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THIRD
INVESTOR
CONFERENCE

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Telefonica

Safe harbor

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***Finance at Telefónica:
for us, WACC means We Are
Careful with Capital***



Contents

- 1. Managing for Cash-Flows: Generation and Distribution.**
- 2. Our 3-D Balance Sheet: Assets, Liabilities, Risks.**
- 3. Conclusions.**



1. *Managing For Cash-flows*

1.1 GENERATION

- FCF Generation
- Regional Sources

1.2 DISTRIBUTION RATIONALE

**FIRM
COMMITMENTS**



- Shareholder Remuneration
- Solvency Protection

**STRATEGIC
FLEXIBILITY**



- Business Expansion
- Financial Flexibility



A Strong Cash Flow For The Period 2003-2006...

**OPERATING
FREE CASH FLOW***

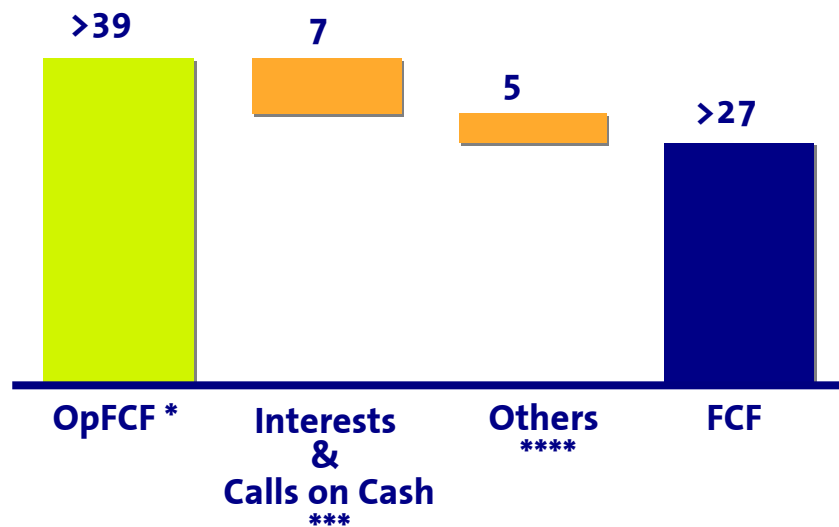
- Client focus & commercial excellence to drive top line growth
- Build-up of a cost efficient model
- Optimizing Capex for lower capital intensity

**NON-OPERATING
OUTFLOWS**

- Financial expenses
- Cash Taxes
- Minorities
- Working capital
- Calls on cash flow

FREE CASH FLOW GENERATION 2003-2006 **

(€ Bn., 2002 constant exchange rates)



* EBITDA-CAPEX

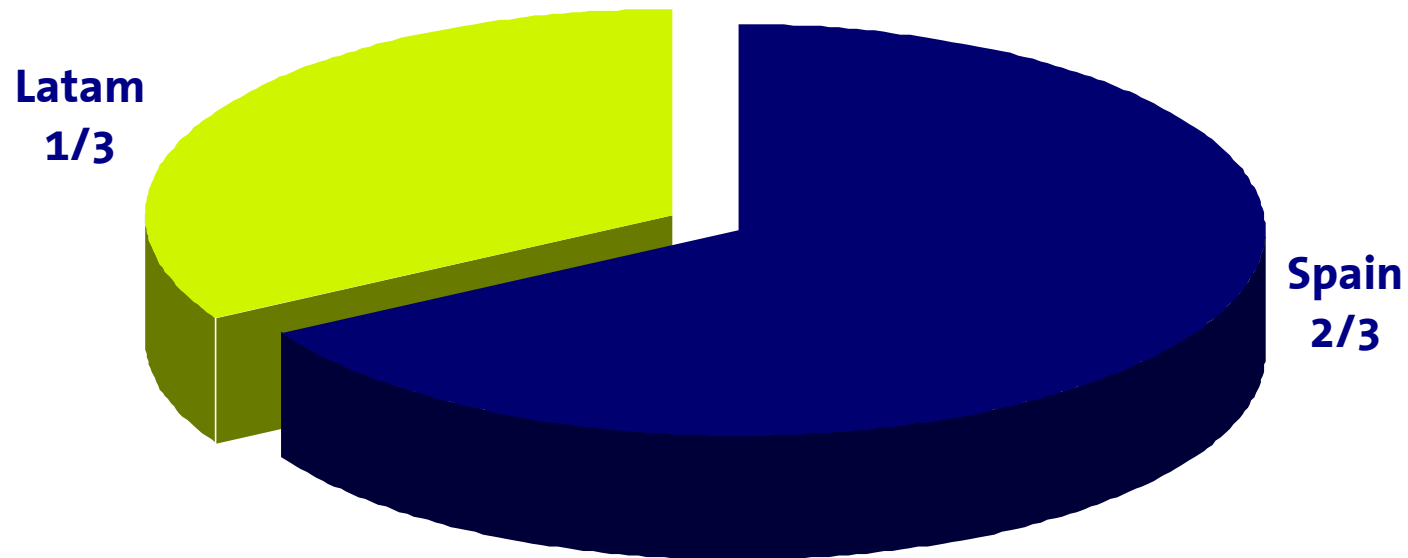
** Before Financial Investments. Excluding forex and changes in consolidation

*** Assuming limited debt reduction

**** Cash Taxes, Minorities and Working Capital

...Which Is Well Balanced By Geographies

2003-2006 FREE CASH FLOW BREAKDOWN BY GEOGRAPHY *



- ➔ Spain more than covers our 03-06 firm commitments.
- ➔ We have proven our active management of Latam exposure.

* Constant Exchange Rates as of 2002

Our Rationale For 2003-2006 Cash-flows Distribution

TWO BASIC PRINCIPLES...

...TO ACHIEVE OUR FOUR PRIORITIES

**TO FULLY DELIVER
ON OUR FIRM
COMMITMENTS**

**TO KEEP STRATEGIC
FLEXIBILITY TO GROW
OUR BUSINESSES**

1. SHAREHOLDER REMUNERATION

**2. SOLVENCY PROTECTION FOR A
“SINGLE A” RATING**

3. BUSINESS LONG TERM EXPANSION

4. FINANCIAL FLEXIBILITY

**ON-GOING
RECIRCULATION**

Cash Flow generation is:

- ➔ **Contingent upon fulfilment of Strategic Plan, sensitive to:**
 - Business risks and opportunities: Demand, costs, competition, capex needs.
 - Financial markets developments: cost of capital.
 - Major technological changes and business opportunities.
- ➔ **Sensitive to changes in Exchanges Rates.**

**FIRM COMMITMENTS AND
SIZE ALLOCATIONS FOR THE
USE OF CASH-FLOW MUST
BE BALANCED AGAINST
THESE ITEMS.**

Our Track Record Shows We Are Delivering On All Four Priorities

SHAREHOLDER REMUNERATION

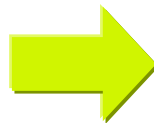
- Cash dividends
- Share buy-backs



- 0.4€ per share until 2006
- 101 Million shares cancelled in 2003

SOLVENCY PROTECTION FOR "SINGLE A" RATING

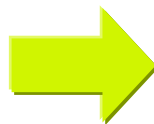
- Debt reduction
- Notional funding of non-debt commitments



- 9 Billion € debt reduction since 2001
- Targeting pre-retirees and Redundancy Program

BUSINESS LONG TERM EXPANSION

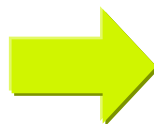
- Add-on acquisitions
- Minority buy-outs
- Capex acceleration



- TCO in Brazil
- Terra Lycos tender offer
- Capex acceleration in Mexico

FINANCIAL FLEXIBILITY

- 2002 devaluations drained 1.3 Bn.€ of OpFCF *



- Crisis management
- Liquidity reserve
- Debt savings due to Fx

* EBITDA-CAPEX

Our Approach To The Destination Of 03-06 Cash-flows (I)

WE HAVE FIRM COMMITMENTS IN EXCESS OF € 15 Bn

**SHAREHOLDER
REMUNERATION**

≅ 7.4 Bn.€

- Cash dividends.
- Share buy-backs.



- 1.2 Bn.€ to be paid in 2003.
- 2 Bn.€ a year from 2004 to 2006.
- 200 Million € executed in 1H03.

**SOLVENCY
PROTECTION FOR
SINGLE A RATING ***

≅ 7.9 Bn.€

- We have cash commitments for 7.9 Billion€:
 - ✓ Gross NPV 98 Redundancy Program of 3.5 Bn.€
 - ✓ Guarantees of 0.8 Bn.€
 - ✓ Gross NPV of Expected 03 Redundancy Program of 3.6 Bn.€
- ... Fully funding NPV of cash commitments would leave (net debt + cash commitments)/ EBITDA in the 1.4x-1.7x region in 2006

* subject to prospective risks and Rating Agencies opinion

Our Approach To The Destination Of 03-06 Cash-flows (II)

€ in Bn.

**TO FULLY DELIVER
ON OUR FIRM
COMMITMENTS**

| | |
|--|-----|
| SHAREHOLDER REMUNERATION | 7.4 |
| SOLVENCY PROTECTION FOR "SINGLE A" RATING | 7.9 |

≈ 50% of FCF allocated
to "hard" commitments

**TO KEEP STRATEGIC
FLEXIBILITY TO GROW
OUR BUSINESSES**

| | |
|-----------------------|----------|
| BUSINESS EXPANSION | } > 11.7 |
| FINANCIAL FLEXIBILITY | |

TOTAL >27



Our Approach To The Destination Of 03-06 Cash-flows (III)

KEEPING STRATEGIC FLEXIBILITY ABOVE 11.5 Bn.€ TO ACCOMMODATE

SELECTIVE BUSINESS EXPANSION BASED ON

AND

FINANCIAL FLEXIBILITY COULD PROVIDE ROOM FOR eg:



- Complementarity to core businesses.
- Target selection based on cash flow generation capabilities.



- A 50% value loss of Latam currencies
- plus**
- A 10% drop of average 04-06 Non-Latam EBITDA below its 2003 level.



2. Our 3-d Balance Sheet

THREE DIMENSIONS

2.1 ASSETS

➔ Discount Rates

2.2 LIABILITIES

➔ Debt Management

2.3 RISKS

➔ Derivatives Management

ASSETS

- Help establish required rates of return for new investments, both for equity and debt.
- Follow WACC parameters in the industry and take them into account.

LIABILITIES

- Rating Target.
- Debt Size and Repayment period.
- Maturity, Currency.

RISKS

- Currency Risk.
- Sovereign Risk.
- Refinancing Risk.
- Maturity, Currency.



2.1 Assets

- ➔ **Creating value for shareholders means investing in businesses/projects with expected returns higher than WACCs.**
- ➔ **We provide a consistent framework for project evaluation and return assessment setting WACC parameters by business and region.**
- ➔ **We can contribute to value creation with balance sheet management by bringing WACCs lower:**
 - **Leveraging to bring WACC lower within the A rating constraint.**
 - **Extracting diversification benefits from financial exposures to help bring risk premia lower.**



2.2 Liabilities

RATING TARGET: COMFORTABLE SINGLE A TO CREATE VALUE

➔ **Creating Shareholder Value via Leverage:**

- Lower cost of funds means lower WACC.
- Sensible Leverage ratios ensure sustainability.

➔ **Creating Shareholder Value via Availability of Funds:**

- A comfortable single A rating ensures smooth and timely access to capital markets.
- Business opportunities not to be constrained by lack or cost of financing.

➔ **Creating Shareholder Value via Crisis Protection:**

- Crisis costs not always reflected in WACC.
- Crisis hit unexpectedly, widen credit spreads or require highly dilutive right issues.
- Legal, Advisory and Financing Fees are not negligible.

➔ **Creating Shareholder Value via Financial Discipline:**

- Fundamental Assessment of Solvency.
- Stable benchmarking of projects and acquisitions.

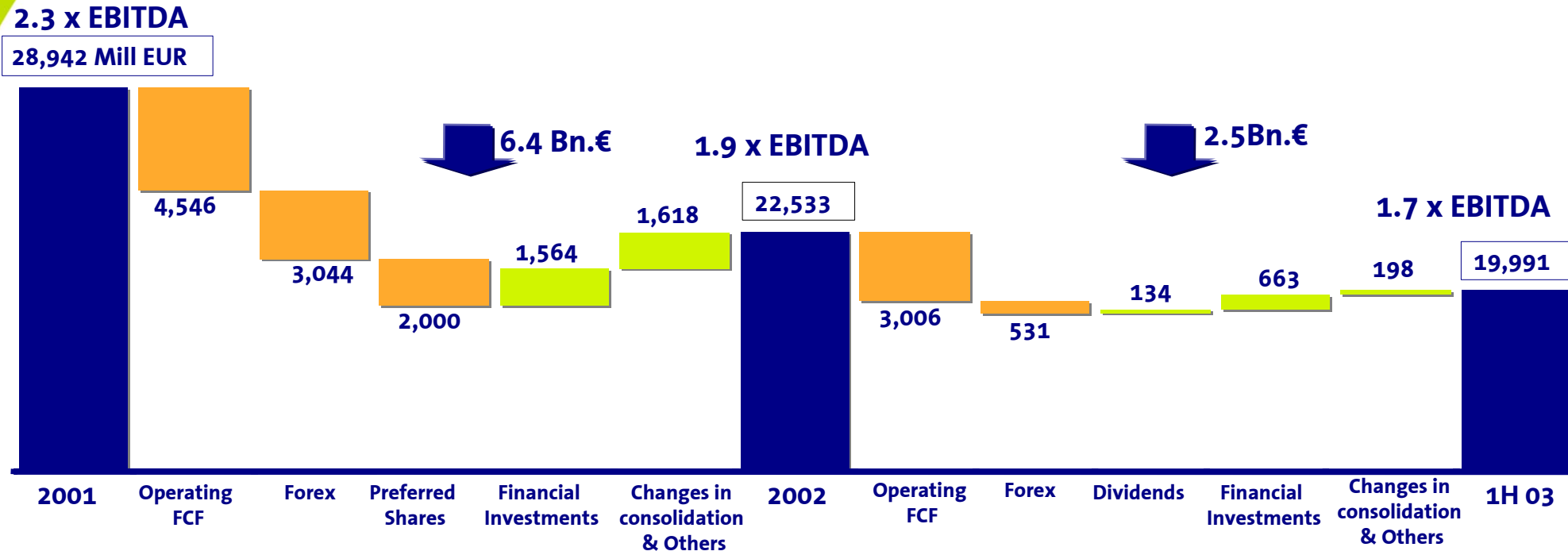
Items Included In Total Debt

Figures in million euros

| | Dec 2002 | Jun 2003 | + Expected New Workforce Redundancy Program |
|--|---------------|---------------|--|
| NET FINANCIAL DEBT | 22,533 | 19,991 | |
| Guarantees (IPSE, AVS) | 776 | 776 | |
| Net pre-retirement commitments | 3,557 | 3,266 | |
| 2003-2007 ERE | 0 | | 0 |
| COMMITMENTS | 4,333 | 4,042 | 3,600 |
| TOTAL DEBT+ NPV of Cash Commitments | 26,866 | 24,033 | 27,633 |



9 Bn Euros Debt Reduction In 2002 & 2003



COMMITMENT TO SINGLE A

- 2002: Achieve Financial net debt < 2 x EBITDA
 - 2003: Achieve Financial net debt + Commitments around 2x EBITDA.
- Making room for 3.6 bn Eur notional NPV of commitments related to workforce reduction in 2003-07

2.3 Risk Management Policy

CURRENCY RISK

- Cash Flow Hedging.
- No FX losses impacting P&L.

SOVEREIGN RISK

- Non-recourse to the parent: Financing at operating company level in Latin America.
- Fund repatriation.

REFINANCING RISKS

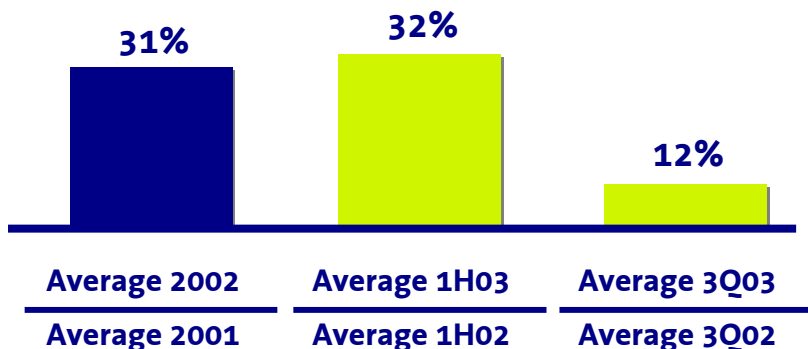
- Average Maturity of Debt longer than period needed to pay off debt in full.
- Liquidity sources greater than planned uses for next 12 months.



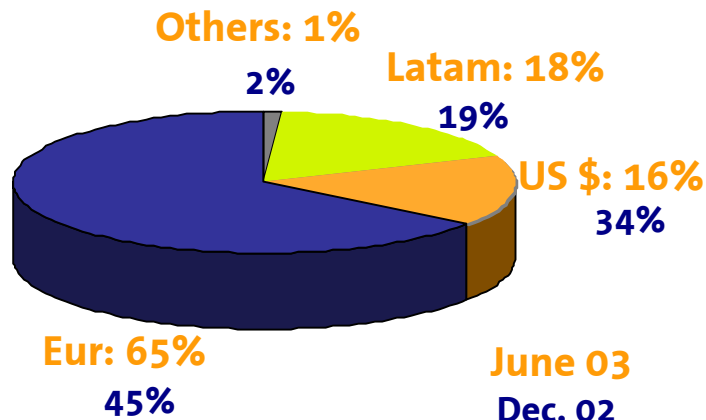
Fx Management: Offsetting Cash-flow Shortfalls With Debt Reduction

LATAM DEPRECIATION vs EURO

Lost Value (Weighted By Ebitda Origin)



DEBT BY CURRENCIES

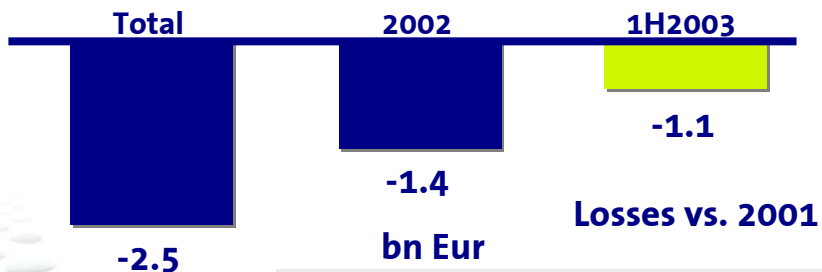


USD debt in Latam fully hedged except in Argentina

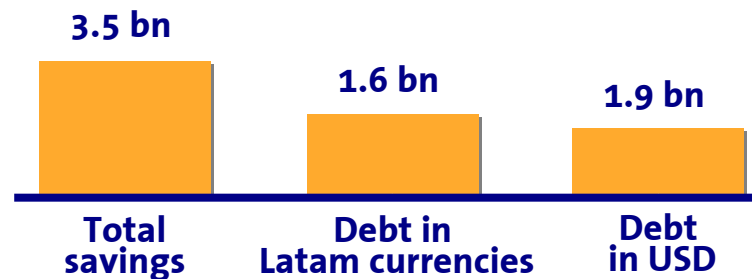
14% + 2.3 bn USD put spreads for 2004

June 03
Dec. 02

CUMULATIVE FX IMPACT ON CASH FLOW (ACTUAL VS 2001 FX RATES)



DEBT REDUCTION DUE TO FX

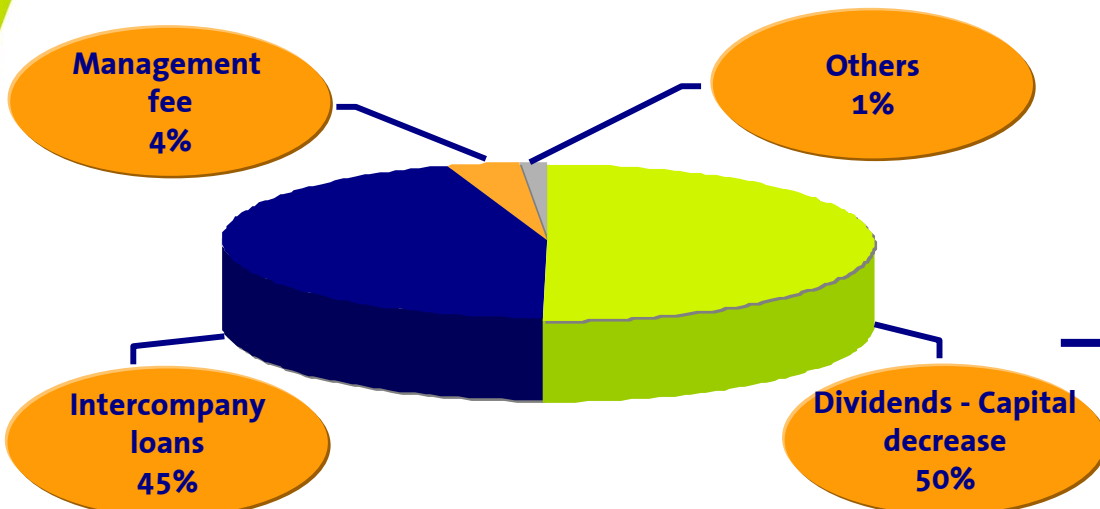


Debt savings more than offset cash-flow shortfall 2002-2003 due to FX depreciation

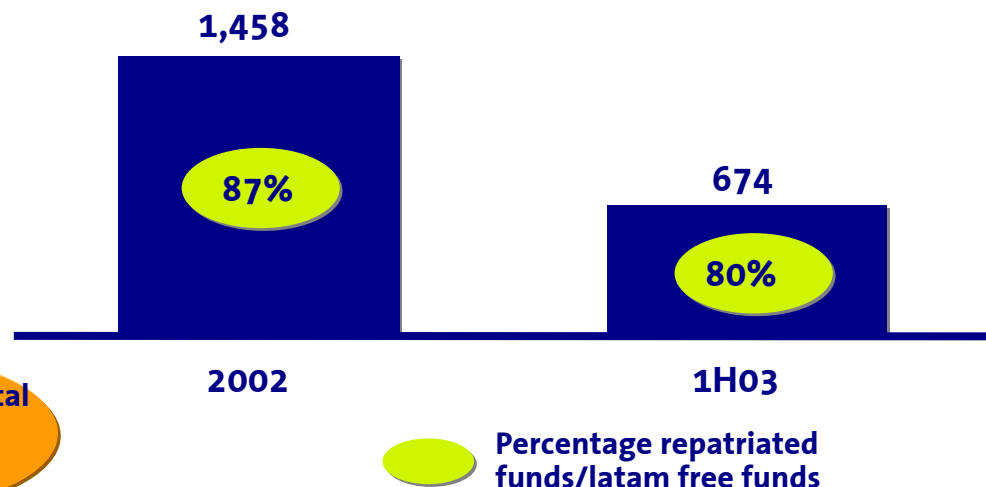
Actively Managing Latin American Risk

1.5 bn USD repatriated from Latam in 2002; 0.7 bn USD in 1H2003.

REPATRIATION VEHICLES 2002 & 1H2003



TOTAL REPATRIATED FUNDS (M USD)



Latam debt (23% of total) non recourse to Parent

➔ 1 bn USD debt restructured in Argentina (67% acceptance):

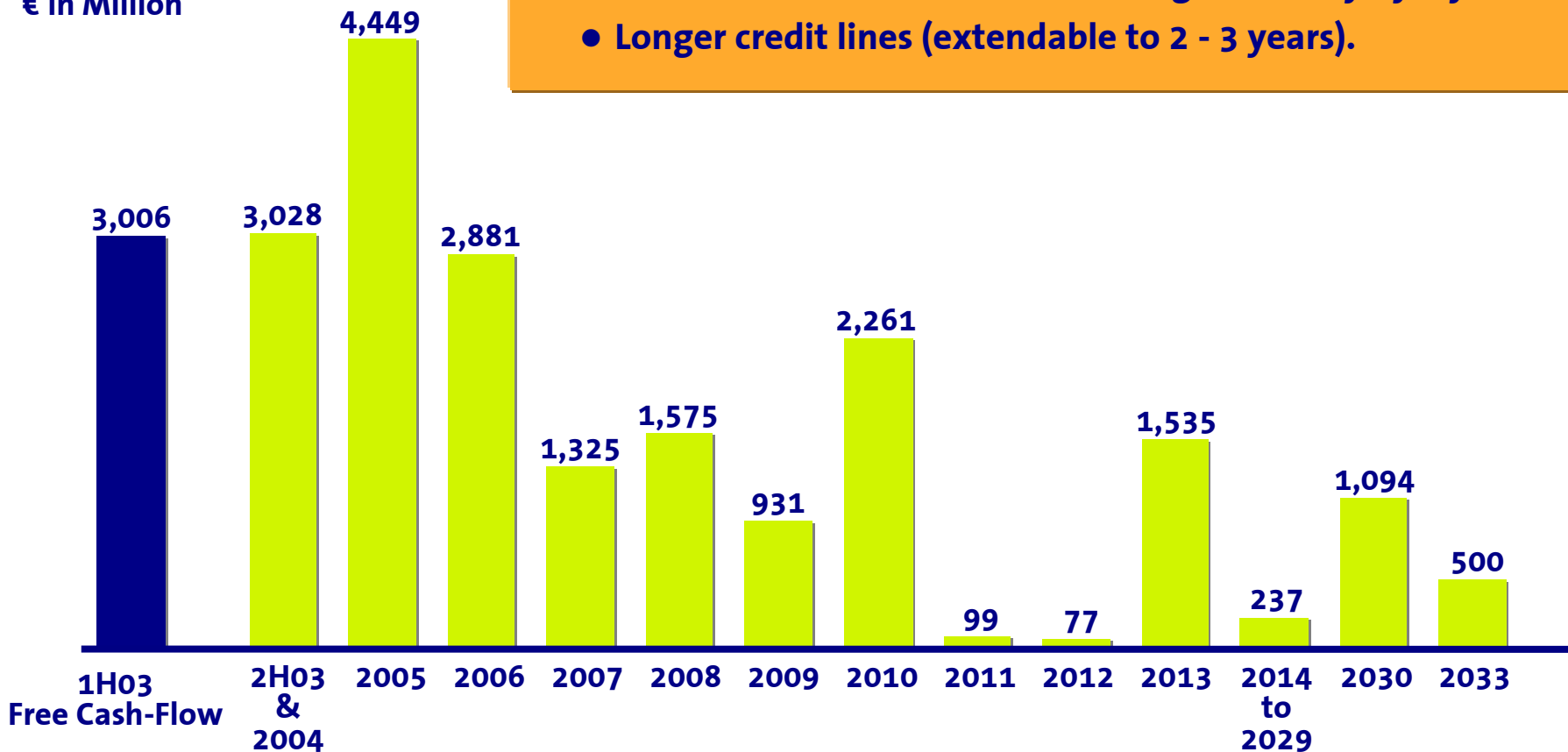
- Avoid liquidity problems
- Allow equitable repayment of intercompany and external debt.
- No haircut to bondholders, just 3 years extension and 15% payment upfront.

Low Refinancing Risk

Average net financial debt maturity 6.3 years (June 03)

- 2003 issuance has increased average maturity by 2 years.
- Longer credit lines (extendable to 2 - 3 years).

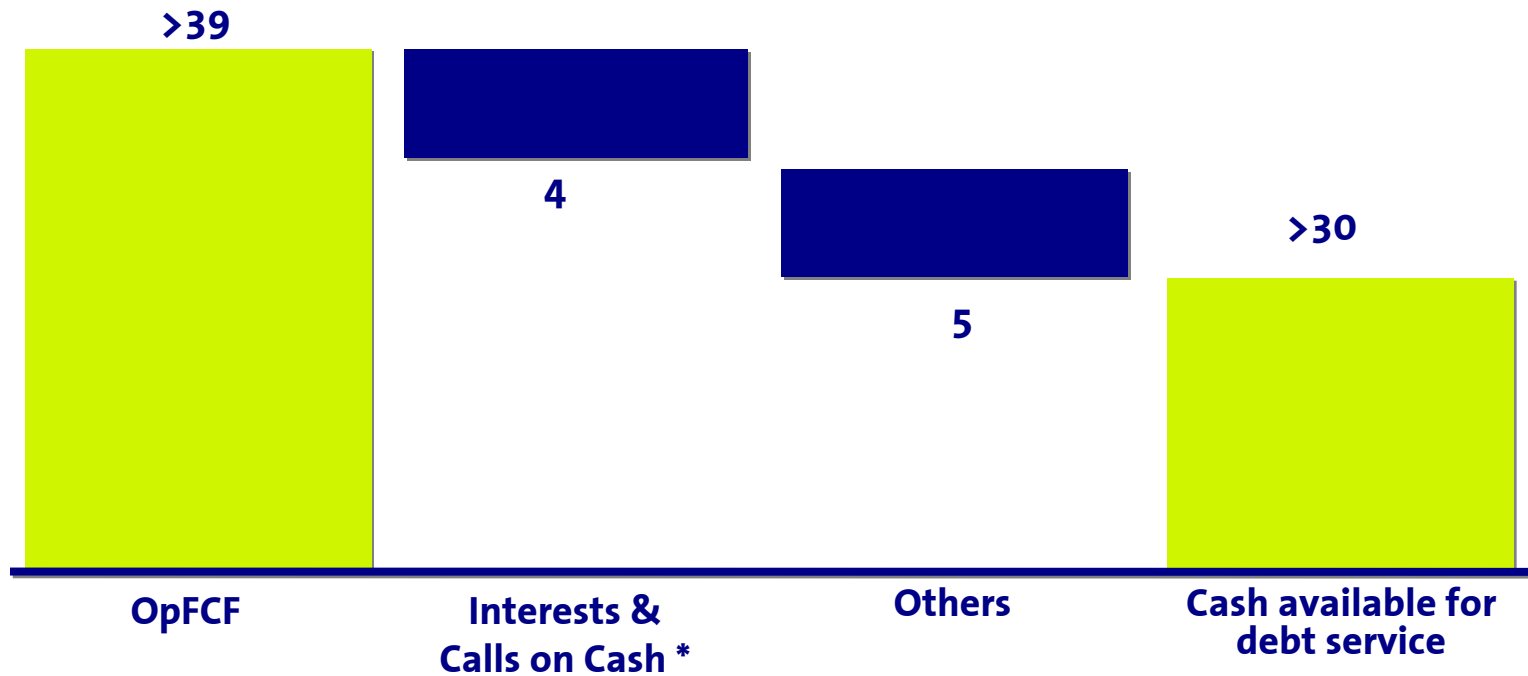
€ in Million



- ➔ Net maturities in 2003 & 2004 equal to cash-flows generated in one semester.
- ➔ Close to 5bn Eur undrawn committed credit lines.

Telefónica Could Fully Pay Its Debt In 4 Years

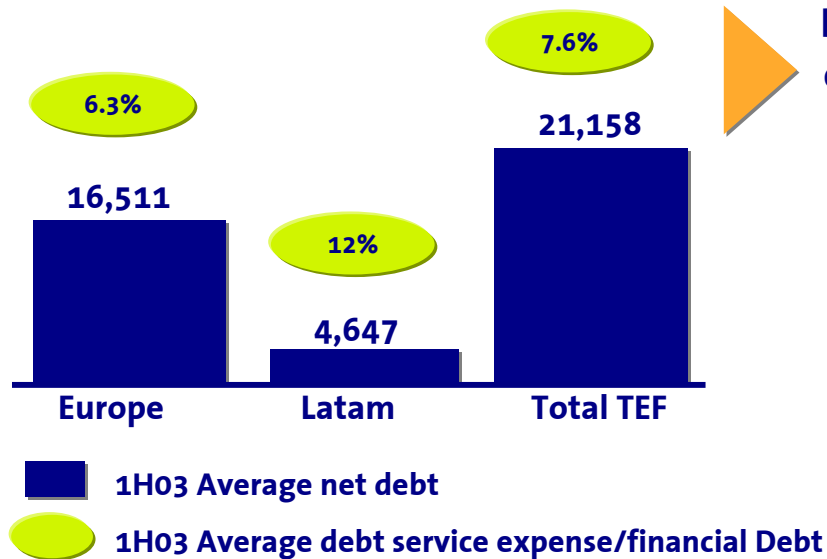
2003-2006: 4-year Cash Flow (billion EUR)



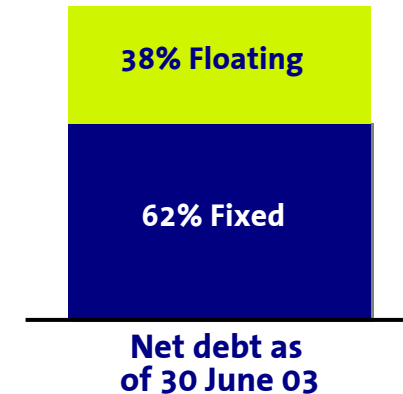
➔ Debt maturity longer than time needed for full repayment

* Interests calculated assuming free cash-flow is used to reduce debt.

Net Financial Expenses: Balance Between Conservatism And Active Management



Debt financial expenses of 802 mill EUR in 1H03



- ➔ Average interest expense in 1H03 of 7.6%, due to conservative liability management :
 - Longer maturities with a positive yield curve raise unit cost of debt and widen credit spreads.
 - Local Funding in Latam significantly more costly than in EUR/USD.
- ➔ Nevertheless, active management of currency exposures has materialized in a 267.5 Million € profit in 2003, via currency swaps.

3. Conclusions

3.1 TELEFÓNICA'S FINANCIAL STRENGTH.

3.2 RISKS WE DON'T HAVE.



3.1 Telefónica's Financial Strength

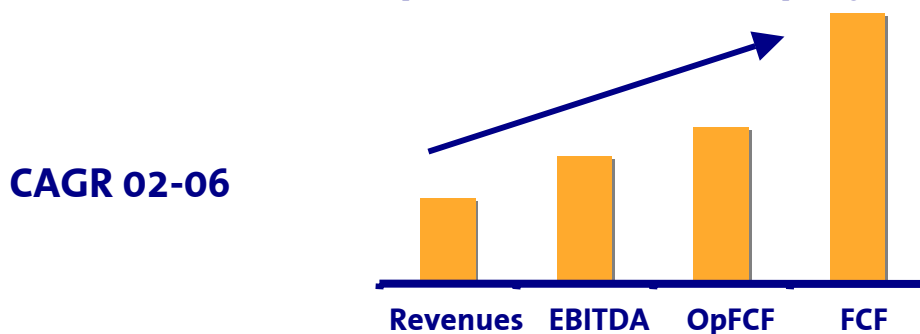
1.- Large Free Cash Flow Generation > 27 Bn.€ (03-06)

- FCF roughly equal to 50% of Market Capitalization.
- FCF roughly equal to 100% of Net Debt + Expected Commitments.

2.- Current and Expected Cash Consumption fully funded

- 20 Bn.€ Net Debt + 7.9 Bn.€ of Cash Commitments targeted.

3.- Powerful Conversion of OpFCF into FCF to Equity



4.- No Asset Disposals, Business Line Divestitures or Unwinding of Financial Stakes Contemplated.

5.- “Hard” Commitments for FCF Allocation at the Top of the Industry and Clear Recirculation Channels for Excess Cash Flow

3.2 *Risks We Don't Have*

➔ **No Extra Liabilities**

- No Pension Liabilities.
- No Real Estate Sale & Lease-back (secured off-balance sheet debt).
- No asset-backed bonds (off-balance sheet).

➔ **No Pressure on stock trading**

- Core Shareholder Stability and no government overhang.
- Liquidity: Telefónica top 3 in ESTOXX in Liquidity: €400M daily.

➔ **Personnel efficiency fully funded.**

➔ **No need to sell off assets.**



Telefónica
