Comision del Mercado de las Telecomunicaciones (CMT).

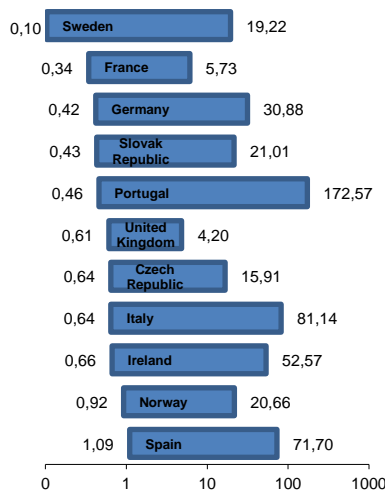
¹⁸ Compounded annual growth rate.

Figure 15 – Telefonica Spain Fixed Telephony Operations



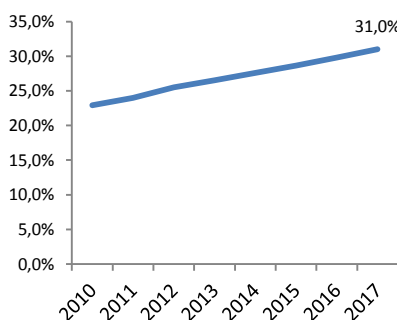
Source: CMT, Company Reports and Analyst Estimates

Figure 16 – Broadband Prices per megabits in the OECD - 2011



Source: OECD

Figure 17 – Spain’s Fixed Broadband Penetrations



Source: CMT and Analyst Estimates

penetration continue to decline, but at slower rates. The development of bundled services strategy, like triple and four play packages, is becoming more popular in Spain as operators want to promote fixed broadband services. The offering of these programs allied with the increasing customer needs for low prices imply a transfer of current fixed telephony subscribers to the ones of bundled packages. We forecast a CAGR of -1.4% for the period of 2011-2017. Regarding Telefonica’s operations in this segment, we expect the same movements. From 2007 to 2011 the company presented a CAGR of -6.2% that was reduced to -2.5% for the period of 2011-2017. This fall was mostly due to the introduction of competitive packages, like the Movistar Fusion¹⁹, that intended a recovery or slower decrease in the market shares.

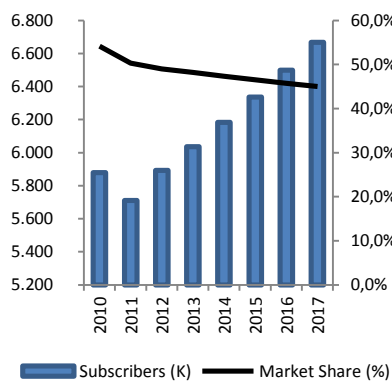
The fixed broadband market in Spain shows a clear growth, fueled by continuous investments in infrastructures in a bid to address the relatively slow data speeds available. This is the problem that has prevented a faster development of the Spanish broadband operations. In 2011, Spain presented one of the slowest broadband in the OECD, even though it was the one with the highest tariffs. In spite of the low speeds attained in the market, the operators do not feel pressured to upgrade its infrastructures²⁰ and networks by investing in fiber-to-the-home technology. In the beginning of 2012, 74.5% of internet users had data speeds below 10 Mbps, which are easily achieved with the current ADSL²¹ network. Regulators, in order to face this lack of attitude, have provided access to the incumbents DSL and FTTH network, which has been stimulating fiber roll-outs. Another factor that has slowed down the pace of development in this sector is the increasing popularity of mobile broadband, with the growing demand for smartphones and 3G enabled devices. During the period of 2007 to 2011 we observed an annual growth of 7.7%. However, and due to the reasons previously mentioned, to which we can add the economic environment, we predict a decrease in pace for the period 2011 to 2017, with a CAGR of 4.4%, reaching a penetration rate of 31% in 2017. In this segment, Telefonica has been affected by charging higher rates than its competitors for the same or inferior levels of data speed, which has led to cuts in market shares. Nevertheless, the introductions of bundled packages, like the previously stated Movistar Fusion, have been contributing for an inversion of the current trend. We forecast that the new fiber roll-outs and the crescent popularity of the triple and 4play packages will lead to increasing market shares. In 2017, we are forecasting a value of 30% against the current 25%, at the cost of the small operators, which are unable to compete in

¹⁹ We will explain the Movistar Fusion program when we describe Telefonica’s wireless operations, since is in this segment that the program has greater impact and from which was originated.

²⁰ Telefonica and Jazztel are facing economic difficulties and an adverse environment within its domestic market and the multinational operators, Orange and Vodafone, currently present lower margins in the segment not being interested in large investments.

²¹ Asymmetric digital subscriber line is a data communications tech that enables faster data transmission over copper telephone lines.

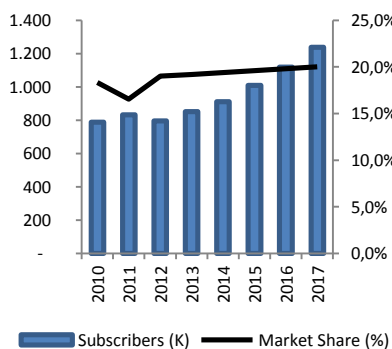
Figure 18 – Telefonica Spain Fixed Broadband Operations



Source: CMT, Company Reports and Analyst Estimates

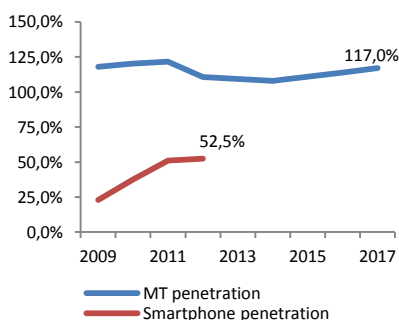
The introduction of the program “Imagenio” allowed for an increase of 1% in Market share at the cost of losses of Digital DTH, ONO and GoITV.

Figure 19 – Telefonica Spain Pay-TV Operations



Source: CMT, Company Reports and Analyst Estimates

Figure 20 – Spain Mobile Telephony and Smartphone penetration (for Smartphone 2012= Q1-2012)



Source: CMT, comScore mobiLens and Analyst Estimates

terms of prices and product offers. We expect the number of Telefonica’s fixed broadband subscribers to increase at a yearly rate of 2.9%.

After small increases in terms of total subscribers in the Pay-TV market until 2011, the Spanish Pay-TV segment is currently in free-fall and lost approximately 100 thousand subscribers in 2012²². The existence of a state TV, which besides free is extremely popular even in international terms, associated with the harsh economic conditions are preventing a fully established market for the pay-TV service, even with the increasing popularity of bundled offers. We expect that, with the improvement of the economic environment, the development of the FTTH technology and with the further increase in bundled offers, the pay-TV segment starts to have more significant developments. CMT expects 8.3 Million accesses by 2023 that compared with our predictions of 6.2 Million for 2017 imply a yearly growth of 5% for the period. Telefonica Pay TV business has been hit by the Government decision of increasing VAT to 21% from the previous 8%. However, the cut in TV prices and the increased bundled offers, in order to retain customers, has mitigated some of the tax effects. The popularity of the “Imagenio”²³ program has allowed for increased market shares, especially at the cost of small operators as it happens with fixed broadband. We are predicting a yearly increase, in terms of subscribers, of 6.8% for the period 2011-2017.

Wireless Business

The Spanish mobile market had an impressive evolution until 2011, the year in which it attained a penetration rate of 120.2%. After this year, the economic conditions clearly inverted this trend and in the first quarter of 2012 the penetration rate already registered a value of 115.5%. In terms of mobile broadband, we could observe a slow development, due to the lack of network available, which puts Spain behind the European average, with high room to grow. The Government’s plans to expand the access to mobile broadband network through distribution of additional frequencies assure a faster development of the sector. This together with the launch of 4G/LTE technology in Spain and the increasing demand for handsets and smartphones, will be the main drivers for future growth of mobile telephony. However, due to the already covered economic distress, we predict that those effects will be felt only after 2014 with the recovery of mobile penetration. We forecast a CAGR of -0.7% for mobile telephony during the 2011-2017 period. The Spanish mobile market is characterized by high competition, especially in the current period, in which operators try to retain subscribers through decreased tariffs and diversified bundled offers. We have assisted to price

²² Accordingly with the last report of CMT.

²³ Imagenio offers TV services at lower rates than competitors and a package featuring TV series and films for 12€ and sports for 20€. The competitors, especially Digital +, offer the cine package for 16.95€ and the sports package for 19.95€.

wars between the three majors operators, which started upon the maintenance of subsidized handsets and smartphones by Orange after Vodafone and Telefonica ended the subsidized program²⁴. In response to those actions Telefonica introduced the Movistar Fusion program that allows for fixed telephony (550 min/month from fixed to mobiles), mobile telephony (500 min/month + 1GB and free sms) and fixed broadband (10MB/second) for 49.90€/month. The package can be upgraded to fiber, with TV subscription and both by increasing 10€ for each respective upgrade. This culminated with a retaliation by France Telecom Orange that started offering a similar package for 43€, but with less advantages as does not have free SMS, mobile broadband only have 200 min/month + 0.5 GB and there is not the possibility of TV and fiber. As we stated previously, mobile broadband will be the main driver for market growth in this segment, which will be prejudicial for Yoigo that was left out from the 2011's 4G Spectrum Digital auction. We think that Telefonica will be able to stabilize its losses in market share around 37%, attributable to the predicted success of the Movistar Fusion program and the more developed infrastructures in terms of FTTH but especially LTE network. We think that Telefonica will be able to benefit from its modern 3G and 4G network coverage that will drive the adoption of smartphones devices and data cards that will further lead to an increasing consumption in mobile data. We are expecting a CAGR of -2.6% for mobile subscribers for the period of 2011-2017.

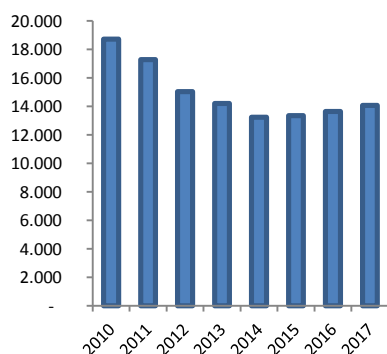
Figure 21 – Telefonica Spain Mobile Telephony Operations



Source: CMT, Company Reports and Analyst Estimates

Regarding ARPUs, we are predicting that the European sovereign debt crisis and its effects in the country will lead to its decrease, as to retain subscribers, operators will have to lower tariffs and increase the offering of bundled packages. In terms of fixed ARPUs, we expect greater resilience on the fixed broadband sector, since as the roll-out of FTTH is implemented we will observe increasing Data and IT services revenues. However, this is currently being mitigated by the decreasing tariffs that are transforming Movistar Fusion in one of the most popular offers in Spain. Concerning Voice ARPU, we expect a constant reduction mainly due to the reasons mentioned above and the decreasing popularity associated with fixed telephony. In mobile terms, we have two contrary effects, the discontinue in the subsidization of handsets and smartphones that contributed to increasing ARPUs and the growth in regulation, especially the decrease in MRTs, joined with the mentioned low tariffs to preserve subscribers. We expect that mobile revenues will be under pressure at least until 2014 as the company adapts to the economic climate, new market regulation and competitor stress in terms of price. After this period we forecast an inversion in the trends, even though to levels inferior to the ones registered in 2011, fueled by mobile broadband

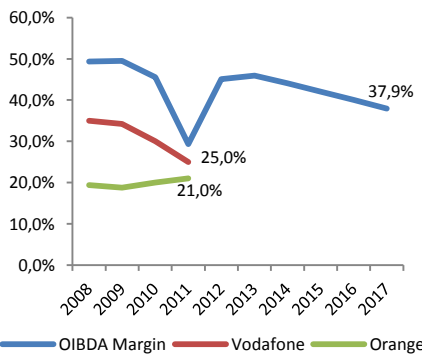
Figure 22 – Telefonica Spain Revenues (€ Millions)



Source: Company Reports and Analyst Estimates

²⁴ In November Vodafone went back on its decision.

Figure 23 – Telefonica Spain OIBDA Margin



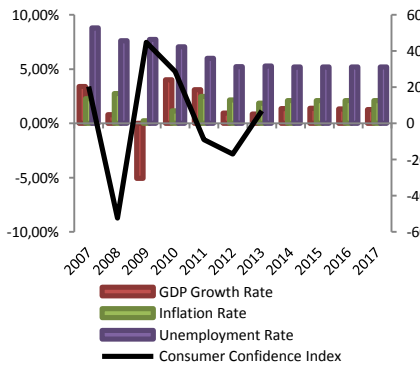
Source: Company Reports and Analyst Estimates

developments²⁵ and increasing subscribers. We forecast CAGRs of -3.1% and -3.7% for fixed and mobile revenues respectively for the period of 2011-2017.

Still, not everything is bad in Telefonica’s domestic market. The introduction of a workforce reduction program led to higher OIBDA margins, which are expected to increase at least until 2013, when a downward trend, to the market average, is forecasted. In the first quarter of 2012 already 3.149 employees were dismissed, which considering the average yearly cost per employee of €415 thousand and the average working years (55), it implies 12 years of saving and a value saved of at least €15Billion. This indicates a decrease in personal expenses that, besides having a direct impact on margins, will allow the company to augment its commercial offers. This will ease for a reducing churn rate and avoid the continuous trend of decreasing subscribers, without hurting the company’s OIBDA. We forecast a CAGR of 1% for Telefonica’s OIBDA for 2011-2017.

Germany

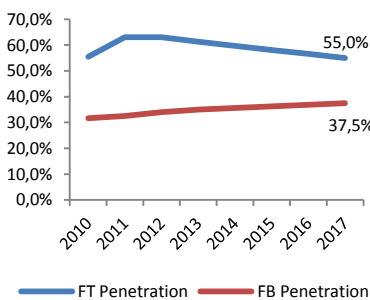
Figure 24 – Germany’s Macro Indicators



Source: IMF, ZEW and Analyst Estimates

In Germany the economic outlook has been less severe than in the rest of Europe. Since the financial crisis struck the world in 2008, followed by the European sovereign debt crisis, Germany has shown to be the strongest and most solid economy in Europe with positive, although small, GDP growth rates and low levels of unemployment and inflation. Although recent signs may suggest that Germany will not be able to continuously avoid the structural problems that have impacted the continent, we expect that it will continue to outperform the remaining European countries. This means that negative events will always have a smaller effect in this country, which makes us believe that the exposure of Telefonica to this market is positive and will mitigate some of the losses predicted for its domestic market.

Figure 25 – Germany Fixed Telephony and Broadband Penetrations



Source: Bundesnetzagentur, Company Reports and Analyst Estimates

Regarding the German telecommunications market, it is considered one of the most technologically developed worldwide due to intensive capital expenditures, since reunification, which modernized telecom infrastructures. The country is served by an extensive system of automatic telephone exchanges connected by modern networks of fiber-optic cable, coaxial cable, microwave radio relay and a domestic satellite system; cellular telephone service is widely available, expanding rapidly, and ensures roaming services to many foreign countries. Penetration rates for all sectors in Germany are high and, as we could see before, well above the OECD average. In the fixed telephony segment, we expect that the increasing usage of mobile phones and VoIP²⁶ devices will lead German consumers to follow the worldwide trend of decreasing the number of fixed lines. We expect the usage

²⁵ In 2015 we expect developments in 4G/LTE technology, mainly increasing speeds, with the realization of a Digital auction of spectrum that was originally set aside for DTT but due to market conditions may be reallocated for mobile broadband.

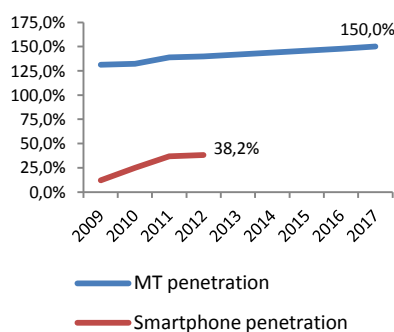
²⁶ Voice over Internet Protocol refers to the transmission techniques involved in the delivery of voice communications and multimedia sessions over Internet Protocol networks.

of fixed telephony to tend to the same usage of fixed broadband as the demand for triple and four-play offers increase. A CAGR of -0.1% is anticipated for the period of 2010-2017. Concerning the development of the fixed broadband segment in Germany, we could observe that in mid 2011 the penetration was well above OECD levels and was revealing some deceleration in the growth rates. In spite of that, we predict that the number of German fixed broadband subscribers, although slowly, will rise by the already mentioned increasing demand for package offers. A CAGR of 2.4% is predicted for the period 2011-2017. The same trends are expected for the pay-tv segment, which we believe will grow at similar rates as the main driver of triple and four-play offers, fixed broadband, with a CAGR of 2.3% for the period 2011-2017.

About the mobile market, even though it is well above the OECD levels, as in the other segments, we expect a steady growth similar to the GDP growth rate, thus a CAGR of 1.3% is predicted for the period 2011-2017. This growth will be attributable mostly to the increasing demand for Smartphones and mobile broadband. Although there is a possibility of low growth due to economic conditions, these will definitely be the main drivers in the future. Currently we expect increasing data consumption, with the introduction and development of 4G technology and LTE, and rising package offers to be the main trends and drivers that will affect the German telecom market in foreseeable future.

The competitive environment in the German telecom market is considered to be stable and is expected to continue in that path for the following years. The country has four main operators: Telefonica, KPN, Vodafone and Deutsche Telekom, being the last two the ones that dominate the market with high market shares both in terms of subscribers and revenues. Currently every player in the market is dealing with some funding needs, which suggests that no operator will be keen to accelerate competitive intensity. However, the more fragile position of KPN²⁷, associated with the increasing popularity of the O2 brand in Germany, can constitute an opportunity for Telefonica to increase its market share. Regarding Telefonica’s fixed telephony operations, we observe that the company is one of the smallest players in the market with only 4% of the market share in 2011. This value will be mainly influenced by the market trends, since neither significant technological advances nor any major investment by O2 are expected in the foreseeable future, meaning that will depend on the success of the package offers of O2²⁸. We expect a CAGR of 4.5% for the period of 2011-2017. Regarding the fixed broadband operations, we need to mention that Telefonica has been able to

Figure 26 – Germany Mobile Telephony and Smartphone penetration (for Smartphone 2012= Q1-2012)



Source: Bundesnetzagentur, comScore mobiLens and Analyst Estimates

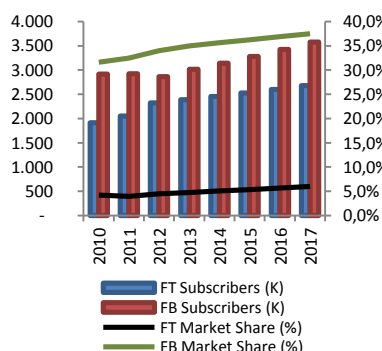
KPN presents a worse financial position than its self imposed limit and was left out from the mobile digital spectrum of 2011 implying a decrease of the LTE financial benefits even if it rents the competitors capacity. DT faces potential significant funding requirements in order to keep up with the others operators investments in cable technology. Vodafone is experiencing pressure in many of its European markets.

²⁷ KPN currently presents a yearly decrease of 10.7%, 3.3% and 2% for EPS (09-11), Revenues (08-11) and EBITDA (11-12) respectively. Besides it presents a yearly increase in net debt/EBITDA (09-11) of 4.7%. Vodafone presents a yearly decrease in European revenues (09-11) of 2.7% and in the group EBITDA (09-11) of 1%. Source: KPN and Vodafone company reports.

²⁸ Currently O2 charges lower tariffs, than DT, for the same package – to be presented upon the explanation of O2 fixed broadband operations – however the fact that the incumbent is able to offer also 3Play packages prevent the company to grow further in the market.

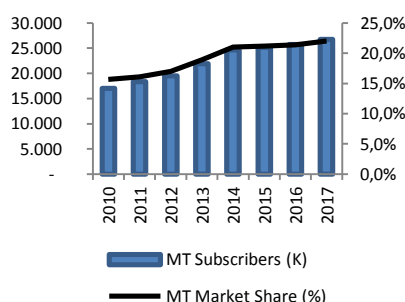
In 2010 Telefonica acquired Hansenet to face consumer needs and increase its fixed broadband network in Germany.

Figure 27 – Telefonica Germany Fixed Operational Data



Source: Bundesnetzagentur, Company Reports and Analyst Estimates

Figure 28 – Telefonica Germany Mobile Operational Data



Source: Bundesnetzagentur, Company Reports and Analyst Estimates

Telefonica introduced in the market the “O2 Blue” rates that have been increasingly popular. However such rates have been decreasing the company’s margins.

In the end of 2012 the Bundesnetzagentur, the German telecom regulatory body plans to decrease MTR from €0.033/min to €0.0185/min and in 2013 to €0.0179/min.

monetize the acquisition of Hansenet. With the acquisition of this company, Telefonica has increased its market share, especially in this segment, and was able to face the modern telecom consumer needs with increasing package deals that their direct competitors, DT and Vodafone, already offer. In this segment, Telefonica appears to have gained an important advantage against its peers, by offering for the same double-play package²⁹ at lower prices, charging only €24.99 while Deutsche Telekom and Vodafone charge €29.95. Currently, Telefonica has a 9.5% market share and we expect only a small increase of approximately 11% due to the fact that we believe these rates are not sustainable in a period of economic turmoil and in a company with debt related problems; and because Vodafone and, especially, DT have a more developed TV operations system being able to offer triple and four-play packages. We expect a CAGR of 4.4% for the period of 2011-2017 regarding the number of subscribers. Telefonica’s TV operations are still in an initial phase, focused mainly in Internet TV (IPTV³⁰). A CAGR of -4.2% is expected for 2011-2017, due to the intense competition and to the fact that other operators already offer TV in their packages.

In Telefonica’s mobile operations we expect a growth in subscribers caused by the already mentioned expected loss in KPN subscriber base. Besides that, the company has been gaining growing popularity and market awareness due to its very competitive tariffs. We are expecting Telefonica’s market share to attain 22% and, consequently, its subscriber base will grow at an expected CAGR of 6.5% for the period of 2011-2017. This development will be mostly due to the low prices that the company is charging and to the above average desire of German subscribers to consume mobile data, a factor that Telefonica has been capable to capture.

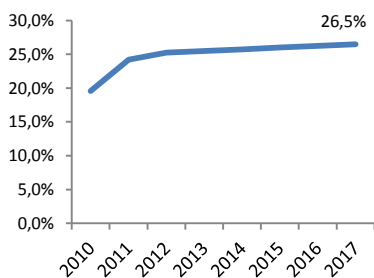
Regarding revenues we expected that ARPUs will be affected by many opposing aspects. On the one hand, we expect positive growth in the company’s ARPU, especially the mobile one, prompted by increasing consumption of mobile data and LTE enabled Smartphones, supported by the success of the program “O2 MY Handy”³¹. On the other hand, the European financial difficulties, the price discounts that the company has been offering to increase its subscriber base and the expected decrease in MTR (2013) act as a downward pressure on the ARPU. We expect that in the following years, until 2014-2015, these pressures have an increasing weigh in the ARPU. However, we anticipate that, when the European economy starts to recover, and with that the consumption and consumer confidence, the ARPU will stabilize or even increase. We are anticipating a CAGR

²⁹ The package comprises fixed telephony at a fixed rate and internet at 16 Mbits/s.

³⁰ Internet Protocol television is a system through which television services are delivered using Internet protocol.

³¹ This program allows the client, not necessarily an O2 subscriber, to acquire an unlocked Smartphone with the payment being made from 12 to 24 months. Source: O2 Deutschland.

Figure 29 – Telefonica Germany OIBDA Margin



Source: Company Reports and Analysts Estimates

of 5.1% in revenues for the period of 2011-2017, mostly driven by quantities' growth until 2014, further accompanied by increasing prices. We think that it is also important to refer that, although contributing to an increasing subscriber base and consequently increasing market share, Telefonica Deutschland's low tariffs and the strong demand for smartphones increased commercial and supplier expenses and have widened the gap between its margins, between 25% and 27%, and the ones from its competitors, approximately 35%. We expect OIBDA to grow YoY at a rate of 6.7% due to greater efficiency, promoted at the company level, but still far from its peers.

Table 1 – Germany Operating and Financial Data

	2010	2011	2012	2013	2014	2015	2016	2017	CAGR
Fixed Telephony Accesses (K)	1.916	2.055	2.321	2.388	2.456	2.527	2.601	2.677	4,9%
Internet and Data Accesses	2.915	2.922	2.864	3.014	3.142	3.279	3.424	3.580	3,0%
Mobile Telephony Accesses	17.049	18.380	19.489	21.914	24.643	25.170	25.713	26.765	6,7%
Pay - TV Accesses	77	83	60	61	61	62	63	64	-2,6%
Wholesale Accesses	1.117	1.042	1.088	1.145	1.194	1.246	1.301	1.360	2,9%
Revenues (Millions)	4.826 €	5.035 €	5.207 €	5.535 €	5.894 €	6.049 €	6.369 €	6.790 €	5,0%
OIBDA	944 €	1.219 €	1.314 €	1.411 €	1.517 €	1.573 €	1.672 €	1.799 €	9,7%

Source: Company Reports and Analysts estimates

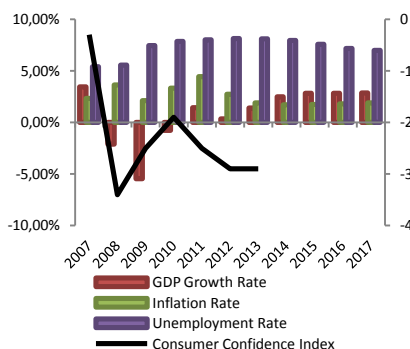
In November 2011 O2 Germany admitted that its mobile network was being overloaded. That situation has been affecting its high rate of customer satisfaction.

O2 Deutschland IPO had an high demand and was boosted by the high value opportunities recognized but also because of the Tax credits. The company will not pay taxes until 2016 and after that the rate will be a low one (12%/13%).

We are expecting some capital expenditures since there has been a necessity for increasing capacity, especially in the mobile business, in the LTE and 3G network. Only the high debt constraints and contracts, like the agreement between O2 and DT, where DT's infrastructure will connect to O2's German fiber points, will keep Capex from increasing that much.

According to our assumptions for the 3 scenarios and the valuation indicators described in the chapter "Valuation Assumptions & Financials", we valued through an average of the APV and DCF³² model Telefonica's German operations. Our price per share was €6.03 which indicates that the IPO of the 23% of Telefonica Deutschland was made at a 7.1% discount. We assumed that this discount was demanded by the investors due to Telefonica's position as a forced seller and the fact that investors will take a minority position within the firm.

Figure 30 – UK's Macro Indicators



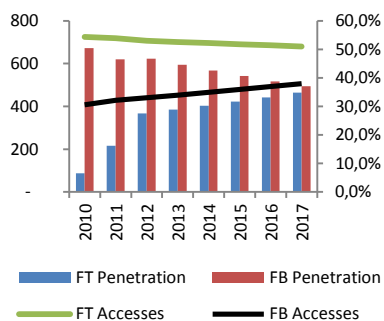
Source: IMF, GfK NOP (UK) and Analyst Estimates

United Kingdom

In the United Kingdom we can expect similar macroeconomic conditions as the ones in Germany - solid GDP growth rates and low inflation, although with higher unemployment rates. Since we anticipate the effects of the macroeconomic variables on the British telecommunications market to be quite alike with the ones in Germany we decided to focus on the scrutiny of the UK Telecommunications market.

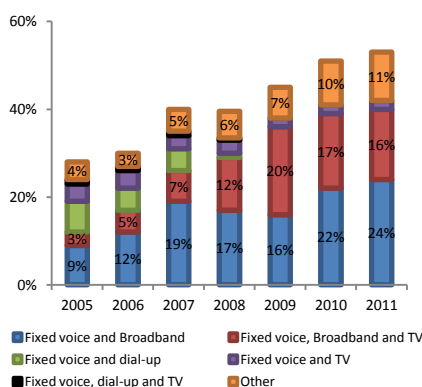
³² We used both methods due to better capture the results of the tax effect in the overall company.

Figure 31 – Telefonica UK Fixed Accesses (K) and Market Penetration (%)



Source: Ofcom, Company Reports and Analysts Estimates

Figure 32 – Multiplay Services in the UK



Source: Ofcom, Company Reports and Analysts Estimates

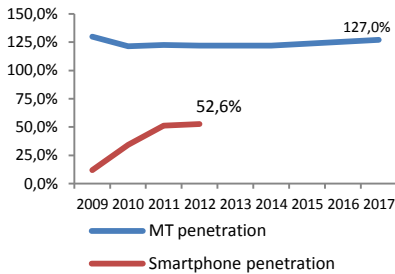
In this market we will divide our analysis into fixed and mobile operations due to the different market conditions that can be found in each one of them. Regarding fixed telecommunications we have been able to observe a slow decrease in penetration rates for fixed telephony accompanying the worldwide tendency of exchanging fixed telecom devices for mobile ones. However we have assisted to an inverse path for fixed broadband services, whose total number of users has increased an average of 5.8% YoY since 2007. These two sectors are dominated by the incumbent, British Telecom, whose more advanced infrastructures and greater coverage allow for a more favorable position in the market. Considering the future we anticipate the maintenance of past trends. In the fixed telephony segment we expect penetration will continue to decrease at sluggish rates, mostly due to the increasing number of bundle offers, especially double-play packages that contain fixed broadband³³. We will be expecting a CAGR of -0.7% for the period 2011-2017. This implies a growing popularity of the fixed broadband segment. The usage of Internet in the United Kingdom has risen a lot in the last years, with 8 in 10 households having at least one subscription to access Internet. We are expecting that this trend will continue and that will fuel the demand for double and triple-play packages. Fixed Broadband in the UK is slightly above the OECD average, however if we consider that there are some Eastern European and South American countries pulling down the average we can assume that there is still some opportunity to grow. We are anticipating a CAGR of 3.6% for the period 2011-2017.

As was stated above, in the fixed segment the dominant player is British Telecom with a 2011 market share of 50.1% and 31.3% for fixed telephony and broadband respectively. In this sector Telefonica is one of the smallest players in the market with a market share of 0.7% and 3.1% for the same segments. We do not expect great developments in Telefonica’s British fixed operations since it lacks the infrastructures to compete in terms of coverage, with the countrywide British Telecom and Virgin, and in terms of package offered, as the company cannot offer the pay-TV option. Besides Telefonica can hardly compete in terms of price, as the increasing costs, because of its small size, and the constants MTR reductions prevents the firm from offering discounts to increase its subscriber base. We are expecting that both operations tend for a similar number of subscribers as most of them will have a joint subscription of both services. For fixed telephony we expect a CAGR of 13.6% from a total of 87 thousand subscribers in 2011 to a total of 464 thousand in 2017 with a market share of 1.4%. For the fixed broadband we anticipate a CAGR of -3.73% for the same period and a market share of 2% in 2017.

³³ According to Ofcom the most popular bundle offered in the United Kingdom is double-play containing fixed telephony and fixed broadband access.

Currently 2 in every 5 UK citizens have a Smartphone and the tendency is to increase.

Figure 33 – UK Mobile Telephony and Smartphone penetration (for Smartphone 2012 = Q1-2012)

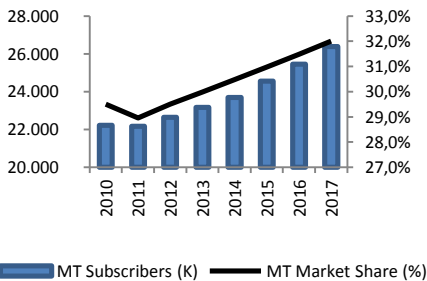


Source: Ofcom, comScore mobiLens and Analyst Estimates

Telefonica was the mobile market leader in UK with some advantage, however the merger between T-Mobile and Orange, forming Everything Everywhere (EE) took their position upon the date of the merger.

On September 2012 the EC approved the merger between Vodafone and O2 in the United Kingdom as did not posed any monopolist threats.

Figure 34 – Telefonica UK Mobile Operational Data



Source: Ofcom, Company Reports and Analysts Estimates

Ofcom with the support of the EC imposed a MRT cut in 2011 from 4.3 pence/min to 2.66 pence/min. Until 2014 a new cut will be imposed cutting MRTs to 0.69pence/min.

Regarding the British mobile telecommunications, we can observe that in 2009, the year when the effects from the financial crisis started being felt, penetration rates reached a value of 129.8% decreasing afterwards to values near 122%. With the stabilization of the British economy but especially with the increasing demand for Smartphones and mobile broadband we anticipate a recover in the total number of mobile subscribers to values in the vicinity of the ones encountered before the subprime crisis, approximately 127% of mobile penetration rate in 2017. In the Mobile telecom market, Telefonica is one of the important players with a market share of 29.2% in the 2nd quarter of 2012, only surpassed by EE that has 34.4%. We are expecting increasing, although slowly, market shares for the firm motivated by the resilience that Telefonica has demonstrated to the increase market share of Three, whose most affect was EE. Besides the joint venture between Telefonica and Vodafone³⁴, following the same path as T-mobile and Orange, will allow for improved coverage and network speeds as well as a sooner release of the 4G technology in the UK, replying to the early release of 4G by EE³⁵. In this segment we should refer the increase, above average, in contract subscribers following the central lines of the company in terms of a reduced churn rate. From 2007-2011 the CAGR for mobile contract costumers was 12.6%. We expect a CAGR of 3% in the mobile telephony for 2011-2017 and a CAGR of 4.8% in the contract segment for the same period.

Regarding the company revenues, these are being affected by Ofcom MTR cuts, by the decrease in the total traffic and MOU³⁶ and by the discounts and lower tariffs that although leading to a lower ARPU, allowed for an augmented subscriber base. We anticipate decreased mobile ARPU's, influenced in the first years by poorer economic conditions³⁷ but mainly due to the constants decrease of the MTR's by the regulators. After 2015 we expect a recover stimulated by an increasing data ARPU, whose trend was being mitigated by the traffic and MOU evolution. In fixed operations we expect stable ARPU's due to impossibility of price decrease and Telefonica's low influence in the market. This implies a decrease in revenues, in local currency, until 2014 and a CAGR of 1.2% for the 2011-2017 period. We expect that the low tariffs and the cuts in MTRs will affect the company's margins between 2012 and 2014 followed by a recover in the following years, as a result of the stabilization of the market and consequent reduction in commercial activity. A CAGR of 1.2% is expected in OI DBA for the

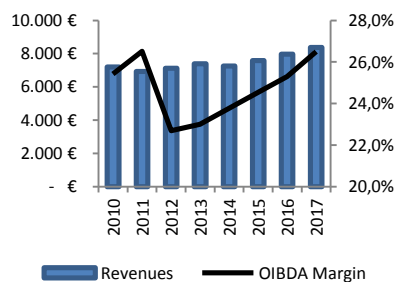
³⁴ According with Ofcom the deal is worth £438 Millions. Both firms will continue to compete while sharing their network infrastructures. The subscribers will not be able to roam between both networks, but will benefit from greater coverage. The objective from this JV, besides the greater coverage – 98% of UK territory for 2G, 3G and 4G by 2015 – will be to get an advantageous position in the 2013 digital auction and in the future release of the 800Mhz spectrum.

³⁵ In August EE release 4G technology in some UK areas however, the technology is still not available to the general British public.

³⁶ Minutes of Use.

³⁷ Although not in the monetary Union, United Kingdom is also affected by the sovereign debt crisis, especially at the export level.

Figure 35 – Telefonica UK Revenues and OIBDA margin



Source: Company Reports and Analysts Estimates

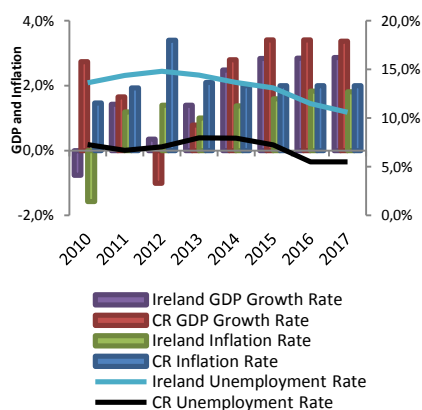
2011-2017 period. In Euros we will be waiting for increasing rates caused by the expected appreciation of the British pound³⁸.

We expect an above average level of investment next year caused by the expenditure that Telefonica will have to undertake in the beginning of 2013 with the auction for the Digital Dividend Spectrum³⁹. This auction will be very important for the company since without this spectrum O2 will not be capable to provide 4G services in an efficient basis.

Rest of Europe

Telefonica has three remaining operations in Europe besides the ones already analyzed: Ireland, Czech Republic and Slovakia and TIWS⁴⁰. The conditions in these regions are similar to the rest of Europe, with more severity in Ireland since it is still recovering from the crisis that affected its banking system. For the emerald island, we expect low growth rates until 2014-2015 with high rates of unemployment and inflation around 1%. With a weaker economic environment than normal in this country, we assume a slowdown in consumption, which will lead to a decrease in mobile penetration rates. Besides the deceleration in the telecom market, we presume that Telefonica’s Irish operations will be also affected by reductions in ARPUs, caused by expected decreases in MTRs and market share. Irish telecom consumers are following the bundle tendency already described which will affect the company that only developed mobile operations. We expect a CAGR of -0.9%, -4.7% and -6.3% between 2010 and 2017 for subscribers, revenues and OIBDA, respectively. We anticipate that Capex will be kept at normal levels after O2 Ireland paid €224.5 Million in November for the radio spectrum auction.

Figure 36 – Ireland and Czech Republic Macro Indicators



Source: IMF and Analysts Estimates

In Czech Republic, we expect a small slowdown of the economy, followed by solid steady growth, high, although decreasing, unemployment rates and inflation around 2%. Operations, especially mobile, are expected to be affected by increasing competition, promoted by the regulatory authorities to reduce the power and influence of the Incumbent, O2 Czech Republic, the market leader in all sectors⁴¹. In order to promote such improvement in competition, we anticipate an additional decrease of mobile termination and roaming rates or the promotion of a new entrant either by enabling it to piggyback on other operators' network infrastructure or by waiving a portion of the license fee in exchange for meeting coverage conditions. We expect these situations to incentivize Telefonica in raising its investment in wireless data services, as compensation for the loss of

In 2011 Czech Mobile Termination Rates were ranked as one of the highest in the OECD. In June of 2012 CTU cut MRTs from USD0.0793 per minute to USD0.0285 per minute. However there is falling in the market that cuts are not over, with the number USD0.014 per minute the one that gather greater consensus.

³⁸ According with the estimates from IMF for the forward exchange rates.

³⁹ Market consensus points for an investment of Telefonica in the values of €1.5 Billions.

⁴⁰ Telefonica International Wholesale Services, Telefonica’s unit that provides wholesale services outside Spain.

⁴¹ 2011 Market shares of 71.8%, 50.9%, 41.3% and 18.8% for fixed telephony, broadband, mobile telephony and pay TV respectively. Source: Czech Telecommunication Office (CTU) and company reports.

voice revenue, particularly in high-speed 4G LTE mobile broadband, whose spectrum auction is expected for the beginning of 2013⁴². In association with the decreased ARPUs, we believe that the poorer economic conditions in Europe and the already high penetration rate, 140% in mobile telephony, will decrease the pace of the market. Regarding the fixed operations, we expect an approximation of fixed telephony, broadband and pay-tv’s subscribers with the increasing offers of double, triple and four-play packages. We expect a CAGR of 0.8%, -2.5% and -4.3% between 2010 and 2017 for subscribers, revenues (CZK) and OIBDA (CZK), respectively. In Euros, we anticipate smaller growth rates due to the anticipated depreciation of the Czech Crown.

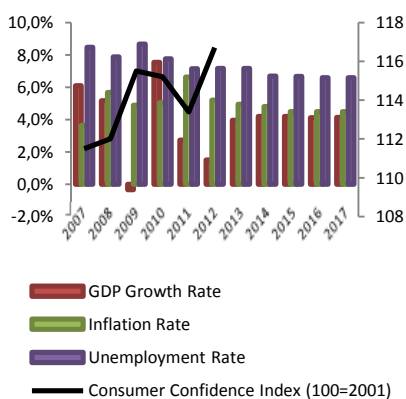
Table 2 - Ireland and Czech Republic Operating and Financial Data

	2010	2011	2012	2013	2014	2015	2016	2017	CAGR
Fixed Telephony Accesses (K)	1.669	1.582	1.483	1.540	1.519	1.344	1.483	1.456	-1,9%
Internet and Data Accesses	910	995	1.052	1.025	1.041	1.199	1.052	1.056	2,2%
Mobile Telephony Accesses	7.415	7.729	7.863	7.785	7.870	7.591	7.863	7.748	0,6%
Pay - TV Accesses	129	136	140	139	140	167	140	148	2,0%
Wholesale and other Accesses	131	144	152	151	154	171	152	152	2,1%
Revenues (Millions)	3.045 €	2.853 €	2.660 €	2.422 €	2.201 €	2.248 €	2.302 €	2.346 €	-3,7%
OIBDA	1.228 €	1.137 €	949 €	873 €	792 €	808 €	827 €	837 €	-5,3%

Source: Company Reports and Analysts estimates

Brazil

Figure 37 – Brazil Macro Indicators



Source: IMF, CNI and Analysts Estimates

The high levels of poverty have been identified as the main obstacle to attain the predicted development of the Brazilian economy. This problem has been intensively fought by the Government bodies.

Brazil is currently one of the countries, alongside China and Canada, with one of the highest future growth prospects⁴³. In spite of the poor performance of its stock exchange in 2011 - loss of 18% year-on-year - high GDP growth rates are predicted for the country, averaging in 3.7% in real terms. Besides the high GDP growth rates, manageable and decreasing unemployment rates are expected for the period in analysis. However, inflation above 4% and high poverty, especially outside urban areas, are points that can affect the Brazilian economy in a way that it acts like a barrier for companies’ revenues growth. Brazil has evolved a lot in this last years, especially with Lula da Silva in the country presidency, and the same principles appear to have been followed by his successor, President Dilma Rousseff. The new president is putting pressure in the Brazilian senate to approve measures to fight one of the most overwhelming dilemmas in Brazilian economy, high levels of poverty. Measures to stem unemployment, improve wage growth and extend credit facilities to the growing middle class are just examples of actions that are currently over the table. In addition to those, the cut of interest rates and the decreasing levels of public debt, the lowest in 14 years⁴⁴, are being considered remarkable by the international community. All these factors,

⁴² Source: Czech Telecommunication Office (CTU).

⁴³ OECD predicts that by 2025 Brazil will outpace Japan and the eurozone. Source: OECD.

⁴⁴ Source: IMF World Economic Outlook.

associated with a high and stable, and with a trend to increase, level of consumer confidence, bode well for a consumer-driven industry as the industry of Telecommunications.

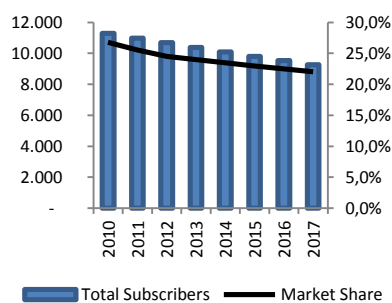
The Brazilian telecommunications market is divided in three main regions, Area I and II, whose main incumbent is Oi, controlling 77.5% of the population and 63% of the GDP; and Area III, which represents the state of São Paulo, with the main incumbent, Vivo⁴⁵. The central companies in the Brazilian telecom market are America Moviles that has as its fixed harm Embratel - the incumbent for long distance calls in all states - and as its mobile arm, Claro. Oi, which is controlled by the Portuguese telecommunications company Portugal Telecom, offers all services under the same brand. Telefonica, which provides now all telecom services under the same name, Vivo. Besides those, TIM Brazil - Brazilian subsidiary of Telecom Italia - that previously only offered mobile services and now also offers fixed broadband services, after buying the optic fiber network provider for Rio de Janeiro and São Paulo, AES Atimus. The telecom competitive environment in Brazil is considered to be very stable, since operators pursue the following reasoning: every one of the telecom carriers is motionless until one or two of them ramp up their price aggression and package offering. This strategy is then followed by the remaining operators that then decide to settle down. In the short term, the first to start this completion wars was TIM Brazil that began offering extremely low rates for on-network long distance calls. This had an answer from Claro and Vivo that reduced prices to surge subscriber growth and, at the same time, Vivo itself also started offering unlimited postpaid plans and launched Vivo Directo, a new push-to-talk offering.

Figure 38 – Brazilian Telecommunications Market



Source: Teleco

Figure 39 – Telefonica Brazil Fixed Telephony operations



Source: Company Reports, Teleco and Anatel

Wireline Operations

Regarding the wireline market, we can observe the continuation of several telecommunications trends. The substitution of fixed telephony for the mobile equivalent and the growing adoption of double, triple and four-play offers are the most visible in this country. In the fixed telephony market, we assist to a slow increase in the total number of subscribers accompanied with the slow increase in fixed telephony penetration rates. This happens due to the rising adoption of voice and data packages that increases both fixed telephony and fixed broadband subscribers, with the objective of benefiting from reduced prices. In the long term, we expect contrary effects for the penetration rate of fixed telephony, a growing adoption of these packages associated with an increasing rural penetration and the growing rate of substitution of fixed for mobile. We anticipate that, as time passes by, the second effect will have an escalating weight and will lead to reducing penetration rates. We anticipate a CAGR of -1% for the period 2011-

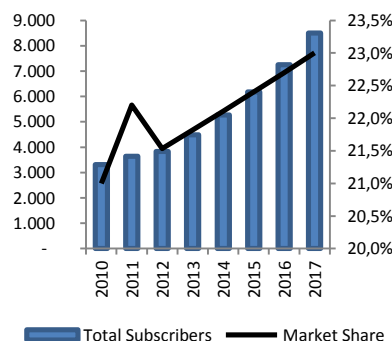
⁴⁵ Data for the year of 2011. Source: Anatel, Banco Central do Brazil and Instituto Brasileiro de Geografia e Estatística (IBGE);

According with Oi CEO Francisco Valim Oi is interested in buying GVT from Vivendi and could benefit from its increasing momentum especially in fixed telephony

2017. This segment is dominated by Oi, which similarly to Telefonica, is losing momentum, although at higher decreasing rates in comparison with the Spanish company. This loss in market share has been benefiting both Embratel and GVT that have constantly increased their market shares in this segment since 2007. We expect fixed telephony operations for Telefonica to stagnate and, consequently, we predict a declining market share to values near 22%⁴⁶ and a CAGR for the total number of subscribers of -2.8% for the period 2011-2017.

Figure 40 – Telefonica Brazil Fixed Broadband operations

Regarding the fixed broadband market, this segment continues to exhibit solid growth despite the increasing popularity of mobile broadband. A big part of this growth is associated with the already referred bundled offers boom, though this is a segment with a very high growth potential. On the one hand, the number of subscribers with only a fixed broadband contract is increasing⁴⁷, while on the other hand, this segment has not yet reached the totality of the Brazilian territory⁴⁸. Compared to the rest of Latin America, Brazil presents lower prices and increasing broadband speeds, prove of efficiency, even though it is still far from the prices and levels of speed practiced in Europe. In order to further develop the fixed broadband segment, considered one most important globally, the Brazilian Federal Government implemented a Broadband National plan. Such plan targets the upgrade of infrastructures that, although occurring at a slower rate than predicted, should significantly improve broadband accesses, creating new investment opportunities for telecom companies⁴⁹. For this segment we predict a CAGR of 13.2% for the period 2011-2017. We forecast a stable competitive market for the future, due to the realization of the predicted results for the digital spectrum auction. For Telefonica, we predict that the company will slowly increase its market share with the decreasing lack of awareness that affected its fixed operations and was mitigated with the integration of all services under the Vivo name. A CAGR of 15.1% is expected for the period 2011-2017.



Source: Company Reports, Teleco and Anatel

Figure 41 – Telefonica Brazil Pay-TV operations

Concerning the pay television sector, this is a segment that experienced constant growth over the years, and even during the credit crush period. This expansion was due to the constant developments in the field, like HD television, 3D technology or even the Digital Video Recorder, and also due to the demand for triple and four-play offers that, similarly with the double-play, is also growing. With this upsurge in package offers, we forecast that TV penetration rates will have the same trend as fixed broadband and that, in the long term, will probably show



Source: Company Reports, Teleco and Anatel

⁴⁶ We are predicting an adoption of fixed broadband services for the already subscribers of fixed telephony and a increasing shift of operator due to the high tariffs charged by Vivo in fixed telephony.

⁴⁷ Source: Anatel;

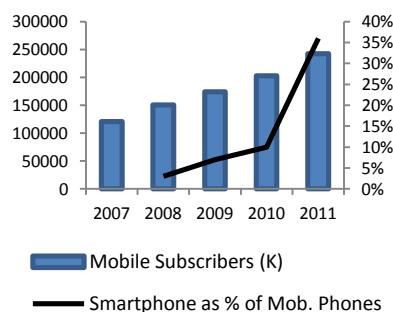
⁴⁸ Source: Teleco;

⁴⁹ Source: <http://www4.planalto.gov.br/brasilconectado/pnbl>

This year Telefonica acquired a great quantity of band spectrum in the 3.5GHz band that associated with the 49% stake of cable operator TVA acquisition will allow for an increasing Market share in the TV sector.

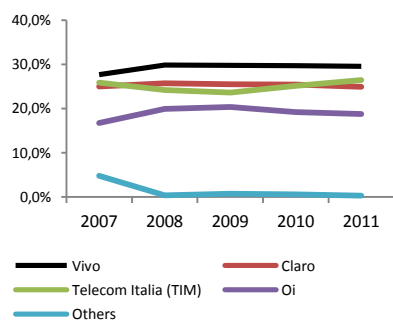
similar values. A CAGR of 15% is expected for the period 2011-2017⁵⁰. We believe that this segment is extremely important for Telefonica in the short/medium-term, due to the high investments done in the sector. Currently, Telefonica invested on a Video on Demand Over the Top service to surge its IPTV operations. Due to this fact, we predict a growth in market shares that will also be followed by Embratel, which was able to take control of Net Serviços the largest multi-service cable provider in Latin America after changes in regulation⁵¹; and Oi, mostly at the expense of smaller players, like Sky, that do not have multiple play offers in the market. A CAGR of 32% is expected for Telefonica’s TV subscribers for the period of 2011-2017.

Figure 42 – Brazilian Mobile Subscribers and Smartphone evolution



Source: Company Reports, Teleco, BNAméricas and Nielsen

Figure 43 – Brazilian Mobile Telephony Market Shares



Source: Teleco

Wireless Operations

In reference to the mobile telephony segment, we observe a sustainable growth through the years. Fueled by new technological developments, this segment has been constantly retrieving subscribers from the fixed sector. At the end of 2011, Brazil’s mobile penetration rate was the 11th highest worldwide, with a value of 123% and increasing approximately 18% year-on-year. For the future, we do not expect continuously high growth as registered before, which lead us to believe that by 2017 mobile penetration rates will be approximately 160%, with a CAGR of 4.25% for the period of 2011-2017. We anticipate this growth in mobile penetration rates to be caused by several factors: the low levels of rural penetration⁵², the increasing demand for Smartphone devices and the development of new mobile broadband technology, especially 3G. The growth of 3G in Brazil is considered impressive, as the number of WCDMA⁵³ subscribers rose from 2000 in June 2008 to more than 33 Million in 2012, representing approximately 18% of the total accesses. The market shares in the mobile segment have been somewhat stable throughout the years and we expect them to continue in such path. This means that for us, the primary source of growth in the mobile segment is the increase in population, which is expected to grow at 1% a year. This trend is caused by the increasing levels of competition promoted by government measures, like the decrease in tariffs and tax benefits, which, besides decreasing revenues per user, will also promote new telecom investments. We expect a CAGR of 5.23% for Telefonica’s mobile subscribers for the period 2011-2017.

Regarding the evolution of ARPUs, we expect a shrinkage in the fixed telephony ones, as the demand for those services continues to decrease and being

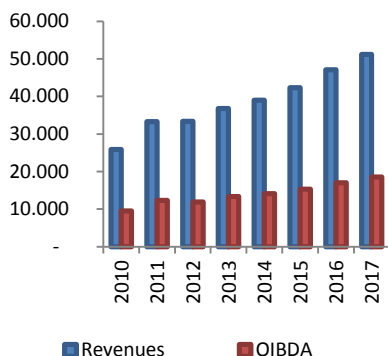
⁵⁰ The public TV in Brazil is served mainly by three networks (Globo, Bandeirantes and Record) and two TV channels (TV Cultura and TV Brazil) that do not have great diversity when compared with the number and type of channels existing in paid segment. Only the high prices associated with the low level of income in the Brazilian society have delayed the clear dominance of the paid segment over the free one. The increasing offer of telecom packages and the growth of the Brazilian economy appear to be changing this situation.

⁵¹ The Brazilian Government approved laws to increase competition by removing the limits on foreign ownership.

⁵² So far the growth in mobile penetrations is mostly due to multiple users of SIM cards in the main cities, while a great number of Brazilians do not have one mobile phone.

⁵³ Wide-Band Code-Division Multiple Access is a standard interface in 3G telecommunication.

Figure 44 – Telefonica Brazil Revenues and OIBDA (BRL)



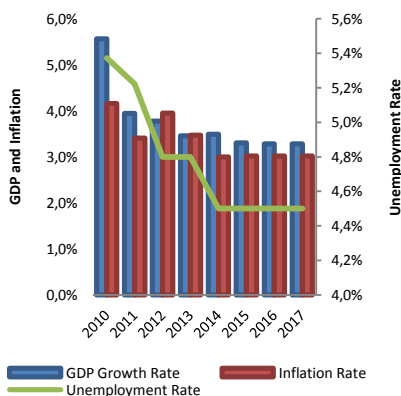
Source: Company Reports and Analysts Estimates

substituted by mobile devices. Data and Pay TV ARPUs are expected to grow especially after 2014, when the realization of the 2014 FIFA World Cup and the preparations for the 2016 Olympic Games will fuel the Brazilian economy, improving telecom infrastructures and increasing the country income level, whose population will continue to increase consumption of multi-play packages. In the mobile segment we expect opposing forces. On the one hand, MRT cuts are predicted for 2013⁵⁴ and possibly a further subsequent reduction in 2014, following the definition of the reference level for MRT by Anatel. On the other hand, the realization of the sport events previously referred, will increase roaming rates and the growth in data traffic, which will lead to an increase in the data ARPU. We forecast that both fixed and mobile revenues will increase in the predicted period, 2011-2017, at a rate of 2.5% and 4.6%, respectively. Concerning OIBDA margins, we expect approximately a constant path due to commercial activity mitigated, by increasing efficiency and reaching the levels of its peers.

In respected to CAPEX, Telefonica has stated that it wants to invest R\$24 Billions in its operations, updating its fiber network and improving its IPTV connections. Besides that, Telefonica is expected to participate in the next year 4G LTE Digital Dividend Spectrum for the 700 MHz band in which consensus expects the company to pay a similar value to the one for the digital auction in the 2500 MHz and 450MHz band, R\$1.05 Billions.

According to our assumptions for the 3 scenarios and the valuation indicators described in the section “Valuation Assumptions & Financials”, we evaluated through a DCF model Telefonica’s Brazilian operations. Our price per share was R\$46.99, which indicates a potential gain for investors of 5.6%. We assume that the stock is being a bit penalized by the market due to the debt constraints and concerns about the domestic market of the parent company.

Figure 45 – Mexican Macro Indicators



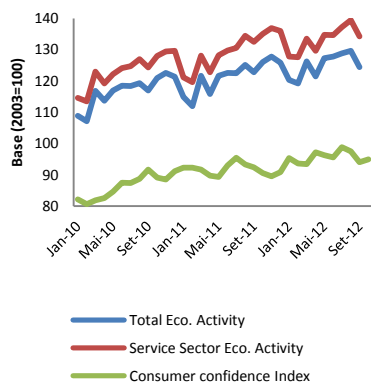
Source: IMF and Analysts Estimates

Mexico

Mexico is considered a country with a developed, free-market and exports-oriented economy that has been trying to establish itself as an upper-middle income country. In Mexico we observe similar macroeconomic conditions as the ones in Brazil. High GDP growth rates and decreasing levels of unemployment, associated with increasing consumer confidence and higher economic activity, especially in the service sector. These aspects paint a favorable picture for the Mexican economy regarding the upcoming years. The main problem in the country’s economic structure and one of the major factors that may delay the predicted growth are the below average wages of Mexican workers. Their

⁵⁴ In Brazil, although regulator Anatel does not fix MTRs, which are freely negotiated among operators, it incentivized the reduction of MTRs in 2010 by cutting fixed-to-mobile tariffs in conjunction with annual readjustments of 2011, 2012 and 2013.

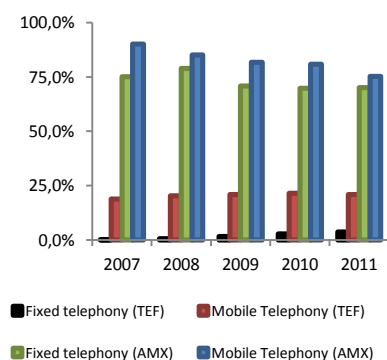
Figure 46 – Mexican economic activity and consumer confidence



Source: Instituto Nacional de Estadística y Geografía

The lack of competition associated with the low tariffs that they charge in the market and with inefficient competition regulation that until 2011 could not influence Carlos Slim’s actions in the market, led to a clear dominance of America Moviles over the Mexican telecom market.

Figure 47 – Mexican Market Shares for Telefonica and America Moviles

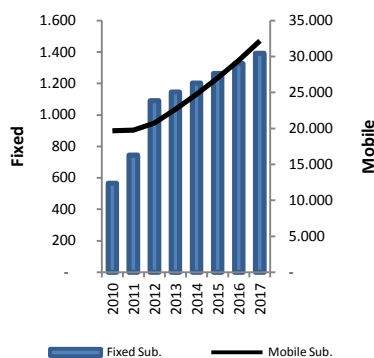


Source: CoFeTel and Company Reports

presence in the North America Free-Trade Association (NAFTA) increased Mexican exports and allowed for fiscal reforms, which still did not have the expected impact in the wage level. Mexican wages have been widening the gap with the ones from industrialized countries but are also experiencing a downwardly equalizing trend between industry sectors. However in the last years we have assisted to the introduction of several reforms that led to the upgrade of several infrastructures, the modernization of labor laws and to the procuring permission for private investment in several economic sectors like energy and telecommunications. Besides the modernization of the Mexican economic landscape, these reforms are contributing to the inversion of the income trends described.

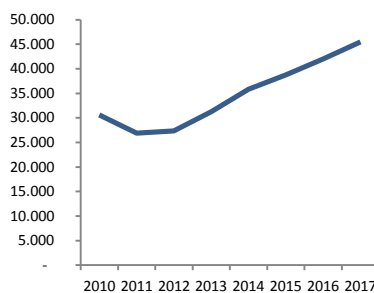
Mexico, although being the domestic market for one of the most important telecommunication’s company in the world (America Moviles), is a Latin American country that presents one of the lowest rates of penetration, especially in the mobile sector. The high levels of poverty outside the big cities and the lack of infrastructures have been delaying the telecommunication’s boom in Mexican territory. However, due to the improvement in the disposable income for the rising middle class and the already refereed telecommunications reforms, we anticipate a surge in the number of mobile subscribers in the market, approximately 6% of CAGR between 2012 and 2017. Regarding the fixed telephony, we are expecting that the Mexican market follows the worldwide tendency of substituting fixed subscriptions for the mobile ones, which implies a decrease in the fixed telephony penetration rate. We anticipate a recover or, at least, stabilization in this sector as package offerings become more usual and popular in this market. The Mexican Telecom market is clearly dominated by its incumbent, who in 2011 had 70.1% of market share in its mobile operations and 75.3% in the fixed ones. The other market players are Telefonica with a market share of 20.9% and 3.8% in the mobile and fixed operations, respectively, and Nextel with 3.9% in the mobile operations. However, not constituting a threat for the dominant position of the company controlled by Carlos Slim, Telefonica has maintained a stable situation in the market, taking advantage of some opportunities to further increase its position. We expect this to increase in the following years in light of recent events. In the mobile telecommunications markets the Mexican telecommunications regulatory body pursues increasing competition. In mid-2011 it imposed a \$US1 Billion to America Moviles domestic mobile arm, Telcel, which was then revoked when the company agreed to stop giving its costumers discounted rates on calls to other Telcel users, a policy that other wireless providers found difficult to compete with. Telcel was also required to cut off its interconnection rates for calls placed into its network by outside mobile users throughout 2014. Besides, the Mexican congress

Figure 48 – Evolution of Telefonica’s Mexican Fixed and Mobile Subscribers



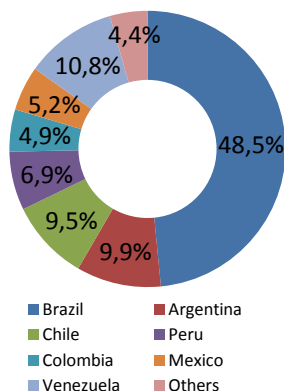
Source: Company Reports and Analysts Estimates

Figure 49 – Evolution of Mexican Operations Revenues (Mexican Pesos)



Source: Company Reports and Analysts Estimates

Figure 50 – Weight of each country in LatAm operations (€ OIBDA)



Source: Company Reports and Analysts Estimates

approved a tough new antitrust monopoly policy that raised fines and permitted prison for monopolistic practices. We anticipate that these measures will put some pressure in America Moviles operations and consequently lead to an increase in prices and a loss of some subscribers that will benefit Telefonica, whose market share we expect to stabilize around 23%-24% in 2016-2017. In the fixed operations we are anticipating the same trend as in the mobile ones, however in a smaller frame, especially due to the higher number of competitors and the smaller position that the company holds in the market.

In addition to anticipating a more significant position in the market, we are also expecting upward movements in the company’s ARPU. Following a huge drop in Mobile Termination Rates in 2010⁵⁵, which did not had the desired effect as the gap between America Moviles and its competitors still widened, we saw an upward trend, after 2011. The increase of the company’s ARPU, which was mostly due to the introduction of the 3G technology, is predicted to be maintained until 2014-2015, the period in which we are anticipating increasing company offers to target lower-income costumers, like the offering of telecom packages, and supplementary policies, aiming at further leveling of the competitive playing field that will lead to more constants or even decreasing ARPU’s⁵⁶. We also expected that the high levels of inflation will put some pressure in the exchange rate and will depreciate the Mexican Peso against the Euro. Nevertheless, we are predicting a CAGR in revenues (€) of 7% for the period 2012-2017.

Regarding Capex, we expect a decrease in investments due to the recent 5-year agreement of Telefonica with Grupo Lusacell, in which they agreed to share their networks. Besides cutting costs, the agreement provides access to a greater network of land line assets that the company has been unable to buy itself, due to the cap on foreign investment, and allow a more significant position in the market.

Rest of Latin America

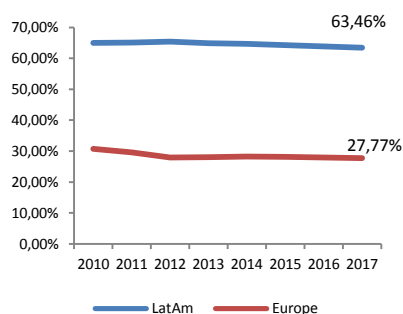
Regarding the remaining of Latin America operations, we should expect similar conditions as the ones presented upon the analysis of the Brazilian and Mexican operations. A stable and high GDP growth rate accompanied with decreasing levels of employment and high inflation rates that will put some pressure in the devaluation of the local currency against the Euro, especially in Venezuela and Argentina.

We expect a high progress in the number of subscribers, with the exception of fixed telephony, with a CAGR of 4.7% between 2011-2012 caused by the good

⁵⁵ In 2010 CoFeTel had to intervene to resolve a disagreement between Telcel and Alestra and interrupted the planned gradual decrease of MRTs setting the MRT at MXN 0.3912/min, a decrease of 59%.

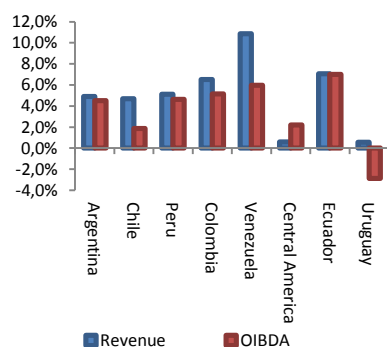
⁵⁶ We believe that the introduction of new regulation policies in Mexico will not be focused in MRT rates, which we predict that will be kept constant, due to the lack of effects on the previous decrease.

Figure 51 – Evolution Pre-Pay subscribers over total subs. per operational region



Source: Company Reports and Analysts Estimates

Figure 52 – Revenue and OIBDA CAGR for 2011-2017 in LatAm (Home currency)



Source: Company Reports and Analysts Estimates

economic conditions that influence positively consumption, improved infrastructures, introduction of new devices and technologies, but especially, due to the regulatory measures. This last factor induced a greater competition and decreased the influence of the incumbent that, although having as consequence decreasing ARPU and revenues for the companies, are benefic for the consumer that is able to enjoy reduced prices. However and even though the bundle trend is registering an increase, the majority of the consumers are unable to afford bundled voice and data contracts, pay TV and broadband internet connections, proved by the higher number of pre-pay subscribers when compared with the European operations. This situation is affecting one of Telefonica’s objective referred by us, the reduction of churn rates. Regarding revenues and OIBDA, we expect a CAGR of 3.7% and 2.6%, respectively, for the same time period. In this case we should notice that we are expecting the introduction of MRT cuts in some of the Latin American countries, especially in Chile and Colombia. In terms of operation costs, we expect an increase in personal expenses, mostly due to the high inflation that will rise wages. Besides we project a growth, bellow revenues, of expenses with suppliers because currently the new suppliers contracts are made at a central level, through Telefonica Global Resources, as part of the new policy of increasing efficiency imposed by Telefonica. Finally, we also expect higher Capex levels than the ones registered in Europe to face the higher growth, increasing consumer and the necessity of improved infrastructures to deliver new types of products like fiber and 4G communications⁵⁷.

Table 3 – Latin America Countries Operating and Financial Data

	2010	2011	2012	2013	2014	2015	2016	2017	CAGR
Fixed Telephony Accesses (K)	24.404	23.961	23.482	23.860	23.874	22.130	23.482	23.012	-0.8%
Internet and Data Accesses	7.672	8.254	8.938	8.632	8.626	13.743	8.938	10.307	4.3%
Mobile Telephony Accesses	149.255	166.298	178.807	186.239	194.449	201.904	209.683	217.948	5.6%
Pay - TV Accesses	1.793	2.258	2.271	3.662	4.328	5.121	6.067	7.194	22.0%
Wholesale and other Accesses	620	683	687	719	752	785	818	854	4.7%
Revenues (Millions)	25.756 €	29.237 €	30.553 €	31.970 €	32.897 €	33.906 €	35.193 €	36.317 €	5.0%
OIBDA	13.713 €	10.940 €	10.968 €	11.153 €	11.500 €	11.888 €	12.366 €	12.795 €	-1.0%

Source: Company Reports and Analysts Estimates

⁵⁷ In some regions 3G will be the new tech introduced, due to the lack of infrastructures and telecom devices available.

Debt & Liquidity Constraints

The company's strategy led to downgrades in the company's rating - On 20th June 2012 Moody's downgraded Telefonica to Baa2 – and to a mistrusted eye from the investors, which has been reflected in the trend followed by the company stock price.

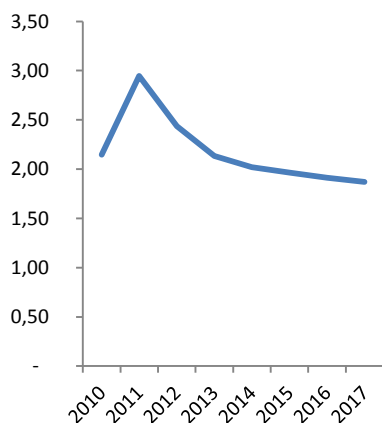
According to what was stated previously, the aggressive acquisition strategy that Telefonica undertook, in order to being able to grow and consolidate its position outside the domestic market, left the company with a huge amount of outstanding debt and a lot of liquidity constraints. In order to regain the market confidence and, by itself, put the company in a more stable financial position, Telefonica's managers decided to implement a divestment strategy that focused on the discharge of non-strategic fixed assets. In those we can include the sale of power lines and other fixed assets across their entire portfolio and interests in other companies.

Telefonica imposed a commitment for the end of 2012 of Net Debt /OIBDA < 2.35 which can be considered quite challenging. Although the divestment process so far has been considered nothing far from impressive⁵⁸, not because of the amount achieved but due to the short time frame in which it was accomplished, the complex economic environment in Europe may delay this objective. The fact that Telefonica reiterated its commitment regarding revenues (YoY Revenue growth > 0%, previously 1%) appears to be the cause for some doubts.

In light of the information so far⁵⁹, we are considering a Net Debt /OIBDA of 2.43 that can only be reduced with increasing cost efficiency and further divestments, making it possible to attain the proposed commitment. Since Telefonica already imposed a cost efficient program that is expected to increase margins until 2013-2014, we are going to focus on possible divestments that, even though may not affect the commitment in this period, will certainly influence it in the next ones.

Telefonica holds a stake of 10.47% in Telecom Italia that could be considered as a high source of liquidity. However, we think that it is an extremely crucial strategic asset for the firm since it allows for the maintenance of its competitive position in Brazil by acting as an implicit right of veto over Telecom Italia selling TIM Brazil to a key competitor like America Moviles. Another asset is O2 Czech Republic that, by its important position in Czech telecom market, is considered an asset slower to exit and with higher completion risk. The most likely sources of liquidity for us are the sale of O2 Ireland because it is a company and a position that does not reveal strategic importance, due to the low value that brings to the group, and because it is also an asset that is likely to find willing buyers ready to participate in the in-market consolidation. The remaining solution is the listing of part of Telefonica's Latin America operations that, besides being undoubtedly a great source of liquidity, can represent a barrier against further European economic

Figure 53 – Net Debt / OIBDA



Source: Company Reports and Analysts Estimates

⁵⁸ In September 2012 Telefónica had €10.1 billion of undrawn credit facilities that increased by €950 Million from Chinese bank to reduce its expose to Spain. Besides it had €7.6 billion in cash that can cover the €6.7 billion of debt maturing in 2013 and €7.9 billion maturing in 2014 meaning that if necessary the firm does not have to access markets until 2015.

⁵⁹ We are already considering the 2% stake on the Portuguese Telecom company Portugal Telecom.

On the 3rd quarter conference call Telefonica's executives announced that they were considering an IPO for the totality of Latin America Operations. The IPO offering is expected to include all of the carrier's LatAm units, which would be grouped in a holding company. The fact that some of the units are already listed, like the Brazilian one, does not influence the operation. Shareholders of such units will receive shares of the new holding company equivalents to the value previously held by them.

difficulties and was considered an option when the company presented its 3rd quarter results. We consider this a risky option for Telefonica at this point, since investors may demand the same kind of discount as in the case of O2 Germany and the firm will have to cash in less than the fair value of the operations.

We valued the Latin America unit, through a DCF approach, in € 37.36 Billions and decided to evaluate the effect of the IPO in the Net Debt/OIBDA over our time horizon:

Table 4 – Net Debt/OIBDA considering an IPO of a % of Telefonica's LatAm Opreations

	2010	2011	2012	2013	2014	2015	2016	2017
10%	2,15	2,95	2,43	1,97	1,85	1,79	1,73	1,69
15%	2,15	2,95	2,43	1,88	1,76	1,70	1,64	1,60
20%	2,15	2,95	2,43	1,80	1,68	1,61	1,56	1,51

As we can see in the Table ... an IPO of a determined percentage of the firm's Latin America operations will lead to increasing liquidity and to a consequent decrease of Net debt, without affecting the company's operational data. We can also regard that as the percentage increase, the greater is the decrease in the Net Debt/OIBDA.

We believe that the increasing liquidity, reducing cash outflow and decreasing debt would mean a change in position of rating agencies⁶⁰ towards Telefonica and consequently a more solid position in markets. However we should regard upon the normal practice of rating agencies of considering the country rating plus one notch as a cap for companies rating. This implies that if we assist to a degradation of Spain's financial position Telefonica could see an increase in its cost of debt, rising difficulties upon debt refinancing and higher discount from investors upon deleveraging measures. These factors will put a superior pressure on the company's value and affect the fulfillment of the company's commitments with the market.

Comparables

Table 5 – Telefonica's main comparables

	1 Yr Return	Net Debt/EBITDA	EV/EBITDA	P/E ratio	EV/Sales	Div. Yield
Telefonica	-14,3%	3,07	5,47	7,46	1,69	0,00%
British Telecom	33,2%	1,61	4,84	8,69	1,55	4,06%
Vodafone	-5,5%	1,49	5,93	10,23	2,33	6,93%
Deutsche Telekom	4,8%	2,09	3,93	13,58	1,35	8,18%
KPN	-53,3%	2,36	3,41	5,23	1,35	3,19%
France Telecom	-19,2%	2,02	3,49	5,96	1,16	16,53%
Telecom Italia	-7,9%	2,76	3,82	5,40	1,56	6,19%
America Moviles	10,3%	1,24	5,92	12,56	2,22	1,28%
Average		2,08	4,60	8,64	1,65	5,79%

Source: Bloomberg

⁶⁰ On December 20 S&P reiterated its position on Telefonica's rating affirming that the negative outlook "reflects the risk of a downgrade in 2013-2014 if the group failed to maintain sufficient liquidity comfort ahead of continuously massive annual debt maturities". They also stated that "the group's liquidity is likely to remain adequate in the foreseeable future" which bodes well for the company.

After a careful analysis of the table above, which contains certain indicators related with the value and performance of Telefonica and its comparables, we can observe that the European companies, especially the ones in the Euro area, had a very negative performance this year in the financial markets. The only exception is Deutsche Telekom that by being located in the strongest economy in the Euro zone, and possibly the whole continent, is regarded by investors as a less risky asset with a greater safety. In times of debt aversion in the market, we can observe that the firms that present a higher level of Net Debt/EBITDA also show a poorer performance in the financial markets. Even Vodafone, which presents a lower than average Net Debt/EBITDA, was penalized by increasing this multiple in approximately 60% in less than 1 year. On the other hand, we have corporations like America Moviles or British Telecom that, by having a lower Net Debt/EBITDA or being less exposed to the Euro conundrum, have positive returns. The fact that Telefonica is very connected to Spain and its economic situation, despite being a diversified company, associated with the company’s high levels of debt, led investors to attribute a higher probability than the one considered by us, in the “Very Bad” scenario. This led to a lower valuation and consequently to a reduced stock value.

Valuation Assumptions & Financials

Scenario Analysis

For the valuation of Telefonica we considered 3 scenarios⁶¹ which we believe will cover most of the possible events that could affect the company normal operations, having into account the current situation of the company. Our basic assumptions for each of the scenarios are described in the table below.

Table 6 – Scenario Assumptions

“Very Good” Scenario	Base Scenario	“Very Bad” Scenario
Consumption and overall confidence levels in Europe start to recover in 2013 ;	Consumption and overall confidence levels in Europe start to recover between 2014 and 2015;	Consumption and overall confidence levels in Europe start to recover not earlier than 2015-2016 ;
German consumption levels increase;	German consumption levels are not totally influenced by the lack of confidence in Europe;	German consumption levels decrease caused by the lack of confidence in Europe and affect penetration rates, especially mobile;
Spain will not need to ask for financial aid. The Spanish Government replaces some of the austerity measures by ones that stimulate growth and consumption;	Spain will not need to ask for financial aid however austerity measures will have a great weight upon consumption decrease;	Spain asks for financial aid. The Government increases austerity measures to meet the objectives of ECB, IMF and EC, leading to recession and decrease in consumption
Brazilian economy grows further than expected and measures to reduce poverty in	Brazilian economy grows as predicted and the decreases in Mobile Termination Rates will be	Brazil's economy, as the ones from other LatAm countries, grows slower affected by the

⁶¹ Base Scenario, that will be the one in which we have focused our analysis, the Very Good Scenario and the Very bad scenario.

rural areas are implemented;	somehow mitigated by the expected increases in roaming during 2014 and 2016;	high levels of poverty. And the normal protectionist views of Latin American countries affect revenues ⁶² ;
The decreases in Mobile Termination Rates in Brazil will be mitigated at all by the expected increases in roaming during 2014 and 2016;	The exports and consequently the economy of the remaining of Latin American countries will not have further decreases than the ones expected by the respective Government bodies;	Brazilian decreases in Mobile Termination Rates will eliminate any expected increases in roaming during 2014 and 2016, with the possibility of reducing the companies ARPUS;
Latin American countries economy is fueled by the early recover of European consumption;	Countries like Chile, Peru or Uruguay will find affordable and efficient solutions to overcome the landscape difficulties;	The exports and consequently the economy of the remaining of Latin American countries will be affected by further distress in European financial condition;
Telefonica will have no major problems in broaden their operations in Latin America from the capitals to the rural areas, due to the general increase in income;	Telefonica will be able to efficiently broaden their operation in Latin America from the capitals to the rural areas;	The short-term agreement achieved by US congressman to avoid the “fiscal cliff” is a weak one and is not able evade major problems with the taxes still increasing. The effects will spread to Latin American and European countries, worsening the economic conditions in the firsts and decreasing the growth prospects in the seconds. Telefonica encounters difficult conditions to broaden their operations into the rural areas of LatAm due to complex landscape and lack of infrastructures.

For the Base Scenario we attribute a probability of 85%, whereas for the “Very Good” and “Very Bad” Scenario the probabilities were 5% and 10% respectively, as we believe that our assumptions for the second are more likely to occur.

Revenue Projections

In order to project revenues we had to consider 4 key factors: Expected Population⁶³, Penetration rates, Market shares and the Average Revenues per User (ARPU). Regarding the market factors, they correspond to our vision of the market having in consideration diverse aspects like macroeconomic indicators, the intervention of Government bodies and telecom regulators, expected Mobile Termination and Roaming rates movements, the competitive environment, the objectives of the company and the trends in the telecommunications market.

With these inputs we were able to estimate the company's subscribers per country and consequently the value of the revenues in the respected country currency.

Free Cash Flow Projections

After computing the OIBDA we translated the values obtained to Euros and consolidate⁶⁴, estimating the remaining information at a group level⁶⁵.

Our valuation assumptions are shown in the table below:

⁶² Already this year the Argentine government has nationalized YPF, owned by Repsol, and the Brazilian government already shown a willingness to increasingly regulate the oil industry as a mean of funding domestic growth and the same can be extended to other industries like Telecommunications.

⁶³ Correspond to predictions of United Nations and International Monetary Fund

⁶⁴ Using IMF estimates for the forward exchange rates.

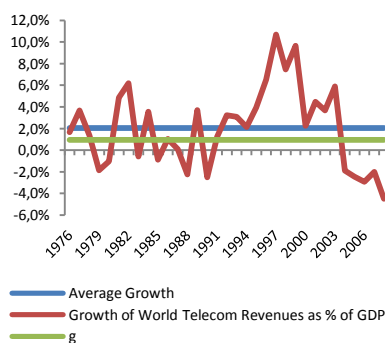
⁶⁵ We consolidate the country information in an earlier stage due to the lack of information about the non-listed operations of the company.

Table 7 – Valuation Assumptions

	Group	Brazil	Germany
Risk-Free Rate ⁶⁶	2.2%	5.27%	2.2%
Market Premium ⁶⁷	6,0%	6,0%	6,0%
Debt/EV ⁶⁸	49.7%	35.4%	49.7%
Tax Rate ⁶⁹	30.0%	34.0%	12.0%
Unlevered Beta ⁷⁰	0.66	0.66	0.66
Levered Beta ⁷¹	1.11	1.11	1.11
Country Beta ⁷²	1.58	1.65	1
Unlevered Return on Equity ⁷³	8.46%	11.81%	6.12%
Return on Equity ⁷⁴	12.71%	16.25%	8.84%
Cost of Debt ⁷⁵	5.92%	5.92%	5.92%
WACC ⁷⁶	8.45%	11.88%	7.04%

Regarding the terminal growth rate (g) used to compute the terminal value, we assume that it will vary depending on the scenario. For our base scenario we considered a g equal to 0.95%, computed using a weighted average of all countries expected terminal growth rates. For the “very good” scenario g is equal to 1.15% and for the “very bad” one equals 0.75%⁷⁷. When computing the growth rates for each country we had into account factors like the predicted GDP growth rate, the historical and predicted growth in penetrations, the capacity of each market to increase subscribers and the predicted evolution of ARPUs. Besides we felt it was important to analyze the evolution of telecommunications revenues as a percentage of the world’s GDP as it acts as a good proxy for the terminal growth rate⁷⁸. With the analysis of the graph we can take some conclusions that support our terminal growth rate. The data available gives an average of 2%, 1%

Figure 54 – Evolution of the Growth of Telecom revenues as % of GDP



Source: World Bank, World Development Indicators and EconStats

⁶⁶ 2-year average of 10 year German and United States Government bonds, due to the current historical low levels presented by the German bonds. For Brazil the rate is adjusted by the inflation forecasted differential (2.2% EU and 5.2% Brazil).

⁶⁷ Damodaran 2012.

⁶⁸ Average Debt to Enterprise Value, at market values, from comparable companies. For Brazil we used only the comparables from the region due to the usual lower levels of Debt in the capital structure.

⁶⁹ Computed using an OIBDA weighted average of the stated corporate tax rate from each country. In Germany, due to the future tax benefits, in order to compute the value through the APV method we used the predicted 0% until 2016 and the predicted 12% for 2016 onwards. For the calculation of the DCF we used the long term rate of 12%.

⁷⁰ Average of the comparable’s betas unlevered at the company’s capital structure and respective country corporate tax rate. The betas were obtained using 3-years of monthly data on the S&P500 index.

⁷¹ Unlevered beta re-levered at the previously defined capital structure and tax rate. $\beta_l = \beta_u \times (1 + (1 - T) \times \frac{D}{E})$

⁷² Computed using an OIBDA weighted average of 3-years of monthly data of each country index on the S&P500 index. For Brazil we used Bovespa and for Germany we used DAX.

⁷³ $Re_u = r_f + \beta_u \times \text{Market Risk Premium} \times \text{Country Beta}$

⁷⁴ $Re = r_f + \beta_l \times \text{Market Risk Premium} \times \text{Country Beta}$

⁷⁵ Computed using the cost of debt equation $(1 + r_d) = (1 + y) \times (1 - PD)$, where y = average 10-years CDS + risk free and PD = 0.0038%. We only considered the first part of the equation as Telefonica is considered Investment Grade by the 3 major rating agencies: S&P (BBB), Moody’s (Baa2) and Fitch (BBB+).

⁷⁶ $WACC = R_e \times \frac{E}{EV} + (1 - T) \times R_d \times \frac{D}{EV}$

⁷⁷ For Brazil the g considered was 1.5%, 2,0% and 1.0% for the base, best and worst scenario respectively and for Germany was 0.7%, 0.75% and 0.25% for the 3 scenarios presented.

⁷⁸ As we could see in the figure 13 the evolution of the telecommunication industry follows closely the evolution of the global economy.

higher than the g we estimated, however it does not take into account the last 4 years that were very damaging for the telecommunications industry, as referred previously. Moreover we believe that this value would overestimate the fair price of Telefonica, as it has into account regions like Asia and Africa, where telecom growth has been impressive⁷⁹, not covered by Telefonica's operations.

Company Value Projections

Considering the assumptions previously described, and considering all the scenarios, we value Telefonica at €13.78 per share. This represents a premium of 31.5% over the current price of €10.48. Regarding the Brazilian operations, are valued at BRL 46.99 per share. This represents a upside of 5.6% over the current price of BRL 44.5. Finally the German operations, whose value had already been referred in the analysis of the respective market, are valued at €6.03 per share representing a premium of 3.1% over the current price of €5.85.

Table 9 – € Millions for Group and Germany and BRL for Vivo except prices in units

	Group	Brazil	Germany
PV	39.230,43	17.714,16	2.092,76
Terminal Value	86.579,22	36.126,95	6.223,85
%	69%	67%	75%
EV	125.809,65	53.841,11	8.316,61
Net Debt 2012⁸⁰	58.119,04	936,00	1579.5
Minority Stakes Held⁸¹	3.569,71	N/A	N/A
Telecom Italia	1.336,48	N/A	N/A
China Unicom	1.470,23	N/A	N/A
Digital Plus	473,00	N/A	N/A
Other	290,00	N/A	N/A
Vivo Minority Stake (26.1%)	-5.714,53	N/A	N/A
Czech Minority Stake (30.59%)⁸²	-1.270,11	N/A	N/A
Germ. Minority Stake (23%)	-1.549,54	N/A	N/A
Shares Outstanding	4.551	1.126	1.117
Equity Value	62.726,14	52.905,03	6.737,11
Price per share⁸³	13.78	46.99	6.03

⁷⁹ In Asia, from 2000 to 2008 the number of total subscribers increased by 500%, superior than the world increase of 400%. Africa, from 2003 to 2008, registered superior CAGRs in the mobile telephony segment (47% against the world's 23%) and in fixed broadband (30.6% against the world's 17%). Source: ITU World Telecommunication/ICT Indicators database

⁸⁰ Computed having into account Telefonica's market values of debt and the estimated amount of cash.

⁸¹ Telcom Italia and China Unicom stakes correspond to market values, Digital Plus corresponds to the reported book value by Telefonica and the other assets correspond to the analyst's estimates.

⁸² Using Market Prices.

⁸³ These prices correspond to weighted average according with the scenarios described. For the group the prices obtained were €13.96 for the base scenario, €19.86 to the very best scenario and €9.28 to very bad scenario. For Brazil the prices obtained were BRL 47.17, BRL 53.89 and BRL 42.00. For Germany the prices obtained were €6.06, €6.24 and €5.66.

We performed a sensitivity analysis on our valuation in regard to the value of the WACC and the value of the growth⁸⁴. Since our objective is only to evaluate how sensible is the price to the variations of these inputs we will only have into account the price from the base scenario.

Table 9 – Sensitivity Analysis on Telefonica’s Valuation Parameters (€)

		Growth				
		0,35%	0,65%	0,95%	1,25%	1,55%
W A C C	7,45%	13,35	14,06	14,83	15,66	16,56
	7,95%	12,94	13,64	14,39	15,20	16,08
	8,45%	12,54	13,22	13,96	14,75	15,62
	8,95%	12,14	12,81	13,53	14,32	15,17
	9,45%	11,75	12,41	13,12	13,89	14,73

Table 10 – Sensitivity Analysis on Telefonica’s Germany Valuation Parameters (€)

		Growth				
		0,30%	0,50%	0,70%	0,90%	1,10%
W A C C	6,64%	5,93	6,11	6,30	6,51	6,74
	6,84%	5,82	5,99	6,18	6,38	6,60
	7,04%	5,71	5,88	6,06	6,26	6,47
	7,24%	5,61	5,78	5,95	6,14	6,35
	7,44%	5,52	5,68	5,85	6,03	6,23

Table 11 – Sensitivity Analysis on Telefonica’s Brazil Valuation Parameters (BRL)

		Growth				
		47,17	0,50%	1,00%	1,50%	2,00%
W A C C	10,88%	48,64	50,33	52,21	54,29	56,62
	11,38%	46,39	47,90	49,56	51,40	53,44
	11,88%	44,33	45,68	47,17	48,80	50,60
	12,38%	42,45	43,67	44,99	46,45	48,05
	12,88%	40,72	41,82	43,02	44,32	45,75

After analysing the tables presented before we can conclude that, although, being very sensible to the change in parameters, our estimate for Telefonica’s base price is always superior to the current value of the company. When considering our lowest estimate we are still able to achieve a premium, against the current price, of 12.1%. Regarding Telefonica Germany we are able to conclude that the price range defined by Telefonica for the IPO – €5.25 to € 6.5 – appears to be correct as almost all our values fall in that interval. Finally, considering Telefonica Brazil we could see that with more negative conditions than the ones expected, higher WACC or lower Growth rates, the company price falls below its current price. We think that it is also important to state that only with growth rates superior than 2% and a WACC inferior to 11.38% that the value paid by Telefonica to Portugal Telecom in 2010 could correspond to the company’s fair value.

⁸⁴ These two factors are the ones that most influence the terminal value, which according to our predictions represents more than half of the company’s enterprise value. This associated with the fact that these values are broader, depending on several sub factors, led us to choose these as the inputs for our sensitivity analysis.

Appendix

Balance Sheet (€ Millions)	2010	2011	2012E	2013F	2014F	2015F	2016F	2017F
Assets								
PP&E & Intangibles	60.828	59.533	56.891	57.183	57.502	57.789	58.105	58.456
Goodwill	29.582	29.107	28.968	28.968	28.968	28.968	28.968	28.968
Current tax receivable	1.331	1.567	1.682	1.613	1.613	1.678	1.758	1.841
Current financial assets	1.574	2.625	2.776	2.776	2.776	2.776	2.776	2.776
Inventories	1.028	1.164	1.224	1.135	1.134	1.165	1.208	1.253
Trade and other receivables	12.426	11.331	11.715	11.197	11.189	11.493	11.918	12.361
Cash and cash equivalents	4.220	4.135	7.616	5.458	5.458	5.458	5.458	5.458
Other Assets	18.786	20.161	17.522	16.489	15.681	15.045	15.078	15.131
Total Assets	129.775	129.623	128.394	124.819	124.321	124.371	125.268	126.243
Liabilities								
Financial Debt	61.100	66.311	63.068	56.964	53.803	53.326	53.340	53.639
Provisions	6.540	8.675	8.082	8.082	8.082	8.082	8.082	8.082
Current tax payable	2.822	2.568	2.946	2.765	2.768	2.876	3.013	3.154
Trade and other payables	9.314	9.406	8.617	8.534	8.583	8.857	9.230	9.614
Other Liabilities	18.315	15.281	14.202	14.022	14.070	14.232	14.440	14.408
Total Liabilities	98.091	102.241	96.914	90.367	87.305	87.373	88.104	88.897
Total Shareholder's Equity	31.684	27.382	31.480	34.452	37.016	36.998	37.164	37.346
Total Liabilities & Shareholder's Equity	129.775	129.623	128.394	124.819	124.321	124.371	125.268	126.243

Income Statement (€ Millions)	2010	2011	2012E	2013F	2014F	2015F	2016F	2017F
Revenues	60.737	62.837	62.553	61.690	61.644	63.319	65.660	68.099
Spain	18.713	17.283	15.021	14.195	13.220	13.336	13.625	14.063
Rest of Europe	15.724	15.523	15.070	15.525	15.527	16.077	16.842	17.719
Latin-America	25.756	29.237	30.553	31.970	32.897	33.906	35.193	36.317
Internal expenditure capitalized	737	739	787	563	554	568	588	611
Operating Expenses	40.375	44.501	42.239	39.900	40.129	41.411	43.156	44.947
Supplies	17.606	18.256	17.891	17.851	17.928	18.429	19.135	19.860
Personnel expenses	8.409	11.080	8.598	6.512	6.565	6.851	7.223	7.622
Subcontracts	12.228	13.019	13.561	13.417	13.474	13.899	14.474	15.049
Bad debt provision	853	818	777	837	880	907	944	979
Taxes	1.279	1.328	1.412	1.282	1.283	1.325	1.381	1.436
Other Gains (Losses)	4.679	1.135	536	471	476	490	508	526
Operating income before D&A (OIBDA)	25.778	20.210	21.637	22.825	22.546	22.965	23.600	24.288
Depreciation and amortization	9.303	10.146	10.393	10.242	10.294	10.352	10.403	10.460
Operating income (OI)	16.475	10.064	11.244	12.583	12.251	12.613	13.197	13.828
Profit from associated companies	76	635	501	356	355	365	379	393
Net financial income (expense)	- 2.649	- 2.941	- 3.246	- 3.092	- 2.744	- 2.576	- 2.547	- 2.547
Income before taxes	13.902	6.488	7.497	9.135	9.151	9.672	10.272	10.888
Income taxes	3.829	301	2.078	2.750	2.754	2.911	3.092	3.277
Income from continuing operations	10.073	6.187	5.419	6.386	6.397	6.761	7.180	7.611
Minority interest	- 95	784	421	338	339	358	381	403
Net income	10.168	5.403	4.997	6.047	6.058	6.402	6.799	7.207

Cash Flow Statement (€ Millions)	2010	2011	2012E	2013F	2014F	2015F	2016F	2017F
OIBDA	25.778	20.210	21.637	22.825	22.546	22.965	23.600	24.288
D&A	9.303	10.146	10.393	10.242	10.294	10.352	10.403	10.460
Profit from Associates	76	635	501	356	355	365	379	393
Net Financial Results	- 2.649	- 2.941	- 3.246	- 3.092	- 2.744	- 2.576	- 2.547	- 2.547
Interests Paid	- 2.514	- 2.671	- 3.518	- 3.262	- 2.946	- 2.783	- 2.758	- 2.759
Earnings Before Interest paid and taxes	16.416	9.159	11.015	12.397	12.097	12.454	13.030	13.646
Tax	4.521	425	3.063	3.731	3.641	3.749	3.922	4.107
Earnings Before Interest paid	11.894	8.734	7.952	8.666	8.456	8.706	9.108	9.539
D&A	9.303	10.146	10.393	10.242	10.294	10.352	10.403	10.460
CF from Operating Activities	21.197	18.880	18.345	18.907	18.751	19.058	19.511	19.999
Capital Expenditures	32.298	8.376	7.612	10.534	10.613	10.639	10.719	10.812
Δ Working Capital	- 174	56	629	450	59	48	82	90
Δ Gain (loss) Financial Investments	- 1.827	- 1.702	2.634	694	650	609	-	-
Δ Deferred Tax	3.270	2.059	276	231	207	141	107	156
Δ Other Assets and Liabilities	4.826	1.078	2.648	109	0	80	112	116
CF from Investing Activities	25.855	11.115	7.980	9.268	9.697	9.857	10.582	10.942
Free Cash Flow to the Firm	- 4.658	7.765	10.364	9.639	9.054	9.200	8.929	9.057
Financial Expenses (Interest Paid)	- 2.514	- 2.671	- 3.518	- 3.262	- 2.946	- 2.783	- 2.758	- 2.759
Interest Tax Shield	693	124	985	982	887	838	830	831
Net Changes in Equity (cash)	- 2.663	- 10.489	- 1.321	- 3.413	- 3.833	- 6.778	- 7.015	- 7.428
Δ Post employment provision	- 60	25	214	-	-	-	-	-
Δ Net Debt	9.202	5.296	- 6.724	- 3.946	- 3.161	- 477	14	299
CF from Financing Activities	4.658	- 7.765	- 10.364	- 9.639	- 9.054	- 9.200	- 8.929	- 9.057

Disclosures and Disclaimer

Research Recommendations

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

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