Long Term Incentive Plan (LTIP): Understanding FCF & TSR as key indicators and how we all contribute
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2. KEY PERFORMANCE INDICATORS – FCF & TSR

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#1: The basics: understanding P&L, FCF, Balance sheet and Net Debt
## TEF Group 2017 key financial and operational metrics

### P&L

<table>
<thead>
<tr>
<th>€m</th>
<th>Reported</th>
<th>Reported y-o-y</th>
<th>Organic y-o-y</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenues</td>
<td>52,008</td>
<td>(0.1%)</td>
<td>+3.4%</td>
</tr>
<tr>
<td>OIBDA</td>
<td>16,187</td>
<td>+7.1%</td>
<td>+5.3%</td>
</tr>
<tr>
<td>Underlying OIBDA</td>
<td>16,638</td>
<td>+0.4%</td>
<td></td>
</tr>
<tr>
<td>OIBDA margin</td>
<td>31.1%</td>
<td>+2.1 p.p.</td>
<td>+0.6 p.p.</td>
</tr>
<tr>
<td>CapEx (ex-spectrum)</td>
<td>8,159</td>
<td>(4.9%)</td>
<td></td>
</tr>
<tr>
<td>OpCF (ex-spectrum)</td>
<td>8,027</td>
<td>+22.8%</td>
<td>+12.2%</td>
</tr>
<tr>
<td>Net Income</td>
<td>3,132</td>
<td>+32.2%</td>
<td></td>
</tr>
<tr>
<td>EPS</td>
<td>0.56</td>
<td>+33.9%</td>
<td></td>
</tr>
</tbody>
</table>

### FCF

| €m | 4,947 | +13.0% |

### Total Assets (Balance Sheet)

| €m | 115,066 | (6.9%) |

### Net Financial Debt

| €m | 44,230 | (9.0%) |

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- **Reported vs. Organic (organic variations assume no changes in FX and consolidation perimeter)**
- **Revenues less operational expenses (OpEx)**
- **OIBDA excluding extraordinary items (e.g. tower sales, PSI/EREs)**
- **Investment in infrastructure deployments (e.g. FTTX, 3G/4G, service platforms) & intangible assets (patents, concessions, brand)**
- **OIBDA less Capital Expenditures excluding spectrum costs (CapEx ex-spectrum)**
- **Final profit after tax attributable to TEF's shareholders**
- **Earnings Per Share is the net income divided by total TEF number of shares outstanding (it is the profit attributable to each TEF share)**
- **Revenues, OpEx and CapEx amounts are adjusted considering “cash criteria” (collection & payments dates)**
- **Total Assets = Total Equity + Total Liabilities**
- **Total debts (short & long term) less cash and other “liquid” assets**
## Profit & Loss Account (P&L)

<table>
<thead>
<tr>
<th>Revenues</th>
<th>OpEx¹</th>
<th>OIBDA</th>
<th>Depreciation &amp; Amortization</th>
<th>EBIT</th>
<th>Financial &amp; Taxes expenses</th>
<th>Minorities &amp; Others</th>
<th>Net Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>€m</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>52,008</td>
<td></td>
<td>16,187</td>
<td></td>
<td>6,791</td>
<td></td>
<td></td>
<td>3,132</td>
</tr>
<tr>
<td>(35,821)</td>
<td></td>
<td>(9,396)</td>
<td></td>
<td>(3,418)</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

1. OpEx also include other operating and extraordinary expenses and capitalized expenses in fixed assets

1. OpEx also include other operating and extraordinary expenses and capitalized expenses in fixed assets.

- Broadband Connectivity 39%
- Voice and Access 39%
- Services over connectivity 12%
- Others 10%

- Supplies 41%
- Other operating expenses 40%
- Personnel costs 19%

Amount depends on useful life of asset base and long term should be similar to annual capex (ongoing business).

Reflects financial cost of our debts and also accrued tax expenses linked to profits generated in the year.

Minorities are related to OBs where TEF does not own a 100% stake (Germany, Brazil, Colombia, CAM).
Free Cash Flow (FCF) – Selected as new KPI to deliver the LTIP

€m

16,187

(8,159)

8,027

434

(1,726)

(1,005)

(783)

4,947

OIBDA

CapEx (ex-spectrum)

OpCF (ex-spectrum)

Working capital

Net debt interest payment

Tax payments

Minorities, spectrum & others

FCF

- Reflects the annual change in balance in net working capital (see definition below and balance sheet on next page)

WORKING CAPITAL = CURRENT ASSETS (EX CASH) - CURRENT LIABILITIES (EX ST DEBT)

- Cash balance generated from all the collections from clients vs. our payments to employees and suppliers

- Dividend paid to minorities
- Spectrum payments

FCF uses:
- Debt reduction
- Shareholders remuneration (Dividend)
- Share buybacks
- Financial investments
- Others

+13.0% y-o-y

• Dividend paid to minorities
• Spectrum payments

CURRENT ASSETS (EX CASH)

WORKING CAPITAL

CURRENT LIABILITIES (EX ST DEBT)
3 Balance sheet

€m

TOTAL ASSETS 115,066

NON-CURRENT ASSETS 95,135

CURRENT ASSETS 19,931

Net Working Capital

TOTAL LIABILITIES 29,066

NON-CURRENT LIABILITIES 59,382

CURRENT LIABILITIES 29,066

TOTAL EQUITY & LIABILITIES 115,066

EQUITY 26,618

• Equity attributable to TEF’s equity holders
• Non-controlling interests

• Long term financial debt
• Non-current trade and other payables
• Deferred tax liabilities
• Long term provisions

• Current trade and other payables
• Current tax payables
• Short term provisions
• Short term financial debt

• Property, plant and equipment
• Intangible assets
• Goodwill
• Long term financial assets
• Deferred tax assets

• Inventories
• Trade and other receivables
• Tax receivables
• Short term financial assets
• Cash and cash equivalents
4 Net Debt Evolution

-€4.4bn

Net Debt Dec-16: €48,595
Net Debt Dec-17: €44,230

FCF

Net financial investments
Hybrid issue
Pre-retirement commitments
FX & MTM & Others
Net financial investments
Hybrid issue
Pre-retirement commitments
FX & MTM & Others

• Remuneration to TEF shareholders (€40c/share)
• Hybrids coupons
• Sale of 40% stake in Telxius
• Cash received from new hybrid bonds
• Yearly cash payments from ex employees (EREs, PSIs, …)
• Adjustments due to FX changes in net debt foreign currencies
• Mark-to-market value (MTM) of derivatives instruments
• Other adjustments

ND/OIBDA 2.95x
ND/OIBDA 2.66x
#2: Key performance indicators – Free Cash Flow (FCF) & Total Shareholder Return (TSR)
Key performance indicators of the Long Term Incentive Plan (LTIP)

- The LTIP will have a total duration of 5 years and will be divided into 3 independent cycles of 3 years each. The first cycle will be considered as initiated from January 1, 2018 and will end on December 31, 2020.

- The number of Shares to be delivered at the end of each Plan will be the following:
  - 50% of the shares will be delivered when achieving specific target of annual FCF generation.
  - 50% of the shares will be delivered when achieving a TSR target (total shareholder return) of the Telefónica share in relation to a defined basket of comparable companies in the sector.

![Diagram showing the calculation of the number of shares to be delivered]
# Free Cash Flow (FCF) generation target

**KEY PERFORMANCE INDICATOR (KPI)**

<table>
<thead>
<tr>
<th>DESCRIPTION</th>
<th>Free Cash Flow (FCF)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Measure with a financial KPI – Free Cash Flow according to the formula approved in the Annual Budget. New indicator included for the new cycles.</td>
<td></td>
</tr>
</tbody>
</table>

**DELIVERY CONDITIONS**

<table>
<thead>
<tr>
<th>YEAR</th>
<th>% FULFILLMENT (Ex-spectrum)</th>
<th>% DELIVERY</th>
</tr>
</thead>
<tbody>
<tr>
<td>2014</td>
<td>88.2%</td>
<td>0%</td>
</tr>
<tr>
<td>2015</td>
<td>106.66%</td>
<td>100%</td>
</tr>
<tr>
<td>2016</td>
<td>109.50%</td>
<td>100%</td>
</tr>
<tr>
<td>2017</td>
<td>99.30%</td>
<td>98.25%</td>
</tr>
</tbody>
</table>

FCF targets and awards will be measured annually (1/3rd for each year) and not over the 3-year cycle.

Degree of achievement of the FCF Target.
**Total Shareholder Return (TSR) target**

**KEY PERFORMANCE INDICATOR (KPI)**

**DESCRIPTION**

Measure of the total return (with dividends) of Telefonica in relation to a basket of comparables.\(^1\)
- Closest competitors (Weighting): VOD (10%), AMX (10%), DT (10%), BT (10%), ORA (10%), TI (10%) and SWISSCOM (10%)
- Other Telcos: TELENOR (5%), TELIA (5%), KPN (5%), TIM BR (5%), BELGACOM (5%) and MILLICOM (5%)

**DELIVERY CONDITIONS**

<table>
<thead>
<tr>
<th>KPI achievement level (TSR percentile of the company)</th>
<th>Multiplier Coefficient</th>
</tr>
</thead>
<tbody>
<tr>
<td>Below the median</td>
<td>0%</td>
</tr>
<tr>
<td>Above the median</td>
<td>30%</td>
</tr>
<tr>
<td>In the top quartile</td>
<td>100%</td>
</tr>
</tbody>
</table>

The TSR target has to be met at the end of the 3-year cycle.

**FULFILLMENT OF PREVIOUS CYCLES**

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Delivery %</td>
<td>100%</td>
<td>100%</td>
<td>97.8%</td>
<td>0%</td>
<td>0%</td>
<td>0%</td>
<td>0%</td>
<td>0%</td>
<td>0%</td>
<td>0%</td>
</tr>
</tbody>
</table>

1. One update against the comparator group used for previous PIP. Oi has been removed from the comparator group and Swisscom adds the 5% weighting so it is now 10%
Telefonica’s relative performance over the PIP cycles

**TEF Share Price (€)**

<table>
<thead>
<tr>
<th>Year</th>
<th>Paid</th>
<th>Share Price</th>
</tr>
</thead>
<tbody>
<tr>
<td>PIP 2006</td>
<td>100%</td>
<td>€12.83</td>
</tr>
<tr>
<td>PIP 2007</td>
<td>100%</td>
<td>€16.54</td>
</tr>
<tr>
<td>PIP 2008</td>
<td>97.8%</td>
<td>€17.74</td>
</tr>
<tr>
<td>PIP 2009</td>
<td>0%</td>
<td>€15.41</td>
</tr>
<tr>
<td>PIP 2010</td>
<td>0%</td>
<td>€15.66</td>
</tr>
<tr>
<td>PIP 2011</td>
<td>0%</td>
<td>€17.85</td>
</tr>
<tr>
<td>PIP 2012</td>
<td>77.0%</td>
<td>€9.53</td>
</tr>
<tr>
<td>PIP 2013</td>
<td>0%</td>
<td>€10.26</td>
</tr>
<tr>
<td>PIP 2014</td>
<td>0%</td>
<td>€12.11</td>
</tr>
<tr>
<td>PIP 2015</td>
<td>0%</td>
<td>€11.80</td>
</tr>
<tr>
<td>PIP 2016</td>
<td>Currently 0%</td>
<td>€7.71</td>
</tr>
</tbody>
</table>

**Notes:**
1. Data as of 09/07/2018
2. Source: Bloomberg
#3: TSR and main value drivers – Fundamentals and sustainability matter most
Key drivers of Total Shareholder Return (TSR)

**TSR Formula**

- Share Price appreciation
- Dividend yield

**Key drivers that explain TSR**

- **FUNDAMENTALS**
  - REVENUE growth
  - OpCF MARGIN improvement

- **SUSTAINABILITY**
  - VALUATION MULTIPLE change

- **FREE CASH FLOW USE**
  - NET DEBT variation
  - NUMBER OF SHARES change
  - DIVIDEND payment
Long term fundamentals are the key drivers of TSR but portfolio and financing decisions plus macro also matter …

**FUNDAMENTALS**

| A | ASSET purchases | (higher revenues) |
| B | ASSET divestitures | (lower revenues) |
| C | Δ EQUITY (# shares) | (depends on price) |
| D | DIVIDEND payment | (depends on price) |
| E | Δ FX (local vs €) | (€ lower vs. € higher) |
| F | Δ INTEREST RATES | (lower or higher) |

**SUSTAINABILITY**

| S | ? |

**FREE CASH FLOW USE**

| DEBT | SHARES | DIVIDEND |
| (financed with debt and/or equity) | (cash lowers debt) | (buybacks vs new issues) |

**Telefonica**

We choose it all
Telefonica – key historical consensus figures (2009-2018)
From a valuation perspective, improving long term OpCF growth is a must to increase our valuation and share price.

**MULTIPLIER EFFECT**

- **FUNDAMENTALS**
  - OpCF: € 7.8 bn
  - • REVENUES
  - • EBITDA margin
  - • CAPEX intensity
  - • OpCF margin

- **SUSTAINABILITY**
  - EV / OpCF: 12.4x
  - • INTEREST RATES
  - • GDP growth
  - • EXPECTATIONS of long term OpCF

**ENTERPRISE VALUE**

- Net Debt + Hybrids + Employee Commit.: € 96.7 bn
- • Financing and CAPITAL STRUCTURE
- • Active PORTFOLIO MANAGEMENT

**NET DEBT**

- € 56.6 bn
- • Total NUMBER of SHARES

**EQUITY VALUE**

- € 40.1 bn
- € 7.711 / share

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1. Bloomberg as of 09/07/2018
2. EV uses 1Y FWD consensus net debt and it is adjusted for hybrids and net employee commitments
Summary of key takeaways

- Financial statements are crucial for company management and investors

- Strong fundamentals (measured as OpCF long term sustainability) are the critical driver of Total Shareholder Return (TSR)

- Delivering or exceeding our FCF generation target has not only a positive impact on TSR but also increases investors’ confidence on TEF’s share performance

- From a valuation perspective, short term growth and margin improvement matter less than long term OpCF sustainability
#4: Annex:

PIP/TFSP 2015 plan
Current status of PIP/TFSP 2015 Plan as of July 15th, 2017

<table>
<thead>
<tr>
<th>Peer 2015</th>
<th>TSR</th>
</tr>
</thead>
<tbody>
<tr>
<td>TIM Participações S.A.</td>
<td>34.09%</td>
</tr>
<tr>
<td>Telcel ASA</td>
<td>20.25%</td>
</tr>
<tr>
<td>Orange</td>
<td>19.08%</td>
</tr>
<tr>
<td>Millicom International Cellular SA</td>
<td>4.48%</td>
</tr>
<tr>
<td>75th Percentile</td>
<td>3.14%</td>
</tr>
<tr>
<td>America Movil S.A.B. de C.V.</td>
<td>0.45%</td>
</tr>
<tr>
<td>Deutsche Telekom AG</td>
<td>-1.77%</td>
</tr>
<tr>
<td>Oi S.A.</td>
<td>-2.10%</td>
</tr>
<tr>
<td>50th Percentile</td>
<td>-2.78%</td>
</tr>
<tr>
<td>TeliaSonera Aktiebolag (publ)</td>
<td>-3.47%</td>
</tr>
<tr>
<td>Swisscom AG</td>
<td>-4.10%</td>
</tr>
<tr>
<td>Koninklijke KPN N.V.</td>
<td>-12.54%</td>
</tr>
<tr>
<td>Vodafone Group Plc</td>
<td>-16.25%</td>
</tr>
<tr>
<td>Proximus PLC</td>
<td>-21.37%</td>
</tr>
<tr>
<td>Telefónica, S.A.</td>
<td>-23.77%</td>
</tr>
<tr>
<td>Telecom Italia S.p.A.</td>
<td>-39.96%</td>
</tr>
<tr>
<td>BT Group plc</td>
<td>-53.30%</td>
</tr>
</tbody>
</table>

#3 out of 15 (21.53rd percentile)
0.0% payout 2015
Dec. 15 Reference Value 11,798 ME
Telefonica

We choose it all