Telefónica

Interim report

Telefónica Czech Republic – January to September 2011 Financial Results

November 10, 2011

Telefónica Czech Republic, a.s. announces its unaudited financial results for January to September 2011. These results are consolidated and prepared according to International Financial Reporting Standards and fully include the results of Telefónica Slovakia, Telefónica O2 Business Solutions and other smaller operating companies.

Operational Highlights

- **Solid commercial momentum** in focused areas maintained despite continuous intense competition:
    - **Another strong contract mobile customers growth: +6.3% year-on-year**, with 39 thousand net additions in 3Q 2011, helped by continuous **mobile broadband customers growth** and **improved churn**.
    - **xDSL accesses grew by 10.0% year-on-year reaching 854 thousand** (48 thousand net additions in 9M 2011), and VDSL launch helping to protect existing base, manage fixed BB ARPU and enhance the churn.
    - **Decline in fixed accesses continued to decelerate: -5.0% year-on year**, with 67 thousand net losses in 9M 2011 (9 thousand in 3Q, -60.7% year-on-year).
- **Consolidated business revenues decline slowed down to -5.4% year-on-year in 3Q 2011** (-6.3% year-on-year in 9M) on the back of **better mobile revenues performance**, while prevailing competitive pressure in some segments and additional MTR continue to dilute total business revenues.
- **Guided OIBDA[1] decreased by 6.1%** year-on-year in 9M 2011, while **guided OIBDA margin[2] maintained flat year-on-year reaching solid 43.0% in 9M 2011** (45.6% in 3Q) on the back of **continuous OpEx efficiencies** and **positive and growing OIBDA in Slovakia**.
- **Telefónica Slovakia** maintained its **commercial momentum** seen already in the previous quarters reporting 38.1% year-on-year subscribers' growth and further **improving its financial performance**.
- **2011 full year guidance[3] confirmed** for OIBDA and CapEx.

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[1] OIBDA excludes brand fees and management fees (CZK 634 million in 9M 2010 and CZK 834 million in 9M 2011) and impairment reversal in 3Q/9M 2010 (CZK 4,343 million) assuming constant FX rate of 2010

[2] Guided OIBDA over Business revenues

[3] OIBDA decline of -1% to -5%, CapEx around CZK 5.7 billion. In terms of 2011 guidance calculation, OIBDA excludes brand fees and management fees (CZK 1,057 million in 2010). In addition, 2010 OIBDA base excludes reversal of the impairment loss of CZK 4,343 million. 2011 guidance excludes changes in consolidation, includes potential capital gains from non-core asset sales, assuming constant FX rates of 2010

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"I am pleased that our financial performance in the third quarter showed improving trends, in line with our expectations. This is a result of continuous customers' growth in key areas, which also helped us to outperform the market. Mobile contract customers sustained commercial momentum, helped also by improving churn, which I see relevant in highly competitive market. In fixed broadband area, we maintained double digit growth, and migration of existing customers to VDSL positively impacts ARPU. Additionally, Telefónica Slovakia further increased the subscribers' base and improved its mix," says Jesús Pérez de Uriguen, the Chief Financial Officer and the First Vice-Chairman of the Board of Directors of Telefónica Czech Republic when commenting on the operator's financial results. *"This customers' growth together with better spend patterns in mobile residential segment and still improving financials in Slovakia is reflected in better performance of our revenues compared to the first half. Despite some improvement in top line performance, we keep focusing on efficiencies in our cost base, which helped us to maintain margin at 43% in the first nine months, the same as in the last year*", he adds.

Consolidated Financial Statements

Consolidated **business revenues** went down 6.3% year-on-year to CZK 38,977 million in 9M 2011 (-5.4% year-on-year in 3Q to CZK 13,079 million). Financial performance of the Group in the third quarter improved compared to previous two quarters helped by better spend in mobile residential segment and lower ICT revenues decline. At the same time, revenues continued to be impacted by prevailing competitive pressure largely in corporate and SMB mobile segments and MTR cuts. Fixed business revenues in the Czech Republic declined by 7.8% year-on-year reaching CZK 16,836 million in 9M 2011, while in 3Q the decline rate improved posting a -7.5% year-on-year to CZK 5,536 million. Mobile revenues in the Czech Republic declined by 8.9% to CZK 19,545 million in 9M 2011 with a lower decline in 3Q (-7.2% year-on-year reaching CZK 6,620 million). Excluding the impact of MTR cuts, the decline rate improved to -3.6% in 3Q, compared to -7.0% in 2Q and -5.0% in 1Q, due to already mentioned better spend in residential segment. On the other hand, revenues in Slovakia continued to post a solid growth and recorded a 43.5% year-on-year increase reaching EUR 113.2 million in 9M 2011 (+33.3% year-on-year to EUR 40.1 million in 3Q 2011 alone).

Also in 3Q 2011, the Company has continued in its effort to deliver cost efficiencies in both commercial and non-commercial areas, to compensate for pressure in revenues. Despite higher commercial activities largely in fixed and mobile broadband areas, total consolidated **operating costs** decreased by 3.7% year-on-year reaching CZK 23,603 million in 9M 2011 (-4.6% excluding brand fees and management fees), also positively impacted by MTR cuts. Positive impact coming from 2010 and 2011 restructuring programs led to a 10.1% year-on-year reduction in personnel expenses in 9M 2011. The total Group headcount reached 7,187 at the end of September 2011, down by 6.9% year-on-year and -1.9 % quarter-over-quarter. In 3Q 2011 alone, the headcount has been reduced by additional 142 employees.

Guided Operating income before depreciation and amortization (OIBDA)[4] decreased by 6.1% year-on-year reaching CZK 16,815 million in 9M 2011 while in 3Q it declined only 4.8% year-on-year to CZK 5,970 million. At the same time margin remained flat year-on-year reaching solid 43.0% (45.6% in 3Q alone, +0.2 p.p. year-on-year), on the back of already mentioned focus on cost efficiency and improving profitability in Slovakia. In terms of **reported OIBDA**, it reached CZK 15,949 million in 9M 2011, -26.2% year-on-year and CZK 5,675 million in 3Q. Year-on-year OIBDA comparison in 3Q and 9M 2011 has been significantly impacted by an impairment reversal (CZK 4,343 million) booked in 3Q 2010. Excluding this item, OIBDA would decline -6.3% and -7.6% year-on-year in 3Q and 9M 2011 respectively.

Depreciation and amortization charges went up by 1.1% in 3Q as well as 9M 2011, like in previous quarters being impacted by an impairment reversal booked in 3Q 2010 (higher gross value of fixed assets). On fully comparable basis (excluding the impact of impairment reversal on OIBDA, D&A and income tax in both 2010 and 2011), **net income** would decline 9.7% year-on-year in 3Q and 10.8% in 9M 2011, largely due to decline in OIBDA, not fully compensated by lower depreciation and amortization, financial expenses and income tax expense. In respect of reported consolidated

[4] In terms of 2011 guidance calculation, OIBDA excludes brand fees and management fees (CZK 634 million in 9M 2010 and CZK 834 million in 9M 2011) and impairment reversal in 3Q/9M 2010 (CZK 4,343 million), assuming constant FX rates of 2010

net income, it amounted to CZK 2,205 million and CZK 5,816 million in 3Q and 9M 2011, down by 63.3% and 43.9% year-on-year respectively due to above mention impact of impairment reversal.

Consolidated **CapEx** (excluding business acquisitions) reached CZK 3,690 million in 9M 2011, down by 1.0% year-on-year .The Company continued to direct investments into the capacity expansion and quality improvement of 3G network. In addition, CapEx was spent on further expansion of 3G network coverage, including coverage of currently unserved areas on the basis of network sharing contract with T-Mobile. At the end of September 2011, the Company covered already 1,153 towns and cities in the Czech Republic with its 3G network, representing around 65% population coverage. Additionally, the Company focused its investments into the upgrade of its fixed broadband with VDSL technology aiming at strengthening its position on highly competitive fixed broadband market in the Czech Republic and improving customer experience. In Slovakia, CapEx was largely spent on additional network investment related to the launch and expansion of 3G network. Also, the relevant part of CapEx was spent to improve Company's systems (CRM) to further enhance customer relationship, simplify and streamline processes and consequently increase the operating efficiency.

Group free cash flows decreased 11.8% year-on-year reaching CZK 10,242 million in 9M 2011 (-6.5% year-on-year to CZK 4,222 million in 3Q), as a combination of **6.5% decline in cash from operating activities**, broadly **in line with OIBDA decline**, and an 8.3% increase in cash used in investing activities driven by higher CapEx related cash payments due to different CapEx phasing in 2011 compared 2010.

The consolidated **financial debt** amounted to CZK 2,969 million at 30 September 2011, broadly in line with the end of 2010. At the same time, **cash and cash equivalents** reached CZK 15,050 million, up from CZK 4,798 million at the end of 2010, due to accumulation of cash for dividend payment (CZK 12,884 million) made on 6 October 2011.

CZ Mobile Business Overview[5]

As expected, dynamics of the mobile business improved in 3Q 2011 compared to previous quarters on the back of improvement in residential spend, while tough competition in SMB and corporate segments continued to dilute financial performance. In addition, further MTR cuts (from CZK 1.37 per minute to CZK 1.08 per minute as of 1 July, -34.9% year-on-year[6]) impacted mobile revenues in 3Q 2011. In the commercial area, the Company sustained solid subscribers' growth in contract segment supported by customers' demand for mobile broadband proposition, despite intense competitive pressure. In the mobile broadband area, the Company recorded positive results of its marketing campaign educating the customers on the benefits of smartphones and mobile internet. This resulted into the acceleration of mobile internet net additions in 3Q compared to pre-campaign months.

Total **mobile customer base** reached 4,882 thousand at the end of September 2011, a 0.5% year-on-year increase. In 9M 2011, the Company recorded 43.6 thousand net additions in its mobile customer base, by 92.8% more year-on-year (excluding the disconnection inactive contract customers in 2Q 2010). This is largely a result of continuous strong contract base growth

[5] Figures are shown net of inter-segment charges between fixed and mobile businesses
[6] From CZK 1.66 to CZK 1.37 in January 2011 and to CZK 1.08 in July 2011

and lower decline in prepaid base. The number of **contract customers** went up 6.3% year-on-year reaching 2,995 thousand at the end of 3Q 2011 with 131.8 thousand net additions in 9M 2011 (+14.4% year-on-year, excluding the disconnection of 111 thousand inactive contract customers in 2Q 2010). This performance continued to be supported by customers migrating from the prepaid to the contract segment, positive contribution of mobile broadband customers' growth and lower churn. At the end of September 2011, contract customers accounted already for 61.4% of the base (+3.3 percentage points year-on-year), the highest figure ever. The number of **prepaid customers** reached 1,887 thousand at the end of 3Q 2011, down by 7.4% year-on-year, with 88.1 thousand net losses in 9M 2011, lower than 92.6 thousand in the same period of 2010.

The blended monthly average **churn rate** reached 1.93% in 3Q 2011 posting a 0.3 percentage point year-on-year decrease. This is a result of improvement in contract churn which reached just 1.05% in 3Q, posting a 0.1 percentage points year-on-year decrease and -0.2 percentage points decrease compared to 1Q 2011. Prepaid churn improved by 0.3 percentage points year-on-year reaching 3.30% in 3Q on the back of increased focus on higher quality customers' acquisition and success of the customer loyalty scheme activities awarding them for regular top-ups.

In terms of usage, total **mobile traffic**[7] carried by the customers in the Czech Republic reached 6,645 million minutes in 9M 2011, up by 1.3% year-on-year (+2.0% in 3Q), primarily as a result of the increasing contract customer base.

In 9M 2011, mobile **blended ARPU**[8] reached CZK 425.7, down 9.4% year-on-year (-10.4% year-on-year to CZK 424.0 in 3Q alone), continued to be impacted by MTR cuts and competition. Excluding the impact of MTR cuts, total ARPU in 3Q 2011 would have declined 6.7% year-on-year. Voice ARPU dilution driven by persisting competition is the key drivers for the majority of the decline. **Contract ARPU** reached CZK 582.8 and CZK 574.4 in 9M and 3Q 2011, down by 12.5% and 14.2% year-on-year respectively (-10.8% year-on-year in 3Q 2011 excluding the MTR cuts impact). **Prepaid ARPU** decreased by 8.4% year-on-year in 9M 2011 reaching CZK 186.7, while in 3Q, it reached CZK 188.5, -8.1% year-on-year (-3.1% excluding the MTR cuts impact). **Data ARPU** declined 2.2% and 2.8% year-on-year in 9M and 3Q 2011reaching CZK 116.6 and CZK 120.0. Similarly to previous quarters in 2011, decrease in data roaming prices and continuous SMS/MMS bundling were the key drivers behind data ARPU dilution. Nevertheless, excluding these two items, data ARPU would improve 4.0% year-on-year in 9M 2011 with mobile internet customer base uptake remaining the key driver for that improvement.

Total mobile **business revenues** in the Czech Republic declined by 8.9% year-on-year to CZK 19,545 million in 9M 2011 with a lower decline in 3Q (-7.2% year-on-year to CZK 6,620 million), while mobile service revenues went down by 10.1% and 9.6% year-on-year in these periods due to above mentioned competitive pressures leading to lower spend in SMB and corporate segments, MTR cuts, and lower data roaming prices. Mobile termination rate cuts diluted mobile service revenues by 3.8 percentage points and 3.7 percentage points in 9M and 3Q 2011 respectively. Despite fierce competitive pressures, continuous growth in contract customer base and better spend in residential segment helped the revenues from monthly fees to report a flat

[7] Inbound and outbound, including roaming abroad, excluding inbound roaming
[8] Including inter segment revenues

year-on-year performance in 3Q 2011, compared to -2.9% and -1.5% year-on-year recorded in 2Q and 1Q. Despite a 1.3% year-on-year growth in mobile outbound voice traffic, traffic revenues decreased by 16.5% year-on-year to CZK 5,294 million in 9M 2011 (-15.7% year-on-year in 3Q), due to higher number of traffic bundling and competitive pressure. Interconnection revenues went down by 29.8% year-on-year to CZK 1,966 million in 9M 2011, largely impacted by MTR cuts and lower incoming traffic. Other revenues (including SMS & MMS, data and other business revues) continued to report similar trends in 3Q compared to the previous quarters with lower data roaming prices and more SMS/MMS bundling having pressure on them. In 9M 2001, these revenues declined 2.6% year-on-year reaching CZK 5,359 million (-2.5% year-on-year in 3Q). However, excluding SMS, MMS and data roaming, data revenues would report 3.7% year-on-year growth in 9M 2011, confirming positive impact of the growth in mobile broadband revenues contribution.

CZ Fixed Business Overview[9]

In 3Q 2011, the fixed business continued to report solid commercial performance in broadband customer base and fixed accesses seen already in previous quarters, while revenues shown the lowest year-on-year decline in 2011 helped by better performance of ICT revenues. Continuous migration of the existing customers to recently VDSL proposition helped the Company to better manage fixed broadband ARPU and enhance churn, which is relevant in highly competitive market environment.

The total number of **fixed accesses** declined by 5.0% year-on-year reaching 1,602 thousand at the end of September 2011, with 67.3 thousand net losses in 9M 2011 (-20.7% year-on-year) and only 9 thousands disconnections in 3Q, which is a 60.7% year-on-year improvement. This is largely a result of lower traditional telephony lines' losses and continuous solid uptake of naked accesses.

The number of **xDSL accesses** reached 854 thousand at the end of 3Q 2011, up 10.0% year-on-year. In 9M 2011, their number increased by 48.5 thousand. In respect of VDSL, already72.5 thousand customers subscribed for the new service by the end of September 2011, which represents some ¼ of total addressable existing base. The total number of **O_2 TV customers** reached 131 thousand at the end of 3Q 2011, flat year-on-year.

Voice traffic generated in the fixed network went down 13.5% in 9M 2011 to 1,140 million minutes, with a lower decline rate at -12.7% in 3Q, still impacted by fixed telephony lines losses and fixed to mobile substitution effect.

In 9M 2011, total fixed business revenues went down 7.8% year-on-year reaching CZK 16,836 million. However, in 3Q alone, the decline rate further decelerated to 7.5% year-on-year (-7.6% year-on-year in 2Q and -8.3% year-on-year in 1Q). Revenues from traditional accesses fell by 16.5% year-on-year in 9M (-16.2% year-on.-year in 3Q) reaching CZK 3,286 million in 9M 2011 due to continuous fixed telephony lines losses, while revenues from traditional voice revenues went down by 8.6% year-on-year to CZK 5,105 million in 9M 2011. In 3Q alone, they declined just

[9] Figures are shown net of inter-segment charges between fixed and mobile businesses

by 8.0% year-on-year, helped by higher transit revenues in the quarter. Internet & broadband revenues increased in total by 1.2% year-on-year in 9M 2011 (+2.0% year-on-year in 3Q) reaching CZK 4,529 million in 9M 2011, positively impacted by xDSL customer growth and migration of current higher value customers to VDSL, which is relevant in a highly competitive fixed broadband market. IT services and business solutions revenues decreased by 5.6% year-on-year reaching CZK 1,439 million in 9M 2011, while in 3Q, the decline rate slowed down to -3.2%.

Slovakia

In 3Q 2011, Telefónica Slovakia reported another strong set of commercial and financial results, thus further strengthening its position on Slovak mobile market and supporting positively the Group's financial performance. By 30 September 2011 the total **number of active customers** increased by as much as 38.1% year-on-year reaching 1,079 thousand on that day. In 3Q 2011, the total subscribers net additions reached 76.4 thousand, the highest figure in the year. The number of **contract customers** grew by 55.3% year-on-year reaching 445 thousand at the end of September, which translates into 34.4 thousand net additions in the quarter, while the number of **prepaid active customers** increased by 28.2% year-on-year ending up at 634 thousand at the end September 2011 (+42.0 thousand in the quarter). Consequently, the customer mix in Slovakia improved further and contract customers represented already significant 41.2% of total customer base, up 4.6 percentage point year-on-year. In terms of financial performance, **total revenues** of Telefónica Slovakia in local currency increased by 43.5% year-on-year reaching EUR 113.2 million in 9M 2011 (+33.3% year-on-year in the quarter to EUR 44.1 million, up from EUR 38.5 million in 2Q), fuelled by the strong base growth and improving customer mix. Excluding the impact of MTR cuts (-28.3% to EUR cents 5.51 effective from 1st June 2011), the revenues year-on-year growth rates improved reaching 53.9% in 3Q 2011 (+47.9% in 2Q). In 3Q 2011, OIBDA for Telefónica Slovakia further grew compared to previous quarters, thus helping to support the Group's profitability. In 3Q 2011, **contract ARPU** reached EUR 17.3, slightly diluted by MTR cuts and lower roaming prices, while **prepaid ARPU** stood at EUR 8.5.

Other relevant information

On 28th July 2011, Telefónica Czech Republic, a.s. announced the approval of the transformation project of the subsidiary Telefónica O2 Business Solutions, spol. s r.o. in the form of a demerger by spin-off. Under this project, a part of enterprise of the demerged company was spun-off into a newly founded subsidiary Internethome, s.r.o., the business of which is providing of electronic communications services. The transformation including the spin-off became legally effective on 1st October 2011, following the registration of Internethome, s.r.o. in the Commercial Register. By this transformation the demerged company, Telefónica O2 Business Solutions, spol. s r.o. will not cease to exist and remains providing ICT services.

At the meeting of the Supervisory Board of Telefónica Czech Republic, a.s. held on 8th November 2011, Alfonso Alonso Durán resigned from his office of member as well as Chairman. Further resignations of the Supervisory Board members Anselmo Enriquez Linares, Eduardo Andres Julio Zaplana Hernández-Soro, Guillermo José Fernández Vidal and Luis Lada Díaz were discussed and their offices terminated on this day. José María Álvarez-Pallete López, Enrique Medina Malo and Patricia Cobian were appointed as co-opted members to take office until the next General

Meeting. At the same meeting José María Álvarez-Pallete López was elected as the Chairman of the Supervisory Board.

Alfonso Alonso Durán also resigned from the office of Vice-Chairman and member of the Audit Committee of Telefónica Czech Republic, a.s., at the meeting held on the same day, 8th November 2011. Vladimír Dlouhý, a substitute member of the Audit Committee, became the new member of the Audit Committee.

Attachment:
The consolidated balance sheet and income statement of Telefónica Czech Republic prepared in accordance with International Financial Reporting Standards (all figures in CZK million).

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About Telefónica Czech Republic

Telefónica Czech Republic is a major integrated operator in the Czech Republic. It is now operating almost seven million lines, both fixed and mobile, making it one of the world's leading providers of fully converged services. The organization offers the most comprehensive portfolio of voice and data services in this country. It is paying special attention to the exploitation of the growth potential, particularly in the data and Internet sector. Telefónica Czech Republic operates the largest fixed and mobile network including a 3rd generation network, CDMA (for data), and UMTS, enabling voice, data and video transmission. Telefónica Czech Republic is also a notable provider of ICT services.

About Telefónica

Telefónica is one of the world's largest telecommunications operators by market capitalisation. Its activities are centred mainly on the fixed and mobile telephony businesses, while its broadband business is the key growth driver underpinning both. It operates in 25 countries and has a global customer base of 260 million. Telefónica's growth strategy is focused on the markets in which it has a strong foothold: Spain, Europe and Latin America. Telefónica is a 100% private sector company with its shares listed in Madrid and other stock exchanges and more than 1.5 million individual shareholders.

INCOME STATEMENT	Jan – Sep 2011	Jan –Sep 2010
Business revenues	38,977	41,597
Other recurring revenues	61	144
Revenues	**39,038**	**41,742**
Internal expenses capitalized in fixed assets	460	460
Operating expenses	(23,602)	(24,499)
Other operating income/(expenses)	(145)	(422)
Gain on sale of fixed assets	205	2
Impairment reversal/(loss)	(7)	4,327
OIBDA	**15,949**	**21,610**
Depreciation and amortization	(8,702)	(8,610)
Operating Income	**7,247**	**13,000**
Net financial income (expense)	(62)	(155)
Income before tax	**7,185**	**12,845**
Income tax	(1,369)	(2,478)
Net Income	**5,816**	**10,366**
BALANCE SHEET	**30.09.2011**	**31.12.2010**
Non-current assets	**73,262**	**78,285**
- Intangible assets	7,236	7,989
- Goodwill	13,452	13,448
- Property, plant and equipment and investment property	52,400	56,651
- Long-term financial assets and other non-current assets	174	192
- Deferred tax assets	-	5
Current assets	**23,683**	**14,495**
- Inventories	516	606
- Trade and other receivables	7,797	8,626
- Current tax receivable	266	453
- Short-term financial investments	59	12
- Cash and cash equivalents	15,050	4,798
Non-current assets classified as held for sale	**147**	**12**
Total assets	**97,092**	**92,792**
Equity	**66,104**	**73,176**
Non-current Liabilities	**3,708**	**6,896**
- Long-term financial debt	-	2,883
- Deferred tax liabilities	3,556	3,936
- Long/Term Provisions	55	52
- Other long/term liabilities	97	25
Current Liabilities	**27,280**	**12,720**
- Short-term financial debt	2,969	141
- Trade and Other payables	9,512	9,978
- Current income tax payable	-	-
- Short-term provisions and other liabilities	14,799	2,601
Liabilities assoc. with non-current assets classified as held for sale	**-**	**-**
Total Equity and Liabilities	**97,092**	**92,792**