



# FIFTH **INVESTOR** CONFERENCE

Valencia. May 25 th - 26 th. Ciudad de las Artes y las Ciencias

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# VALUE ADDITION BY COST SUBTRACTION

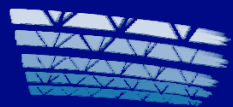
**Santiago Fernández Valbuena**

Chief Financial Officer, Telefónica, S.A.



Valencia - May 26, 2006

Telefónica, S.A.  
Chief Financial Officer



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Chief Financial Officer

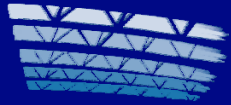


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# 00 Introduction

- **From Bean-Counting to Bean-Growing**
  - Finance helps transform top line growth and operating margins into Free Cash Flow.
- **Finance delivers very visible synergies**
  - Active Management of liabilities, currencies and tax planning boost profits:

**OVERLAYING  
BUSINESSES**

**ADDING TO  
THE BOTTOM  
LINE**

**ACHIEVING BETTER RATES, CHEAPER DEBT, LOWER TAXES**



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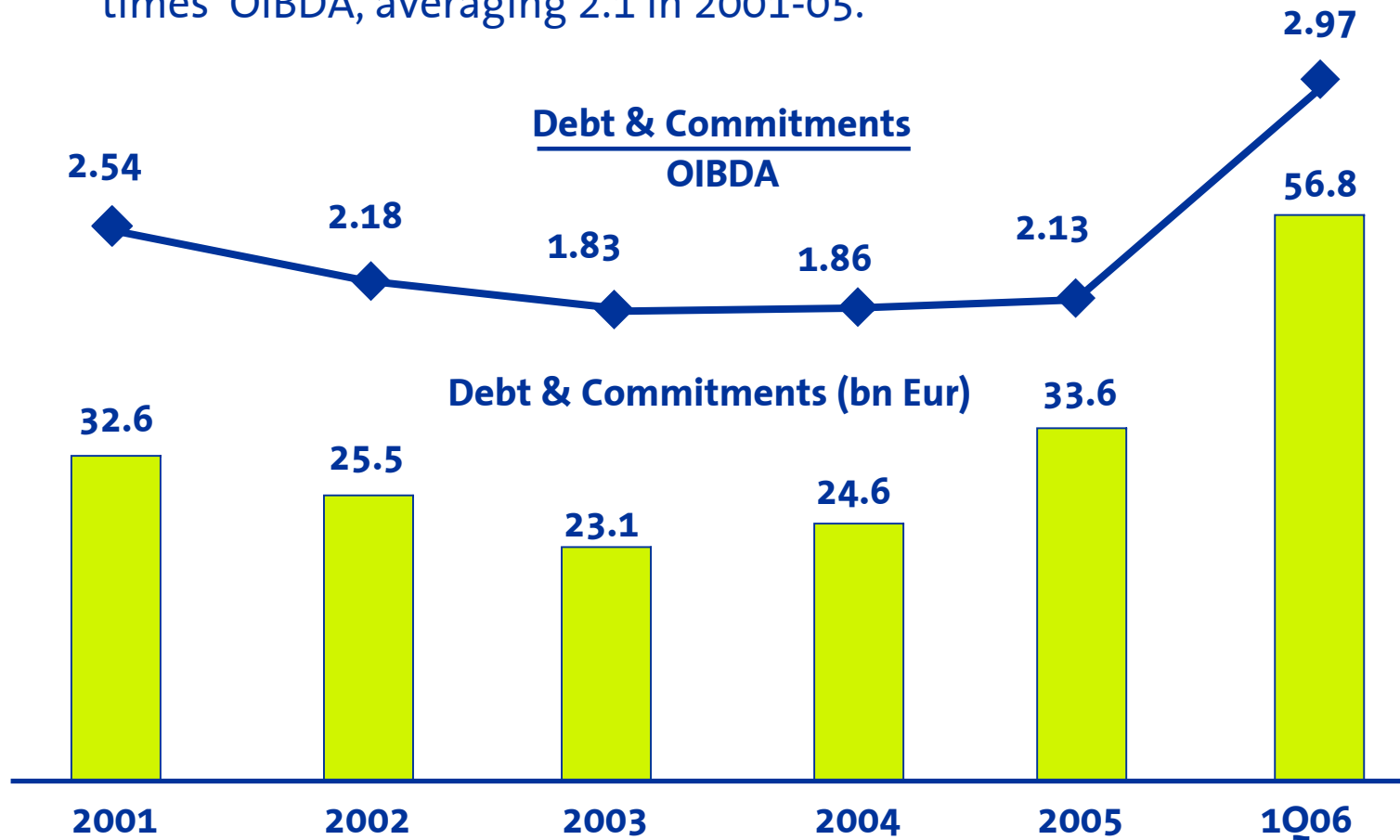
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# 01 Telefónica has historically kept leverage under control...

- Debt & Commitments have been moving between 1.8 and 2.6 times OIBDA, averaging 2.1 in 2001-05.





# 01 ...and we will bring it back to normal

**Our updated Financial Policy rests on two pillars**

Telefónica targets:

**BBB+/Baa1 as rating floor**

$$\frac{\text{Net debt + cash commitments}}{\text{Operating Income before D\&A}} \leq 2.5X$$
 } **over the medium term**



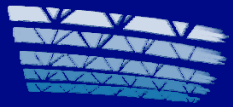


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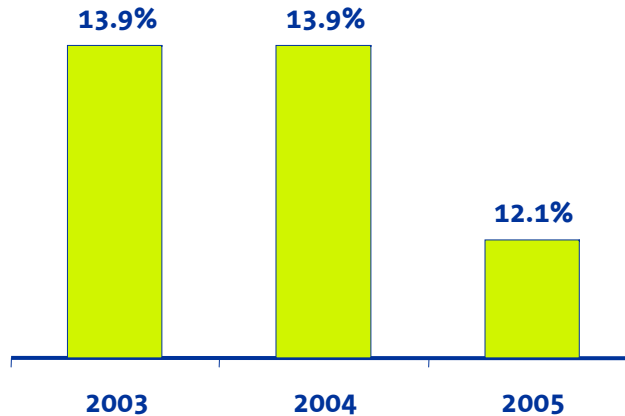
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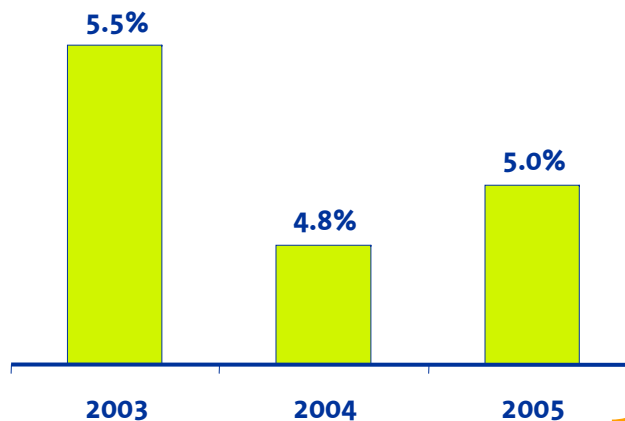


## 02 Decreasing financial expenses

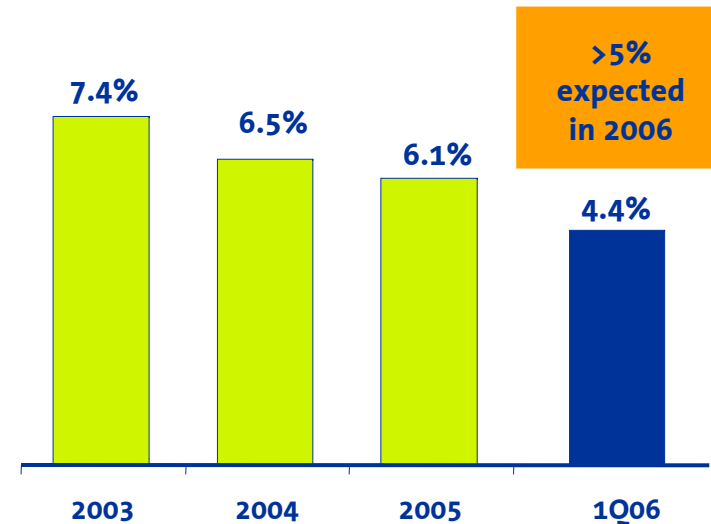
Evolution of Latam cost



Evolution of ex-Latam cost



Evolution of average cost



■ Decreasing trend pushed by:

- Refinancing at low rates in the last 3 years in Spain
- Diversification of Latam debt outside Brazil and Argentina at lower rates
- 400 bps SELIC rate reduction in Brazil since September 2005.
- Higher weight of Eur and GBP debt following O2 acquisition.



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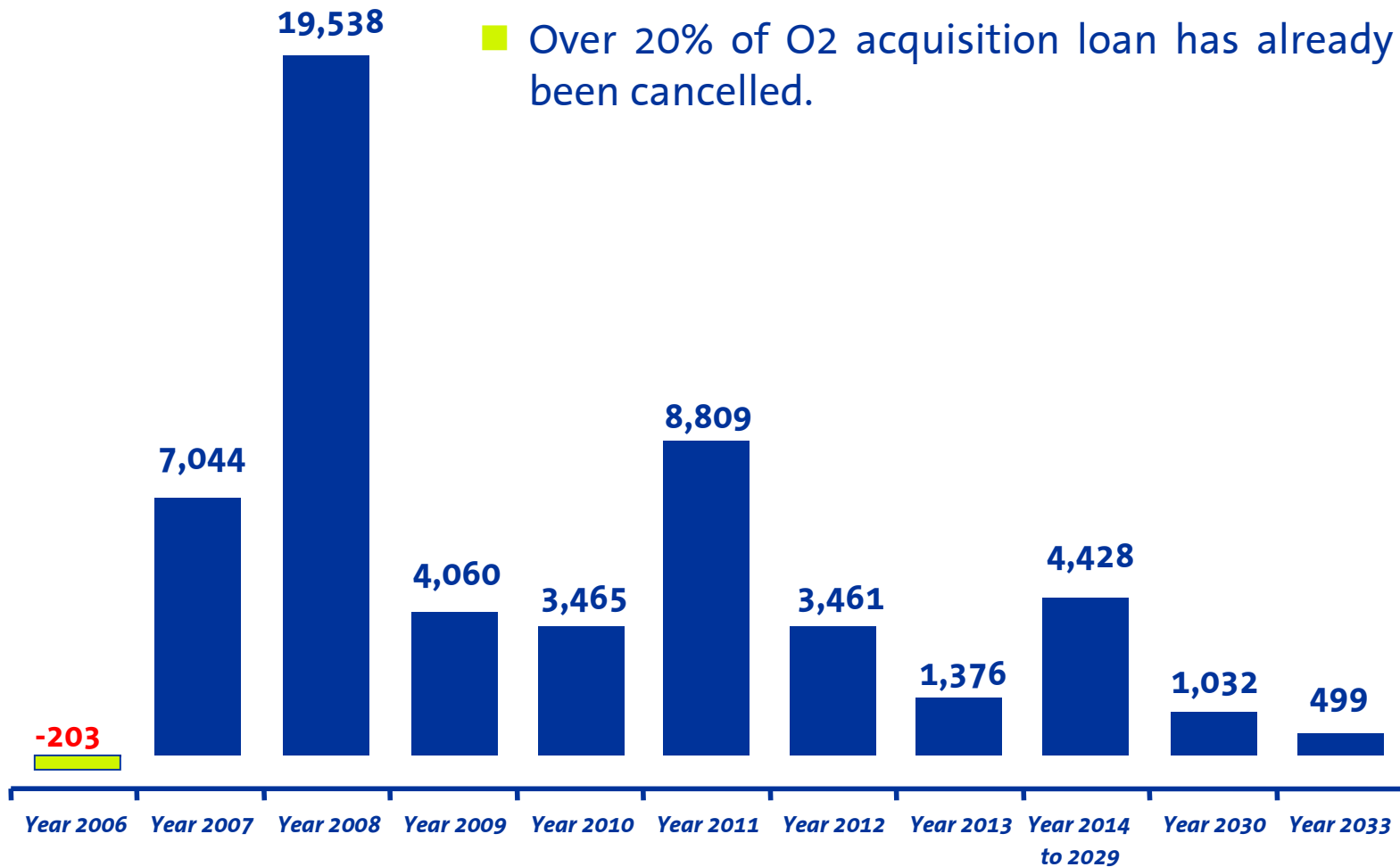


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## 03 Average financial debt maturity close to 5 years

- After Q1 6.6 bn Eur refinancing, we face negative 2006 maturities.
- Over 20% of O2 acquisition loan has already been cancelled.

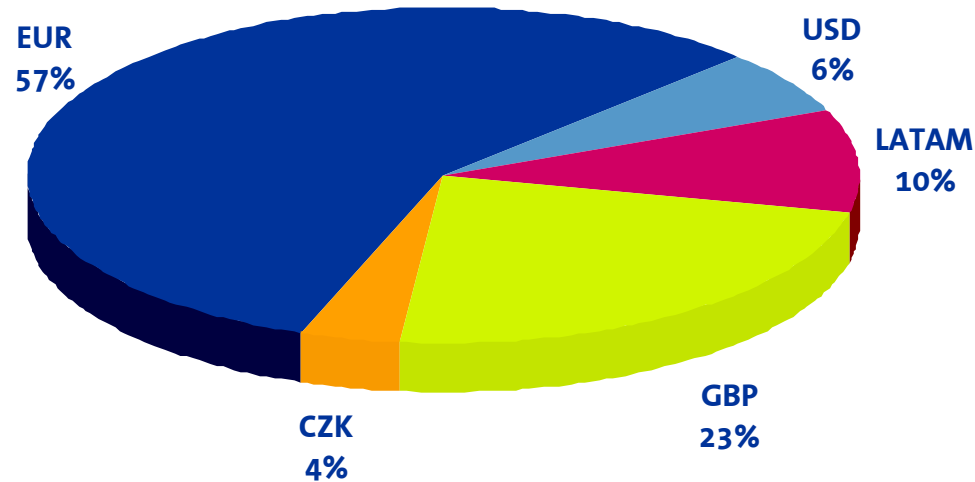


Telefónica S.A.  
Chief Financial Officer



## 03 Currency diversification in liability portfolio

- Latam hedging: 9 bn Eur denominated in USD and Latam currencies
- Europe hedging: 12 bn Eur in sterling, 2 bn eur in Czech Koruna
- 57% (30 bn Eur) denominated in Euros

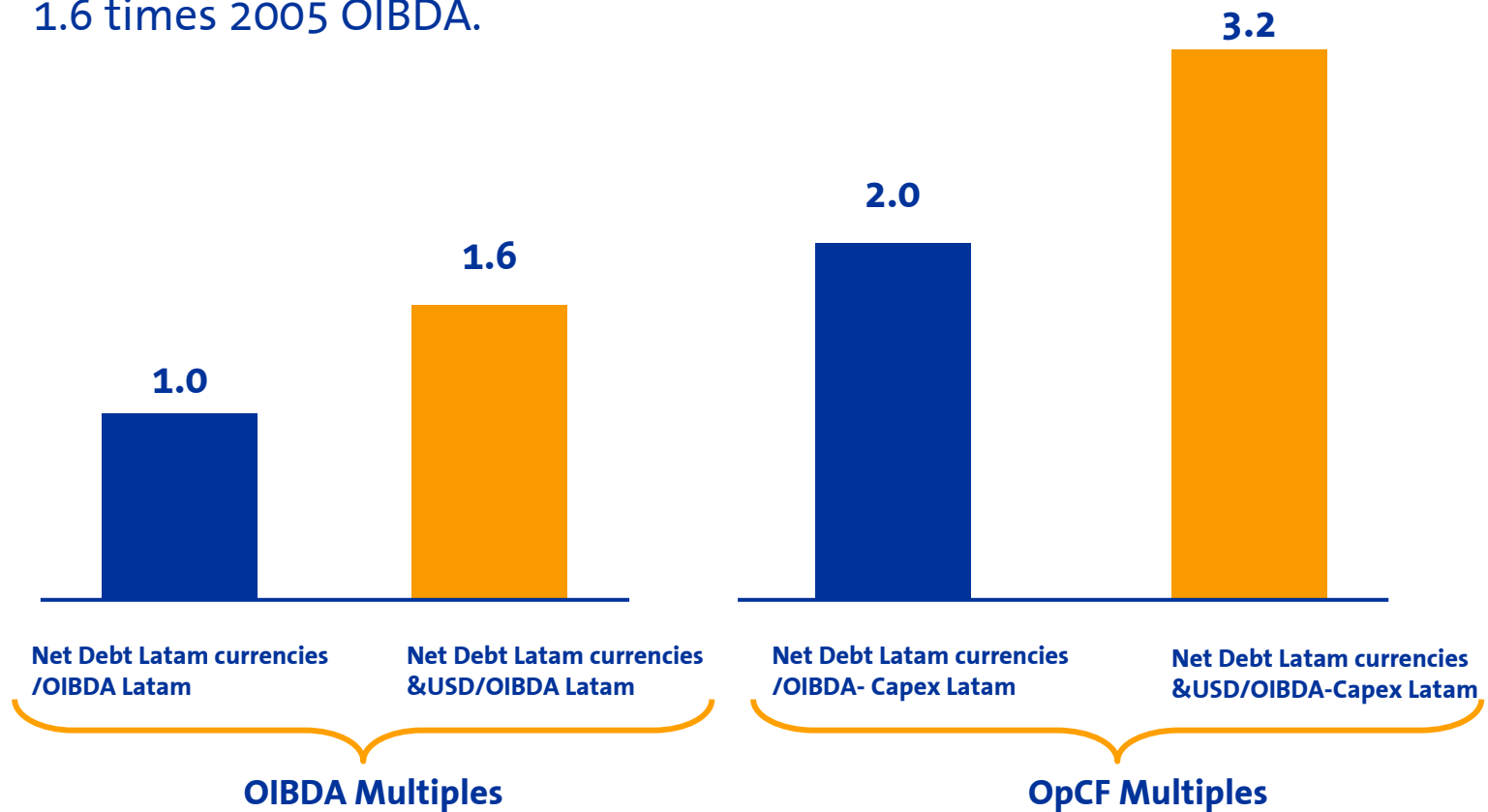


**Our strategy is not focused on debt percentages, but on  
Cash-Flow, and  
Assets....**

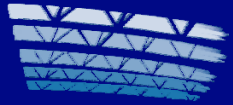


## 03 FX risk of Latam CF hedged for around 3 years

- Debt in Latam currencies as of March-06 reached 2.0 times 2005 operating CF, and 1.0 times 2005 OIBDA.
- When adding USD debt hedge ratios (\*) rise to 3.2 times 2005 OpCF and 1.6 times 2005 OIBDA.

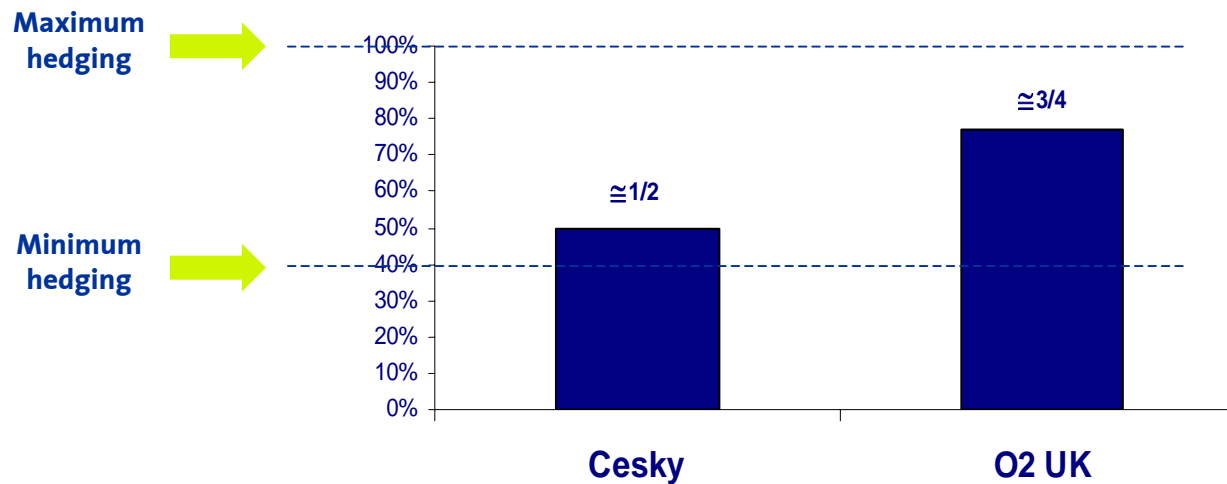


\* Hedging degree varies across countries in the region



## 03 Hedging asset value of European acquisitions

- Risk reduction requires lower than 100% hedging due to the lack of perfect correlation between foreign asset and liabilities values in Euro terms.
- Hedging degree higher than in Latam as interest rate differentials are smaller.



### Close to 200 M Eur savings

#### O2 UK hedging degree

Euro funding of O2 Germany and Ireland by buying pounds for acquisition payment at rates cheaper than the one at announcement

#### Cesky hedging degree

6% Czech Koruna appreciation since acquisition while Czech Koruna liabilities kept at around 50% of the purchase price for playing convergence within EU

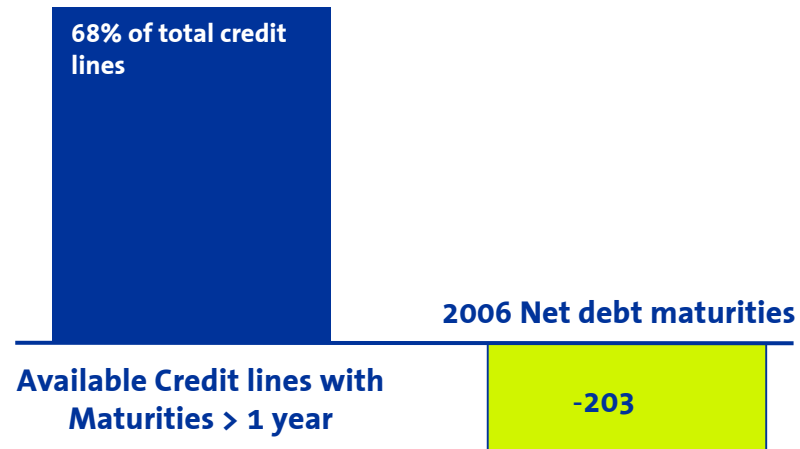


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## 03 Healthy Liquidity Position

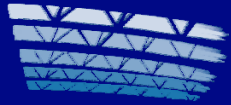
No Liquidity  
risk in 2006

More than 8.2 billion  
in credit lines



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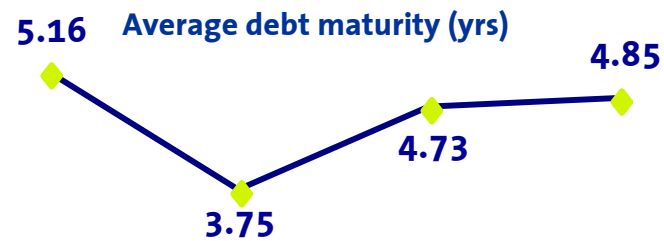




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# 03 Liquidity increased through refinancing

## Refinancing Plan already in progress



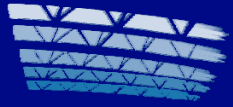
- ✓ 7.3 billion Euro long term refinancing executed
- ✓ More than 1 year average debt maturity extension

## Keeping open access to capital markets

|                 | Peers (1) | Telefónica at O2 acquisition | Telefónica as of Q1 |
|-----------------|-----------|------------------------------|---------------------|
| Banking Debt    | 25%       | 73%                          | 60%                 |
| Capital Markets | 75%       | 27%                          | 40%                 |

(1) Arithmetic average of Telecom Italia, France Telecom, Deutsche Telecom and Verizon debt structure. Source: Annual Reports.



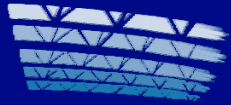


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# 04 Recorded Tax Credits

| December 2005          |                                  |
|------------------------|----------------------------------|
| <b>ASSETS</b>          | <b>LIABILITIES</b>               |
| Investments including: | Long term liabilities including: |
| Net Tax credits        | Deferred Taxes*                  |
| 4,020 MM €             | 2,477 MM €                       |
| Deferred Taxes         |                                  |
| 4,365 MM €             |                                  |

\* Increase due to goodwill allocated to assets

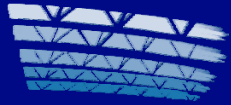
|         |            |
|---------|------------|
| Spain   | 3,520 MM € |
| Latam   | 209 MM €   |
| Móviles | 195 MM €   |
| Others  | 96 MM €    |

88%

TEF expects to offset it during the period 2006-2008



**BEFORE FINAL TAX RATE CONVERGENCE**



# 04 Tax Outlook:

Tax and accounting reforms in progress

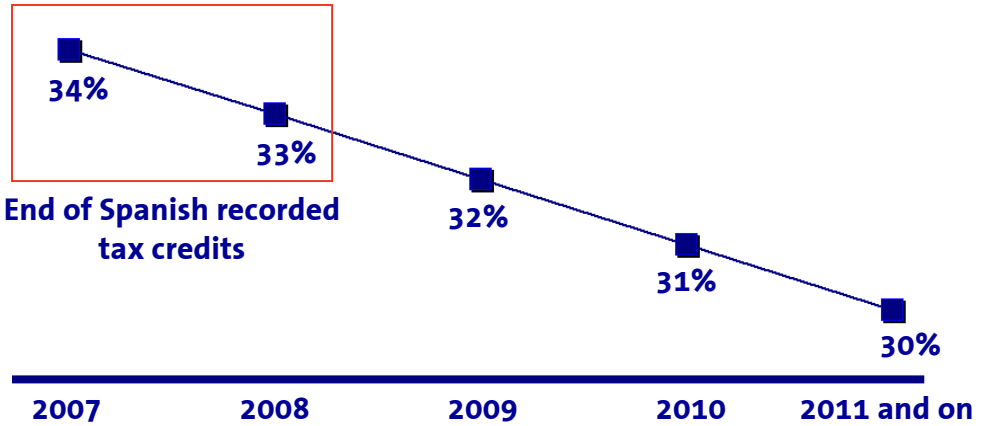
## Milestones

May – June 2006

Definitive ruling on the Tax allowance for Export Activities (DAEX) case (European Union)

2007 CIT reform

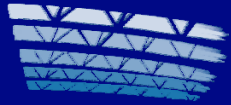
Proposal to amend Corporate Income Tax in Spain: gradual reduction of tax rates and phasing out of tax credits (allowances)



2007-on

- Final Resolution on UK UMTS VAT claim in European Tax Court.
- Accounting and tax reforms: Tax alignment to IFRS rules (2007-2008?). [IFRS currently applies to listed companies + consolidated groups only].





## 04 Tax Outlook (cont.)

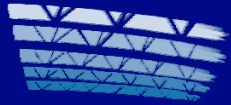
The current nominal tax rate in Spain is the highest in Europe (\*)



| Country        | CIT (%) 2006 |
|----------------|--------------|
| Spain          | 35%          |
| France         | 33.83%       |
| Belgium        | 33%          |
| Italy          | 33%          |
| Greece         | 32%          |
| United Kingdom | 30%          |
| Netherlands    | 29.6%        |
| Norway         | 28%          |
| Sweden         | 28%          |
| Denmark        | 28%          |
| Finland        | 26%          |
| Germany        | 26%          |
| Austria        | 25%          |
| Portugal       | 25%          |
| Czech Republic | 24%          |
| Poland         | 19%          |
| Hungary        | 16%          |
| Bulgaria       | 15%          |
| Ireland        | 12.50%       |

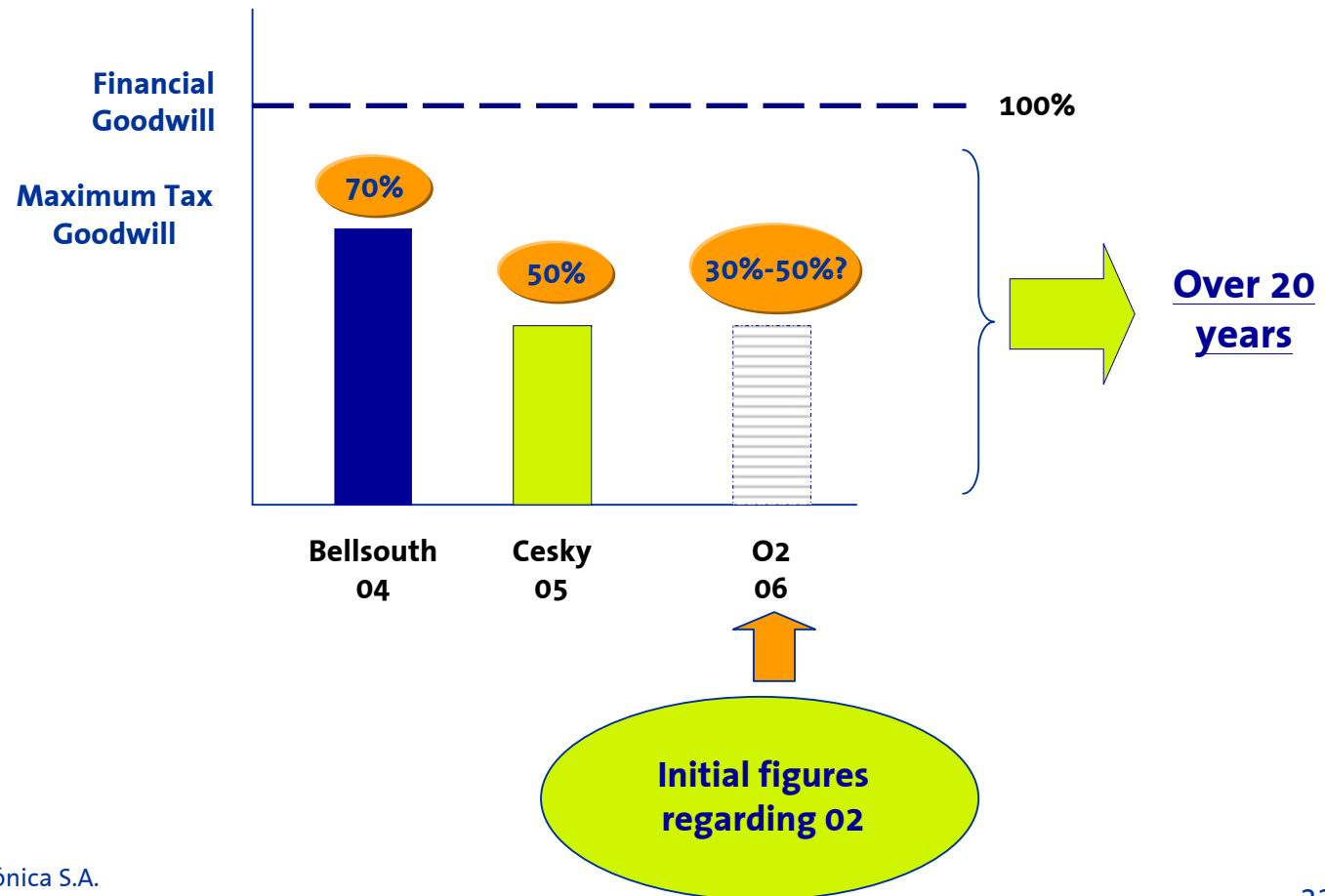
...and the planned reduction will be insufficient to catch up with the “leaders”

(\*) Local taxes not included



# 04 Goodwill: Amortization taxwise

Financial Goodwill arising out of the acquisition of a foreign entity can be amortized taxwise in Spain under certain and **exceedingly strict circumstances** once an allocation analysis for the underlying assets, rights and contingent liabilities has been produced (PPA).



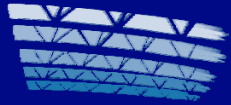


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## 05 CONCLUSIONS

### Debt targets and metrics clearly defined:

- ✓ BBB+Baa1 rating
- ✓ 2.5x leverage

### Unit cost of debt falling:

- ✓ More Eurocentric Debt
- ✓ Falling Latam costs
- ✓ Successful Risk Mgmt.

### Tax outlook encouraging:

- ✓ Timing of Tax Credit exhaustion and Corporate Tax Reform boosting C-F

**HIGHER CASH FLOWS  
AND  
LOWER DISCOUNT RATES**



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