Interim report

Telefónica Czech Republic – January to September 2013 Financial Results

November 5, 2013

Telefónica Czech Republic, a. s. announces its unaudited financial results for January to September 2013. These results are consolidated and prepared according to International Financial Reporting Standards and fully include the results of Telefónica Slovakia and other smaller operating companies.

Operational Highlights

- **Continuous solid customers' growth in key areas**:
  - **Continuous total mobile customers' growth: +1% year-on-year to 5.1 million**, with 105 thousand[1] net additions in 9M 2013. Continued **strong contract trading** (117 thousand net adds in the nine months of the year[1]) and **low churn** remained the drivers of the growth. **Prepaid base growth was flat** mainly due to migration to FREE Tariffs.
  - **Smartphone penetration growing above 32%**, up by 7.5 percentage points year-on-year.
  - **xDSL accesses grew by 1.9% year-on-year reaching 919 thousand**, with VDSL (already over 80% of total accessible base in residential segment) continues helping to manage fixed BB ARPU dilution and maintain churn.
  - **O_2 TV customer base gained momentum in Q3** thanks to new innovative IPTV platform.
  - **Fixed accesses disconnections in line with previous periods:** accesses down by 7% year-on year in 9M 2013**.**
- **Consolidated operating revenues** went **down by 5.8% year-on-year** reaching CZK 35,579 million in 9M 2013 (-1.7% year-on-year excluding impact of MTR cuts).
- **Guided OIBDA** (excluding brand fees and management fees) **went down by 9.3% year-on-year**, **impacted** by **non-recurring items,** while **OIBDA margin**[2] reached solid **39.4%** on the back of **continuous efficiency agenda** (Group OpEx: -4.9% year-on-year in 9M, -6.6% in Q3) and **growing profitability in Slovakia**.
- **Consolidated free cash flow in 9M growing 6.7% year-on-year.**
- **Telefónica Slovakia** maintained its **strong commercial momentum** reporting 13.9% year-on-year subscribers' growth (+117 thousand in 9M).
- **2013 full year guidance**[3] **reiterated.**
- **Cancellation** of own shares purchased in 2012 (the first 2% tranche) will be **effective as of 15 November 2013.**

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[1] Excluding the impact of inactive customers disconnection in Q1 2013 (114 thousand)
[2] Guided OIBDA/Operating revenues
[3] OIBDA margin: limited margin erosion year-on-year (2012 base: 41.4%), CapEx: less than CZK 6 billion (excluding business acquisitions and excluding investments for spectrum license)

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Consolidated Financial Statements

In 9M 2013, consolidated **operating revenues went down by 5.8% year-on-year to CZK 35,579 million. Excluding the MTR cuts impact** (from CZK 1.08 in 1H 2012, down to CZK 0.55 in Q3 2012, to CZK 0.41 in Q2 2013, and CZK 0.27 per minute in Q3 2013 in Czech Republic, and EURc 3.18 in Q3 2012 to EURc 1.22 per minute in Q3 2013 in Slovakia) they would have **declined by 1.7%** year-on-year.

Fixed operating revenues in the Czech Republic declined by 4.1% year-on-year reaching CZK 15,182 million in 9M 2013, exhibiting more positive trend compared to 2012.

Mobile operating revenues in the Czech Republic reported 10.2% year-on-year decline to CZK 16,641 million in 9M 2013, largely on the back of MTR cuts and intensified competitive pressures with decline in traditional voice and messaging revenues. Conversely, the Company is harvesting the benefits of its data-centric proposition, with **non-messaging data revenues** (excluding CDMA) **growth of 26.5%** year-on-year in 9M 2013 (+35.8% in Q3), significantly boosted by introduction of the new FREE tariffs in Q2 and Q3. **Excluding the MTR cuts impact**, mobile operating revenues would go **down by 4.1% year-on-year in 9M 2013.**

Revenues in Slovakia continued to post positive financial performance and reached 9.4% year-on-year increase to EUR 155 million in the nine months of 2013 (+20.7% year-on-year excluding MTR impact to EUR 171 million).

In 9M 2013, the Company has continued in its effort to deliver efficiencies in both commercial and non-commercial areas of its operations. Total consolidated **operating costs went down by 4.9%** year-on-year to CZK 21,786 million in 9M 2013 (6.6% year-on-year decrease in Q3). Personnel expenses (excluding restructuring costs) declined by 8.1% year-on-year in 9M 2013 (-12.9% year-on-year in Q3) as the Group continued in its restructuring program focused on building leaner and efficient organizational structure. In 9M 2013, the total Group headcount has been optimised by 743 employees (in Q3 by 147). As a result, the Group's headcount reached 5,622 at the end of September 2013, representing 12.2% year-on-year reduction. Moreover, launch of FREE Tariffs in Q2 2013 is helping the Company to benefit from further simplification of its business model and eliminate handsets subsidies in consumer segment.

Guided Operating income before depreciation and amortization (OIBDA)[4] **declined by 9.3%** year-on-year, while the **OIBDA margin** reached 39.4% in 9M 2013, down by 1.5 percentage points year-on-year. However, in Q3 2013 it was 41.9% (flat year-on-year), showing substantial improvement over both Q1 and Q2 2013 (+5.4 percentage points and +2 percentage points, respectively). The year on year performance has been impacted by positive impact of the CZK 220 million gain from the sale of non-core assets in Q1 2012 (80% stake in Informační linky, a.s.) and higher restructuring costs booked in 9M 2013 (CZK 354 million) compared to 9M 2012 (CZK 242 million). Reported OIBDA (including brand fees and management fees) reached CZK 13,206 million in the first nine months of the year (CZK 4,591 million in Q3).

[4] In terms of the 2013 guidance calculation, OIBDA excludes brand fees and management fees, 2013 guidance excludes changes in consolidation, includes potential capital gains from sales of non-core asset, assuming constant FX rates of 2012.

Depreciation and amortization charges went down by 1.8% year-on-year reaching CZK 8,331 million in the first nine months of 2013. Consolidated **net income** excluding aforementioned non-recurring items in 9M 2012 and 9M 2013 **declined by 18.7%** year-on-year largely due to a decline in comparable OIBDA. Reported net income amounted to CZK 3,743 million, down by 25.4% year-on-year.

Consolidated **CapEx** reached CZK 3,448 million in 9M 2013, **down by 13%** year-on-year. The Company continued to focus on efficient investments into growth areas. These include largely further capacity expansion and improvement of the quality of mobile broadband network, in line with growing demand for mobile data services. In H1 2013, the Company commenced deployment of LTE network in existing 1,800 MHz band spectrum, launching LTE services in selected parts of Prague since 15th May 2013 followed by LTE rollout in Brno in October 2013. Additionally, the Company focused its investments into the capacity enhancement in its fixed broadband networks by VDSL expansion.

Consolidated **free cash flows surged by 6.7%** year-on-year reaching CZK 7,466 million in the period of January to September 2013. Net cash from operating activities recorded positive development (+0.3 % year-on-year) due to focus on working capital cash management, lower interest and income tax payments. Cash used in investing activities decreased by 9% year-on-year as a result of combination of lower proceeds on disposal of fixed assets (9M 2012 impacted by proceeds on disposal of 80% of shares of subsidiary Informační linky, a. s. worth CZK 220 million), a decrease in payments for CapEx, and impact of the obligatory temporary warranty paid by the Company in Q3 in connection with its participation in Spectrum Auction scheduled for this year.

The consolidated **long-term financial debt** amounted to CZK 3,000 million at the end of September 2013, flat compared to the end of 2012. At the same time, **cash and cash equivalents** reached CZK 9,085 million. The Company continued to accumulate cash for dividend payment and payment related to the reduction of part of the share premium scheduled for Q4.

CZ Mobile Business Overview

The Company continuously monitors its customers' needs and demands in changing market environment. In line with this approach, on 15th April, the Company substantially simplified its mobile tariff portfolio and launched new FREE Tariffs. These simple and price transparent tariffs bring the customers more value via unlimited on-net calls and SMS in each package, while the FREE CZ tariff offers unlimited all-net calls and SMS and 1GB data package on top of that. The reaction of the market to new unlimited tariffs was very positive and clearly demonstrated the shift of customers from price to value-oriented and as at September 30th nearly half of residential contract base has migrated to new tariffs. Moreover, after successfully addressing needs of our residential customers with FREE Tariffs, the Company consequently also addressed needs of its business customers with Vario Tariffs (with major adoption by customers in Q3 2013) and thus continues in its commitment to be innovation leader in the Czech mobile market.

In the mobile internet area, the Company continued in its support of smartphone sales via introduction of instalment model, keeping best price guarantee proposition for bestselling smartphones and the data proposition in its new FREE and Vario tariffs. As a result, Revenues from Internet in Handsets in Q3 2013 doubled compared to 2012 period, smartphone penetration[5] grew further, reaching 32.2% at the end of September 2013, up by 7.5 percentage points year-on-year, and smartphone sales represented close to 68% of total handset sales in 9M 2013, with the share of high and mid-end smartphones continuously increasing.

It should be highlighted that since the beginning of 2013, the Company has applied a more conservative activity criteria for reporting mobile customers, which has led to the disconnection of 114 thousand inactive mobile contract customers on the reported customer base, effective since January 1, 2013, with no impact on revenues.

The total **mobile customer base** reached 5,074 thousand at the end of September 2013, a 1.0% year-on-year increase, despite aforementioned disconnection of contract base. Total net additions amounted to 105 thousand excluding the adjustment due to both, good traction in the contract segment throughout the 9M 2013 and migration of part of prepaid base customers to FREE Tariffs. **Contract customers** grew by 1.7% year-on-year reaching 3,195 thousand. Net additions during the first nine months of the year excluding the impact of the disconnection reached 117 thousand. This growth was fostered mainly by solid trading, sustained low churn and aforementioned customers migrating from the prepaid to the contract segment as an effect of FREE tariffs introduction in April 2013. The number of **prepaid customers** reached 1,880 thousand at the end of September 2013, down by 0.2% year-on-year.

The blended monthly average **churn rate** reached 2.2% in 9M 2013, while contract churn was at 1.4% impacted by the commented adjustment in the customer base. Excluding the impact of inactive customers disconnections, churn continued to be low at 1%. Prepaid churn was 3.5% in 9M 2013.

[5] Smartphones as % of total handsets base

In terms of usage, total **mobile traffic**[6] carried by our customers in the Czech Republic reached 7,909 million minutes in 9M 2013, up by 11.5% year-on-year, supported by successful adoption of unlimited FREE Tariffs.

In 9M 2013, **total mobile ARPU** declined by 16.2% year-on-year to CZK 331.8, impacted largely by MTR cuts, and lower effective prices for outgoing traffic due to initial dynamics of new tariffs adoption by customers (both FREE and Vario tariffs). Excluding the impact of MTR cuts, total ARPU would have declined by 9.9%. **Contract ARPU** went down by 16.3% year-on-year reaching CZK 442.6 in 9M 2013. **Prepaid ARPU** decreased by 16.5% year-on-year to CZK 147.2.

Total **mobile operating revenues** in the Czech Republic declined by 10.2% year-on-year to CZK 16,641 million in 9M 2013. At the same time, mobile gross service revenues went down by 12.4% year-on-year to reach CZK 15,326 million. Continuous competitive pressures leading to lower spend together with MTR cuts continued to be the key drivers for the decline. Excluding the impact of mobile termination rate cuts, mobile gross service revenues would decline by 5.9% year-on-year in the nine months of the fiscal year. Mobile originated voice revenues declined by 12.6% year-on-year to CZK 9,429 million, while messaging (SMS & MMS) revenues were 23.5% lower due to lower effective per unit price. Terminated revenues went down by 32.5% year-on-year to CZK 1,661 million in 9M 2013, largely impacted by MTR cuts not fully compensated by higher incoming traffic. On the other hand, non-messaging data revenues considerably improved by 18% year-on-year (+26.5% excl. CDMA) reaching CZK 2,590 million, supported by growing revenues from mobile internet, and remained the key growth driver of mobile revenues.

[6] Inbound and outbound, including roaming abroad, excluding inbound roaming

CZ Fixed Business Overview

In the first nine months of 2013, the Company continued to report solid commercial and financial performance on the back of healthy growth of voice wholesale revenues, as well as via successful proposition of its VDSL service and new IPTV to the broadband customer base in highly competitive and slowing market. Continuous migration of existing ADSL customers to the VDSL service and new IPTV platform for O_2 TV are both helping the Company to manage fixed broadband ARPU dilution and sustain low churn.

The total number of **fixed accesses** declined by 7% year-on-year reaching 1,412 thousand at the end of September 2013, with 88 thousand net losses during the nine months period. The Company managed to moderately decelerate disconnections of fixed accesses in throughout 9M 2013 with consecutive quarterly net losses deceleration.

The number of **xDSL accesses** reached 919 thousand at the end of 9M 2013, up by 1.9% year-on-year together with further improvement in xDSL accesses composition. In respect of VDSL, 336 thousand customers (+41% year-on-year) have already subscribed for the upgraded service (76 thousand net additions in the nine months of the year), which represents 41% of the total xDSL residential base and 80% of the total addressable existing residential base (~ 51% of households). The total number of **O_2 TV customers** reached 148 thousand at the end of 9M 2013, +5.6% year-on-year thanks to new innovative IPTV platform launched in Q3 that is appreciated by the customers (5 thousand net adds in Q3 2013).

Total **fixed operating revenues** went down by 4.1% year-on-year reaching CZK 15,182 million in 9M 2013, continuing in better momentum in 9M 2013 compared to 9M 2012 mainly due to significant growth in voice wholesale revenues and growing ICT business. Revenues from voice retail services in 9M 2013 continued in trend and fell by 18.4% year-on-year, in line with performance in previous periods, reaching CZK 3,417 million, due to continuing fixed telephony line losses. Voice wholesale revenues improved by 17.6% year-on-year in 9M 2013 to CZK 3,492 million, while Internet & broadband revenues (incl. IPTV) declined by 3.6% year-on-year to CZK 4,520 million in 9M 2013, resulting from competitive ARPU pressures compensated by the combination of xDSL customer growth, migration of customers to VDSL, as well as growing IPTV customer base thanks to our new IPTV platform. ICT revenues went up by 1.4% year-on-year to CZK 1,551 million, with an increasing share of recurring ICT revenues, in line with the Company's strategy to focus on proposition of innovative ICT solutions to mitigate dependency on one-off projects for the public sector.

Slovakia

In 9M 2013, Telefónica Slovakia achieved strong commercial and financial performance. At the end of September 2013, the total number of customers reached 1,471 thousand, posting a 13.9% year-on-year growth. Their number increased by more than 117 thousand in the first nine months of the year, thanks to maintained growth performance of the contract customers as well as the prepaid segment. The number of contract customers grew by 21% year-on-year reaching 740 thousand at the end of September 2013 (+80 thousand net adds in 9M), while the number of prepaid customers increased by 7.5% year-on-year ending up at 732 thousand. Consequently, the customer mix in Slovakia further improved and the number of contract customers has surpassed the number of prepaid customers (50.3% of the total customer base at the end of 9M 2013, up by 3 percentage points year-on-year).

In terms of financial performance, the **total operating revenues** of Telefónica Slovakia in local currency increased by 9.4% year-on-year reaching EUR 155 million in 9M 2013. Excluding the impact of MTR cuts, the growth rate would be 20.7%, fuelled by customer growth, refreshed proposition, improving customer mix and the focus on acquiring higher value customers. At the same time, OIBDA of Telefónica Slovakia went up by 24.2% year-on-year to EUR 49.2 million, resulting in healthy 31.8% OIBDA margin. **Contract ARPU** reached EUR 15.2, while **prepaid ARPU** was at EUR 7.2 in the first nine months of 2013.

Realisation of Share Buyback Program

The Annual General Meeting of the Company held on 19th April 2012 approved the share buyback program, based on which the Company is allowed to purchase its own ordinary shares to the extent that it does not exceed 32,208,989 shares, i.e. will not exceed 10% of the total number of the Company's ordinary shares. The period during which the Company is authorized to acquire its shares shall be 5 years from the date of the General Meeting.

During 2012, a 1st tranche of the share buyback was executed and 2% of the registered shares were purchased. The cancellation of these 6,441,798 treasury shares purchased in the 1st tranche and the corresponding reduction of the registered capital by CZK 560,436,426 will be effective as of 15th November 2013.

Based on the above-mentioned General Meeting resolution, the Board of Directors adopted, on 26th February 2013, a resolution to continue with own ordinary shares acquisition program (share buyback, 2nd tranche) in the extent of up to 6,441,798 of the ordinary shares, i.e. up to another 2% of the total ordinary shares issued by the Company. Following the above resolutions, the Company commenced the 2nd tranche of purchasing its own shares on 5th March 2013. On 29th October 2013, after purchasing 5,428,035 shares representing 1.69% of total ordinary shares issued by the Company, the Board of Directors decided to stop the acquisition. The total price of shares purchased during 2013 amounted to CZK 1,595 million, resulting in average price of CZK 294 per share.

Other relevant facts

Telefónica Czech Republic filed a lawsuit against the conditions of the spectrum auction
On 29th September 2013, Telefónica Czech Republic filed a lawsuit against unlawful interference at the Municipal Court in Prague. The lawsuit was filed not against the auction as such. The lawsuit was filed against discriminatory and unlawful provisions of the terms and conditions of the spectrum auction in the 800, 1,800 and 2,600 MHz bands, which deform the rules of the auction.

Majority shareholder considering strategic alternatives
On 15th October 2013, TELEFÓNICA, S.A., the majority stakeholder of Telefónica Czech Republic, has stated that it is considering strategic alternatives regarding its stake in Telefónica Czech Republic, including conversations with investor group PPF, not having certainty with respect to the feasibility of reaching an agreement, nor with respect to the eventual terms and conditions of such agreement.

Announcement on stopping the acquisition of Telefónica Czech Republic's own shares
On 29th October 2013, following i) the resolution of the Company's General Meeting held on 19 April 2012, which approved the ordinary share acquisition (share buy-back) program in the extent of up to 32,208,989 shares, i.e. up to 10% of total number of the Company's ordinary shares during the 5 years period from the date of the General Meeting, ii) the resolution of the Board of Directors adopted on 18 May 2012 related to the commencement of the share buyback program in the extent of up to 6,441,798 shares, i.e. up to 2% of total number of Company's ordinary shares and iii) the resolution of the Board of Directors adopted on 26 February 2013 related to the continuation of the share buyback program in the extent of up to 6,441,798 shares, i.e. up to 2% of total number of company ordinary shares, the Board of Directors adopted the decision to stop the acquisition of the Company's own shares as of 29 October 2013. The Board of Directors decided to stop the acquisition due to stock price volatility driven by speculation about the potential sale of the majority stake by TELEFÓNICA, S.A.

Telefónica and T-mobile are announcing signing of the agreement on sharing 2G and 3G networks
On 30th October 2013, Telefónica Czech Republic and T-Mobile Czech Republic have signed an agreement regarding the sharing of their current 2G and 3G mobile networks. The deal has been reached in order to achieve significant efficiencies in 2G and 3G networks and technologies. The transaction will bring substantial benefits to the customers of both operators, especially in improvement of service quality and coverage. The deal is the result of negotiations that began this year in August.

To meet the technological challenges involved in the project, the first trials in lab conditions will commence already next week. The main goal of these trials is to confirm the technological solution. After the trials we will start operating shared 2G and 3G networks commercially during the first half of 2014, and in the following years the operations will be gradually extended to the whole area of the Czech Republic, excluding Prague and Brno.

The deal builds upon the very successful 3G network sharing scheme, which both companies already implemented in 2011-2012. This sharing scheme, which was the first active in Europe, helped accelerate 3G deployment in smaller towns. Currently, Telefónica and T-Mobile share almost 1,000 3G sites. The final number of shared sites that will be in scope of the new agreement will be dependent on the outcomes of the trials. This deal has no relevance to any new technologies or future spectrum allocations.

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 eight 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 largest telecommunications companies in the world in terms of market capitalisation and number of customers. From this outstanding position in the industry, and with its mobile, fixed and broadband businesses as the key drivers of its growth, Telefonica has focused its strategy on becoming a leading company in the digital world. The company has a significant presence in 25 countries and a customer base that amounts more than 300 million accesses around the world. Telefonica has a strong presence in Spain, Europe and Latin America, where the company focuses an important part of its growth strategy. Telefonica is a 100% listed company, with more than 1.5 million direct shareholders.

All amounts in CZK million

CONSOLIDATED INCOME STATEMENT	**Jan – Sep 2013**	**Jan – Sep 2012**
Operating revenues	35,579	37,751
Other recurring revenues	75	73
Revenues	**35,654**	**37,824**
Internal expenses capitalized in fixed assets	452	470
Operating expenses	(21,786)	(22,910)
Other operating income/(expenses)	(329)	(165)
Gain on sale of fixed assets	51	270
Impairment reversal/(loss)	(8)	(19)
OIBDA	**14,034**	**15,470**
Brand fees & management fees	(828)	(780)
OIBDA after brand fees & management fees	**13,206**	**14,690**
Depreciation and amortization	(8,331)	(8,488)
Operating Income	**4,875**	**6,202**
Net financial income (expense)	(119)	(123)
Results attributed to joint venture	(6)	0
Income before tax	**4,750**	**6,079**
Income tax	(1,007)	(1,060)
Net Income	**3,743**	**5,019**

All amounts in CZK million

CONSOLIDATED BALANCE SHEET	30.9.2013	31.12.2012
Non-current assets	**62,817**	**67,835**
- Intangible assets	6,396	6,833
- Goodwill	13,499	13,497
- Property, plant and equipment and investment property	42,274	46,691
- Long-term financial assets and other non-current assets	159	141
- Deferred tax assets	489	673
Current assets	**16,711**	**11,364**
- Inventories	455	487
- Trade and other receivables	7,138	7,730
- Current tax receivable	1	101
- Short-term financial investments	32	2
- Cash and cash equivalents	9,085	3,044
Total assets	**79,528**	**79,199**
Equity	**53,334**	**60,574**
Non-current Liabilities	**5,852**	**6,322**
- Long-term financial debt	3,000	3,000
- Deferred tax liabilities	2,754	3,206
- Long-term Provisions	33	29
- Other long-term liabilities	65	87
Current Liabilities	**20,342**	**12,303**
- Short-term financial debt	16	31
- Trade and Other payables	8,753	9,982
- Current income tax payable	142	5
- Short-term provisions and other liabilities	11,431	2,285
Total Equity and Liabilities	**79,528**	**79,199**