Telefónica

Capital Structure Strategy and New IFRS for 2018

Telefónica Group
23 March 2018

Finance and Accounting session

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Telefónica

Key Objectives

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Key Objectives

Capital Structure Strategy

Guarantee Solvency and Liquidity

Interest rates and FX volatility management

Cost optimization across capital structure

New IFRS for 2018

Implications and main changes of new accounting standards

Capital Structure Strategy

Jesús Romero
Deputy Chief Financial Officer

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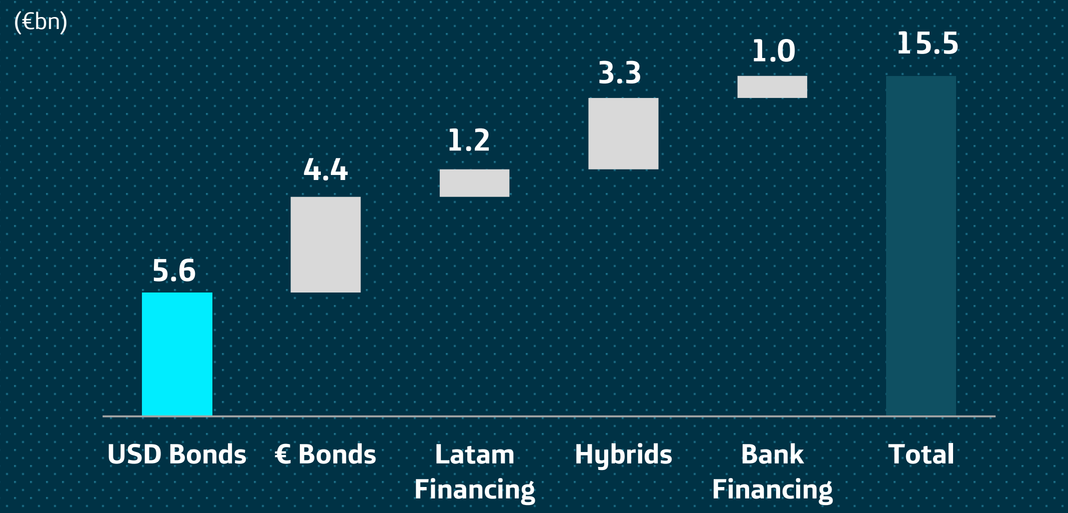
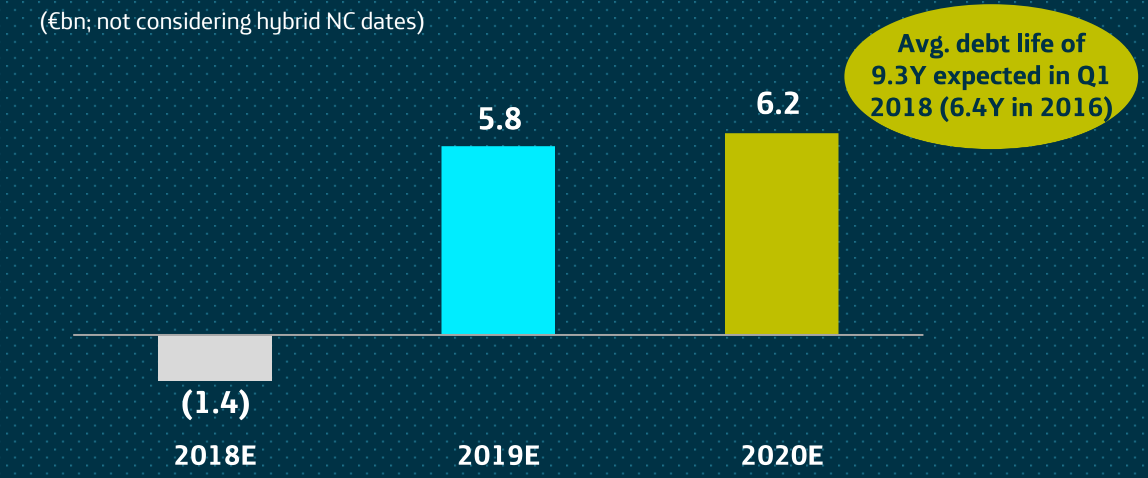
Long term financing strengthened our balance sheet in 2017 and YTD

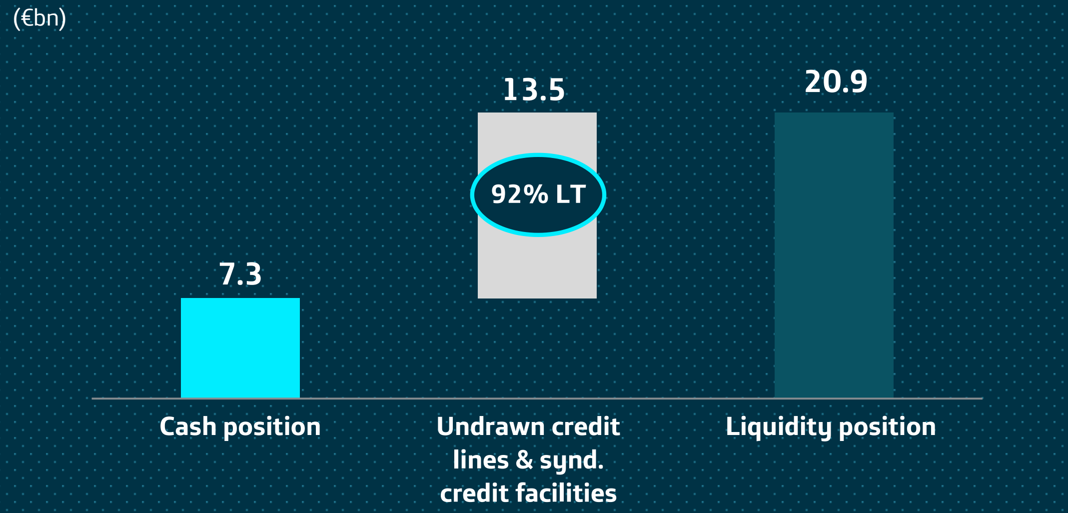
Sources of long-term financing (FY 17 & 2018 YTD)



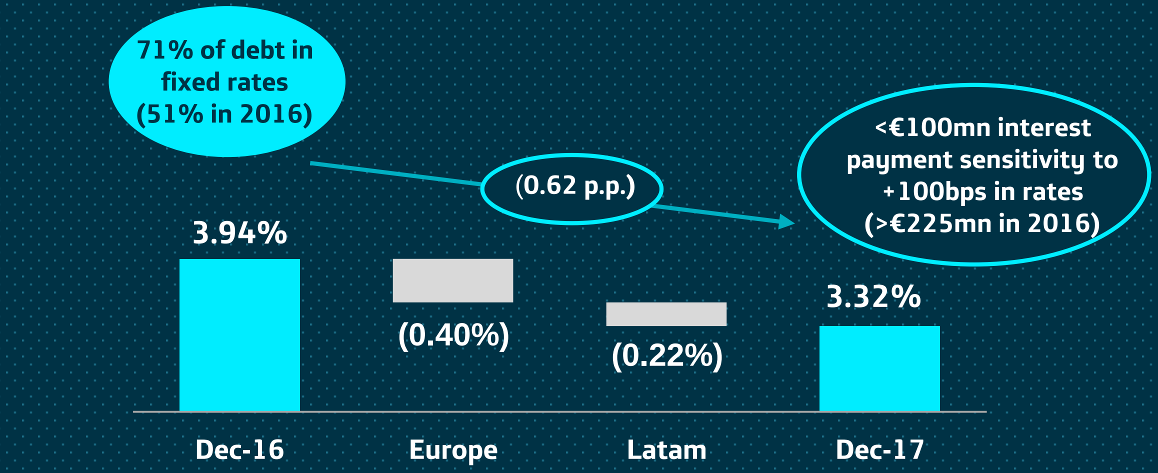
Net Debt maturities (March 2018 PF with 2018 YTD issues)



Liquidity position (Dec-17)



Interest payments cost (Dec-17)



Source: Telefónica

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Key Finance objectives – guarantee solvency and liquidity

1. Fully committed to a solid investment grade credit rating (BBB/Baa2)

2. Current liquidity covers debt maturities in excess of two years

3. Manage and hedge main risks – focus on interest rates and FX

Meet key objectives while optimizing costs across our capital structure

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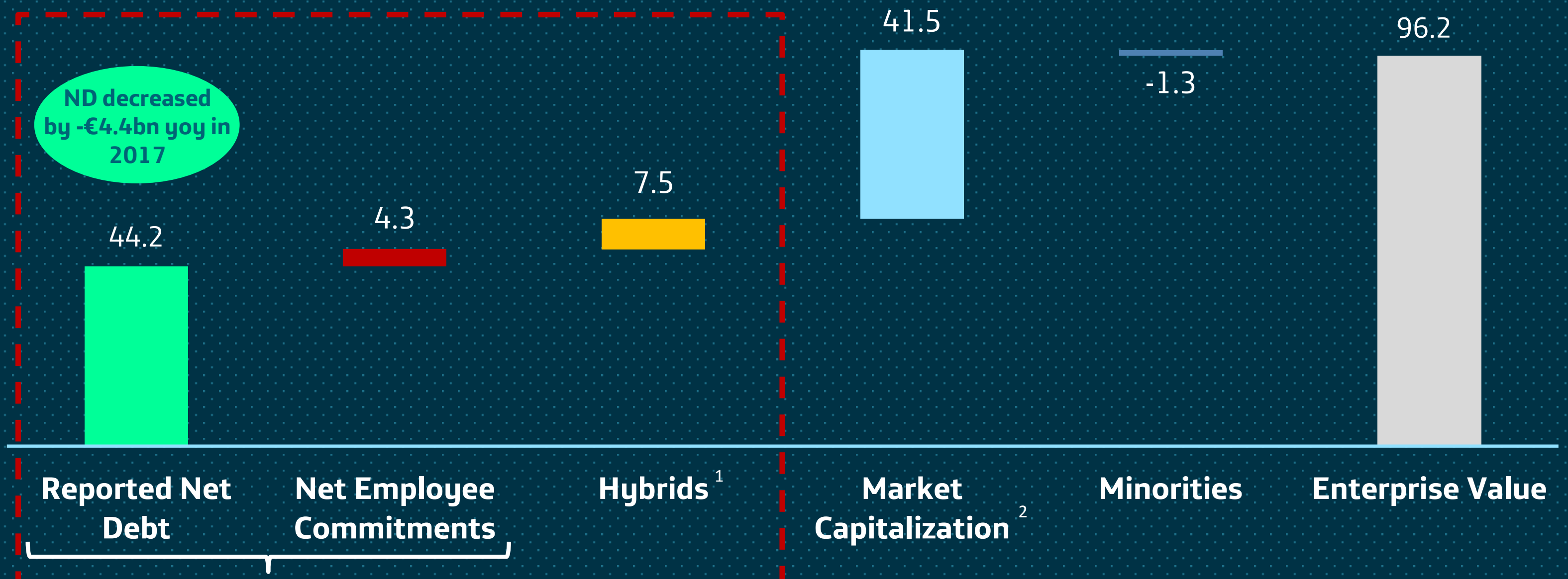
Capital structure breakdown and pricing of debt vs. equity

€bn



	Reported Net Debt + Net Employee Commitments	Hybrids [1] Pre-LM	Hybrids [1] Post-LM	Market Capitalization [2]	Minorities	Enterprise Value
Interest & Dividend outflows (€m)	1,726	354		2,077 (€40c/share)		
FCF ex spectrum & unlevered FCF (€m)				5,300		6,559[3]
		Pre-LM	*Post-LM*	*Post-tax*		
Cash Yields (%)	Pre-tax 3.32% Post-tax[4] 2.59%	5.34% 4.17%	4.41% 3.45%	5.00% (Div. yield) 12.77% (FCF yield)		6.82% (unlevered FCF yield)

In six quarters, TEF refinanced €19bn at historically low rates and long tenors, equivalent to 34% of total debt plus hybrids and 20% of enterprise value

1. Hybrids valued at issuance date
2. Data as of 20/03/2018. Source: Bloomberg
3. FCF ex spectrum plus financial payments net of taxes and adjusted for minorities
4. Assuming TEF's effective cash tax rate of 21.9%

Source: Telefónica

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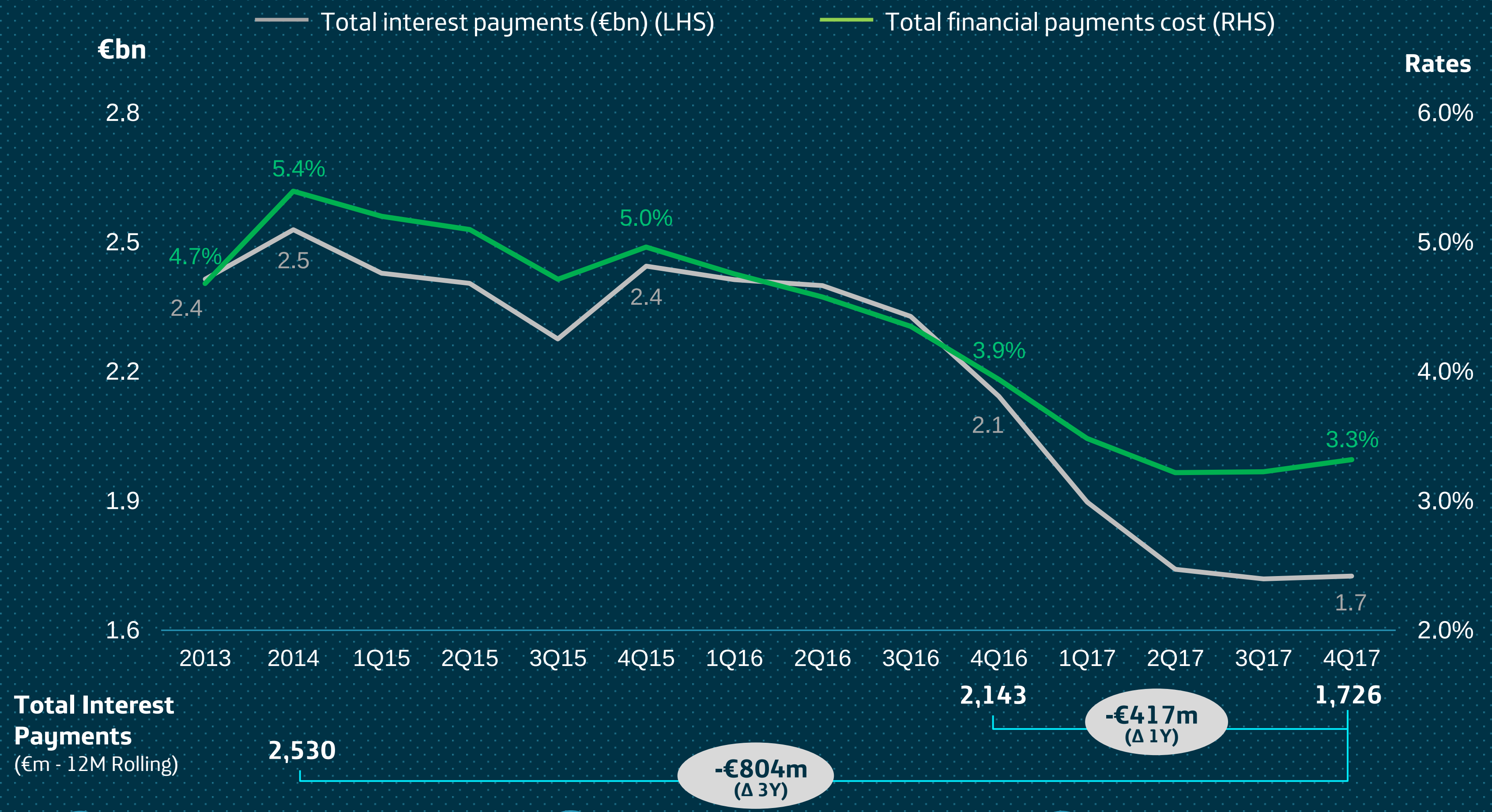
Historical trend in financial payments and key trade-offs in costs



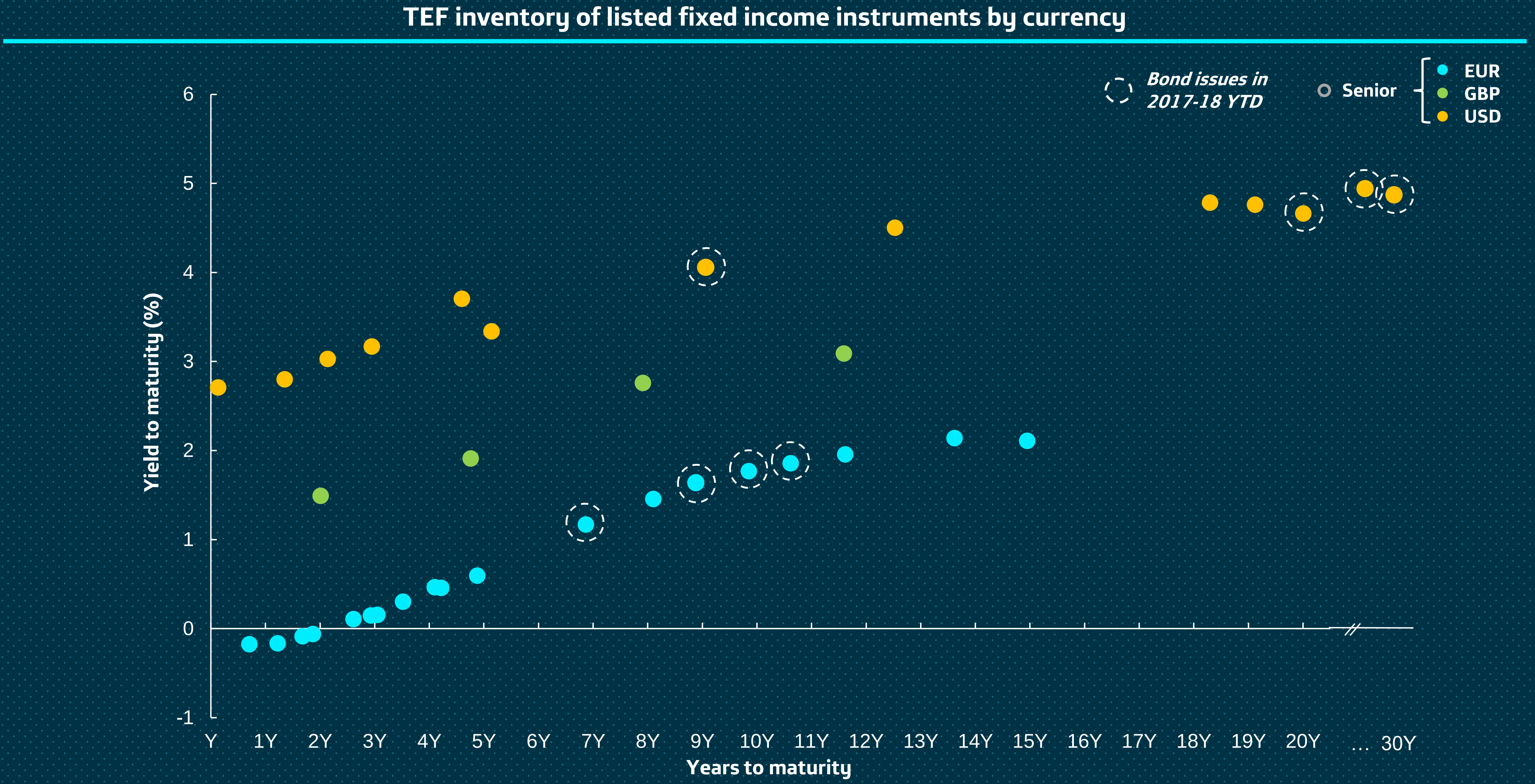
1 **AVERAGE MATURITY:** low maturities = lower cost; in context of rising interest rates, preferable to increase average debt life

2 **FLOATING vs. FIXED RATES:** floating = lower cost; in context of rising interest rates, safer to increase weight of fixed rate debt

3 **FX MIX:** cost in euros are lower than in LatAm currencies; consider expected FX changes and compare extra financial cost vs. FX impact on principal

Source: Telefónica

Current market value of senior bonds - €39bn vs. notional €37bn



Source: Bloomberg. Data as of March 20th

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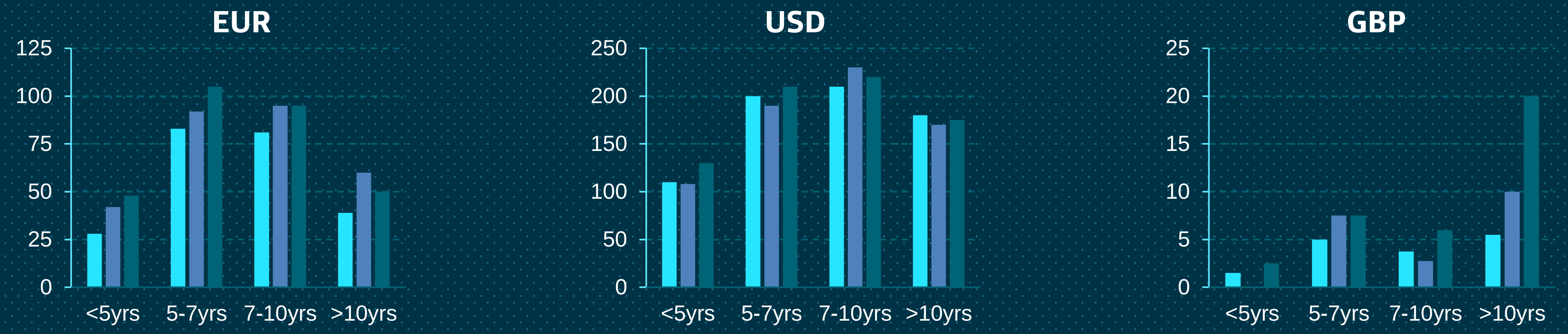
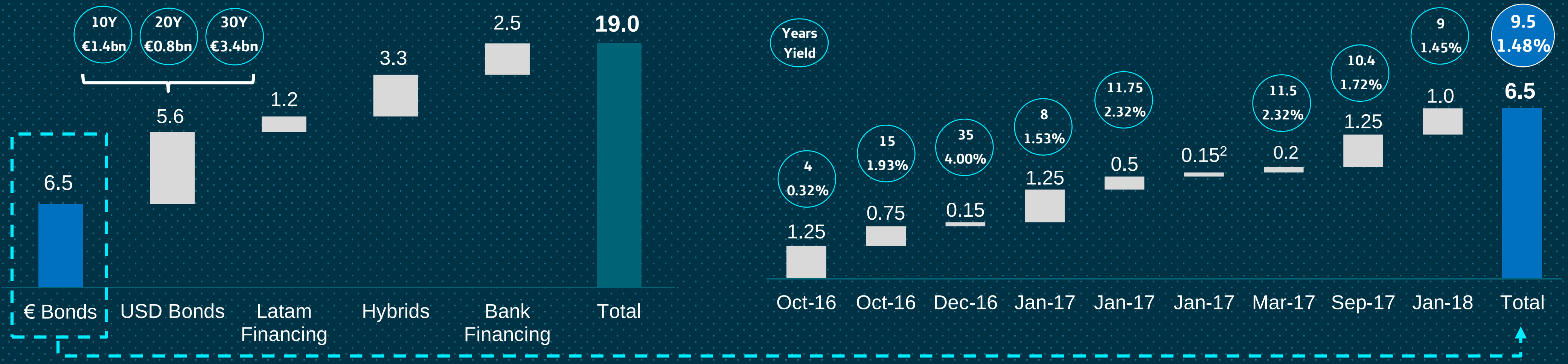
Credit market depth is critical, specially in long tenors

Total Corporate IG issuance[1] in 2017 – 300bn in EUR, 728bn in USD and 36bn in GBP

Maturity breakdown



TEF: clear focus of long-term financing in last six quarters (between October 16 to March 18 in €bn)



1. Source: UBS Corporate Debt Capital Markets
2. Floating rate note (Euribor 3m + 40 bps)

Source: Telefónica

Derivatives – turn a 30Y USD coupon of 4.895% into 3.17% in €

Same steps used to turn 20Y USD bond with a fixed coupon of 4.665% into a 20Y EUR "synthetic" bond with a fixed coupon of 2.87%

Notional	Currency	Coupon (%)			HEDGING ACTIVITY
$1,250m	USD	Fixed (30Y T-Bond 3.165% + TEF Spread 1.73%)	Pay out	ISSUE	***30Y USD bond with a fixed coupon of 4.895%*** *(maturity March-2048)*
$1,250m	USD	Fixed (30Y T-Bond 3.165%)	Pay in		1 **Interest Rate Swap (IRS)** to shift fixed USD debt to floating
	USD	Floating (USD LIBOR 3M)	Pay out		
$1,250m	USD	Floating (USD LIBOR 3M)	Pay in		2 **Currency Interest Rate Swap (CIRS)** to hedge FX and basis (spread) risks due to notional exchange
	EUR	Floating (EURIBOR 3M) +/- *(basis spread + 0.07%)*	Pay out		
		INITIAL AND FINAL NOTIONAL EXCHANGE			
$1,250m	USD	Fixed (TEF spread 1.73%)	Pay in		3 **Currency Interest Rate Swap (CIRS)** to hedge TEF margin credit risk (spread)
	EUR	*Fixed (TEF spread 1.52%)*	*Pay out*		
€1,022m[1]	EUR	Floating (EURIBOR 3M)	Pay in		4 **Interest Rate Swap (IRS)** to shift floating EUR debt to fixed
	EUR	*Fixed (30Y Swap 1.58%)*	*Pay out*		
€1,022m[1]	EUR	Fixed (30Y Swap + TEF spread +/- basis spread) (1.58% + 1.52% + 0.07%)	Pay out	RESULT	***30Y EUR "synthetic" bond with a fixed coupon of 3.17%*** *(maturity March-2048)*

1. Assuming FX USD/EUR=1.222

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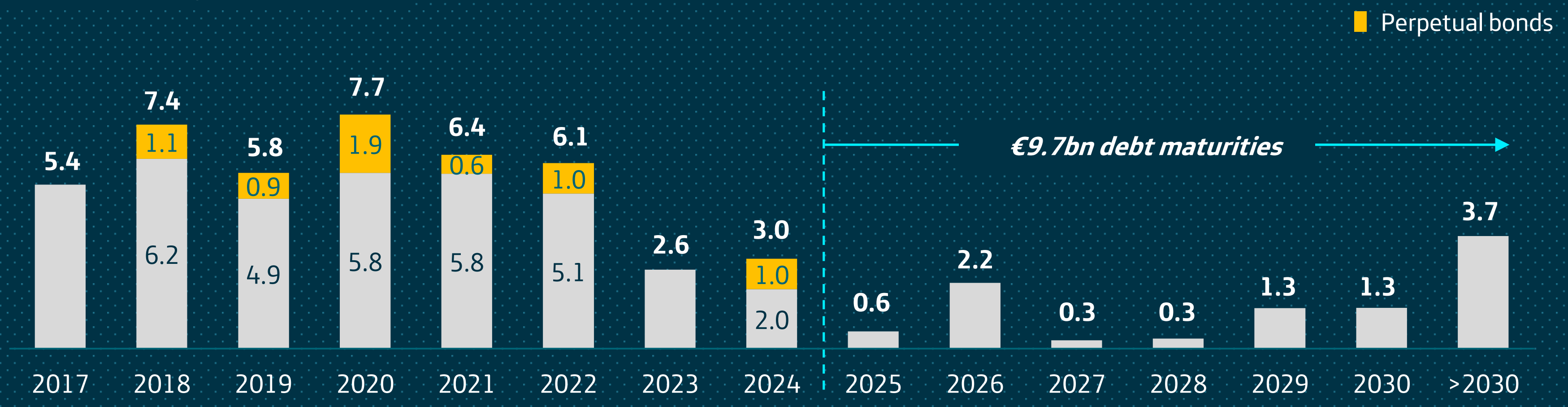
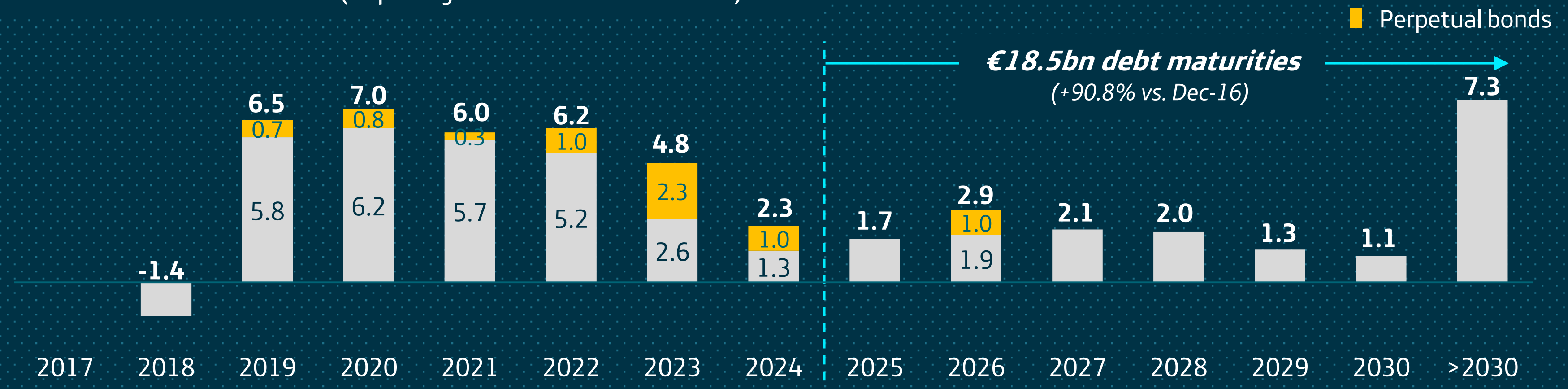
Trade offs (1) – increased average debt life (6.4Y to 9.3Y in 5Qs)

Avg. Debt maturity was 6.4Y (Dec-16) vs. current 9.3Y (Mar-18 PF with 2018 YTD issues) - €bn

December 2016 (Liquidity[1]: €21.3 bn)



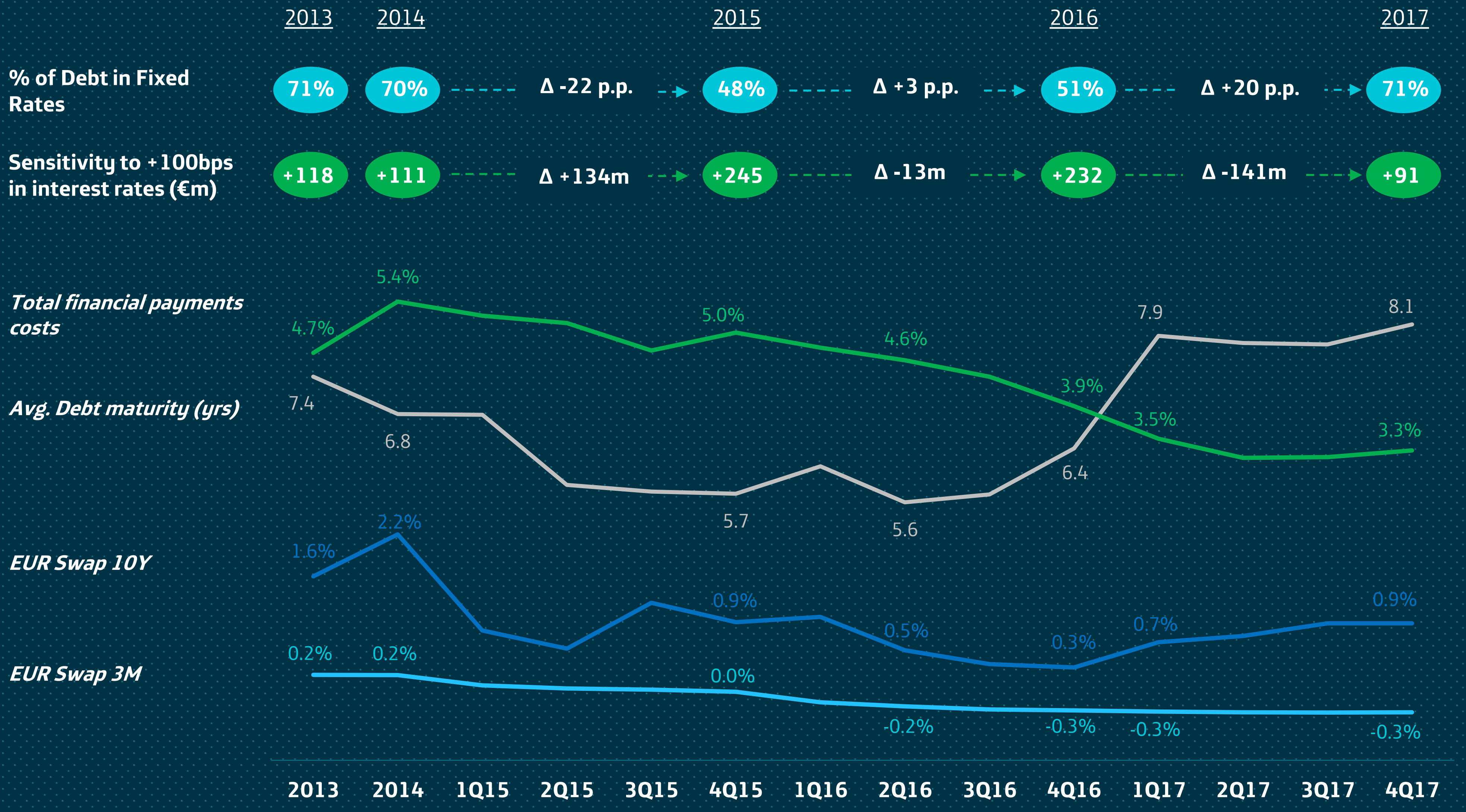
March 2018 PF with 2018 YTD issues (Liquidity[1]: €20.9bn as of Dec-17)



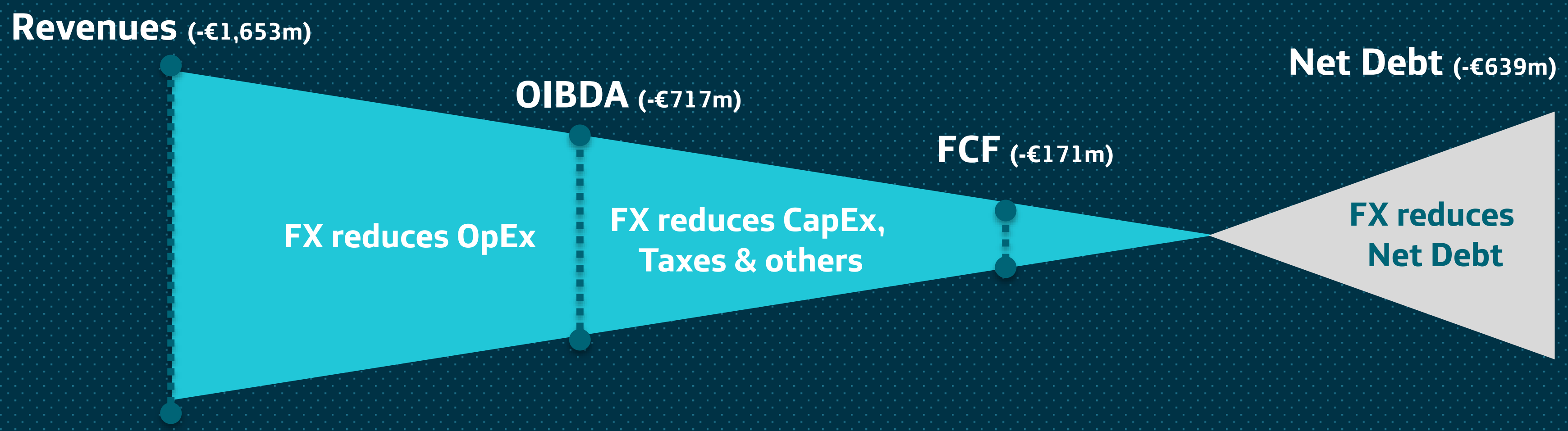
1.Includes Cash position and undrawn credit lines & syndicated credit facilities

Source: Telefónica

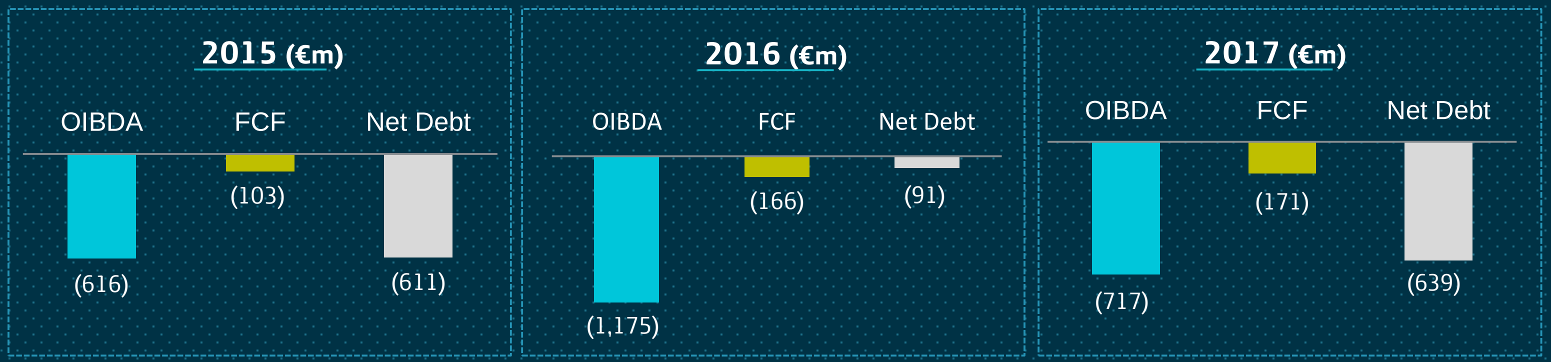
Trade offs (2) – increased fixed vs. floating rate debt



Trade offs (3) – FX hedging strategy produced positive results



FX impact in FCF is mitigated, "natural hedge"

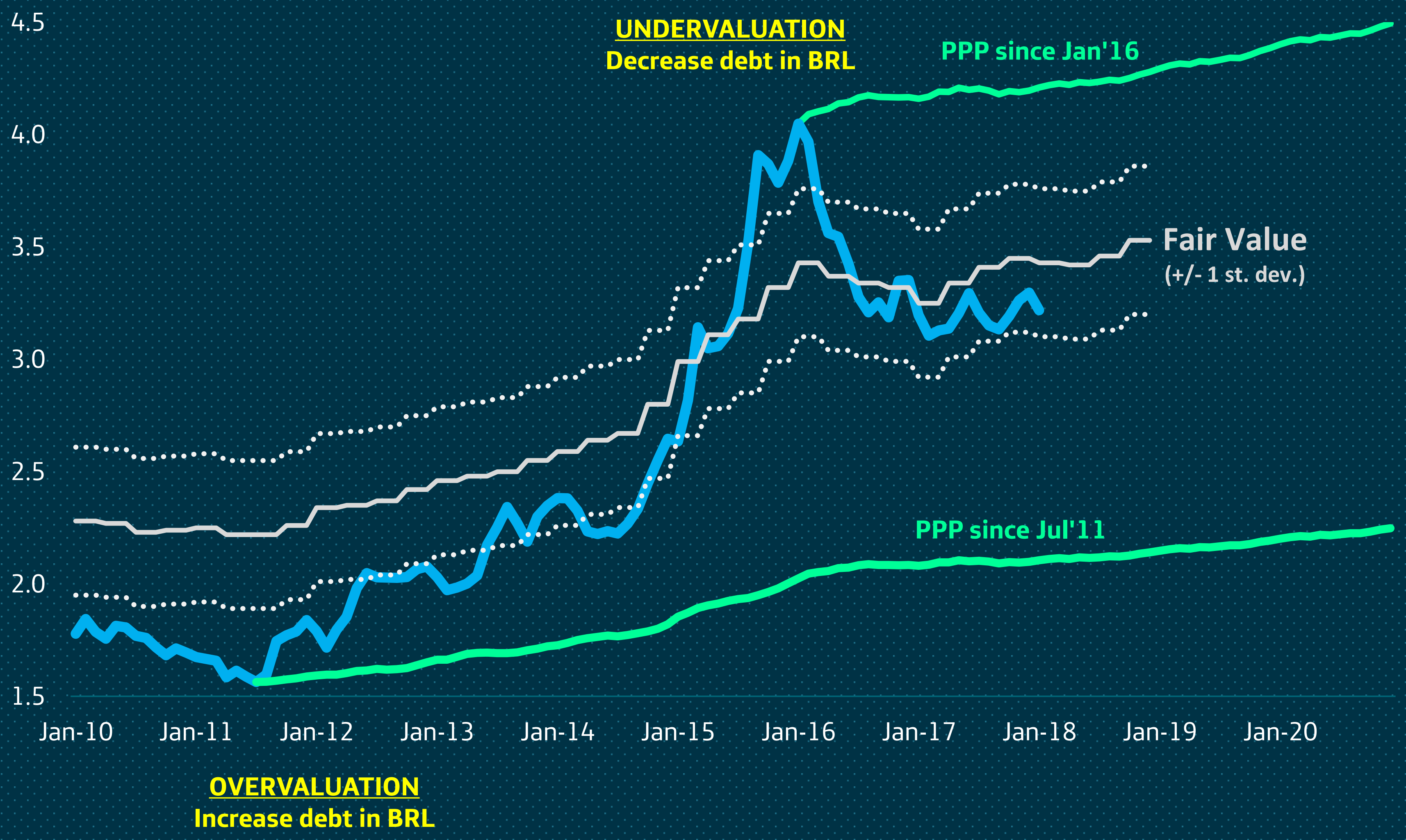


Debt structure more than offsets FCF impact

European FCF significantly… …exceeds dividends and interest payments… …LatAm is all upside

Levels of FX debt constantly monitored relative to FX fair value views

Illustrative case study: BRL/USD spot rates relative to equilibrium levels



PPP: Purchasing Power Parity

FX hedging in 2016 – decision making based on economic profit analysis

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Executed 1st large EU hybrid liability management; annual savings >€60m

Hybrids Pre-LM

1st Call Date (currency)	NOTIONAL (€m)	Years to Call	COUPON (%)
Sep-18 (EUR)	1,125	0.49	6.50%
Dec-19 (EUR)	850	1.70	4.20%
Mar-20 (EUR)	750	2.02	5.00%
Nov-20 (GBP)[1]	685	2.68	6.75%
Sep-21 (EUR)	625	3.49	7.625%
Mar-22 (EUR)	1,000	3.98	3.75%
Jun-23 (EUR)	1,000	5.21	2.625%
Mar-24 (EUR)	1,000	6.03	5.875%
TOTAL TEF Holding	**7,035**	**3.23**	**5.16%**
Mar-20[2] (USD)	417	1.94	8.5%
TOTAL TEF Group	**7,452**	**3.16**	**5.34%**

Hybrids Post-LM

1st Call Date (currency)	NOTIONAL (€m)	Years to Call	COUPON (%)
Sep-18[3] (EUR)	0	0.49	0
Dec-19 (EUR)	705	1.70	4.20%
Mar-20 (EUR)	592	2.02	5.00%
Nov-20 (GBP)[1]	196	2.68	6.75%
Sep-21 (EUR)	293	3.49	7.625%
Mar-22 (EUR)	1,000	3.98	3.75%
Sep-23 (EUR)	2,250	5.21	2.833%
Mar-24 (EUR)	1,000	6.03	5.875%
Sep-26 (EUR)	1,000	8.51	3.88%
TOTAL TEF Holding	**7,035**	**4.86**	**4.17%**
Mar-20[2] (USD)	417	1.94	8.5%
TOTAL TEF Group	**7,452**	**4.70**	**4.41%**

1. FX: 0.88 GBP/EUR
2. COLTEL Hybrid (FX: 1.20 USD/EUR)
3. €473m outstanding; assumes exercise at first call date (Sept 18)

Implied costs of equity component of recently issued hybrid bonds

A Hybrid Dec-17 (5.5Y)

	NOTIONAL	COUPON (%)	COST (€m)
Hybrid	1,000	2.625%	26.3
EUR senior	500	0.40%	2.0
Equity	500	4.85%	24.3
Implied cost of Equity (post tax[1])		**3.79%**	

B Hybrid Mar-18 (5.7Y)

	NOTIONAL	COUPON (%)	COST (€m)
Hybrid	1,250	3.0%	37.5
EUR senior	625	0.95%	5.9
Equity	625	5.05%	31.6
Implied cost of Equity (post tax[1])		**3.95%**	

C Hybrid Mar-18 (8.5Y)

	NOTIONAL	COUPON (%)	COST (€m)
Hybrid	1,000	3.875%	38.8
EUR senior	500	1.64%	8.2
Equity	500	6.11%	30.6
Implied cost of Equity (post tax[1])		**4.77%**	

Consider hybrids as attractive long term components of our capital structure

1. Assuming TEF's effective cash tax rate of 21.9%
Source: Telefónica

Main takeaways

Objectives – guarantee solvency and liquidity; solid investment grade credit rating (BBB/Baa2)

Hedge interest rate and FX risks while optimizing capital structure costs

In 2017 we strengthened our balance sheet ahead of potentially higher interest rates

Refinanced €19bn since Oct 2016, equivalent to 34% of total debt and 20% of enterprise value

Q1 2018: issued €3bn in senior bonds, executed €2.25bn hybrid LM and refinanced €5.5bn RCF

Stronger balance sheet and solid track record of risk management

New IFRS for 2018

Marta Soto

Head of Accounting Policies

Overview

IFRS 15: The new revenue standard

Major changes and implications of the new standard

IFRS15

IMPACTS (*):
Opening pre-tax equity 2018: €+1.0 Bn

Estimated P&L impact based on FY17:
- **Revenue: €-60 Mill**
- **OIBDA: €-80 Mill**

(*) Unaudited figures

Replacing various different standards on revenue recognition. IFRS 15 delivers a unified accounting model across industries ensuring…

Higher comparability
Higher consistency

EFFECTIVE DATE…

… January 1st 2018
… Partial Retrospective approach adopted by Telefónica

CORE OF THE STANDARD…

… Revenue recognition is **based on the contract with the customer and** is not necessarily aligned with billing

CHANGES IN REVENUE RECOGNITION…

… New revenue mix
… Variations in timing of revenue recognition

AND IN SOME COST RECOGNITION…

… Certain costs of customer acquisition have to be capitalized

IFRS 9: Financial Instruments

Main changes

Classification & Measurement

- Financial Assets Classification based on:
  - Business model
  - Contractual Cash Flow Characteristics
- Financial Assets Measurement:
  - Fair Value through profit and loss (FVtPL)
  - Fair Value through other comprehensive income (FVtOCI)
  - Amortised Cost (AC)

Impairment

- We move from an incurred loss model to a new impairment model based on **EXPECTED CREDIT LOSSES**
- Objective: To reflect the pattern of deterioration or its improvement

Opening pre-tax equity impact 2018: €-200 Mill

No relevant impact expected in P&L FY18

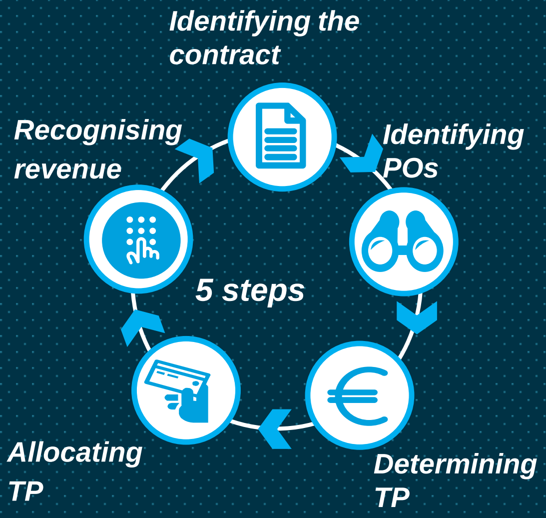
Hedge Accounting

- Simplification of IAS 39 requirements but higher volume of information about the activities carried out by the Entity regarding risk management
- Objective: To align hedge accounting with risk management

IFRS 15 in detail

IFRS 15: The model

Applying a 5 Step Model to determine **when and how to recognise revenue**



1 Identifying the contract

Agreement that creates enforceable **rights and obligations**

2 Identifying performance obligations

- Good or services that are **distinct;** or
- A **series** of specified goods or services substantially the same with **same pattern of transfer to the customer**

3 Determining the transaction price

The amount to which an entity expects to be entitled in **exchange for transferring promised goods or services to a customer**

4 Allocating the transaction price

To each performance obligation **based on the relative standalone selling price**

5 Recognising revenue

when a performance obligation **is satisfied by transferring the good or service** to the customer

Other aspects: Cost Capitalization

Capitalization of incremental **costs for obtaining a contract** if the amortization period is over 12 months long

Areas of major impact for Telefónica

IFRS 15: Basic Adjustment

Step 4 implications through an example...
... affecting those offers with a discount on the handset or the service, or both

S./150 per month during 18 months
Total = S./2,700

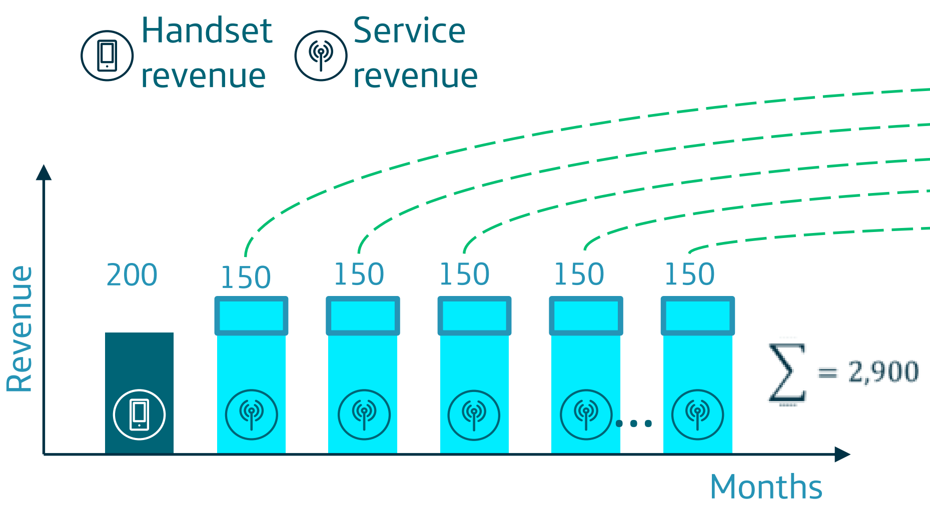
Handset Price with service(*) S./200

Total Contract = S./2,900

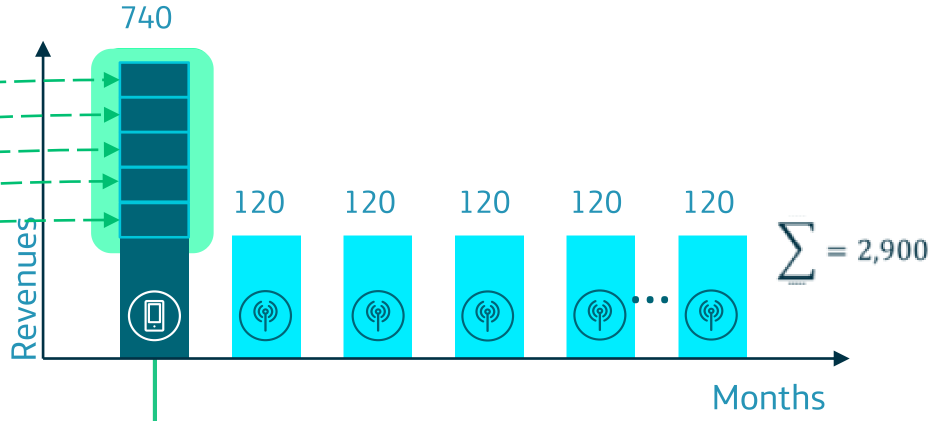
SSPR = S./740

(*) SSP = S./925

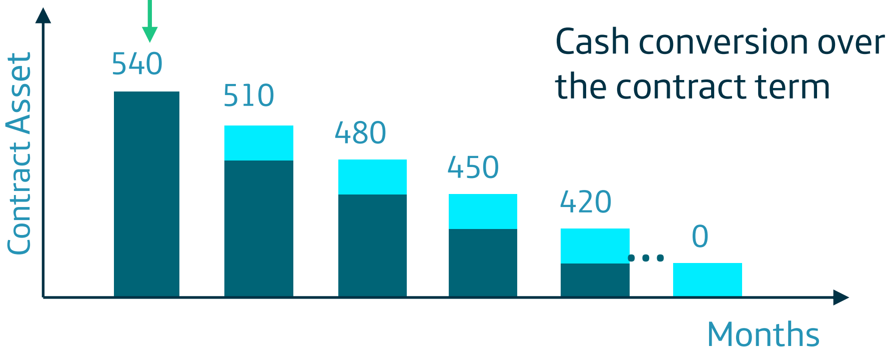
Before...	...After
Revenue = Billing	**Revenue ≠ Billing**
	The difference is reflected in the Balance Sheet



P&L Impact



Balance Sheet Impact



Key points
- Total revenue of contracts is the same
- Time of recognition differs
- Revenue mix changes
- New B/S items: contract assets and contract liabilities

IFRS 15: Cost Capitalisation

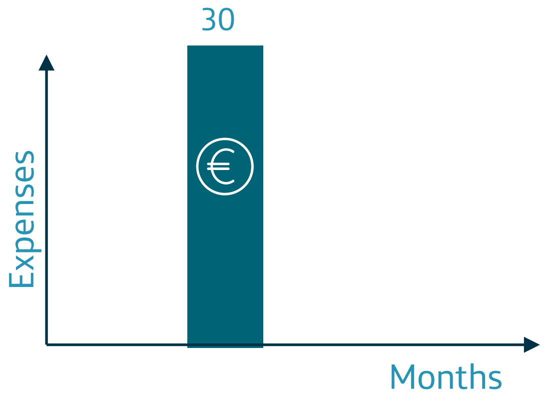
Incremental costs have to be capitalised if the entity expects to recover those costs

Let's see an example…

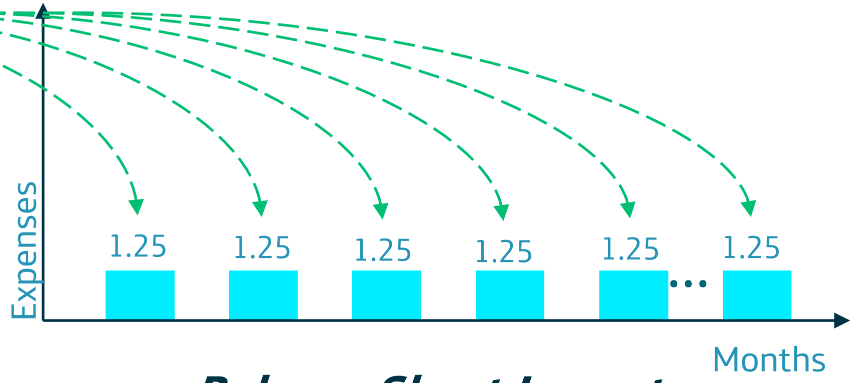
A dealer is paid a commission of 30 € for a new contract with a customer. The total duration of the contract is 24 months

Before…	**…After**
One shot recognition	OPEX accrual in accordance with the **pattern of transfer of the services**

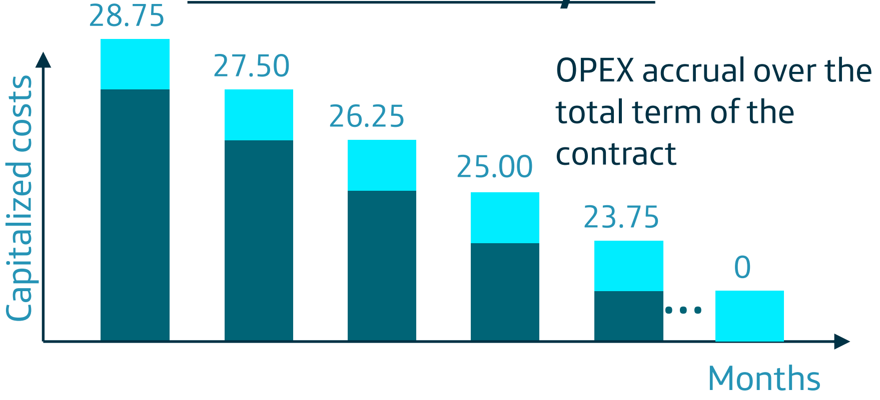
P&L Impact



P&L Impact



Balance Sheet Impact



Key points

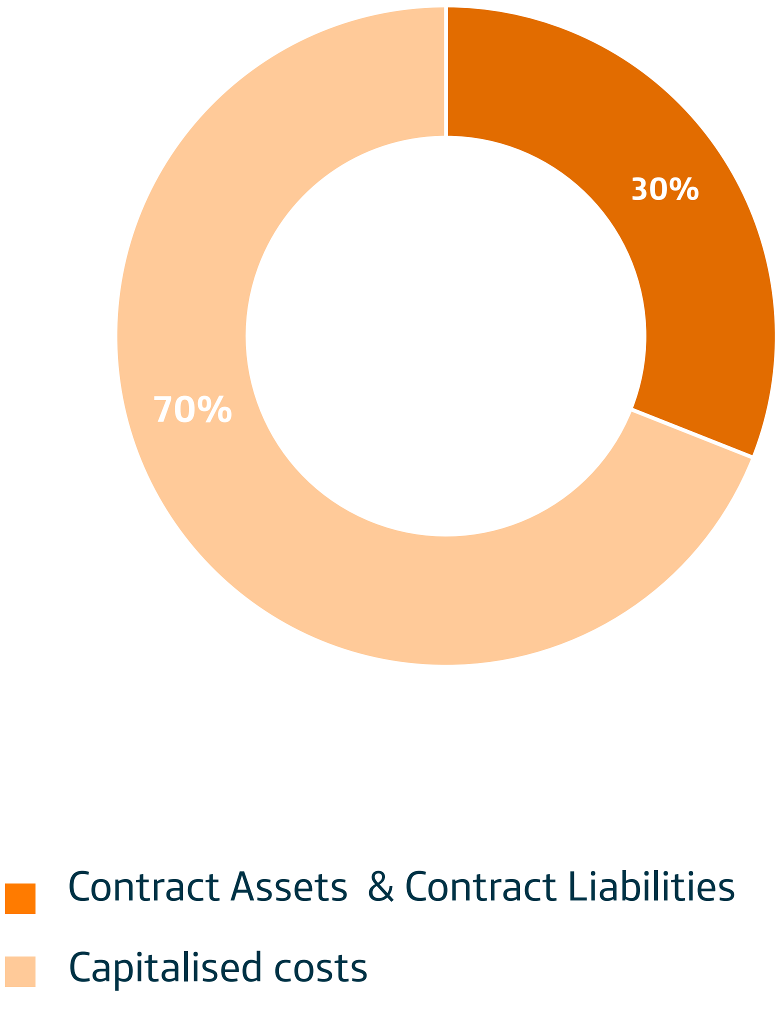
Sales commissions with deferral period longer than 12 months
New B/S item: Capitalized costs

IFRS 15: Opening equity impact 2018

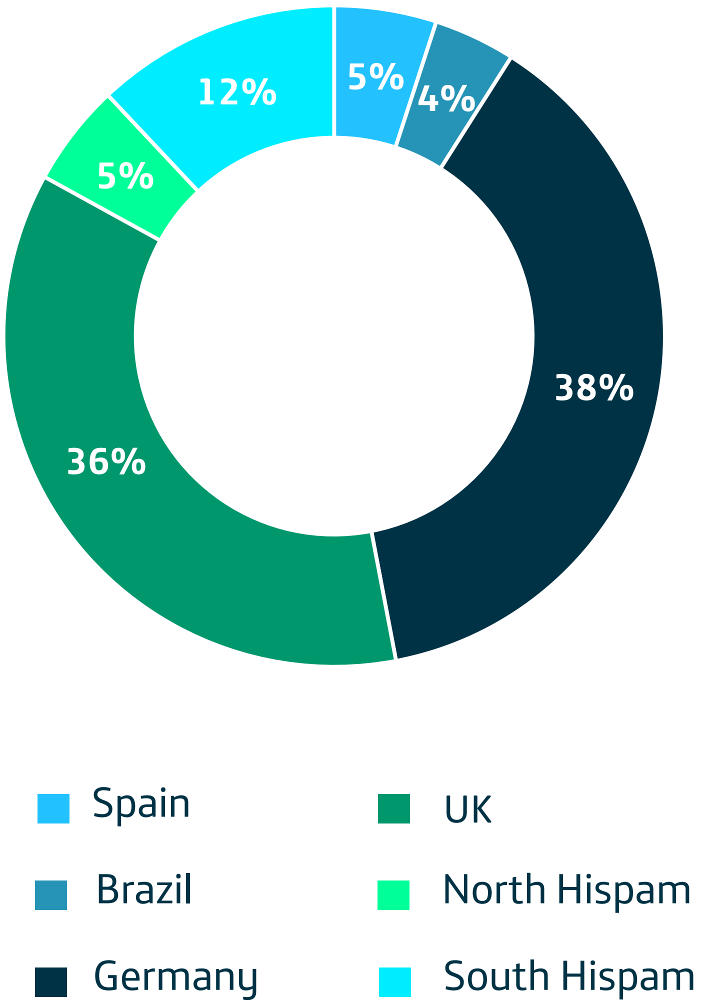
The following charts represent the estimated equity impact on a pre-tax basis of €+1.0 Bn distributed by areas of impact and segments

Unaudited figures

Areas of impact

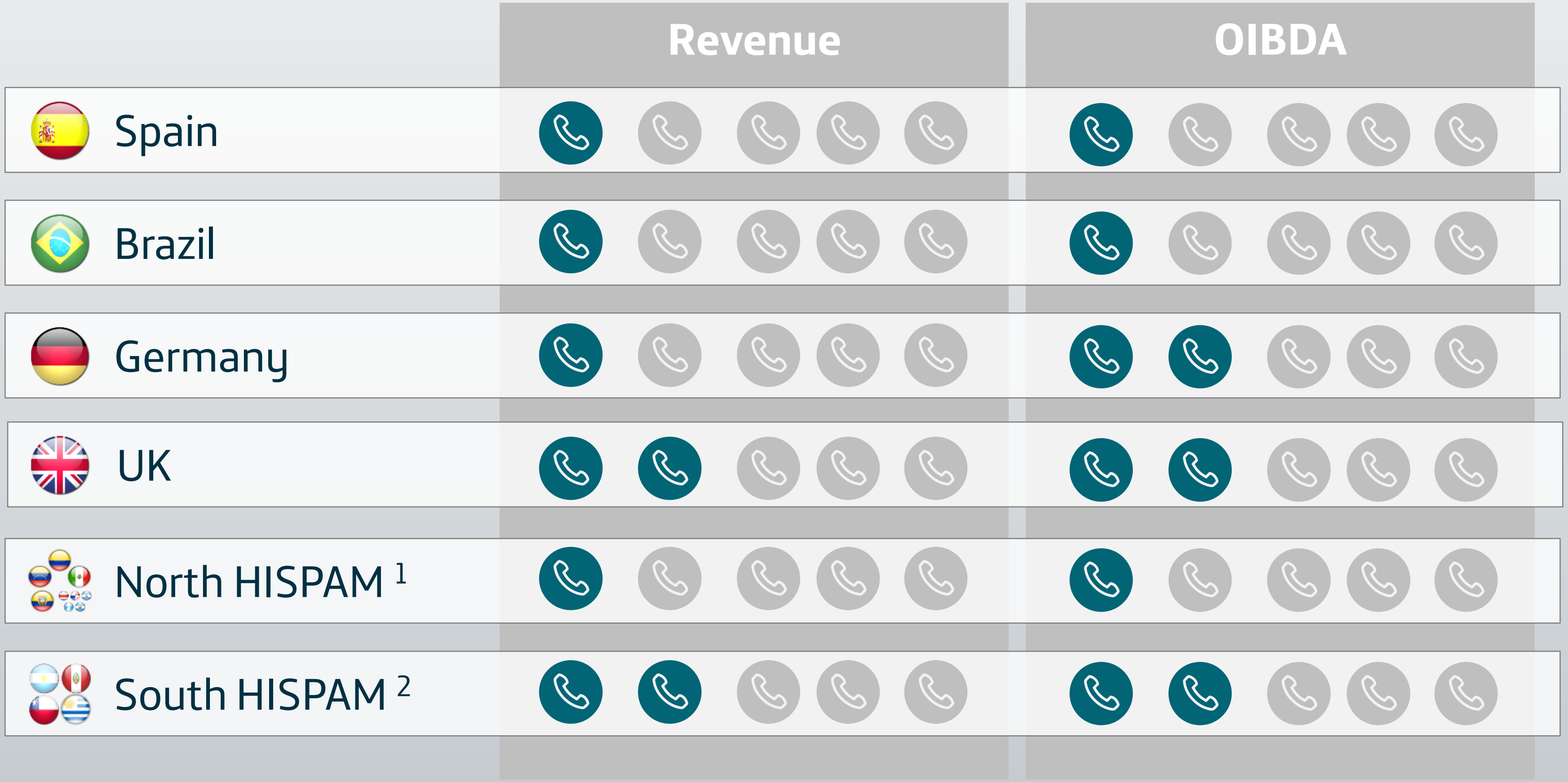


Segment Distribution



IFRS 15: Estimated contribution per region

Non-relevant impacts in any segment



Telefónica Total Group	Revenue: € -60 Mill -0.1% over Revenue	OIBDA: € -80 Mill -0.5% over OIBDA

Estimated P&L impact based on FY17

Unaudited figures

[1] North HISPAM: Colombia, Mexico, Costa Rica, El Salvador, Guatemala, Nicaragua, Panama, Ecuador and Venezuela
[2] South HISPAM: Argentina, Peru, Chile and Uruguay

Key Takeaways

Laura Abasolo

Chief Financial and Control Officer

Key Takeaways

Capital Structure Strategy

Impressive refinancing exercise: €19bn

Solid risk management track record

Healthier Balance Sheet

New IFRS for 2018

No material impacts expected
-0.1% Revenues and -0.5% OIBDA (estimated impact based on FY17)

Guidance not affected under new standards

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Q&A Session

Laura Abasolo

Jesús Romero

Marta Soto

Pablo Eguirón

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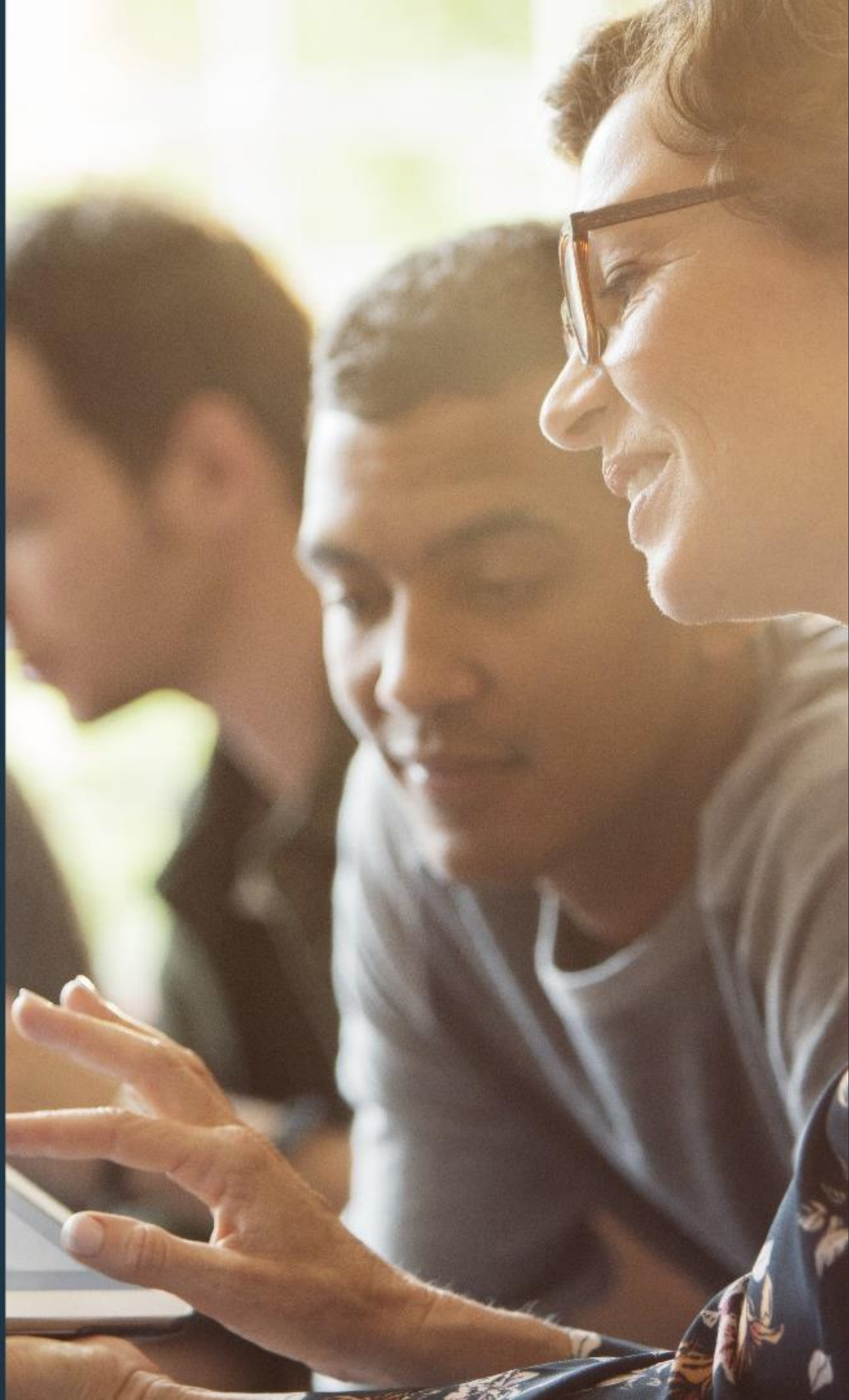
Appendix



IFRS 15: Practical Expedients

The Standard contains certain **practical expedients** for the adoption of revenue recognition

TRANSITION

Telefónica Group will adopt the **cumulative transitional approach**. recognizing the cumulative effect of the initial application of the Standard as an adjustment in equity in 2018

PORTFOLIO APPROACH

Telefónica Group will **use portfolios as a method** of clustering similar contracts. wherever possible

FINANCIAL COMPONENT

Telefónica Group will **not require the calculation of the financing arrangement** for those commercial offers where the customer pays for the good or service in **one year or less**

COSTS

Telefónica Group will **not capitalize incremental costs**. that would create an asset with an amortization period of **one year or less** and recognize the costs as expenses directly upon incurrence

MODIFIED CONTRACTS

For modified contracts, Telefónica Group will **not evaluate** separately the effects of the **contract modifications before January 1st 2018**

COMPLETED CONTRACTS

Contracts with customers completed before the effective date of January 1st 2018 do not create adjustments to the financial statements and will therefore **not have any effect** for the Telefónica Group

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In October 2015, the European Securities Markets Authority (ESMA) published guidelines on Alternative Performance Measures (APM), applicable to regulated information published from July 3, 2016. Information related to APM used in this presentation are included in the our consolidated financial statements and consolidated management report for the year 2017 submitted to the Spanish National Securities Market Commission (CNMV), Note 2, page 283 of the .pdf filed. Recipients of this document are invited to read it.

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