Telefónica January-September 2019
Results Conference Call Transcript

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Introduction

Pablo Eguirón – *Global Director of Investor Relations*

Good morning, and welcome to Telefónica's conference call to discuss January-September 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 third 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 Chief Operating Officer, Mr. Ángel Vilá.

Presentation

Ángel Vilá – *Chief Operating Officer*

Q3 overview | Advancing on strategy execution

Thank you, Pablo. Good morning and welcome to Telefónica's third quarter results conference call. Today with me is Laura Abasolo, Chief Finance and Control Officer. Following our presentation, we will host a Q&A session and invite you to ask any questions you may have.

We are pleased to present a solid set of results, advancing on our strategy execution, as summarised on slide 1:

First, we continue gaining relevance. Through larger and technologically more advanced networks. We are UBB leaders in Spain and Latin America, already accessing 123m premises passed worldwide, of which 54m with our own network. On top, we are number 1 in virtualisation, with approximately 100m customers already in Full Stack, and artificial intelligence.

This makes us more relevant to our customers, which are more valuable and loyal. Churn comes down, and average revenue per access grew 4.3% year-on-year in the quarter.

Second, we deliver sustainable and profitable growth. Revenues are back to reported annual growth in the quarter at +1.7%. Organic OIBDA grew c.a. 1% year-on-year, with even stronger FCF growth in the first 9 months up +40.3% year-on-year.

And third, we remain focused on improving returns. Through being simpler and more efficient, and via enhancing our financial flexibility.

We continue switching off legacy (more than 400 copper central offices closed so far in Spain), and during the last few months we have signed sharing agreements with TIM and American Towers in Brazil, and with Vodafone for mobile in the UK and cable in Germany.

Balance sheet wise, this is the 10th straight quarter of net debt reduction, with average debt maturity at above 10 years. Let me conclude saying that portfolio management remains a core focus to further improve our returns going forward.

Accelerating strategic actions in Q3

As shown on slide 2, we are accelerating strategic actions.

We are executing on efficiencies: Spain's new workforce restructuring Program will result into direct annual savings from 2020 of approximately 210 million euros. 80% of the group's annual target of digitalisation savings for 2019 have already been achieved to September. And the copper network' switch off in Spain progresses well, with 157 central offices' closed in the quarter and ~2k expected by 2021.

Second, on portfolio management: monetisation of the mobile telco infrastructure is a priority for the next months and we have just started with tower sales during this quarter in Spain, Peru and Chile to Telxius. Brazil, Germany and UK are to follow in the coming quarters.

Third, we are reaching agreements with new partners to further enrich our value proposition. We created a 50/50 JV with Prosegur, a growth opportunity in the residential/business security services market. We have announced, as well, the creation of a 50/50 joint venture with AtresMedia to produce and distribute Spanish fiction series for both companies and third parties.

And fourth, we are introducing new alternative models to accelerate fiber expansion with less CapEx and reduced time to market. As such, we signed a partnership in Brazil with American Tower and are franchising through the Terra brand.

Key operating metrics

Key operating metrics are shown on slide 3,

Robust momentum continued in high-value accesses, with double-digit increase in both FTTX/Cable and LTE. Fiber penetration over FBB has reached 67% (it was 59% a year ago) whilst LTE over total mobile stands at 54% (44% a year ago). This back both a 4.3% increase in the average revenue per access, and 20 basis points of churn sequential improvement.

All helping to make our business more sustainable, via increased customer lifetime value, which exceeded 8 years for our UK mobile contract customers, and 5 years for our Spanish Fusion clients.

Key financial metrics

Turning to slide 4, we summarise this quarter's key financial metrics.

I would start by mentioning that third quarter reported figures include a significant provision in Spain, related to the mentioned workforce restructuring, as well as other non-recurrent factors, that Laura will explain in detail later on. FX and negative effects from regulation also impact reported figures.

Revenues surpassed the 11.9 billion euros mark in the quarter, showing both organic and reported growth. Underlying OIBDA exceeded 4.2 billion euros and organic OIBDA grew 1.1% up to September.

FCF generation remains solid, totalling 1.4 billion euros in the quarter or 4.1 billion euros up to September.

Underlying Earnings per Share reached 0.47 euros per share.

Finally, noticeably net financial debt decreased 8% in the last 12 months to 38.3 billion euros.

Right on track for 2019 guidance | 9M in line with expectations

Let's move to slide 5.

We are right on track to fulfil our 2019 guidance, as our 9 months results are aligned with internal expectations. We expect to exceed the revenue guidance. Q4 OIBDA is expected to be solid across regions, and we reiterate our full year goal of growing organically around 2% OIBDA level.

As for the first tranche of 2019 dividend, 0.2 euros per share in cash, it will be paid on the next 19th of December.

Solid fundamentals

On slide 6 we go through growth trends in Revenue and OIBDA during the quarter, consistent with our solid fundamentals. Latin America remains a key growth contributor, with Europe improving its momentum, driven by improvements in Spain and Germany and solid growth in UK.

Revenue mix continues its transformation process, with 55% of revenues already coming from broadband and services beyond connectivity, 2 percentage points higher than a year ago. Digital revenues increased 17.4% vs Q3 18 in organic terms, whilst B2B sales maintained momentum at +3.7%. All supporting our sustainable growth trends.

OIBDA improved trends in Q3 in main markets, like Spain, Germany and Brasil, while maintained a very strong performance in UK.

B2B | Growth momentum

Moving to slide 7, the B2B segment, which is 20% of Group revenues, keeps its momentum with a low to mid-single digit revenue growth in both Europe and Latam.

Our strong and flexible portfolio and customer focus set us in a privileged position to gain relevant deals and increase customers' satisfaction.

As a key partner for the digital transformation of corporates, B2B digital services deliver solid revenue growth of 29% year-on-year to 1.6 billion euros in the first nine months, mainly in Cloud, IoT and Security, where we enjoy a distinctive profile.

B2C| Data-centric value proposals

Turning to slide 8,

In the B2C segment, we aim to maximise data monetisation applying innovative pricing models such as the new flexible data and handset offer in Germany, or the unlimited data offers launched in the UK aimed at blended ARPU increase.

Our device integrated offer plays a key role to foster handset sales, being remarkable our handset renewal program "Phoenix" based on AI and already launched in 7 countries, with very positive results so far.

At the same time, we have identified five key spaces to develop our consumer portfolio leveraging our global service and technological platforms. Those 5 spaces where we will focus our efforts are: "My Digital Telco", "My Entertainment", "My Things", "My Home" and "My Financial Services". Specifically, and within "My Entertainment", we have proven to increase Video engagement while growing ARPU and loyalty, with continued IPTV and OTT growth reaching 10 million video accesses as of September.

Leading-edge technological platforms

Moving to slide 9,

We continue working on our platforms' strategy.

On the 1st and 2nd platforms, we have the largest UBB footprint outside China (123 million premises and 54 million own) and a leadership position in FTTH coverage which, coupled with more than 2/3 of our processes already being digitalised, set us ahead of the pack for 5G.

In the 3rd platform, we are capturing the digitalisation opportunity and we have already created several unicorns of Digital services, delivering roughly 2 billion euros revenues per quarter with a 17% year-on-year growth.

Lastly, our 4th platform enables the application of Artificial Intelligence to improve the customer experience, revenue generation and efficiencies through different projects.

Digital Transformation at the core

Slide 10 shows the progress done with our Digital transformation plan.

Digital sales increased 27% vs the first nine months of 2018 with more personalised offers thanks to Data Driven models. Cognitive contact centres and digital channels are being increasingly used, and a very ambitious Processes Automation program continues to be deployed, all resulting into lower commercial costs and higher customer satisfaction.

All in all, Telefónica has already captured 80% of the more than 340 million euros targeted E2D digitalisation savings for 2019.

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

Laura Abasolo – *Chief Financial and Control Officer*

Spain | Solid value strategy

Thank you Ángel.

As shown on slide 11, our successful value strategy again allowed us to reinforce our leading market position.

Within an increasingly segmented market, our strategy, leading services and content proposal, which results into a higher value customer base, continued to deliver growth. We offer increasingly more services to our customers, and total convergent accesses grew 5% year-on-year in the third quarter. At the same time ARPU grew 1.7% year-on-year, to EUR 90.6, the highest ever.

Moreover, our differential assets, namely our FTTH network, increasingly delivers returns on the retail and wholesale businesses, with a combined 28% uptake.

We continue working to enhance and segment our value offering including adjacent services and tapping new sources of growth. As such, we have added “2nd Home”, “Movistar Car”, “Movistar+ Lite” and others to our portfolio of products. And over the next few months we will start offering home security and insurance services to our customers.

Spain | Strong improvement in Revenue and OIBDA trends

We now move to slide 12, where we show the marked improvement in growth during this quarter. Service revenue grew for the ninth consecutive quarter, up 1% vs Q3 18. The sequential improvement was mainly driven by convergent revenues, that grow 5.4% year-on-year, from 2.9% in the previous quarter.

OIBDA posted as well a better year-on-year performance in Q3 (+1.8 p.p. vs Q2) reflecting the growth in retail revenues, lower football net cost increase and higher commercial costs reduction (resulting from our digitalisation program).

Worth to note, we booked in the quarter a 1.7 billion euros provision in personnel expenses mainly related to the voluntary “employment suspension plan“ we already shared with you. This plan will allow us to capture a run-rate of direct savings of approximately €210M since 2020.

As such, operating cash flow amounts to 2.6 billion euros in 9M with further efficiencies already in the pipeline.

Germany | Robust commercial performance

Moving to slide 13,

Telefónica Deutschland delivered a robust commercial performance in both own brand and partners with 392 thousand contract net adds. Customer experience continued to improve and its “O2 my app” was well recognised in the latest connect test with a “very good” rating.

Revenue growth sequentially improved by 0.3 percentage points to 1.9%, mainly driven by the good traction in retail resulting in an accelerated MSR growth of +1.6% year-on-year. Thus, OIBDA reduced its decline by 1.0 percentage points quarter-on-quarter.

Nine-month CapEx continued to phase-out and increased by 5.7% year-on-year, further enhancing customer experience.

UK | Continued strong financial and operational momentum

Moving to slide 14,

O2 remained the largest mobile network operator in the UK growing its customer base by 6%, with positive net adds across all customer segments: contract, prepay and MVNO. It is also worth highlighting our successful 5G launch including unlimited data offers in mid-October.

Revenues delivered a healthy growth of 4.1% year-on-year mainly supported by both, the innovative "Custom Plans" proposition and SMIP.

As a result, OIBDA strongly grew by 5.7% year-on-year.

In the first nine months, OIBDA minus CapEx increased by 6.2% year-on-year while investment continued in customer experience, network and the foundation for 5G.

Brazil | Gaining customers & growing ARPU

On slide 15, we start reviewing our Brazilian operation, where we have again improved our subscribers quality mix, leveraging on our best-in-class networks.

We have strengthened our leadership in the mobile arena reaching a market share of 32.3%, almost 40% in contract, thanks to our differential assets and customer experience excellence.

As for the fixed business, the ongoing transformation process continued with the acceleration of the FTTH deployment, having already passed 10m homes. In addition, and as already mentioned, we are implementing alternative FTTH expansion models, through partnerships and franchises, which will further enhance our reach with very limited impact on CapEx, whilst contributing to reduce our time to market. This will allow us to gain further exposure to the large FTTH opportunity in the Brazilian market.

As a result of this growth in value, we continued showing ARPU increase in our main services: +5% in mobile, +12% in FBB and +4% in Pay TV.

Brazil | Largest revenue growth in 15Qs, record-level margins

Moving to slide 16.

Revenue growth accelerated significantly to +3% year-on-year, largest growth seen in 15 quarters, thanks to our successful M4M strategy in both contract and prepaid. Fixed revenues remain affected by the legacy businesses, however fiber and IPTV once again posted sound growth, allowing us to confirm that we are on the right track to stabilize overall fixed revenues in the next few quarters.

As regards FCF evolution, it increased by a remarkable 15% year-on-year in the first 9 months, thanks to the OIBDA margin expansion, leveraged on digitalisation and simplification, and despite the acceleration in CapEx driven by the ongoing business transformation.

Hispam | Accelerating growth in value; contract and FTTx

Next slide shows the review of our Hispam operations.

In South Hispam, we maintained solid revenue and OIBDA growth, in line with previous quarters, thanks to growth in contract and fiber accesses, progressive tariffs' update and the improvement showed in Perú, where we returned to positive revenue growth after 2.5 years of revenue contraction.

In Hispam North, financials continued to be affected by Mexico, where OIBDA is highly impacted by the recognition of spectrum fees as OpEx, overshadowing the sound commercial performance across the region. It is worth highlighting contract net adds in Colombia, that hit a record high for the last 15 quarters, along with the sound growth in prepaid and contract accesses in Mexico.

Telxius | Accelerating tower expansion, increased cash visibility

On slide 18 we show Telxius' progress during the quarter.

Tower portfolio has increased with the acquisition during this quarter of 432 towers in Spain, Peru and Chile, to a total of 1,090 towers acquired so far in 2019. On top of acquired towers, Telxius has built 316 new towers during the first nine months of the year.

All the above translates into a tenancy ratio of 1.35x at the end of September. Worth highlighting that YTD the increase in the number of tenants other than Telefonica has grown by 28% year-on-year.

Revenues and OIBDA continued growing at mid-single digit year-on-year in the first nine months, although affected in the quarter by the seasonality of exceptional capacity sales in cable. We continue seeing ample room for further organic growth going forward.

Q3 OIBDA & Net income | Non-recurrent factors

Turning to slide 19, we detail non-recurrent factors in Q3 reported results, which impact negatively OIBDA by 1.5 billion euros and net income by 1.2 billion euros. These relate mainly to:

- Restructuring costs of 1.9 billion euros, mainly in Spain, that will enhance future profitability.
- Capital gains of almost 400 million euros from the sale of both Telefonica Panamá and 9 Data Centers.

Currency headwinds minimised at FCF level

Moving to slide 20,

Currencies continue to weigh negatively in Q3, but lowered their year-on-year drag due to easier comps for the Brazilian currency. As such, forex deducted 1.5 percentage points to OIBDA variation in the quarter (3.2 percentage points up to September).

In the first nine months of 2019, the 391 million euros negative impact in OIBDA is reduced to 160 million euros negative hit at the FCF level, as forex also reduced CapEx, taxes and minorities.

As regards net debt, FX had barely any impact on a 12-months rolling basis.

Steady net debt reduction

Let's now move to balance sheet metrics on slide 21.

Our net debt further comes down this third quarter, to a total decline in the first nine months of the year of €2.8bn to 38.3 billion euros. This has been driven by strong FCF generation, that shows an impressive +40.3% year-on-year growth to 4.1 billion euros up to September.

Strong FCF generation is coupled with inorganic measures, and including post-closing events, debt declined further to 37.6 billion euros, or 2.46 times OIBDA.

Lastly, let me mention that under IFRS 16 net debt would be impacted by 7.3 billion euros worth of leases.

Refinancing at historically low rates and longer tenors

Slide 22 presents how we have actively continued to refinance taking advantage of favourable market conditions, issuing long tenors at historically low rates while also diversifying financing sources.

Total financing activity adds up to 6.9 billion euros year-to-date, allowing us to extend our average debt life above 10 years and maintain a robust liquidity position of close to 25 billion euros.

Such financing activity at historically low interest rates has also allowed us to lower our effective interest payments cost to 3.30% as of September 2019, 22 basis points lower than in September 2018.

I will now hand back to Ángel to recap.

Ángel Vilá – *Chief Operating Officer*

Q3 Summary

Thank you, Laura.

To summarise, I would like to again highlight our best-in class customers' value, our focus on digitalisation and our technological advantage. As such, we have delivered reliable and solid growth in Q3 whilst lowering net debt for the 10th consecutive quarter mainly due to our strong FCF generation. All this, allows us to reaffirm the guidance for 2019.

Finally, I would like to remark the progress on strategic projects announced last month such as towers monetisation, restructuring in Spain and new products partnerships, among others. We remain fully committed to continue working with determination in these and other strategic initiatives in the coming months to achieve the best results.

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

Q&A session

Joshua Mills - *Exane*

I have two questions both in Spain. The first one is how do you think the MásMóvil - Orange deal can impact on your own wholesale revenues, whether this is a headwind and how many lines can be affected by that?

And then secondly, just whether in the aftermath of this, you will consider offering a more contingent model style agreement to Euskaltel to access to your fiber network, given that they are currently looking to expand their network and could be willing to make some volume commitments. Could you look at offering cheaper than NEBA prices in order to facilitate that?

Ángel Vilá – *Chief Operating Officer*

Thank you, Joshua.

On the first question with the MásMóvil wholesale agreement with Orange, we are not expecting significant impact from the recent deal because the fiber to the home premises involved were already available in bitstream and the agreement in mobile is for 5G.

What we see is that for 5G MásMóvil maybe is designing a strategy in which access to the 5G network is offered by a third party, so minimizing deployment of their own network. This doesn't have an impact on us, though in terms of spectrum allocation we think this could be a positive regarding future spectrum auctions.

Again in fiber, what we see is that it's a change of model from OpEx to CapEx. It could erode maybe Orange's base further, but we do not expect a significant impact on us. MásMóvil said that the savings would contribute to higher OIBDA, so we do not expect extra aggressiveness from them in the market.

Regarding the possibility of a deal with Euskaltel, we have been open to reach agreements with different players on fiber always in the terms which are commercially attractive for the parties. This is not underway, but we have demonstrated our openness in previous situations.

Mathieu Robilliard - *Barclays*

First, I have a question about OIBDA trends. You reiterated the guidance for the full year, 2% revenue growth, you are pacing slightly below in the 9 months. Where should we expect an acceleration of OIBDA in Q4? Is it from Spain, something I think you said in the past should materialize? Or is it coming from other geographies?

And then, in terms of the cost savings for Spain, you do mention that by 2020 you would have already €210 million cost savings annually, which is very close to the full run-rate that I think you guided for €220m. Does it mean that a very large portion of the employees have already taken the plan and that's why you are so confident for your profit in 2020?

Ángel Vilá – *Chief Operating Officer*

Thank you, Mathieu.

On the first question, regarding the group guidance, and specifically your question was in OIBDA, let me address this question in full.

We are reiterating our full year guidance. This guidance is built on lots of moving parts. We have different revenue lines with different attached margins from very different geographies. So, what we see is that at the top line level we are delivering stronger than anticipated revenues, based in handset sales which are growing 17% in the first 9 months, and we are seeing roughly in line service revenue growth. Most geographical units, at the service revenue are performing as expected, including Spain and Brazil, some others are doing a notch better, some others doing a notch worse including smaller contributors such as Mexico. In fact, Spain has posted this quarter the highest growth rate since 2016.

At the OIBDA level, the largest drag in growth is explained by Mexico performance, that is detracting close to 1 percentage point to the quarter's growth on a weaker top line and impact of changes in the spectrum accounting. If we were to exclude this negative Mexican contribution, results are very much in line with expectations to date, and we would be posting a 1 percentage point higher OIBDA growth rate. I would like to highlight that for our 4 largest divisions, 3 of them are accelerating trends of the OIBDA (Spain, Brazil and Germany), and the U.K. which is the fourth large one, continues to show strong results.

So, what do we expect looking at Q4? At the operating revenues level, we will very likely continue to be above guidance at the end of the year, including top line growth in the quarter in both Brazil and Spain. Again, breaking down service revenue performance, IT and digital services will contribute more than initially anticipated, with different margins though.

Group OIBDA should show continued growth in Q4 towards the full year target. Despite stronger revenue growth and slightly different mix, we are confident in meeting our guidance, thanks to efficiency mainstreams, including the workforce restructuring in Spain. In addition, the impact of spectrum fee accounting in Mexico will start to annualize from Q4.

So, to conclude on this guidance question and despite tough competitive environments in some of our markets and macro political headwinds, we would be today comfortably meeting the OIBDA guidance when excluding Mexico, and we are confident that our efficiency gains will help us overrun these factors and meet the full year group OIBDA guidance.

Mathieu Robilliard - *Barclays*

Sorry if I can just follow up on Spain. Should we see already in Q4 in Spain some of the benefits of the employee reduction?

Ángel Vilá – *Chief Operating Officer*

Yes that was your second question which I was about to address. The €210 million annual savings will be the run rate from next year. We will see part of those savings already flowing into Q4 because the employees that had to leave with this program have already left the company at the end of last month. So those savings are ready to start flowing in the months of November and December of this year.

David Wright – *Bank of America Merill Lynch*

A couple of questions please, guys. First of all, I think I saw your Spanish business and your TV customers decline. And I think that's the first time for a couple of years and even back in 2017, I think it's a digital push, drag if anything. So just wondering if we could expect that dynamic to evolve a little and if there's a shift from the kind of mid-tier customers down to the lower connectivity segment.

And then I have to admit, I'm still a little bit confused about the group OIBDA guidance. By definition, you've done 1.1% through the first 9 months, you've done 0.8% in Q3. To make 2%, you're going to have to do over 4.5% even to make 1.5% I guess and your guidance is around 2%. You'd have to do sort of closer to 3%. It’s not really obvious how that works. I know you've given some answers, but the 1% Mexico unwound on its own doesn't really get us there. So what are the big drivers, the more material drivers divisionally towards that, please.

Ángel Vilá – *Chief Operating Officer*

Thank you, David.

On the TV commercial performance in Spain and in general commercial performance in the quarter, we had a quarter with contained commercial trading which was impacted by some tariff upgrades at the beginning of the quarter for premium customers, then the end of promotions, and it's always a quarter with back-to-school commercial activities.

We have seen fixed broadband positive net adds for second quarter in a row with good performance in premium fiber. On pay TV, to your question, one has to bear in mind that pay TV penetration in our convergent base is already high at 93% and, regardless of the overall number, the mix is very important: we are adding higher-value pay TV customers with better mix and better ARPU growth.

So we have a base of TV very well penetrated and we are seeing improvement in the mix of that one. And this is reflected on, as you can see in Slide 11, the convergent customer base actually shows a move up with high end customers being 30% of our convergent base, 2 percentage points more than in Q2, and convergent ARPU is 1.7% up y-o-y.

With respect to group OIBDA guidance, what we're expecting is a strong fourth quarter. You've seen the trends, improving trends that we have in our 4 big units in the group, 3 of them (Spain, Germany, Brazil) improving and accelerating their OIBDA growth.

We have specific factors, for instance, helping us in our operations: in Spain the comparison of content cost (the fourth quarter is going to experience the lowest growth rate in content costs), and we're going to start seeing benefits from the recently closed personnel restructuring plan. Germany already yesterday confirmed their OIBDA guidance; Brazil shows strong growth and they were confident in their call yesterday that this is to continue; the U.K. is performing strongly. And then, we will have easier comps in some of our Hispam units, such is the case of Mexico with spectrum accounting. And we are on track for progressive turnaround in some of our units in the region such as Peru.

David Wright – *Bank of America Merill Lynch*

And just maybe a quick expansion on Spain. I think you gave some interesting stats in the Q2, around 28% of subs high end and I think it was 30% percent mid-range €80 and about 40% low-end and €55 customers. Can you give us an indication of how that mix is continuing to shift, please?

Ángel Vilá – *Chief Operating Officer*

Well the mix is, if I could say, polarizing. On the upper end we have grown the high value customer from 28% to 30% and, what we call lower-end, which is an ARPU that equals to the average ARPU of our closest competitor, is now 41% and the mid-end is at 29%.

Nawar Cristini – *Morgan Stanley*

Firstly, on Spanish competition. We are hearing mixed messages from your competitors about the competitive landscape in Spain. So, it will be helpful to have your views on this. And also, to have any colour about whether you are seeing any change of behavior from competitors?

And secondly, on Brazil. Momentum seems to be building for market consolidation there. Could you elaborate a little bit on your views on the topic and, in particular, the level of involvement that you would be willing to pay and possible implications on leverage?

Ángel Vilá – *Chief Operating Officer*

Thank you very much for your questions.

On the first one, competitive environment in Spain. We believe that the market remains competitive but has a rational structure. And we see no structural change despite intense activity in the low-end and despite some of our peers' comments.

What we do see is more polarization, or if you want, more market segmentation. On the high end, it is a rational segment with Orange and us being the only ones having access to football and targeting the highest value customers. In the mid to low segment, promotional intensity increased as a result of Vodafone needing to reposition after abandoning football in an effort to turn around their operation. And in the low end, it is very competitive. There is intense competition with MVNOs, low-end brands from convergent players and the fight between MasMovil and Vodafone. Of course, we are not immune to competition, but we are far more protected than others, thanks to our positioning and differential assets within a market structure that is very well-defined and segmented.

In Q3, we have seen promotional activity, as always in the third quarters, but it was milder than one year ago. The promos that we saw were less intense and for shorter periods. As a proof, portability volumes continued going down. So, for us, being high-end focused makes us more protected from these competitive dynamics. Proof of this is our performance, 9 straight quarters of service revenue growth with clear acceleration in this quarter, convergent revenues growing mid-single digit for the last 15 quarters including this quarter at 5.3%. As I said before, in this quarter, we have achieved the best y-o-y revenue growth since 2016, and this with 40.1% organic OIBDA margin. So yes, we think it is a competitive market, but rational, and a market in which we are outperforming.

On the question on potential M&A in Brazil, there is speculation, especially regarding Oi and the mobile part of Oi. First, Brazil is a very attractive market from the macro point of view, where they have recently approved the pension reform and this sets a future for balanced public finances. It is attractive on sector structure, and recently there has been approval of PLC 79, which is very good news for the industry. And third, Brazil is a very attractive market because of our position of leadership.

So, we think it is a market where we are strong, and we want to be stronger. We have always defended in-market consolidation in the sector as a catalyst to improve returns, but also to accelerate sector transformation towards a digital society. And Brazil of course is not an exception. Although Oi has not formally said that they are selling mobile assets, we will closely monitor the situation. We think that there could be significant value creation from synergies, but we also think that if market consolidation were possible, none of the three players in Brazil would be capable of doing it alone. It would also require Oi's intention and capacity to do so, the company is under judicial intervention. So, lots of moving parts. Although this might sound like “déjà vu”, lots of stars need to be aligned. But it looks like this time, they may actually align at some point.

Nawar Cristini – *Morgan Stanley*

And how do you think about implications on leverage?

Laura Abasolo – *Chief Financial and Control Officer*

I think it is too soon to say. And being a transaction in which more than one party is involved, it shouldn't be really sizeable. In any case, we will look at that within our overall target of maintaining a solid investment grade credit rating, and also aligned with the performance you have seen regarding deleverage so far, in which we have accelerated the pace and we have again posted a very sound net financial debt reduction in the first 9 months of 2019 of almost €3bn.

Mandeep Singh – *Redburn*

Thank you for taking the questions. They're primarily related to free cash flow and net debt. You talk about factoring benefits in free cash flow in the text of your report. Could you just sort of help quantify that for us?

And relating to sort of organic deleveraging versus inorganic, if you exclude hybrids, asset sales and potentially any benefits from factoring that you will tell us about, it doesn't look like there has been any organic deleveraging in the first nine months. So if you could just like bring us up-to-date to what's going on with deleveraging organically and inorganically, so we just understand the moving parts?

Laura Abasolo – *Chief Financial and Control Officer*

Yes. Thank you for your question. Regarding free cash flow, we indeed believe we have reached a very sound free cash flow in the first nine months of the year. It has been EUR4.3 billion and that is a strong year-on-year performance.

The drivers behind that free cash flow are various. First, the solid revenue and OIBDA organic growth. Obviously, the very positive tax contribution, but also lower financial payments and working capital generation.

Regarding working capital generation, there has been a big improvement that is mostly due to the deferred spectrum payment in Germany. Excluding that, it has also been helped by the positive effect of the Brazilian court decision in 2018. But in fact, the working capital measures are being lower than the ones we did in 2018. So, we have been less active in that front. And regarding supplier financing, for instance, that we publish the figure, it has been below what we had in 2018. It has been slightly above 300 million and for the full 2019, it should be below what we did in 2018.

To give you a little bit flavour of working capital; working capital has been affected obviously by seasonality, there are some measures that are to unwind through the remainder of the year. We also do sale of receivables, commercial and financial agreements to postpone payments, and I have specifically mentioned the supplier financing figure being below last year's. We also do handset financing and other measures. And this is pretty much in line with what we do every year. But as I said in the first nine months of the year, there has been less measures and working capital has proved being better because of the deferred payment of the spectrum and the judicial decision in Brazil.

Regarding the net debt figure and evolution, we again believe the free cash flow is being the main driver. There has been other impacts of course, as always. I mean, the net debt figure and the solid investment grade credit rating targets are being achieved through a combination of free cash flow and also inorganic measures, as it has been the case also in this year. And we are already accounting for the sale of 9 Data Centers, the sale of Guatemala, Nicaragua and Panama and more is to come because we are still not accounting for El Salvador and Costa Rica, whose regulatory approval we expect by the end of the year. Hybrids have indeed helped for these nine months, as we have the liability management positive impact and also the 500 million issuance we did in September. But this is a temporary improvement. So, we definitely do not count on that for our net financial debt deleveraging, but you are already seeing it.

Jakob Bluestone – *Credit Suisse*

Firstly, on Spain. Can you maybe comment a little bit on the outlook for convergent ARPU, obviously it accelerated this quarter as you highlighted with price hikes and through past promotions rolling off, but we also had Orange who were highlighting the sort of negative effects from spin down on ARPU. From your comments on the market being sort of increasingly polarized, it sounds like you are sort of expecting that, you are not seeing a big impact from spin down on ARPU. But I would just be interested if you could maybe share a little bit how you see the outlook for the Spanish convergent ARPUs.

And then just secondly, in Brazil, you announced these fibre franchise and partnership agreements. And I'll just be interested if you saw similar model being applicable elsewhere, particularly in Spain. Would you look at similar sort of deals or setups, or indeed other forms of monetization in Spanish fixed line?

Ángel Vilá – *Chief Operating Officer*

Thank you, Jakob for the questions.

Convergent ARPU, as you saw €90.6 is up both y-o-y 1.7% and up q-o-q 2.5%. This is the result of a positive impact from tariff upgrades that we have had in "more for more" moves during the year. It also has a positive impact from upselling, and it has the dilutive effect from promos and has that dilutive effect from what we call multi-brand, which is the lower ARPU from our O2 convergent brand. But, the impact from both tariff upgrades and also upselling, is more than countering the dilutive impact of promos and multi-brand.

In Brazil, on fiber building agreements that we have reached. First, it's a very different situation from Spain. Spain, we have already 22.7m premises passed with fiber. Penetration is very high already, while in Brazil, which is a huge country, penetration is still much lower. So, what we have done, we are prioritizing the cities in Brazil across to three categories: a category of cities where we're going to do the fiber deployment from our own CapEx; then second tier, which is cities where we are going to do partnerships like the first one we have announced with American Tower Corporation, but others to follow; and third, the third tier of cities that we are going to address via franchises.

This is allowing us to do a faster deployment in the market limiting the impact on our CapEx, because the partners are going to be investing in passing the homes and then we will take care of connecting the customers in the partnerships. These partnerships can take the format of this type of commercial agreement like the one we've reached with American Tower Corporation, could also take the format of JVs or Equity partnerships into fiber Cos. So, we're exploring all options in Brazil and in countries where still fiber penetration is low, but not in Spain.

Jakob Bluestone – *Credit Suisse*

Can I just follow-up just on the Fusión point. Is your expectation that when you take all those pluses and minuses that you can continue to grow Fusión ARPU? Is that sort of your assumption?

Ángel Vilá – *Chief Operating Officer*

Well, we are going to continue applying the same kind of strategies that we have been using up to now, including "more for more". Of course, this will be depending on market conditions; we are getting into a quarter where we will have Black Friday and Christmas campaigns, but we have seen also ARPU increases in fourth quarters in previous years. So, we would like to continue applying the same strategy, but I cannot forecast the ARPU on a quarterly basis.

Michael Bishop – *Goldman Sachs*

Just 2 questions for myself. Firstly, could you give us a bit more colour on the U.K. mobile trends going forward, because it seems like you've got very positive contract net adds momentum, but clearly there's also some headwinds going forward and we've seen 5G being launched at no premium by operators. And then secondly, I was just keen to get your latest thoughts on the tower strategy. And you mentioned that you transferred some towers in particular in Spain into Telxius, but I was wondering if I could get your updated thoughts and your broader thinking of the towers you identified and how quickly we might see those transferred, or even sold externally.

Ángel Vilá – *Chief Operating Officer*

Thank you, Michael.

On UK; UK reported one more set of strong quarterly results with top line growth of 4.1%, OIBDA 5.7%, and overall customer base growth. Mobile accesses are 5.6% up y-o-y to more than 34m. And this allows us to maintain the market-leading position being the largest network carrier, also the UK most favourite mobile network with the highest sector leading loyalty. The contract base of this 34m is 17.4m, growing 8.7% and prepaid base is 8.6m. MVNO partner base 8.1m, growing 8%. So we are growing customers more in the contract base than through the MVNOs.

So, we have very good traction in the UK, which is reflecting into sound revenue growth and ARPU improvements. This though, as you said, can be affected by a number of factors. On the one hand, there is a regulatory focus on revenue spending measures such as Roam-Like-at-Home, also lower out-of-bundle revenues, and then some decisions that have been taken to going into 5G, not applying a premium pricing versus 4G. So, lots of moving parts, but still we expect to continue outperforming the UK market in our UK business.

With respect to the tower strategy, we announced in early September a push to accelerate the monetization of our tower portfolio. We had already set up Telxius a few years ago, a company that has 18k towers, where we own 50.1% and we have as partners KKR and one of the largest family offices in Spain.

The total number of owned towers by Telefónica is around 69k of which 18k are in Telxius, 51k owned by Telefónica's OBs. The 4 largest markets (Germany, UK, Spain, Brazil) account for around 2/3 of that number of towers.

What we are planning to do is to monetize the remaining portfolio of towers that can be transferred. And as in any tower portfolio, one needs to conduct the diligence of which towers have more or less ability for co-location, technical capabilities and so on, so one has to filter the portfolio of towers, but we are going to be monetizing those progressively.

We have already, in this quarter, transferred to Telxius the remaining towers we had in Spain, Chile and Peru. This is "de facto" (because some people have asked why is this monetization), this is "de facto" monetization because our partners are taking 50% of the equity of this monetization, through less dividends payout by Telxius. And therefore, less leakage for us on those dividends. Or depending on the size of the deal by direct equity contributions.

So, we have transferred the remaining towers in Spain, Chile, Peru. The next batches or lots of towers that you should see will be in Brazil, in the UK (where we are already in advanced talks with our partner Vodafone), and in Germany. So, you should expect us in the coming quarters to give you consistent update on the monetization of those towers.

We are going to be open to different alternatives of monetization. We think there is value in doing these transactions through Telxius because we get the double benefit of monetizing the towers, and at the same time keeping the controlling stake in a larger and more valuable infrastructure company. But we remain open to different monetization avenues.

Jerry Dellis – *Jefferies*

First question has to do with consumer convergent segment in Spain, please. You highlighted how the proportion of Fusion customers at the high-end has been increasing. And on a year-on-year basis, it is indeed up 1 percentage point to 30%. But when we look at the medium and the low tier segments, we see much more material shifts year-on-year. Looks like the medium segment is now 9 percentage points less as a proportion as to where it was in Q3 '18, and the low-end segment is now 41% which is up 8 percentage points year-on-year. So, it looks like there's been quite a lot of shift from medium down to low. And perhaps that puts more and more pressure on you to keep raising prices on Fusion customers at the high end. Is that the right way of sort of thinking about the pressures that you face in keeping the convergent business growing, or is there another way of looking at this? And in particular, is it possible to see a situation in which going forward, the Fusion business or the convergent segment can grow revenues without such reliance on price increases, please?

And my second question has to do with the B2B segment in Spain. I think we understood that B2B revenues were rather flat at the Q2 stage because of some issues around sort of invoice phasing. The third quarter progression in B2B revenues is also flat. So, it will be interesting please to have your thoughts on the outlook for B2B revenue growth in Spain.

Ángel Vilá – *Chief Operating Officer*

Thank you for your questions. On the first one on the consumer convergence segment in Spain, you have to look at Fusión through different metrics and KPIs: one is the base or the number of customers, then the mix of that base, the ARPU and the churn.

We have sustained momentum on our base. It's up quarter-on-quarter and year-on-year. Year-on-year, the customer base in Fusion is growing 2.4% to 22.9 million accesses and 4.7 million customers. The mix that you were pointing out is polarizing. Here, I would like to qualify how we have defined this mix. Because this mix is defined by types of products, and since these types of products move their prices up, what we call "low" could have been at the bottom end pricewise of what have been "mid" 1 year ago. So low-end is €50 to €72 products, mid-end is €95 to €105 and high-end ranges from €110 to €190. So, our share in our customers that have products above €95, that will be adding up the medium and the top segment is 59% which is resulting in an increase our ARPU, because there is not only increase in the number of customers, but also increase in the ARPU of each one of these segments, and this is sometimes overlooked. And this, we're achieving with churn, which is the fourth element of how we look at Fusion, of 1.6%, which is controlled (it was 1.7% in the first quarter, 1.5% in the second, 1.6% in the third). So we believe that we have a solid and resilient mix which is making us less dependent on the fights at the low end.

So, are our services expensive given the substantially higher ARPU that we have with respect to our competitors? I think your question is "is this too expensive, will you see downgrade or will you find it harder to More for More". So the first question will be: are these services too expensive? well 90.6 convergent ARPU includes 5 services per customer with an average of less than 4 services for the bundles of our competitors. We have a higher number of mobile lines per customer. And pay TV penetration is also higher. So, on a "per service" basis our prices are similar, slightly higher than those of our peers. So, we think that we have a very competitive offer, and very importantly, which is well priced.

Is there still room to grow through More for More moves? Well, we have been leading the market in the last years through offer upgrades. All our competitors have followed, and they continue to do so, not only the 5 telco operators have put prices up this year both frontbook and backbook, but also over-the-top players have been putting their prices up. So depending on market conditions, we think that there is room for selective More for More.

On B2B, which is your second question and it's 27% of service revenues in Spain, we are growing for the sixth consecutive quarter, and the growth is 0.4% year-on-year with a sequential improvement of 0.3 percentage points versus the previous quarter. Here, what we see is pressure on the traditional communications. This has 2 parts: traditional communications and IT services. We see pressure on traditional communications impacted by contract renewals basically. And at the same time, we see IT continuing to grow at double-digit. We have a very strong position in B2B where we are the clear market leader. We have competitive advantages due to scale, brand, convergence network and digital services. So, we think that momentum is good and we will continue to see growth in B2B segment.