Telefónica January-June 2019
Results Conference Call Transcript

25th July 2019

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Introduction

Pablo Eguirón – *Global Director of Investor Relations*

Good morning, and welcome to Telefónica's conference call to discuss January-June 2019 results. I am Pablo Eguirón, Global Director of Investor Relations.

Before proceeding, let me mention that financial information contained in this document related to the second quarter 2019 has been prepared under international financial reporting standards, as adopted by the European Union. From the first of January 2019 we implemented IFRS 16. In organic terms, the effects of the accounting change to IFRS 16 are excluded in 2019. This financial information is unaudited.

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

Presentation

José María Álvarez-Pallete – *Chairman and Chief Executive Officer*

The most advanced network | Q2 Group highlights

Thank you Pablo. Good morning and welcome to Telefónica's second quarter and first half results conference call. With me today are Ángel Vilá, Chief Operating Oficer and Laura Abasolo, Chief Finance and Control Officer. Following our presentation we will host a Q&A session and take any questions you may have.

I'd like to begin this presentation by highlighting that we have the widest and most advanced UBB network, with 121m premises passed with UBB/FTTH, the world's largest footprint excluding China. Our key areas of focus are:

First, business sustainability starts with unabated momentum in high-value accesses, growing double-digit both in FTTx/Cable and LTE, with average revenue per access accelerating its growth to 4.4% year-on-year in the second quarter. Digitalisation translates into longer customer lifetime value, benefitting our customer satisfaction from a world-class digital experience.

Second, our growth is reliable and sustainable. Broadband connectivity & Services over Connectivity already account for 55% of total revenues (was 48% 3 years ago) and are increasingly less exposed to regulation. Efficiencies and digitalisation savings help to translate top-line growth into improved OIBDA trends in Q2, with OpCF turning positive and FCF reaching almost 3 billion EUR in the first half, up 78% year-on-year.

Third, we have the best technology at the customers' service, with the most advanced networks in Europe and Latin America. Networks which are flexible, secure and virtualised, software-based and with an open architecture that integrates elements of Artificial Intelligence. We are number 1 in virtualisation and AI and at the same time moving towards 5G, though at the right speed.

And fourth, our balance sheet continued to strengthen, with net debt coming down for the 9th consecutive quarter and standing below 39 billion euros (including post-closing events) at the end of June. This clearly reflects our focus on deleverage and our ultimate goal to improve ROCE.

Through all this, we can continue returning value to our shareholders.

Financial achievements

To review Telefónica's financial achievements in the second quarter, please move to slide number 2.

Reported headlines were positively affected in the second quarter by IFRS 16 accounting standards and some other special factors, whilst negatively impacted by FX movements against the euro, regulation and perimeter changes.

Consolidated revenues reached 12.1 billion euros, growing organically 3.7% vs the second quarter of 2018. OIBDA exceeded 4.4 billion euros, improving its growth rate to 1.6% year-on-year. OpCF ex-spectrum totalled 2.6 billion euros, up 0.9% year-on-year, back to growth after the decline seen in the first quarter, which was mainly due to Capex phasing.

Net income reached almost 900 million euros in the quarter and FCF again strongly expanded, +35.1% year-on-year, to 1.3 billion euros.

Net financial debt stood at 40.2 billion euros at the final of June, 5.7% lower than a year ago.

2019 guidance reiterated

Let's now move to guidance on slide 3.

We are well on track to deliver our full year outlook across all three metrics, as our first half figures are in line with expectations. We reiterate our guidance of growing revenues and OIBDA by around 2% in the full year, with CapEx to Sales standing at levels of 15%

Regarding our dividend, we paid the second tranche of 2018 dividend (0.2 euros per share in cash) on the 20th of June. We confirm the 0.4 euros per share in cash for 2019, first tranche payable on the 19th of December, and the second tranche in June 2020.

Delivering robust financials

On slide 4 we show how we again delivered robust financials in this second quarter.

Revenues kept their healthy organic growth rate, with all regions growing in the second quarter. Europe maintained its momentum and increased by 1.7% year-on-year, and LatAm grows by +6.2%. By components, service revenues grew by 2.3%, with handsets sales accelerating their annual growth rate to 16.7%. It is worth highlighting the performance posted by digital services and the B2B segment, up 19.0% and 4.3% respectively. Reported revenues were almost flat in the quarter, improving the trend from the 1.7% annual drop seen in the first quarter.

At the OIBDA level, we show sequential improvements, with Europe coming back to growth at +0.5% and Latam growing by 3.2% year-on-year.

Excluding regulation and in organic terms, revenues and OIBDA would have accelerated its growth trends to 4.5% and 1.9% vs. the first half of 2018.

In reported terms, to note Q2 revenues are almost flat year-on-year after 8 quarters of consecutive decline. In reported terms OIBDA growth is impacted for the second consecutive quarter by IFRS 16 adoption.

Finally, OpCF reversed Q1 trend and shows annual growth, improving by 610 basis points due both to the better operating performance and lower CapEx intensity once phasing impacts fade away.

B2C | Growing engagement and monetisation

Turning to slide number 5, let me share with you some more details for the B2C segment.

Customer experience remains our top priority. Through simple, flexible and tailor-made quality offers we deliver a better customer experience, increasing user engagement and monetisation.

Video remains the key driver for value and loyalty improvement, with total TV accesses up 5% year-on-year, and OTT video service "Movistar Play" expanding by almost 60% after its launch in Mexico and Argentina last quarter. In June we launched our OTT "Movistar+ Lite" in Spain, which is delivering so far promising results.

UBB uptake is growing significantly in both retail and wholesale.

Worth spending some time on Movistar Plus' leading position in Spain, which through differentiation continues growing in relevance among our client base. Not only total users grew to 8m this quarter, but offered functionalities show as well increases in usage, as does audience share, deferred consumption and other features. All in, lifetime value of our customers improves through better churn vs non-TV FBB customers, more than 30% lower, and significantly higher ARPU.

Finally, our customised offers also apply in prepaid and contract mobile, with more personalised benefits (such as data sharing or data transfers) that help us to increase usage, satisfaction and ARPU.

B2B | Relevant growth, leading comms & IT portfolio

We now move on to slide number 6, where we show how B2B, representing 20% of Group revenues, maintains its pace of growth. Around 5% year-on-year on the back of strong trends in Corporate (as much as 8% year-on-year growth in the first half of the year) and improving trend in SMEs (+3% year-on-year in Q2) namely in our LatAm operations.

The evolution of the B2B portfolio around a "digital core" of communications, cloud and security services, with building blocks of best-in-class portfolio of own and third parties' digital services, delivers strong revenue performance. Worth highlighting the agreements signed with Google Cloud and Microsoft during the last quarter, further enriching our portfolio.

Set on the best networks the B2B proposal evolves towards customer centric E2E solutions with operational excellence; let me just highlight Cloud & Security services and our virtualized IoT platform, widely awarded and considered as an industry reference.

Best technological platforms

Moving to slide 7,

In the first platform we already cover 121 million premises with UBB, having the world's largest footprint (ex-China). Furthermore, up to 66% of processes are already digitalised and managed in real time, and 30% of our customers have been migrated to full stack.

We continue digitalising our network, making it more virtual, more converged and scalable, and more efficient, with CapEx needs in core representing just 40% of what needed for our legacy infrastructure.

The third platform provides an enlarged offering with digital services revenues growing by 19% annually in the second quarter.

And lastly, the fourth platform enriches all the above with artificial intelligence and open platforms. New functionalities are available in Movistar Home, and more use cases with Big Data and Data Analytics facilitate our decision making process.

I now hand over to Angel to take you through a detailed review of the business performance.

Ángel Vilá – *Chief Operating Officer*

Spain | Improved commercial activity on superior offering

Thank you José María.

On slide 8 we start reviewing the performance of our Spanish operations, which showed remarkable commercial results in the quarter, thanks to our premium-quality differentiated offering.

Once last quarter tariff upgrades effect was left behind (which had an impact on commercial trading), we improved net adds in each and every market segment during Q2. Worth highlighting is the net adds growth in the higher value, with 326k net adds in mobile contract, 37k net adds in convergence, and 11k net adds in Pay TV, despite the negative seasonality of the end of the football season. Pay TV customers already make for 81% of our total convergent base, a 3 percentage points increase from the same quarter last year. Furthermore, churn improves as well in all segments, proving our pricing power and backing our more-for-more strategy, and above all, increasing our customers lifetime value.

Convergent ARPU shows sequential growth and stands at 88.5 euros in the second quarter up from 88.2 in Q1. The year-on-year comparison is penalised by phasing effects of tariff upgrades, which should nevertheless reverse as from Q3 and go back to annual growth once last year's football promotions expire, and the impact from recent tariff upgrades in the higher-end of our convergent base start to be felt.

Finally, it is again worth highlighting that Telefonica España continues growing its share of net adds in Spanish fiber. Putting together retail and wholesale customers, Telefonica España share in fiber net adds during the quarter stands above its overall market share, with uptake growing to a combined 27% in the second quarter, bringing in visibility and sustainability to our business.

Spain | Service revenue growth for 8th straight quarter

Moving on to slide 9, service revenues grew for the eighth straight quarter at Telefonica España. The sequential slowdown, due to the mentioned negative phasing and tariff calendar effects in B2C, and certain seasonality impacts in B2B, will be reversed in the second half of the year, mostly driven by an improving mix of customers and ARPU growth in B2C (on tariffs uplift and promotions' expiry).

B2B revenues slightly increased year-on-year, growing for 5 straight quarters already, whilst "Wholesale & Other" revenues continue showing an improving trend, once drags such as MTR cuts and MVNO agreements are removed. We should expect this trend to remain in the second half of the year.

OIBDA performance is similar to that seen in the previous quarter and organic margin improved quarter-on-quarter. Again, we should expect solid margin outlook in the second half, once top-line trends improve and content comparison base eases.

Germany |Enhanced network supporting commercial performance

Moving to slide 10, Telefónica Deutschland delivered a strong trading and operational momentum in both own and partner brands. This commercial performance has been supported by recent industry tests in which O2 showed a strong network and service quality improvements.

During the quarter Telefónica Deutschland posted 301 thousand mobile contract net additions, with a significant contribution from partners with a focus on 4G. O2 continued driving to data growth as much as 41% year-on-year to 4.8 GB per month and user.

A key development worth highlighting is the MSR turnaround fuelling sustained revenue growth of 1.6% year-on-year, together with another quarter of strong handset sales, up 12.9% year-on-year. OIBDA trends reflect regulatory impacts as well as ongoing transformation and market investment for future growth.

CapEx strongly increased by 16.9% year-on-year in the first half mainly due to the front-loaded LTE roll-out and network densification, a trend we expect to normalise over the year.

UK | Delivering another robust set of results

Moving to slide 11,

Telefónica UK produced another robust set of results with healthy top- and bottom-line growth on the back of solid commercial trading with 392 thousand mobile contract net adds.

The Company demonstrated once again its market leading position and remains the UK's favourite mobile network with a sector leading loyalty of 0.9%.

Revenues grew by a healthy 4.8% year-on-year as a result of ongoing success of O2's flexible tariffs leading to further traction in handset sales and other revenues. OIBDA delivered a robust annual growth of 9.2% in the second quarter.

Operating cash flow strongly improved by 10% year-on-year in the first half, while the Company successfully continued its efficient investment in network capacity and customer experience.

Brazil | Unmatched quality assets sustains market leadership

On slide 12 we start reviewing our Brazilian operations, where we continue leveraging on our unmatched assets to maintain and even grow our market leadership.

First, and as regards the mobile business, VIVO led the latest Connect mobile review, and we are ranked not only as the best mobile network on a national basis, but also show the best voice and data coverage. This allowed us to increase our market share in the Brazilian mobile market to 32.2%.

We have been able to improve our contract net additions from Q1, and also report a significant improvement in prepaid revenues trend, which for the first time in the last 7 quarters show single-digit annual decline. Total mobile ARPU grows 1.5% year-on-year, roughly in line with Q1, ahead of contract price increases of 9% effective in August.

As for the fixed business, our efforts start bearing fruits, and improved customer mix results into FBB ARPU growth accelerating to 16% year-on-year in Q2 (from +14% in the previous quarter). We have already passed 9.5m homes with FTTH, 2.2m homes already connected.

We offer our IPTV service in all cities with FTTH (142 vs. 130 at the end of Q1), which should be a further driving force to future revenue growth: Pay-TV ARPU (including DTH ARPU) grows already by 5.5% year-on-year in Q2.

Brazil | Sound FCF growth despite Capex acceleration

Next slide shows that our strategy of seeking profitable value results into sound FCF growth, despite investments efforts. Punctual service revenue deceleration in mobile contract is to be reversed as from Q3 on the mentioned tariff upgrades. Mobile prepaid revenues, on their side, improve significantly their trend, which coupled with handset sales, and a lower drag from the fixed business allow for 0.4% total revenue growth, despite tariff calendar and a tough competitive environment.

OpEx performance, helped by digitalisation savings, stands out for another quarter, again being able to beat inflation (OpEx grows by 0.4% year-on-year which compares with 3.4% inflation rate) and showing as much as 2 percentage points sequential improvement. OIBDA margin stands above 40% in the first half of the year.

This allows for FCF growth of 13% in the quarter, no matter CapEx/Sales remains at 19% on the ongoing business transformation.

South Hispam | Service revenue improving across the region

Moving on to the review of our Hispam operations, and starting with South Hispam on slide 14, we would highlight service revenue trends improving in the quarter, driven by strong growth in value KPIs, with positive contract net adds in all countries. This is the seventh straight quarter of positive mobile contract net adds in the region.

Our revenues grew by 17.6% year-on-year in organic terms, with Argentinean revenue growth accelerating on tariffs' increases and value accesses growth. In Peru our convergent offer “Movistar Total”, the first and only truly convergent option in the market, is showing promising results so far with c.a. 100k customers having already signed-up.

OIBDA shows a significant increase from the previous quarter, thanks mainly to the better performance seen in Argentina and Peru.

North Hispam | Sound commercial performance in value segments

As for North Hispam on next slide, we continue seeing good commercial performance thanks to an acceleration in contract net adds in Colombia, following a M4M strategy, and still improving commercial trends in Mexico, that shows positive contract net adds for the third consecutive quarter.

OIBDA performance remains penalised by recognition of spectrum fees as OpEx in Mexico. Should we exclude Mexico, OIBDA would have maintained similar year-on-year trend vs. the previous quarter, growing +7.6% year-on-year in Q2.

Telxius | Strengthening value creation

On slide 16, we take the opportunity to review not only Telxius quarterly performance but also its success story over the last few years. Telxius has been steadily growing in value, leveraging on its prime infrastructure and a well-planned strategy that is bearing fruits. And we wanted to share some of these conclusions with you.

In terms of portfolio, and after adding almost 800 new towers in the quarter, total number of sites stands at 17.6k, 11% higher than in 2016. Over this period, tenancy ratio has increased to 1.36x, with tenants (other than the anchor-tenant) having grown by 43% since December 2016.

Revenues and OIBDA maintained their solid growth rates in the quarter, posting double-digit rates on a year-on-year basis. Telxius has been able to post mid-to-high single digit growth in revenue and OIBDA (excluding capacity sales at the cable business) for the last couple of years.

We see room for further revenue and OIBDA growth, on visibility provided by an enlarged portfolio, and room for increased tenancy ratio. This should provide clean support to the value case.

Improving Customer Value via Devices

These strong results displayed by regions and OBs are supported by group wide projects, aiming to increase customer engagement, value and efficiency. Today I would like to touch upon three of such projects: device relevance, digital transformation and network efficiency via sharing and legacy switch-off.

Starting with Devices on slide 17 we look in more detail at how we can improve customer value via hardware sales. Handset revenues, that grow by c.a. 17% year-on-year in Q2, already make for 11% of our total revenues. This does not only bring in revenue and OIBDA growth, but also helps to increase customer engagement and loyalty, and accordingly improve customer value. Looking at our own experience and test cases ran in different markets, we can say that customers buying their devices in our channels show lower churn and higher ARPU.

This is a sizeable opportunity, as only 30% of our customers renew their handsets with us. Through Phoenix, our Digital Renewal Program, we are starting to offer our customers a “3-click” app-based renewal process. This does not only increase revenues, as said before. Customer satisfaction improves, and the weight of digital sales in our distribution channels (hence efficiency) increases as well. We are prompting a fast rollout of Phoenix, and the program will be implemented in 9 countries during 2019 (being already active in 5 countries).

The size of this opportunity is not limited to mobile handsets’ renewal only. We aim to optimise our sales cycle, and include other devices, accessories and services, with significant upside in all geographies.

Digital Transformation; evolving customer experience

Slide number 18 shows how we are advancing in our Digital transformation program, pushing for further engagement and efficiency gains.

As such, the execution of the several initiatives set around sales, customer service digitalisation and process automation is translating into a higher use of digital channels, better customer experience and additional savings to the ones captured in 2018. Among other relevant indicators, in the first half of the year digital channels operations are growing 28% from the year before, whilst calls to contact centers are down 12%.

As a result, we are progressing well on track and already capturing at the end of the first half 45% of the targeted savings for this year of more than 340 million euros.

Optimising Networks

Moving on to slide 19 we highlight our focus on optimising networks.

Network sharing agreements are an opportunity to reduce costs and investments while improving coverage and quality.

Our customers will benefit from faster roll out of new networks and we capture resources which may be redirected to other investments. Worth to mention is the exclusive agreement signed in Germany with Vodafone to gain access to their cable networks and the recent agreements signed in Brazil and the UK to share both 2G and 4G and 5G deployments with relevant efficiencies behind. We continue to be open minded analysing any potential opportunity on this front.

On the other hand, we are already progressing in the legacy shutdown, a result of our transformation journey.

In mobile, we are reusing 2/3G spectrum to 4G which has a much higher spectral efficiency. In fixed, investment in legacy technologies are reduced and we are pioneering in the Copper Central offices decommissioning, having closed more than 400 CO's so far in Spain and announced more than 1.5 thousand closures.

All this is part of a 6 year plan (from 2020 to 2025) where we expect OIBDA savings coming from asset sales, energy savings and lower maintenance costs, and CapEx savings coming both from deployment and maintenance.

I now hand over to Laura.

Laura Abasolo – *Chief Financial and Control Officer*

H1 Net Income +2.8% y-o-y to 1.8bn€

Thank you Ángel, moving to slide 20, net income reached almost 1.8 billion euros, up 2.8% versus the first half of 2018 despite the negative impact of forex and IFRS 16.

Earnings per share stood at 0.32 euro cents, 12% more than in January-June 2018, reflecting the good operating performance and efficient financial management.

FX impact neutralised at FCF

FX movements continue weighing as slide 21 shows.

Negative impact of FX was nevertheless reduced in the second quarter due to Brazilian real and Argentinian peso improving trends vs. the first quarter.

Again, it is important to mention that the FX drag is naturally hedged in our business, on local currency spending in CapEx, interest payments, working capital and others. Thus, and up to June, a negative FX impact of 332 million euros at the OIBDA level is mostly neutralised at the FCF level, where we have a negative impact of just 91 million euros.

Regarding net debt, FX helped to bring it down by 49 million euros in the last 12 months rolling.

FCF generation remains strong

On slide number 22, you can see how strong our FCF generation has been over the period. In the second quarter of the year FCF surpassed the 1.3 billion euros mark, to reach almost 2.8 billion euros in the first half, 78% higher than in the same period last year.

This significant growth rate is mainly driven by the better performance of operations, and lower working capital consumption, taxes and minorities.

For the second half of the year, we expect FCF ex-spectrum to improve. As José María mentioned at the beginning of the presentation, FCF remains the sustainable driver for further deleverage.

Steady net debt reduction

Let's now move to balance sheet metrics on slide 23.

We present another quarter of debt reduction, nine in a row, thanks to our strong FCF generation that as mentioned before reached 2.8 billion euros in the first half of the year. Comfortably exceeding dividends, hybrid coupons and commitments while helping to bring down net debt.

Taking into consideration post-closing events, related to inorganic measures also contributing to debt payment jointly with FCF generation, net debt figure would stand at 38.7bn EUR, an implied net debt/OIBDA ratio that comes down to 2.56 times.

Lastly, let me mention that under IFRS 16 net debt would be impacted by 7.5 billions euros worth of leases.

Strong liquidity thanks to attractive long-term financing

Slide 24 presents Telefónica's ample and diversified financing activity totaling 6.4 billion euros year-to-date, contributing to both an extension of our average debt life to more than 10 years, and a robust liquidity position of close to 24 billion euros.

Such financing activity has been executed at historical low interest rates, that has allowed us to bring down our interest payments effective cost to 3.35% as of June 2019, 0.2 percentage points lower than in June 2018.

I will now hand back to José María for a final recap.

José María Álvarez-Pallete – *Chairman and Chief Executive Officer*

Concluding remarks Q2 | Consistent trends

Thank you Laura, to summarise.

Q2 results proved again consistent business trends and execution skills on fundamentals.

We continue putting the best technology at our customers' service, relying on our network leadership, having the world's largest UBB/FTTH footprint (ex-China). This allows for better customer experience and translates into higher revenue per access.

Digitalization also benefits our customer satisfaction, whilst helping through efficiencies to translate top-line growth into improved operating trends.

We can then continue posting good levels of profitable and sustainable growth in revenues, OIBDA and OpCF.

This helps leverage, and we have been able to reduce again net financial debt, for 9 straight quarters already.

And finally, following these results we can also say we are fully on track to meet 2019 guidance.

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

Q&A session

Mathieu Robilliard – *Barclays*

I have two questions please. First, with regards to asset sales. So, you have done quite a number of asset sales in good condition over the last few years and I was wondering if you're reaching the end of that process or do you still think there are opportunities to sell assets that are not earning the desired cost of capital or don’t have the prospect to.

Second, with regards to Spain, I think you mentioned in the presentation that you expect revenues to improve in H2, which is esentially in-line with what you've been saying the past quarters. I was wondering if that statement is true also for the OIBDA. Because I think in the previous quarters, you indicated that you're expecting an inflection in OIBDA in the second part of the year.

José María Álvarez-Pallete – *Chairman and Chief Executive Officer*

Regarding your first question on portfolio optimization. Over the last year, we have reshaped our portfolio actively managing assets and looking for profitable growth. We have been investing since a few years ago in Germany and Brazil and we have been divesting or optimizing capital allocation, like the case of Telxius, Antares, data centres or Central America improving ROCE.

We are consistently reviewing our portfolio. And in fact, we have classified all our assets, geographies and infrastructures in 3 categories in order to project this ROCE evolution. And we are benchmarking the ROCE derived from the organic management with any potential inorganic opportunity. And that's why we have been taking the decision of divesting in Central America.

At the same time, we have been able to reinforce our balance sheet for 9 quarters in a row, thanks to organic free cash flow generation and this inorganic move. And as a result we don't feel forced to sell assets anymore just for deleveraging purpose. We will do so in order to try to optimize return on capital employed.

We have a balance sheet that totals €123bn and therefore we think we still have room to optimize return on capital employed. So, you should expect from us to stick to this classification of assets into these 3 categories: the ones that are core, the ones that are to develop and the ones that are to divest. And that includes geographies, infrastructure and products and services. And therefore, we are not in a rush, but you should expect from us to keep doing very selective and very focused on return on capital employed and therefore we still think we have room to grow on this portfolio optimization.

Ángel Vilá – *Chief Operating Officer*

First, I would like to highlight that service revenues have been growing for 8 consecutive quarters in a row in Spain. Across components, (as I said in the presentation, but I want to reiterate), B2C will return to growth in H2 with accelerated growth on better comps, a solid convergent ARPU uplift coming from the tariff upgrade effective now in the summer, the end of the promos of last year football season and improved trading. In B2B, growth is also expected to accelerate in H2 once the punctual impacts of the second quarter are behind us. Wholesale and others is growing nicely, we expect similar trends. So, Q2 is expected to be the lowest y-o-y growth in service revenues in Spain and we will recover stronger growth in the second half.

Then, moving to OIBDA. In the second quarter what we have seen is OpEx going up due to higher cost of TV content and IT, offset by lower personnel and commercial costs. When we look towards the second half of the year we are going to have lower y-o-y growth in net content costs comparison in this H2 vs. H1. We have further efficiencies in commercial channels, call centres, network and IT costs from digitalization and automation, which will allow us to continue posting benchmark margins.

OIBDA margin has improved 1 p.p. from Q1 to Q2. And we expect to have margins in the second half of the year broadly similar to the average margins of the first half. So, this means (as we have said before) that we continue to aim towards not declining OIBDA in Spain in 2019, which would be an achievement not seen for the last years. So, we continue aiming towards OIBDA not declining in Spain.

Jakob Bluestone – *Crédit Suisse*

Firstly, just staying on Spain, where as you just pointed out Q2 was a slowdown in terms of service revenue growth and you mentioned during your presentation that this is largely ARPU driven. Can you maybe give a little bit more colour on the deterioration in the ARPU? So convergent ARPU went from growing slightly to shrinking slightly. Could you maybe just sort of help us understand how much of that is comps, how much of that is competition picking up, how much is dilution from the no-frills brands or other factors? Just to sort of help us understand a little bit what lay behind that slowdown in ARPU. So that's the first question.

And then just secondly, I mean, you obviously in your presentation mentioned optimizing networks and I'm just sort of be interested if you can update us on your thoughts on tower sales across some of your key assets. What's your sort of thinking on that?

Ángel Vilá – *Chief Operating Officer*

On the first question, let me talk about all the moving pieces in the convergent portfolio. The convergent performance is measured by several KPIs; the customer base, the mix of the base, the churn and the ARPU that you were asking about.

On the customer base, we are sustaining the commercial momentum, the customer base in convergence is up q-o-q and y-o-y (+4.1%). We have 22.8m accesses and 4.7m customers.

The mix also remains attractive and skewed towards the higher value packages, which account for 28% of the customer base, up 1% y-o-y.

Fusion churn has improved significantly from 1.7% in Q1 to 1.46% in Q2.

And regarding the ARPU, it stands at €88.5 which is up sequentially 0.3% q-o-q but is down y-o-y on the following factors: we have a positive impact from tariff upgrades, but the different calendar and the different size of the tariff upgrades is weighing on this y-o-y comparison; we have a positive impact from upselling; we have a dilutive effect from promos that have taken place in the last 12 months; we have also had a dilutive effect from mobile add-ons migrating to Fusión multiline packs and less out-of-the-bundle; and we have a dilutive effect from the multibrand convergent offers. We are not only offering convergent propositions in Fusión but also in O2. ARPU ex-O2 would be growing y-o-y.

José María Álvarez-Pallete – *Chairman and Chief Executive Officer*

Taking your question on mobile networks, 5G, and towers, potential network sharing. Well, first let me remind you that at a group level, we have roughly 130,000 sites. 90,000 just on LTE. And therefore, we have probably one of the largest if not the largest UBB fiber network in our territory. So therefore we still have a significant room to go in order to enhance return on capital employed by network sharing.

Focusing on towers, I mean if we were to focus for example in U.K., CTIL owns and operate roughly 18,500 towers and already has 2 large tenants customers of high financial profiles such as Vodafone and ourselves. Therefore, and in the current market environment, it has a significant intrinsic value and we and Vodafone are aligning our intention to crystallize that value. We think that tower sales are probably no longer an effective way of executing such transaction because with the new accounting standards, it becomes a very expensive way of financing. And therefore, we think there are other more effective way of executing such a transaction. But if you add to this amount of towers in the U.K. the fact that Telxius owns and operate roughly 17,550 towers and we have 20,000 towers just in Germany, you will have a better idea of the value that such an asset could have and the potential value creation and debt reduction if we were to share and crystallize the value of those assets. So, you should expect from us to be very focused on optimizing this value, and at the same time preserving our competitive advantage, wherever we have that competitive advantage. So yes, you should expect us to be very active on those fronts.

Georgios Ierodiaconou – *Citi*

Thank you for taking the questions. I have 2, and actually most to follow up. I'd be interested if you could perhaps link the discussion around network sharing with some of the disposal options you have available? In particular, if you could give us a bit of an idea around the agreement you have in Brazil with TIM whether that could be replicated in the rest of the footprint. And how that links then with any monetization options you have or on the tower side.

And then my second question is around network virtualization. And you've been obviously talked about turning off 3G in Europe in the next 2 or 3 years. If you do 2G sharing with other operators and network virtualization. I just wanted to get an idea of what is the path that you see in the coming years in reducing perhaps both the cost and capital intensity of the industry if there are any numbers you could give us if there are concrete numbers that are out and sound credible to you. Any help with that will be appreciated.

Ángel Vilá – *Chief Operating Officer*

We announced an MOU in Brazil with TIM but open to other parties that has the objective of improving return on capital employed with allocating CapEx smartly by 2 ways. First, deprioritizing legacy technologies and second, sharing the cost of investment in new technologies or higher return technologies. So, one leg of this agreement is a full 2G network sharing in a single grid format with the objective of switching off 1 of the 2 networks or (if other people want to join) additional networks in each one of the regions. This is clearly on the way of deprioritizing and making more efficient the return on legacy technologies. This can be extended to any and all geographies in our footprint. The second leg of the agreement that we announced in Brazil is sharing the deployment of 4G at this stage in a subset of cities.

This has to be developed over the next 90 days between the parties, then has to be approved by regulators and depending on the result of this analysis this could be increased to more cities than the ones that are originally ambitioned. We also contemplate (as a result of the work in the next 90 days) opportunities to share in other frequencies and technologies. But here, we will as always be looking not to give away where we have a technological advantage. And we will also include reduction opportunities regarding operations and maintenance across the networks of the different players.

So, this is both on deprioritizing legacy technologies and on making more efficient investments in new technologies.

José María Álvarez-Pallete – *Chairman and Chief Executive Officer*

Taking your second question. As a sector, we think we have a significant opportunity to enhance ROCE through network sharing. Every network element that does not represent a commercial competitive advantage is a candidate for sharing. That includes infrastructure, access, transport or roaming agreements: those are all different alternatives that can offer a full range of possibilities. Passive or active sharing are both to be considered depending on markets and the relative market share that we have. It makes no sense to be ready to give access to our brand-new fiber network because it represents an opportunity to accelerate returns, and at the same time to preserve four or five 2G or 3G networks per country. It makes no sense to start deploying 5G without radically simplifying through network sharing legacy technologies. And it is in this framework that you should read all the agreements that we have signed with Vodafone, TIM or the citing one with Millicom in Colombia. And we are working as we speak on several other projects of the same kind.

In terms of virtualization for 5G namely, there are 2 parts of virtualization. The Core virtualization or the RAN virtualization. Core is more advanced, and we are probably market leaders in that regard with our UNICA technology. And therefore we are also collaborating with suppliers and with some of our competitors to see which part of the 5G deployment we can optimize, but also sharing that part of that virtualization which, again, doesn't represent a commercial advantage. And then on RAN, it's going to be depending on the evolution of 5G and therefore the view that we have on non-standalone 5G or standalone 5G. But as a summary, we think that going forward there is a significant opportunity of enhancing returns through sharing and it is an absolutely no-brainer to share legacy technologies and to decommission as many networks as we can that are not sustainable for the future. And this should represent a significant efficiency opportunity going forward. And on that regard, it's not just mobile networks, also fiber networks are going to be essential, and remember that we have the largest fiber footprint and therefore accelerating the decommissioning of copper namely in Spain presents a significant efficiency opportunity.

Georgios Ierodiaconou - *Citi*

If I could quickly ask a follow-up around Brazil, I'm guessing you have similar discussions for a single 2G grid in other countries. Why has Brazil been successful in the negotiation while other countries haven't reached that an agreement yet?

Ángel Vilá – *Chief Operating Officer*

Well, Brazil has announced a MOU. They will be now developing it over the next 90 days. You need a willing partner, TIM has shown lots of interest, but you should expect us to be looking at this type of agreement in each one of our geographies. So, we'll be working and, in due course, presenting to the market our progress on this front. As José María has said, it's a no-brainer.

Michael Bishop – *Goldman Sachs*

Just moving to Spanish content, as you go into the football season and we just had the Orange's talking about potentially promoting more, it would just be good to get your high-level thoughts on how their content strategy has evolved over the last year and the sort of attach rate you're seeing from content customers that you're winning back from competitors.

And then secondly, just moving to the U.K. performance. I was just wondering if you could give us any indication on how much of the performance is being helped by the Sky MVNO. At least locally it feels like Sky is really pushing mobile and that should be benefiting your trends.

Ángel Vilá – *Chief Operating Officer*

On Spanish content, one year ago there was a lot of concern about the purchase of the sports rights, the cost of those, whether we would be able to wholesale them, the potential to attract retail customers from those players not taking the content…

Well, what we can say is that one year after we are stronger. We're in a much better place. We have been able to capture customers above the initial expectations we had, from players that didn't have the football. These have been customers that have come with ARPUs higher than our average ARPU. And both, in the base but also in the new customers that we have acquired, what we see is that these are customers that have significantly lower churn rate.

Now we're getting to the third quarter scenario in which we're going to start a new season of La Liga. Last year, Vodafone managed to retain a certain number of customers because they still had 8 weekly games from La Liga. From this month of August onwards that would not be the case. So, football fans that stayed with Vodafone will have to look for football elsewhere. And we have control of the whole premium football rights which we have packaged now into one La Liga package, not anymore separating the best match of the week and the others, including the second division. And then we have the Champions including Europa League.

So, we believe that there's going to be an active and dynamic "back to school" time, no doubt. Maybe promotional intensity could be lower than what was in last year.

Michael Bishop – *Goldman Sachs*

Yes, the second question was just around the impact of the Sky MVNO on the O2 U.K. performance, because it feels like at least locally in the U.K. Sky is pushing quite aggressively on mobile.

Ángel Vilá – *Chief Operating Officer*

Well, you have seen the results of our U.K. operation which is having one more quarter of very robust results outperforming the market.

And this is resulting in strong commercial traction, it's resulting in single-digit or high single-digit increases both in revenues and OIBDA. This is coming mainly from our own commercial activity. And I'm afraid we cannot, due to the agreements we have signed in place with Sky, disclose figures regarding that MVNO relationship. You should have to ask them directly, I'm sorry.

Akhil Dattani – *JP Morgan*

I've got 2 follow ups as well please. The first was just stimulation to some of the comments you've been giving around network virtualization and tower sharing. If I understand correctly what you're saying, correct me if I'm wrong here, it sounds like you're saying that you're increasing the view that network differentiation is maybe not as, let's say, core in the way it once was perceived. You don't need to own all the different components to differentiate your network and also there are many different parts which should be happy to share, divest, etcetera. I guess what I'm trying to understand is as we look at the business going forward, what do you think are the key pillars to differentiating? I mean is the network still as core as it once was or is in Spain contents one of your key pillars to differentiating this digitalization, so there's a lot of different pillars there. How do you think about differentiation in trying to protect your business and growing going forward? That's the first question.

The second one just really following up on the various topics we've been discussing in Spain. Midterm you have been doing much better than your peers. Obviously you're confident on H2. But the broader question I guess on Spain is if we look at the Spanish market versus the rest of Europe, one of the big differentiating points is that the deployment cost of infrastructure is much cheaper. It's been one of the big advantages that you've had in terms of your capital intensity. How do you think about your ability to protect your business against that backdrop? Obviously, we've got change of management in Euskaltel where they seem to want to go national. You've got MasMovil being aggressive and you've got Vodafone struggling a lot in that market and Orange also had bad numbers this morning in Spain. So, I guess I'm just trying to understand differentiation in Spain and how do you maintain and protect your returns.

José María Álvarez-Pallete – *Chairman and Chief Executive Officer*

Thanks for your question. I will take the first one on network virtualization and network sharing. We do think that network is a key differentiating factor. And in fact, we have been pretty consistent on that because we have invested roughly €29bn in CapEx during the last 3 years and therefore we are going through one of the highest CapEx investment cycles in the history of Telefónica. As a result of that we have built the largest ultra broadband network outside China. We have doubled the number of LTE sites. We have doubled the number of customer base in ultra broadband. We have more than doubled our LTE customer base. And we have built the largest Spanish-speaking Pay TV platforms. So, we do think that network is a key differentiating asset and we are investing very heavily in transforming our network from legacy networks like copper or 2G or 3G into state-of-the-art large generation IP network that are ready to be virtualized and subject to be run through artificial intelligence.

The factor that we stress around network sharing is the fact that it makes no sense to have 4 or 5 antennas in each roof when you can share and therefore that's not a differentiating factor. And it makes no sense to preserve four or five 2G or 3G networks in every country when you can move the traffic, namely the data traffic from those networks into 4G or to-come 5G networks. So, we think that you need to preserve network differentiation when you have a competitive commercial advantage, but every other part of the network (was that to be infrastructure, was that to be backbone, backhaul) that is not a differentiating factor is a candidate for divesting. Because it makes no sense to invest in 7 different mobile technologies at the same time because that would significantly affect return on capital employed. So, my point is that network differentiation is a key factor, but multiplying the number of networks by 4 or 5 when you don't have a competitive advantage makes no sense, and namely on the legacy part of the network. So, we are investing very heavily, and we will keep doing that in order to preserve that competitive advantage. But we will be sharing anything that is not differentiating us from our peers. I hope that answers your question.

Ángel Vilá – *Chief Operating Officer*

Regarding how we're differentiating and keep differentiating in Spain, this has different components on the different segments. So, for instance, on B2C, what we see is a market which is increasingly segmented and polarized as a consequence of the high convergence penetration. So, you have a low end which is significantly more crowded with 4 national players present, sometimes with multi brands, with MVNOs and local players. But then you have the medium to high end which is where we make most of our revenues and OIBDA, which is less crowded, is more rational, this requires larger investment, spending in network, quality IT services, contents and functionalities. And here we have those differentiating capabilities which allow us to continue applying a “More for More” strategy, which by the way is also being applied by competitors. Orange raised prices in both Orange and Jazztel brands, Vodafone when they revamped their portfolio are also doing “More for More”. Másmovil and Yoigo have been applying “More for More”. Euskaltel, you talked about them, they have raised prices in services of different brands.So B2C, a market which is more segmented, convergent, more polarized and where we hit much higher in revenues and OIBDA than our share in accesses.

In B2B, we have a very strong position in Spain. We are a clear market leaders. Here we are focusing on digital transformation and helping our customers to transform digitally. And here being able to provide services like security, cloud, IoT, big data, digital workplaces is something that differentiates us from our competitors, and it's allowing us to have the performance that you've seen with the business growing for the last 5 quarters.

And then the third component is wholesale and other where our base of fiber that we are wholesaling (and our NEBA figures are growing significantly and they are obviously revenue accretive to the old copper), and then, the further wholesale of content that we have are going to trigger our ability to differentiate us from our competitors. A competitor of us presented results this morning had been growing in previous quarters on the base of wholesale revenues that has been slowing down and for us it's accelerating.

So, we continue to be able to differentiate after having invested substantially in our business in all the platforms.

David Wright – *Bank of America Merrill Lynch*

A couple of questions. Firstly, just on Spain, I just wanted to get my understanding was right, just reviewing I think one of the earlier questions.

So, we could expect the revenues to accelerate or to return to growth in H2. B2C & B2B a little better, wholesale similar. And you're also saying net content cost growth also slows. So, I'm wondering why if you're getting some relief from the pricing on the content costs, that you're only really expecting margin to be broadly similar. Why wouldn't it be better? And I'm really sorry to struggle with “EBITDA not in decline”. Does that mean stable? Does that mean growth? “not in decline” I'm struggling with.

My second question, just a little bit more higher level, probably José María. You've seen a fairly precipitous drop in the share price of your German subsidiary over the past few months. And I think do you guys look at that and consider that in the whole framework of asset divestment but also asset acquisitions? Could there ever be an opportunity to take advantage of that share price and perhaps even look to buy more shares in the market, or even consider acquiring minorities given that the market, I'm sure you would feel, doesn't value that asset correctly?

Ángel Vilá – *Chief Operating Officer*

Hi David, on the first question, again I reiterate that we expect acceleration of service revenue growth in the second half compared to what we have seen in the first half. And regarding the margin, you have different moving pieces. There will be lower y-o-y growth in net content cost in the second half versus the first half, but still some growth in the gross cost. The efficiencies from the people plans that we have been applying in the last years have peaked in the first half of this year. That is, with the current or existing plans those are not going to be improving or adding additional savings to the ones that we have achieved because we are already in the run-rate. So, we have different moving pieces.

For us, we have been able to achieve in the second quarter an improvement of 1 p. p. in OIBDA margin to 39.8% organic ex-IFRS 16, which is remarkable, maybe we could have expected this to be a bit lower. So, what we see is that what we are achieving in the second quarter is again back to the pre-IFRS 16 levels, around or very close to 40%. It’s a very strong OIBDA margin. So that's why we say that we expect margins to be broadly on that level.

And then, we expect OIBDA, which has been declining in Spain since 2009, not to decline in 2019. We have been declining for a decade in revenues. Last year 2018, we started increasing revenues in Spain and in 2019 we are accelerating the increase of revenues. And what we're aiming to do is to revert the trend in OIBDA and what we saw as declines. So this could be stable, or very slightly positive OIBDA for 2019.

José María Álvarez-Pallete – *Chairman and Chief Executive Officer*

Taking your question on Germany. Telefónica Deutschland share price has been affected during the last months by mainly 3 factors, I would say.

First is the KPN sell-off, that now it's over, but that has been pretty consistent and affecting the share price evolution during the last months or quarters.

Second was uncertainty around the German auction. I mean, what would be the outcome of the German auction in terms of how much spectrum we will be gaining out of the auction. And if that spectrum would be enough to maintain our performance. And I think that concern is now over as well.

And the third would be the potential fourth MNO.

All those concerns are progressively fading away and most of them were addressed yesterday by our team in Germany during their conference call. So, we think that the share price of Telefónica Deutschland should evolve positively going forward.

We are happy and strongly committed with our stake in Telefónica Deutschland. And we are deep believers on Telefónica Deutschland's intrinsic value. So for the time being, we are comfortable with the stake that we have.

Keval Khiroya – *Deutsche Bank*

A follow-up question from Spain. You mentioned the high-end accounts for 28% of the average customer base, up 1 p.p. from the prior year. Could you tell us how the low and mid-end segments have compared vs. one year ago as well? And, would you also be able to comment on how large the O_2 base is now, last quarter you did say it was 50k to 60k subs.

Ángel Vilá – *Chief Operating Officer*

The high-end, which is ARPUs of €140, what we call the package "Fusión Total", is 28%. The mid-end, which is average ARPU of €85, is 32%, was 41% one year ago. And the low-end, which has ARPUs around €60, is 40%, it was 32% a year ago. So, the ARPU that we call low-end is the average ARPU of the operator which is closest to us. So, one has to bear in mind that we are using this terminology of high, mid and low-end, but low-end for us is the average ARPU for our closest competitor. And this is the result of our "more for more" strategies. We are describing these segments according to which package is going to each segment, but the average ARPU of each one of these segments (high, medium, low), has been going up in the last year. So, this is the detail.

And regarding O_2, we have over 100k fixed broadband subs, over 185k mobile subs at the end of Q2, and we have the lowest churn at 0.8%.

Carl Murdock-Smith – *Berenberg Bank*

I've got two questions on the UK

Could you help us split on the "Handset and others" growth between handsets and the smart metering program? Are you able to give any colour regarding how much of the revenue growth you're getting from that smart metering program and how much of the growth is that and how long will it continue to be a growth driver before starting to flatten in time?

And then secondly, again in the U.K. in terms of the OFCOM pricing review, how much will it cost to reduce out-of-contract customers to the equivalent 30 days SIM-only deal, and just likewise, why have you only committed to do that for direct customers and not contracts taken out with third-party retailers?

Ángel Vilá – *Chief Operating Officer*

The first thing I would like to say is that mobile service revenue as a metric is now less comparable and applicable in the U.K. due to the increasing range for propositions that we have in the market. Basically, "Custom" plans which are selling the device along with a plan. This has 36-months life and this results through the new IFRS accounting into a reclassification of revenues into mobile service revenue and hardware.

So, what we are focused on is looking at the total revenue figure. And here also what we're looking is about the growth of our base, the top-line and the bottom-line growth of our U.K. operation. And all three of these have been growing in the first half. What we see is a very strong traction of “Custom” plans, which is allowing us to capture value and outperform the market, and for an accounting issue, we're not going to slow down our commercial performance.

SMIP is also adding to the growth in our revenue in our U.K. operation. We at this stage cannot disclose the detail on how much it is accounting.

Carl Murdock-Smith – *Berenberg Bank*

It was asking around OFCOM and the actions they're doing at the moment regarding pricing reviews in the U.K. So O2 the other day announced that at the end of mobile handset contracts that you would reduce the pricing of customers automatically to the equivalent 30-days SIM-only deal. But it was also announced that you'd only be doing that for customers that you sold to directly, and not for contracts taken out with third-party retailers. I'm just wondering why that decision, the kind of favourable pricing move, was made only for direct customers and not for those that you sell to through third parties.

Ángel Vilá – *Chief Operating Officer*

In the U.K. in direct channels, we already sell handsets and service into different contracts. So once handset contract is finished, we no longer charge for the handset. So, this has been a very clear and transparent proposition from our U.K. operation. And I think that this differentiates us from some of our competitors. So, we will not be expecting any impact from this.

Mandeep Singh – *Redburn*

I'd like to come back to the German question in a different way, similar to what David asked however. Obviously if you look at sort of capital allocation when you look at your portfolio of assets, you are leaking about €250m of a 12% dividend yield from Germany to minorities. I mean, you made so many great efforts across your portfolio to optimize returns. How is that an acceptable “allocation of capital” to leak that much dividend from Germany, which has negative bond yields, to minorities?

José María Álvarez-Pallete – *Chairman and Chief Executive Officer*

Well, thanks for the question, and we rank the capital allocation decision on the different returns, and therefore, we prioritize the ones that have a highest returns. So, from the time being, we think we have better options that go before the ones that you were mentioning. We agree and as I was saying before, it's not just a question of financial or cash returns or of the dividend leakage. It also has to do with the relative value of the different assets. So, it is in our radar, but we have priorities that go before the one that you were mentioning.