

TELEFONICA S A  
Form 20-F  
February 23, 2017

**As filed with the Securities and Exchange Commission on February 23, 2017**

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

**FORM 20-F**

(Mark One)

**REGISTRATION STATEMENT PURSUANT TO SECTION 12(b) OR (g) OF THE SECURITIES  
EXCHANGE ACT OF 1934**

**OR**

**ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE  
ACT OF 1934**

**For the fiscal year ended December 31, 2016**

**OR**

**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE  
ACT OF 1934**

**OR**

**SHELL COMPANY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934**

**Commission file number: 001-09531**

**TELEFÓNICA, S.A.**

(Exact name of Registrant as specified in its charter)

**KINGDOM OF SPAIN**

(Jurisdiction of incorporation or organization)

**Distrito Telefónica, Ronda de la Comunicación, s/n  
28050 Madrid, Spain**

(Address of principal executive offices)

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(Name, Telephone, E-mail and/or Facsimile number and Address of Company Contact Person)

Securities registered or to be registered pursuant to Section 12(b) of the Act:

Title of each class

Name of each exchange on which registered

|  |                                |
|--|--------------------------------|
| <b>Ordinary Shares, nominal value 1.00 euro per share*</b> | <b>New York Stock Exchange</b> |
| <b>American Depositary Shares, each representing one</b>   | <b>New York Stock Exchange</b> |
| <b>Ordinary Share</b>                                      |                                |

**Guarantees\*\* by Telefónica, S.A. of the \$700,000,000 Fixed Rate Guaranteed Senior Notes Due 2017; \$500,000,000 Floating Rate Guaranteed Senior Notes Due 2017; \$1,250,000,000 Fixed Rate Guaranteed Senior Notes Due 2018; \$1,000,000,000 Fixed Rate Notes Due 2019; \$1,400,000,000 Fixed Rate Guaranteed Senior Notes Due 2020; \$1,500,000,000 Fixed Rate Guaranteed Senior Notes Due 2021; \$750,000,000 Fixed Rate Guaranteed Senior Notes Due 2023; \$2,000,000,000 Fixed Rate Guaranteed Senior Notes Due 2036; each of Telefónica Emisiones, S.A.U.; and of the \$1,250,000,000 Fixed Rate Guaranteed Senior Notes Due 2030 of Telefónica Europe, B.V.**

**New York  
Stock  
Exchange**

Not for trading, but only in connection with the listing of American Depositary Shares, pursuant to the requirements of the New York Stock Exchange.

Not for trading, but only in connection with the listing of the \$700,000,000 Fixed Rate Guaranteed Senior Notes Due 2017; \$500,000,000 Floating Rate Guaranteed Senior Notes Due 2017; \$1,250,000,000 Fixed Rate Guaranteed Senior Notes Due 2018; \$1,000,000,000 Fixed Rate Notes Due 2019; \$1,400,000,000 Fixed Rate Guaranteed Senior Notes Due 2020; \$1,500,000,000 Fixed Rate Guaranteed Senior Notes Due 2021; \$750,000,000 Fixed Rate Guaranteed Senior Notes Due 2023; and \$2,000,000,000 Fixed Rate Guaranteed Senior Notes Due 2036; each of Telefónica Emisiones, S.A.U., and the \$1,250,000,000 Fixed Rate Guaranteed Senior Notes Due 2030 of Telefónica Europe, B.V. (each a wholly-owned subsidiary of Telefónica, S.A.)

Securities registered or to be registered pursuant to Section 12(g) of the Act: **None**

Securities for which there is a reporting obligation pursuant to Section 15(d) of the Act: **None**

The number of outstanding shares of each class of capital stock of Telefónica, S.A. at December 31, 2016 was:

**Ordinary Shares, nominal value 1.00 euro per share: 5,037,804,990**

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes No

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If this report is an annual or transition report, indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.

Yes No

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (Section 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of “accelerated filer and large accelerated filer” in Rule 12b-2 of the Exchange Act (Check one):

Large Accelerated Filer    Accelerated Filer    Non-accelerated Filer

Indicate by check mark which basis of accounting the registrant has used to prepare the financial statements included in this filing:

**U.S. GAAP**

**International Financial Reporting Standards as issued by the International Accounting Standards Board**

**Other**

If “Other” has been checked in response to the previous question, indicate by check mark which financial statement item the registrant has elected to follow.

**Item 17    Item 18**

If this is an annual report, indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes    No

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CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING STATEMENTS

This Annual Report contains statements that constitute forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended (the “Securities Act”), Section 21E of the Securities Exchange Act of 1934 (the “Exchange Act”), as amended, and the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. The forward-looking statements in this Annual Report can be identified, in some instances, by the use of words such as “will,” “shall,” “target,” “expect,” “aim,” “hope,” “anticipate,” “should,” “may,” “might,” “assume,” “estimate,” “plan,” and similar language or other formulations of a similar meaning or, in each case, the negative formulations thereof. Other forward-looking statements can be identified in the context in which the statements are made or by the forward-looking nature of discussions of strategy, plans or intentions. These statements appear in a number of places in this Annual Report including, without limitation, certain statements made in “Item 3. Key Information—Risk Factors,” “Item 4. Information on the Company,” “Item 5. Operating and Financial Review and Prospects” and “Item 11. Quantitative and Qualitative Disclosures About Market Risk” and include statements regarding our intent, belief or current expectations with respect to, among other things:

- the effect on our results of operations of competition in telecommunications markets;
- trends affecting our business financial condition, results of operations or cash flows;
- ongoing or future acquisitions, investments or divestments;
- our capital expenditures plan;
- our estimated availability of funds;
- our ability to repay debt with estimated future cash flows;
- our shareholder remuneration policies;
- supervision and regulation of the telecommunications sectors where we have significant operations;
- our strategic partnerships;
- the potential for growth and competition in current and anticipated areas of our business; and

the outcome of pending or future litigation or other legal proceedings.

Such forward-looking statements are not guarantees of future performance and involve numerous risks and uncertainties, and actual results may differ materially from those anticipated in the forward-looking statements as a result of various factors. The risks and uncertainties involved in our businesses that could affect the matters referred to in such forward-looking statements include but are not limited to:

changes in general economic, business or political conditions in the domestic or international markets in which we operate or have material investments that may affect demand for our services;

exposure to currency exchange rates, interest rates or credit risk related to our treasury investments or in some of our financial transactions;

existing or worsening conditions in the international financial markets;

the impact of new accounting standards current, pending or future legislation and regulation in countries where we operate, as well as any failure to renew or obtain the necessary licenses, authorizations and concessions to carry out our operations and the impact of limitations in spectrum capacity;

compliance with anti-corruption laws and regulations and economic sanctions programs;

customers' perceptions of services offered by us;

the potential effects of technological changes and sector trends;

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- failure of suppliers to provide necessary equipment and services on a timely basis;
- the impact of unanticipated network interruptions including due to cyber-security actions;
- the effect of reports suggesting that electromagnetic fields may cause health problems;

the impact of impairment charges on our goodwill and assets as a result of changes in the regulatory, business, economic or political environment;

potential liability resulting from our internet access and hosting services arising from illegal or illicit use of the internet, including the inappropriate dissemination or modification of consumer data; and

- the outcome of pending or future litigation or other legal proceedings.

Readers are cautioned not to place undue reliance on those forward-looking statements, which speak only as of the date of this Annual Report. We do not undertake any obligation to update any forward-looking statements that may be made to reflect events or circumstances after the date of this Annual Report including, without limitation, changes in our business or acquisition strategy or planned capital expenditures, or to reflect the occurrence of unanticipated events.

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CERTAIN TERMS AND CONVENTIONS

Our ordinary shares, nominal value 1.00 euro per share, are currently listed on each of the Madrid, Barcelona, Bilbao and Valencia stock exchanges (collectively, the “**Spanish Stock Exchanges**”) and are quoted through the Automated Quotation System under the symbol “TEF.” They are also listed on the London and Buenos Aires stock exchanges. American Depositary Shares (“**ADSs**”), each representing the right to receive one ordinary share, are listed on the New York Stock Exchange and on the Lima Stock Exchange. ADSs are evidenced by American Depositary Receipts (“**ADRs**”) issued under a Deposit Agreement with Citibank, N.A., as Depositary.

As used herein, “**Telefónica**,” “**Telefónica Group**,” “**Group**”, the “**Company**” and terms such as “**we**,” “**us**” and “**our**” mean Telefónica, S.A. and its consolidated subsidiaries, unless the context requires otherwise.

As used herein, “**Atento**” means Atento Holding, Inversiones y Teleservicios, S.A. and its consolidated subsidiaries, unless the context requires otherwise.

Below are definitions of certain technical terms used in this Annual Report:

“**Access**” refers to a connection to any of the telecommunications services offered by Telefónica. A single fixed customer may contract for multiple services, and Telefónica believes that it is more useful to count the number of accesses a customer has contracted for, than to merely count the number of Telefónica’s customers. For example, a customer that has fixed line telephony service and broadband service is counted as two accesses rather than as one customer.

“**ARPU**” is the average revenues per user per month. ARPU is calculated by dividing total gross service revenues (excluding inbound roaming revenues) from sales to customers for the preceding 12 months by the weighted average number of accesses for the same period, and then dividing by 12.

“**Bundles**” refer to combination products that combine fixed services (wirelines, broad band and television) and mobile services.

“**Churn**” is the percentage of disconnections over the average customer base in a given period.

**“Cloud computing”** is the delivery of computing as a service rather than a product, whereby shared resources, software and information are provided to computers and other devices as a utility over a network (typically the Internet).

**“Commercial activity”** includes the addition of new lines, replacement of handsets and migrations.

**“Data ARPU”** is the average data revenues per user per month. Data ARPU is calculated by dividing total data revenues from sources such as Short Message Service (SMS), Multimedia Messaging Services (MMS), other mobile data services such as mobile connectivity and mobile Internet, premium messaging, downloading ringtones and logos, mobile mail and wireless application protocol (WAP) connectivity from sales to customers for the relevant period by the weighted average number of accesses for the same period, and then dividing by the relevant period.

**“Data revenues”** include revenues from SMS, MMS, other mobile data services such as mobile connectivity and mobile Internet, premium messaging, downloading ringtones and logos, mobile mail and WAP connectivity from sales to customers.

**“Data traffic”** includes all traffic from Internet access, messaging (SMS, MMS) and connectivity services that is transported by the networks owned by Telefónica.

**“FaasT”** is a cybersecurity technology that scans an organization’s system 24 hours a day, seven days a week, in order to prevent cybernetic attacks.

**“Fixed telephony accesses”** includes public switched telephone network, or PSTN, lines (including public use telephony), and integrated services digital network, or ISDN, lines and circuits. For purposes of calculating Telefónica’s number of fixed line accesses, Telefónica multiplies its lines in service as follows: PSTN (x1); basic ISDN (x1); primary ISDN (x30, x20 or x10); 2/6 digital accesses (x30).

**“Fixed termination rates”** is an established fixed network tariff that applies when a customer makes a call to someone in a network operated by another operator.

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**“FTTx”** is a generic term for any broadband network architecture that uses optical fiber to replace all or part of the metal local loop.

**“Gross adds”** means the gross increase in the customer base measured in terms of accesses in a period.

**“HDTV”** or “high definition TV” has at least twice the resolution of standard definition television (SDTV), allowing it to show much more detail than an analog television or digital versatile disc (DVD).

**“Interconnection revenues”** means revenues received from other operators which use Telefónica’s networks to connect or to finish their calls and SMS or connect to their customers.

**“Internet and data accesses”** include broadband accesses (including retail asymmetrical digital subscriber line “ADSL,” very high bit-rate digital subscriber line “VDSL”, satellite, fiber optic and circuits over 2 Mbps), narrowband accesses (Internet service through the PSTN lines) and the remaining non-broadband final customer circuits. Internet and data accesses also include “Naked ADSL”, which allows customers to subscribe for a broadband connection without a monthly fixed line fee.

**“IPTV” (Internet Protocol Television)** refers to distribution systems for television subscription signals or video using broadband connections over the IP protocol.

**“ISP”** means Internet service provider.

**“IT”**, or information technology, is the acquisition, processing, storage and dissemination of vocal, pictorial, textual and numerical information by a microelectronics-based combination of computing and telecommunications.

**“Latch”** is a cybernetic application, protecting accounts and on-line services.

**“Local loop”** means the physical circuit connecting the network termination point at the subscriber’s premises to the main distribution frame or equivalent facility in the fixed public telephone network.

**“LTE”** means Long Term Evolution, a 4G mobile access technology.

**“M2M”**, or machine to machine, refers to technologies that allow both mobile and wired systems to communicate with other devices of the same ability.

**“Market share”** is the percentage ratio of the number of final accesses or operator revenues over the existing total market in an operating area.

**“Metashield”** is a cybernetic product for protecting metadata (information on data) in digital documents and archives.

**“Mobile accesses”** includes accesses to the mobile network for voice and/or data services (including connectivity). Mobile accesses are categorized into contract and prepaid accesses.

**“Mobile broadband”** includes Mobile Internet (Internet access from devices also used to make voice calls such as smartphones), and Mobile Connectivity (Internet access from devices that complement fixed broadband, such as PC Cards/dongles, which enable large amounts of data to be downloaded on the move).

**“MTR”** means mobile termination rate, which is the charge per minute or SMS paid by a telecommunications network operator when a customer makes a call to another network operator.

**“MVNO”** means mobile virtual network operator, which is a mobile operator that is not entitled to use spectrum for the provision of mobile services. Consequently, an MVNO must subscribe to an access agreement with a mobile network operator in order to provide mobile access to their customers. An MVNO pays a determined tariff to such a mobile network operator for using the infrastructure to facilitate coverage to their customers.

**“Net adds”** means the number of new accesses in a certain period.

**“Non SMS data revenues”** means data revenues excluding SMS revenues.



**“OTT services” or “over the top services”** means services provided through the Internet (such as television).

**“P2P SMS”** means person to person short messaging service (usually sent by mobile customers).

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**“Pay TV”** includes cable TV, direct to home satellite TV, or DTH, and Internet Protocol TV, or IPTV.

**“Revenues”** means net sales and revenues from rendering of services.

**“Service revenues”** means revenues less revenues from handset sales. Service revenues are mainly related to telecommunications services, especially voice revenues and data revenues (SMS and data traffic download and upload revenues) consumed by Telefónica’s customers.

**“SIM”** means subscriber identity module, a removable intelligent card used in mobile handsets, USB modems, etc. to identify the user in the network.

**“Tacyt”** is a cybersecurity tool that supervises, stores, analyzes, correlates and classifies mobile applications.

**“Unbundled local loop” or “ULL”** includes accesses to both ends of the copper local loop leased to other operators to provide voice and DSL services (fully unbundled loop, fully ULL) or only DSL service (shared unbundled loop, “shared ULL”).

**“VoiceTraffic”** means voice minutes used by Telefónica’s customers over a given period, both outbound and inbound.

**“VoIP”** means voice over Internet protocol.

**“Wholesale accesses”** means accesses Telefónica provides to its competitors, who then sell services over such accesses to their residential and corporate clients.

**“Wholesale ADSL”** means accesses of broadband or fiber that we provide to our competitors, who then sell services over such accesses to their residential and corporate clients.



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PRESENTATION OF CERTAIN FINANCIAL INFORMATION

In this Annual Report, references to “U.S. dollars,” “dollars” or “\$,” are to United States dollars, references to “pounds sterling,” “sterling” or “£” are to British pounds sterling, references to “reais” refer to Brazilian reais and references to “euro”, “euros” or “€” are to the single currency of the participating member states in the Third Stage of the European Economic and Monetary Union pursuant to the treaty establishing the European Community, as amended from time to time.

Our consolidated financial statements as of December 31, 2015 and 2016, and for the years ended December 31, 2014, 2015 and 2016 included elsewhere in this Annual Report including the notes thereto (the “Consolidated Financial Statements”), are prepared in conformity with International Financial Reporting Standards (“IFRS”) as issued by the International Accounting Standards Board (“IASB”).

**Retrospective revisions**

The consolidated income statement and cash flow data for the years ended December 2014 and 2015 (and also for the years ended December 2012 and 2013 in “Item 3. Key Information Selected Financial Data”) included in this Annual Report has been retrospectively amended to show the reclassification of the results attributable to our operations in the United Kingdom as continuing operations.

On March 24, 2015, Telefónica, S.A. reached an agreement with Hutchison Whampoa Group for the acquisition of Telefónica’s operations in the United Kingdom “O2 UK”. In accordance with IFRS 5, companies under the sale agreement were classified as a disposal group held for sale at that date, and their operations qualified as discontinued operations in the consolidated financial statements for the year ended December 31, 2015.

Following the European Commission’s (the “EC”) decision to prohibit such sale to Hutchison Whampoa Group, the Board of Directors of Telefónica, S.A. at its meeting on June 29, 2016 agreed that Telefónica will continue to explore different strategic alternatives for O2 UK to be implemented when market conditions are deemed appropriate. Given that the execution of a sale transaction is less certain, Telefónica’s operations in the United Kingdom are no longer presented as discontinued operations and the respective assets and liabilities cease to be classified as held for sale. Thus, these items are presented line by line in the Consolidated Financial Statements. Comparative financial information has been amended accordingly.

In addition, our 2015 and 2014 financial information by operating segment has been amended to reflect our current reporting structure: Telefónica Spain, Telefónica United Kingdom, Telefónica Germany, Telefónica Brazil and Telefónica Hispanoamérica (formed by the Group's operators in Argentina, Chile, Peru, Colombia, Mexico, Venezuela, Central America, Ecuador and Uruguay), which is the same as our organizational structure prior to the elimination of our Telefónica United Kingdom operating segment, which was approved by the Board of Directors of Telefónica, S.A. on February 26, 2014.

Moreover, our consolidated statement of financial position as of December 31, 2014 has been adjusted to reflect the finalization of the purchase price allocation for the acquisition of E-Plus Mobilfunk GmbH Co KG ("**E-Plus**"). The impact of such finalization on our 2014 net income was immaterial and adjusted against retained profits as of December 31, 2014. As a result, we have not restated the consolidated income statement for the year ended December 31, 2014 in connection with this finalization.

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PART I

Item 1. Identity of Directors, Senior Management and Advisors

A. Directors and Senior Management

Not applicable.

B. Advisers

Not applicable.

C. Auditors

Not applicable.

Item 2. Offer Statistics and Expected Timetable

Not applicable.

Item 3. Key Information

A. Selected Financial Data

The following table presents certain selected consolidated financial data. It is to be read in conjunction with “Item 5. Operating and Financial Review and Prospects”, “Item 4. Information on the Company—Business Overview” and the Consolidated Financial Statements. The consolidated income statement and cash flow data for the years ended December 31, 2014, 2015 and 2016 and the consolidated statement of financial position data as of December 31, 2015 and 2016 set forth below are derived from, and are qualified in their entirety by reference to the Consolidated

Financial Statements.

The consolidated income statement and cash flow data for the year ended December 31, 2015 set forth below has been retrospectively amended in 2016 to show the reclassification of the results attributable to our operations in the United Kingdom as continuing operations and is not derived from Telefónica, S.A.'s consolidated financial statements for such year, which are not included herein. See "Presentation of Certain Financial Information Retrospective revisions".

The consolidated income statement and cash flow data for the year ended December 31, 2014 set forth below is derived from Telefónica, S.A.'s consolidated financial statements for that year. The consolidated statement of financial position data as of December 31, 2014 set forth below have been retrospectively amended to show the finalization of the purchase price allocation for the acquisition of E-Plus and is not derived from Telefónica, S.A.'s consolidated financial statements for such year, which are not included herein. See "Presentation of Certain Financial Information Retrospective revisions".

The consolidated statement of financial position as of December 31, 2012 and 2013 and the consolidated income statement and cash flow data for the years ended December 31, 2012 and 2013 set forth below are derived from Telefónica, S.A.'s consolidated financial statements for such years, which are not included herein.

Our Consolidated Financial Statements have been prepared in accordance with IFRS as issued by the IASB.

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The basis of presentation is described in detail in Note 2 to our Consolidated Financial Statements.

| Millions of euros   | 2012      | 2013      | 2014      | 2015      | 2016      |
|---|-----------|-----------|-----------|-----------|-----------|
| Revenues  | 62,356    | 57,061    | 50,377    | 54,916    | 52,036    |
| Other income  | 2,323     | 1,693     | 1,707     | 2,011     | 1,763     |
| Supplies  | (18,074)  | (17,041)  | (15,182)  | (16,547)  | (15,242)  |
| Personnel expenses  | (8,569)   | (7,208)   | (7,098)   | (10,349)  | (8,098)   |
| Other expenses  | (16,805)  | (15,428)  | (14,289)  | (16,802)  | (15,341)  |
| Depreciation and amortization   | (10,433)  | (9,627)   | (8,548)   | (9,704)   | (9,649)   |
| OPERATING INCOME  | 10,798    | 9,450     | 6,967     | 3,525     | 5,469     |
| Share of profit (loss) of investments accounted for by the equity method                    | (1,275)   | (304)     | (510)     | (10)      | (5)       |
| Net finance expense   | (3,062)   | (2,696)   | (2,519)   | (2,341)   | (2,706)   |
| Net exchange differences  | (597)     | (170)     | (303)     | (268)     | 487       |
| Net financial expense   | (3,659)   | (2,866)   | (2,822)   | (2,609)   | (2,219)   |
| PROFIT BEFORE TAX   | 5,864     | 6,280     | 3,635     | 906       | 3,245     |
| Corporate income tax  | (1,461)   | (1,311)   | (383)     | (155)     | (846)     |
| PROFIT AFTER TAX FROM CONTINUING OPERATIONS   | 4,403     | 4,969     | 3,252     | 751       | 2,399     |
| PROFIT FOR THE YEAR   | 4,403     | 4,969     | 3,252     | 751       | 2,399     |
| Attributable to equity holders of the Parent  | 3,928     | 4,593     | 3,001     | 616       | 2,369     |
| Attributable to non-controlling interests   | (475)     | (376)     | 251       | 135       | 30        |
| Weighted average number of shares-Basic (thousands)(1)                                      | 4,847,311 | 4,872,974 | 4,850,311 | 5,070,588 | 5,060,519 |
| Basic and diluted earnings per share attributable to equity holders of the parent (euro)(1) | 0.81      | 0.94      | 0.58      | 0.07      | 0.42      |
| Basic and diluted earnings per ADS (euro)(1)  | 0.81      | 0.94      | 0.58      | 0.07      | 0.42      |
| Weighted average number of ADS-Basic (thousands)(1)   | 4,847,311 | 4,872,974 | 4,850,311 | 5,070,588 | 5,060,519 |
| Dividends per ordinary share (cash and scrip) (euro)  | 0.83      | 0.35      | 0.75      | 0.75      | 0.75      |
| Dividends per ordinary share (cash and scrip) (\$) (2)                                      | 1.06      | 0.47      | 0.98      | 0.83      | 0.82      |
| Consolidated Statement of Financial Position Data   |           |           |           |           |           |
| Cash and cash equivalents   | 9,847     | 9,977     | 6,529     | 2,615     | 3,736     |
| Property, plant and equipment   | 35,021    | 31,040    | 33,156    | 33,910    | 36,393    |



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|   |         |         |         |          |         |
|---|---------|---------|---------|----------|---------|
| Total assets                              | 129,773 | 118,862 | 122,348 | 120,329  | 123,641 |
| Non-current liabilities                   | 70,601  | 62,236  | 62,318  | 60,509   | 59,805  |
| Equity net                                | 27,661  | 27,482  | 30,321  | 25,436   | 28,385  |
| Capital stock                             | 4,551   | 4,551   | 4,657   | 4,975    | 5,038   |
| Consolidated Cash Flow Data               |         |         |         |          |         |
| Net cash provided by operating activities | 15,213  | 14,344  | 12,193  | 13,615   | 13,338  |
| Net cash used in investing activities     | (7,877) | (9,900) | (9,968) | (12,917) | (8,208) |
| Net cash used in financing activities     | (1,243) | (2,685) | (4,041) | (3,612)  | (4,220) |

The per share and per ADS computations for all periods presented have been reported using the weighted average number of shares and ADSs, respectively, outstanding for each period, and have been adjusted to reflect the stock dividends which occurred during the periods presented, as if these had occurred at the beginning of the earliest period presented and have also been adjusted for mandatorily convertible notes issued in 2014. In accordance with (1) IAS 33 ("Earnings per share"), the weighted average number of ordinary shares and ADSs outstanding for each of the periods covered has been restated to reflect the issuance of shares pursuant to Telefónica's scrip dividend in June 2012, December 2014, December 2015 and December 2016. As a consequence, basic and diluted earnings per share have also been restated from 2012 to 2015.

(2) Quantities in U.S. dollars are calculated in accordance with the conversion rate published by the Depositary (Citibank, N.A.) in connection with each dividend payment.

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## Exchange Rate Information

As used in this Annual Report, the term “Noon Buying Rate” refers to the rate of exchange for euro, expressed in U.S. dollars per euro, in the City of New York for cable transfers payable in foreign currencies as certified by the Federal Reserve Bank of New York for customs purposes. The Noon Buying Rate certified by the New York Federal Reserve Bank for the euro on February 10, 2017 was \$1.065= 1.00 euro. The following tables describe, for the periods and dates indicated, information concerning the Noon Buying Rate for the euro. Amounts are expressed in U.S. dollars per 1.00 euro.

**Noon Buying Rate**

| Year ended December 31,          | Period end | Average (1) | High   | Low    |
|----------------------------------|------------|-------------|--------|--------|
| 2012                             | 1.3186     | 1.2909      | 1.3463 | 1.2062 |
| 2013                             | 1.3779     | 1.3303      | 1.3816 | 1.2774 |
| 2014                             | 1.2101     | 1.3155      | 1.3816 | 1.2447 |
| 2015                             | 1.0859     | 1.1032      | 1.2015 | 1.0524 |
| 2016                             | 1.0552     | 1.1075      | 1.1516 | 1.0375 |
| 2017 (through February 10, 2017) | 1.0650     | 1.0661      | 1.0802 | 1.0416 |

Source: Federal Reserve Bank of New York.

(1) The average of the Noon Buying Rates for the euro on the last day reported of each month during the relevant period.

**Noon Buying Rate**

| Month ended        | High   | Low    |
|--------------------|--------|--------|
| August 31, 2016    | 1.1334 | 1.1078 |
| September 30, 2016 | 1.1271 | 1.1146 |
| October 31, 2016   | 1.1212 | 1.0866 |
| November 30, 2016  | 1.1121 | 1.0560 |
| December 31, 2016  | 1.0758 | 1.0375 |

|   |        |        |
|---|--------|--------|
| January 31, 2017                              | 1.0794 | 1.0416 |
| February 10, 2017 (through February 10, 2017) | 1.0802 | 1.0650 |

Source: Federal Reserve Bank of New York.

Monetary policy within the member states of the euro zone is set by the European Central Bank.

Our ordinary shares are quoted on the Spanish Stock Exchanges in euro. Currency fluctuations may affect the dollar equivalent of the euro price of our shares listed on the Spanish Stock Exchanges and, as a result, the market price of our ADSs, which are listed on the New York Stock Exchange. Currency fluctuations may also affect the dollar amounts received by holders of ADSs on conversion by the depositary of any cash dividends paid in euro on the underlying shares.

Our consolidated results are affected by fluctuations between the euro and the currencies in which the revenues and expenses of some of our consolidated subsidiaries are denominated and recorded (principally the Brazilian real, the pound sterling, the Argentine peso, the Peruvian nuevo sol, the Chilean peso, the Colombian peso, the Mexican peso and the Venezuelan bolívar fuerte). See Note 3 (b) to our Consolidated Financial Statements for information on the exchange rate translation methodology we used in preparing our consolidated financial information.

#### B. Capitalization and Indebtedness

Not applicable.

#### C. Reasons for the Offer and Use of Proceeds

Not applicable.

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D. Risk Factors

The Telefónica Group's business is affected by a series of intrinsic risk factors that affect exclusively the Group, as well as a series of external factors that are common to businesses of the same sector. The main risks and uncertainties facing the Company which could affect its business, financial position, reputation, corporate image and brand and its results of operations, must be considered jointly with the information in the Consolidated Financial Statements, and are as follows:

**Group-Related Risks**

**Worsening of the economic and political environment could negatively affect Telefónica's business.**

Telefónica's international presence enables the diversification of its activities across countries and regions, but it exposes Telefónica to various legislation, as well as to the political and economic environments of the countries in which it operates. Any adverse developments or even uncertainties in this regard, including exchange-rate or sovereign-risk fluctuations, may adversely affect the Company's business, financial position, cash flows and results of operations and/or the performance of some or all of the Group's financial indicators.

Economic conditions may adversely affect the level of demand of existing and prospective customers, as they may no longer deem critical the services offered by the Group.

Growth in Europe and financial stability may be affected by political uncertainty in some European countries due to upcoming general elections, a possible revival of the crisis in Greece, restructuring of the banking sector and due to the impact of steps taken towards an EU banking union and a capital markets union. In particular, the British exit process from the European Union following the vote to leave in the recent referendum, will require an adjustment of the economy to whatever new trade and investment relationships are put in place in the future, with the consequences in the meantime being uncertainty regarding investment, activity and financial market volatility. In 2016, the Telefónica Group obtained 24.5% of its revenues in Spain (22.6% in 2015), 14.4% in Germany (the same percentage as in 2015) and 13.2% in United Kingdom (14.3% in 2015).

In Latin America, there is an increasing exchange rate risk brought on by external factors such as increasing interest rates in the United States amid still low commodity prices and doubts about growth and imbalances in China; as well as internal factors as a consequence of the still high fiscal and external deficits in the most important Latin American

countries or the low liquidity in exchange markets as it is the case in Argentina.

Some of the most significant macroeconomic risk factors in the region affect Mexico, as it is the country with the highest commercial and financial exposure to the United States. In this sense, increasing interest rates and the possible overhaul of trade agreements between both countries could imply higher restrictions on imports into the United States that would affect negatively the economic activity in Mexico.

Brazil is undertaking several measures principally focused on adjusting its public finances. A constitutional amendment limiting public spending has been approved and the government has submitted a new social security reform bill to Congress. However, the possibility of a new bout of political turmoil, which could weaken the support of the reforms, is not negligible. While signs of stabilization have emerged, economic growth continues to be negative and the unemployment rate has hit double digits, having a sizable effect on consumption spending. Moreover, despite financing external needs have decreased, internal needs are still high. All these elements have led to new downgrades to the country's credit rating during 2016, which now is below investment grade.

In countries such as Chile, Colombia and Peru, the recent uptick in commodity prices is having a positive impact on its fiscal and external accounts, but growth continues to be below its potential level due to the lower external inflows, which have affected investment and, to a lower extent, consumption.

In Argentina, the new government is focused on resolving Argentina's macroeconomic and financial imbalances and on recovering international confidence. Although reforms taking place may have positive effects in the medium term, short term risks persist, including exchange rate risk, especially due to the high inflation rate amid an economic contraction.

During 2016, Telefónica Hispanoamérica represented 24.2% of the Telefónica Group's revenues (26.2% in 2015), of which 23.8% proceeded from revenues in Argentina, 19.9% in Peru and 17.2% in Chile. During 2016, Telefónica Brazil represented 21.3% of the Telefónica's Group revenues (20.1% in 2015). In this respect, approximately 30.4% of the Group's revenues were generated in countries that do not have investment grade status (in order of importance, Brazil, Argentina, Ecuador, Nicaragua, Venezuela, Guatemala, Costa Rica and El Salvador), and other countries are only one notch away from losing this threshold.

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“Country risk” factors include the following, among others:

unexpected adverse changes in regulation or administrative policies, including changes that modify the terms and conditions of licenses and concessions and their renewal (or delay their approval);

abrupt exchange rate movements;

high inflation rates;

expropriation or nationalization of assets, adverse tax decisions, or other forms of state intervention;

economic-financial downturns, political instability and civil disturbances; and

maximum limits on profit margins imposed in order to limit the prices of goods and services through the analysis of cost structures (for example, in Venezuela, a maximum profit margin has been introduced that is set annually by the Superintendence for Defense of Socioeconomic Rights).

Any of the foregoing may adversely affect the business, financial position, results of operations and cash flows of the Group.

**The Group's financial condition and results of operations may be adversely affected if it does not effectively manage its exposure to foreign currency exchange rates or interest rates.**

At December 31, 2016, 50.8% of the Group's net debt (in nominal terms) was pegged to fixed interest rates for over a year, while 20% was denominated in a currency other than the euro. At December 31, 2016, the net financial debt ratio in Latin American currencies was 13%.

To illustrate the sensitivity of financial expenses to a change in short-term interest rates at December 31, 2016: (i) a 100 basis points increase in interest rates in all currencies in which Telefónica has a financial position at that date would lead to an increase in financial expenses of 232 million euros for the year ended December 31, 2016, (ii) whereas a 100 basis points decrease in interest rates in all currencies (even if negative interest rates are reached), would lead to a reduction in financial expenses of 201 million euros for the year ended December 31, 2016. These calculations were made assuming a constant currency and balance position equivalent to the position at year end

taking into account the derivative financial instruments arranged.

According to the Group's calculations, the impact on results arising from a 10% depreciation of Latin American currencies against the US dollar and a 10% depreciation of other global currencies against the euro, excluding the pound sterling, would result in exchange losses of 43 million euros for the year ended December 31, 2016, primarily due to the depreciation of the Venezuelan bolívar and, to a lesser extent, the Argentinean peso. These calculations were made assuming a constant currency financial position with an impact on profit or loss for the year ended December 31, 2016, including derivative instruments in place.

During 2016, Telefónica Brazil represented 24.6% (27.0% in 2015), Telefónica Hispanoamérica represented 23.0% (32.9% in 2015) and Telefónica United Kingdom represented 11.3% (14.6% in 2015) of the operating income before depreciation and amortization (OIBDA) of the Telefónica Group.

The Telefónica Group uses a variety of strategies to manage this risk, among others the use of financial derivatives, which themselves are also exposed to risk, including counterparty risk. However, the Group's risk management strategies may not achieve the desired effect, which could adversely affect the Group's business, financial condition, results of operations and cash flows.

**Existing or worsening conditions in the financial markets may limit the Group's ability to finance, and consequently, the ability to carry out its business plan.**

The performance, expansion and improvement of the Telefónica Group's networks, the development and distribution of the Telefónica Group's services and products, the implementation of Telefónica's strategic plan and new technologies, the renewal of licenses or the expansion of the Telefónica Group's business in countries where it operates, may require a substantial amount of financing.

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A decrease in the liquidity of Telefónica, a difficulty in refinancing maturing debt or raising new funds as debt or equity could force Telefónica to use resources allocated to investments or other commitments to pay its financial debt, which could have a negative effect on the Group's business, financial condition, results of operations and/or cash flows.

Funding could be more difficult and costly in the event of a significant deterioration of conditions in the international or local financial markets due to the uncertainties regarding the hikes in interest rates on the part of the US Federal Reserve and the oil prices instabilities, or if there is an eventual deterioration in the solvency or operating performance of Telefónica.

At December 31, 2016, gross financial debt scheduled to mature in 2017 amounted to 13,326 million euros (which includes the net position of derivative financial instruments and certain current payables), and gross financial debt scheduled to mature in 2018 amounted to 7,195 million euros.

In accordance with its liquidity policy, Telefónica has covered its gross debt maturities over the next twelve months with cash and credit lines available at December 31, 2016. Telefónica's liquidity could be affected if market conditions make it difficult to renew existing undrawn credit lines, 8% of which, at December 31, 2016, were scheduled to mature prior to December 31, 2017.

In addition, given the interrelation between economic growth and financial stability, the materialization of any of the economic, political and exchange rate risks referred to above could lead to a negative impact on the availability and cost of Telefónica's financing and its liquidity strategy, which could have a negative effect on the Group's business, financial condition, results of operations and/or cash flows.

**Adoption of new accounting standards could affect reported results and financial position.**

Accounting Standardization Bodies and other authorities may periodically change accounting regulations that govern the preparation of the Group's consolidated financial statements. Those changes could have a significant impact on the way the Group accounts and presents its financial position and its operating income. In some instances, a modified standard or a new requirement with retroactive nature must be implemented, which requires the Group to restate previous financial statements.



See details of the implementation of new standards and interpretations issued in Note 3 of the Consolidated Financial Statements. In particular, Telefónica is required to adopt the new accounting standards IFRS15 Revenue from Contracts with Customers, effective from January 1, 2018, and IFRS 16 Leases, effective for the financial years from January 1, 2019. These standards present significant changes that could affect both the amount and moment of recognition of revenues and expenses related with certain sales transactions, as well as the accounting treatment for all lease contracts (other than short-term leases and leases of low-value assets). These changes could have a material impact on the Group's financial statements. Such impact is under analysis as of the date of this Annual Report.

## **Risks Relating to the Group's Industry**

**The Group operates in a highly regulated industry which requires government concessions for the provision of a large part of its services and the use of spectrum, which is a scarce and costly resource.**

The telecommunications sector is subject to laws and sector-specific regulations in the majority of the countries where the Group provides its services. Additionally, many of the services the Group provides require the granting of a license, concession or official approval, which usually requires certain obligations and investments to be made, such as those relating to the acquisition of spectrum. Among the main risks of this nature are those related to spectrum regulation and licenses/concessions, rates, universal service regulation, regulated wholesale services over fiber networks, privacy, functional separation of businesses and network neutrality. The fact that the Group's business is highly regulated both affects its revenues and imposes costs on its operations.

Thus, as the Group provides most of its services under licenses, authorizations or concessions, it is vulnerable to administrative bodies' decisions, such as economic fines for serious breaches in the provision of services and, potentially, revocation or failure to renew these licenses, authorizations or concessions, or the granting of new licenses to competitors for the provisions of services in a specific market.

In this regard, the Telefónica Group pursues its license renewals on the terms referred in their respective contractual conditions, though it cannot guarantee that it will always complete this process successfully or under the most beneficial terms for the Group. In many cases complying with certain obligations is required, including, among others, minimum specified quality, service and coverage standards and capital investment. Failure to comply with these obligations could result in the imposition of fines, revision of the contractual terms, or even the revocation of the license, authorization or concession.

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Additionally, the Telefónica Group could be affected by regulatory actions carried out by the antitrust authorities. These authorities could prohibit certain actions, such as new acquisitions or specific practices, create obligations or lead to heavy fines. Any such measures implemented by the competition authorities could result in economic and/or reputational loss for the Group, in addition to a loss of market share and/or harm to the future growth of certain businesses. Regarding the merger of Telefónica Deutschland Holding AG and E-Plus, other providers such as United Internet and the regional cable operator Airdata lodged an appeal before the General Court against the decision of the EU which authorized such merger. Telefónica Deutschland has been accepted as an interested party of the process and it has presented its statements in both cases. United Internet has lodged a second appeal against the EC in relation to the content of the letter of commitment assumed by Telefónica Deutschland regarding the implementation of remedies for non-network operators. In December 2016, each of Mass Response Service GmbH and Multiconnect GmbH filed an appeal before the General Court against the decision of the EU that Telefónica Deutschland is not obliged to grant access to Full-Mobile Virtual Network Operators (“**MVNO**”) under the non-MNO remedy of the commitments. Telefónica Deutschland will apply for leave to intervene as an interested party.

### Regulation of spectrum and access to new government licenses/concessions of spectrum

On September 14, 2016, the EC adopted, among other texts, a proposed Directive for the establishment of a European Electronic Communication Code, which could have significant implications, inter alia, for access to networks, spectrum use, auction conditions, duration and renewal of licenses, universal service, consumer protection, audiovisual services and platforms. It is estimated that the approval of such regulatory framework will take place in a year and a half.

On December 14, 2016, the European Parliament and Council agreed on a decision regarding the use and availability of the 700 MHz band. This could require new cash outflows from Telefónica between 2017 and 2022 in both the United Kingdom and Spain, where it is expected that the 700 MHz band will be available between 2020-2022. In connection with spectrum auctions for 2.3 and 3.4 GHz band, in the United Kingdom, Ofcom issued a consultation document on November 21, 2016. Responses were due by January 30, 2017, and a decision is expected in the second quarter of 2017. In Germany, the regulatory agency for electricity, gas, telecommunications, post and railway (“**BNetzA**”) initiated a proceeding for the demand-oriented allocation of new frequencies for the further rollout of digital 5G infrastructures, which include the timely allocation of the 2 GHz spectrum expiring at the end of 2020 and 2025 (so called UMTS spectrum) and further spectrum (inter alia 3.5 GHz). A decision about the allocation procedure is expected towards the end of 2017 and an auction may take place in 2018 or 2019.

In Latin America, spectrum auctions are expected to take place requiring potential cash outflows to obtain additional spectrum or to meet the coverage requirements associated with these licenses. Specifically, the procedures expected to take place in 2017-2018, in the relevant jurisdiction for the Group, are:

Mexico: An auction spectrum in the 2500 MHz band is expected to take place between the third quarter of 2017 and the second quarter of 2018. A wholesale network tender, which will offer services in the 700 MHz band was concluded on November 17, 2016. Altán was the tender winner and the commercial operations must begin no later than March 31, 2018.

Colombia: During 2017 the Ministry of Information Technologies and Communications published for commentaries until March 7, 2017, the project of resolution with the conditions for an auction of 70 MHz of spectrum band in 700 MHz and 5 MHz in 1900 MHz. In addition, the Ministry published a project of decree increasing the spectrum cap for lower bands to 45 MHz and 90 MHz for upper bands. The schedule for the auction has not been set yet.

Argentina: The Government instructed the regulatory authority to issue new regulations during 2017 to ensure the reassignment of frequencies of the radio spectrum for the provision of wireless or fixed wireless services and enables the reassignment of frequencies previously granted to other provider.

However, it is likely that some of these spectrum tender procedures will not be completed, or even initiated in the mentioned dates. In addition to the above, it may be the case that certain administrations may not yet have announced their intention to release new spectrum but may do so during 2017. The above does not include processes announced via general statements by administrations, which involve bands not key to Telefónica's needs. Furthermore, Telefónica may also seek to acquire spectrum on the secondary market where opportunities might arise.

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*Risks relating to concessions and licenses previously granted*

The terms of concessions and licenses granted to the Group and necessary for the provision of its services may be challenged or amended by the regulators at any time, which may materially adversely affect its business, financial condition, results of operations and cash flows.

The German regulator initiated consultations in March and July 2016 on the frequency distribution after the merger between Telefónica Deutschland and E-Plus, particularly in the 2 GHz band and on the future spectrum allocation for 5G band. The result of such consultations could lead, among others, to proposals by the regulator reorganizing the spectrum that Telefónica Deutschland holds on the 2 GHz band.

In the United Kingdom, Telefónica has an obligation in its 800 MHz spectrum license to provide indoor coverage to 98% of the United Kingdom population (and 95% of the population of each of England, Wales, Scotland and Northern Ireland) and an obligation in its 900/1800 MHz spectrum license to provide voice and text services to 90% of the United Kingdom landmass, both by the end of 2017, and to be maintained, thereafter. Inherent with these obligations is a risk of Telefónica United Kingdom not meeting the required targets. Telefónica United Kingdom is actively working towards mitigating the risk through the continuous investment in an infrastructure improvement program, upgrading its 2G and 3G Networks and continued roll-out of its 4G Network.

In the state of São Paulo, Telefônica Brazil provides local and national long-distance Fixed Switched Telephony Service ("STFC") under the so-called public regime, through a concession agreement, which is expected to remain in force until 2025. In accordance with current regulations, Telefônica Brasil informed the Brazilian regulatory authority (Agencia Nacional de Telecomunicações or "ANATEL") that the net value, as of December 31, 2015, of assets assigned to the provision of STFC (which include, among others, switching and transmission equipment and public use terminals, external network equipment, energy equipment and system and operation support equipment) were estimated to total 7.8 billion Brazilian reais. At December 31, 2016, this value is estimated to total 8,813,916 Brazilian reais (this value will be updated in the second half of 2017). In principle, the assets assigned to the provision of STFC were considered reversible assets. During the last months, a bill amending the regulatory framework in Brazil has been processed, establishing, among others, that such assets will no longer be reversible under the new licenses regime in exchange for significant broadband investment commitments. Recently, the processing at the Senate of such bill has been challenged before the Federal Supreme Court. Such Court and, consequently, the Senate's governing board has decided to send the bill for voting in plenary. With the bill being sent to the plenary, it could be understood that there is no more dispute for the Supreme Court to decide upon. In case that the bill is finally approved, ANATEL will be entitled to adopt the pertinent administrative decisions for the transformation of the respective licenses with the consequent modification of the future binding obligations to STFC providers.

In Colombia, the Ministry of Information Technologies and Communications (“**ITC**”) issued Resolution 597 on March 27, 2014, to renew 850 MHz/1900 MHz licenses for 10 additional years. However, the reversion of assets (other than radio frequencies, which it is clear that must be returned) and its scope was widely discussed between the relevant mobile operators (including Telefónica Colombia) and the ITC in the context of the liquidation of the previous concession contract, taking into consideration the terms of the contract, and the Constitutional Court’s interpretation of Law 422 of 1998 and Law 1341 of 2009. Discussions on the matter concluded on February 16, 2016, when the ITC convened an arbitration proceeding, in accordance with in the terms of the relevant concession contract. The relevant concession holders (including Telefónica Colombia) filed a response to the claim prompted by the ITC. The arbitration process is still ongoing.

In Peru, Telefónica has concessions for the provision of the fixed-line service until November 2027. In December 2013, Telefónica filed a partial renewal request for these concessions for five more years. In December 2014 and June 2016, Telefónica also filed a renewal request for twenty more years in relation to a concession for the provision of local carrier service and one of the concessions to provide mobile-line services in provinces, respectively. As of the date of this Annual Report, the decision of the Ministry of Transport and Communications (Ministerio de Transportes y Comunicaciones) in all such proceedings is still pending and according to the legislation, the concessions subject of these procedures remain in force as long as the procedures are in progress.

Telefónica Móviles Chile, S.A. was awarded 2x10 MHz spectrum on the 700 MHz band in March 2014. A claim was brought by a consumer organization against the 700 MHz assignments. The decision by the Supreme Court on the appeal presented by such consumer organization is still pending.

During the year ended December 31, 2016, the Group’s consolidated investment in spectrum acquisitions and renewals amounted to 345 million euros.

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The Group's failure to obtain sufficient or appropriate spectrum capacity in the jurisdictions discussed above or any others in which it operates, or its inability to assume the related costs, could have an adverse impact on its ability to launch and provide new services and on Telefónica's ability to maintain the quality of existing services, which may adversely affect the Group's business, financial condition, results of operations and cash flows.

### *Regulation of wholesale and retail charges*

The European Regulation 2015/2120 on Net Neutrality and Roaming was adopted on November 25, 2015. From June 15, 2017, operators may not charge roaming users within the EU an additional fee on their domestic prices for roaming calls, SMS and data services. However, in some circumstances, operators may apply consumption limits and additional surcharge under a "fair use policy". In January 2017, wholesale roaming caps have been agreed between the Council and the Parliament and the maximum wholesale caps have been set at the following limits: 0.01€/sms; 0.032€/minute; data services glide path: 7.7€/GB (June – December 2017); 6€/GB (2018); 4.5€/GB (2019); 3.5€/GB (2020); 3€/GB (2021) and 2.5€/GB (2022).

On September 14, 2016, the EC presented its proposal of the regulatory framework which, among other measures, intends to incorporate a European methodology and a European upper limit for the call-termination prices for landline phone/ mobile phone applicable in EU.

The decreases in wholesale mobile termination rates ("MTR") in Europe are also noteworthy. In the United Kingdom, the current rate is 0.503 ppm. A further cut to 0.495 ppm will come into effect from April 1, 2017.

In Germany, on August 30, 2016, BNetzA adopted a regulatory decision, which considers with pure long run incremental cost ("LRIC") a new cost model for the calculation of MTR. Telefónica Deutschland has appealed the decision in court, but the appeal has not yet been decided. BNetzA approved new MTR on November 30, 2016, in a provisional decision, which sets the rates to 0.011 euro/minute as of December 1, 2016, to 0.0107 euro/minute as of December 1, 2017, and to 0.0095 euro/minute as of December 1, 2018, until the end of November 2019. Before taking a final decision, the new MTR are nationally consulted and notified to the EC. There is consequently a risk that when the new MTR are approved (which will be retroactively enforceable from December 1, 2016), and with the new termination rates applicable from January 1, 2017, the rates will significantly decrease. Regarding fixed networks termination rates, BNetzA adopted at the end of January 2017 a provisional decision which establish a tariff of 0.0010 euro/minute.

In Spain, on July 1, 2016, the Spanish National Regulatory and Competition Authority (Comisión Nacional de los Mercados y la Competencia or "CNMC") initiated the process of reviewing the prices of mobile termination, with a

final decision expected to be adopted during 2017.

Additionally, on January 17, 2017, the CNMC issued the analysis of the market for access and call origination on fixed networks. The CNMC maintains the obligation of Telefónica, as an operator with significant market power, to provide a wholesale interconnection offer and a wholesale line rental ("WLR"), both with cost-oriented prices regarding manufacturing costs and the adoption of a management accounting system. Telefónica is equally obliged to non-discrimination, transparency and separation of accounts. In Latin America, it is likely that MTRs will also be reduced in the short to medium term.

In Brazil, ANATEL has issued ex-ante regulations to ensure competition in the wholesale market, which includes reductions of the MTR. In this regard, the Plano Geral de Metas de Competição ("**PGMC**"), amended by Resolution 649/2015, established that mobile termination fees are subject to successive yearly reductions from 2016 until 2019, when the definitive cost-oriented-model fees are expected to be in force (such Resolution has been challenged in courts without a definitive outcome). On December 5, 2016, ANATEL issued a public consultation for the revision of the PGMC, which addresses changes in the relevant wholesale markets regulated by the PGMC and also in the cost-oriented model. The mentioned public consultation is available for comments until March 22, 2017.

In Mexico, on September 23, 2016, the Instituto Federal de Telecomunicaciones ("**IFT**") announced that the MTRs applicable to operators different from the so-called Prevailing Economic Agent for 2017 will be 0.1906 pesos per minute, as long as the regulatory asymmetry of the Prevailing Economic Agent introduced by Mexico with the constitutional reform on 2014 and the new Federal Telecommunication Law on 2014 remains in effect.

In Colombia, the Comisión de Regulación de Comunicaciones ("**CRC**") published a regulatory project for public comments in November 2016. In the project the CRC proposes a symmetric termination rate of 11.17 COP per minute and 4.3 million COP per monthly capacity from 2017 for established operators and an asymmetric termination rate of 19.01 COP per minute and 7.6 million COP per monthly capacity for challenger operators in a five-year period. The CRC also proposes regulatory measures to promote the entry of mobile virtual network operators ("**MVNOs**"), including the regulation of prices for the access to the mobile networks. The project is still in debate.

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In Peru, the Organismo Supervisor de las Telecomunicaciones (“**OSIPTEL**”) started the process for the revision of the values on charges of interconnection for mobile termination of calls in telecommunication services networks in November 2016. The new values established by OSIPTEL will apply as of the fourth quarter of 2017.

As a result of the foregoing regulatory actions, Telefónica may receive lower prices for certain of its services, which may materially adversely affect its business, financial condition, results of operations and cash flows.

### *Regulation of Universal Services*

The Universal Service (“**US**”) is an economic and legal term which refers to the obligation imposed to telecommunication operators to provide a basic service to all inhabitants of a country. In general, the goal is to promote quality services availability at affordable, reasonable and fair prices, to increase the access to advances telecommunication services (such as broadband) and to move forward with the availability of such services to all customers. On its reform proposal for the regulatory framework issued on September 14, 2016, the EC seeks to modernize the Universal Services area in Europe, removing the mandatory inclusion of the traditional services (telephone boxes, directories and information services) and focusing on the provision of affordable broadband services. The EC also proposed that the US must be funded from general budgets and not from sectorial budgets. However, if this funding method does not thrive, the affordable broadband inclusion could result more expensive for the sector. In any case, it is estimated that the new regulation will not be applicable before 2020.

In Spain, the licenses of Telefónica de España and Telefónica Telecomunicaciones Públicas for the provision of USs expired on December 31, 2016. Both companies have been designated for the provision of these services from January 1, 2017.

In Brazil, on December 15, 2016, a proposal of the General Plan for Universalisation of Fixed Switched Telephony Services (“**PGMU**”) was approved by ANATEL.

The imposition on the Telefónica Group of additional or more onerous obligations to provide US services in the jurisdictions where it operates could have a material adverse effect on its business, financial condition, results of operations and cash flows.

### *Regulation of fiber networks*



On February 24, 2016, the Spanish CNMC adopted a final resolution on the wholesale broadband market regulation, which raises a geographical segmentation in competitive (66 cities, 34% of total population) and non-competitive areas. It is anticipated that this resolution will last for at least four years. Its implementation is expected to result in a moderate increase of the current regulatory obligations of Telefónica in Spain, in terms of its granting of access to other operators to its fiber network and with respect to certain aspects relating specifically to the business segment (high quality bitstream service for business customers with national coverage). This Resolution has been appealed by Telefónica España. Additionally, on January 18, 2016, the CNMC adopted a resolution which approves the reference offer of the new wholesale unbundled virtual access service to Telefónica's new broadband Ethernet service (local NEBA). The NEBA service should be operative in 12 months from the date of the resolution's adoption.

Any of such obligations and restrictions could raise costs and limit Telefónica's freedom to provide the mentioned services, which could materially adversely affect Telefónica's business, financial condition, results of operations and cash flows.

#### *Regulations on privacy*

An intense data protection and privacy regulation may result in limitations to offer innovative digital services such as Big Data services. In Europe the new General Data Protection Regulation ("**GDPR**") of April 27, 2016, will be directly applicable in all member States from May 25, 2018. The GDPR introduces administrative fines of up to 4% of an undertaking's annual global turnover for breaching the new data protection rules.

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On January 10, 2017, the EC presented its proposal for a regulation on ePrivacy, which will replace the current Directive 2002/58/EC on privacy in the electronic communications sector and will complement the recently approved GDPR. The proposal also introduces administrative fines of up to 4% of an undertaking's annual global turnover for breaching new regulations.

In October 2015, the Court of Justice of the European Union declared invalid the decision of the EC as regards the "Safe Harbor Agreement" relating to the transfer of personal data from the EU to the United States. Subsequently, the EC adopted a new decision on Privacy Shield on July 12, 2016, which considers that there is an adequate level of protection of personal data transferred from the EU to US self-certified companies complying with the Privacy Shield principles. Telefónica USA, Inc. has self-certified itself as Privacy Shield compliant. The Privacy Shield has been challenged before the EU's General Court by civil-society groups, but the admission of their appeals is still pending.

In Brazil, the adoption of a Personal Data Protection Act is still pending, this could lead to further obligations and restrictions for operators in relation to the collection of personal data and its treatment.

Any of such obligations and restrictions could raise costs and limit Telefónica's ability to provide certain services, which could materially adversely affect Telefónica's business, financial condition, results of operations and cash flows.

*Regulation of network neutrality*

Under the principle of network neutrality applicable to Internet access services area, network operators could not establish technical or commercial restrictions regarding the terminals that can be connected or the services, or applications and contents that can be accessed or distributed through the Internet by the end user. It also refers to the non-discriminatory behaviour (e.g. non-anticompetitive) to be adopted by operators regarding the different types of Internet traffic circulating through their networks.

In Europe, the application of the so-called "net neutrality Regulation" (Regulation (EU) 2015/2120 of November 25, 2015) will be monitored by national regulatory authorities following guidance to be delivered by the European Regulatory Authority ("BEREC") on August 30, 2016. This guidance could directly impact internet access service commercial practices (for example, some zero rating offers) and it may limit network management practices or increase transparency requirements on the Internet Access Service.

Telefónica operates in Latin American countries where net neutrality is being implemented, such as Chile, Colombia, Mexico and Peru, where OSIPTEL adopted regulations aimed at providing clear guidelines on the implementation of the net neutrality regime adopted in 2012 and in force since January 1, 2017. In Brazil, the President approved a net neutrality decree (regulating Marco Civil) on May 11, 2016. In Mexico, the IFT scheduled a public consultation to be carried out in August 2016 in respect of the guidelines that will be issued regarding net neutrality, which was postponed to the first quarter 2017. In Chile, on November 22, 2016, the Commission of Telecommunications submitted a bill for amending the Network Neutrality Act. The main changes are the establishment of rules more restricted to apply measures for traffic management and restrictive rules for “Zero Rating”. If changes to regulation such as those described above, or otherwise, occur in the various jurisdictions where the Telefónica Group operates, it could have a material adverse effect on its business, financial condition, results of operations and cash flows.

**The Telefónica Group is exposed to risks in relation to compliance with anti-corruption laws and regulations and economic sanctions programs.**

The Telefónica Group is required to comply with the laws and regulations of various jurisdictions where it conducts operations. In particular, the Group's international operations are subject to various anti-corruption laws, including the US Foreign Corrupt Practices Act of 1977 and the United Kingdom Bribery Act of 2010, and economic sanctions programs, including those administered by the United Nations, the European Union and the United States, including the US Treasury Department's Office of Foreign Assets Control. The anti-corruption laws generally prohibit providing anything of value to government officials for the purposes of obtaining or retaining business or securing any improper business advantage. As part of the Telefónica Group's business, it may deal with entities, the employees of which are considered government officials. In addition, economic sanctions programs restrict the Group's business dealings with certain sanctioned countries, individuals and entities.

Although the Group has internal policies and procedures designed to ensure compliance with applicable anti-corruption laws and sanctions regulations, there can be no assurance that such policies and procedures will be sufficient or that the Group's employees, directors, officers, partners, agents and service providers will not take actions in violation of the Group's policies and procedures (or otherwise in violation of the relevant anti-corruption laws and sanctions regulations) for which the Group or they may be ultimately held responsible. Violations of anti-corruption laws and sanctions regulations could lead to financial penalties, exclusion from government contracts, damage to the Group's reputation and other consequences that could have a material adverse effect on the Group's business, results of operations and financial condition.

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Telefónica is currently conducting internal investigations covering various countries regarding possible violations of applicable anti-corruption laws. Telefónica has been in contact with governmental authorities about these matters and intends to cooperate with those authorities as the investigations continue. It is not possible at this time to predict the scope or duration of these matters or their likely outcome.

**Customers' perceptions of services offered by the Company may put it at a disadvantage compared to competitors' offerings.**

Customers' perceptions of the assistance and services offered are critical to operating in highly-competitive markets. The ability to predict and respond to the changing needs and demands of customers affects the Company's competitive position relative to other technology sector companies, and its ability to extract the value generated during this process of transformation. Failure to do so adequately could have an adverse impact on the Group's business, financial condition, results of operations and cash flows.

**Telefónica may not be able to adequately foresee and respond to technological changes and sector trends.**

In a sector characterized by rapid technological change, it is essential to be able to offer the products and services demanded by the market and consider the impacts of changes in the life cycle of technical assets, secure margins and select the right investments to make.

The Telefónica Group operates in markets that are highly competitive and subject to constant technological development. Therefore, as a consequence of both of these characteristics, it is subject to the effects of actions by competitors in these markets and to its ability to anticipate and adapt, in a timely manner, to constant technological changes, changes in customer preferences that are taking place in the industry, as well as economic, political and social circumstances.

Failure to do so adequately could have an adverse effect on the Group's business, financial condition, results of operations and cash flows.

New products and technologies arise constantly, and their development can render obsolete the products and services the Telefónica Group offers and the technology it uses. This means that Telefónica must invest in the development of new products, technology and services so it can continue to compete effectively with current or future competitors, which may result in the decrease of the Group's profits and revenue margins. In this respect, margins from traditional

voice and data business are shrinking, while new sources of revenues are deriving from mobile Internet and connectivity services that are being launched. Research and development costs amounted to 906 million euros in 2016, representing a decrease of 14.1% from 1,055 million euros in 2015 (1,111 million euros in 2014). These expenses represented 1.7%, 1.9% and 2.2% of the Group's consolidated revenues in 2016, 2015 and 2014, respectively. These figures have been calculated using the guidelines established in the Organization for Economic Cooperation and Development ("OECD") manual. One technology that telecommunications operators, including Telefónica (in Spain and Latin America), are focused on is the new FTTx-type network, which offers broadband access using optical fiber with superior services, such as Internet speed of up to 300MB or HD television services. However, substantial investment is required to deploy these networks, which entails fully or partially substituting copper loop access with optic fiber. While an increasing demand for the capabilities offered by these new networks to end users exists, the high level of the investments requires a continuous analysis of the return on investment.

The explosion of the digital market and entry of new players in the communications market, such as MVNOs, Internet companies or device manufacturers, may cause the loss of value of certain assets, and affect the Group's ability to generate income. Therefore, it is necessary to update the business model, encouraging the pursuit of incomes and additional efficiencies to those followed traditionally. Failure to do so adequately could have an adverse effect on the Group's business, financial condition, results of operations and cash flows.

In addition, the ability of the Telefónica Group's IT systems (operational and backup) to respond to Telefónica's operating requirements is a key factor to be taken into account with respect to the commercial development, customer satisfaction and business efficiency. Any failure by the Telefónica Group's IT systems to adequately respond to the Group's evolving operating requirements could have an adverse effect on the Group's business, financial condition and results of operations.

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**Telefónica depends on its suppliers.**

The existence of critical suppliers in the supply chain, especially in areas such as network infrastructure, information systems or handsets, with a high concentration in a small number of suppliers, poses risks that may affect Telefónica's operations, and may cause legal contingencies or damages to its image in the event that inappropriate practices are produced by a participant in the supply chain.

As of December 31, 2016, the Telefónica Group depended on three handset suppliers and 12 network infrastructure suppliers, which together accounted for 80% of the awarded contracts for the year then ended. These suppliers may, among other things, extend delivery times, raise prices and limit supply due to their own stock shortfalls and business requirements.

If these suppliers fail to deliver products and services to the Telefónica Group on a timely basis, it could jeopardize network deployment and expansion plans, which in some cases could adversely affect the Telefónica Group's ability to satisfy its license terms and requirements, or otherwise have an adverse effect on the Group's business, financial condition, results of operations and cash flows.

**Unanticipated network interruptions can lead to quality loss or the interruption of the service.**

Unanticipated network interruptions as a result of system failures, including those due to network, hardware or software, stealing of infrastructure elements or cyber-attacks, which affect the quality of or cause an interruption in the Telefónica Group's service, could lead to customer dissatisfaction, reduced revenues and traffic, costly repairs, penalties or other measures imposed by regulatory authorities and could harm the Telefónica Group's image and reputation.

Telecommunications companies worldwide face increasing cybersecurity threats as businesses become increasingly dependent on telecommunications and computer networks and adopt cloud computing technologies. Cybersecurity threats include gaining unauthorized access to Telefónica's systems or inserting computer viruses or malicious software in its systems to misappropriate consumer data and other sensitive information, corrupt Telefónica's data or disrupt its operations. Unauthorized access may also be gained through traditional means such as the theft of laptop computers, portable data devices and mobile phones and intelligence gathering on employees with access.

Telefónica attempts to mitigate these risks through a number of measures, including backup systems and protective systems such as firewalls, virus scanners and other physical and logical security. However, these measures are not always effective. Although the Telefónica Group has insurance policies to cover these types of incidents, and the claims and loss in revenue caused by service interruptions to date have been covered by these policies, these policies may not be sufficient to cover all possible monetary losses.

**The telecommunications industry may be affected by the possible effects that electromagnetic fields, emitted by mobile devices and base stations, may have on human health.**

In some countries, there is a concern regarding potential effects of electromagnetic fields, emitted by mobile devices and base stations, on human health. This public concern has caused certain governments and administrations to take measures that have hindered the deployment of the infrastructures necessary to ensure quality of service, and affected the deployment criteria of new networks and digital services such as smart meters development.

There is a consensus between certain expert groups and public health agencies, including the World Health Organization that states that currently there are no established risks associated with exposure to low frequency signals in mobile communications. However, the scientific community is still investigating this issue especially with respect to mobile devices. Exposure limits for radio frequency suggested in the guidelines of the Protection of Non-Ionizing Radiation Protection Committee have been internationally recognized. The mobile industry has adopted these exposure limits and works to request authorities worldwide to adopt these standards.

Worries about radio frequency emissions may discourage the use of mobile devices and new digital services, which could cause the public authorities to implement measures restricting where transmitters and cell sites can be located, how they operate, the use of mobile telephones and the massive deployment of smart meters and other products using mobile technology. This could lead to Telefónica being unable to expand or improve its mobile network.

The adoption of new measures by governments or administrations or other regulatory interventions in this respect, and any future assessment on the adverse impact of electromagnetic fields on health, may adversely affect the business, financial conditions, results of operations and cash flows of the Telefónica Group.

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**Possible regulatory, business, economic or political changes could lead to asset impairment.**

The Telefónica Group reviews on an annual basis, or more frequently when the circumstances require it, the value of assets and cash-generating units, to assess whether their carrying values can be supported by the future expected cash flows, including, in some cases synergies allowed for in acquisition costs. Potential changes in the regulatory, business, economic or political environment may result in the need to introduce changes to estimates made and to recognize impairments in goodwill, intangible assets or fixed assets. Although the recognition of impairments of property, plant and equipment, intangible assets and financial assets results in a non-cash charge on the income statement, it could adversely affect the results of the Telefónica Group's operations. In this respect, the Telefónica Group has experienced impairments on certain of its investments, affecting its results of operations in the year in which they were experienced. In 2016, impairment losses in goodwill were recognized amounting to 215 million euros for Telefónica operations in Venezuela (124 million euros) and Mexico (91 million euros).

**The Telefónica Group's networks carry and store large volumes of confidential, personal and corporate data, and its Internet access and hosting services may lead to claims for illegal or illicit use of the Internet.**

The Telefónica Group's networks carry and store large volumes of confidential, personal and business data, through both voice and data traffic. The Telefónica Group stores increasing quantities and types of customer data in both business and consumer segments. Despite its best efforts to prevent it, the Telefónica Group may be found liable for any loss, transfer, or inappropriate modification of the customer data or general public data stored on its servers or transmitted through its networks, any of which could involve many people and have an impact on the Group's reputation, or lead to legal claims and liabilities that are difficult to measure in advance.

In addition, the Telefónica Group's Internet access and hosting servers could lead to claims for illegal or unlawful use of the Internet. Telefónica, like other telecommunications providers, may be held liable for any loss, transfer or inappropriate modification of the customer data stored on its servers or carried by its networks.

In most countries in which the Telefónica Group operates, the provision of its Internet access and hosting services (including the operation of websites with shelf-generated content) are regulated under a limited liability regime applicable to the content that it makes available to the public as a technical service provider, particularly content protected by copyright or similar laws. However, regulatory changes have been introduced imposing additional obligations on access providers (such as blocking access to a website) as part of the struggle against some illegal or illicit uses of the Internet, notably in Europe.



Any of the foregoing could have an adverse effect on the business, financial position, results of operations and cash flows of the Group.

**Telefónica and Telefónica Group companies are party to lawsuits, tax claims, antitrust and other legal proceedings.**

Telefónica and Telefónica Group companies are party to lawsuits, tax claims, antitrust and other legal proceedings in the ordinary course of their businesses, the financial outcome of which is unpredictable. An adverse outcome or settlement in these or other proceedings could result in significant costs and may have a material adverse effect on the Group's business, financial condition, results of operations, reputation and cash flows. In particular, the Telefónica Group is party to certain judicial tax proceedings in Peru concerning the clearance of certain previous years' income tax, in respect of which a contentious-administrative appeal is currently pending and to certain tax proceedings in Brazil, primarily relating to the ICMS (a Brazilian tax on telecommunication services) and to the Corporate Tax. Further details on these matters are provided in Notes 17 and 21 of the Consolidated Financial Statements.

Item 4. Information on the Company

A. History and Development of the Company

Overview

Telefónica, S.A., is a corporation duly organized and existing under the laws of the Kingdom of Spain, incorporated on April 19, 1924. We:

Are a diversified telecommunications group which provides a comprehensive range of services through one of the world's largest and most modern telecommunications networks;

Are focused on providing telecommunications services; and

operate principally in Europe and Latin America.

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The following significant events occurred in 2016:

On January 12, 2016, DTS and Mediaproducción, S.L.U. reached an agreement for the broadcasting of the thematic pay TV channel called "BeIN Sports LaLiga" with contents of the Spanish national league championship first and second division and the Copa del S.M. el Rey, corresponding to the three seasons 2016/17, 2017/18 and 2018/19. The total value of the agreements relating to those channels amounted to 2,400 million euros.

On January 28, 2016, Telefónica announced that its subsidiary Telefónica de España signed the first Collective Agreement of Related Companies, which was supported by the largest trade unions. Telefónica Móviles España and Telefónica Soluciones were also parties to this agreement. The agreement contemplates, among other elements, an "Individual Employment Suspension Plan" for their respective employees, the implementation of which is entirely voluntary in the period from 2016-2017. All employees who fulfil the following criteria are eligible to participate in the plan: (i) employees must have been employed as of January 1, 2015, (ii) as of the date of the agreement, such employees must have worked for the Group 15 years or more, and (iii) as of December 31, 2017, such employees must be at least 53 years old. In relation to the aforementioned plan, Telefónica has opened the registration period for employees to sign up to the plan and the value of the recognized expenses resulting from the plan was approximately 2,896 million euros (see "Item 6. – Directors, Senior Management and Employees").

On February 11, 2016, Telefónica announced the creation of Telxius Telecom, S.A., a company which brings together certain infrastructure assets of the Group, which is intended to enable the management of the Telefónica Group's infrastructure on a global scale with a more specialized and focused approach, with the aim of increasing the services provided to other operators, improving the return on capital invested and allowing Telxius Telecom, S.A. to participate more actively in the growth opportunities that exist in the industry, including the possibility of incorporating third party assets.

· On April 8, 2016, the Board of Directors of Telefónica, S.A. resolved to adopt the following resolutions:

To propose to the next General Shareholders' Meeting the appointment of PricewaterhouseCoopers Auditores S.L. as statutory auditor for the annual accounts of Telefónica, S.A. and its consolidated group of companies for the years 2017, 2018 and 2019 (see "Item 16F – Change in Registrant's Certifying Accountant").

To appoint Mr. José María Álvarez-Pallete López as Chairman of the Board of Directors and of the Executive Commission, replacing Mr. César Alierta Izuel.

To take formal note of and record the voluntary resignation presented as members of the Board of Directors of Telefónica, S.A. by Mr. Carlos Colomer Casellas, Mr. Alfonso Ferrari Herrero, Mr. José Fernando de Almansa Moreno-Barreda and Mr. Santiago Fernández Valbuena.

Based on the proposal of the Nominating, Compensation and Corporate Governance Committee, to appoint Ms. Sabina Fluxà Thienemann, Mr. José Javier Echenique Landiribar, Mr. Peter Löscher and Mr. Juan Ignacio Cirac -Sasturain as Independent Directors of Telefónica, S.A. The ratification of such resolutions was approved by the General Shareholders Meeting held on May 12, 2016.

- To appoint as Coordinating Independent Director, Mr. Francisco Javier de Paz Mancho.

To appoint: (i) the Independent Director Mr. José Javier Echenique Landiribar as a member of the Executive Commission; (ii) the Independent Director Mr. José Javier Echenique Landiribar as Chairman of the Audit and Control Committee; and (iii) the Independent Director Mr. Francisco Javier de Paz Mancho as a member and Chairman of the Nominating, Compensation and Corporate Governance Committee.

In addition, the Board of Directors agreed to call the Annual General Shareholders' Meeting which was held in Madrid, at the Recinto Ferial de la Casa de Campo, Pabellón de Cristal, Avenida de Portugal, sin número, at 1:00 p.m. on the second call on May 12, 2016.

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- On April 27, 2016, the Board of Directors of Telefónica, S.A. resolved to adopt the following resolutions:

To appoint Ms. Sabina Fluxà Thienemann (Independent Director) as a member of the Nomination, Compensation and Corporate Governance Committee, and Mr. Francisco Javier de Paz Mancho (Independent Director) as a member of the Audit and Control Committee.

- To cease Mr. Francisco Javier de Paz Mancho as member of Service Quality and Customer Service Committee.

To reorganize the current Regulation and Institutional Affairs Committees so as to become a single Committee, under the name "Regulation of Institutional Affairs Committee".

To reorganize the current Strategy and Innovation Committees so as to become a single Committee under the name "Strategy and Innovation Committee", and to appoint Mr. Juan Ignacio Cirac Sasturain (Independent Director) and Mr. Peter Löscher (Independent Director) as members of such committee.

On May 11, 2016, Telefónica, S.A. announced the decision of the EC to prohibit the potential acquisition by Hutchison Whampoa Group of the Telefónica subsidiary in the United Kingdom (O2 UK) under EU the Council Regulation (EC) No. 139/2004 of January 20, 2004 on the control of concentrations between undertakings (the “**EU Merger Regulation**”).

On May 12, 2016, Telefónica, S.A. announced the holding of the Annual General Shareholders’ Meeting of Telefónica S.A. at second call with the attendance, present or represented, of shareholders holding shares representing 56.13% of the share capital of the Company, which approved by a majority of votes all the resolutions submitted by the Board of Directors for deliberation and vote by the General Shareholders’ Meeting.

Furthermore, the Company announced that, according to the shareholder remuneration policy, a dividend distribution was agreed, charged to unrestricted reserves, of a fixed gross amount of 0.40 euro for each Company share issued, in circulation and carrying entitlement to such distribution. The payment of this dividend was executed on May 19, 2016.

On June 29, 2016, following the EC’s decision to prohibit the sale of O2 UK to the Hutchison Whampoa Group, the Board of Directors of Telefónica, S.A. agreed that Telefónica will continue to explore different strategic alternatives for O2 United Kingdom, to be implemented when market conditions are deemed appropriate. Given that the execution of a transaction for sale is now less certain, Telefónica’s operations in the United Kingdom have ceased to be presented as discontinued operations and the respective assets and liabilities are no longer classified as held for sale. Further details are provided in Note 2 of the Consolidated Financial Statements.

On July 10, 2016, Telefónica Internacional, S.A.U. (a 100% subsidiary of Telefónica, S.A.) sold 361,794,559 shares of China Unicom (Hong Kong) Limited ("**China Unicom HK**"), representing 1.51% of the share capital of the company, through a block trade process, at a price of 7.80 Hong Kong dollars per share, for a total amount of 2,822 million Hong Kong dollars, approximately 322 million euros. As of December 31, 2016, Telefónica maintained a stake of close to 1% in China Unicom HK.

On September 5, 2016, Telefónica, S.A. announced that it is considering various strategic options with respect to Telefónica's United Kingdom subsidiary (O2 UK) (all of which would involve Telefónica maintaining a majority shareholding), including, among others, a potential initial public offering.

On September 28, 2016, the Company announced its decision to proceed with the share capital reduction by means of a cancellation of 74,627,988 shares of the Company's own stock, representing 1.5% of the Company's current share capital. As a result, 74,627,988 shares of Telefónica were cancelled, reducing the company's share capital by the same amount. Telefónica's share capital after the reduction, at such date, stood at 4,900,571,209 euros made up of an equal number of ordinary shares, all of a single series and with a nominal value of one (1) euro per share. On October 11, 2016, the public deed of this share capital reduction was registered in the Madrid mercantile registry (Registro Mercantil).

On October 27, 2016, the Executive Commission of Telefónica's Board of Directors agreed that the corporate resolution required to carry out the free-of-charge capital increase related to the scrip dividend shareholder compensation scheme ("**Telefónica Flexible Dividend**") approved by the Annual General Shareholders' Meeting held on May 12, 2016, should be adopted at the Executive Commission meeting scheduled for November 11, 2016. On November 11, 2016, the Executive Commission agreed the implementation of the aforementioned capital increase.

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Furthermore, the Company announced the amendment of the dividend policy for the years 2016 and 2017. Telefónica would pay in 2016, 0.55 euros per share, of which 0.35 euros would be paid in November 2016 via a voluntary scrip dividend and 0.20 euros in cash in the second quarter of 2017. Relating to the 2017 dividend, it would amount to 0.40 euros per share in cash, of which 0.20 euros would be paid in the fourth quarter of 2017 and 0.20 euros in the second quarter of 2018. As a result, in the calendar year 2016 payments amounted to 0.75 euros per share while in the calendar year 2017 payments will amount 0.40 euros.

On November 7, 2016, Moody's Investors Service published its resolution to lower the long-term credit rating of Telefónica, S.A., from Baa2 to Baa3. At the same time, Moody's lowered the short-term rating to Prime-3 from Prime-2.

On November 15, 2016, Telefónica, S.A. announced that the entire share capital of Televisión Federal, S.A. ("**Telefé**") was sold to Viacom International Inc. in exchange for 345 million dollars (322 million euros).

On December 1, 2016, Telefónica announced that, on November 29, 2016, the free-of-charge allotment rights trading period for the free-of-charge capital increase related to Telefónica's Flexible Dividend had ended. The holders of 29.99% of the free-of-charge allotment rights accepted the purchase commitment assumed by Telefónica. The gross amount paid by Telefónica for these rights amounted to 499,707,062.36 euros. The Company waived the rights thus acquired, which were amortized.

The holders of 70.01% of the free-of-charge allotment rights were entitled, therefore, to receive new shares of Telefónica. Nevertheless, Telefónica waived the free-of-charge allotment rights that corresponded to its treasury shares at the record date (November 16, 2016). Therefore, the final number of ordinary shares with a nominal value of one (1) euro issued in the capital increase was 137,233,781 (2.8% of Telefónica's share capital as of that date), totaling 137,233,781 euros. As a result, the share capital of Telefónica after the capital increase, as registered on December 7, 2016, with the commercial registry of Madrid was 5,037,804,990 euros (5,037,804,990 shares).

The new shares were admitted to listing on the Madrid, Barcelona, Bilbao and Valencia stock exchanges (the "**Spanish Stock Exchanges**") on December 13, 2016, and the ordinary trading of the new shares in Spain begun on December 14, 2016.

Business areas

The organizational structure approved by the Board of Directors of Telefónica, S.A. on February 26, 2014 was made up of the following segments: Telefónica Spain, Telefónica United Kingdom, Telefónica Germany, Telefónica Brazil and Telefónica Hispanoamérica (formed by the Group's operators in Argentina, Chile, Peru, Colombia, Mexico, Venezuela, Central America, Ecuador and Uruguay).

Following our signing of an agreement on March 24, 2015 with Hutchison for the sale and purchase of the entire issued share capital of Telefónica Europe plc, and the reclassification of the results attributable to our operations in the United Kingdom as discontinued operations, our segments were revised in 2015 as follows: Telefónica Spain, Telefónica Germany, Telefónica Brazil and Telefónica Hispanoamérica.

Following the EC's decision to prohibit the sale of O2 UK to Hutchison Whampoa Group, the Board of Directors of Telefónica, S.A. at its meeting on June 29, 2016 agreed that Telefónica will continue to explore different strategic alternatives for O2 UK, to be implemented when market conditions are deemed appropriate. Given that the execution of a sale transaction is less certain, Telefónica's operations in United Kingdom are no longer presented as discontinued operations and the respective assets and liabilities cease to be classified as held for sale. Thus, our segments were revised as follows: Telefónica Spain, Telefónica United Kingdom, Telefónica Germany, Telefónica Brazil and Telefónica Hispanoamérica (comprised of our consolidated subsidiaries in Argentina, Chile, Peru, Colombia, Mexico, Venezuela, Central America, Ecuador and Uruguay). As a result, the 2015 and 2014 financial information by operating segment presented in this report has been amended to reflect the inclusion of the Telefónica United Kingdom segment.

Our segments include the information relating to wireline, wireless, cable, data, internet and television businesses and other digital services in accordance with each location. The results, assets and liabilities of the segments include the new companies that operate the towers business. Consequently the impacts of the intercompany sales of towers have been eliminated. "Other companies and eliminations" includes the companies belonging to cross-segment areas as well as other Group companies and eliminations in the consolidation process.

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Segment reporting takes into account the impact of the purchase price allocation to assets acquired and the liabilities assumed from the companies included in each segment. The assets and liabilities presented in each segment are those managed by the heads of each segment, irrespective of their legal structure.

The Group manages borrowing activities and taxes centrally. Therefore, it does not disclose the related assets, liabilities, revenue and expenses by reportable segments. In addition, revenue and expenses arising from intra-group invoicing for the use of the trademark and management services have been eliminated from the operating results of each Group segment. These adjustments have no impact on the Group's consolidated results.



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The following chart shows the organizational structure of the principal subsidiaries of the Telefónica Group at December 31, 2016, including their jurisdictions of incorporation and our ownership interest. For further detail, see Exhibit 8.1 to this Annual Report.

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Telefónica, S.A., the parent company of the Telefónica Group, also operates as a holding company with the following objectives:

- coordinate the Group's activities;
- allocate resources efficiently among the Group;
- provide managerial guidelines for the Group;
- manage the Group's portfolio of businesses;
- foster cohesion within the Group; and
- foster synergies among the Group's subsidiaries.

Our principal executive offices are located at Distrito Telefónica, Ronda de la Comunicación, s/n, 28050 Madrid, Spain, and our registered offices are located at Gran Vía, 28, 28013 Madrid, Spain. Our telephone number is +34 900 111 004.

**Capital Expenditures and Divestitures**

Our principal capital expenditures during the three years ended December 31, 2016, consisted of additions to property, plant and equipment and additions to intangible assets, including spectrum. In 2016, 2015 and 2014, we made capital expenditures of 8,928 million euros, 10,461 million euros and 9,448 million euros, respectively.

**Year ended December 31, 2016**

Capital expenditures in 2016 decreased 14.7% compared to 2015. Capital expenditures in 2016 included the cost of spectrum mainly in Peru and Brazil, amounting to 345 million euros.

Investment by Telefónica Spain amounted to 1,847 million euros and was primarily focused on rapid fiber optic roll out, together with investments in the LTE network, reaching a 96% population coverage, and transport network modernization. Investment by Telefónica United Kingdom in 2016 amounted to 931 million euros and was mainly focused on increasing LTE coverage, achieving 95% population coverage by year-end 2016 and also, pursuing the improvement of network capacity. Investment by Telefónica Germany in 2016 amounted to 1,108 million euros, with LTE roll out the company's main focus, achieving a coverage of 79% by year-end 2016, and network consolidation activities, which are allowing to enhance customer experience and to capture integration synergies. Investment by Telefónica Brazil in 2016 amounted to 2,138 million euros and was mainly dedicated to extend the coverage and capacity of 4G and 3G mobile networks, as well as improving network quality, and the deployment and connection of fiber network in the fixed business. Investment by Telefónica Hispanoamérica in 2016 amounted to 2,613 million euros and was mainly focused on improving the coverage and capacity of 3G and 4G networks, the roll out of ultra-broadband fixed capabilities (fiber / HFC) and the quality enhancement in broadband and TV services.

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**Year ended December 31, 2015**

Capital expenditures in 2015 increased 10.7% compared to 2014. Capital expenditures in 2015 included the cost of spectrum mainly in Germany, Argentina, Ecuador and Spain, amounting to 1,585 million euros.

Investment by Telefónica Spain in 2015 amounted to 1,827 million euros and was primarily focused on fiber networks, 3G, 4G and fiber as well as improvement of the quality of broad-band services and Pay TV. Investments by Telefónica United Kingdom in 2015 amounted to 883 million euros and was mainly focused on increasing LTE coverage, achieving 79.6% population coverage by year-end 2015, seeking to achieve improvements of network capacity and quality in line with the operator's objectives. Investment by Telefónica Germany in 2015 amounted to 2,230 million euros, focusing on its LTE roll-out strategy. Investment by Telefónica Brazil in 2015 amounted to 2,105 million euros, and related mainly to the continuation of the 3G and LTE roll-outs and the expansion of the roll-out of fiber optic. Investment by Telefónica Hispanoamérica in 2015 amounted to 3,060 million euros and was mainly focused on LTE roll-outs, densification of the 3G network, the continuation of ultra-broad band (UBB) roll-out for fixed broadband by speed upgrades and network digitalization as well as improving the Pay TV network.

**Year ended December 31, 2014**

Capital expenditures in 2014 increased 0.6% compared to 2013. Capital expenditures in 2014 included the cost of spectrum mainly in Brazil, Argentina, Venezuela, Colombia and Panama, amounting to 1,294 million euros.

Investment by Telefónica Spain in 2014 amounted to 1,732 million euros. Fiber optic was rolled out rapidly, and by year-end 2014 Telefónica Spain had created more than 10 million "fiber-to-the-house" ("FTTH") facilities in Spain, increasing its investments in LTE networks. Investments by Telefónica United Kingdom in 2014 amounted to 755 million euros, mainly due to the greater LTE coverage, which extends outdoor to the areas where an estimated 58% of the population is concentrated, and a network capacity ramped up to cope with denser 3G and 4G traffic.

Investment by Telefónica Germany in 2014 amounted to 849 million euros, focusing on its LTE roll-out strategy, securing 61% coverage in 2014. Investment by Telefónica Brazil in 2014 amounted to 2,933 million euros, mainly due to the fact that the mobile segment featured a continuation of LTE roll-outs in 2014, improving network capacity, systems and applications. Investment in the fixed-line network was used to expand roll-out of fiber optic, larger volumes of IPTV customers and corporate projects. Investment by Telefónica Hispanoamérica in 2014 amounted to 2,842 million euros mainly focused on LTE roll-outs in practically all operations in the region. Investment was also allocated to the densification of the 3G network, optimization of fixed-mobile convergence systems, the continuation of ultra-broad band (UBB) roll-out for fixed broadband by speed upgrades and network digitalization, television and

digital initiatives.

#### Financial Investments and Divestitures

There were no significant financial investments in 2016. Our principal financial divestiture in 2016 was the sale of Telef , which was completed on November 11, 2016, for 345 million U.S. dollars (approximately 322 million euros) and the sale on July 10, 2016 of 361,794,559 shares of China Unicom (Hong Kong) Limited (“China Unicom”), representing 1.51% of the share capital of the company, at a price of 7.80 Hong Kong dollars per share for a total amount of 2,822 million Hong Kong dollars, approximately 322 million euros.

Our principal financial investment in 2015 was the acquisition of GVT, which was completed on May 28, 2015, through our subsidiary Telef nica Brasil for a total purchase price of 4,663 million euros (through payment in cash and debt assumption) as well as the delivery of shares representing 12% of the share capital of Telef nica Brasil (following its integration with GVT) and the acquisition on April 30, 2015 of 56% of DTS for an initial consideration of 707 million euros, subject to the finalization of the working capital and net debt adjustments. Our principal divestiture in 2015 was the sale of our stake in Telef nica Italia (we disposed of 872 million ordinary shares in Telecom Italia in exchange for approximately 1,025 million euros and 1,110 million ordinary shares in Telecom Italia in exchange for 4.5% of the share capital in Telef nica Brasil). In addition, we also exchanged 46 million treasury shares of Telef nica for approximately 3.5% of the Share Capital of Telef nica Brasil.

Our principal financial investment in 2014 was the acquisition of E-Plus, which was completed on October 1, 2014, through our subsidiary Telef nica Deutschland for a total purchase price of 7,463 million euros. Our principal divestitures in 2014 were the completion of the sales of Telef nica Czech Republic, a.s. on January 28, 2014, Telef nica Ireland, Ltd on July 2, 2014, and the sale of shares representing approximately 2.5% of the share capital of China Unicom (Hong Kong) Limited (“**China Unicom**”) for approximately 687 million euros.

Active portfolio management is part of Telef nica's strategy and therefore it may undertake transactions involving its or its subsidiaries' shares, including transactions similar to those undertaken in the 2014-2016 period or otherwise, at any time.

#### Public Takeover Offers

Not applicable

#### Recent Developments

The principal events that have occurred since December 31, 2016, are set forth below:

On February 10, 2017, Telefónica announced that it has received several offers for the acquisition of an equity stake in Telxius Telecom, S.A.U. Telefónica is in the process of negotiating and analyzing the diverse alternatives presented.

On February 20, 2017 Telefónica has reached an agreement for the sale of up to 40% of the total share capital of Telxius Telecom, S.A.U. to Taurus Bidco S.à.r.l. (hereafter, "KKR", entity managed by Kohlberg Kravis Roberts & Co. L.P.), for a total amount of 1,275 million euros (12.75 euros per share).

The aforementioned agreement includes a purchase agreement for the sale of 62 million shares (representing 24.8% of the share capital) of Telxius Telecom, S.A.U. for a price of 790.5 million euros, as well as stock options over 38 million shares (representing 15.2% of the share capital) for a price of at least 484.5 million euros.

These options correspond to a call option exercisable by KKR and to a put option exercisable by Telefónica upon maturity of the call option.

The closing is subject to obtaining the corresponding regulatory approvals. The exercise window of the options would take place during the fourth quarter of 2017, provided that regulatory approvals have been obtained on that date.

After the transaction Telefónica will maintain the control over Telxius.

For information related to our significant financing transactions completed in 2016 and through the date of this Annual Report, see "Item 5. Operating and Financial Review and Prospects—Liquidity and Capital Resources—Anticipated Sources of Liquidity".

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B. Business Overview

Telefónica is one of the world's leading communications services providers. Our objective is to create, protect and promote fixed and mobile connections for our customers helping them to take control of their digital lifestyle. Therefore, we offer our customers connectivity, simple products and services and also the security that we protect their data, managing it in a responsible way.

In order to develop its business model, Telefónica has an organizational structure completely focused on customers and incorporates the digital offering as the main focus for commercial policies. The structure gives greater visibility to local operations, bringing them closer to the corporate decision-making center, simplifying the global structure and strengthening the transverse areas to improve flexibility and agility in decision making. On top of the transverse areas, which are led by the Chief Commercial Digital Officer, who is responsible for fostering revenue growth, and the Chief Global Resources Officer who is in charge of the efficiency of the cost side, the organizational structure is composed of the following segments: Telefónica Spain, Telefónica United Kingdom, Telefónica Germany, Telefónica Brazil and Telefónica Hispanoamérica (comprised of our consolidated subsidiaries in Argentina, Chile, Peru, Colombia, Mexico, Venezuela, Central America, Ecuador and Uruguay). These segments include the information related to wireline, wireless, DSL, TV, and other digital services provided in each country or countries.

The Telefónica Group's strategy aims to:

· Enhance value through:

○ Offering excellent connectivity, for which, our infrastructure management and our continuous investment in network are key. We aim to return the control over the data to our customers.

○ Providing a bundled offer with video and digital services. We offer our customers additional data in order to amplify their services, such as video or digital services, through unique, simple and clear offers.

○ Providing increased customer value and customer experience with digital access, aiming to offer the best products, solutions and contents.

· With the following enablers:

○

End-to-end Digitalization. We reduce our legacy investments to improve virtualization, reduce physical servers, data centers and applications, digitalization of IT systems and processes, digitalization of front-and back office, offering a true digital experience to our customers.

- o Big Data and Innovation to add value to our customers and return the control over data to our customers.

- o Continued focus on capital allocation in our legacy investments and simplification processes in order to continue investing.

Moreover, Telefónica has increased its presence in key markets. In 2014 Telefónica acquired E-Plus (through Telefónica Germany) and in 2015 Telefónica acquired DTS (through Telefónica Spain) and GVT (through Telefónica Brazil).

On February 10, 2016, Telefónica announced the creation of “Telxius” a company which brings together certain infrastructure assets of the Group in several countries, which will enable the management of the Telefónica Group’s infrastructure on a global scale with a more specialized and focused approach, with the aim of increasing the services provided to other operators, improving the return on capital invested and allowing Telefónica to participate more actively in the growth opportunities that exist in the industry, including the possibility of incorporating third party assets.



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## 2016 highlights

In 2016 Telefónica has taken further steps aimed at achieving profitable and sustainable long-term growth, and improving in efficiencies and synergies, which resulted in a higher OIBDA (+14.3% year-on-year in reported terms). Additionally, the investment levels over total revenues continued above 17% with a total amount of 8,928 million euros, with more than 2,000 million euros dedicated to LTE and ultra-broad band (“**UBB**”). The Company closed the year with a total of 350 million accesses, representing a stable growth level (0.7% versus 2015), where the downward growth trend in prepay and fixed voice was more than compensated by the growth in value customers. Post-pay customers, which grew by 6.3% year-on-year, reaching 111 million customers, while fiber customers amounted to 7.3 million customers at December 2016, representing a 18.9% increase year-on-year.

In 2016, **revenues** totaled 52,036 million euros, down 5.2% compared to 2015 in reported terms. **OIBDA** totaled 15,118 million euros in 2016, up 14.3% in reported terms. In organic terms (which term and calculation is explained further below), OIBDA was up 4.7%, due mainly to the positive evolution of all the regions mainly as a consequence of the integration synergies in Telefónica Brazil and Telefónica Germany, the positive evolution of service revenues and the continuous effort in efficiency and simplification.

Telefónica’s **total accesses** totaled 350.0 million as of December 31, 2016. Group accesses increased by 0.7% year-on-year, mainly as a result of the solid growth in accesses in Telefónica Germany, Telefónica United Kingdom and Telefónica Hispanoamérica. By service, it is worth highlighting the higher commercial activity based on high value customers, resulting in a sustained growth of the contract mobile segment (smartphones and LTE) and fiber. It is worth mentioning, the growth in accesses in Telefónica Hispanoamérica (representing 39% of the Group’s total accesses as of December 31, 2016) up by 0.9% year-on-year, the growth in accesses in Telefónica Germany (representing 14% of the Group’s total) up by 2.0% year-on-year and the growth in accesses in Telefónica United Kingdom (representing 7% of the Group’s total) up by 1.9% year-on-year.

The below table shows the evolution of accesses over the past two years as of December 31 of such years:

**ACCESSES**

| <b>Thousands of accesses</b> | <b>2015(*)</b> | <b>2016</b> | <b>% Reported YoY</b> |
|------------------------------|----------------|-------------|-----------------------|
| Fixed telephony accesses (1) | 39,734.9       | 38,280.1    | (3.7%)                |
| Internet and data accesses   | 21,365.3       | 21,652.1    | 1.3%                  |
| Broadband (2)                | 20,971.3       | 21,194.9    | 1.1%                  |

|                               |                  |                  |                |
|-------------------------------|------------------|------------------|----------------|
| Fiber                         | 7,393.1          | 9,162.9          | 23.9%          |
| Mobile accesses               | 272,103.9        | 276,450.0        | 1.6%           |
| Prepay                        | 167,845.1        | 165,663.2        | (1.3%)         |
| Contract                      | 104,258.8        | 110,786.8        | 6.3%           |
| M2M                           | 11,526.3         | 14,002.0         | 21.5%          |
| Pay TV                        | 8,271.6          | 8,289.0          | 0.2%           |
| <b>Final Clients Accesses</b> | <b>341,475.6</b> | <b>344,671.1</b> | <b>0.9%</b>    |
| <b>Wholesale Accesses</b>     | <b>6,062.8</b>   | <b>5,300.9</b>   | <b>(12.6%)</b> |
| <b>Total Accesses</b>         | <b>347,538.4</b> | <b>349,972.1</b> | <b>0.7%</b>    |

Notes:

(\*) Accesses include GVT and DTS customers since May 1, 2015. There were no variations in organic terms during the period.

(1) Includes "fixed wireless" and Voice over IP accesses.

(2) Includes DSL, satellite, optic fiber, cable modem and broadband circuits.

The below table shows the evolution of accesses by segment:

| Accesses 2016  | YoY<br>variation | % Over Total<br>Accesses |       |
|----------------|------------------|--------------------------|-------|
|                |                  | 2015                     | 2016  |
| Spain          | (1.8%)           | 12.1%                    | 11.8% |
| United Kingdom | 1.9%             | 7.3%                     | 7.4%  |
| Germany        | 2.0%             | 13.9%                    | 14.1% |
| Brazil         | 0.3%             | 27.9%                    | 27.8% |
| Hispanoamérica | 0.9%             | 38.7%                    | 38.8% |
| Others         | 40.7%            | 0.1%                     | 0.1%  |

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The Group's strategy is based on capturing growth in its markets, especially on attracting high-value customers.

**Mobile accesses** totaled 276.5 million at December 31, 2016, up 1.6% compared to December 31, 2015, affected mainly by the increase in the number of contract accesses, up 6.3% year-on-year, continuing to increase their weight over total mobile accesses reaching 40.1% (+1.8 p.p. year-on-year).

**Smartphone accesses** maintained a strong growth rate (up 16.6% year-on-year), totaling 147 million accesses and reaching a penetration rate over total accesses of 57.1% (+7.6 p.p. year-on-year), reflecting the Company's strategic focus on the growth of its data services.

**Fixed broadband accesses** stood at 21.2 million at December 31, 2016, up 1.1% year-on-year. UBB accesses stood at 9.2 million at December 31, 2016.

**TV accesses** totaled 8.3 million at December 31, 2016, remaining stable year-on-year (+0.2%) due to the effort in capturing high value customers in Telefónica Brazil and Telefónica Hispanoamérica.

The table below shows the evolution of our estimated access market share for mobile and DSL for the past two years.

## Competitive Position Evolution

|                | Mobile Market Share<br>(1) |       |
|----------------|----------------------------|-------|
| Telefónica     | 2015                       | 2016  |
| Spain          | 30.8%                      | 30.5% |
| United Kingdom | 27.2%                      | 26.8% |
| Germany        | 38.1%                      | 37.9% |
| Brazil         | 28.4%                      | 30.2% |
| Argentina      | 32.3%                      | 33.3% |
| Chile          | 36.7%                      | 33.4% |
| Peru           | 49.7%                      | 44.0% |
| Colombia       | 22.4%                      | 23.2% |

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|                 |       |       |
|-----------------|-------|-------|
| Venezuela       | 34.2% | 37.8% |
| Mexico          | 22.7% | 24.2% |
| Central America | 33.2% | 34.1% |
| Ecuador         | 29.7% | 31.0% |
| Uruguay         | 34.9% | 33.1% |

(1) Internal estimation in both years

|            | DSL Market<br>Share (1) |       |
|------------|-------------------------|-------|
| Telefónica | 2015                    | 2016  |
| Spain      | 43.5%                   | 42.5% |
| Brazil     | 28.1%                   | 28.0% |
| Argentina  | 29.4%                   | 28.6% |
| Chile      | 39.4%                   | 36.4% |
| Peru       | 80.5%                   | 78.7% |
| Colombia   | 18.1%                   | 16.6% |

(1) Internal estimation in both years

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In this section, we discuss changes in the Group's consolidated income statements for 2016 and 2015. Changes in the Group's consolidated income statements for 2015 and 2014 are discussed in a separate section further below.

| <b>Consolidated Results</b>  | <b>Year ended December 31</b> |                      |               |                      | <b>Variation</b>    |              |
|--|-------------------------------|----------------------|---------------|----------------------|---------------------|--------------|
|  | <b>2015(*)</b>                |                      | <b>2016</b>   |                      | <b>2016 vs 2015</b> |              |
| <b>Millions of euros</b>   | <b>Total</b>                  | <b>% of revenues</b> | <b>Total</b>  | <b>% of revenues</b> | <b>Total</b>        | <b>%</b>     |
| Revenues   | 54,916                        | 100.0%               | 52,036        | 100.0%               | (2,880)             | (5.2%)       |
| Other income   | 2,011                         | 3.7%                 | 1,763         | 3.4%                 | (248)               | (12.3%)      |
| Supplies   | (16,547)                      | (30.1%)              | (15,242)      | (29.3%)              | 1,305               | (7.9%)       |
| Personnel expenses   | (10,349)                      | (18.8%)              | (8,098)       | (15.6%)              | 2,251               | (21.8%)      |
| Other expenses   | (16,802)                      | (30.6%)              | (15,341)      | (29.5%)              | 1,461               | (8.7%)       |
| <b>OPERATING INCOME BEFORE DEPRECIATION AND AMORTIZATION (OIBDA)</b> | <b>13,229</b>                 | <b>24.1%</b>         | <b>15,118</b> | <b>29.1%</b>         | <b>1,889</b>        | <b>14.3%</b> |
| Depreciation and amortization  | (9,704)                       | (17.7%)              | (9,649)       | (18.5%)              | 55                  | (0.6%)       |
| <b>OPERATING INCOME</b>  | <b>3,525</b>                  | <b>6.4%</b>          | <b>5,469</b>  | <b>10.5%</b>         | <b>1,944</b>        | <b>55.2%</b> |
| Share of loss of investments accounted for by the equity method      | (10)                          | (0.0%)               | (5)           | (0.0%)               | 5                   | (54.3%)      |
| Net financial expense  | (2,609)                       | (4.8%)               | (2,219)       | (4.3%)               | 390                 | (14.9%)      |
| <b>PROFIT BEFORE TAX</b>   | <b>906</b>                    | <b>1.6%</b>          | <b>3,245</b>  | <b>6.2%</b>          | <b>2,339</b>        | <b>n.m.</b>  |
| Corporate income tax   | (155)                         | (0.3%)               | (846)         | (1.6%)               | (691)               | n.m.         |
| <b>PROFIT FOR THE YEAR</b>   | <b>751</b>                    | <b>1.4%</b>          | <b>2,399</b>  | <b>4.6%</b>          | <b>1,648</b>        | <b>n.m.</b>  |
| Attributable to equity holders of the Parent                         | 616                           | 1.1%                 | 2,369         | 4.6%                 | 1,753               | n.m.         |
| Attributable to non-controlling interests                            | 135                           | 0.2%                 | 30            | 0.1%                 | (105)               | (77.9%)      |

(\*)Amended data: comparative information was amended to cease to present the results of Telefónica United Kingdom as discontinued operations.

**Adjustments made to calculate organic variations**

Year-on-year changes referred to in this document as “organic” or presented in “organic terms” intend to present year-on-year variations on a comparable basis, by considering a constant perimeter of consolidation and constant exchange rates and by making certain other adjustments which are described herein. “Organic variations” should not be viewed in isolation or as an alternative to reported variations.

For purposes of this report, 2016/2015 “organic” variation is defined as the reported variation as adjusted to exclude the impacts detailed below:

**Foreign exchange effects and hyperinflationary adjustments in Venezuela:** we have excluded the impact of changes in exchange rates by assuming constant average foreign exchange rates year on year. In particular, we have used the average foreign exchange rates of 2015 for both years.

Foreign exchange rates had a negative impact on our reported 2016 results, mainly due to the depreciation versus the euro of various Latin American currencies (in particular the Argentine peso, the Brazilian real and, to a lesser extent, the Venezuelan bolivar), and the pound sterling.

We have also excluded the impact of hyperinflationary adjustments in Venezuela by reversing such adjustments.

**Changes in the scope of consolidation:** we have excluded the impact of changes in our consolidation perimeter in 2016 and 2015. The main changes in our consolidation perimeter in such years related to the consolidation of GVT in Telefónica Brazil since May 2015 and the consolidation of DTS in Telefónica Spain since May 2015. In addition, Telefé was sold in November 2016.

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In order to exclude the impact of these changes in our perimeter for the calculation of organic variations, the 2015 comparative figures:

oinclude GVT's results from January 1 to April 30, 2015;

oinclude DTS's results from January 1 to April 30, 2015;

oexclude Telef 's results from November 1 to December 31, 2015.

**Restructuring costs:** we have excluded the impact in 2016 and 2015 of certain restructuring costs, mainly those related to the first Collective Agreement of Related Companies in Spain, restructuring processes relating to Germany and Brazil and the Group's simplification program in global areas.

The distribution by segment of the restructuring costs is as follows (impacts on OIBDA):

| Million euros                                 | 2015  | 2016  |
|---|-------|-------|
| Telef nica Spain (Individual Suspension Plan) | 2,896 | 789   |
| Telef nica Spain (other restructuring plans)  | -     | 48    |
| Telef nica Brazil                             | 7     | 40    |
| Telef nica Germany                            | 74    | 89    |
| Telef nica United Kingdom                     | 4     | 37    |
| Telef nica Hispanoam rica                     | 38    | 84    |
| Other companies                               | 198   | 293   |
| Total restructuring costs                     | 3,217 | 1,380 |

· **Results of tower sales:** the results attributable to the sale of towers in 2016 and 2015 have been excluded.

In 2016, the results from the sale of towers totaled 1 million euros, mainly in Telef nica Hispanoam rica. In 2015, the results from the sale of towers totaled 65 million euros, distributed as follows: Telef nica Spain (38 million euros), Telef nica Brazil (10 million euros) and Telef nica Hispanoam rica (18 million euros, mainly in Chile).

**Irrevocable commitment with Fundación Telefónica:** in 2015 we have excluded the expense (325 million euros) resulting from Telefónica, S.A.'s irrevocable commitment to make a donation to Fundación Telefónica in order to provide this entity with the financing required so that it can carry out its existing or new social programs and non-profit activities in the short and medium term.

**Adjustment to the final purchase price of E-Plus:** in 2015 we have excluded the result from the difference between the preliminary purchase price of E-Plus (as estimated at the end of the valuation period) and the final purchase price agreed with KPN, totaling 104 million euros (which had a 102 million euros positive impact on OIBDA, net of costs related to the acquisition).

**Spectrum acquisition:** we have excluded the impact of spectrum acquisitions in 2016 and 2015.

In 2016, these acquisitions totaled 345 million euros, 284 million euros corresponding to Telefónica Perú, 48 million euros corresponding to Telefónica Brasil, 7 million euros corresponding to Telefónica Spain and 6 million euros corresponding to Telefónica Germany.

In 2015 these acquisitions totaled 1,585 million euros, 1,198 million euros corresponding to Telefónica Germany, 49 million euros corresponding to Telefónica Spain and 338 million euros corresponding to Telefónica Hispanoamérica (mainly Argentina and Ecuador).

**Gains or losses on the sale of companies:** the gains obtained or losses incurred from the sale of companies have not been included in organic variations.

In 2016 the 199 million euros in profit obtained from the sale of Telefé and the 29 million euros obtained from the sale of Telecomunicaciones Personalizadas were not included. Similarly, the loss of 16 million euros incurred in the sale of Vocem was also not included.

**Impairment of goodwill:** the impairment losses on goodwill have not been included in organic variations.



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In 2016, the impairment loss on the goodwill assigned to Telefónica Venezolana and Telefónica Móviles Mexico amounting to 124 and 91 million euros, respectively, has been excluded.

In 2015, the impairment loss on the goodwill generated by the acquisition of Telefónica Digital Inc. amounting to 104 million euros was excluded.

**Other adjustments:** we have excluded the impact of the impairment resulting from the deterioration in certain minority participations, totaling 23 million euros in 2015. We have also excluded the impact of the provisions recorded in Telefónica Spain to optimize the distribution network (18 and 30 million euros in 2016 and 2015, respectively).

The table below shows 2016/2015 variations in reported and organic terms (the latter, calculated in accordance with the adjustments referred to above) of certain income statement and other measures:

|                           | <b>YoY variation</b> |                  |
|---------------------------|----------------------|------------------|
|                           | <b>% Reported</b>    | <b>% Organic</b> |
|                           | <b>YoY</b>           | <b>YoY</b>       |
| <b>TELEFÓNICA 2016</b>    |                      |                  |
| Revenues                  | (5.2%)               | 1.3%             |
| Other income              | (12.3%)              | (13.9%)          |
| Supplies                  | (7.9%)               | (3.1%)           |
| Personnel expenses        | (21.8%)              | 1.9%             |
| Other expenses            | (8.7%)               | 0.2%             |
| <b>OIBDA</b>              | <b>14.3%</b>         | <b>4.7%</b>      |
| <b>Operating income</b>   | <b>55.2%</b>         | <b>8.3%</b>      |
| CapEx                     | (14.7%)              | 3.9%             |
| <b>OpCF (OIBDA-CapEx)</b> | <b>n.m.</b>          | <b>5.6%</b>      |

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The table below shows the contribution to reported growth of each item considered to calculate the organic variations, as explained above. For each line item, the contribution to reported growth, expressed in p.p., is the result of dividing the amount of each impact (on a net basis when the impact affects both years) by the consolidated reported figure for the previous year.

| Contribution to reported growth (percentage points) |  |                             |                                |                         |  |  |                                 |  |
|---|--|-----------------------------|--------------------------------|-------------------------|--|--|---------------------------------|--|
| <b>TELEFÓNICA<br/>2016</b>                          | <b>Exchange rate<br/>effect and<br/>hyperinflation</b> | <b>Perimeter<br/>change</b> | <b>Restructuring<br/>costs</b> | <b>Towers<br/>sales</b> | <b>Commitment<br/>with<br/>Fundación</b> | <b>Adjustments<br/>to the final<br/>purchase<br/>price of<br/>E-Plus</b> | <b>Spectrum<br/>acquisition</b> | <b>Capital<br/>gains/<br/>on sale<br/>of compa</b> |
| Revenues  | (8.0)  | 1.4                         | --                             | --                      | --                                       | --   | --                              | --   |
| Other income  | (3.9)  | 1.7                         | --                             | (3.2)                   | --                                       | (5.2)  | --                              | 11.3   |
| Supplies  | (6.7)  | 1.9                         | --                             | --                      | --                                       | --   | --                              | --   |
| Personnel<br>expenses                               | (7.0)  | 1.1                         | (17.2)                         | --                      | --                                       | --   | --                              | --   |
| Other expenses                                      | (8.7)  | 1.3                         | (0.1)                          | 0.0                     | (1.9)                                    | 0.0  | --                              | 0.1  |
| <b>OIBDA</b>  | <b>(8.8)</b>   | <b>1.3</b>                  | <b>13.6</b>                    | <b>(0.5)</b>            | <b>2.5</b>                               | <b>(0.8)</b>   | <b>--</b>                       | <b>1.6</b>   |
| <b>Operating<br/>income</b>                         | <b>(20.2)</b>  | <b>(0.9)</b>                | <b>51.1</b>                    | <b>(1.8)</b>            | <b>9.2</b>                               | <b>(2.9)</b>   | <b>--</b>                       | <b>6.0</b>   |
| Capex   | (7.9)  | 1.5                         | --                             | --                      | --                                       | --   | (11.7)                          | --   |
| <b>OpCF<br/>(OIBDA-CapEx)</b>                       | <b>(12.4)</b>  | <b>0.2</b>                  | <b>65.1</b>                    | <b>(2.3)</b>            | <b>11.7</b>                              | <b>(3.7)</b>   | <b>44.1</b>                     | <b>7.6</b>   |

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### **Results discussion**

**Revenues** totaled 52,036 million euros in 2016, decreasing 5.2% compared to 2015 in reported terms. This decrease was mainly attributable to the impact of changes in foreign exchange rates and hyperinflation in Venezuela (-8.0 p.p.), which was partially offset by the changes in the consolidation perimeter, which contributed with 1.4 p.p. to the year-on-year growth. In organic terms, revenues increased 1.3% due to the increase in service revenues offset by the decrease in handset revenues affected by the extension of handset lifecycles.

The structure of revenues reflects Telefónica's business diversification, the segment with the largest contribution to our revenues in 2016 was Telefónica Spain, representing 24.4% (+1.8 p.p. compared to 2015), followed by Telefónica Hispanoamérica, representing 24.2% despite the adverse impact of exchange rates and hyperinflation in Venezuela, (-2.0 p.p. compared to 2015), and Telefónica Brazil, representing 21.3% (+1.2 p.p. compared to 2015).

**Mobile business revenues** totaled 32,401 million euros in 2016 (of which 28,030 million euros corresponded to service revenues and 4,032 million euros corresponded to handset revenues) down 8.8% year-on-year in reported terms. This decrease was mainly attributable to the impact of changes in foreign exchange rates and hyperinflation in Venezuela (-8.7 p.p.). Excluding this impact, the year-on-year decrease was 0.1%, mainly due to the decrease of mobile revenues in Europe due to less handsets revenues that offset the increase of mobile revenues in Telefónica Hispanoamérica and in Telefónica Brazil as a result mainly of the increase in the customer base and data adoption.

**Mobile service revenues**, which is included in mobile business revenues, totaled 28,030 million euros in 2016, down 7.5% year-on-year in reported terms explained by the impact of changes in foreign exchange rates and hyperinflation in Venezuela (-8.9 p.p.). Excluding this impact, mobile service revenues increased year-on-year by 1.5% due mainly to the higher customer base and higher data consumption.

**Mobile data revenues**, which is included in mobile service revenues, totaled 14,663 million euros in 2016, up 2.1% in reported terms. This increase was mainly attributable to higher consumption of data by our customers, which was partially offset by the impact of changes in foreign exchange rates and hyperinflation in Venezuela (-10.2 p.p.). Excluding this impact, mobile data revenues increased by 12.3% due mainly to the increase of non-SMS data revenues (up 19.7%) and higher use of data per customer. Mobile data revenues accounted for 52% of mobile service revenues in 2016, up 4.9 p.p. compared to 2015 in reported terms.

**Fixed revenues** totaled 18,187 million euros in 2016, up 1.9% year-on-year in reported terms. This increase was mainly attributable to the full year of consolidation of GVT and DTS in 2015 (which accounted for +4.7 p.p. of the year-on-year increase), which was partially offset by the impact of changes in foreign exchange rates and

hyperinflation in Venezuela (-6.9 p.p.). Excluding these impacts, fixed revenues increased 3.9%. This increase was mainly due to higher broad band connection revenues and Pay-TV revenues as a result of the commercial actions carried out by the Company in order to increase our value proposition and the higher customer base in Pay-TV.

**Other income** totaled 1,763 million euros in 2016, including the profit obtained from the sale of Telef  (199 million euros) and Telecomunicaciones Personalizadas (29 million euros). It also included income derived from the sale of towers totaling 1 million euros.

In 2015, other income included the positive result from the E-Plus price adjustment (104 million euros), the positive impact from the expired payment obligation (98 million euros) in Telef nica Brazil and the spectrum swap with AT&T in Telef nica Mexico carried out in December 2015 (79 million euros). Other income also included in 2015, income derived from the sale of real estate (78 million euros) and the sale of towers totaling 65 million euros in Telef nica Spain.

**Total expenses**, which include supply costs, personnel costs and other expenses (principally external services and taxes) but do not include amortization and depreciation expenses, were 38,681 million euros in 2016, down year-on-year 11.5% in reported terms. This decrease was mainly attributable to the impact of changes in foreign exchange rates and hyperinflation in Venezuela (-7.5 p.p.). The costs are explained in detail below:

**Supplies** amounted to 15,242 million euros in 2016, down 7.9% year-on-year in reported terms mainly as a result of the impact of foreign exchange rates and hyperinflation in Venezuela (-6.7 p.p.). In organic terms, supplies expenses decreased by 3.1% year-on-year, mainly due to lower handset consumption associated with a longer handset lifecycle, and lower interconnection costs.

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**Personnel expenses** amounted to 8,098 million euros in 2016, down 21.8% in reported terms year-on-year compared to 2015. This decrease was mainly attributable to the restructuring provision of 1,336 million euros, principally in Telefónica Spain, accounting for 17.2 p.p. of the year-on-year decrease. In organic terms, personnel costs increased 1.9% year-on-year due to inflationary pressure in some Latin American countries and the internalization of services in Telefónica Brazil, which was partially offset by the savings generated from restructuring plans in recent years.

The average headcount was 132,120 employees in 2016, down 1.1% compared to 2015.

**Other expenses** amounted to 15,341 million euros in 2016, down 8.7% in reported terms. This decrease was mainly attributable to the impact of foreign exchange rates and hyperinflation in Venezuela (-8.7 p.p.) In organic terms, other expenses remained flat year-on-year (+0.2%), principally due to savings in commercial costs, benefitting from higher synergies in Telefónica Spain, Telefónica Brazil and Telefónica Germany, which offset in part the negative impact of the inflation rates in some Latin American countries resulting in higher network costs.

**OIBDA** was 15,118 million euros in 2016, up 14.3% in reported terms as a result of various factors that affect comparability, mainly the lower restructuring costs in 2016 (1,380 million euros) compared to 2015 (3,217 million euros), which accounted for 13.6 p.p. of the year-on-year increase, the provision related to the agreement between Telefónica, S.A. and Fundación Telefónica registered in 2015 (+2.5 p.p.), the impact of the consolidation of GVT, DTS and Telefé (+1.3 p.p.) and the capital gain from the sale of Telefé, Telecomunicaciones Personalizadas and Vocem (+1.6 p.p.). These factors more than offset the impact of changes in foreign exchange rates and hyperinflation in Venezuela (-8.8 p.p.), the adjustments made to the final acquisition price of E-Plus in 2015 (-0.8 p.p.), the impairment loss on goodwill (-0.8 p.p.) and finally the lower sale of towers (-0.5 p.p.). In organic terms, OIBDA grew 4.7% due mainly to the positive evolution of all the regions as consequence of the positive evolution of service revenues, integration synergies captured in Telefónica Brazil and Telefónica Germany and the continuous effort to contain costs.

**OIBDA margin** stood at 29.1% in 2016, up 5 p.p. compared to 2015 in reported terms. In organic terms OIBDA margin was 31.5% and increased 1 p.p. compared to 2015 thanks to the increase in service revenues and higher content costs.

By segments, the main contributors to Group OIBDA were Telefónica Spain with 29.6% (+11.9 p.p. compared to 2015 due to lower restructuring cost provision in 2016), Telefónica Brazil with 24.6% (-2.4 p.p. compared to 2015) and Telefónica Hispanoamérica with 23% (reducing its contribution by 9.9 p.p. compared to 2015 due to the lower contribution of Argentina, Peru and Mexico).

**Depreciation and amortization** amounted to 9,649 million euros in 2016, down 0.6% year-on-year in reported terms, mainly due to the impact of foreign exchange rates and hyperinflation in Venezuela partially offset by the consolidation of GVT and DTS. The total depreciation and amortization charges arising from purchase price allocation processes amounted to 801 million euros in 2016, down 10% year-on-year.

**Operating income (OI)** in 2016 totaled 5,469 million euros, up 55.2% in reported terms compared to 2015 for the reasons set forth above. In organic terms, operating income grew 8.3% year-on-year mostly as a result of cost savings.

The **share of loss of investments accounted for by the equity method** for 2016 was a loss of 5 million euros (compared to a loss of 10 million euros in 2015).

**Net financial expense** amounted to 2,219 million euros in 2016, 14.9% lower than the previous year, due to savings from the management of debt (pound sterling hedges linked to Telefónica United Kingdom and the lower cost of debt in European currencies). On the other hand, the higher finance income resulting from the inflation in Venezuela was mainly offset by the income from the sale of equity investments, with the capital loss from the sale of the 1.5% stake in China Unicom (155 million euros) in 2016, and the positive impact from the divestment of the holding in Telecom Italia, S.p.A. (380 million euros) in 2015.

**Corporate income tax** amounted to 846 million euros in 2016. Considering a pre-tax profit of 3,245 million euros, the effective tax rate stood at 26.1%, 9.0 p.p. higher than the 2015 effective tax rate, due to lower tax credits recognition in 2016.

As a result of the foregoing, **profit for the year attributable to equity holders of the parent** for 2016 was 2,369 million euros (616 million euros in 2015).

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**Profit attributable to non-controlling interest** reached 30 million euros, 105 million euros less than in 2015, mainly due to the increase in losses attributable to minority interests at Telefónica Germany, offset by the lower profit attributable to minority interests in Telefónica Brazil.

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## TELEFÓNICA SPAIN

The below table shows the evolution of accesses in Telefónica Spain over the past two years as of December 31 of such years:

**ACCESSES**

| <b>Thousand of accesses</b>   | <b>2015</b>     | <b>2016</b>     | <b>% Reported YoY</b> |
|-------------------------------|-----------------|-----------------|-----------------------|
| Fixed telephony accesses (1)  | 10,005.6        | 9,720.2         | (2.9%)                |
| Internet and data accesses    | 6,000.0         | 6,094.5         | 1.6%                  |
| Broadband (2)                 | 5,962.0         | 6,067.3         | 1.8%                  |
| Fiber                         | 2,223.0         | 2,998.3         | 34.9%                 |
| Mobile accesses               | 17,258.5        | 17,237.7        | (0.1%)                |
| Prepay                        | 2,777.1         | 2,329.3         | (16.1%)               |
| Contract                      | 14,481.4        | 14,908.4        | 2.9%                  |
| M2M                           | 1,778.8         | 2,006.3         | 12.8%                 |
| Pay TV                        | 3,671.5         | 3,657.0         | (0.4%)                |
| <b>Final Clients Accesses</b> | <b>36,935.6</b> | <b>36,709.4</b> | <b>(0.6%)</b>         |
| <b>Wholesale Accesses</b>     | <b>5,037.7</b>  | <b>4,525.5</b>  | <b>(10.2%)</b>        |
| <b>Total Accesses</b>         | <b>41,973.3</b> | <b>41,234.9</b> | <b>(1.8%)</b>         |

Notes:

(\*) There were no variations in organic terms during the period.

(1) PSTN (including Public Use Telephony) x1; ISDN Basic access x1; ISDN Primary access; 2/6 Digital Access x30.

(1) Company's accesses for internal use included. Includes VoIP and Naked ADSL.

(2) Include ADSL, satellite, fiber optic and retail broadband circuit.

In 2016 the commercial activity was leveraged on the differentiated assets of the Company and, in the second half of 2015 was strengthened by the convergent offer "Movistar Fusión+" launched in July 2015. During the first semester of 2016 the tariffs of the consumer segment, fundamentally broadband, postpaid mobile and "Fusion" were revised and, on



July 3, 2016 a new "Movistar Fusión+" portfolio was launched, increasing the value offered to customers and tailoring it to their preferences. Basic bundles now include content from the Spanish "La Liga", to which "UEFA Champions and Europe League" are added in ultrafast packages; and the new "Movistar Fusión+" bundles include additional mobile lines and Premium TV content. It is important to highlight the good evolution of the second mobile line included in "Fusión+ Contigo" since its launching on June 1, 2016.

Churn evolution was positive in 2016, especially taking into account the elimination of "Fusión" long-term contracts on August 1, 2015, reflecting the higher loyalty of the customers with bundles services. This fact has resulted in a positive performance of commercial activity in 2016, broadband net adds grew by 39% year-on-year, there were more than 775 thousand new fiber accesses, and mobile contract net adds continued growth (+0.4 million customers). In fixed telephony the net loss of accesses decreased by 35.5% year-on-year.

Telefónica Spain had 41.2 million accesses at the end of December 2016, down 1.8% year-on-year, explained by the decrease in prepay mobile accesses and fixed telephony accesses. Retail accesses also declined by 0.6% year-on-year.

**"Movistar Fusión"**, with a customer base of 4.3 million with 2.5 million additional wireless lines to the base offer as of December 31, 2016, maintained a solid year-on-year growth (+5% and +26% respectively compared to December 2015) and contributed 83% of the fixed retail broadband customer base (3.0% year-on-year) and 73% of the wireless contract customer base (6 p.p. year-on-year). There was significant growth in the penetration of the high value services of "Movistar Fusión", with 37% of the customer base already using 100 Mb or 300 Mb ultra-fast broadband (+8 p.p. year-on-year) and 68% of the customer base with Pay-TV as of December 31, 2016 (+5 p.p. year-on-year).

**Fixed accesses** decreased 2.9% year-on-year, with a net loss of 285 thousand accesses in the year 2016. This decrease was mainly due to a slower fixed access market evolution.

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**Retail broadband accesses** presented 105 thousand new accesses in 2016, totaling 6.1 million accesses (+1.8% year-on-year) due to a low churn (1.4% in 2016, +0.02 p.p. year-on-year).

**Fiber accesses** showed a good evolution in terms of net adds (0.8 million new accesses in 2016), reaching 3.0 million customers in 2016 (up 34.9% compared to 2015), 49% of which corresponded to broad band accesses (+12 p.p. year-on-year), and with more than 775 thousand new accesses in 2016. Ultra-speed fiber accesses, with 100 or 300 Mb (with additional ARPU of 10 euros, including VAT) reached 2.0 million accesses (68% of total fiber accesses). At December 31, 2016 the fiber deployment reached 17.1 million premises, 2.7million more than at December 31, 2015, and continues to be the largest in Europe.

Total **mobile accesses** stood at 17.2 million, down 0.1% compared with year-end 2015 as a result of the decrease in prepay accesses. The contract access base accelerated its growth during 2016, growing by 2.9% year-on-year. Smartphone penetration stood at 70.9% of the mobile voice base (+4.6 p.p. compared to year-end 2015) and significantly boosted data traffic growth to 62% year-on-year in 2016 due to the higher number of customers with the renewed portfolio containing superior data packages.

LTE network rollout continued to progress well and coverage reached (based on our estimates) approximately 91% of the population at the end of 2016, up 16 p.p. compared to 2015, due to the deployment of the 800 MHz. As a result, the LTE customer base reached 6.0 million customers in 2016, almost doubling the customer base in 2015, while penetration reached 40% (+19 p.p. year-on-year).

**Pay-TV accesses** reached 3.7 million, in line with the previous year, including 613 thousand satellite TV accesses from DTS.

Given the high penetration level of the convergent offer “Fusión”, the revenue breakdown by service is considered to be increasingly less relevant in 2016. For this reason, Telefónica Spain has disclosed a new revenue breakdown that management believes is more meaningful.

The table below shows the evolution of Telefónica Spain’s results over the past two years:

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Millions of euros

| TELEFÓNICA SPAIN              | 2015         | 2016         | % Reported YoY | % Organic YoY (3) |
|-------------------------------|--------------|--------------|----------------|-------------------|
| Revenues                      | 12,402       | 12,713       | 2.5%           | (0.1%)            |
| <b>Consumer (1)</b>           | <b>6,129</b> | <b>6,536</b> | <b>6.6%</b>    | <b>1.8%</b>       |
| Fusion                        | 3,368        | 4,095        | 21.6%          | 21.6%             |
| Out of Fusion                 | 2,761        | 2,441        | (11.6%)        | (20.0%)           |
| <b>Corporate</b>              | <b>3,473</b> | <b>3,423</b> | <b>(1.4%)</b>  | <b>(1.4%)</b>     |
| Communications                | 2,799        | 2,708        | (3.3%)         | (3.3%)            |
| IT                            | 674          | 716          | 6.2%           | 6.2%              |
| <b>Others (2)</b>             | <b>2,152</b> | <b>2,257</b> | <b>4.8%</b>    | <b>3.2%</b>       |
| Other income                  | 516          | 476          | (7.6%)         | (6.4%)            |
| Supplies                      | (2,996)      | (3,375)      | 12.7%          | 4.4%              |
| Personnel expenses            | (5,173)      | (2,997)      | (42.1%)        | (6.2%)            |
| Other expenses                | (2,413)      | (2,350)      | (2.6%)         | (4.8%)            |
| <b>OIBDA</b>                  | <b>2,336</b> | <b>4,467</b> | <b>91.2%</b>   | <b>1.4%</b>       |
| OIBDA margin                  | 18.8%        | 35.1%        | 16.3 p.p.      | 0.6 p.p.          |
| Depreciation and amortization | (1,898)      | (1,830)      | (3.6%)         | (4.8%)            |
| <b>Operating income (OI)</b>  | <b>438</b>   | <b>2,637</b> | <b>n.m.</b>    | <b>5.1%</b>       |
| CapEx                         | 1,827        | 1,847        | 1.1%           | 3.0%              |
| OpCF (OIBDA-CapEx)            | 509          | 2,621        | n.m.           | 0.6%              |

Notes:

- (1) Consumer revenues also include freelance revenues.
- (2) Other revenues include wholesale, subsidiaries and other revenues.
- (3) See adjustments made to calculate organic variation below.

Adjustments made to calculate organic variations

As explained above, year-on-year changes referred to in this document as “organic” or presented in “organic terms” intend to present year-on-year variations on a comparable basis.

With respect to Telefónica Spain, we have made the following adjustments in order to calculate 2016/2015 variations in organic terms:

**Changes in the scope of consolidation:** DTS was included in Telefónica’s consolidation perimeter on May 1, 2015. In order to exclude the impact of this change in the perimeter for the calculation of organic variations, the 2015 comparative figures include DTS’s results from January 1 to April 30, 2015.

**Restructuring costs:** the impact of certain restructuring costs related to the Voluntary Suspension Plan in Spain and amounting to 837 million and 2,896 million euros in 2016 and 2015, respectively, has been excluded.

**Results of tower sales:** the result obtained by Telefónica Spain from the sale of towers in 2015 totaling 38 million euros, has been excluded. Telefónica Spain recognized no result from the sale of towers in 2016.

**Spectrum acquisition:** we have excluded the impact of spectrum acquisitions in 2016 and 2015, which totaled 7 and 49 million euros, respectively.

**Gains or losses on the sale of companies:** in 2016, the gain obtained from the sale of Telecomunicaciones Personalizadas for 29 million euros was excluded.

**Optimization of the distribution network:** the impact of the provisions recorded for 18 million and 30 million euros in 2016 and 2015, respectively, have been excluded.

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The table below shows 2016/2015 variations in reported and organic terms (the latter, calculated in accordance with the adjustments referred to above) of certain income statement and other measures, and the contribution of each item for which we have adjusted to our reported growth:

| TELEFÓNICA<br>SPAIN 2016      | YoY variation        |                     | Contribution to reported growth (percentage points) |                        |                 |                         |  |                                  |
|-------------------------------|----------------------|---------------------|---|------------------------|-----------------|-------------------------|--|----------------------------------|
|                               | %<br>Reported<br>YoY | %<br>Organic<br>YoY | Perimeter<br>change                                 | Restructuring<br>costs | Towers<br>sales | Spectrum<br>acquisition | Capital<br>Gains/losses<br>on sale of<br>companies | Spain<br>distribution<br>channel |
| Revenues                      | 2.5%                 | (0.1%)              | 2.6   | --                     | --              | --                      | --   | --                               |
| Other income                  | (7.6%)               | (6.4%)              | 0.1   | --                     | (7.4)           | --                      | 5.6  | --                               |
| Supplies                      | 12.7%                | 4.4%                | 7.9   | --                     | --              | --                      | --   | --                               |
| Personnel<br>expenses         | (42.1%)              | (6.2%)              | 0.5   | (39.8)                 | --              | --                      | --   | --                               |
| Other expenses                | (2.6%)               | (4.8%)              | 2.8   | --                     | --              | --                      | --   | (0.5)                            |
| <b>OIBDA</b>                  | <b>91.2%</b>         | <b>1.4%</b>         | <b>(0.2)</b>  | <b>88.1</b>            | <b>(1.6)</b>    | <b>--</b>               | <b>1.2</b>   | <b>0.5</b>                       |
| CapEx                         | 1.1%                 | 3.0%                | 0.4   | --                     | --              | (2.3)                   | --   | --                               |
| <b>OpCF<br/>(OIBDA-CapEx)</b> | <b>n.m.</b>          | <b>0.6%</b>         | <b>(2.2)</b>  | <b>n.m.</b>            | <b>(7.5)</b>    | <b>8.2</b>              | <b>5.6</b>   | <b>2.3</b>                       |

## Results discussion

**Revenues** in Telefónica Spain in 2016 were 12,713 million euros, up 2.5% year-on-year in reported terms mainly as a result of the consolidation of DTS since May 1, 2015 (which accounted for +2.6 p.p. of the year-on-year increase). In organic terms, revenues were flat year-on-year, as lower handset revenues were offset by higher service revenues.

Given the high penetration level of the convergent offer (which means the offer of more than a single service for a single price), the revenue breakdown by service is considered to be increasingly less relevant. For this reason, Telefónica Spain has established a new revenue breakdown that management believes is more meaningful.

**Consumer revenues** (6,536 million euros in 2016) grew by 6.6% year-on-year in reported terms, as a result of the consolidation of DTS since May 1, 2015 (+4.8 p.p. of the year-on-year increase). In organic terms, these revenues increased 1.8% year-on-year, mainly driven by the growth in ARPU and in the number of customers. It is worth highlighting the strong growth in "Fusión" revenues during 2016 (4,095 million euros, +21.6% year-on-year) which more than offset the drop in "non-Fusión" revenues.

**Business revenues** (3,423 million euros in 2016) decreased by 1.4% year-on-year in reported terms, improving the year-on-year trend, mainly due to a better evolution in communications revenues evolution and higher IT revenues. During 2016, business revenues showed a path of stabilization, supported by the commercial offer renovation, with integrated connectivity solutions, IT and digital services, all of them key for the digitalization of the businesses.

**Other revenues**, which include wholesale, subsidiaries and other revenues (2,257 million euros in 2016) grew by 4.8% year-on-year in reported terms, due to the growth in wholesale TV revenues and fixed ingoing voice revenues.

**Fusión ARPU** was 80.4 euros in 2016, up 12.0% year-on-year in reported terms, boosted by the demand of higher value packages and the tariff revisions, as well as the improvement in the customers' mix stimulated by the renovation of the portfolio that took place in August, 2016 including mobile additional lines and additional contents in the convergent offers.

**OIBDA** amounted to 4,467 million euros in 2016, up 91.2% year-on-year in reported terms, as a consequence of the provisions recorded in 2015 totaling 2,896 million euros relating to restructuring cost by the "Employment Suspension Plan" and 30 million euros relating to restructuring of the distribution channel. The OIBDA reported in 2016 also included 837 million euros of provisions due to the Individual Suspension Plan and other restructuring plans, and 18 million euros of provision due to the restructuring of the distribution channel.

In organic terms OIBDA increased 1.4% year-on-year, mainly due to the higher service revenues, lower personnel costs (down by 6.2% year-on-year in organic terms which is mainly explained by the savings generated by the "employment suspension plan" (207 million euros) since April 2016) and lower other expenses, which dropped 2.6% in reported terms and down 4.8% in organic terms excluding changes in the perimeter of consolidation, principally due to lower commercial costs, which in total offset the increase of supplies (+12.7% in reported terms, +4.4% in organic terms) impacted by higher content costs and IT equipment purchases.

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**OIBDA margin** was 35.1% in 2016 in reported terms and 41.6% in organic terms, up 16.3 p.p. year-on-year in reported terms.

**TELEFÓNICA UNITED KINGDOM**

As explained above, the consolidated income statement for 2015 appearing in the Consolidated Financial Statements has been amended to retroactively show the reclassification of Telefónica United Kingdom's results as continuous operations. Therefore, these results do not match the results published for such period. Consequently, segmented information has been modified for 2015.

The table below shows the evolution of accesses in Telefónica United Kingdom over the past two years as of December 31 of such years:

**ACCESSES**

| <b>Thousands of accesses</b>  | <b>2015</b>     | <b>2016</b>     | <b>% Reported YoY</b> |
|-------------------------------|-----------------|-----------------|-----------------------|
| Fixed telephony accesses (1)  | 247.1           | 272.6           | 10.3%                 |
| Internet and data accesses    | 21.0            | 23.7            | 12.8%                 |
| Broadband                     | 21.0            | 23.7            | 12.8%                 |
| Mobile accesses               | 25,018.8        | 25,462.7        | 1.8%                  |
| Prepay                        | 10,561.4        | 9,701.4         | (8.1%)                |
| Contract                      | 14,457.4        | 15,761.3        | 9.0%                  |
| M2M (2)                       | 2,383.9         | 3,266.9         | 37.0%                 |
| <b>Final Clients Accesses</b> | <b>25,286.9</b> | <b>25,759.0</b> | <b>1.9%</b>           |
| <b>Total Accesses</b>         | <b>25,286.9</b> | <b>25,759.0</b> | <b>1.9%</b>           |

Notes:

(1) Includes "fixed wireless" and Voice over IP accesses.

(2) Includes 720 thousand M2M accesses on the global platform since the first quarter 2016.

In 2016, Telefónica United Kingdom maintained market momentum, as a result of the O2 brand recognition, the commercial proposal success and the customer loyalty. These factors have allowed the company to keep growing in a competitive market.

The **total access** base grew 1.9% year-on-year and stood at 25.8 million at December 31, 2016, mainly driven by a 1.8% increase in the mobile customer base.

The contract **mobile customer** base grew 9.0% year-on-year and reached 15.8 million accesses, with a broadly stable 61.9% share over the total mobile base driven by the incorporation of 720 thousand M2M accesses on the global platform, not accounted before. Net adds reached 444 thousand accesses due to the solid contribution of postpay accesses. Smartphone penetration reached 68.4% of the total mobile accesses base, up 8.0 p.p. year-on-year, driven by the continued growth of LTE customers (+36.1% year-on-year reaching 10.4 million at December 31, 2016). LTE penetration reached 47% of the total mobile access base.

The prepay access base decreased 8.1% year-on-year to 9.7 million at December 31, 2016.

The table below shows the evolution of Telefónica United Kingdom's results over the past two years:

Millions of euros

| TELEFÓNICA UNITED KINGDOM     | 2015         | 2016         | % Reported YoY | % Organic YoY (1) |
|-------------------------------|--------------|--------------|----------------|-------------------|
| Revenues                      | 7,837        | 6,861        | (12.5%)        | (1.5%)            |
| Mobile service revenues       | 5,778        | 5,121        | (11.4%)        | (0.3%)            |
| Other income                  | 170          | 148          | (12.7%)        | (1.8%)            |
| Supplies                      | (3,769)      | (3,226)      | (14.4%)        | (3.7%)            |
| Personnel expenses            | (549)        | (528)        | (3.9%)         | 1.2%              |
| Other expenses                | (1,760)      | (1,546)      | (12.1%)        | (1.1%)            |
| <b>OIBDA</b>                  | <b>1,929</b> | <b>1,709</b> | <b>(11.4%)</b> | <b>1.7%</b>       |
| OIBDA margin                  | 24.6%        | 24.9%        | 0.3 p.p.       | 0.8 p.p.          |
| Depreciation and amortization | (1,196)      | (1,090)      | (8.9%)         | 2.6%              |
| <b>Operating income (OI)</b>  | <b>733</b>   | <b>619</b>   | <b>(15.5%)</b> | <b>0.2%</b>       |
| CapEx                         | 883          | 931          | 5.5%           | 18.7%             |
| OpCF (OIBDA-CapEx)            | 1,046        | 778          | (25.6%)        | (12.7%)           |

(1) See adjustments made to calculate organic variation below.





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Adjustments made to calculate organic variations

As explained above, year-on-year changes referred to in this document as “organic” or presented in “organic terms” intend to present year-on-year variations on a comparable basis.

With respect to Telefónica United Kingdom, we have made the following adjustments in order to calculate 2016/2015 variations in organic terms:

**Exchange rate effect:** we have excluded the impact of changes in exchange rates by assuming constant average foreign exchange rates year on year. In particular, we have used the average foreign exchange rates of 2015 for both years.

**Restructuring costs:** we have excluded the impact in 2016 and 2015 of restructuring costs, amounting to 37 and 4 million euros, respectively.

The table below shows 2016/2015 variations in reported and organic terms (the latter, calculated in accordance with the adjustments referred to above) of certain income statement and other measures, and the contribution of each item for which we have adjusted to our reported growth:

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| TELEFÓNICA UNITED<br>KINGDOM 2016 | YoY variation     |                  | Contribution to reported growth<br>(percentage points) |                        |
|-----------------------------------|-------------------|------------------|--|------------------------|
|                                   | % Reported<br>YoY | % Organic<br>YoY | Exchange rate<br>effect                                | Restructuring<br>costs |
| Revenues                          | (12.5%)           | (1.5%)           | (11.0)   | --                     |
| Other income                      | (12.7%)           | (1.8%)           | (10.9)   | --                     |
| Supplies                          | (14.4%)           | (3.7%)           | (10.7)   | --                     |
| Personnel expenses                | (3.9%)            | 1.2%             | (12.0)   | 6.9                    |
| Other expenses                    | (12.1%)           | (1.1%)           | (11.0)   | --                     |
| <b>OIBDA</b>                      | <b>(11.4%)</b>    | <b>1.7%</b>      | <b>(11.1)</b>  | <b>(2.0)</b>           |
| CapEx                             | 5.5%              | 18.7%            | (13.2)   | --                     |
| <b>OpCF (OIBDA-CapEx)</b>         | <b>(25.6%)</b>    | <b>(12.7%)</b>   | <b>(9.3)</b>   | <b>(3.6)</b>           |

**Results discussion**

Total **revenues** were 6,861 million euros in 2016, down by 12.5% year-on-year in reported terms mainly due to the depreciation of the pound sterling (which accounted for -11 p.p. of the year-on-year decrease). In organic terms, revenues decreased by 1.5% year-on-year due mainly to lower handset sales, which declined by 8.0% year-on-year.

**Mobile service revenues** totaled 5,121 million euros in 2016, down by 11.4% year-on-year in reported terms due mainly to the depreciation of the pound sterling (which accounted for -11.1 p.p. of the year-on-year decrease). Excluding this impact, mobile service revenues decreased by 0.3% due to the “Refresh” commercial model as well as the low interconnection fares. Under the Refresh commercial model, certain revenues related to handset are not considered as mobile service revenues, but as handset revenues.

Mobile **ARPU** decreased by 12.1% year-on-year in reported terms due mainly to the depreciation of the pound sterling. In organic terms, **ARPU** went down by 1.1% adversely affected by the “Refresh” model, while data ARPU increased by 2.3%. In the “Refresh” model handset revenues are not considered as mobile service revenues, but as handset revenues and ARPU does not reflect the handset revenues.

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| TELEFÓNICA UNITED KINGDOM           | 2015        | 2016        | %YoY           | %Organic YoY  |
|-------------------------------------|-------------|-------------|----------------|---------------|
| Voice Traffic (millions of minutes) | 90,527      | 93,306      | 3.1%           | 3.1%          |
| <b>ARPU (EUR)</b>                   | <b>19.4</b> | <b>17.0</b> | <b>(12.1%)</b> | <b>(1.1%)</b> |
| Prepay                              | 7.7         | 7.5         | (3.1%)         | 9.7%          |
| Contract (1)                        | 33.5        | 28.8        | (14.1%)        | (3.5%)        |
| <b>Data ARPU (EUR)</b>              | <b>11.3</b> | <b>10.3</b> | <b>(9.0%)</b>  | <b>2.3%</b>   |
| % non-SMS over data revenues        | 59.4%       | 61.4%       | 2.0 p.p.       | 2.0 p.p.      |

Notes:

(1) Excludes M2M.

**OIBDA** totaled 1,709 million euros in 2016, down 11.4% year-on-year in reported terms, as a result mainly of the depreciation of the sterling pound. In organic terms, OIBDA increased by 1.7% year-on-year due to the reduction of costs offset by lower service revenues.

The **OIBDA margin** stood at 24.9% in 2016, with an increase of 0.3 p.p. in reported terms compared to 2015. In organic terms, OIBDA margin stood at 25.5%.

Table of Contents**TELEFÓNICA GERMANY**

The below table shows the evolution of accesses in Telefónica Germany over the past two years as of December 31 of such years:

**ACCESSES**

| Thousands of accesses         | 2015            | 2016            | %Reported<br>YoY |
|-------------------------------|-----------------|-----------------|------------------|
| Fixed telephony accesses (1)  | 1,997.8         | 2,010.3         | 0.6%             |
| Internet and data accesses    | 2,330.6         | 2,324.5         | (0.3%)           |
| Broadband                     | 2,098.0         | 2,104.0         | 0.3%             |
| VDSL                          | 516.8           | 805.5           | 55.9%            |
| Mobile accesses               | 43,062.8        | 44,320.7        | 2.9%             |
| Prepay                        | 23,979.4        | 23,784.0        | (0.8%)           |
| Contract                      | 19,083.4        | 20,536.6        | 7.6%             |
| M2M                           | 632.0           | 787.8           | 24.6%            |
| <b>Final Clients Accesses</b> | <b>47,391.2</b> | <b>48,655.5</b> | <b>2.7%</b>      |
| <b>Wholesale Accesses</b>     | <b>972.0</b>    | <b>691.0</b>    | <b>(28.9%)</b>   |
| <b>Total Accesses</b>         | <b>48,363.2</b> | <b>49,346.4</b> | <b>2.0%</b>      |

Notes:

(1) Includes "fixed wireless" and Voice over IP accesses.

During 2016 Telefónica Germany maintained market momentum with the launch of a new Premium portfolio called "O2 Free" on October 5, 2016, which underpins the company's data monetization strategy, offering more content at a higher price with a clear focus on retaining and developing the premium customer base. Competitive pressure in the non-premium segment is showing some signs of improvement. At the same time, Telefónica Germany delivered on its integration milestones, generating additional savings in line with its synergy targets.

The **total access** base grew 2.0% year-on-year and stood at 49.3 million at December 31, 2016, mainly driven by a 2.9% increase in the mobile base (which reached 44.3 million).

The contract **mobile customer** base grew 8% year-on-year and reached 20.5 million accesses, with a broadly stable 46.3% share over the total mobile base. Net adds reached 1.5 million accesses due to the solid contribution of partners (second brands). Smartphone penetration reached 59% of the total mobile access base, up 5.2 p.p. year-on-year driven by the continued growth of LTE customers (+53% year-on-year reaching 12.1 million at December 31, 2016) which reflects the continuous demand by customers for high speed mobile data access. LTE penetration reached 27% of the total mobile access base.

The prepay access base remained broadly stable year-on-year (-0.8%) at 23.8 million. The prepay segment lost 195 thousand accesses in 2016 due to the partner segment.

The retail broadband access loss trend continued to improve, with 6 thousand net additions in 2016. VDSL registered 289 thousand net additions (+60% year-on-year) in 2016 and continued to benefit from the continued strong demand, while the wholesale DSL customer base continued to fall due to the planned dismantling of the legacy infrastructure.

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The table below shows the evolution of Telefónica Germany's results over the past two years:

Millions of euros

| TELEFÓNICA GERMANY            | 2015         | 2016         | % Reported YoY | % Organic YoY (1) |
|-------------------------------|--------------|--------------|----------------|-------------------|
| Revenues                      | 7,888        | 7,503        | (4.9%)         | (4.9%)            |
| <b>Mobile Business</b>        | <b>6,832</b> | <b>6,498</b> | <b>(4.9%)</b>  | <b>(4.9%)</b>     |
| Mobile service revenues       | 5,532        | 5,437        | (1.7%)         | (1.7%)            |
| <b>Fixed Business</b>         | <b>1,043</b> | <b>981</b>   | <b>(5.9%)</b>  | <b>(5.9%)</b>     |
| Other income                  | 265          | 146          | (45.0%)        | (9.3%)            |
| Supplies                      | (2,712)      | (2,452)      | (9.6%)         | (9.6%)            |
| Personnel expenses            | (655)        | (646)        | (1.4%)         | (7.9%)            |
| Other expenses                | (2,928)      | (2,757)      | (5.8%)         | (5.0%)            |
| <b>OIBDA</b>                  | <b>1,858</b> | <b>1,794</b> | <b>(3.4%)</b>  | <b>2.9%</b>       |
| OIBDA margin                  | 23.6%        | 23.9%        | 0.4 p.p.       | 1.9 p.p.          |
| Depreciation and amortization | (2,128)      | (2,211)      | 3.9%           | 3.9%              |
| <b>Operating income (OI)</b>  | <b>(270)</b> | <b>(417)</b> | <b>54.2%</b>   | <b>9.8%</b>       |
| CapEx                         | 2,230        | 1,108        | (50.3%)        | 6.8%              |
| OpCF (OIBDA-CapEx)            | (372)        | 686          | c.s.           | (2.1%)            |

(1) See adjustments made to calculate organic variation below.

#### Adjustments made to calculate organic variations

As explained above, year-on-year changes referred to in this document as “organic” or presented in “organic terms” intend to present year-on-year variations on a comparable basis.

With respect to Telefónica Germany, we have made the following adjustments in order to calculate 2016/2015 variations in organic terms:

**Restructuring costs:** we have excluded the impact of restructuring costs associated with simplification processes implemented in Germany. In 2016, restructuring costs had an 89 million euros impact on OIBDA. In 2015, restructuring costs had a 74 million euros impact on OIBDA.

**Adjustments to the final purchase price of E-Plus:** in 2015 we have excluded the result from the difference between the preliminary purchase price of E-Plus (as estimated at the end of the valuation period) and the final purchase price agreed with KPN, totaling 104 million euros (which had 102 million euros positive impact on OIBDA, net of costs related to the acquisition).

**Spectrum acquisition:** the CapEx organic variation exclude spectrum acquisition, which in 2015 amounted to 1.198 million euros (6 million euros in 2016).



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The table below shows 2016/2015 variations in reported and organic terms (the latter, calculated in accordance with the adjustments referred to above) of certain income statement measures and CapEX and the contribution of each item for which we have adjusted to our reported growth:

|                                | YoY variation  |               | Contribution to reported growth (percentage points) |   |                      |
|--------------------------------|----------------|---------------|---|---|----------------------|
|                                | % Reported YoY | % Organic YoY | Restructuring costs                                 | Adjustments to the final purchase price of E-Plus | Spectrum acquisition |
| <b>TELEFÓNICA GERMANY 2016</b> |                |               |   |   |                      |
| Revenues                       | (4.9%)         | (4.9%)        | --  | --  | --                   |
| Other income                   | (45.0%)        | (9.3%)        | --  | (39.4)  |                      |
| Supplies                       | (9.6%)         | (9.6%)        | --  | --  | --                   |
| Personnel expenses             | (1.4%)         | (7.9%)        | 6.4   | --  | --                   |
| Other expenses                 | (5.8%)         | (5.0%)        | (0.9)   | (0.1)   | --                   |
| <b>OIBDA</b>                   | <b>(3.4%)</b>  | <b>2.9%</b>   | <b>(0.8)</b>  | <b>(5.5)</b>                                      | <b>--</b>            |
| CapEx                          | (50.3%)        | 6.8%          | --  | --  | (53.5)               |
| <b>OpCF (OIBDA-CapEx)</b>      | <b>c.s.</b>    | <b>(2.1%)</b> | <b>4.1</b>  | <b>27.4</b>                                       | <b>n.m.</b>          |

## Results discussion

Total **revenues** were 7,503 million euros in 2016, down 4.9% year-on-year in reported terms due mainly to the lower service revenues and handset sales.

**Mobile service revenues** totaled 5,437 million euros in 2016, decreasing 1.7% year-on-year in reported terms due mainly to the impact of termination and roaming tariffs, the increasing share of partner segment (second brands) within the customer base and the competitive pressure. Telefónica Germany continued to focus on data revenues, which increased by 5.3% and accounted for 55% of mobile service revenues in 2016. Non-P2P SMS data revenues amounted to 2,300 million euros (increasing +13.1% year-on-year) and non-P2P SMS data revenues accounted for 76.9% of the total data revenues (+5.3 p.p. year-on-year).

**Fixed revenues** were 981million euros in 2016 (down 5.9% year-on-year), due to lower wholesale revenues driven by the planned decommissioning of the legacy ULL platform.

**Mobile ARPU** was 10.3 euros in 2015 (down 3.7% year-on-year), while contract ARPU stood at 16.5 euros (down 4.1% year-on-year), as a result of the high pricing pressure in a competitive market, higher share of wholesale customers in the customer base and the consequent change in the weight of retail to wholesale. Data ARPU was 5.7 euros (+3.4% year-on-year).

| <b>TELEFÓNICA GERMANY</b>           | <b>2015</b> | <b>2016</b> | <b>% YoY</b>  |
|-------------------------------------|-------------|-------------|---------------|
| Voice Traffic (millions of minutes) | 117,877     | 113,896     | (3.4%)        |
| <b>ARPU (EUR)</b>                   | <b>10.7</b> | <b>10.3</b> | <b>(3.7%)</b> |
| Prepay                              | 5.8         | 5.7         | (1.6%)        |
| Contract (1)                        | 17.2        | 16.5        | (4.1%)        |
| <b>Data ARPU (EUR)</b>              | <b>5.5</b>  | <b>5.7</b>  | <b>3.4%</b>   |
| % non-SMS over data revenues        | 71.6%       | 76.9%       | 5.3 p.p.      |

Notes:

(1) Excludes M2M.

**OIBDA** totaled 1,794 million euros in 2016, decreasing 3.4% year-on-year in reported terms as a result mainly of the previously mentioned positive impact of the final purchase price of E-Plus in 2015 (-5.5 p.p.) and the lower restructuring costs recorded in 2016 (-0.8 p.p.). In organic terms, OIBDA grew by 2.9% year-on-year, driven by the synergies captured in integration (approximately 150 million euros in 2016) mainly by employees restructuring and infrastructure dismantling.

The **OIBDA margin** stood at 23.9% in reported terms for 2016, up 0.4 p.p. compared to 2015 (+1.9 p.p. in organic terms).

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## TELEFÓNICA BRAZIL

The below table shows the evolution of accesses in Telefónica Brazil over the past two years as of December 31 of such years:

**ACCESSES**

| <b>Thousands of accesses</b>  | <b>2015</b>     | <b>2016</b>     | <b>% Reported YoY</b> |
|-------------------------------|-----------------|-----------------|-----------------------|
| Fixed telephony accesses (1)  | 14,654.5        | 14,338.4        | (2.2%)                |
| Internet and data accesses    | 7,195.5         | 7,383.2         | 2.6%                  |
| Broadband                     | 7,129.5         | 7,311.0         | 2.5%                  |
| Fiber and VDSL                | 3,779.9         | 4,171.0         | 10.3%                 |
| Mobile accesses               | 73,261.3        | 73,769.8        | 0.7%                  |
| Prepay                        | 42,194.4        | 40,387.2        | (4.3%)                |
| Contract                      | 31,066.9        | 33,382.6        | 7.5%                  |
| M2M                           | 4,234.7         | 5,005.1         | 18.2%                 |
| Pay TV                        | 1,787.9         | 1,712.7         | (4.2%)                |
| <b>Final Clients Accesses</b> | <b>96,899.3</b> | <b>97,204.2</b> | <b>0.3%</b>           |
| <b>Wholesale Accesses</b>     | <b>22.3</b>     | <b>17.9</b>     | <b>(19.5%)</b>        |
| <b>Total Accesses</b>         | <b>96,921.5</b> | <b>97,222.2</b> | <b>0.3%</b>           |

Notes:

(\*) There were no variations in organic terms during the period.

(1) Includes "fixed wireless" and Voice over IP accesses.

Telefónica Brazil closed the year 2016 improving its competitive position in the mobile as well as in the fixed market. In the mobile business, leadership has been maintained in the higher value segments, which permitted the operator to capture mobile market revenue growth in 2016. In the fixed business, the transformation towards fiber and Pay-TV was strengthened after the integration of GVT in May 2015.

Revenues and OIBDA evolution was positively supported by the acceleration of mobile data and the good evolution of fiber and Pay-TV. Additionally, Telefónica Brazil carried out costs control measures and generated benefits from the synergies with GVT that offset the adverse macroeconomic situation in Brazil.

However, results in 2016 were adversely affected by the interconnection tariff reduction in the mobile business (-33.8%) and in the retail fixed-mobile tariff (-20.6%), fixed-local (-65.9%) and fixed-interurban (-21.3%) since February 25, 2016.

Telefónica Brazil reached 97.2 million **accesses** at December 31, 2016, up 0.3% compared with December 2015.

In the **mobile business**, the strategic focus remained on gaining and retaining high value customers, reaching a market share of 42.1% in the contract segment as of December 31, 2016 (Source: Anatel), preserving the leadership. Telefónica Brazil maintained its market leadership in terms of total accesses with a market share of 30.2% as of December 2016 (source: Anatel), driven by the contract clients growth (7.5% year-on-year), and offset the fall in prepaid clients (-4.3% year-on-year). An improvement has been experienced on the “familiar plans”, giving the chance to proceed to data sharing among the same family, as well as progress in online client assistance through “meu vivo”, acclaiming one of Vivo’s strengths and continuing with constant upgrades.

In its **fixed business**, Telefónica Brazil maintained its strategic focus on fiber deployment, with 17 million premises passed with fiber at December 31, 2016 and 4.3 million homes connected. Traditional accesses decreased 2.2% due to the fixed-mobile substitution. Retail broadband accesses totaled 7.3 million accesses at the end of 2016, increasing 2.5% year-on-year. Among them, 59% accesses were connected with FTCC. Pay TV customers reached 1.7 million as of December 31, 2016, down 4.2% in reported terms due mainly to the macroeconomic situation and a commercial strategy based in value clients gaining. IPTV accesses increased in relevance representing 13% of total Pay TV accesses.

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The table below shows the evolution of Telefónica Brazil's results over the past two years:

**Millions of Euros**

| <b>TELEFÓNICA BRAZIL</b>      | <b>2015</b>  | <b>2016</b>  | <b>% Reported YoY</b> | <b>% Organic YoY (1)</b> |
|-------------------------------|--------------|--------------|-----------------------|--------------------------|
| Revenues                      | 11,060       | 11,097       | 0.3%                  | 0.9%                     |
| <b>Mobile Business</b>        | <b>6,906</b> | <b>6,669</b> | <b>(3.4%)</b>         | <b>1.7%</b>              |
| Mobile service revenues       | 6,495        | 6,357        | (2.1%)                | 3.1%                     |
| <b>Fixed Business</b>         | <b>4,154</b> | <b>4,428</b> | <b>6.6%</b>           | <b>(0.2%)</b>            |
| Other income                  | 416          | 348          | (16.3%)               | (16.6%)                  |
| Supplies                      | (2,568)      | (2,249)      | (12.4%)               | (10.9%)                  |
| Personnel expenses            | (1,042)      | (1,167)      | 11.9%                 | 3.1%                     |
| Other expenses                | (4,293)      | (4,315)      | 0.5%                  | 2.0%                     |
| <b>OIBDA</b>                  | <b>3,573</b> | <b>3,714</b> | <b>3.9%</b>           | <b>5.3%</b>              |
| OIBDA margin                  | 32.3%        | 33.5%        | 1.2 p.p.              | 1.4 p.p.                 |
| Depreciation and amortization | (1,916)      | (2,038)      | 6.4%                  | 2.5%                     |
| <b>Operating income (OI)</b>  | <b>1,657</b> | <b>1,676</b> | <b>1.1%</b>           | <b>8.8%</b>              |
| CapEx                         | 2,105        | 2,138        | 1.6%                  | (2.9%)                   |
| OpCF (OIBDA-CapEx)            | 1,468        | 1,576        | 7.3%                  | 17.8%                    |

(1) See adjustments made to calculate organic variation below.

## Adjustments made to calculate organic variations

As explained above, year-on-year changes referred to in this document as “organic” or presented in “organic terms” intend to present year-on-year variations on a comparable basis.

With respect to Telefónica Brazil, we have made the following adjustments in order to calculate 2016/2015 variations in organic terms:

**Exchange rate effect:** we have excluded the impact of changes in exchange rates by assuming constant average foreign exchange rates year on year. In particular, we have used the average foreign exchange rates of 2015 for both years.

**Changes in the scope of consolidation:** GVT was included in Telefónica's consolidation perimeter in May 2015. In order to exclude the impact of this change in the perimeter for the calculation of organic variations, the 2015 comparative figures include GVT's results from January 1 to April 30, 2015.

**Restructuring costs:** we have excluded the impact of restructuring costs associated with the simplification processes implemented in Telefónica Brazil. In 2016, these restructuring costs totaled 40 million euros. In 2015, these restructuring costs totaled 7 million euros

**Results of tower sales:** the results attributable to the sale of towers have been excluded (10 million euros in 2015).

**Spectrum acquisition:** the impact of spectrum acquisitions has been excluded (48 million euros in 2016).

The table below shows 2016/2015 variations in reported and organic terms (the latter, calculated in accordance with the adjustments referred to above) of certain income statement and other measures, and the contribution of each item for which we have adjusted to our reported growth:

|                                   | YoY variation                 |                              | Contribution to reported growth (percentage points) |                             |                                |                         |                                 |
|-----------------------------------|-------------------------------|------------------------------|---|-----------------------------|--------------------------------|-------------------------|---------------------------------|
| <b>TELEFÓNICA<br/>BRAZIL 2016</b> | <b>%<br/>Reported<br/>YoY</b> | <b>%<br/>Organic<br/>YoY</b> | <b>Exchange<br/>rate effect</b>                     | <b>Perimeter<br/>change</b> | <b>Restructuring<br/>costs</b> | <b>Towers<br/>sales</b> | <b>Spectrum<br/>acquisition</b> |
| Revenues                          | 0.3%                          | 0.9%                         | (5.2)   | 4.6                         | --                             | --                      | --                              |
| Other income                      | (16.3%)                       | (16.6%)                      | 4.4   | (7.9)                       | --                             | 2.3                     | --                              |
| Supplies                          | (12.4%)                       | (10.9%)                      | (4.6)   | 3.4                         | --                             | --                      | --                              |
| Personnel expenses                | 11.9%                         | 3.1%                         | (5.8)   | 11.0                        | 3.3                            | --                      | --                              |
| Other expenses                    | 0.5%                          | 2.0%                         | (5.2)   | 3.7                         | --                             | --                      | --                              |
| <b>OIBDA</b>                      | <b>3.9%</b>                   | <b>5.3%</b>                  | <b>(5.4)</b>  | <b>5.1</b>                  | <b>(1.0)</b>                   | <b>(0.3)</b>            | --                              |
| CapEx                             | 1.6%                          | (2.9%)                       | (5.3)   | 7.6                         | --                             | --                      | 2.4                             |
| <b>OpCF<br/>(OIBDA-CapEx)</b>     | <b>7.3%</b>                   | <b>17.8%</b>                 | <b>(5.6)</b>  | <b>1.4</b>                  | <b>(2.4)</b>                   | <b>(0.7)</b>            | <b>(3.5)</b>                    |

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## Results discussion

**Revenues** totaled 11,097 million euros in 2016, up 0.3% in reported terms and 0.9% year-on-year in organic terms, due mainly to the depreciation of the Brazilian real (which accounted for -5.2 p.p. of the evolution) and the consolidation of GVT (+4.6 p.p.). In organic terms, the year-on-year variation of 0.9% was principally due to the good evolution in the mobile business (+1.7% year-on-year), which was partially offset by the impact of the regulatory interconnection tariff reduction, impacting resulting in a reduction in fixed revenues, that decreased by 0.2%.

**Revenues from the mobile business** totaled 6,669 million euros in 2016, down 3.4% in reported terms due mainly to the depreciation of the Brazilian real (which accounted for -5.0 p.p. of the evolution). In organic terms, revenues from the mobile business increased by 1.7% due to the positive evolution of service revenues (+3.1% year-on-year) as a result of the good performance of outbound revenues, which in turn increased as a result of an increase in the customer base and the increased proportion of data revenues. This offsets the decrease in inbound revenues because of the fall in interconnection, due to the decrease of tariffs, and prepaid revenues associated with the customer base fall. Additionally, handsets revenues slow down 23.9% in reported terms due to a lower commercial activity.

**Fixed telephony revenues** totaled 4,428 million euros, up by 6.6% in reported terms due mainly to the impact of the consolidation of GVT (+12.3 p.p.) and partially offset by depreciation of the Brazilian real (which accounted for -5.6 p.p. of the evolution). In organic terms, revenues were down by 0.2%, mainly due to the regulatory impact of the decrease of the fixed-mobile and fixed-fixed tariffs that compensate the increase in broadband and new services revenues, which were up by 6.5% year-on-year in organic terms supported by the increase in fiber and Pay TV revenues.

The mobile **ARPU** increased 13.3% year-on-year in reported terms due mainly to the better quality of the customer base and the expansion of data revenues that compensate the depreciation of the Brazilian real. In organic terms, it increased 19.3% year-on-year as a consequence of the higher data ARPU which more than offset the negative impact of the reduction in the mobile termination rates. We believe the high quality of the client base is reflected in an increase in the outbound ARPU and the 25.3% growth in the data ARPU.

| TELEFÓNICA BRAZIL                   | 2015       | 2016       | % YoY        | % Local Currency YoY |
|-------------------------------------|------------|------------|--------------|----------------------|
| Voice Traffic (millions of minutes) | 379,430    | 373,074    | (1.7%)       | (1.7%)               |
| <b>ARPU (EUR)</b>                   | <b>6.3</b> | <b>7.1</b> | <b>13.3%</b> | <b>19.3%</b>         |
| Prepay                              | 3.2        | 3.4        | 5.4%         | 11.2%                |
| Contract (1)                        | 13.3       | 12.9       | (2.9%)       | 2.4%                 |
| <b>Data ARPU (EUR)</b>              | <b>2.9</b> | <b>3.5</b> | <b>19.1%</b> | <b>25.3%</b>         |

|                              |       |       |          |          |
|------------------------------|-------|-------|----------|----------|
| % non-SMS over data revenues | 82.9% | 88.4% | 5.5 p.p. | 5.5 p.p. |
|------------------------------|-------|-------|----------|----------|

Notes:

(1) Excludes M2M.



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**OIBDA** stood at 3,714 million euros in 2016, up 3.9% in reported terms. This evolution was affected by the recognition of a 40 million euros related to a restructuring personnel plan in 2016 compared with the 7 million euros provision registered in 2015, the positive impact from the expired payment obligation (98 million euros) in 2015, the negative impact of the depreciation of the Brazilian real (-5.4 p.p.) and the consolidation of GVT (+5.1 p.p.). In organic terms, the year-on-year increase was 5.3% due to revenue improvement and cost efficiency compensating a worse macro scenario with higher inflation, more devaluation and greater insolvencies provision rates. Personnel expenses totaled 1,167 million euros in 2016, up 11.9% in reported terms as result mainly of the consolidation of GVT, which was partially offset by the depreciation of the Brazilian real. In organic terms, personnel expenses increased by 3.1% year-on-year due to higher social benefits and the internalization of network contractors that compensates benefits from restructuring plans and voluntary redundancy programs in 2016. In addition, supplies costs fell (-10.9% in organic terms) thanks to the positive impact of the interconnection tariff reduction and lesser devices consumption (commercial activity focused on profitable clients).

**The OIBDA margin** stood at 33.5% in reported terms for 2016, up 1.2 p.p. compared to 2015.

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The below table shows the evolution of accesses in Telefónica Hispanoamérica over the past two years as of December 31 of such years:

**ACCESSES**

| <b>Thousands of accesses</b>            | <b>2015</b>      | <b>2016</b>      | <b>% Reported YoY</b> |
|---|------------------|------------------|-----------------------|
| Fixed telephony accesses (1)            | 12,829.8         | 11,938.6         | (6.9%)                |
| Internet and data accesses              | 5,667.8          | 5,707.9          | 0.7%                  |
| Broadband                               | 5,610.4          | 5,570.7          | (0.7%)                |
| Mobile accesses                         | 113,302.7        | 115,284.5        | 1.7%                  |
| Prepay                                  | 88,332.8         | 89,461.2         | 1.3%                  |
| Contract                                | 24,969.8         | 25,823.3         | 3.4%                  |
| M2M                                     | 2,296.9          | 2,561.3          | 11.5%                 |
| Pay TV                                  | 2,812.2          | 2,919.2          | 3.8%                  |
| <b>Final Clients Accesses</b>           | <b>134,612.4</b> | <b>135,850.3</b> | <b>0.9%</b>           |
| <b>Wholesale Accesses</b>               | <b>30.9</b>      | <b>66.5</b>      | <b>115.6%</b>         |
| <b>Total Accesses T. Hispanoamérica</b> | <b>134,643.3</b> | <b>135,916.8</b> | <b>0.9%</b>           |

Notes:

(1) Includes "fixed wireless" and Voice over IP accesses.

**Total accesses** reached 135.9 million at December 31, 2016 (+ 0.9% year-on-year).

**Mobile accesses** totaled 115.3 million customers and grew 1.7% year-on-year, highlighting the higher quality of the customer base.

In the contract segment, accesses grew 3.4% year-on-year. Growth was particularly strong in Argentina (+3.3%), Chile (+7.5%) and Colombia (+6.0%). Annual net adds reached 854 thousand customers, mainly due to the contribution of Argentina (+231 thousand accesses), Chile (+218 thousand accesses) and Colombia (+203 thousand

accesses), benefitting from a successful strategy of migrations (from prepay to contract), as well as a higher amount of gross adds.

In the prepay segment, accesses grew 1.3% year-on-year, with net adds of 1,1 million customers. Growth was driven mainly by Mexico (+1.5 million accesses), Colombia (+0.6 million accesses) and Central America (+0.8 million accesses), compensating the negative net adds in other markets like Peru (-1.2 million accesses) and Chile (-1.0 million accesses). Such increases were explained by strong price competition in the prepay segment, not followed by Movistar to avoid harming the quality levels of the network (avoiding reduced price offers), along with the focus on attracting high value customers that allowed the acceleration of migration processes from prepay to contract.

The smartphone customer base grew 14.7% year-on-year to 46.1 million accesses, with a penetration over mobile accesses of 41.3% (+4.7 p.p. year-on-year), mainly due to the growth in all countries of the region. At the same time, 4G accesses continued growing, reaching 15.5 million accesses at the end of the year.

**Traditional fixed business accesses** stood at 11.9 million at December 31, 2016 (-6.9% year-on-year) with negative net adds of 0.9 million customers, affected by the erosion of traditional fixed business in the region, including Argentina (-4.0% year-on-year), Peru (-5.8% year-on-year), Chile (-5.4% year-on-year) and Colombia (-5.4% year-on-year).

**Broadband accesses** totaled 5.6 million at December 31, 2016 (-0.7% year-on-year), due to negative net adds in Colombia (-3.6%) and Argentina (-1.6%), which were not enough to offset the positive performance of Peru (+2.4%). The penetration of fixed broadband accesses over traditional fixed business accesses was 46.7% at December 31, 2016 (+2.9 p.p. year-on-year). There was progressive migration towards data plans with higher speeds, with 62.1% of broadband accesses having a speed over 4Mb at December 31, 2016 (+9 p.p. year-on-year).

**TV accesses** totaled 2.9 million (+3.8% year-on-year), with net adds of 107 thousand customers as a result of an improvement in all the countries in the region that offer the service. Growth was particularly positive in Peru (+6.2%), Colombia (+5.9%) and Chile (+2.5%).

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The table below shows the evolution of Telefónica Hispanoamérica's results over the past two years:

**Millions of euros**

| <b>TELEFÓNICA HISPANOAMÉRICA</b> | <b>2015</b>   | <b>2016</b>  | <b>% Reported YoY</b> | <b>% Organic YoY (1)</b> |
|----------------------------------|---------------|--------------|-----------------------|--------------------------|
| Revenues                         | 14,387        | 12,579       | (12.6%)               | 7.5%                     |
| <b>Mobile Business</b>           | <b>10,347</b> | <b>8,882</b> | <b>(14.2%)</b>        | <b>6.3%</b>              |
| Mobile service revenues          | 9,160         | 7,918        | (13.6%)               | 7.0%                     |
| <b>Fixed Business</b>            | <b>4,070</b>  | <b>3,732</b> | <b>(8.3%)</b>         | <b>12.2%</b>             |
| Other income                     | 347           | 274          | (21.3%)               | (10.4%)                  |
| Supplies                         | (4,176)       | (3,704)      | (11.3%)               | 4.4%                     |
| Personnel expenses               | (1,686)       | (1,584)      | (6.1%)                | 22.8%                    |
| Other expenses                   | (4,516)       | (4,088)      | (9.5%)                | 7.0%                     |
| <b>OIBDA</b>                     | <b>4,356</b>  | <b>3,477</b> | <b>(20.2%)</b>        | <b>3.9%</b>              |
| OIBDA margin                     | 30.3%         | 27.6%        | (2.6 p.p.)            | (1.0 p.p.)               |
| Depreciation and amortization    | (2,241)       | (2,190)      | (2.3%)                | 7.5%                     |
| <b>Operating income (OI)</b>     | <b>2,115</b>  | <b>1,287</b> | <b>(39.1%)</b>        | <b>0.5%</b>              |
| CapEx                            | 3,060         | 2,613        | (14.6%)               | 6.5%                     |
| OpCF (OIBDA-CapEx)               | 1,296         | 864          | (33.3%)               | (0.3%)                   |

(1) See adjustments made to calculate organic variation below.

**Adjustments made to calculate organic variations**

As explained above, year-on-year changes referred to in this document as “organic” or presented in “organic terms” intend to present year-on-year variations on a comparable basis.

With respect to Telefónica Hispanoamérica, we have made the following adjustments in order to calculate 2016/2015 variations in organic terms:

**Exchange rate effects and hyperinflationary adjustments in Venezuela:** we have excluded the impact of changes in exchange rates by assuming constant average foreign exchange rates year on year. In particular, we have used the average foreign exchange rates of 2015 for both years. We have also excluded the impact of hyperinflationary adjustments in Venezuela, by reversing such adjustments.

**Restructuring costs:** we have excluded the impact of restructuring costs in 2016 and 2015, amounting to 84 and 38 million euros, respectively.

**Results of tower sales:** the results attributable to the sale of towers have been excluded (1 million euros in 2016 and 18 million euros in 2015).

**Spectrum acquisition:** the impact of spectrum acquisitions has been excluded in 2016 (284 million euros, corresponding to Peru) and 2015 (338 million euros, mainly corresponding to Argentina and Ecuador).

**Capital gains and losses on sales of companies:** gains and losses obtained from the sale of companies are excluded to calculate organic variations. In 2016, the profit from the sale of Telef  for 15 million euros was excluded.

**Goodwill impairments:** Impairment losses from goodwill in consolidation are excluded to calculate organic variations. In 2016, the impairment loss on the goodwill assigned to Telef nica Venezolana and Telef nica M viles Mexico amounting to 124 and 91 million euros, respectively.

The table below shows 2016/2015 variations in reported and organic terms (the latter, calculated in accordance with the adjustments referred to above) of certain income statement and other measures, and the contribution of each item for which we have adjusted to our reported growth:

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|                                      | YoY variation        |                     | Contribution to reported growth (percentage points) |                        |                 |                         |  |               |
|--------------------------------------|----------------------|---------------------|---|------------------------|-----------------|-------------------------|--|---------------|
| TELEFÓNICA<br>HISPANOAMÉRICA<br>2016 | %<br>Reported<br>YoY | %<br>Organic<br>YoY | Exchange rate<br>effect and<br>hyperinflation       | Restructuring<br>costs | Towers<br>sales | Spectrum<br>acquisition | Capital<br>Gains/losses<br>on sale of<br>companies | Impa          |
| Revenues                             | (12.6%)              | 7.5%                | (20.0)  | --                     | --              | --                      | --   |               |
| Other income                         | (21.3%)              | (10.4%)             | (10.7)  | --                     | (5.0)           | --                      | 4.2  | --            |
| Supplies                             | (11.3%)              | 4.4%                | (15.6)  | --                     | --              | --                      | --   | --            |
| Personnel expenses                   | (6.1%)               | 22.8%               | (32.4)  | 4.2                    | --              | --                      | --   | --            |
| Other expenses                       | (9.5%)               | 7.0%                | (21.2)  | --                     | --              | --                      | --   | 4.8           |
| <b>OIBDA</b>                         | <b>(20.2%)</b>       | <b>3.9%</b>         | <b>(17.5)</b>                                       | <b>(1.6)</b>           | <b>(0.4)</b>    | <b>--</b>               | <b>0.3</b>   | <b>(4.9)</b>  |
| CapEx                                | (14.6%)              | 6.5%                | (19.1)  | --                     | --              | (1.2)                   | --   |               |
| <b>OpCF<br/>(OIBDA-CapEx)</b>        | <b>(33.3%)</b>       | <b>(0.3%)</b>       | <b>(13.6)</b>                                       | <b>(5.5)</b>           | <b>(1.3)</b>    | <b>2.9</b>              | <b>1.1</b>   | <b>(16.6)</b> |

## Results discussion

**Revenues** amounted to 12,579 million euros in 2016, decreasing 12.6% year-on-year in reported terms due to the foreign exchange effects and the hyperinflation in Venezuela (-20.0 p.p.). Revenues increased 7.5 % year-on-year in organic terms mainly due to the growth in data revenues (mobile and fixed) and the growth of the customer base, higher data usage per customer and higher data penetration.

**Mobile service revenues** reached 7,918 million euros in 2016 and decreased by 13.6% year-on-year in reported terms. This decrease was mainly driven by the foreign exchange effects and the hyperinflation in Venezuela (which decreased growth by 20.6 p.p. of the year-on-year variation). Excluding these effects, these revenues grew by 7.0% principally as a result of the increase of service revenues in Argentina (18.4%). Mobile service revenues performance by country was as follows:

In Argentina: mobile service revenues amounted to 1,628 million euros in 2016, decreasing 25.8% year-on-year in reported terms. This decrease was mainly due to the exchange rate effect, reducing growth by 44.2 p.p. Excluding this effect, revenues increased by 18.4% due to the data revenues growth leveraged on the higher 4G customer base, permitting data consumption acceleration and commercial offers adapted to the inflationary environment.

In Mexico: mobile service revenues reached 1,246 million euros in 2016, decreasing 19% year-on-year in reported terms. In local currency, these revenues decreased 4.9%, mainly due to lower prepaid revenues as a result of strong competition and due to the regulatory impact, which was partially offset by a satisfactory performance in wholesale service.

In Chile: service revenues reached 1,103 million euros in 2016, decreasing 6.3% year-on-year in reported terms mainly due to the foreign exchange effect (-3.1 p.p.). In local currency, these revenues decreased by 3.2% affected by lower prepaid revenues as well as lower interconnection rates.

In Peru: mobile service revenues reached 1,206 million euros in 2016, decreasing 13.2% year-on-year in reported terms mainly due to the foreign exchange effect (-5 p.p.). In local currency these revenues decreased by 8.2%, affected by the reduction of prepaid and contract revenues due to higher aggressiveness in the market, resulting in lower ARPU's.

**Data revenues** in the segment reached 3,511 million euros in 2016 and decreased 4.8% year-on-year in reported terms mainly due to foreign exchange effects and the hyperinflation in Venezuela (-24.4 p.p.). Excluding these effects, these revenues grew 19.6 % year-on-year mainly due to the increase in data revenues in most of the countries of the region and by the higher data penetration which grew from 41.3% in 2015 to 46.1 % during 2016.

**Fixed business revenues** reached 3,732 million euros in 2016, and decreased 8.3% in reported terms. Excluding the foreign exchange effects and the hyperinflation in Venezuela (which decreased growth by 20.5p.p.) these revenues grew by 12.2% due to the increase in broadband and new services revenues (+21.6%). Revenues from broadband and new services, accounted for 53.7% of fixed revenues (+3.0 p.p. year-on-year). The growth was particularly notable in Argentina (44.7%), Colombia (17.4%) and Chile (11.7%) with a strong growth in broadband revenues due to the higher quality of the customer base as well as the tariff adjustment.

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**OIBDA** reached 3,477 million euros in 2016, decreasing 20.2% in reported terms, negatively affected by the goodwill impairment in Mexico and Venezuela and restructuring costs in 2016 and 2015, previously mentioned, and offset by the generated capital gain from the Telef  sale. Excluding these adjustments, exchange rate effects and hyperinflation in Venezuela, OIBDA increased 3.9% in organic terms. This growth is mainly due to the good evolution in revenues and higher commercial efficiencies that offset higher interconnection, content and network costs, up principally due to the devaluation in certain countries in the region. Energy, electricity and call center costs also increased during 2016.

Below additional information by country.

Argentina: OIBDA reached 797 million euros in December 2016, decreasing 20.7% in reported terms. In local ocurrency, OIBDA increased by 26.6%, mainly due to the revenue growth as well as to lower commercial costs recorded in 2016, as a result of lower commercial activity and greater commercial efficiency.

Chile: OIBDA reached 704 million euros in December 2016, decreasing 7.4% in reported terms mainly due to the oexchange rate evolution (-3 p.p.). In local currency, OIBDA decreased by 4.4%, explained by the decrease in mobile service revenues.

Peru: OIBDA reached 782 million euros in December 2016, decreasing 17.1% in reported terms mainly due to the oexchange rate evolution. In local currency, OIBDA decreased by 12.3%, as the efforts in costs savings were oinsufficient to compensate higher interconnection costs associated with higher traffic, and more than offset the revenue increase.

Colombia: OIBDA reached 464 million euros in December 2016, decreasing 15% in reported terms mainly due to othe exchange rate evolution. In local currency, OIBDA decreases 5.1% year-on-year due to higher interconnection costs associated to the successful offer “Todo Destino”.

The **OIBDA margin** was 27.6% in 2016, decreasing 2.6 p.p. in reported terms. This decrease is affected by the margin reduction in Chile (-1.7 p.p.), Peru (-2.8 p.p.), Colombia (-3.3 p.p.) and Mexico (-5.0 p.p.), reflecting a higher commercial effort focused on higher value segments.

**2015/2014 Consolidated results**

In this section, we discuss changes in the Group’s consolidated income statements for 2015 and 2014. The consolidated income statement data for the years ended December 31, 2015 and 2014 set forth below has been retrospectively amended, in order to cease to present our operations in the United Kingdom as a discontinued operation.



As explained above, the consolidated income statement for the year ended December 31, 2015 has been amended to retroactively show the reclassification of Telefónica United Kingdom's results as continuing operations. Therefore, the results below differ from the results previously published for such period. The segmented financial information shown below has been amended for 2015 as discussed above.

Telefónica's **total accesses** totaled 347.5 million as of December 31, 2015. Telefónica United Kingdom customers have been included in the 2014 and 2015 customer base, since we have classified Telefónica United Kingdom and its operations as continuing operations. Group accesses increased 1.9% year-on-year, as a result mainly of the additional accesses gained following the purchase of GVT by Telefónica Brazil and DTS in Telefónica Spain and the growth in accesses in Telefónica Hispanoamérica, Telefónica Germany and Telefónica United Kingdom. If we consider the accesses from GVT and DTS as of December 31, 2014 to make both years comparable, accesses would have decreased by 0.8% affected, in part, by prepaid disconnections in Telefónica Brazil (which resulted in the disconnection of 11.5 million accesses in 2015 and 1.6 million accesses in 2014). In 2015, commercial activity increased based on high value customers, resulting in growth of the contract mobile segment (smartphones and LTE), fiber and Pay TV. Accesses in Telefónica Hispanoamérica (38.7% of the Group's total as of December 31, 2015) increased by 2.3% year-on-year, Telefónica United Kingdom (7.3% of the Group's total as of December 31, 2015) increased by 2.3% year-on-year, while accesses in Telefónica Germany (13.9% of the Group's total) increased by 1.5% year-on-year.

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The below table shows the evolution of accesses 2014 and 2015:

**ACCESSES**

| <b>Thousands of accesses</b>  | <b>2014</b>      | <b>2015</b>      | <b>% Reported YoY</b> | <b>% Organic YoY (1)</b> |
|-------------------------------|------------------|------------------|-----------------------|--------------------------|
| Fixed telephony accesses (2)  | 36,830.0         | 39,734.9         | 7.9%                  | (3.0%)                   |
| Internet and data accesses    | 18,151.7         | 21,365.3         | 17.7%                 | 1.3%                     |
| Broadband (3)                 | 17,668.5         | 20,971.3         | 18.7%                 | 1.8%                     |
| Fiber (4)                     | 1,755.0          | 6,100.3          | 247.6%                | 29.9%                    |
| Mobile accesses               | 274,458.0        | 272,103.9        | (0.9%)                | (0.9%)                   |
| Prepay                        | 175,720.4        | 167,845.1        | (4.5%)                | (4.5%)                   |
| Contract                      | 98,737.6         | 104,258.8        | 5.6%                  | 5.6%                     |
| M2M                           | 9,787.4          | 11,526.3         | 17.8%                 | 17.8%                    |
| Pay TV (5)                    | 5,087.2          | 8,271.6          | 62.6%                 | 12.0%                    |
| <b>Final Clients Accesses</b> | <b>334,526.9</b> | <b>341,475.6</b> | <b>2.1 %</b>          | <b>(0.7 %)</b>           |
| <b>Wholesale Accesses</b>     | <b>6,521.6</b>   | <b>6,062.8</b>   | <b>(7.0%)</b>         | <b>(7.0%)</b>            |
| <b>Total Accesses</b>         | <b>341,048.5</b> | <b>347,538.4</b> | <b>1.9%</b>           | <b>(0.8%)</b>            |

Notes:

- T. Ireland customers are excluded since the third quarter 2014. Accesses include E-Plus customers since the fourth quarter 2014 and GVT and DTS customers since May 1 2015.

(1) In order to calculate organic changes, we have added the accesses of DTS and GVT as of December 31, 2014 to our accesses as of such date.

(2) Includes "fixed wireless" and Voice over IP accesses.

(3) Includes DSL, satellite, optic fiber, cable modem and broadband circuits.

(4) Includes 3.25 million GVT fiber (FTTx) customers since second quarter 2015.

(5) Includes 1.1 million DTS customers.

The below table shows the contribution of each item for which we have adjusted our reported growth. With respect to each line item, the contribution to reported growth of such line item, expressed in p.p., is the result of dividing the

impact of each item for which we have adjusted by the amount of such line item, on a reported basis, for the prior year.

| <b>TELEFÓNICA<br/>2015</b> | <b>% Reported<br/>YoY</b> | <b>% Organic<br/>YoY (1)</b> | <b>DTS</b> | <b>GVT</b> |
|----------------------------|---------------------------|------------------------------|------------|------------|
| Fixed telephony accesses   | 7.9%                      | (3.0%)                       | 0.0 p.p.   | 11.2 p.p.  |
| Internet and data accesses | 17.7%                     | 1.3%                         | 0.0 p.p.   | 16.2 p.p.  |
| Broadband                  | 18.7%                     | 1.8%                         | 0.0 p.p.   | 16.6 p.p.  |
| Fiber                      | n.m.                      | 29.9%                        | 0.0 p.p.   | n.m.       |
| Pay TV                     | 62.6%                     | 12.0%                        | 28.3 p.p.  | 16.9 p.p.  |
| Final Clients Accesses     | 2.1%                      | (0.7%)                       | 0.4 p.p.   | 2.4 p.p.   |
| Total Accesses             | 1.9%                      | (0.8%)                       | 0.4 p.p.   | 2.3 p.p.   |

(1) In order to calculate organic changes, we have added the accesses of DTS and GVT as of December 31, 2014 to our accesses as of such date.

The table below shows the evolution of accesses by segment:

| <b>Accesses 2015</b> | <b>YoY variation</b>      |                              | <b>% Over<br/>Total<br/>Accesses</b> |             |
|----------------------|---------------------------|------------------------------|--------------------------------------|-------------|
|                      | <b>% Reported<br/>YoY</b> | <b>% Organic<br/>YoY (1)</b> | <b>2014</b>                          | <b>2015</b> |
| Spain                | 1.9%                      | (1.6%)                       | 12.1%                                | 12.1%       |
| United Kingdom       | 2.3%                      | --                           | 7.3%                                 | 7.3%        |
| Germany              | 1.5%                      | --                           | 14.0%                                | 13.9%       |
| Brazil               | 1.4%                      | (6.4%)                       | 28.0%                                | 27.9%       |
| Hispanoamérica       | 2.3%                      | --                           | 38.6%                                | 38.7%       |
| Others               | 16.6%                     | --                           | 0.1%                                 | 0.1%        |

(1) In order to calculate organic changes, we have added the accesses of DTS and GVT as of December 31, 2014 to our accesses as of such date.

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The Group's strategy is based on capturing growth in its markets, especially on attracting high-value customers.

**Mobile accesses** totaled 272.1 million at December 31, 2015, down 0.9% compared to December 31, 2014, affected mainly by the decrease in prepay accesses (due to the disconnection of prepay accesses in Brazil (11.5 million accesses in 2015 and 1.6 million accesses in 2014)). Contract accesses, however, were up 5.6% year-on-year, continuing to increase their weight over total mobile accesses up to 38.3% (+2.3 p.p. year-on-year).

**Smartphone accesses** maintained a strong growth rate (up 48.3% year-on-year), totaling 126.2 million accesses as of December 31, 2015 and reaching a penetration rate over total accesses of 49.5% (+14.3 p.p. year-on-year), reflecting the Company's strategic focus on the growth of its data services.

**Fixed broadband accesses** stood at 21.0 million at December 31, 2015, up 18.7% year-on-year (of which 16.6 p.p. was due to the inclusion of accesses from GVT in the 2015). Fiber accesses stood at 6.1 million at December 31, 2015.

**TV accesses** totaled 8.3 million up 63% year-on-year (of which 28 p.p. was due to the inclusion of accesses from DTS and 17 p.p. was due to the inclusion of accesses from GVT in the 2015 access base).

Telefónica's customer base includes the consumer and business segments, and therefore is not affected by customer concentration risk.

| Consolidated Results | Year ended December, 31 |               |          |               | Percent Change |       |
|----------------------|-------------------------|---------------|----------|---------------|----------------|-------|
|                      | 2014 (*)                |               | 2015 (*) |               | 2015 vs 2014   |       |
| Millions of euros    | Total                   | % of revenues | Total    | % of revenues | Total          | %     |
| Revenues             | 50,377                  | 100.0%        | 54,916   | 100.0%        | 4,539          | 9.0%  |
| Other income         | 1,707                   | 3.4%          | 2,011    | 3.7%          | 304            | 17.8% |
| Supplies             | (15,182)                | (30.1%)       | (16,547) | (30.1%)       | (1,365)        | 9.0%  |
| Personnel expenses   | (7,098)                 | (14.1%)       | (10,349) | (18.9%)       | (3,251)        | 45.8% |

|  |               |              |               |              |                |                |
|--|---------------|--------------|---------------|--------------|----------------|----------------|
| Other expenses   | (14,289)      | (28.4%)      | (16,802)      | (30.6%)      | (2,513)        | 17.6%          |
| <b>OPERATING INCOME BEFORE DEPRECIATION AND AMORTIZATION (OIBDA)</b> | <b>15,515</b> | <b>30.8%</b> | <b>13,229</b> | <b>24.1%</b> | <b>(2,286)</b> | <b>(14.7%)</b> |
| Depreciation and amortization  | (8,548)       | (17.0%)      | (9,704)       | (17.7%)      | (1,156)        | 13.5%          |
| <b>OPERATING INCOME</b>  | <b>6,967</b>  | <b>13.8%</b> | <b>3,525</b>  | <b>6.4%</b>  | <b>(3,442)</b> | <b>(49.4%)</b> |
| Share of loss of investments accounted for by the equity method      | (510)         | (1.0%)       | (10)          | (0.0%)       | 500            | (97.9%)        |
| Net financial expense  | (2,822)       | (5.6%)       | (2,609)       | (4.8%)       | 213            | (7.5%)         |
| <b>PROFIT BEFORE TAX</b>   | <b>3,635</b>  | <b>7.2%</b>  | <b>906</b>    | <b>1.7%</b>  | <b>(2,729)</b> | <b>(75.1%)</b> |
| Corporate income tax   | (383)         | (0.8%)       | (155)         | (0.3%)       | 228            | (59.6%)        |
| <b>PROFIT FOR THE YEAR</b>   | <b>3,252</b>  | <b>6.5%</b>  | <b>751</b>    | <b>1.4%</b>  | <b>(2,501)</b> | <b>(76.9%)</b> |
| Attributable to equity holders of the Parent                         | 3,001         | 6.0%         | 616           | 1.1%         | (2,385)        | (79.5%)        |
| Attributable to non- controlling interests                           | 251           | 0.5%         | 135           | 0.3%         | (116)          | 46.2%          |

(\*) Amended data

#### Adjustments made to calculate organic variations

As previously mentioned, year-on-year changes referred to in this document as “organic” or presented in “organic terms” intend to present year-on-year variations on a comparable basis (see Consolidated Results 2016/2015- Adjustments for the calculation of organic variations)

The adjustments made to calculate 2015/2014 organic variations are the following:

**Foreign exchange effects and the impact of hyperinflationary adjustments in Venezuela:** We have excluded the impact of changes in exchange rates by assuming constant average foreign exchange rates in 2015 and 2014. In particular, we have used the average foreign exchange rates of 2014 for both years.

Foreign exchange rates had a negative impact on our reported 2015 results, mainly due to the depreciation of various Latin American currencies versus the euro, in particular the Brazilian real and, to a lesser extent, the Venezuelan bolívar.

We have also excluded the impact of hyperinflationary adjustments in Venezuela by reversing such adjustments.



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**Changes in the scope of consolidation:** We have excluded the impact of changes in our consolidation perimeter in 2015 and 2014. The main changes in our consolidation perimeter in such years related to the consolidation of GVT in Telefónica Brazil since May 2015, the consolidation of DTS in Telefónica Spain since May 2015, the consolidation of E-Plus in Telefónica Germany since October 2014 and the sale of Telefónica Ireland in July 2014.

In order to exclude the impact of these changes in our perimeter, we have:

- o consolidated GVT's results from May 1 to December 31, 2014 in our 2014 results;
- o consolidated DTS's results from May 1 to December 31, 2014 in our 2014 results;
- o consolidated E-Plus's results from January 1 to September 30, 2014 in our 2014 results; and
- o excluded Telefónica Ireland's results from January 1 to June 30, 2014 from our 2014 results.

**Restructuring costs:** We have excluded the impact of certain restructuring costs, mainly those related to the 1st Collective Agreement of Related Companies in Telefónica Spain, restructuring processes relating to Telefónica Germany, Telefónica United Kingdom and Telefónica Brazil and the Group's simplification program.

In 2015, these restructuring costs totaled 3,217 million euros and were aimed at increasing future efficiency, representing a further step towards the transformation and simplification initiatives carried out by Telefónica. These costs were distributed by segment as follows (impacts on OIBDA): Telefónica Spain (2,896 million euros), Telefónica Germany (74 million euros), Telefónica Hispanoamérica (38 million euros), Telefónica Brazil (7 million euros), Telefónica United Kingdom (4 million euros) and other companies (197 million euros).

In 2014, these restructuring costs totaled 658 million euros and were attributable to the simplification initiatives that the Group has implemented to meet its targets. These costs were mainly distributed by segment as follows (impacts on OIBDA): Telefónica Germany (414 million euros), Telefónica Brazil (68 million euros), Telefónica Hispanoamérica (99 million euros, mainly in Peru) and other companies (77 million euros).

**Results of tower sales:** The results attributable to the sale of towers in 2015 and 2014 have been excluded in both years.

In 2015 the results from the sale of towers totaled 65 million euros, distributed as follows: Telefónica Spain (38 million euros), Telefónica Brazil (10 million euros) and Telefónica Hispanoamérica (18 million euros, mainly in Chile). In 2014 the results from the sale of towers totaled 196 million euros in OIBDA, mainly in Telefónica Spain (191 million euros).

**Irrevocable commitment with Fundación Telefónica:** In 2015 we have excluded the expense (325 million euros) resulting from Telefónica, S.A.'s irrevocable commitment to make a donation to Fundación Telefónica in order to provide this entity with the financing required so that it can carry out its existing or new social programs and non-profit activities in the short and medium term.

**Adjustments to the final purchase price of E-Plus:** In 2015 we have excluded the positive result from the difference between the preliminary purchase price of E-Plus (as estimated at the end of the valuation period) and the final purchase price agreed with KPN, totaling 104 million euros (which had a 102 million euros positive impact on OIBDA, net of costs related to the acquisition).

**Spectrum acquisition:** We have excluded the impact of spectrum acquisitions in 2015 and 2014.

In 2015, these acquisitions totaled 1,585 million euros, 1,198 million euros corresponding to Telefónica Germany, 49 million euros corresponding to Telefónica Spain and 338 million euros corresponding to Telefónica Hispanoamérica (mainly Argentina and Ecuador).



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In 2014 these acquisitions totaled 1,294 million euros, 889 million euros corresponding to Telefónica Brazil and 405 million euros corresponding to Telefónica Hispanoamérica with the following distribution by country or region:

- o Telefónica Argentina (168 million euros);
- o Telefónica Colombia (111 million euros); and
- o Telefónica Venezuela and Central America (126 million euros).

**Real Estate Efficiency Plan:** In 2014 we have excluded the impact of certain urban assets qualification changes in Telefónica Spain and also the investment in Telefónica's Barcelona head office, which had an impact on capital expenditures (Capex) of 78 million euros.

**Other adjustments:** We have excluded the partial adjustment of the goodwill generated in the acquisition of Telefónica Digital Inc. amounting to 104 million euros y the impact of the impairment resulting from the deterioration in certain minority participations, totaling 23 million euros in 2015. We have also excluded the impact of the 30 million euros provision recorded in 2015 in Telefónica Spain to optimize the distribution channel.

The table below shows 2015/2014 variations in reported and organic terms (the latter, calculated in accordance with the adjustments referred to above) of certain income statement and other measures:

|                              | <b>YoY variation</b> |                  |
|------------------------------|----------------------|------------------|
| TELEFÓNICA<br>2015           | % Reported YoY       | % Organic<br>YoY |
| Revenues                     | 9.0%                 | 3.5%             |
| Other income                 | 17.8%                | 15.3%            |
| Supplies                     | 9.0%                 | 0.3%             |
| Personnel expenses           | 45.8%                | 4.0%             |
| Other expenses               | 17.6%                | 8.1%             |
| <b>OIBDA</b>                 | <b>(14.7%)</b>       | <b>3.2%</b>      |
| <b>Operating income (OI)</b> | <b>(49.4%)</b>       | <b>4.0%</b>      |
| CapEx                        | 10.7%                | 4.9%             |

**OpCF (OIBDA-CapEx) (54.4%) 1.3%**

The below table shows the contribution of each item for which we have adjusted to our reported growth. With respect to each line item, the contribution to reported growth of such line item, expressed in p.p., is the result of dividing the impact of each item for which we have adjusted by the amount of such line item, on a reported basis, for the prior year.

Table of Contents**Contribution to reported growth (percentage points)**

| TELEFÓNICA<br>2015               | Exchange rate<br>effect and<br>hyperinflation | Perimeter<br>change | Restructuring<br>costs | Towers<br>sales | Commitment<br>with<br>Fundación | Adjustments<br>to the final<br>purchase<br>price of<br>E-Plus | Spectrum<br>acquisition | Real<br>Estate<br>Efficiency<br>Plan |  |
|----------------------------------|---|---------------------|------------------------|-----------------|---------------------------------|---|-------------------------|--------------------------------------|--|
| Revenues                         | (2.3)   | 7.6                 | -                      | -               | -                               | -   | -                       | -                                    |  |
| Other income                     | (2.7)   | 7.5                 | -                      | (7.7)           | -                               | 6.1   | -                       | -                                    |  |
| Supplies                         | 0.3   | 8.4                 | -                      | -               | -                               | -   | -                       | -                                    |  |
| Personnel<br>expenses            | (1.5)   | 7.1                 | 36.3                   | -               | -                               | -   | -                       | -                                    |  |
| Other expenses                   | (4.4)   | 9.9                 | (0.1)                  | -               | 2.3                             | -   | -                       | -                                    |  |
| <b>OIBDA</b>                     | <b>(3.2)</b>                                  | <b>4.8</b>          | <b>(16.5)</b>          | <b>(0.8)</b>    | <b>(2.1)</b>                    | <b>0.7</b>  | -                       | -                                    |  |
| <b>Operating<br/>Income (OI)</b> | <b>(5.3)</b>                                  | <b>(4.2)</b>        | <b>(36.7)</b>          | <b>(1.9)</b>    | <b>(4.7)</b>                    | <b>1.5</b>  | -                       | -                                    |  |
| CapEx                            | (3.7)   | 7.9                 | -                      | -               | -                               | -   | 2.8                     | (0.8)                                |  |
| <b>OpCF<br/>(OIBDA-CapEx)</b>    | <b>(2.4)</b>                                  | -                   | <b>(42.2)</b>          | <b>(2.1)</b>    | <b>(5.4)</b>                    | <b>1.7</b>  | <b>(4.4)</b>            | <b>1.3</b>                           |  |

## Results Discussion

**Revenues** totaled 54,916 million euros in 2015, increasing 9.0% compared to 2014 in reported terms. This increase was mainly attributable to the consolidation of E-Plus, GVT and DTS (which accounted for 7.6 p.p. of the year-on-year increase), which was partially offset by the impact of changes in foreign exchange rates and hyperinflation in Venezuela (-2.3 p.p.). In organic terms, revenues increased 3.5% due to higher connectivity revenues, mainly in the mobile business as a consequence of the strong data revenue growth. The growing focus on our key markets was reflected in the revenue mix with Telefónica Spain, Telefónica Brazil and Telefónica Germany accounting for 57.1% of the revenues, increasing local scale and keeping at the same time the Group's differential diversification and global scale.

The **structure of revenues** reflects Telefónica's business diversification. Despite the adverse impact of exchange rates and hyperinflation in Venezuela, the segment with the largest contribution to our revenues in 2015 was Telefónica Hispanoamérica, representing 26.2% (+0.1 p.p. compared to 2014), followed by Telefónica Spain, representing 22.6% (-1.3 p.p. compared to 2014), Telefónica Brazil, representing 20.1% (-2.2 p.p. compared to 2014), Telefónica Germany, which increased its contribution with respect to 2014 to 14.4% (+3.4 p.p. year-on-year), and Telefónica

United Kingdom representing 14.3% (+0.3 p.p. compared to 2014).

**Mobile business revenues** totaled 35,540 million euros in 2015 (of which 30,289 million euros corresponded to service revenues and 4,984 million euros corresponded to handset revenues) up 8.2% year-on-year in reported terms. This increase was mainly attributable to the consolidation of E-Plus (which accounted for 6.1 p.p. of the year-on-year increase), which was partially offset by the impact of changes in foreign exchange rates and hyperinflation in Venezuela (-1.6 p.p.). Excluding these impacts, year-on-year growth was 3.5% due to higher mobile revenues in Telefónica Hispanoamérica and Telefónica Brazil as a result mainly of the increase in the customer base and data adoption.

**Mobile service revenues** totaled 30,289 million euros in 2015, up 6.6% year-on-year in reported terms. This increase was mainly attributable to the consolidation of E-Plus (which accounted for 6.0 p.p. of the year-on-year increase), which was partially offset by the impact of changes in foreign exchange rates and hyperinflation in Venezuela (-2.2 p.p.). Excluding these impacts, year-on-year growth was 2.6% due mainly to the higher customer base and higher data consumption.

**Mobile data revenues** totaled 13,869 million euros in 2015, up 18.9% in reported terms. This increase was mainly attributable to the consolidation of E-Plus (which accounted for 7.9 p.p. of the year-on-year increase) and the higher consumption of data of our customers, which was partially offset by the impact of changes in foreign exchange rates and hyperinflation in Venezuela (-2.2 p.p.). Excluding these impacts, mobile data revenues increased by 12.2% due mainly to the increased revenues of non-SMS data (up 20.4%) and higher use of data per customer. Mobile data revenues accounted for 45.5% of mobile service revenues in 2015, up 4.8 p.p. compared to 2014 in reported terms.

**Fixed revenues** totaled 17,854 million euros in 2015, up 9.5% year-on-year in reported terms. This increase was mainly attributable to the consolidation of GVT and DTS (which accounted for +10.9 p.p. of the year-on-year increase), which was partially offset by the impact of changes in foreign exchange rates and hyperinflation in Venezuela (-3.9 p.p.). Excluding these impacts, fixed revenues increased 2.2%. This increase was mainly due to higher broad band connection revenues and Pay-TV revenues as a result of the commercial actions carried out by the Company in order to increase our value proposition and the higher customer base in Pay-TV.

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**Other income** in 2015 mainly included own work capitalized in our fixed assets, profit from the sale of other assets, and the sale of towers by Telefónica Spain, Telefónica Brazil and Telefónica Hispanoamérica.

In 2015, other income totaled 2,011 million euros, up 17.8% year-on-year in reported terms. In 2015, other income was positively affected by the consolidation of E-Plus, GVT and DTS, the positive result from the E-Plus price adjustment (104 million euros), the positive impact from the expired payment obligation (98 million euros) in Telefónica Brazil, the spectrum swap with AT&T in Telefónica Mexico carried out in December 2015 (79 million euros), the sale of real estate in Telefónica Spain (78 million euros) and the result from the sale of towers amounting to 65 million euros.

In 2014, the sale of towers had a positive impact of 196 million euros. Other income also included an extraordinary sale of real estate in Telefónica Spain (63 million euros).

**Total expenses** (which include supply costs, personnel costs and other expenses (principally external services and taxes) but do not include amortization and depreciation expenses), were 43,698 million euros in 2015, up year-on-year 19.5% in reported terms. This increase was mainly attributable to the consolidation of E-Plus, GVT and DTS (which accounted for 8.7 p.p. of the year-on-year increase) and higher restructuring costs amounting to 3,217 million euros (which accounted for 7.0 p.p. of the year-on-year increase), which was partially offset by the impact of changes in foreign exchange rates and hyperinflation in Venezuela (-1.9 p.p.). The costs are explained in detail below:

**Supplies** amounted to 16,547 million euros in 2015, up 9.0% year-on-year in reported terms mainly as a result of the consolidation of E-Plus, GVT and DTS (which accounted for 8.4 p.p. of the year-on-year increase). In organic terms, supplies expenses grew by 0.3% year-on-year, due to increased commercial activity in high-end devices and higher TV content costs, which more than offset the decrease in mobile interconnection costs.

**Personnel expenses** amounted to 10,349 million euros in 2015, up 45.8% in reported terms year-on-year compared to 2014. This increase was mainly attributable to higher restructuring costs of 3,146 million euros (which accounted for +36.3 p.p. of the year-on-year increase), the consolidation of E-Plus, GVT and DTS (which accounted for 7.1 p.p. of the year-on-year increase), and was partially offset by the impact of changes in foreign exchange rates and hyperinflation in Venezuela (-1.5 p.p.). In organic terms, personnel costs increased 4.0% year-on-year mainly affected by inflationary pressures in some Latin American countries.

The average headcount was 133,569 employees in 2015, up 10.8% compared to 2014 (-2.1% excluding the impact of changes in the scope of consolidation).

**Other expenses** amounted to 16,802 million euros in 2015, up 17.6% in reported terms. This increase was mainly attributable to the consolidation of E-Plus, GVT and DTS (which accounted for 9.9 p.p. of the year-on-year increase), the provision of 325 million euros related to the irrevocable agreement between Telefónica, S.A. and Fundación Telefónica for its short-and mid-term financing (+2.3 p.p.) and to a lesser extent, the impairment resulting from the deterioration in certain minority participations, the goodwill value adjustment in Telefónica Digital Inc. (+1.1 p.p.) and the decrease in other expenses related to restructuring processes (-0.1 p.p.), which was partially offset by the impact of changes in foreign exchange rates and hyperinflation in Venezuela (-4.4 p.p.). In organic terms, other expenses increased by 8.1% compared to 2014, mainly as a result of increased network costs, higher IT costs and a higher commercial activity. Increased inflation in some Latin American countries offset in part the savings resulting from the simplification measures carried out by the Company.

**OIBDA** was 13,229 million euros in 2015, down 14.7% in reported terms. This decrease was mainly attributable to the higher restructuring costs (which accounted for 16.5 p.p. of the year-on-year decrease and included a restructuring costs provision of 3,217 million euros), the impact of changes in foreign exchange rates and hyperinflation in Venezuela (-3.2 p.p.), the provision of 325 million euros related to the agreement between Telefónica S.A. and Fundación Telefónica for its short and mid-term financing (-2.1 p.p.) and, to a lesser extent, the decreased results from the sale of towers (-0.8 p.p.), the provision recorded in connection with the optimization of the distribution channel in Spain of 30 million euros (-0.2 p.p.) and the impairment resulting from the deterioration in certain minority participations (-0.8 p.p.), which was partially offset by the impact of the consolidation of E-Plus, GVT and DTS (+4.8 p.p.) and the adjustments made to the final acquisition price of E-Plus (+0.7 p.p.).

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In organic terms, OIBDA grew 3.2% due to the positive evolution of Telefónica Germany (+20.9% year-on-year), reflecting increased synergies, the better performance of Telefónica Brazil (+2.9% year-on-year) and the results from Telefónica Hispanoamérica (+7.2% year-on-year).

**OIBDA margin** stood at 24.1% in 2015, down 6.7 p.p. compared to 2014 in reported terms due mainly to the restructuring costs provision of 3,217 million euros in 2015.

By segments, Telefónica Hispanoamérica was the main contributor to Group OIBDA with 32.9% (+6.7 p.p. compared to 2014), Telefónica Brazil contributed 27.0% (+4.2 p.p. compared to 2014), Telefónica Germany contributed 14.0% (+9.3 p.p. compared to 2014) and Telefónica United kingdom contributed 14.6% (+3.3 p.p. compared to 2014). Telefónica Spain contributed 17.7% to Group OIBDA, down 18.9 p.p. compared to 2014, mainly as a result of the restructuring cost provision of 2,896 million euros in 2015.

**Depreciation and amortization** amounted to 9,704 million euros in 2015, up 13.5% year-on-year in reported terms, mainly due to the consolidation of E-Plus, GVT and DTS. The total depreciation and amortization charges arising from purchase price allocation processes amounted to 894 million euros in 2015, up 26.3% year-on-year.

**Operating income (OI)** in 2015 totaled 3,525 million euros, down 49.4% compared to 2014 for the reasons set forth above for OIBDA. In organic terms, operating income grew 4.0% year-on-year as a result of higher revenues and costs savings.

The **share of loss of investments accounted for by the equity method** for 2015 was a loss of 10 million euros (compared to a loss of 510 million euros in 2014). The loss recorded in 2014 was mainly due to the valuation adjustment of Telco, S.p.A. at Telecom Italia, S.p.A. amounting to 464 million euros.

**Net financial expense** amounted to 2,609 million euros in 2015, 7.5% lower than the previous year. Excluding exchange rate differences, costs improved by 21.2% (536 million euros) to 1,993 million euros. Negative foreign exchange differences amounted to 616 million euros (excluding monetary correction), primarily due to adoption of the SIMADI exchange rate for the Venezuelan bolivar. The lower cost of debt in euros explains 146 million euros of this improvement, due to lower fixed rate debt and capture of the reduction in short-term rates. The divestment of the entire holding in Telecom Italia, S.p.A. generated a positive variation of 404 million euros. Other effects resulted in losses of 13 million euros. These included the monetary correction for inflation in Venezuela, net of higher expenses in Latin America currencies, costs for updating contingencies, and other gains and losses on equities. The effective cost of debt over 2015, excluding exchange rate differences and the positive impact of the divestment of Telecom Italia, S.p.A., stood at 4.82%, down 52 basis points year-on-year.

**Corporate income tax** totaled 155 million euros in 2015, compared to 383 million euros in 2014, mainly due to the temporary difference recorded related to a restructuring provision the activation of tax credit in Spain. Considering a pre-tax income of 906 million euros, the effective tax rate was 17.1% in 2015, 6.5 p.p. higher than in 2014.

**Profit attributable to non-controlling interest** reduced the profit for the year attributable to equity holder of the parent by 135 million euros, 116 million euros less than in 2014, mainly due to the lower profit attributable to minority interests in Telefónica Brazil and Colombia Telecomunicaciones.

As a result of the foregoing, profit for the year attributable to equity holders of the parent for 2015 was 616 million euros, down by 79.5% year on year compared to 2014.



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## TELEFÓNICA SPAIN

The below table shows the evolution of accesses in Telefónica Spain over the past two years as of December 31 of such years:

## ACCESSES

| Thousands of accesses        | 2014     | 2015     | %Reported<br>YoY | %Organic<br>YoY (1) |
|------------------------------|----------|----------|------------------|---------------------|
| Fixed telephony accesses (2) | 10,447.8 | 10,005.6 | (4.2%)           | (4.2%)              |
| Internet and data accesses   | 5,928.7  | 6,000.0  | 1.2%             | 1.2%                |
| Broadband (3)                | 5,885.9  | 5,962.0  | 1.3%             | 1.3%                |
| Fiber                        | 1,316.8  | 2,223.0  | 68.8%            | 68.8%               |
| Mobile accesses              | 17,575.4 | 17,258.5 | (1.8%)           | (1.8%)              |
| Prepay                       | 3,328.1  | 2,777.1  | (16.6%)          | (16.6%)             |
| Contract                     | 14,247.3 | 14,481.4 | 1.6%             | 1.6%                |
| M2M                          | 1,612.4  | 1,778.8  | 10.3%            | 10.3%               |
| Pay TV                       | 1,884.7  | 3,671.5  | 94.8%            | 10.5%               |
| Final Clients Accesses       | 35,836.7 | 36,935.6 | 3.1%             | (0.9%)              |
| Wholesale Accesses           | 5,366.0  | 5,037.7  | (6.1%)           | (6.1%)              |
| Total Accesses               | 41,202.7 | 41,973.3 | 1.9%             | (1.6%)              |

## Notes:

(1) In order to calculate organic changes, we have added the accesses of DTS as of December 31, 2014 to our accesses as of such date.

(2) PSTN (including Public Use Telephony) x1; ISDN Basic access x1; ISDN Primary access; 2/6 Digital Access x30. Company's accesses for internal use included. Includes VoIP and Naked ADSL.

(3) Includes ADSL, satellite, optical fiber, cable modem and broadband circuits.

The below table shows the contribution of each item for which we have adjusted to our reported growth. With respect to each line item, the contribution to reported growth of such line item, expressed in p.p., is the result of dividing the impact of each item for which we have adjusted by the amount of such line item, on a reported basis, for the prior year:

| TELEFÓNICA<br>SPAIN<br>2015 | %Reported<br>YoY | %Organic<br>YoY (1) | DTS       |
|-----------------------------|------------------|---------------------|-----------|
| Pay TV                      | 94.8%            | 10.5%               | 76.3 p.p. |
| Final Clients Accesses      | 3.1%             | (0.9%)              | 4.0 p.p.  |
| Total Accesses              | 1.9%             | (1.6%)              | 3.5 p.p.  |

(1) In order to calculate organic changes, we have added the accesses of DTS as of December 31, 2014 to our accesses as of such date.

In 2015 the commercial activity was leveraged on the differentiated assets of the Company and, in the second half of 2015 was strengthened by the convergent offer “Movistar Fusión+” launched in July 2015 as well as the promotion that included all “TV Premium Extra” content from 9.90 euros/month, launched in August 2015. This promotion was subscribed by almost 700 thousand customers, reflecting the attractiveness of the offer (new TV contents and ultra-speed fiber in an economic environment where private consumption continues to improve).

Churn evolution has been positive in 2015, especially taking into account the elimination of “Fusión” long-term contracts on August 1, 2015. This fact, together with the good evolution in adds since the launching of “Movistar Fusión+” has resulted in a positive performance of commercial activity. In 2015, broadband net adds duplicated year-on-year, fiber net adds grew by 25.3%, mobile contract net adds resumed growth (+0.2 million customers) and in fixed telephony the net loss of accesses decreased by 31.1% year-on-year.

The results of Telefónica Spain in 2015 showed a lower decrease in revenues compared to the year-on-year results of 2014-2013, as a result of the transformation strategy implemented in recent years which relies on a high value offer based on the differentiated assets of Telefónica Spain, a more rational market in competition terms and a more favorable macroeconomic context, with improvement in private consumption.

Telefónica Spain had 42.0 million accesses at the end of December 2015, up 1.9% year-on-year, after the consolidation of the DTS satellite TV accesses (0.9 million accesses at December 2015). The organic variation was down by 1.6%, explained by the decrease in mobile accesses and fixed telephony accesses, although it is important to highlight that retail accesses grew by 3.1% year-on-year.

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“Movistar Fusión”, with a customer base of 4.2 million with 1.5 million additional wireless lines to the base offer as of December 31, 2015, maintained a solid year-on-year growth (+13% and +8% respectively compared to December 2014) and contributed 81% of the fixed retail broadband customer base and 63% of the wireless contract customer base. There was significant growth in the penetration of the high value services of “Movistar Fusión”, with 31.8% of the customer base already using 100 Mb or 300 Mb ultra-fast broadband (+10.9 p.p. year-on-year) and 62.4% of the customer base with Pay-TV as of December 31, 2015 (+17.7 p.p. year-on-year).

**Fixed accesses** decreased 4.2% year-on-year, with a net loss of 442 thousand accesses in the year 2015. This decrease was mainly due to a lower fixed access market growth.

**Retail broadband accesses** totaled 6.0 million and grew 1.3% year-on-year, with net adds of 76 thousand accesses, due to the good evolution of fiber adds (+37.1% year-on-year) and lower churn (1.4% in 2015, -0.1 p.p. year-on-year).

**Fiber accesses** posted a new record in terms of net adds (0.9 million new accesses in 2015), reaching 2.2 million customers (1.7 times compared to December 31, 2014), representing 37.3% of total broadband customers (+14.9 p.p. year-on-year). Two thirds of fiber accesses are benefiting from the new speeds (30 and 300 Mb) launched in May 2015.

Ultra-speed fiber accesses, with 100 or 300 Mb (with additional ARPU of 12 euros, including VAT) reached 1.5 million accesses (68.6% of total fiber accesses), after the new record of 0.5 million accesses in 2015, triggered by the higher level of adds (+25.9% year-on-year) and contained churn (0.9%, +0.1 p.p. year-on-year).

At December 31, 2015 our fiber deployment reached 14.3 million premises, 4 million more than at December 31, 2014.

Total **mobile accesses** stood at 17.3 million, down 1.8% compared with year-end 2014 as a result of the decrease in prepay accesses. The contract access base accelerated its growth during 2015, growing by 1.6% year-on-year. The positive evolution of contract portability (-162 thousand customers at December 31, 2015, compared to -508 thousand customers at December 31, 2014), resulted in a positive contract net adds base (excluding M2M) (+68 thousand customers at December 31, 2015, compared to -113 thousand customers at December 31, 2014). Smartphone penetration stood at 66.3% of the mobile voice base (+5.7 p.p. compared to year-end 2014) and significantly boosted data traffic growth to 86.8% year-on-year in 2015 due to the higher number of customers with the renewed portfolio containing superior data packages.

LTE network rollout continued to progress well and coverage reached (based on our estimates) approximately 75% of the population at the end of 2015, up 17 p.p. compared to December 31, 2014, due to the deployment of the 800 MHz. As a result, the LTE customer base reached 3.3 million customers at December 31, 2015, doubling the customer base at December 31, 2014, while the penetration reached 21% (+10 p.p. year-on-year).

**Pay-TV accesses** reached 3.7 million, up by 94.8% in reported terms compared to December 31, 2014 as a result of the acquisition of DTS (+10.5% in organic terms), including 926 thousand satellite TV accesses from DTS.

The table below shows the evolution of Telefónica Spain's results over the past two years:

Millions of euros

| TELEFÓNICA SPAIN              | 2014         | 2015         | %Reported<br>YoY | %Organic<br>YoY (1) |
|-------------------------------|--------------|--------------|------------------|---------------------|
| Revenues                      | 12,023       | 12,402       | 3.2%             | (2.1%)              |
| Mobile Business               | 4,556        | 4,337        | (4.8%)           | (4.8%)              |
| Mobile service revenues       | 3,888        | 3,677        | (5.4%)           | (5.4%)              |
| Fixed Business                | 8,543        | 9,359        | 9.6%             | 1.9%                |
| Other income                  | 635          | 516          | (18.7%)          | 7.0%                |
| Supplies                      | (2,592)      | (2,996)      | 15.6%            | (2.7%)              |
| Personnel expenses            | (2,139)      | (5,173)      | 141.8%           | 4.0%                |
| Other expenses                | (2,256)      | (2,413)      | 7.0%             | (0.2%)              |
| <b>OIBDA</b>                  | <b>5,671</b> | <b>2,336</b> | <b>(58.8%)</b>   | <b>(4.3%)</b>       |
| OIBDA Margin                  | 47.2%        | 18.8%        | (28.3 p.p.)      | (1.0 p.p.)          |
| Depreciation and amortization | (1,805)      | (1,898)      | 5.2%             | 2.4%                |
| <b>Operating Income (OI)</b>  | <b>3,866</b> | <b>438</b>   | <b>(88.7%)</b>   | <b>(7.8%)</b>       |
| CapEx                         | 1,732        | 1,827        | 5.5%             | 4.5%                |
| OpCF (OIBDA-CapEx)            | 3,939        | 509          | (87.1%)          | (8.3%)              |

(1) See adjustments made to calculate organic variation below.

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Adjustments made to calculate organic variations

As explained above, year-on-year changes referred to in this document as “organic” or presented in “organic terms” intend to present year-on-year variations on a comparable basis.

With respect to Telefónica Spain, we have made the following adjustments in order to calculate 2015/2014 variations in organic terms:

**Changes in the scope of consolidation:** We have excluded the impact of changes in our consolidation perimeter in 2015 and 2014. The only change to our Telefónica Spain consolidation perimeter in such years is related to the consolidation of DTS in Telefónica Spain since May 1, 2015. In order to exclude the impact of such change in our perimeter, we have consolidated DTS’s results from May 1 to December 31, 2014 in our 2014 results.

**Restructuring costs:** We have excluded the impact of the 2,896 million euros of restructuring costs in 2015, mainly those related to the Voluntary Suspension Plan in Spain. The restructuring process is aimed at increasing future efficiency, representing a further step towards the transformation and simplification initiatives carried out by Telefónica.

No restructuring costs were excluded from our 2014 results to calculate organic variations.

**Results of tower sales:** The results attributable to the sale of towers in 2015 and 2014 have been excluded in both years. In 2015, the results from the sale of towers totaled 38 million euros. In 2014, the results from the sale of towers totaled 191 million euros.

**Spectrum acquisition:** We have excluded the impact of spectrum acquisitions in 2015, which totaled 49 million euros.

**Real Estate Efficiency Plan:** We have excluded the impact of certain urban assets qualification changes in Telefónica Spain in 2014, totaling 49 million euros.

**Spain distribution channel:** We have excluded the impact of the 30 million euros provision recorded in 2015 in Telefónica Spain to optimize the distribution network.

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The table below shows 2015/2014 variations in reported and organic terms (the latter, calculated in accordance with the adjustments referred to above) of certain income statement and other measures, and the contribution of each item for which we have adjusted to our reported growth:

| TELEFÓNICA<br>SPAIN<br>2015   | YoY variation    |                 | Contribution to reported growth (percentage points) |                        |                 |                         |                                      |                                  |
|-------------------------------|------------------|-----------------|---|------------------------|-----------------|-------------------------|--------------------------------------|----------------------------------|
|                               | %Reported<br>YoY | %Organic<br>YoY | Perimeter<br>change<br>(DTS)                        | Restructuring<br>costs | Towers<br>sales | Spectrum<br>acquisition | Real<br>Estate<br>Efficiency<br>Plan | Spain<br>distribution<br>channel |
| Revenues                      | 3.2%             | (2.1%)          | 5.4   | --                     | --              | --                      | --                                   | --                               |
| Other income                  | (18.7%)          | 7.0%            | 0.9   | --                     | (24.5)          | --                      | --                                   | --                               |
| Supplies                      | 15.6%            | (2.7%)          | 18.7  | --                     | --              | --                      | --                                   | --                               |
| Personnel<br>expenses         | 141.8%           | 4.0%            | 2.4   | 135.4                  | --              | --                      | --                                   | --                               |
| Other expenses                | 7.0%             | (0.2%)          | 5.9   | --                     | (0.1)           | --                      | --                                   | 1,3                              |
| <b>OIBDA</b>                  | <b>(58.8%)</b>   | <b>(4.3%)</b>   | <b>(0.4)</b>  | <b>(51.1)</b>          | <b>(2.7)</b>    | <b>--</b>               | <b>--</b>                            | <b>(0.5)</b>                     |
| CapEx                         | 5.5%             | 4.5%            | 1.1   | --                     | --              | 2.8                     | (2.8)                                | --                               |
| <b>OpCF<br/>(OIBDA-CapEx)</b> | <b>(87.1%)</b>   | <b>(8.3%)</b>   | <b>(1.0)</b>  | <b>(73.5)</b>          | <b>(3.9)</b>    | <b>(1.2)</b>            | <b>1.3</b>                           | <b>(0.8)</b>                     |

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## Results Discussion

**Revenues** in Telefónica Spain in 2015 were 12,402 million euros, up 3.2% year-on-year in reported terms mainly as a result of the consolidation of DTS since May 1, 2015 (which accounted for +5.4 p.p. of the year-on-year increase). In organic terms, revenues were down by 2.1% due to lower mobile service revenues in the mobile business and lower access and voice revenues in the fixed business.

We consider revenue breakdown to be increasingly less relevant given the high penetration level of our convergent offer, by which we mean the offer of more than a single service for a single price. However, we continue to report revenue separately for information purposes. Fixed business revenues were up by 9.6% year-on-year in 2015, due to the consolidation of DTS, the repositioning of tariffs, higher retail broadband revenues and new services, mainly related to TV and IT services. Excluding the impact of DTS, fixed revenues increased by 1.9%. Mobile business revenues fell 4.8% year-on-year in 2015 due to the decline in mobile accesses and the 3.6% drop in ARPU.

**Mobile ARPU** was 15.3 euros in 2015, down by 3.6% year-on-year. Mobile ARPU is becoming less representative of the Group's business performance, owing to its high dependence on the allocation of revenue in convergent offers.

| TELEFÓNICA SPAIN                    | 2014   | 2015   | %YoY     |
|-------------------------------------|--------|--------|----------|
| Voice Traffic (millions of minutes) | 35,600 | 36,368 | 2.2%     |
| ARPU (EUR)                          | 15.9   | 15.3   | (3.6%)   |
| Prepay                              | 6.2    | 5.7    | (8.2%)   |
| Contract (1)                        | 20.6   | 19.5   | (5.3%)   |
| Data ARPU (EUR)                     | 7.0    | 7.8    | 11.0%    |
| % non-SMS over data revenues        | 95.0%  | 95.5%  | 0.5 p.p. |

Notes:

(1) Excludes M2M.

**OIBDA** amounted to 2,336 million euros in 2015, down 58.8% year-on-year in reported terms, mainly due to provisions recorded in 2015 totaling 2,926 million euros (relating to restructuring cost accounted for 51.1 p.p. of the year-on-year decrease and 0.5 p.p. of the year-on-year decrease in distribution channel restructuring) and, to a lesser extent, the lower proceeds (38 million euros in 2015 compared to 191 million euros in 2014) from the sale of towers (-2.7 p.p.). This decrease was partially offset by the sale of real estate assets amounting to 73 million euros (net of costs).

In organic terms OIBDA decreased 4.3% year-on-year, mainly due to the lower revenues, higher personnel costs and higher content costs. The higher personnel costs, up by 4.0% year-on-year in organic terms, were primarily due to the resumption of the Company's contribution to its pension plan in July 2014, and to a lesser extent, the acquisition of DTS. Telefónica Spain had 32,171 employees at the end of December 2015, up 7.2% year-on-year, due mainly to the acquisition of DTS.

**OIBDA margin** was 18.8% in 2015, down 28.3 p.p. year-on-year.



Table of Contents**TELEFÓNICA UNITED KINGDOM**

As explained above, the consolidated income statement for the year ended December 31, 2015 has been amended to retroactively show the reclassification of Telefónica United Kingdom's results as continuing operations. Therefore, the results below differ from the results previously published for such period. The segmented financial information shown below has been amended for 2015 as discussed above.

The table below shows the evolution of accesses in Telefónica United Kingdom over the past two years as of December 31 of such years:

**ACCESSES**

| <b>Thousands of accesses</b>  | <b>2014</b>     | <b>2015</b>     | <b>% Reported YoY</b> |
|-------------------------------|-----------------|-----------------|-----------------------|
| Fixed telephony accesses (1)  | 228.0           | 247.1           | 8.4%                  |
| Internet and data accesses    | 19.2            | 21.0            | 9.4%                  |
| Broadband                     | 19.2            | 21.0            | 9.4%                  |
| Mobile accesses               | 24,479.1        | 25,018.8        | 2.2%                  |
| Prepay                        | 10,761.2        | 10,561.4        | (1.9%)                |
| Contract                      | 13,717.9        | 14,457.4        | 5.4%                  |
| M2M                           | 2,192.0         | 2,383.9         | 8.8%                  |
| <b>Final Clients Accesses</b> | <b>24,726.4</b> | <b>25,286.9</b> | <b>2.3%</b>           |
| <b>Total Accesses</b>         | <b>24,726.4</b> | <b>25,286.9</b> | <b>2.3%</b>           |

Notes:

(1) Includes "fixed wireless" and Voice over IP accesses

In 2015, Telefónica United Kingdom maintained market momentum, as a result of O2's brand recognition, the success of commercial proposal success and customer loyalty. These factors have allowed the company to keep growing in a competitive market.

The **total access** base grew 2.3% year-on-year and stood at 25.3 million at December 31, 2015, mainly driven by a 2.2% increase in the mobile base.

The contract **mobile customer base** grew 5.4% year-on-year and reached 14.5 million accesses, with a broadly stable 57.8% share over the total mobile base. Net adds reached 539 thousand accesses due to the solid contribution of postpay accesses. Smartphone penetration reached 60% of the total mobile accesses base, up 15.4 p.p. year-on-year, driven by the continued growth of LTE customers (+85.8% year-on-year reaching 7.6 million at December 31, 2015). LTE penetration reached 35% of the total mobile access base.

The prepay access base decreased 1.9% year-on-year to 10.6 million at December 31, 2015.

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The table below shows the evolution of Telefónica United Kingdom's results over the past two years:

**Millions of euros**

| <b>TELEFÓNICA UNITED KINGDOM</b> | <b>2014</b>  | <b>2015</b>  | <b>% Reported<br/>YoY</b> | <b>% Organic<br/>YoY (1)</b> |
|----------------------------------|--------------|--------------|---------------------------|------------------------------|
| Revenues                         | <b>7,062</b> | <b>7,837</b> | <b>11.0%</b>              | <b>(0.1%)</b>                |
| <b>Mobile service revenues</b>   | 5,397        | 5,778        | 7.1%                      | (3.6%)                       |
| Other income                     | 184          | 170          | (7.5%)                    | (16.7%)                      |
| Supplies                         | (3,520)      | (3,769)      | 7.1%                      | (3.6%)                       |
| Personnel expenses               | (460)        | (549)        | 19.5%                     | 6.8%                         |
| Other expenses                   | (1,522)      | (1,760)      | 15.7%                     | 4.1%                         |
| <b>OIBDA</b>                     | <b>1,744</b> | <b>1,929</b> | <b>10.6%</b>              | <b>(0.2%)</b>                |
| OIBDA Margin                     | 24.7%        | 24.6%        | (0.1 p.p.)                | (0.0 p.p.)                   |
| Depreciation and amortization    | (1,121)      | (1,196)      | 6.7%                      | (3.9%)                       |
| <b>Operating Income (OI)</b>     | <b>623</b>   | <b>733</b>   | <b>17.6%</b>              | <b>6.5%</b>                  |
| CapEx                            | 755          | 883          | 17.0%                     | 5.3%                         |
| OpCF (OIBDA-CapEx)               | 989          | 1,046        | 5.7%                      | (4.4%)                       |

(1) See adjustments made to calculate organic variation below.

## Adjustments made to calculate organic variations

As explained above, year-on-year changes referred to in this document as “organic” or presented in “organic terms” intend to present year-on-year variations on a comparable basis.

To calculate the organic growth for 2015 of Telefónica United Kingdom, we have made the following adjustments:

**Exchange rate effect:** we have excluded the impact of changes in exchange rates by assuming constant average foreign exchange rates for 2014 and 2015. In particular, we have used the average foreign exchange rates of 2014 for both years.

**Restructuring costs:** we have excluded the impact from 2015 of restructuring costs, associated with certain simplification processes implemented in Telefónica United Kingdom amounting to 4 million euros. There were not restructuring costs in Telefónica United Kingdom in 2014.

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The table below shows 2015/2014 variations in reported and organic terms (the latter, calculated in accordance with the adjustments referred to above) of certain income statement measures, and the contribution of each item for which we have adjusted to our reported growth:

|   | YoY variation     |                  | Contribution to reported growth<br>(percentage points) |                        |
|---|-------------------|------------------|--|------------------------|
|   | % Reported<br>YoY | % Organic<br>YoY | Exchange rate<br>effect                                | Restructuring<br>costs |
| <b>TELEFÓNICA UNITED<br/>KINGDOM 2015</b> |                   |                  |  |                        |
| Revenues                                  | <b>11.0%</b>      | <b>(0.1%)</b>    | <b>11.0</b>  | -                      |
| Other income                              | (7.5%)            | (16.7%)          | 9.2  | -                      |
| Supplies                                  | 7.1%              | (3.6%)           | 10.7   | -                      |
| Personnel expenses                        | 19.5%             | 6.8%             | 11.8   | 0.8                    |
| Other expenses                            | 15.7%             | 4.1%             | 11.5   | -                      |
| <b>OIBDA</b>                              | <b>10.6%</b>      | <b>(0.2%)</b>    | <b>11</b>  | <b>(0.2)</b>           |
| CapEx                                     | 17.0%             | 5.3%             | 11.6   | -                      |
| <b>OpCF (OIBDA-CapEx)</b>                 | <b>5.7%</b>       | <b>(4.4%)</b>    | <b>10.5</b>  | <b>(0.4)</b>           |

## Results Discussion

Total **revenues** were 7,837 million euros in 2015, up 11.0% year-on-year in reported terms due mainly to the appreciation of the pound sterling (which accounted for 11 p.p. of the year-on-year increase). In organic terms, revenues decreased by 0.1% year-on-year due mainly to lower handset sales, down by 13.9%.

**Mobile service revenues** totaled 5,778 million euros in 2015, up 7.1% year-on-year in reported terms due mainly to the appreciation of the pound sterling (which accounted for 10.7 p.p. of the year-on-year increase). Excluding this impact, mobile service revenues decreased by 3.6% due to the “Refresh” commercial model as well as the low interconnection fares. Under the Refresh commercial model, certain revenues related to handset are not considered as mobile service revenues, but as handset revenues.

Mobile **ARPU** increased by 2.9% year-on-year in reported terms due mainly to the appreciation of the pound sterling. In organic terms, ARPU went down by 7.3% adversely affected by the “Refresh” commercial model, as well as a

decrease in data ARPU of 5.7%. Revenues under the “Refresh” commercial model, are not considered as service revenues but as handset revenues, therefore, smartphone sales are not reflected in ARPU.

| TELEFÓNICA UNITED KINGDOM           | 2014        | 2015        | %YoY        | %Organic YoY  |
|-------------------------------------|-------------|-------------|-------------|---------------|
| Voice Traffic (millions of minutes) | 49,096      | 50,231      | 2.3%        | 2.3%          |
| <b>ARPU (EUR)</b>                   | <b>18.8</b> | <b>19.4</b> | <b>2.9%</b> | <b>(7.3%)</b> |
| Prepay                              | 7.3         | 7.7         | 4.4%        | (6.0%)        |
| Contract (1)                        | 33.1        | 33.5        | 1.4%        | (8.7%)        |
| <b>Data ARPU (EUR)</b>              | <b>10.8</b> | <b>11.3</b> | <b>4.7%</b> | <b>(5.7%)</b> |
| % non-SMS over data revenues        | 57.9%       | 59.4%       | 1.5 p.p.    | (1.5 p.p.)    |

Notes:

(1) Excludes M2M.

**OIBDA** totaled 1,929 million euros in 2015, up 10.6% year-on-year in reported terms, as a result mainly of the appreciation of the pound sterling. In organic terms, OIBDA decreased by 0.2% year-on-year due to lower service revenues, which was partially offset by expense restraint.

The **OIBDA margin** stood at 24.6% in reported terms for 2015, down 0.1 p.p. compared to 2014.

Table of Contents**TELEFÓNICA GERMANY**

The below table shows the evolution of accesses in Telefónica Germany over the past two years as of December 31 of such years:

**ACCESSES**

| <b>Thousands of accesses</b>  | <b>2014</b>     | <b>2015</b>     | <b>%</b>            |
|-------------------------------|-----------------|-----------------|---------------------|
|                               |                 |                 | <b>Reported YoY</b> |
| Fixed telephony accesses (1)  | 2,036.4         | 1,997.8         | (1.9%)              |
| Internet and data accesses    | 2,387.0         | 2,330.6         | (2.4%)              |
| Broadband                     | 2,143.8         | 2,098.0         | (2.1%)              |
| VDSL                          | 256.5           | 516.8           | 101.5%              |
| Mobile accesses               | 42,124.9        | 43,062.8        | 2.2%                |
| Prepay                        | 23,350.7        | 23,979.4        | 2.7%                |
| Contract (2)                  | 18,774.1        | 19,083.4        | 1.6%                |
| M2M                           | 414.0           | 632.0           | 52.7%               |
| <b>Final Clients Accesses</b> | <b>46,548.3</b> | <b>47,391.2</b> | <b>1.8%</b>         |
| <b>Wholesale Accesses</b>     | <b>1,113.3</b>  | <b>972.0</b>    | <b>(12.7%)</b>      |
| <b>Total Accesses</b>         | <b>47,661.5</b> | <b>48,363.2</b> | <b>1.5%</b>         |

Notes:

(1) Includes "fixed wireless" and Voice over IP accesses.

(2) In the fourth quarter of 2014, 428 thousand E-Plus accesses were excluded before integration, due to the criteria harmonization.

In 2015, Telefónica Germany maintained market momentum, increasing slightly its estimated mobile service revenue market share.

The **total access** base grew 1.5% year-on-year and stood at 48.4 million at December 31, 2015, mainly driven by a 2.2% increase in the mobile base (which reached 43.1 million).

The contract mobile customer base grew 1.6% year-on-year and reached 19.1 million accesses, with a broadly stable 44.3% share over the total mobile base. Net adds reached 309 thousand accesses due to the solid contribution of partners (second brands). Smartphone penetration reached 54.2% of the total mobile access base, up 5.5 p.p. year-on-year driven by the continued growth of LTE customers (+154.5% year-on-year reaching 7.9 million at December 31, 2015). LTE penetration reached 18.6% of the total mobile access base.

The prepay access base increased 2.7% year-on-year to 24.0 million. Prepay posted 629 thousand net additions in 2015, 32.5% more than in 2014 due to the strong contribution from wholesale agreements (second brands). The retail broadband access loss trend continued to improve, with 46 thousand net loss in 2015, more than halving the number of 2014. VDSL was once again the main growth engine of fixed performance with 260 thousand net additions (+55% year-on-year) in 2015.



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The table below shows the evolution of Telefónica Germany's results over the past two years:

Millions of euros

| TELEFÓNICA GERMANY            | 2014         | 2015         | %Reported<br>YoY | %Organic<br>YoY (1) |
|-------------------------------|--------------|--------------|------------------|---------------------|
| Revenues                      | 5,522        | 7,888        | 42.9%            | 1.2%                |
| Mobile Business               | 4,375        | 6,832        | 56.2%            | 2.8%                |
| Mobile service revenues       | 3,580        | 5,532        | 54.5%            | 0.1%                |
| Fixed Business                | 1,138        | 1,043        | (8.3%)           | (8.3%)              |
| Other income                  | 106          | 265          | 150.4%           | 14.7%               |
| Supplies                      | (2,144)      | (2,712)      | 26.5%            | (3.4%)              |
| Personnel expenses            | (828)        | (655)        | (20.9%)          | (10.1%)             |
| Other expenses                | (1,923)      | (2,928)      | 52.2%            | (1.1%)              |
| <b>OIBDA</b>                  | <b>733</b>   | <b>1,858</b> | <b>153.7%</b>    | <b>20.9%</b>        |
| OIBDA Margin                  | 13.3%        | 23.6%        | 10.3 p.p.        | 3.8 p.p.            |
| Depreciation and amortization | (1,426)      | (2,128)      | 49.3%            | (3.8%)              |
| <b>Operating Income (OI)</b>  | <b>(693)</b> | <b>(270)</b> | <b>(61.0%)</b>   | <b>(57.2%)</b>      |
| CapEx                         | 849          | 2,230        | 162.8%           | (11.1%)             |
| OpCF (OIBDA-CapEx)            | (116)        | (372)        | n.m.             | 126.2%              |

(1) See adjustments made to calculate organic variation below.

#### Adjustments made to calculate organic variations

With respect to Telefónica Germany, we have made the following adjustments in order to calculate 2015/2014 variations in organic terms:

**Changes in the scope of consolidation:** We have excluded the impact of changes in our consolidation perimeter in 2015 and 2014. The only change to our Telefónica Germany consolidation perimeter in such years related to the consolidation of E-Plus in Telefónica Germany since October 1, 2014. In order to exclude the impact of this change in our perimeter, we have consolidated E-Plus's results from January 1 to September 30, 2014 in our 2014 results.

**Restructuring costs:** We have excluded the impact of restructuring costs associated with certain simplification processes implemented in Germany. In 2015, restructuring costs had a 74 million euros impact on OIBDA. In 2014, restructuring costs had a 414 million euros impact on OIBDA.

**Spectrum acquisition:** We have excluded the impact of spectrum acquisitions in 2015, amounting to 1,198 million euros. There were no spectrum acquisitions in 2014.

**Adjustments to the final purchase price of E-Plus:** In 2015 we have excluded the result from the difference between the preliminary purchase price of E-Plus (as estimated at the end of the valuation period) and the final purchase price agreed with KPN, totaling 104 million euros (which had a 102 million euros positive impact on OIBDA net of costs related to the acquisition).

The table below shows 2015/2014 variations in reported and organic terms (the latter, calculated in accordance with the adjustments referred to above) of certain income statement and other measures, and the contribution of each item for which we have adjusted to our reported growth:

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| <b>TELEFÓNICA<br/>GERMANY 2015</b> | <b>YoY variation</b>      |                          | <b>Contribution to reported growth (percentage points)</b> |                                |                                 |  |
|------------------------------------|---------------------------|--------------------------|--|--------------------------------|---------------------------------|--|
|                                    | <b>% Reported<br/>YoY</b> | <b>% Organic<br/>YoY</b> | <b>Perimeter<br/>change<br/>(E-Plus)</b>                   | <b>Restructuring<br/>Costs</b> | <b>Spectrum<br/>acquisition</b> | <b>Adjustments to<br/>the final purchase<br/>Price of E-Plus</b> |
| Revenues                           | 42.9%                     | 1.2%                     | 41.1   | --                             | --                              | --   |
| Other income                       | 150.4%                    | 14.7%                    | 32.3   | --                             | --                              | 98.6   |
| Supplies                           | 26.5%                     | (3.4%)                   | 30.9   | --                             | --                              | --   |
| Personnel expenses                 | (20.9%)                   | (10.1%)                  | 26.9   | (39.0)                         | --                              | --   |
| Other expenses                     | 52.2%                     | (1.1%)                   | 54.7   | (0.9)                          | --                              | 0.1  |
| <b>OIBDA</b>                       | <b>153.7%</b>             | <b>20.9%</b>             | <b>50.2</b>  | <b>46.5</b>                    | <b>--</b>                       | <b>13.9</b>  |
| CapEx                              | 162.8%                    | (11.1%)                  | 36.8   | --                             | 141.2                           | --   |
| <b>OpCF<br/>(OIBDA-CapEx)</b>      | <b>n.m.</b>               | <b>126.2%</b>            | <b>(47.1)</b>  | <b>(293.2)</b>                 | <b>1,031.3</b>                  | <b>(87.7)</b>  |

## Results Discussion

Total **revenues** were 7,888 million euros in 2015, up 42.9% year-on-year in reported terms due mainly to the consolidation of E-Plus since October 1, 2014 (which accounted for 41.1 p.p. of the year-on-year increase). In organic terms, revenues increased by 1.2% due mainly to higher handset sales arising from Christmas campaigns.

**Mobile service revenues** totaled 5,532 million euros in 2015, up 54.5% year-on-year in reported terms, due mainly to the consolidation of E-Plus since October 1, 2014 and to a lesser extent, the increasing share of the partner segment (second brands) within the customer base. Telefónica Germany continued to focus on data revenues, which increased by 58.4% and accounted for 51.3% of mobile service revenues in 2015. Non-P2P SMS data revenues amounted to 2,034 million euros (increasing 4.9% year-on-year), accounting for 71.6% of the total data revenues (+0.4 p.p. year-on-year).

**Fixed revenues** were 1,043 million euros in 2015, down 8.3% year-on-year, due to continued decrease in accesses.

**Mobile ARPU** was 10.7 euros in 2015, down 8.9% year-on-year, while contract ARPU stood at 17.2 euros down 6.5% year-on-year, as a result of the higher share of wholesale customers in the customer base. Data ARPU was 5.5 euros, down 6.8% year-on-year, mainly as a result of the continued decline of SMS volumes.

| TELEFÓNICA GERMANY                  | 2014   | 2015   | %YoY     |
|-------------------------------------|--------|--------|----------|
| Voice Traffic (millions of minutes) | 41,186 | 62,696 | 52.2%    |
| ARPU (EUR)                          | 11.8   | 10.7   | (8.9%)   |
| Prepay                              | 5.4    | 5.8    | 8.2%     |
| Contract (1)                        | 18.4   | 17.2   | (6.5%)   |
| Data ARPU (EUR)                     | 5.9    | 5.5    | (6.8%)   |
| % non-SMS over data revenues        | 71.2%  | 71.6%  | 0.4 p.p. |

Notes:

(1) Excludes M2M.

**OIBDA** totaled 1,858 million euros in 2015, up 153.7% year-on-year in reported terms, as a result mainly of the consolidation of E-Plus (which accounted for 50.2 p.p. of the increase), the lower restructuring costs recorded in 2015 (+46.5 p.p.) and the positive result from the E-Plus preliminary acquisition price and the final acquisition price agreed on with KPN (+13.9 p.p.). In organic terms, OIBDA increased by 20.9% year-on-year, driven by the increased synergies, which mainly affected personnel expenses and supplies.

The **OIBDA margin** stood at 23.6% in reported terms for 2015, up 10.3 p.p. compared to 2014.

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## TELEFÓNICA BRAZIL

The below table shows the evolution of accesses in Telefónica Brazil over the past two years as of December 31 of such years:

## ACCESSES

| Thousands of accesses         | 2014            | 2015            | %Reported<br>YoY | %Organic<br>YoY (1) |
|-------------------------------|-----------------|-----------------|------------------|---------------------|
| Fixed telephony accesses (2)  | 10,743.4        | 14,654.5        | 36.4%            | (1.6%)              |
| Internet and data accesses    | 4,082.6         | 7,195.5         | 76.2%            | 2.5%                |
| Broadband                     | 3,939.8         | 7,129.5         | 81.0%            | 3.6%                |
| Fiber                         | 374.6           | 3,779.9         | n.m.             | 14.0%               |
| Mobile accesses               | 79,932.1        | 73,261.3        | (8.3%)           | (8.3%)              |
| Prepay                        | 51,582.4        | 42,194.4        | (18.2%)          | (18.2%)             |
| Contract                      | 28,349.7        | 31,066.9        | 9.6%             | 9.6%                |
| M2M                           | 3,506.9         | 4,234.7         | 20.8%            | 20.8%               |
| Pay TV                        | 770.6           | 1,787.9         | 132.0%           | 9.7%                |
| <b>Final Clients Accesses</b> | <b>95,528.6</b> | <b>96,899.3</b> | <b>1.4%</b>      | <b>(6.4%)</b>       |
| <b>Wholesale Accesses</b>     | <b>25.9</b>     | <b>22.3</b>     | <b>(14.0%)</b>   | <b>(14.0%)</b>      |
| <b>Total Accesses</b>         | <b>95,554.5</b> | <b>96,921.5</b> | <b>1.4%</b>      | <b>(6.4%)</b>       |

## Notes:

(1) In order to calculate organic changes, we have added the accesses of GVT as of December 31, 2014 to our accesses as of such date.

(2) Includes "fixed wireless" and Voice over IP accesses.

The below table shows the contribution of each item for which we have adjusted to our reported growth. With respect to each line item, the contribution to reported growth of such line item, expressed in p.p., is the result of dividing the impact of each item for which we have adjusted by the amount of such line item, on a reported basis, for the prior year:

| TELEFÓNICA<br>BRAZIL<br>2015  | %Reported<br>YoY | %Organic<br>YoY (1) | GVT             |
|-------------------------------|------------------|---------------------|-----------------|
| Fixed telephony accesses      | 36.4%            | (1.6%)              | 38.6 p.p.       |
| Internet and data accesses    | 76.2%            | 2.5%                | 72.0 p.p.       |
| Broadband                     | 81.0%            | 3.6%                | 74.6 p.p.       |
| Fiber                         | n.m.             | 14.0%               | 785.0 p.p.      |
| Pay TV                        | 132.0%           | 9.7%                | 111.5 p.p.      |
| <b>Final Clients Accesses</b> | <b>1.4%</b>      | <b>(6.4%)</b>       | <b>8.3 p.p.</b> |
| <b>Total Accesses</b>         | <b>1.4%</b>      | <b>(6.4%)</b>       | <b>8.3 p.p.</b> |

## Notes:

(1) In order to calculate organic changes, we have added the accesses of GVT as of December 31, 2014 to our accesses as of such date.

Telefónica Brazil closed the year 2015 improving its competitive position in the mobile as well as in the fixed market. In the mobile business, Telefónica Brazil kept its leadership in the higher value segments, which permitted the operator to capture mobile market revenue growth in 2015. In the fixed business, the transformation towards fiber and Pay-TV was strengthened by the GVT consolidation in May 2015, adding as of December 31, 2015, 8.5 million customers to the Group.

Revenues and OIBDA evolution were positively supported by the acceleration of mobile data and the good evolution of fixed broadband and Pay-TV. Additionally, Telefónica Brazil carried out costs control measures aimed at offsetting the adverse macroeconomic situation.

However, results in 2015 were adversely affected by the interconnection tariff reduction in the mobile business (-33.0%) and in the retail fixed-mobile tariff (-23.3%) since February 24, 2015.

Telefónica Brazil reached 96.9 million **accesses** at December 31, 2015, up 1.4% due mainly to the consolidation of GVT. Excluding the impact of such consolidation, accesses were down 6.4%, due to the disconnection of prepay accesses.

In the **mobile business**, the strategic focus remained on gaining and retaining high value customers, reaching a market share of 42.4% in the contract segment as of December 31, 2015 (Source: ANATEL). Telefónica Brazil maintained its market leadership in terms of total accesses with a market share of 29.5% as of December 2015 (source: ANATEL). The commercial offer in the contract segment included a higher data volume, more minutes of voice traffic and

innovative products such as “Vivo Bis” (pursuant to which the data not consumed in a month is automatically added to data available for the following month). The contract growth was partially offset by the disconnection of 11.5 million prepay accesses.

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In the **fixed business**, Telefónica Brazil maintained its strategic focus on fiber deployment, with 16.6 million premises passed with FTTx at December 31, 2015 and 3.8 million homes connected, and also on increasing Pay-TV accesses (up 10% year-on-year). Fixed telephony accesses stood at 14.7 million in 2015, up 36.4% in reported terms due mainly to the consolidation of GVT. In organic terms, these accesses were down by 1.6% year-on-year. Retail broadband customers totaled 7.1 million customers as of December 31, 2015, up 81.0% year-on-year due mainly to the consolidation of GVT (up 3.6% year-on-year in organic terms due to the increase of fiber accesses). Of the 7.1 million customers at the end of 2015, 53.0% were connected with FTTC. Pay TV customers stood at 1.8 million as of December 31, 2015, up 132.0% in reported terms due mainly to the consolidation of GVT, increasing by 9.7% year-on-year in organic terms due to a higher penetration of high value and IPTV clients. IPTV accesses increased their relevance, representing 9.6% of total Pay-TV accesses.

The table below shows the evolution of Telefónica Brazil's results over the past two years:

Millions of euros

| TELEFÓNICA BRAZIL             | 2014         | 2015         | %Reported<br>YoY | %Organic<br>YoY (1) |
|-------------------------------|--------------|--------------|------------------|---------------------|
| Revenues                      | 11,231       | 11,060       | (1.5%)           | 4.5%                |
| <b>Mobile Business</b>        | 7,618        | 6,906        | (9.3%)           | 6.2%                |
| Mobile service revenues       | 7,228        | 6,495        | (10.1%)          | 5.3%                |
| <b>Fixed Business</b>         | 3,613        | 4,154        | 15.0%            | 1.9%                |
| Other income                  | 261          | 416          | 59.3%            | 35.4%               |
| Supplies                      | (2,680)      | (2,568)      | (4.2%)           | 4.4%                |
| Personnel expenses            | (976)        | (1,042)      | 6.8%             | 3.5%                |
| Other expenses                | (4,293)      | (4,293)      | (0.0%)           | 8.6%                |
| <b>OIBDA</b>                  | <b>3,543</b> | <b>3,573</b> | <b>0.9%</b>      | <b>2.9%</b>         |
| OIBDA Margin                  | 31.5%        | 32.3%        | 0.8 p.p.         | (0.5 p.p.)          |
| Depreciation and amortization | (1,762)      | (1,916)      | 8.7%             | 12.9%               |
| <b>Operating Income (OI)</b>  | <b>1,781</b> | <b>1,657</b> | <b>(6.9%)</b>    | <b>(6.7%)</b>       |
| CapEx                         | 2,933        | 2,105        | (28.2%)          | (1.1%)              |
| OpCF (OIBDA-CapEx)            | 610          | 1,468        | 140.8%           | 9.3%                |

(1) See adjustments made to calculate organic variation below.

Adjustments made to calculate organic variations



As explained above, year-on-year changes referred to in this document as “organic” or presented in “organic terms” intend to present year-on-year variations on a comparable basis. With respect to Telefónica Brazil, we have made the following adjustments in order to calculate 2015/2014 variations in organic terms:

**Foreign exchange effects:** We have excluded the impact of changes in exchange rates by assuming constant average foreign exchange rates in 2015 and 2014. In particular, we have used the average foreign exchange rate of 2014 for both years. Foreign exchange rates had a negative impact on our reported 2015 Telefónica Brazil results as a result of the depreciation of the Brazilian real.

**Changes in the scope of consolidation:** We have excluded the impact of changes in our consolidation perimeter in 2015 and 2014. The only change to our Telefónica Brazil consolidation perimeter in such years related to the consolidation of GVT since May 1, 2015. In order to exclude the impact of this change in our perimeter, we have consolidated GVT's results from May 1 to December 31, 2014 in our 2014 results.

**Restructuring costs:** We have excluded the impact of certain restructuring costs associated with certain simplification processes implemented in Telefónica Brazil. In 2015, these restructuring costs totaled 7 million euros. In 2014, these restructuring costs totaled 68 million euros.

**Spectrum acquisition:** We have excluded the impact of spectrum acquisitions in 2014 amounting to 889 million euros (related to a LTE block in the 700 MHz band) while there were no spectrum acquisitions in 2015.

**Results of tower sales:** The results attributable to the sale of towers in 2015 and 2014 have been excluded in both years. The results from the sale of towers totaled 10 million euros and 1 million euros in 2015 and 2014, respectively.

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The table below shows 2015/2014 variations in reported and organic terms (the latter, calculated in accordance with the adjustments referred to above) of certain income statement and other measures, and the contribution of each item for which we have adjusted to our reported growth:

| TELEFÓNICA<br>BRAZIL<br>2015  | YoY variation    |                 | Contribution to reported growth (percentage points) |                              |                        |                         |                 |
|-------------------------------|------------------|-----------------|---|------------------------------|------------------------|-------------------------|-----------------|
|                               | %Reported<br>YoY | %Organic<br>YoY | Exchange<br>rate effect                             | Perimeter<br>change<br>(GVT) | Restructuring<br>Costs | Spectrum<br>acquisition | Towers<br>sales |
| Revenues                      | (1.5%)           | 4.5%            | (16.6)  | 10.1                         | --                     | --                      | --              |
| Other income                  | 59.3%            | 35.4%           | (26.9)  | 34.5                         | --                     | --                      | 4.1             |
| Supplies                      | (4.2%)           | 4.4%            | (16.2)  | 7.2                          | --                     | --                      | --              |
| Personnel expenses            | 6.8%             | 3.5%            | (18.1)  | 26.8                         | (6.2)                  | --                      | --              |
| Other expenses                | (0.0%)           | 8.6%            | (16.9)  | 7.6                          | --                     | --                      | --              |
| <b>OIBDA</b>                  | <b>0.9%</b>      | <b>2.9%</b>     | <b>(17.0)</b>                                       | <b>12.5</b>                  | <b>1.7</b>             | <b>--</b>               | <b>0.3</b>      |
| CapEx                         | (28.2%)          | (1.1%)          | (12.1)  | 15.1                         | --                     | (30.3)                  | --              |
| <b>OpCF<br/>(OIBDA-CapEx)</b> | <b>140.8%</b>    | <b>9.3%</b>     | <b>40.7</b>   | <b>0.2</b>                   | <b>9.9</b>             | <b>145.8</b>            | <b>1.7</b>      |

## Results Discussion

**Revenues** totaled 11,060 million euros in 2015, down 1.5% in reported terms, mainly due to the depreciation of the Brazilian real (which accounted for -16.6 p.p. of the evolution) and partially offset by the impact of the consolidation of GVT (+10.1 p.p.). In organic terms, the year-on-year variation was 4.5%, principally due to the good evolution in the mobile business (+6.2% year-on-year) as well as the fixed business (+1.9% year-on-year), which was partially offset by the impact of the regulatory interconnection tariff reduction (-2.7 p.p. of the year-on-year variation).

**Revenues from the mobile business** totaled 6,906 million euros in 2015, down 9.3% in reported terms due mainly to the depreciation of the Brazilian real (which accounted for -15.3 p.p. of the evolution). Excluding this impact, revenues from the mobile business increased by 6.2% due to the positive evolution of service revenues (+5.3% year-on-year) as a result of the good performance of outbound revenues, which increased as a result of an increase in the contract customer base and the higher data penetration. This trend was partially offset by lower inbound revenues affected by lower interconnection tariffs. Handset revenues were up by 5.1% in reported terms, due to higher proportion of contract add and higher smartphones and LTE handset sales.

**Fixed telephony revenues** totaled 4,154 million euros, up by 15.0% in reported terms due mainly to the consolidation of GVT (+31.9 p.p.) and were partially offset by the impact of depreciation of the Brazilian real (which accounted for -19.4 p.p. of the evolution). Excluding these effects, revenues were up by 1.9%, mainly due to the increase in fixed broadband revenues, which were up by 9.3% supported by the increase of fiber and the growth of Pay TV accesses with higher ARPU, in spite of the lower retail fixed-mobile tariff (-2.5 p.p.).

The **mobile ARPU** decreased 13.2% year-on-year in reported terms due mainly to depreciation of the Brazilian real. In organic terms, it increased 1.6% year-on-year as a consequence of the higher data ARPU which more than offset the negative impact of the reduction in the mobile termination rates. We believe the high quality of the customer base is reflected in an increase in the outbound ARPU and the 31.5% growth in the data ARPU.

| TELEFÓNICA BRAZIL                   | 2014    | 2015    | %YoY     | %Local Currency YoY |
|-------------------------------------|---------|---------|----------|---------------------|
| Voice Traffic (millions of minutes) | 127,412 | 131,029 | 2.8%     | 2.8%                |
| ARPU (EUR)                          | 7.3     | 6.3     | (13.2%)  | 1.6%                |
| Prepay                              | 3.9     | 3.2     | (18.5%)  | (4.7%)              |
| Contract (1)                        | 15.7    | 13.3    | (15.0%)  | (0.7%)              |
| Data ARPU (EUR)                     | 2.6     | 2.9     | 12.5%    | 31.5%               |
| % non-SMS over data revenues        | 77.4%   | 82.9%   | 5.5 p.p. | 5.5 p.p.            |

Notes:

(1) Excludes M2M.

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**OIBDA** stood at 3,573 million euros in 2015, up 0.9% in reported terms due mainly to the consolidation of GVT (which accounted for +12.5 p.p. of the evolution) and, to a lesser extent, the lower restructuring costs incurred in 2015 compared to 2014 (+1.7 p.p.), and the higher results from the sale of towers compared to 2014 (+0.3 p.p.), all of which was partially offset by the negative impact of the depreciation of the Brazilian real (-17.0 p.p.). In organic terms, the year-on-year increase was 2.9% due to revenue growth and cost efficiency offsetting a worse macro scenario with higher inflation, high devaluation and a higher rate of bad debt. Personnel expenses totaled 1,042 million euros in 2015, up 6.8% in reported terms as result mainly of the consolidation of GVT, which was partially offset by the depreciation of the Brazilian real. In organic terms, personnel expenses increased by 3.5% year-on-year due to higher social benefits and the internalization of the work of certain network contractors which more than offset the savings resulting from restructuring plans in 2014. In addition, network costs grew due to higher energy costs and the deployment and improvement of fixed- and mobile networks, legal contingencies and higher content costs. OIBDA was also positively impacted by the expiration of a payment obligation (98 million euros).

**The OIBDA margin** stood at 32.3% in reported terms for 2015, up 0.8 p.p. compared to 2014.

Table of Contents**TELEFÓNICA HISPANOAMÉRICA**

The below table shows the evolution of accesses in Telefónica Hispanoamérica over the past two years as of December 31 of such years:

**ACCESSES**

| Thousands of accesses            | 2014      | 2015      | % Reported YoY |
|----------------------------------|-----------|-----------|----------------|
| Fixed telephony accesses (1) (2) | 13,374.4  | 12,829.8  | (4.1%)         |
| Internet and data accesses       | 5,433.8   | 5,667.8   | 4.3%           |
| Broadband                        | 5,379.4   | 5,610.4   | 4.3%           |
| Mobile accesses                  | 110,346.5 | 113,302.7 | 2.7%           |
| Prepay (3)                       | 86,698.0  | 88,332.8  | 1.9%           |
| Contract                         | 23,648.5  | 24,969.8  | 5.6%           |
| M2M                              | 2,062.2   | 2,296.9   | 11.4%          |
| Pay TV                           | 2,431.9   | 2,812.2   | 15.6%          |
| Final Clients Accesses           | 131,586.6 | 134,612.4 | 2.3%           |
| Wholesale Accesses               | 16.4      | 30.9      | 87.8%          |
| Total Accesses T. Hispanoamérica | 131,603.0 | 134,643.3 | 2.3%           |

Notes:

(1) Includes "fixed wireless" and Voice over IP accesses.

(2) Includes 50 thousand "fixed wireless" additional customers in Peru, in the second quarter of 2014.

(3) In the fourth quarter of 2014, 1.8 millions of inactive customers were disconnected in Central America.

Total accesses in Telefónica Hispanoamérica reached 134.6 million accesses at December 31, 2015 (+2.3% year-on-year).

**Mobile accesses** totaled 113.3 million (+2.7% year-on-year) due to positive net adds of 3.0 million accesses.

There was strong contract segment growth, which expanded by 5.6% year-on-year. Growth was particularly strong in Peru (+12.9% year-on-year), Mexico (+22.3% year-on-year) and Chile (+4.2% year-on-year). Annual net adds reached 1.3 million accesses, primarily due to Peru (+659 thousand net adds) which benefitted from a successful migration strategy (from prepay to contract). Mexico also showed positive net adds (+327 thousand accesses) due to higher commercial activity.

In the prepay segment (+1.9% year-on-year), with net adds of 1.6 million customers, growth was driven mainly by Mexico (+2.9 million customers) while Venezuela and Central America closed with 1.2 million net adds, partially compensating the net loss in Chile (-0.9 million customers) and Peru (-0.7 million customers) where we have faced a fierce competition and we have concentrated on high value customers migrating the best prepaid customers to contract and not following competition offers that would damage the quality of our networks due to intense traffic.

There was growth in smartphones (+43.7% year-on-year) to 40.2 million accesses as of December 31, 2015, with a penetration over mobile accesses of 36.7% (+10.4 p.p. year-on-year), related mainly to Mexico, Argentina, Peru and Colombia. 4G handsets also continued to grow, reaching 8.3 million accesses as of December 31, 2015 (corresponding to a penetration of 7.4%).

Traditional **fixed business accesses** stood at 12.8 million at December 31, 2015 (-4.1% year-on-year), with negative net adds of 545 thousand customers, affected by the erosion of traditional fixed business in the region, including Chile (-5.9% year-on-year), Peru (-4.4% year-on-year), Colombia (-2.1% year-on-year) and Argentina (-1.9% year-on-year).

**Broadband accesses** totaled 5.6 million at December 31, 2015 (+4.3% year-on-year), after reaching net adds of 0.2 million accesses during 2015 due mainly to access growth in Peru (+8.0%), Chile (+5.8%) and Colombia (+4.0%). The penetration of fixed broadband accesses over traditional fixed business accesses was 43.7% at December 31, 2015 (+3.5 p.p. year-on-year). There was progressive migration towards data plans with higher speeds, with 53.4% of broadband accesses having a speed over 4Mb at December 31, 2015 (+4 p.p. year-on-year).

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Pay TV accesses totaled 2.8 million (+15.6% year-on-year), with net adds of 0.4 million accesses as a result of an improvement in all countries in the region that offer the service. Growth was particularly positive in Peru (+26.7% year-on-year), Colombia (+17.5%) and Chile (+7.2%).

The table below shows the evolution of Telefónica Hispanoamérica's results over the past two years:

Millions of euros

| TELEFÓNICA HISPANOAMÉRICA     | 2014         | 2015         | %Reported<br>YoY | %Organic<br>YoY (1) |
|-------------------------------|--------------|--------------|------------------|---------------------|
| Revenues                      | 13,155       | 14,387       | 9.4%             | 10.1%               |
| Mobile Business               | 9,578        | 10,347       | 8.0%             | 10.2%               |
| Mobile service revenues       | 8,454        | 9,160        | 8.4%             | 10.6%               |
| Fixed Business                | 3,604        | 4,070        | 12.9%            | 10.0%               |
| Other income                  | 254          | 347          | 36.5%            | 29.6%               |
| Supplies                      | (3,841)      | (4,176)      | 8.7%             | 7.2%                |
| Personnel expenses            | (1,525)      | (1,686)      | 10.6%            | 16.0%               |
| Other expenses                | (3,975)      | (4,516)      | 13.6%            | 15.1%               |
| <b>OIBDA</b>                  | <b>4,068</b> | <b>4,356</b> | <b>7.1%</b>      | <b>7.2%</b>         |
| OIBDA Margin                  | 30.9%        | 30.3%        | (0.6 p.p.)       | (0.8 p.p.)          |
| Depreciation and amortization | (2,034)      | (2,241)      | 10.2%            | 7.8%                |
| <b>Operating Income (OI)</b>  | <b>2,034</b> | <b>2,115</b> | <b>4.0%</b>      | <b>6.7%</b>         |
| CapEx                         | 2,842        | 3,060        | 7.7%             | 17.2%               |
| OpCF (OIBDA-CapEx)            | 1,226        | 1,296        | 5.7%             | (7.0%)              |

(1) See adjustments made to calculate organic variation below.

### Adjustments made to calculate organic variations

As explained above, year-on-year changes referred to in this document as “organic” or presented in “organic terms” intend to present year-on-year variations on a comparable basis.

With respect to Telefónica Hispanoamérica, we have made the following adjustments in order to calculate 2015/2014 variations in organic terms:

**Foreign exchange effects and the impact of hyperinflationary adjustments in Venezuela:** We have excluded the impact of changes in exchange rates by assuming constant average foreign exchange rates in 2015 and 2014. In particular, we have used the average foreign exchange rates of 2014 for both years.

We have also excluded the impact of hyperinflationary adjustments in Venezuela.

**Restructuring costs:** We have excluded the impact of certain restructuring costs associated with certain simplification processes implemented in Telefónica Hispanoamérica. In 2015, restructuring costs totaled 38 million euros. In 2014, restructuring costs totaled 99 million euros.

**Results of tower sales:** The results attributable to the sale of towers in 2015 and 2014 have been excluded, which totaled 18 million euros (mainly in Chile) in 2015 and 4 million euros in 2014.

**Spectrum acquisition:** We have excluded the impact of spectrum acquisitions in 2015 and 2014. In 2015, these acquisitions totaled 338 million euros and related to Telefónica Argentina (196 million euros), Telefónica Ecuador (127 million euros), Telefónica Chile (6 million euros) and Telefónica México (8 million euros). In 2014, these acquisitions totaled 405 million euros and related to Telefónica Argentina (168 million euros), Telefónica Colombia (111 million euros) and Telefónica Venezuela and Central America (126 million euros).



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The table below shows 2015/2014 variations in reported and organic terms (the latter, calculated in accordance with the adjustments referred to above) of certain income statement and other measures, and the contribution of each item for which we have adjusted to our reported growth:

| TELEFÓNICA<br>HISPANOAMÉRICA<br>2015 | YoY variation    |                 | Contribution to reported growth (percentage points) |                 |                        |                         |
|--------------------------------------|------------------|-----------------|---|-----------------|------------------------|-------------------------|
|                                      | %Reported<br>YoY | %Organic<br>YoY | Exchange rate effect<br>and Hyperinflation          | Towers<br>sales | Restructuring<br>Costs | Spectrum<br>acquisition |
| Revenues                             | 9.4%             | 10.1%           | (0.6)   | --              | --                     | --                      |
| Other income                         | 36.5%            | 29.6%           | 2.1   | 5.1             | --                     | --                      |
| Supplies                             | 8.7%             | 7.2%            | 1.5   | --              | --                     | --                      |
| Personnel expenses                   | 10.6%            | 16.0%           | --  | --              | (4.1)                  | --                      |
| Other expenses                       | 13.6%            | 15.1%           | (1.4)   | --              | --                     | --                      |
| <b>OIBDA</b>                         | <b>7.1%</b>      | <b>7.2%</b>     | <b>(2.0)</b>  | <b>0.3</b>      | <b>1.5</b>             | <b>--</b>               |
| CapEx                                | 7.7%             | 17.2%           | (3.6)   | --              | --                     | (3.3)                   |
| <b>OpCF (OIBDA-CapEx)</b>            | <b>5.7%</b>      | <b>(7.0%)</b>   | <b>1.5</b>  | <b>1.0</b>      | <b>5.1</b>             | <b>7.7</b>              |

## Results Discussion

**Revenues** amounted to 14,387 million euros in 2015, increasing 9.4% year-on-year in reported terms mainly due to the good results of data revenues (fixed as well as mobile) and voice revenues, in both cases due to a higher customer base, increased consumption and higher data penetration. This increase was partially offset by foreign exchange effects and hyperinflation in Venezuela and the decrease in mobile termination rates. In organic terms, revenues increased 10.1% year-on-year.

Mobile service revenues reached 9,160 million euros in 2015, up 8.4% year-on-year in reported terms mainly due to increased revenues in Argentina, Peru, Mexico and Chile, as explained in greater detail below, which was partially offset by the foreign exchange effects and the hyperinflation in Venezuela (which accounted for -2.2 p.p. of the year-on-year variation). Mobile service revenues performance by country was as follows:

In Argentina, mobile service revenues reached 2,194 million euros in 2015 and grew by 29.2% year-on-year in reported terms mainly due to the good performance of consumption and data penetration and, to a lesser extent, the growth of the voice business and the foreign exchange effect (which increased growth by 6.4 p.p.). In local currency, these revenues grew by 22.9%.

In Mexico, mobile service revenues reached 1,539 million euros in 2015, increasing by 8.9% in reported terms mainly due to a higher customer base and the positive performance of the data business. In local currency these revenues grew by 8.4%, accounting the foreign exchange effect for 0.5 p.p. of the year-on-year reported increase.

In Chile, mobile service revenues reached 1,177 million euros in 2015, up 5.8% in reported terms year-on-year mainly due to the foreign exchange effect (which accounted for 4.6 p.p. of the increase) and the increase in data revenues, which more than compensated the fall in the traditional voice business and the lower mobile termination rates. In local currency these revenues grew by 1.2%.

In Peru, mobile service revenues reached 1,390 million euros in 2015, up 11.2% in reported terms mainly due to the foreign exchange effect (which accounted for 7.0 p.p. of the increase) and the higher contract customer base, the data boom and higher inbound revenues.

In Venezuela and Central America, mobile service revenues reached 1,261 million euros in 2015, down 3.5% in reported terms mainly due to the foreign exchange effect and hyperinflation in Venezuela (which decreased growth in 35.1 p.p.). Excluding these effects, these revenues increased by 31.7% mainly due to the higher tariffs in all services in order to try to compensate the high inflation in Venezuela and the higher non-SMS data revenues (+83% in 2015), which represented 83.4% of total data revenues (+11.4 p.p. year-on-year).

Data revenues in the segment were up by 19.5% in reported terms in 2015, reaching 3,198 million euros mainly due to the increase in penetration of data which increased from 31.7% to 34.9% in 2015 and higher data usage. This increase was partially offset by foreign exchange effects and hyperinflation in Venezuela (which decreased growth by 4.2 p.p.). Excluding these effects, these revenues grew by 23.6% as a result of the aforementioned increase in penetration of data.

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Fixed business revenues reached 4,070 million euros in 2015, up 12.9% in reported terms mainly due to the increase in broadband and new services revenues (+20.5%). Revenues from broadband and new services, accounted for 64.7% of fixed revenues (+4.9 p.p. year-on-year). The growth was mainly related to Argentina which experienced a substantial increase in voice and broadband revenues, as well as Chile and Peru, which had increased broad band revenues. Excluding the foreign exchange effect and hyperinflation in Venezuela (which decreased growth by 2.9 p.p.) these revenues grew by 10.0%.

**ARPU** was up by 6.1% in 2015, due to the data ARPU increase (+19.9% year-on-year) due to the increase of smartphone penetration and higher average consumption, which offset voice ARPU decrease. The lower ARPU was mainly due to lower interconnection costs and the devaluation of certain Latin American currencies against the U.S. dollar, which more than offset the increase in outgoing voice ARPU (up 7.0% year-on-year).

**OIBDA** reached 4,356 million euros in 2015, up 7.1% in reported terms (+7.2% in organic terms), being Telefónica Argentina, Telefónica Peru and Telefónica Chile the main contributors to this growth, as higher revenues offset higher costs. OIBDA was positively affected by a spectrum swap in Mexico with AT&T in December 2015 (which contributed 79 million euros). The higher costs were mainly attributable to:

higher commercial costs, due to higher handset costs as a result of higher high-end handset sales (which more than offset lower interconnection costs resulting from the mobile termination rates reductions in Chile, Colombia, Peru and Mexico);

- higher personnel costs driven by increases in inflation in some countries of the region;
- higher costs related to commercial campaigns, higher network costs due to higher voice and data traffic; and
- higher costs resulting from the devaluation of certain Latin American currencies against the U.S. dollar.

Additional information by country is provided below:

Argentina: OIBDA reached 1,006 million euros, up by 25.4% in reported terms mainly due to the exchange rate effect and higher service revenues, more than offsetting the higher costs resulting from the overall prices increase, although Telefónica continued to carry out cost containment plans in order to offset the inflation effect. In local currency, the year-on-year variation was 19.2%.

Chile: OIBDA reached 760 million euros, up 7.4% in reported terms mainly due to the exchange rate effect and higher service revenues, lower supply costs due to regulatory changes (lower interconnection costs resulting from the mobile termination rates reduction) and efficiency measures that helped to offset the commercial effort made to gain higher value customers. In local currency, the year-on-year variation was 2.7%.

Peru: OIBDA reached 943 million euros, up by 11.8% in reported terms mainly due to the exchange rate effect and higher service revenues, which more than offset higher commercial costs resulting from higher competitive pressure in the Peruvian market. In local currency OIBDA decreased by 4.7% year-on-year.

Venezuela and Central America: OIBDA reached 342 million euros, down by 26.1% in reported terms mainly due to the exchange rate effect and hyperinflation in Venezuela. Excluding these impacts, OIBDA grew 15.8% mainly driven by higher service revenues, which compensated the overall rise in prices, and higher purchases in dollars for services and equipment purchases, which were affected by the currency devaluation in Venezuela.

**OIBDA margin** reached 30.3% in 2015, with a year-on-year decrease of 0.6 p.p. in reported terms. This margin decrease was driven by lower margins in all countries in the segment except Mexico (which benefitted from higher commercial efforts focused on higher value segments), especially in Argentina and Colombia.

#### Our services and products

New digital technologies are the main driving force of social and economic transformation today. This premise is the basis upon which we build our vision: we want to provide access to digital life, using the best technology and without leaving anyone behind.

Connectivity is our ally in reducing the digital divide and, due to our fixed and mobile network infrastructure and the services we develop around it, we can aid progress in the communities in which we operate.

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To move towards this vision, at Telefónica we work on three basic fronts:

- 1) Providing access to technology through digital inclusion, in other words, by means of network roll-out and an accessible and affordable offer for all sectors of the population.
- 2) Developing innovative services that add value to our connectivity and which we develop through innovation: Big Data, the Internet of Things (IoT), eHealth, digital education and eFinances.
- 3) Incorporating sustainability principles to all of our product development processes.

## **Mobile business**

Telefónica offers a wide variety of mobile and related services and products to personal and business customers. Although they vary from country to country, Telefónica's principal services and products are as follows:

- **Mobile voice services:** Telefónica's principal service in all of its markets is mobile voice telephony.

**Value added services:** Customers in most of the markets have access to a range of enhanced mobile calling features, including voice mail, call hold, call waiting, call forwarding and three-way calling.

**Mobile data and Internet services:** Current data services offered include Short Messaging Services, or SMS, and Multimedia Messaging Services, or MMS, which allow customers to send messages with images, photographs, sound recordings and video recordings. Customers may also receive selected information, such as news, sports scores and stock quotes. Telefónica also provides mobile broadband connectivity and Internet access. Through mobile Internet access, customers are able to send and receive e-mail, browse the Internet, download games, purchase goods and services in m-commerce transactions and use Telefónica's other data and software services.

- **Wholesale services:** Telefónica has signed network usage agreements with several MVNOs in different countries.

**Corporate services:** Telefónica provides business solutions, including mobile infrastructure in offices, private networking and portals for corporate customers that provide flexible online billing.

**Roaming:** Roaming agreements allow Telefónica customers to use their mobile handsets when they are outside their service territories, including on an international basis.

**Fixed wireless:** Telefónica provides fixed voice telephony services through mobile networks in Brazil, Venezuela, Argentina, Peru, Mexico, Ecuador, El Salvador, Guatemala and Nicaragua.

**Trunking and paging:** Telefónica provides digital mobile services for closed user groups of clients and paging services in Spain and most of its operations in Latin America.

#### Fixed-line telephony business

The principal services Telefónica offers in its fixed businesses in Europe and Latin America are:

**Traditional fixed telecommunication services:** Telefónica's principal traditional fixed telecommunication services include PSTN lines; ISDN accesses; public telephone services; local, domestic and international long-distance and fixed-to-mobile communications services; corporate communications services; supplementary value added services (including call waiting, call forwarding, voice and text messaging, advanced voicemail services and conference-call facilities); video telephony; business oriented value-added services; intelligent network services; leasing and sale of handset equipment; and telephony information services.

**Internet and broadband multimedia services:** the principal Internet and broadband multimedia services include Internet service provider service; portal and network services; retail and wholesale broadband access through ADSL, naked ADSL (broadband connection without the monthly fixed line fee); narrowband switched access to Internet for Universal Service, and other technologies. Telefónica also offers high-speed Internet services through fiber to the home (FTTH) in certain markets (primarily Spain, Brazil and Chile) and VDSL-based services (primarily Spain and Germany). Telefónica also offers VoIP services in some markets.

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**Data and business-solutions services:** the data and business-solutions services principally include leased lines; virtual private network, or VPN, services; fiber optics services; the provision of hosting and application, or ASP, service, including web hosting, managed hosting, content delivery and application, and security services; outsourcing and consultancy services, including network management, or CGP; and desktop services and system integration and professional services.

**Wholesale services for telecommunication operators:** the wholesale services for telecommunication operators principally include domestic interconnection services; international wholesale services; leased lines for other operators; network deployment; and local loop leasing under the unbundled local loop regulation framework). It also includes bit stream services, bit stream naked, wholesale line rental accesses and leased ducts for other operators' fiber deployment.

## Digital services

The main highlights in services developed by Telefónica Digital are:

**Video/TV services:** IPTV services (Internet protocol), over-the-top network television services, and cable and satellite TV. Advanced pay TV services are also offered, such as high-definition TV (HDTV), Multiroom (allowing clients to watch different TV channels in different rooms), Digital Video Recording (DVR), Multiscreen (all contents in everywhere), CatchUp contents, third party contents and Cloud Video Services (such as Last 7 days, RestartTV and Cloud DVR). In addition, Telefónica offers accessible content with subtitles, audio description and sign language functionalities through the Movistar+ 5s service. The aim is to contribute toward the inclusion of disabled people across the country.

**IoT (Internet of Things):** Telefónica Global IoT portfolio services include:

**Smart Connectivity:** horizontal services including mostly basic users (machines) managed through two different connectivity platforms, SmartM2M (developed and owned by Telefónica) and Jasper (third party developed)

**Smart Services:** full end-to-end “device + connectivity + application” solutions targeting to four pre-defined specific vertical sectors: Cities, Mobility, Energy and Retail

**Personal IoT:** set of services, focused on the B2C segment, supporting usual healthcare, safety and fitness practice through different electronic and communication processes (SMS and push messages, web-based solutions, tracking, wearables).

**Financial services and other payment services:** These services allow final customers and financial institutions to make money transfers, payments and mobile recharges.

**Security services:** A broad set of facilities (Managed Security, Cloud and Comms Security, Cybersecurity (threats, vulnerabilities and antifraud platforms)) targeting to protect information stored in different end customers' devices and networks from unauthorized access, use, disclosure, disruption or destruction, and including 11Paths developed services such as Latch, FaasT, Metashield or Tacyt.

**Cloud computing services:** Includes Managed Cloud, which allows us to build fully managed infrastructure environments for large enterprises and also manage the complex tools and applications that run on top of that infrastructure; and in addition, for small and medium sized businesses "All-in" Bundles (Comms+Devices+Cloud). Telefónica is bundling offers based on a Cloud Service Broker that provides a vast self-service experience to the customer and a large set of capabilities, flexibility and a comprehensive commercial offer.

**Advertising:** Portfolio of marketing channels that third party brands can use to acquire and engage with customers. Traditional channels such as messaging are utilized alongside new channels like programmatic display and sponsored connectivity – all fueled by powerful customer data.

**Big Data:** Includes the product "Smart Steps" which helps retailers, municipalities and public security bodies to understand the influx of people. Anonymous mobile data network and aggregates are used to calculate the influx of people in an area. Telefónica also offers B2B opt-in services to the financial sector (Smart Digits) for improving fraud prevention and credit scoring in Brazil, United Kingdom and Chile. Recently a Smart Steps joint venture has been launched with China Unicom based out of Beijing to sell data insights in China.



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### Sales and Marketing

Our sales and marketing strategy is aimed toward reinforcing our market position, generating brand awareness, promoting customer growth and achieving customer satisfaction. We use a variety of marketing initiatives and programs, including those that focus on customer value, with in-depth market segmentation; programs to promote customer loyalty; pricing initiatives aimed toward stimulating usage, including segmented packages and innovative tariff options; and initiatives that are responsive to the latest market trends, including those aimed toward boosting demand for our mobile Internet and mobile broadband offerings. In connection with these and our other sales and marketing initiatives, we market our products through a broad range of channels, including television, radio, billboards, telemarketing, direct mail and Internet advertising. We also sponsor a variety of local cultural and sporting events in order to enhance our brand recognition.

### Competition

The telecommunications industry is competitive and consumers generally have a choice of mobile and fixed line operators from which to select services. We are a global telecommunications services provider and face significant competition in most of the markets in which we operate. In Europe, our largest competitor is Vodafone and in Latin America, our largest competitor is América Móvil. Newer competitors, including handset manufacturers, MVNOs, internet companies and software providers, are also entering the market and offering integrated communications services.

We compete in our markets on the basis of the price of our services; the quality and range of features; the added value we offer with our service; additional services associated with those main services; the reliability of our network infrastructure and its technological attributes; and the desirability of our offerings, including bundled offerings of one type of service with another and, in the case of the mobile industry, in most of the markets offerings that include subsidized handsets.

To compete effectively with our competitors, we need to successfully market our products and services and to anticipate and respond to various competitive factors affecting the relevant markets, such as the introduction of new products and services, different pricing strategies and changes in consumer preferences. See “Risk Factors – Risks Relating to the Group’s Industry – The Company may not be able to adequately foresee and respond to technological changes and sector trends.”

### Strategic Partnerships

## **China Unicom**

Since 2005, we have had a stake in China Unicom and its predecessor company. On September 6, 2009 we entered into a strategic alliance agreement with China Unicom, which provides, among other areas for cooperation, joint procurement of infrastructure and client equipment, common development of mobile service platforms, joint provisions of service to multinational customers, roaming, research and development, sharing of best practices and technical, operational and management know-how, joint development of strategic initiatives in the area of network evolution, joint participation in international alliances and exchanges of senior management. In furtherance of this strategic alliance we entered into a subscription agreement with China Unicom, pursuant to which we increased our voting interest in the share capital of China Unicom to 8.06% and China Unicom obtained 0.87% voting interest in our share capital in October 2009.

Pursuant to the strategic alliance agreement mentioned above, China Unicom has agreed to use its best endeavors to maintain a listing of all the issued ordinary shares of China Unicom on the Hong Kong Stock Exchange. For so long as the strategic alliance agreement with us is in effect, China Unicom shall not (i) offer, issue or sell any significant number of its ordinary shares (including treasury shares), or any securities convertible into or other rights to subscribe for or purchase a significant number of China Unicom's ordinary shares (including treasury shares), to any current major competitor of Telefónica or (ii) make any significant investment, directly or indirectly, in any current major competitor of Telefónica. We made similar undertakings.

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The initial term of the strategic alliance agreement between us and China Unicom terminated on September 6, 2012 and it is subject to automatic annual renewals, subject to either party's right to terminate on six months' notice. Also, the strategic alliance agreement may be terminated by China Unicom if our shareholding in China Unicom drops below 5% of its issued share capital or if China Unicom's shareholding in us drops below 0.5% of our issued share capital. In addition, the strategic alliance agreement is subject to termination in the event either party is in default and automatically terminates on a change in control of China Unicom.

On January 28, 2011, China Unicom completed its acquisition of 21,827,499 Telefónica shares.

On June 10, 2012, Telefónica, S.A. through its 100% subsidiary, Telefónica Internacional, S.A.U., and China United Network Communications Group Company Limited ("Unicom Parent") through a 100% owned subsidiary, signed an agreement for the acquisition by this last company of 1,073,777,121 shares of China Unicom-Hong Kong-Limited, owned by Telefónica, equivalent to 4.56% of the issued share capital of China Unicom.

On July 21, 2012 the aforementioned agreement was complemented by a Supplemental Agreement which determined the acquisition of the shares at a price of HK\$10.02 per share, for a total amount of HK\$10,759,246,752.42 (approximately 1,142 million euros). The transaction was completed on July 30, 2012.

On November 10, 2014, Telefónica, through its 100% subsidiary, Telefónica Internacional, S.A.U., sold 597,844,100 shares of China Unicom, representing 2.5% of the share capital of the company, by means of a block trade, at a price of HK\$11.14 per share, for a total amount of HK\$6,660 million, approximately 687 million euros at the exchange rate as at the date of the sale.

Further to the sale, Telefónica maintains its commitment to the strategic alliance with China Unicom.

On December 18, 2015 a Smart Steps joint venture was launched with China Unicom based out of Beijing to sell data insights in China.

On July 10, 2016, Telefónica Internacional, S.A.U. (a 100% subsidiary of Telefónica, S.A.) sold 361,794,556 shares of China Unicom (Hong Kong) Limited ("**China Unicom HK**"), representing 1.51% of the share capital of the company, through a block trade process, at a price of 7.80 Hong Kong dollars per share, for a total amount of 2,822 million Hong Kong dollars, approximately 322 million euros.

As of the date of this Annual Report, Telefónica's shareholding in China Unicom amounts to approximately of 1% of its capital stock. Furthermore, Mr. César Alierta, former chairman of Telefónica, S.A. and currently a member of the Board of Directors of Telefónica, is a member of the Board of Directors of China Unicom while Mr. Wang Xiaochu, chairman of China Unicom, is a member of the Board of Directors of Telefónica.

## **Telecom Italia**

Through a series of transactions from 2007 to 2009, Telefónica acquired an indirect holding of 10.49% in the voting shares of Telecom Italia (7.21% of the dividend rights) through its holdings in Telco, S.p.A. ("Telco").

On June 16, 2014, the Italian shareholders of Telco (Assicurazioni Generali S.p.A., Intesa Sanpaolo, S.p.A. Mediobanca, S.p.A.) requested the initiation of the process of demerger of such company, as provided in the shareholders' agreement.

The implementation of such demerger process, which was approved by the General Shareholders' Meeting of Telco held on July 9, 2014, was subject to obtaining all the required anti-trust and telecommunications approvals (including in Brazil and Argentina). Once the aforementioned approvals were obtained, the demerger deed was executed on June 17, 2015, becoming effective on June 18, 2015 after its registration in the Madrid Mercantile Registry. As a consequence of the demerger, the Telecom Italia ordinary shares held by Telco – which represented 22.3% of the company's ordinary share capital – were allocated as follows: 14.72% to Telco TE, S.p.A., a newly created company owned by Telefónica; 4.31% to a newly created company owned by the Generali group; and 1.64% to each of the newly created companies owned by Intesa Sanpaolo and Mediobanca respectively.

Moreover, the shareholders' agreement in force between the shareholders of Telco ceased to have effect on June 18, 2015.

In accordance with the regulatory and competition commitments it had assumed, Telefónica completed the divestment of its entire stake in Telecom Italia during this period.

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The Telecom Italia group is principally engaged in the communications sector and, particularly, in telephone and data services on fixed lines for final and wholesale customers, in the development of fiber optic networks for wholesale customers in the provision of broadband services and Internet services, in domestic and international mobile telecommunications (especially in Brazil), in the television sector using both analog and digital terrestrial technology and in the office products sector. Telecom Italia operates primarily in Europe, the Mediterranean basin and in South America.

For more information, please see “Item 5. Operating and Financial Review and Prospects —Operating Results—Significant Factors Affecting the Comparability of our Results of Operations in the Period Under Review” and “Item 10. Additional Information—Material Contracts.”

Regulation

Please see Appendix VI to our Consolidated Financial Statements.

Licenses and Concessions

Please see Appendix VI to our Consolidated Financial Statements.

Seasonality

Our business is not significantly affected by seasonal trends.

Patents

Our business is not materially dependent upon the ownership of patents, commercial or financial contracts or new manufacturing processes.



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Disclosure Pursuant to Section 219 of the Iran Threat Reduction and Syria Human Rights Act

Section 219 of the Iran Threat Reduction and Syria Human Rights Act of 2012 added Section 13(r) to the Exchange Act. Section 13(r) requires an issuer to disclose in its annual or quarterly reports filed with the SEC whether the issuer or any of its affiliates has knowingly engaged in certain activities, transactions or dealings with the Government of Iran, relating to Iran or with designated natural persons or entities involved in terrorism or the proliferation of weapons of mass destruction during the period covered by the annual or quarterly report. Disclosure is required even when the activities were conducted outside the United States by non-U.S. entities and even when such activities were conducted in compliance with applicable law.

The following information is disclosed pursuant to Section 13(r). None of these activities involved U.S. affiliates of Telefónica.

Roaming Agreements with Iranian Operators

Some of our subsidiaries have entered into roaming agreements with Iranian telecommunication companies. Pursuant to such roaming agreements our subsidiaries' customers are able to roam in the particular Iranian network (outbound roaming) and customers of such Iranian operators are able to roam in our relevant subsidiary's network (inbound roaming). For outbound roaming, our subsidiaries pay the relevant Iranian operator roaming fees for use of its network by our customers, and for inbound roaming the Iranian operator pays the relevant subsidiary roaming fees for use of the respective network by its customers.

Our subsidiaries were party to the following roaming agreements with Iranian telecommunication companies in 2016:

*Telefónica Móviles España S.A.* (“**TME**”), our Spanish directly wholly-owned subsidiary, has respective roaming agreements with (i) Mobile Telecommunication Company of Iran (“**MTCI**”), (ii) MTN Irancell (“**Irancell**”), (iii) (1) Taliya (“**Taliya**”), and (iv) Telecommunication Kish Co (“**TKC**”). During 2016 TME recorded the following revenues related to these roaming agreements: (i) 105,261.99 euros from MTCI, (ii) 8,690.70 euros from Irancell, (iii) none from Taliya and (iv) none from TKC.

TME also holds a roaming hub through its 55% directly-owned subsidiary, Link2One, a.e.i.e. (“**L2O**”). Under the related agreement, L2O provides a roaming hub service to Irancell enabling the latter to maintain a relationship with other members of the hub. Some members of the hub are also entities of the Telefónica Group. During 2016 L2O recorded revenues of 172,707.82 euros from Irancell.

*Telefónica Germany GmbH & Co. OHG* (“**TG**”), our German 63.22% indirectly-owned subsidiary, has respective  
(2) roaming agreements with (i) MTCI and (ii) Irancell. During 2016 TG recorded revenues of (i) 380,001.54 euros from MTCI and (ii) 1,090.56 euros from Irancell.

(3) *Telefónica UK Ltd* (“**TUK**”), our English directly wholly-owned subsidiary, has a roaming agreement with Irancell. During 2016 TUK recorded 186.93 euros in roaming revenues under this agreement.

*Telefónica Argentina, S.A. and Telefónica Móviles Argentina, S.A.* (together “**TA**”), our Argentinean directly  
(4) wholly-owned subsidiaries, have a roaming agreement with Irancell. During 2016 TA recorded 41.82 euros in roaming revenues under this agreement.

(5) *Telefónica Brasil S.A.* (“**TB**”), our Brazilian 73.68% indirectly owned subsidiary, has a roaming agreement with Irancell. During 2016 TB recorded 5.39 euros in roaming revenues under this agreement.

(6) *Pegaso Comunicaciones y Sistemas, S.A. de C.V.* (“**PCS**”), our Mexican directly wholly-owned subsidiary, has a roaming agreement with Irancell. During 2016 PCS recorded 1.61 euros in roaming revenues under this agreement.

The net profit recorded by our subsidiaries pursuant to these agreements did not exceed the related revenues recorded thereunder.

The purpose of all of these agreements is to provide our customers with coverage in areas where we do not own networks. For this purpose, we intend to continue maintaining these agreements.

#### International Carrier Agreement with Iran

Telefónica de España has an international carrier agreement with Telecommunication Company of Iran (“**TCI**”).



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Pursuant to this agreement, both companies interconnect their networks to allow international exchange of telephone traffic. Telefónica de España recorded 16,023.82 euros in revenues under this agreement in 2016. The net profit recorded by Telefónica de España pursuant to this agreement did not exceed such revenues.

The purpose of this agreement is to allow the exchange of international telephone traffic. Consequently, we intend to continue maintaining this agreement.

C. Organizational Structure

See “—History and Development of the Company” and “—Business Overview”.

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D. Property, Plant and Equipment

Our central headquarters for the Telefónica Group are located in “Distrito Telefónica,” in Madrid, Spain.

Fixed Networks

We own fixed networks in Spain, Latin America and Europe, having an incumbent role in Spain, Argentina (the greater Buenos Aires metropolitan area and the southern portion of the country), Brazil (São Paulo), Chile, Peru and Colombia.

Following market trends, competitive environments, evolution of technologies and new multimedia and broadband services demanded by our customers, we have upgraded our networks in recent years in the following manners:

progressive introduction of broadband access technologies over copper: ADSL, ADSL2+, VDSL2, etc., increasing the bandwidth capacity provided to our broadband clients several times in the last ten years;

introduction of fiber access technologies (xPON) across different deployment scenarios: fiber to the home (FTTH), fiber to the building (FTTB), fiber to the curb (FTTC), fiber to the node (FTTN), etc., increasing the access speed up to 300 Mbps;

service support based on powerful Internet Protocol/ Multiprotocol Label Switching (IP/MPLS) backbones, providing full connectivity to the rest of the network layers, such as access and control, to support services for business and customer market segments (fixed and mobile);

migration of the legacy time division multiplexing (TDM) switching networks (PSTN and ISDN) to new generation network (NGN) over all-IP packet networks;

migration from legacy transport technologies, such as asynchronous transfer mode (ATM), frame relay (FR), low-rate leased lines, plesiochronous digital hierarchy (PDH) and synchronous digital hierarchy (SDH), to the new generation of optical transport ones, such as dense wavelength division multiplexing (DWDM), coarse wavelength division multiplexing (CWDM) and new generation-synchronous digital hierarchy (NG-SDH);

introduction of IMS (Internet Multimedia Subsystem) to simplify the control of the network and ease the deployment of new services over the all-IP converged network;

empowerment of the intelligence of the network to better manage its use, to avoid saturations and frauds and to identify new business opportunities;

convergence of fixed and mobile networks, services and support systems from both technological and operational points of view; and

deployment of new services such as Pay TV, to customers connected through broadband accesses in Spain, Chile and Brazil.

### Mobile Networks

We operate mobile networks in Spain, the United Kingdom, Germany, Brazil, Argentina, Venezuela, Chile, Peru, Colombia, Mexico, Guatemala, Panama, El Salvador, Nicaragua, Costa Rica, Ecuador and Uruguay.

We use a number of mobile technologies in the countries in which we operate, namely: GSM, UMTS and LTE, the latter being already deployed in all our operations. We continue the work of upgrading our mobile networks in line with market trends, the demand of new services from customers and the evolution of technologies. The main steps we are currently taking include:

- evolution of broadband into mobile access using technologies such as HSUPA/HSPA+ and LTE;

deployment of new services such as mobile television and distribution services for next generation music, video and games;

exploration of the adequacy of new technologies such as HSPA and LTE to provide mobile accesses with increased bandwidth, in particular:

HSPA: we have extended our coverage up to the majority of the urban/suburban areas, and we have increased the capacity of the network by upgrading the network technology to the latest available releases of UMTS standards 3GPP REL 6, REL 7 and REL 8;

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LTE: together with main vendors and sharing experience with other operators, we are exploiting the opportunities that LTE brings to create higher capacity at lower relative cost by user/traffic unit. We are now expanding the capacity of LTE networks in all operations, and we are planning the deployment of LTE-Advanced, the evolved version of LTE, in the coming years.

convergence of fixed and mobile networks, services and support systems from both technological and operational points of view.

### Satellite communications

The services provided using satellite platforms include television contribution signal to feed cable and IPTV head ends, DTH television, VSAT mainly for telephony and Internet access in rural areas, emergency solutions, corporate communications and international communications.

### Submarine cables

We are one of the world's largest submarine cable operators. We participate in approximately 25 international underwater cable systems (nine of which are moored in Spain) and own eleven domestic fiber optic cables.

There are submarine cable connections between Spain and Africa, America, Asia and Europe, respectively, which are jointly owned by us with other telecom operators. The SAM-1 cable, which we own, has a length of approximately 22,000 kilometers underwater and 3,000 kilometers terrestrial and links different countries such as the United States, Puerto Rico, Ecuador, Guatemala, Peru, Chile, Brazil, Argentina and Colombia.

Extensions of the submarine cable network are being deployed to help meet the capacity demand in the future. The BRUSA cable will link Brazil and the United States, while the Marea cable will link the United States and Europe through Spain. Both cables are expected to begin operating in 2018.

The principal services using the capacity of submarine cables are voice circuits, Internet and dedicated circuits for international traffic and for corporations and business customers.

On February 10, 2016, Telefónica announced the creation of Telxius, a company which brings together certain infrastructure assets of the Group, which enables the management of the Telefónica Group's infrastructure on a global scale with a more specialized and focused approach, with the aim of increasing the services provided to other operators, improving the return on capital invested and allowing Telxius to participate more actively in the growth opportunities that exist in the industry, including the possibility of incorporating third party assets.

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Item 4A. Unresolved Staff Comments

Not applicable.

Item 5. Operating and Financial Review and Prospects

A. Operating Results

Presentation of Financial Information

The information in this section should be read in conjunction with our Consolidated Financial Statements and the notes thereto, included elsewhere in this Annual Report. Our Consolidated Financial Statements have been prepared in accordance with IFRS as issued by the IASB. See also “Presentation of Certain Financial Information Retrospective revisions”.

Following our signing of an agreement on March 24, 2015 with Hutchison for the sale and purchase of the entire issued share capital of Telefónica Europe plc and the reclassification of the results attributable to our operations in the United Kingdom as discontinued operations, our segments were amended in 2015 to reflect the elimination of the Telefónica United Kingdom segment.

Following the EC’s decision to prohibit such sale to Hutchison Whampoa Group, the Board of Directors of Telefónica, S.A. at its meeting on June 29, 2016 agreed that Telefónica will continue to explore different strategic alternatives for O2 UK, to be implemented when market conditions are deemed appropriate. Given that the execution of a sale transaction is less certain, Telefónica’s operations in the United Kingdom are no longer presented as discontinued operations and the respective assets and liabilities cease to be classified as held for sale. Thus, our segments were amended and are now the same as they were prior to the elimination of our Telefónica United Kingdom operating segment, which were approved by the Board of Directors of Telefónica, S.A. on February 26, 2014: Telefónica Spain, Telefónica United Kingdom, Telefónica Germany, Telefónica Brazil and Telefónica Hispanoamérica (comprised of our consolidated subsidiaries in Argentina, Chile, Peru, Colombia, Mexico, Venezuela, Central America, Ecuador and Uruguay).

These segments include the information related to wireline, wireless, DSL, TV, and other digital services provided in each country or countries. The results, assets and liabilities of the segments include the new companies that operate the towers business and, consequently the impacts of the intercompany sales of towers have been eliminated. Any services not specifically included in these new segments are part of “Other companies and eliminations”.

In 2013, Telefónica created the role of the Chief Commercial Digital Officer, who is responsible for fostering revenue growth. On the cost side, the Company has strengthened the role of the Chief Global Resources Officer. Both Officers report directly to the Chief Operating Officer (COO), as well as the local operators in Spain, Brazil, Germany and the United Kingdom, in addition to the Hispanoamérica unit (which excludes Brazil).

### ***Non-GAAP financial information***

The management of the Group uses a series of measures in its decision-making, in addition to those expressly defined in the IFRS, because they provide additional information useful to assess the Group’s performance, solvency and liquidity. These measures should not be viewed in isolation or as a substitute for the measures presented according to the IFRS.

The non-GAAP financial measures included in this Annual Report are operating income before depreciation and amortization, net financial debt and net financial debt plus commitments and free cash flow.

### ***Operating income before depreciation and amortization***

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Operating income before depreciation and amortization (OIBDA) is calculated by excluding solely depreciation and amortization from operating income. OIBDA is used to track the performance of the business and to establish operating and strategic targets of the Telefónica Group companies. OIBDA is a commonly reported measure and is widely used among analysts, investors and other interested parties in the telecommunications industry, although not a measure explicitly defined in IFRS, and therefore, may not be comparable to similar indicators used by other companies. OIBDA should not be considered as a substitute for operating income.

The following table provides a reconciliation of our OIBDA to operating income for the periods indicated.

Year ended December 31,

| Millions of euros                                     | 2014 (*) | 2015 (*) | 2016    |
|---|----------|----------|---------|
| Operating income before depreciation and amortization | 15,515   | 13,229   | 15,118  |
| Depreciation and amortization                         | (8,548)  | (9,704)  | (9,649) |
| Operating income                                      | 6,967    | 3,525    | 5,469   |
| (*) Amended data.                                     |          |          |         |

The following tables provide a reconciliation of OIBDA to operating income for us and each of our business areas for the periods indicated.

2016

| Millions of euros                                     | Telefónica Spain | Telefónica United Kingdom | Telefónica Germany | Telefónica Brazil | Telefónica Hispano-américa | Other and eliminations | Total Group |
|---|------------------|---------------------------|--------------------|-------------------|----------------------------|------------------------|-------------|
| Operating income before depreciation and amortization | 4,467            | 1,709                     | 1,794              | 3,714             | 3,477                      | (43)                   | 15,118      |
| Depreciation and amortization                         | (1,830)          | (1,090)                   | (2,211)            | (2,038)           | (2,190)                    | (290)                  | (9,649)     |
| Operating income                                      | 2,637            | 619                       | (417)              | 1,676             | 1,287                      | (333)                  | 5,469       |

2015 (\*)



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| Millions of euros                                     | Telefónica Spain | Telefónica United Kingdom | Telefónica Germany | Telefónica Brazil | Telefónica Hispano-américa | Other and eliminations | Total Group |
|---|------------------|---------------------------|--------------------|-------------------|----------------------------|------------------------|-------------|
| Operating income before depreciation and amortization | 2,336            | 1,929                     | 1,858              | 3,573             | 4,356                      | (823)                  | 13,229      |
| Depreciation and amortization                         | (1,898)          | (1,196)                   | (2,128)            | (1,916)           | (2,241)                    | (325)                  | (9,704)     |
| Operating income                                      | 438              | 733                       | (270)              | 1,657             | 2,115                      | (1,148)                | 3,525       |

(\*) Amended data.

2014 (\*)

|   |                  |                           |                    |                   | Telefónica      |                        |             |         |       |         |
|---|------------------|---------------------------|--------------------|-------------------|-----------------|------------------------|-------------|---------|-------|---------|
| Millions of euros                                     | Telefónica Spain | Telefónica United Kingdom | Telefónica Germany | Telefónica Brazil | Hispano-américa | Other and eliminations | Total Group |         |       |         |
| Operating income before depreciation and amortization |                  |                           |                    | 5,671             | 1,744           | 733                    | 3,543       | 4,068   | (244) | 15,515  |
| Depreciation and amortization                         |                  |                           |                    | (1,805)           | (1,121)         | (1,426)                | (1,762)     | (2,034) | (400) | (8,548) |
| Operating income                                      |                  |                           |                    | 3,866             | 623             | (693)                  | 1,781       | 2,034   | (644) | 6,967   |

(\*) Amended data.

*Net financial debt and net financial debt plus commitments*

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As calculated by us, net financial debt includes: (i) current and non-current financial liabilities in our consolidated statement of financial position (which includes the negative mark-to-market value of derivatives) and (ii) other payables included in "Trade and other payables" (mainly corresponding to payables for deferred payment of radio spectrum). From these liabilities, it is subtracted: i) the cash and cash equivalents, ii) the current financial assets (which include short-term derivatives), iii) the positive mark-to-market value of derivatives with a maturity beyond one year, and iv) other interest-bearing assets (components of "Trade and other receivables" and "Non-current financial assets" in our consolidated statement of financial position).

We calculate net financial debt plus commitments by adding to net financial debt gross commitments related to employee benefits, and deducting the value of long-term assets associated with those commitments and the tax benefits arising from the future payments of those commitments.

We believe that net financial debt and net financial debt plus commitments are meaningful for investors and analysts because they provide an analysis of our solvency using the same measures used by our management. We use net financial debt and net financial debt plus commitments to calculate internally certain solvency and leverage ratios used by management. Nevertheless, neither net financial debt nor net financial debt plus commitments as calculated by us should be considered as a substitute for gross financial debt as presented in the consolidated statement of financial position.

The following table presents a reconciliation of net financial debt and net financial debt plus commitments as of December 31, 2016 and 2015 to the Telefónica Group's gross financial debt as indicated in the consolidated statement of financial position.

| Millions of euros  | 12/31/2016 | 12/31/2015 (*) |
|--|------------|----------------|
| Non-current financial liabilities                                    | 45,612     | 47,117         |
| Current financial liabilities  | 14,749     | 12,970         |
| Gross financial debt   | 60,361     | 60,087         |
| Cash and cash equivalents  | (3,736)    | (2,615)        |
| Current financial assets   | (2,954)    | (3,053)        |
| Positive mark-to-market value of long-term derivative instruments    | (5,048)    | (5,315)        |
| Other non-current liabilities included in "Trade and other payables" | 749        | 1,073          |
| Other current liabilities included in "Trade and other payables"     | 449        | 462            |
| Other assets included in "Non-current financial assets"              | (524)      | (691)          |
| Other assets included in "Current trade and other payables"          | (702)      | (787)          |

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|  |         |         |
|--|---------|---------|
| Net financial debt                             | 48,595  | 49,161  |
| Gross commitments related to employee benefits | 6,839   | 6,070   |
| Value of associated long-term assets           | (749)   | (736)   |
| Tax benefits                                   | (1,569) | (1,666) |
| Net commitments related to employee benefits   | 4,521   | 3,668   |
| Net financial debt plus commitments            | 53,116  | 52,829  |

(\*) Amended data.

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*Free Cash Flow*

The Group's Free cash flow is calculated starting from "Net cash flow provided by operating activities" as indicated in the consolidated statement of cash flows; deducting (Payments on investments)/Proceeds from the sale of investments in property, plant and equipment and intangible assets, net (without considering cash received from the sale of real state), adding the cash received from government grants and deducting dividends paid to minority interests. The cash used to cancel commitments related to employee benefits is added back (originally included in the Net cash flow provided by operating activities) as it represents the payments of principal of the debt incurred with those employees.

We believe that Free cash flow is a meaningful measure for investors and analysts because it provides an analysis of the cash flow available to meet our debt repayment requirements and protect solvency levels (financial debt and commitments). It also provides information regarding amounts available to and remunerate the parent company's shareholders once our debt payment obligations are met. The same measure is used internally by our management. Nevertheless, the Free cash flow as calculated by us should not be considered as a substitute for the various flows of cash as presented in the consolidated statements of cash flows.

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The following table presents the reconciliation between the Telefónica Group's Net cash flow provided by operating activities as indicated in the consolidated statement of cash flows and the Free cash flow for 2016, 2015 and 2014:

| Millions of euros   | 2016         | 2015         | 2014         |
|---|--------------|--------------|--------------|
| <b>Net cash flow provided by operating activities</b>   | 13,338       | 13,615       | 12,193       |
| (Payments on investments)/Proceeds from the sale of investments in property, plant and equipment and intangible assets, net | (9,187)      | (10,256)     | (8,865)      |
| Net cash received from sale of real state   | (8)          | (36)         | (3)          |
| Government grants received  | -            | 7            | 30           |
| Payments related to cancellation of commitments   | 738          | 721          | 789          |
| Dividends paid to minority shareholders   | (511)        | (537)        | (327)        |
| <b>Free Cash Flow</b>   | <b>4,370</b> | <b>3,514</b> | <b>3,817</b> |

#### Significant Factors Affecting the Comparability of Our Results of Operations in the Periods under Review

Please see "Comparative information and main changes in the consolidation scope" in Note 2 to our Consolidated Financial Statements.

#### Significant Changes in Accounting Policies

Please see Note 3(n) to our Consolidated Financial Statements.

#### Critical Accounting Policies and Estimates

The preparation of financial statements in conformity with IFRS requires management to make estimates and assumptions that affect the amounts reflected in the Consolidated Financial Statements and accompanying notes. We base our estimates on historical experience, where applicable, and other assumptions that we believe are reasonable under the circumstances. Actual results may differ from those estimates under different assumptions or conditions.

We consider an accounting estimate to be critical if:

- it requires us to make assumptions because information was not available at the time or it included matters that were highly uncertain at the time we were making our estimate; and

- changes in the estimate or different estimates that we could have selected may have had a material impact on our financial condition, results of operations or cash flows.

The various policies that are important to the portrayal of our financial condition, results of operations and cash flows include:

- accounting for long-lived assets, including goodwill;

- deferred taxes;

- provisions;

- revenue recognition; and

- exchange rate used to remeasure Venezuelan bolívar fuerte (BsF)-denominated items.

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*Accounting for long-lived assets, including goodwill*

Property, plant and equipment and intangible assets, other than goodwill, are recorded at acquisition cost. If such assets are acquired in a business combination, the acquisition cost is the estimated fair value of the acquired property, plant and equipment or intangible assets. Property, plant and equipment and intangible assets with definite useful lives are depreciated or amortized on a straight-line basis over their estimated useful lives.

Intangible assets with indefinite useful lives are not amortized, but are, instead, subject to an impairment test on a yearly basis and whenever there is an indication that such assets may be impaired.

Accounting for long-lived assets and intangible assets involves the use of estimates for determining: (a) the fair value at the acquisition date in the case of such assets acquired in a business combination, and (b) the useful lives of the assets over which they are to be depreciated or amortized. We believe that the estimates we make to determine an asset's useful life are "critical accounting estimates" because they require our management to make estimates about technological evolution and competitive uses of assets.

When an impairment in the carrying amount of an asset occurs, non-scheduled write-downs are made. We perform impairment tests of identifiable intangible and long-lived assets whenever there is reason to believe that the carrying value may exceed the recoverable amount, which is the higher of the asset's fair value less costs to sell and its value in use. Furthermore, previously recognized impairment losses may be reversed when changes in the estimates used to determine the asset's recoverable amount indicate that an impairment loss recognized in prior periods no longer exists or may have decreased.

The determination of whether the impairment of long-lived and intangible assets is necessary involves the use of significant estimates and judgment that includes, but is not limited to, the analysis of the cause of potential impairment in value, the timing of such potential impairment and an estimate of the amount of the impairment, which requires the estimation of the future expected cash flows, discount rates and the fair value of the assets.

Specifically, management has to make certain assumptions in respect of uncertain matters, such as growth in revenues, changes in market prices, operating margins, and technology developments and obsolescence, discontinuance of services and other changes in circumstances that indicate the need to perform an impairment test. Management's estimates about technology and its future development require significant judgment because the timing and nature of technological advances are difficult to predict.

Goodwill arises when the cost of a business combination exceeds the acquirer's interest in the net fair value of the identifiable assets acquired and liabilities assumed at the acquisition date. Goodwill is not amortized, but is, instead, subject to an impairment test on a yearly basis and whenever there is an indication that the goodwill may be impaired.

Non-scheduled write-downs of goodwill are made when an impairment in the carrying amount of goodwill occurs. We review, on a regular basis, the performance of our cash-generating units. We compare the carrying amount of the cash-generating unit to which the goodwill has been allocated with its recoverable amount. The determination of the recoverable amount of the cash-generating unit involves extensive use of estimates and significant management judgment is involved. Methods commonly used by us for valuations include discounted cash flow methods.

A significant change in the facts and circumstances that we relied upon in making our estimates may have a material impact on our operating results and financial condition.



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*Deferred income taxes*

The Group assesses the recoverability of deferred tax assets based on estimates of future earnings, and of all the available options to achieve an outcome, it considers the most efficient one in tax terms within the legal framework the Group is subject to. Such recoverability ultimately depends on the Group's ability to generate taxable earnings over the period for which the deferred tax assets remain deductible. This analysis is based on the estimated schedule for reversing deferred tax liabilities, as well as estimates of taxable earnings, which are sourced from internal projections that are continuously updated to reflect the latest trends.

The recognition of tax assets and liabilities depends on a series of factors, including estimates as to the timing and realization of deferred tax assets and the projected tax payment schedule. Actual Group company income tax receipts and payments could differ from the estimates made by the Group as a result of changes in tax legislation or unforeseen transactions that could affect tax balances.

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***Provisions***

Provisions are recorded when, at the end of the period, we have a present obligation as a result of past events, whose settlement requires an outflow of resources that is considered probable and can be measured reliably. This obligation may be legal or constructive, arising from, but not limited to, regulation, contracts, common practice or public commitments, which have created a valid expectation for third parties that we will assume certain responsibilities. The amount recorded is the best estimation performed by the management in respect of the expenditure that will be required to settle the obligations, considering all the information available at the closing date, including the advice of external experts, such as legal advisors or consultants.

If we are unable to reliably measure the obligation, no provision is recorded and information is then presented in the notes to the Consolidated Financial Statements.

Because of the inherent uncertainties in this estimation, actual expenditures may be different from the originally estimated amount recognized.

***Revenue recognition***

*Connection fees*

Revenues from connection fees originated when customers connect to our network are deferred over the average expected length of the customer relationship.

The expected customer relationship period is estimated based on recent historical experience of customer churn rates. Significant changes in our estimations may result in differences in the amount and timing of revenues recognized.

*Multiple-element arrangements*

Arrangements involving the delivery of bundled products or services are assessed to determine whether it is necessary to separate the arrangement into individual component deliverables, each with its own revenue recognition criteria.

Revenue relating to the bundled contracts is allocated to the different deliverables identified, based on their relative fair values (i.e., the fair value of each individual component deliverables in relation to the total fair value of the bundled deliverables), considering that amounts contingent upon delivery of undelivered items are not allocated to delivered items. Given that the handsets and airtime are price-sensitive and volatile in a competitive marketplace, the determination of fair values in the mobile phone business is quite complex.

Additionally, a significant change in the facts and circumstances upon which we based our fair value estimates may have an impact on the allocation of revenues among the different deliverables identified and, consequently, on future revenues.

***Exchange rate and inflation rates used to translate the financial statements of our Venezuelan subsidiaries***

As of December 31, 2016, there are multiple exchange mechanisms and three published exchange rates legally available for translation of the financial statements of the Venezuelan subsidiaries.

We review, on a regular basis, the economic conditions in Venezuela and the specific circumstances of our Venezuelan operations. Assessment of the exchange rate that better reflects the economics of Telefónica's business activities in Venezuela relies on several factors and is performed considering all the information available at the closing date, and entails the use of assumptions and estimates and significant management judgment.

Due to inherent uncertainties in the estimates required to determine the appropriate exchange rate for the conversion of BsF-denominated financial statements, actual cash flows denominated in such currency may differ from the amounts currently recognized on the basis of our estimates, as a result of changes in currency laws or changes in exchange mechanisms or published exchange rates that may have a material impact on the conversion rate used for our Venezuelan subsidiaries' financial statements, affecting the net monetary position of assets (liabilities) denominated in BsF.

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In addition to this, Venezuela is considered as a hyperinflationary economy since 2009. Telefónica recognizes the effects of inflation by restating the financial information of its Venezuelan operation using the “Índice Nacional de Precios al Consumidor de Venezuela” issued by the Central Bank of Venezuela, or the best estimate in case the final index is not available.

Significant management judgment is required to determine the appropriate inflation rate where the official rate is not available. The estimates and underlying assumptions are based on careful consideration of factors that are considered to be relevant and rely on all the information available at the closing date. Actual results may differ from these estimates as a result of changes in circumstances and assumptions about future developments in Venezuela due to evolving market conditions, uncertainty about currency and operating restrictions or other circumstances arising beyond the control of the Company.

## Operating Environment

Our results of operations are dependent, to a large extent, on the level of demand for our services in the countries in which we operate. Demand for services in those countries is affected by the performance of their respective economies, particularly household private consumption, but also gross domestic product, or GDP, inflation, or CPI, external accounts and unemployment rates.

During 2016, global activity was very similar to 2015 and recent developments suggest that growth in 2017 is going to be higher than in 2016. The European Union has grown for the third year in a row due to the improvement of internal demand, especially in Spain. However, political uncertainty in some European countries due to upcoming general elections and the British exit process from the European Union, could add risks to this outlook depending on their outcome.

In Latin America, economic growth in 2017 is expected to be higher than in 2016, although the growth rates are expected to be significantly lower than those achieved before the global recession. The recent recovery in commodity prices, especially oil and copper, are expected to provide some relief to the external accounts balances and to activity growth in the region. However, a faster monetary normalization in the United States, as well as doubts about growth and imbalances in China, could have an impact on inward external flows, making financing conditions in Latin American countries more stringent, which would affect household private consumption negatively.

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***Operating environment by country***

*Spain*

In 2016, Spanish GDP expanded by 3.2% (according to Consensus Economics Forecast (“CFe”), an independent research firm), the same growth rate as in 2015 and considerably higher than the growth rate of 1.4% in 2014, after the average annual contraction of 1.8% in 2009-2013.

This performance was explained by a positive evolution of internal demand, with household consumption increasing 3.2% in 2016 (CFe), compared to a 2.2% increase in 2014-15 and a contraction on average of -2.5% per year during 2009-13.

Investment also showed positive growth in 2016 for the third consecutive year in a row, at a rate of 3.9% (CFe) compared to an average 4.9% growth in 2014-15 and the 8.1% annual decline experienced on average in 2009-13. Inflation was 1.6% in 2016, compared with -0.1% and -1.1% in 2015 and 2014, respectively.

The current account showed again a surplus in 2016 of 1.7% of GDP (CFe), improving the 2014-15 average of 1.2% of GDP.

The unemployment rate continued its downward trend in 2016 after the 26.9% peak reached in the first quarter of 2013. The unemployment rate reached 19.2% at the end of 2016 (CFe), 1.7pp lower than at the end of 2015.

*United Kingdom*

In 2016, the British economy, measured in terms of GDP, is estimated to have increased by 1.9% (CFe) compared with a growth rate of 2.2% in 2015 and 3.1% in 2014. Household consumption was the main source of economic growth, increasing by 2.7% (CFe) in 2016, compared with a growth rate of 2.5% and 2.1% in 2015 and 2014, respectively, driven by its solid fundamentals, with the unemployment rate decreasing to 5% (CFe) on average, from 5.4% registered in 2015 and 6.2% in 2014. On the other hand, fixed capital investment was flat in 2016 (CFe), decelerating from an increase of 3.4% in 2015, and 6.7% in 2014, as high political and economic uncertainty that followed the Brexit referendum in June was likely weighting on firm’s investment decisions.

Inflation (CPI) increased by 1.6% year-on-year in 2016 accelerating from 0.2% in 2015 and 0.5% in 2014, with upward pressures coming from energy and food prices as well as recent exchange rate depreciation.

The British pound sterling experienced a sharp depreciation relative to the euro in 2016, falling by 17% year-on-year, from 0.74 GBP per EUR in 2015 (year-end) to 0.84 GBP per EUR in 2016 (year-end). The increase in uncertainty about the future trade and economic relations between the United Kingdom and the European Union after the Brexit referendum result, was the main reason behind the currency weakness.

### *Germany*

In 2016, the German economy grew by 1.9%, the highest rate since 2011 and after expanding on average 1.7% in 2014-15.

The economic growth in 2016, as well as in 2015, was mainly due to a positive contribution of the internal demand, especially private consumption that showed the highest growth rate in the last decade (2.0% in 2016 (CFe)), which offsets the negative contribution of the external sector to GDP growth.

In 2016 the CPI rate reached 1.7% year-on-year (compared with an average of 0.3% in 2014-15), and the unemployment rate stood at 5.8%, compared with 6.1% in 2015 and 6.4% in 2014.

### *Brazil*

Brazilian GDP decreased approximately 3.5% in 2016 (CFe), following another decrease of 3.8% in 2015 and an increase of 0.5% in 2014, according to the Brazilian Geography and Statistics Institute. Investments contracted by approximately 10.0% in 2016, after a decrease of 13.9% in 2015. Household consumption decreased by approximately 5.0% in 2016, from a 3.9% decrease in 2015.

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Inflation, as measured by the IPCA, increased by 6.3% in 2016 (above the inflation target established by the Brazilian Central Bank of 4.5% but within its range of tolerance), compared to 10.7% in 2015 and 6.4% in 2014. Due to decreasing inflation, the basic interest rate, the Special Clearance and Escrow System rate (Selic rate), was lowered from 14.25% at the end of 2015 to 13.75% at the end of 2016.

The current account deficit reached 23.7 billion U.S. dollars in 2016, compared to 58.9 billion U.S. dollars in 2015 and 104.2 billion U.S. dollars in 2014. In 2016, this deficit was financed by capital inflows, such as foreign direct investments, which reached 78.9 billion U.S. dollars, while portfolio investments would have had an outflow of 19.8 billion U.S. dollars. International reserves increased by 3.5 billion U.S. dollars in 2016, to a level of 372.2 billion U.S. dollars.

Despite the negative activity data, the country-risk decreased, on the back of lower political uncertainties and the approval of fiscal reforms. The J.P. Morgan Emerging Markets Bond Index Plus (EMBI + Brazil) reached 328 basis points at the end of 2016, down from 523 basis points at the end of 2015 and 259 basis points at the end of 2014. The Brazilian real appreciated in 2016. It appreciated against the U.S. dollar by 16.5%, reaching an exchange rate of 3.26 reais per U.S. dollar on December 31, 2016, compared to 3.90 reais per U.S. dollar on December 31, 2015 and to 2.66 reais per U.S. dollar on December 31, 2014.

*Mexico*

Mexico's real GDP increased by an estimated 2.1% in 2016 (CFe), compared with a 2.6% and 2.3% increase in 2015 and 2014, respectively.

Inflation, as measured by the CPI, was 3.4% year-on-year in 2016 compared with 2.1% in 2015, within the Mexican Central Bank's tolerance range of 2% to 4%.

During 2016, exports decreased by 2.5% (CFe), private consumption increased by 2.7% (CFe) and investment increased by 0.8% compared with 2015.

The current account balance posted a deficit of 31 billion U.S. dollars in 2016 – according to CFe – compared with 33 billion U.S. dollars in 2015 (3.0% and 2.9% of GDP, respectively).

On December 31, 2016, the exchange rate relative to the U.S. dollar was 20.62 Mexican pesos to the U.S. dollar (17.18 and 14.75 on December 31, 2015 and 2014, respectively).

### *Venezuela*

No official data is available for GDP or for inflation for 2016. However, the expectations about the worsening of economic conditions in Venezuela were confirmed by forecasts published by CFe. According to this publication, GDP fell by 10.2% in 2016, after falling 5.7% in 2015.

Private consumption was estimated to have fallen by 11.6% in 2016 and public consumption was estimated to have contracted 6.0%. Additionally, investments are estimated to have declined by 20.3%.

Additionally, exports are estimated to have declined by 29.1% in 2016 and imports are estimated to have contracted by 37.7%. The trade balance was estimated to have reached a 3,900 million U.S. dollars surplus in 2016 compared with 2,300 million U.S. dollars in 2015, but much lower than the 27,200 million U.S. dollars surplus reached in 2014.

The inflationary spiral in Venezuela continues to accelerate its pace. According to CFe, prices are estimated to have increased 567.8% year-on-year in 2016, much higher than the 180.9% and 68.5% inflation rates reached in 2015 and 2014, respectively.

The unemployment rate was estimated to have averaged 9.6% in 2016, a significant increase with respect to the 6.8% and 7.0% average unemployment rates of 2015 and 2014, respectively.



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*Chile*

Chilean GDP expanded at an estimated rate of 1.7% (CFe), 0.6 percentage points below the rate registered in 2015 (2.3%) and 2.9 percentage points under the average annual growth rate for the 2010-2014 period (4.6%). Private consumption grew by an estimated 1.9% (CFe) in 2016, the same as in 2015 (1.9%) but 5.6 percent points under the average annual growth rate for the 2010-2014 period. Investment increased by 0.3% (CFe) after two years of consecutive contraction (-1.5% in 2015 and -4.2% in 2014). As most emerging economies, Chile faced headwinds from the international financial markets tightening, the decreasing commodity prices (especially copper prices), the emerging/advanced capital flows reallocation and subdued economic dynamism in its major commercial partners. Domestically, a persistent slack of confidence and decreasing expectations also weighed negatively on expenditure decisions.

The labor market remained substantially resilient to the economic underperformance for a third year in a row. The unemployment rate reached 6.1% at the end of 2016, with no major changes compared with 5.8% in 2015 and 6.0% in 2014. It remained among the lowest unemployment rates in the last decade. Nominal wages rose accordingly to historical averages.

Inflation, measured by CPI, reached 2.7% in 2016 compared with 4.4% in 2015 and 4.6% in 2014. The appreciation of the Chilean currency, the fall in international oil prices, an increasing supply of fresh food products (vegetables and fruits) and less indexation pressures from past inflation, among others, contributed to this outcome. Core inflation (excluding food and energy) reached 2.8%, 0.1 percentage points above total CPI growth. Both CPI and core CPI inflation ended 2016 around the long-term target of the Chilean Central Bank of 3%.

The Chilean Central Bank kept its reference interest rate unchanged along the year at 3.5%. The monetary policy aimed to anchor inflation expectations to long-term target (3%). In the last months of 2016 the Bank's Council resolutions revealed an increasing expansionary skew regarding future interest rate movements.

The fiscal deficit is estimated to have risen to 3.0% of GDP (CFe), increasing by 0.8 and 1.4 percentage points compared to deficits in 2015 and 2014, respectively.

The trade balance surplus reached 4.6 billion U.S. dollars, improving moderately with respect to 2015 (3.5 billion U.S. dollars), but lower than the 6.3 billion U.S. dollars recorded in 2014. Chilean exports evolved accordingly to copper prices downtrend and a reduced demand for Chilean non-mining exports. In turn, Chilean imports reflected the protracted weakness in domestic demand growth.

At the end of 2016, the nominal exchange rate was 669 Chilean Pesos per U.S. dollar, reflecting a year-over-year Chilean Peso appreciation of 5.3%. The exchange rate performance in 2016 was mainly explained by the recovery of copper prices during the last two months of the year.

### *Argentina*

Argentina's GDP decreased by an estimated 2.2% in 2016 (CFe), in contrast to the 2015 increase of 2.5%, the average annual growth rate of approximately 7.5% achieved from 2005 through 2008 and of 1.7% from 2009 to 2015.

The Argentine peso depreciated by 22% relative to the U.S. dollar, closing at 15.85 Argentine pesos per U.S. dollar at the end of 2016, compared with 12.94 Argentine pesos per U.S. dollar at the end of 2015 and 8.46 Argentine pesos per U.S. dollar at the end of 2014.

The Buenos Aires CPI increased by 41% in 2016 compared with 26.9% in 2015 and 38.0% in 2014.

The estimated current account deficit of 12.8 billion U.S. dollars in 2016 (CFe) is one of the highest in the last decade, although slightly lower than the deficit of 16.8 billion U.S. dollars of 2015. The estimated trade balance is of 0.4 billion U.S. dollars, with a 5.1% decrease in imports and a 0.6% increase in exports, both contributing significantly to this result.

Economic conditions negatively affected the unemployment rate, which increased to 8.9% in 2016 (CFe) from 7.0% in 2015 and 7.3% in 2014.

### *Colombia*

According to CFe, Colombian GDP is estimated to have grown by 2.0% in 2016, significantly below the 3.0% and 4.6% year-on-year growth recorded in 2015 and 2014, respectively. This deceleration was mainly attributable to the adjustment in investment due to a large decline in oil prices and a lower performance in household consumption.

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Despite the lower economic growth, the unemployment rate increased moderately. According to CFe the average unemployment rate estimated for 2016 was 9.3%, slightly above the 8.9% and 9.1% rates showed in 2015 and 2014, respectively.

According to CFe, in 2016 the current account deficit is estimated to have reached 14.2 billion U.S. dollars, representing 4.9% of GDP, which is a significant reduction compared with the 6.4% of GDP registered in 2015.

The Colombian peso depreciated by 11.2% against the U.S. dollar during 2016 (3,001 Colombian pesos per U.S. dollar at the close of 2016). This depreciation was mainly explained by the decrease in oil prices, which affected total exports. Moreover, the net portfolio investment decreased during the period magnifying the Colombian peso depreciation.

The inflation rate was 5.7% year-on-year at the end of 2016, compared with 6.8% year-on-year and 3.7% year-on-year at the end of 2015 and 2014, respectively. The pressure in food prices due to the ENSO (El Niño Southern Oscillation) raised the annual inflation rate to 9% in July of 2016, but in the following months an important correction occurred due to a better performance in food prices.

In 2016 the Colombian Central Bank decided to increase the interest rate by 175 basis points from 5.75% to 7.5%, in line with the increased inflationary pressures observed through the year.

## *Peru*

Peruvian GDP expanded around its potential pace (3.9% according to de CFe, in contrast with the 3.3% expansion of 2015). The main drivers of this acceleration were the favorable development of private consumption (expected to have increased 3.6% in 2016, in contrast to the 3.4% growth of 2015), as well as the lower contraction of fixed investment, which is estimated to have decreased by 2% in 2016, much lower than the 5.1% contraction of 2015.

Consumer prices, as measured by the CPI, increased by 3.2% in 2016, slightly above the Central Bank's target of between 1% and 3% for the third consecutive year, compared with 4.4% in 2015 and 3.2% in 2014. Inflation remained near the upper limit of the Central Bank's target along the year, affected by droughts in several regions and the strong currency volatility.

The Peruvian Central Bank raised its interest key rate by 50 basis points from 3.75% in 2015 to 4.25% in 2016. According to the Central Bank, inflation expectations are within the target range. However, the inflation rate in the last quarter was above the upper limit of 3.0% due to higher prices for fuel and some food items, an effect that should show corrections soon.

The government budget is estimated to show a relatively moderate deficit of around 3.0% of GDP in 2016 (CFE), compared with a slight fiscal deficit of 2.1% in 2015. This is the result of a significant decrease in corporate tax collection due to the reduction from 30% to 28% in the corporate income tax rate.

In the foreign exchange market, the Peruvian Nuevo Sol strengthened by 1.7% against the U.S. dollar in 2016, reaching 3.36 Peruvian Nuevo Sol per U.S. dollar at the end of the year, compared with a depreciation of 14.6% in 2015 and 6.5% in 2014. The commercial surplus of 667 million U.S. dollars in 2016 (considerably higher than the 3,159 million U.S. dollars deficit in 2015) and constant financial capital inflows led to an increase of the international net reserves (US\$ 411 million), reaching 61,900 million U.S. dollars in 2016 compared to 61,500 million U.S. dollars in 2015 and 62,300 million U.S. dollars in 2014.

Country risk, measured by the J.P. Morgan Emerging Markets Bond Index (EMBIG Peru), declined 70 basis points to 170 basis points in 2016. The long-term sovereign debt rating is currently investment grade by Fitch, Standard and Poor's and Moody's rating agencies.

#### Exchange Rate Fluctuations

We publish our Consolidated Financial Statements in euros. Because a substantial portion of our assets, liabilities, revenues and expenses are denominated in currencies other than the euro, we are exposed to fluctuations in the values of these currencies against the euro. Currency fluctuations have had and may continue to have a material impact on our financial condition, results of operations and cash flows.

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We estimate that in 2016 variations in currencies and hyperinflation in Venezuela decreased our consolidated revenues by approximately 8.0%. Currency fluctuations can also have a significant impact on our statement of financial position, particularly equity attributable to equity holders of the parent, and on our statement of cash flows, when translating the financial statements of subsidiaries located outside the Eurozone into euro. In 2016 equity attributable to equity holders of the parent increased by 2,049 million euros and cash and cash equivalents increased by approximately 185 million euros due to the translation of the financial statements of our foreign subsidiaries, principally due to the appreciation of the Brazilian real, Chilean peso and the Colombian peso, partially offset, by the depreciation of the pound sterling, Argentinian peso and Mexican peso relative to the euro.

We estimate that in 2015 variations in currencies and hyperinflation in Venezuela decreased our consolidated revenues by approximately 2.3%. In 2015 equity attributable to equity holders of the parent decreased by 4,657 million euros and cash and cash equivalents decreased by approximately 1,000 million euros due to the translation of the financial statements of our foreign subsidiaries, principally due to the depreciation of the Brazilian real, Argentine peso and the Venezuelan bolívar fuerte, partially offset, by the appreciation of the pound sterling relative to the euro.

We estimate that in 2014 variations in currencies and hyperinflation in Venezuela decreased our consolidated revenues by approximately 12.1%. In 2014 equity attributable to equity holders of the parent decreased by 2,857 million euros and cash and cash equivalents decreased by approximately 1,616 million euros due to the translation of the financial statements of our foreign subsidiaries, principally due to the depreciation of the Venezuelan bolívar fuerte and the Argentine peso, partially offset by the appreciation of the pound sterling relative to the euro.

Venezuela is considered as a hyperinflationary economy since 2009. The inflation rates used to prepare the financial information included herein are based on the National Consumer Price Index of Venezuela (Indice Nacional de Precios al Consumidor de Venezuela) published by the Central Bank of Venezuela, or where a definitive index is not available, the best estimation. On an annual basis, these rates are 511.1%, 190.8% and 64.1% for 2016, 2015 and 2014, respectively. The exchange rates used to convert items denominated in Venezuelan bolívar fuerte, once adjusted for inflation, in the Consolidated Financial Statements are the closing rates as of December 31, 2016, 2015 and 2014, which were 674 bolivars per U.S. dollar (by reference to DICOM), 199 bolivars per U.S. dollar (by reference to SIMADI) and 49.988 bolivars per U.S. dollar (by reference to SICAD II), respectively.

The table below sets forth the average exchange rates against the euro of the U.S. dollar and the key currencies that impacted our consolidated results of operations for the periods indicated. Positive percentage changes represent a decline in the value of the applicable currency relative to the euro, and negative percentage changes represent increases in the value of the applicable currency relative to the euro.

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|                               | 2014(1)  | 2015(1)  | 2016(1)  | % change 2014 to 2015 | % change 2015 to 2016 |
|-------------------------------|----------|----------|----------|-----------------------|-----------------------|
|                               | Average  | Average  | Average  | Average               | Average               |
| Pound Sterling                | 0.81     | 0.73     | 0.82     | (9.88)%               | 11.92%                |
| U.S. Dollar                   | 1.33     | 1.11     | 1.11     | (16.54)%              | -                     |
| Brazilian Real                | 3.12     | 3.64     | 3.83     | 16.67%                | 5.30%                 |
| Argentine Peso                | 10.75    | 10.22    | 16.31    | (4.93)%               | 59.63%                |
| Peruvian Nuevo Sol            | 3.77     | 3.53     | 3.73     | (6.37)%               | 5.75%                 |
| Chilean Peso                  | 756.71   | 723.91   | 747.50   | (4.33)%               | 6.26%                 |
| Mexican Peso                  | 17.65    | 17.57    | 20.63    | (0.45)%               | 17.41%                |
| Venezuelan Bolívar Fuerte (2) | 60.69    | 216.31   | 710.23   | n.m.                  | n.m.                  |
| Czech Crown                   | 27.53    | 27.28    | 27.03    | (0.91)%               | (0.92)%               |
| Colombian Peso                | 2,650.03 | 3,016.49 | 3,369.06 | 13.83%                | 11.69%                |
| Guatemalan Quetzal            | 10.25    | 8.49     | 8.41     | (17.17)%              | (0.99)%               |

*Source: Central treasury bank of the respective countries.*

(1) These exchange rates are used to convert the income statements of our subsidiaries from local currency to euro.

(2) As Venezuela is considered a hyperinflationary country, the income statement from operations in Venezuela is accounted for pursuant to the closing exchange rate of bolívar fuerte to euro.

We describe certain risks relating to exchange rate fluctuations in “Item 3. Key Information—Risk Factors,” and we describe our policy with respect to limiting our exposure to short-term fluctuations in exchange rates under “Item 11. Quantitative and Qualitative Disclosures About Market Risk.”

## Group Results of Operations

Please see “Item 4 —Information on the Company — Business Overview — Financial Results.”

## B. Liquidity and Capital Resources

Cash Flow Analysis

The table below sets forth consolidated cash flow information for the periods indicated. Positive figures refer to cash inflows and those in parenthesis refer to cash outflows.

|                                       | 2014    | 2015     | 2016    |
|---------------------------------------|---------|----------|---------|
| (millions of euros)                   |         |          |         |
| Net cash from operating activities    | 12,193  | 13,615   | 13,338  |
| Net cash used in investing activities | (9,968) | (12,917) | (8,208) |
| Net cash used in financing activities | (4,041) | (3,612)  | (4,220) |

For a discussion of our cash flows for the years ended December 31, 2014, 2015 and 2016, please see Note 20 to our Consolidated Financial Statements.

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Anticipated Uses of Funds

Our principal liquidity and capital resource requirements consist of the following:

- costs and expenses relating to the operation of our business;
- debt service requirements relating to our existing and future debt;
- capital expenditures for existing and new operations;
- acquisitions of new licenses or other operators or companies engaged in complementary or related businesses; and
- dividend, other shareholder remuneration, and pre-retirement payments.

In 2017, we expect to continue transforming our networks, evolving them towards all-IP hyper-connected networks, by investing in FTTx in key markets, and by expanding our mobile networks with LTE in most of our operations, and also with 3G. We also expect to continue investing in IT as a critical factor in our transformation. We expect to continue to invest in TV and digital content to take advantage of the opportunities in the digital markets. We may also use funds to acquire new licenses engaged in complementary or related businesses in the digital world.

We also have liquidity requirements related to the costs and expenses relating to the operation of our business, financial investments, our payment of dividends, shareholder remuneration and pre-retirement payment commitments.

We also have liquidity requirements related to debt service requirements in connection with our existing and future debt. At December 31, 2016, we had gross financial debt of 60,361 million euros compared with 60,087 million euros at December 31, 2015. For the amortization schedule of our consolidated gross financial debt at December 31, 2016 and a further description of financing activity in 2016, see “—Anticipated Sources of Liquidity” below. Our net financial debt decreased by 566 million euros to 48,595 million euros at December 31, 2016, compared with 49,161 million euros at December 31, 2015. The factors contributing to decreased debt in 2016 include: (i) our 2016 cash flow generation of 4,370 million euros; (ii) 500 million euros in net financial investments, mainly due to our China Unicom and Telef  divestment (see Note 2 to our Consolidated Financial Statements); and (iii) the lower euro value of foreign-denominated net financial debt amounting to 91 million euros. The factors contributing to increased debt in 2016 include: (i) remuneration to shareholders (including dividends, issuance of capital instruments, purchase of treasury stock and payment of coupons on undated deeply subordinated securities) amounting to 2,389 million euros; (ii) the payment of labor-related commitments (738 million euros), mainly related to early retirements; and (iii) other factors affecting the liabilities amounting to 1,268 million euros (including the refinancing of commercial liabilities).



For a reconciliation of net financial debt to gross financial debt (the sum of current and non-current interest-bearing liabilities), see “—Presentation of Financial Information—Non-GAAP financial information—Net financial debt and net financial debt plus commitments”.

For a discussion of our liquidity risk management policy, see Note 16 to our Consolidated Financial Statements.

#### Anticipated Sources of Liquidity

Cash flows from operations are our primary source of cash funding for existing operations, capital expenditures, investments, licenses, interest obligations and principal payments. We also rely on external financing, including a variety of short- and medium-term financial instruments, principally bonds and debentures, undated deeply subordinated securities and borrowings from financial institutions. Cash and cash equivalents are mainly held in euros and euro-denominated instruments.

In recent years, we raised funds by issuing equity instruments, principally undated deeply subordinated securities, mandatory convertible notes and new shares.

#### *Financing*

The following table shows the amortization schedule of our consolidated gross financial debt at December 31, 2016 as stated in euro. We may have exchange rate financial derivatives as instruments assigned to the underlying debt instruments. The table below includes the fair value of derivatives classified as financial liabilities (i.e., those with a negative mark-to-market) and excludes the fair value of derivatives classified as current financial assets (1,872 million euros), and those classified as non-current (5,048 million euros) (i.e., those with a positive mark-to-market). For description of the liquidity risk we face, see Note 16 to our Consolidated Financial Statements, and for a description of our financial liabilities, see Note 13 to our Consolidated Financial Statements.

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Millions of euros

|  | Current |       |       |       |       | Non-current         |                      |        |
|--|---------|-------|-------|-------|-------|---------------------|----------------------|--------|
| Maturity                               | 2017    | 2018  | 2019  | 2020  | 2021  | Subsequent<br>years | Non-current<br>total | Total  |
| Debentures and bonds                   | 7,559   | 4,992 | 3,501 | 4,951 | 4,765 | 16,316              | 34,525               | 42,084 |
| Promissory notes & commercial<br>paper | 3,061   | —     | —     | 113   | —     | 186                 | 299                  | 3,360  |
| Other marketable debt securities       | —       | —     | —     | —     | —     | —                   | —                    | —      |
| Total Issues                           | 10,620  | 4,992 | 3,501 | 5,064 | 4,765 | 16,502              | 34,824               | 45,444 |
| Loans and other payables               | 3,357   | 1,903 | 1,336 | 780   | 1,482 | 2,540               | 8,041                | 11,398 |
| Derivative instruments                 | 772     | 300   | 348   | 1,003 | 533   | 563                 | 2,747                | 3,519  |
| Total                                  | 14,749  | 7,195 | 5,185 | 6,847 | 6,780 | 19,605              | 45,612               | 60,361 |

Notes:

- Estimated future interest payments as of December 31, 2016 on our interest-bearing debt (not included above) are as follows: 2,168 million euros in 2017, 1,694 million euros in 2018, 1,436 million euros in 2019, 1,185 million euros in 2020, 956 million euros in 2021 and 5,185 million euros in subsequent years. With respect to floating rate debt, we estimate future interest payments as the forward rates derived from yield curves quoted for the different currencies on December 31, 2016.

During 2016, we obtained financing totaling approximately 10,542 million euros, excluding the euro commercial paper program and short-term banking loans, 9.5% of which were treated as equity (hybrid) and the remaining amount as financial debt. The activity focused mainly on strengthening our liquidity position, refinancing debt maturities in an environment of very low interest rates, and extending debt maturities.

For a description of our financing, see Note 13 to our Consolidated Financial Statements.

In 2017, through the date of this Annual Report, our debt issuances and principal financing arrangements consisted of:

On January 17, 2017, Telefónica Emisiones S.A.U. issued notes under its EMTN Programme filed with the FCA in London on September 13, 2016 in an aggregate nominal amount of 1,750 million euros. This issuance was split into two series: one series, amounting to 1,250 million euros, maturing on January 17, 2025 and with an annual coupon of 1.528%, and the other series, amounting to 500 million euros maturing on October 17, 2028 and with an annual coupon of 2.318%. Both series of notes are guaranteed by Telefónica, S.A;

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On January 17, 2017, Telefónica, S.A. amended the bilateral loan, signed originally on June 26, 2014 for an amount of 2,000 million euros and with an outstanding amount of 1,500 million euros, divided in two tranches with a new amortization schedule: tranche A for 500 million euros maturing on June 26, 2017 and tranche B for 1,000 million euros maturing on June 26, 2019. Later, on February 17, 2017, Telefónica, S.A. signed a new amendment to its bilateral loan extending the maturity date of the tranche A for 500 million euros until June 26, 2019;

On January 25, 2017, Telefónica Emisiones S.A.U. issued notes under its EMTN Programme filed with the FCA in London on September 13, 2016 in an aggregate nominal amount of 150 million euros, maturing on January 25, 2019. The notes are guaranteed by Telefónica, S.A.;

On February 8, 2017, Telefónica Brasil, S.A. issued notes (debentures) in an aggregate notional amount of 2,000 million brazilian reais (approximately 600 million euros) maturing on February 8, 2022.

On February 15, 2017, Telefónica Europe, B.V. drew down an aggregate principal amount of 750 million euros of its long-term financing of 1,500 million euros signed on November 28, 2016 and maturing in 2024.

On February 17, 2017, Telefónica Germany GmbH & Co. OHG agreed a 12 month extension on its 750 million euros syndicated credit facility dated on March 22, 2016 up to March 22, 2022.

Our borrowing requirements are not significantly affected by seasonal trends.

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### *Availability of funds*

At December 31, 2016, we had funds available (including cash and cash equivalents and undrawn lines of credit) totaling 21,274 million euros. This amount included: undrawn lines of credit for an amount of 14,627 million euros (13,491 million euros maturing in more than 12 months); cash and cash equivalents and current financial assets other than those in Venezuela.

We believe that, in addition to internal generation of funds, our working capital, our medium-term note program, our euro commercial paper program, our corporate domestic promissory note program and available lines of credit will allow us to meet our future capital requirements, including (according to our liquidity policy) gross debt maturities over the next twelve months.

For a description of our liquidity and undrawn lines of credit available at December 31, 2016, see Notes 12 and 13 to our Consolidated Financial Statements, and for a discussion of our liquidity risk management and our capital management, see Note 16 to our Consolidated Financial Statements.

Telefónica, S.A. is the parent company of the Telefónica Group and receives funding from its subsidiaries in the form of dividends and loans. Consequently, restrictions on the ability of the Group's subsidiaries to transfer funds to Telefónica, S.A. in the form of cash dividends, loans or advances, capital repatriation and other forms would negatively affect our liquidity and thus our business.

Certain Latin American economies, such as currently Venezuela, or Argentina in the past, have experienced shortages in foreign currency reserves and their respective governments have adopted restrictions on the ability to transfer funds out of the country and convert local currencies into U.S. dollars. This may limit our ability to repatriate funds out of certain subsidiaries from such countries. However, regarding net repatriation of funds to Spain, in 2016 we received 781 million euros from our Latin American subsidiaries, of which 726 million euros was from dividends and 55 million euros was from other items.

### *Credit Ratings*

Our ability to use external sources of financing will depend in large part on our credit ratings. We believe that we are well-positioned to raise capital in financial markets. However, negative conditions in the financial markets or a downgrade of any of the ratings of our debt or the Kingdom of Spain's debt by any of Fitch, Moody's and/or Standard & Poor's may increase the cost of our future borrowings or may make it more difficult to access the public debt markets. In connection with the credit rating agencies' review of our debt ratings, the rating agencies may give

considerable weight to general macroeconomic and political conditions (including sovereign credit rating prospects), the performance of our businesses in countries where we operate, our financial and shareholder remuneration policy, our M&A policy, our ability to integrate acquired companies and our ability to refinance debt.

At December 31, 2016, Telefónica, S.A.'s long-term issuer default rating is "BBB stable outlook" from Fitch, "Baa3 stable outlook" from Moody's and "BBB stable outlook" from Standard & Poor's. During 2016, there were changes in the credit ratings by the three agencies. Moody's downgraded the rating to "Baa3 stable" from "Baa2 negative" on November 7, 2016, Fitch downgraded the rating to "BBB stable" from "BBB+ stable" on September 5, 2016 and Standard and Poor's revised the outlook to "stable" from "positive" on May 17, 2016.

The EC's decision to block the proposed sale of O2 U.K. to Hutchison's Three U.K. had an impact on Telefónica's credit ratings and outlooks by Moody's and Standard and Poor's, as they considered that such decision would delay the Company's deleveraging process. During 2016, we have taken certain measures to protect our credit rating. These measures mainly include: the change in the shareholder remuneration policy, together with the announcement of the commitment to maintain a solid investment grade credit rating. Regarding the 2016 fiscal year dividend, Telefónica will pay 0.55 euros per share, of which 0.35 euros was paid in November 2016 through a voluntary scrip dividend and of which 0.20 euros will be paid in cash in the second quarter of 2017. Regarding the 2017 dividend, Telefónica will pay an amount of 0.40 euros per share in cash, of which 0.20 euros would be paid in the fourth quarter of 2017 and of which 0.20 euros would be paid in the second quarter of 2018. Additionally, it is worth highlighting the strong financing activity undertaken during 2016 together with the maintenance of an appropriate level of liquidity, an active portfolio management through the announced intention to continue analyzing best strategic alternatives for O2 UK and Telxius, the executed sale of Telefé and the partial disposal of China Unicom, as well as the issuance of undated deeply subordinated securities as a solvency protection measure to mitigate negative impacts on our Consolidated Financial Statements.

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### Intragroup Loans

We lend funds to our operating subsidiaries, directly or through holding companies that head our different lines of business. At December 31, 2016, we had loans outstanding totaling 5,671 million euros (9,142 million euros at December 31, 2015) to companies in the Telefónica Group (including subsidiaries located in Latin American countries). These funds are derived from retained cash flows, loans, bonds, issuances of undated deeply subordinated securities and other sources (such as asset disposals).

### C. Research and Development, Patents and Licenses, etc.

Telefónica remains committed to technological innovation as a fundamental tool for being one of the main actors in the new digital universe, with the capacity to help to create a more sustainable world while achieving competitive advantages and distinctive products. By introducing new technologies and developing business solutions and processes, we aim to become a more effective, efficient and customer-oriented Group.

Telefónica bases its innovation strategy on the balance between two main models:

Promoting our **internal research, development and innovation (R&D&i) capabilities**, for which we have developed our own innovation model, which allows us to promote the application of technical research in developing commercial products and services using the knowledge developed in research centers, technological institutes and universities, among other sources;

Promoting the creation of **open innovation ecosystems**, in which the “**Open Future**” initiative stands out as a global program designed to connect entrepreneurs, start-ups, investors, venture capital funds and public and private organizations around the world which promote innovation in collaboration with other actors.

In parallel with these two models, Telefónica seeks to promote the development of sustainable solutions that generate a positive impact on the economic, social and technological progress of the regions in which we operate. To this effect, in addition to the investment made in promoting sustainable innovation projects and in the activities that are developed to guarantee the accessibility of our solutions to all groups, a new subsidiary has been created that is focused on product innovation and the development of disruptive technologies.

Telefónica firmly believes that competitive advantage cannot be based solely on acquired technology, and so has always considered the promotion of internal innovation, research and development activities as a strategic axis, in an effort to achieve this differentiation and move forward in other activities which guarantee the sustainability of our

business.

To this effect, the Telefónica Group's internal innovation policy focuses on contributing with solutions that guarantee Telefónica's commitment to developing a responsible business under the criteria of economic, social and environmental sustainability, by:

- Developing new products and services that enable growth and competition in an increasingly global environment, while being adapted to the diversity and local needs of each market;

- Encouraging the return of innovation through open innovation and creating value from the technology generated;

- Increasing our customers' loyalty and satisfaction;

- Increasing the revenues, profits and value of the Company;

- Increasing the quality of our infrastructure and services, as well as our relationship with our technology providers and solutions;

- Improving business processes and operations with the aim of optimizing resources, increasing efficiency and reducing environmental impact;

During 2016 we carried out numerous technological innovation projects focused on sustainability, process efficiency, the creation of new sources of revenue, customer satisfaction, the consolidation of our presence in new markets and technological leadership.

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We also initiated projects to promote an increase in the access to information technology, new services focused on new Internet business models, advanced user interfaces, distribution of TV and multimedia contents and other value added services, taking advantage of the potential of the new infrastructures. These projects, among others, were undertaken based on our objective to quickly identify emerging technologies that may have a relevant impact on our business, and to test these technologies on pilots related to new platform services, applications and prototypes.

A significant part of the innovation activities and projects are carried out by Telefónica Investigación y Desarrollo S.A.U. (Telefónica I+D), a wholly-owned subsidiary gives support mainly to our business lines. Telefónica I+D receives support from other companies and universities in the execution of its functions. The mission of the company is focused on improving our competitiveness through technological innovation and product development. Telefónica I+D is also responsible for experimental and applied research and for the development of products to increase our range of services and reduce operating costs.

The technological innovation activities of Telefónica I+D focus on three main areas:

- 1. The development of new networks, mainly carried out in collaboration with Telefónica's Global Resources area. These activities are related to new radio and fibre optic access technologies (technologies on the virtualization of network functions, in line with the technological trend known as SDN or defined networks via software) and on topics related to network optimization and *zero touch*, which enable us to have a much more flexible and adaptable network that is dynamically adaptable to the new requirements of digital services and customers.
  - 2. The development of new products and services which are carried out within the framework of the digital services strategy. The following stand out among these activities:
    - o Interpersonal communication of the future with natural access, taking advantage of the possibilities of the Internet and smartphones;
    - o Services related to Big Data, regarding the concept of the Fourth Platform, whose vision is to return the value associated with the data it generates to the customer;
    - o Video and multimedia services (combining text, audio, images and video) with a user experience on all connected devices;
    - o Advanced solutions in emerging ICT businesses, such as *cloud computing* cloud or security;
    - o Management of Internet of Things (IoT) services, related to enriched mobility, energy efficiency and smart retail;



Using users' communication profiles to obtain opportunities to exploit different products and business models  
o (marketing campaigns, targeted advertising, contextual services, churn reduction, cross-selling, etc.).

Experimental and applied research: With a medium and long-term outlook, Telefónica also has “**Scientific Groups**”  
3. whose mission is to investigate the possibilities of new networks and services and to solve the technological, social and environmental challenges that arise.

It should be noted that in 2016 Telefónica I+D Chile, a 100% subsidiary of Telefónica Chile, which was launched in 2014 in collaboration with the Chilean government, for the development of the first products and the generation of the first patents in "enriched mobility", Smart Industry and Smart Agro.

As of December 31, 2016, Telefónica I+D had 612 employees (654 employees in 2015).

The total I+D expense in the Group for 2016 amounted to 906 million euros, 14.1% less than the 1,055 million euros incurred in 2015 (1,111 million euros in 2014). This expense represents 1.7%, 1.9% and 2.2% of the Group's consolidated revenue for 2016, 2015 and 2014, respectively. These figures were calculated using guidelines of the Organization for Economic Co-operation and Development (OECD).

During 2016, Telefónica registered 27 new patent applications, including three through the American office (USPTO), two through the Chilean office (INAPI) and 22 through the Spanish patent and trademark office (OEPM), seven of which were international (PCT) and 15 European applications. Moreover, one utility model was registered in the Spanish patent and trademark office, also through the OEPM.

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Regarding the development of open innovation in Telefónica, the company has the Open Future unit, which includes an open, global program designed to connect entrepreneurs, startups, investors, and public and private organizations from around the world.

The main objective of Open Future\_ is to detect, develop and enhance the talent and technological entrepreneurship in all its phases, for that which drives and accelerates the growth of ideas, projects, initiatives and companies. The integral character of Telefónica Open Future enables innovation to be developed in different stages. It is structured around seven initiatives, the objectives of which are as follows:

**Drive** (Think Big and Talentum Startups).

**Accelerate** (Crowdworking and Wayra).

**Invest** (Telefónica Ventures, Amérigo and CIP Telefónica).

Telefónica Open Future, is present in 16 countries, ended 2016 as one of the main investors in the Spanish area of open innovation and positioning itself as one of the major funds in Europe and Latin America in venture capital investment.

## D. Trend Information

In 2016, Telefónica made great progress towards long-term sustainable and profitable growth in service revenues, continuing to increase efficiencies and capturing synergies thanks to the integrated vision of the businesses, processes and technologies. This allowed us to maintain a strong investment effort in order to be able to offer our customers excellent connectivity. In recent years, the Company has moved forward in its business transformation:

Firstly, Telefónica has defined a new business model with data-oriented offers, bundled services, including converged fixed and mobile services, as well as digital capabilities as part of the global transformation focused on responding to the change in our customers' consumer habits. An essential part of our effort has been the investment in fiber- and LTE networks, which we believe will allow the monetization of data as well as of digital services. In this way, Telefónica has significantly increased data accesses, including 82 million smartphones accesses, 4.8 million Pay TV accesses and 6.6 million fiber accesses during the 2014-2016 period. Additionally, average revenue per access increased by 2.8% year-on-year over the 2015-2016 period, from a year-on-year increase of 1.9% over the 2014-2015 period.

Secondly, changing consumer habits have resulted in a decreasing demand for voice services and an increasing demand for data, due to video downloads and internet connectivity through smartphones. This new trend has allowed us since 2015 to compensate the drop in voice revenues (excluding falls in interconnection tariffs) with higher data and service over connectivity, to be able to start seeing a positive trend in average revenue per access in the majority of our markets.

Thirdly, Telefónica has reinforced its competitive position thanks to an active management of the asset portfolio and to the consolidation of its participation in key markets in 2015: Germany (with the acquisition of E-Plus), Brazil (with the acquisition of GVT) and Spain (with the acquisition of DTS). These strategic acquisitions in key markets coupled with divestments in non-strategic markets, have allowed Telefónica to capture significant synergies.

Lastly, Telefónica launched in 2014 a simplification program focused on increasing growth and capturing synergies across the board; commercial offer simplification; IT network and global process modernization (through higher investments in IT and commercial systems as well as call center costs reduction); and improving sales channels with a more efficient back office. All these measures allow for the liberalization of resources that can be used for transformation, improving network and accelerating the digitalization process.

On the other hand, various factors have contributed to the fact that Telefónica has experienced a downward trend in some key financial performance indicators during the 2014-2016 period.

First, changes in foreign exchange rates, particularly in 2015 with the depreciation of the Brazilian real against the euro and the effects of the depreciation of the Venezuelan bolivar. In 2016 such currencies continued to depreciate and the Company's results were also affected by devaluations in the United Kingdom, Argentina and Mexico, adversely and significantly affecting revenue growth.

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Second, the high inflation in certain countries affected cost growth in numerous markets where Telefónica is present which were not offset by the increase in tariffs.

Third, after a period of significant expansion, Telefónica has generally reduced the scope of its activities and exited certain countries in recent years to reduce its level of indebtedness and strengthen Telefónica's capacity for future growth.

Fourth, Telefónica's business is highly regulated, which affects its revenues and imposes costs on its operations. For example, regulation sets the fixed rates that Telefónica charges for calls received from other companies' networks, and regulators have progressively lowered these rates in recent years.

Fifth, in recent years Telefónica has experienced an intense competition in the markets where it operates, resulting in more bundled offers and making it difficult to monetize value added services.

In the last two years, within the above mentioned simplification process, Telefónica has redefined its processes, readapting its resource necessities, resulting in various provisions which have affected, results in 2015 as well as in 2016.

In the 2014-2016 period these negative factors have contributed to a downward trend in some of Telefónica's key market indicators, such as the Profit for the year (-26.2% during the period). On the other hand, the positive result of the strategy with a focus on sustainable and profitable growth, is reflected in the Revenue trend during the 2014-2016 period, up 3.3%.

### E. Off-Balance Sheet Arrangements

We have commitments that could require us to make material payments in the future. These commitments are not included in our consolidated statement of financial position at December 31, 2016 although they are described in the notes to our Consolidated Financial Statements. For summary of our off-balance sheet commitments, see Note 21(b) and Note 16 to our Consolidated Financial Statements.

### F. Tabular Disclosure of Contractual Obligations

The following table describes our contractual obligations and commitments with definitive payment terms which may require significant cash outlays in the future. The amounts payable (including accrued interest payments) are as of December 31, 2016. For additional information, see our Consolidated Financial Statements.

| Millions of euros                             | Payments Due by Period |                  |               |               |                   |
|---|------------------------|------------------|---------------|---------------|-------------------|
|   | Total                  | Less than 1 year | 1-3 years     | 3-5 years     | More than 5 years |
| Financial liabilities (1)(2)                  | <b>60,361</b>          | 14,749           | 12,380        | 13,627        | 19,605            |
| Operating lease obligations (3)               | <b>10,460</b>          | 1,801            | 2,861         | 2,229         | 3,569             |
| Purchase and other contractual obligations(4) | <b>12,426</b>          | 5,391            | 3,883         | 1,204         | 1,948             |
| Other liabilities (5)                         | <b>4,944</b>           | 1,218            | 3,726         | —             | —                 |
| Total   | <b>88,191</b>          | <b>23,159</b>    | <b>22,850</b> | <b>17,060</b> | <b>25,122</b>     |

(1) Capital (finance) lease obligations are not calculated separately and are instead included as part of our long-term debt obligations.

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Estimated future interest payments as of December 31, 2016 on our interest-bearing debt (not included above) are as follows: 2,168 million euros in 2017, 1,694 million euros in 2018, 1,436 million euros in 2019, 1,185 million euros in 2020, 956 million euros in 2021 and 5,185 million euros in subsequent years. With respect to floating rate debt, we estimate future interest payments as the forward rates derived from yield curves quoted for the different currencies on December 31, 2016. This item includes the fair value of derivatives classified as financial liabilities (i.e., those with a negative mark-to-market) and excludes the fair value of derivatives classified as current financial assets (1,872 million euros), and those classified as non-current (5,048 million euros) (i.e., those with a positive mark-to-market). For a more detailed description of our financial derivative transactions, see Note 16 to our Consolidated Financial Statements. For details of the composition of this item, see “Liquidity and Capital Resources—Anticipated Sources of Liquidity”).

(2) This item includes definitive payments (non-cancellable without penalty cost). Our operating lease obligations have in some cases extension options conditioned on the applicable law of each country. Accordingly, we have included only those amounts that represent the initial contract period. At December 31, 2016, the present value of future payments for operating leases was approximately 7,894 million euros (2,450 million euros in Telefónica Brazil, 1,748 million euros in Telefónica Hispanoamérica, 882 million euros in Telefónica Spain, 2,294 million euros in Telefónica Germany, 418 million euros in Telefónica United Kingdom and 102 million euros in other companies). For a more detailed information about payments due under this item, see Note 18 to our Consolidated Financial Statements.

(3) This item includes definitive payments (non-cancellable without penalty cost) due for agreements to purchase goods (such as network equipment) and services.

(4) “Other liabilities” include: (a) long-term obligations that require us to make cash payments, excluding financial debt obligations included in the table under “Financial Liabilities” above and (b) other provisions. Because of the nature of the risks covered by “Other liabilities” such as other provisions, it is not possible to determine a reliable schedule of potential payments, if any. For details of the composition of other provisions, see Note 15 to our Consolidated Financial Statements.

(5) In addition, at December 31, 2016, we had short-term and long-term employee benefits provisions amounting to 1,002 million euros and 6,147 million euros, respectively, not included in the table above (see Note 15 to our Consolidated Financial Statements).

For details of the composition of, and changes in, our debt, see “—Liquidity and Capital Resources—Anticipated Sources of Liquidity” and Note 13 to our Consolidated Financial Statements.

## Item 6. Directors, Senior Management and Employees

### A. Directors and Senior Management

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During 2016, our Board of Directors met 12 times. At February 23, 2017, our Board of Directors had met two times during 2017. At February 23, 2017, our directors, their respective positions on our Board and the year they were first appointed as a director were as follows:

| Name  | Age | First Appointed | Current Term Ends |
|---|-----|-----------------|-------------------|
| <b>Chairman</b>   |     |                 |                   |
| Mr. José María Álvarez-Pallete López (1)                    | 53  | 2006            | 2017              |
| <b>Vice-Chairmen</b>  |     |                 |                   |
| Mr. Isidro Fainé Casas (1)(2)                               | 74  | 1994            | 2020              |
| Mr. José María Abril Pérez (1)(3)(6)                        | 64  | 2007            | 2018              |
| Mr. Julio Linares López (5)(8)                              | 71  | 2005            | 2020              |
| <b>Members</b>  |     |                 |                   |
| Mr. César Alierta Izuel                                     | 71  | 1997            | 2017              |
| Ms. Eva Castillo Sanz (5)(6)(8)                             | 54  | 2008            | 2018              |
| Mr. Juan Ignacio Cirac Sasturain (6)                        | 51  | 2016            | 2020              |
| Mr. José Javier Echenique Landiribar (1)(4)                 | 65  | 2016            | 2020              |
| Mr. Peter Erskine (1)(6)(7)                                 | 65  | 2006            | 2020              |
| Ms. Sabina Fluxà Thienemann (7)                             | 36  | 2016            | 2020              |
| Mr. Luiz Fernando Furlán                                    | 70  | 2008            | 2018              |
| Mr. Gonzalo Hinojosa Fernández de Angulo (1)(4)(5)(6)(7)(8) | 71  | 2002            | 2017              |
| Mr. Pablo Isla Álvarez de Tejera (7)                        | 53  | 2002            | 2017              |
| Mr. Peter Löscher (6)                                       | 59  | 2016            | 2020              |
| Mr. Antonio Massanell Lavilla (2)(4)(5)(6)(8)               | 62  | 1995            | 2020              |
| Mr. Ignacio Moreno Martínez (3)(4)(5)(8)                    | 59  | 2011            | 2017              |
| Mr. Francisco Javier de Paz Mancho (1)(4)(5)(7)             | 58  | 2007            | 2018              |
| Mr. Wang Xiaochu (9)  | 58  | 2015            | 2020              |

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- (1) Member of the Executive Commission of the Board of Directors.
- (2) Nominated by Fundació Bancaria Caixa d'Estalvis i Pensions de Barcelona (“**la Caixa**”).
- (3) Nominated by Banco Bilbao Vizcaya Argentaria, S.A. (“**BBVA**”).
- (4) Member of the Audit and Control Committee.
- (5) Member of the Regulation and Institutional Affairs Committee.
- (6) Member of the Strategy and Innovation Committee.
- (7) Member of the Nominating, Compensation and Corporate Governance Committee.
- (8) Member of the Service Quality and Customer Service Committee.
- (9) Nominated by China Unicom (Hong Kong) Limited.

Board Committees

At February 23, 2017, the committees of our Board of Directors and members thereof are as follows:

*Executive Commission*

Our Board of Directors has expressly delegated all of its authority and power to the Executive Commission except as prohibited by the Spanish Corporation Act, under our Articles of Association, or under our Board Regulations. This commission is made up of fewer directors and meets more frequently than our Board of Directors. The members of the Executive Commission are Mr. José María Álvarez-Pallete López (Chairman), Mr. Isidro Fainé Casas, Mr. José María Abril Pérez, Mr. José Javier Echenique Landiribar, Mr. Peter Erskine, Mr. Gonzalo Hinojosa Fernández de Angulo, Mr. Francisco Javier de Paz Mancho and Mr. Ramiro Sánchez de Lerín García-Ovies, as secretary.

*Audit and Control Committee*

The Audit and Control Committee functions are regulated by our bylaws and our Board Regulations. The Audit and Control Committee has the primary objective of providing support to our Board of Directors in its supervisory and oversight functions, specifically having the following responsibilities:



To report to the shareholders at the General Shareholders' Meeting regarding matters raised therein for which it is responsible.

To submit to the Board of Directors proposals for the selection, appointment, re-election and replacement of the external auditor, as well as the terms and conditions of the contract therewith, and regularly obtain from such external auditor information regarding the audit plan and the implementation thereof, in addition to the preservation of its independence in the performance of its duties.

To supervise the effectiveness of the Company's internal control system, the internal audit and the systems for the management of risks, including tax risks, as well as to discuss with the auditor the significant weaknesses in the internal control system detected during the audit.

To supervise the process of preparation and submission of regulated financial information.

To establish and maintain appropriate relations with the auditor in order to receive, for review by the Committee, information on all matters that could jeopardize the independence thereof, as well as any other matters relating to the audit procedure, and such other communications as may be provided for in auditing legislation and in technical auditing regulations. In any event, the Audit and Control Committee must receive annually written confirmation from the auditor of its independence vis-à-vis the entity or entities directly or indirectly related thereto, as well as information regarding additional services of any kind provided to such entities by the auditor, or by the persons or entities related thereto, pursuant to the legislation in force.

To issue on an annual basis, prior to the issuance of the audit report, a report stating an opinion regarding the independence of the auditor. This report must in all cases include an opinion on the provision of the additional services referred to in the preceding paragraph.

To report to the Board of Directors in advance on all matters contemplated by law, the By-Laws and the Regulations of the Board of Directors.

Any other powers granted to it under the Regulations of the Board of Directors.

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The Audit and Control Committee meets at least once per quarter and as many times as considered necessary. During 2016, the Audit and Control Committee met thirteen times and, as of the date of this Annual Report, had met two times in 2017. The members of the Audit and Control Committee are Mr. José Javier Echenique Landiribar (chairman), Mr. Gonzalo Hinojosa Fernández de Angulo, Mr. Antonio Massanell Lavilla, Mr. Ignacio Moreno Martínez and Mr. Francisco Javier de Paz Mancho. Our Board of Directors has determined that Mr. José Javier Echenique Landiribar, Mr. Antonio Massanell Lavilla and Mr. Ignacio Moreno Martínez meet the requirements of an “audit committee financial expert” as such term is defined by the SEC.

### *Nominating, Compensation and Corporate Governance Committee*

The Nominating, Compensation and Corporate Governance Committee is responsible for, among other things, reporting to our Board of Directors with respect to proposals for the appointment, re-election and removal of directors, members of the Executive Commission and the other committees of our Board of Directors and top members of our management and management of our subsidiaries. In addition, the Nominating, Compensation and Corporate Governance Committee is responsible for proposing to the Board of Directors, within the framework established in the bylaws, the compensation for the directors and reviewing it periodically to ensure that it is in keeping with the tasks performed by them, as provided in Article 35 of the Board Regulations, to propose to the Board of Directors, within the framework established in the bylaws, the extent and amount of the compensation, rights and remuneration of a financial nature, of the chairman, the executive directors and the senior executive officers of Telefónica, including the basic terms of their contracts, for purposes of contractual implementation thereof and to supervise compliance with the corporate governance rules in effect from time to time.

The members of the Nominating, Compensation and Corporate Governance Committee are Mr. Francisco Javier de Paz Mancho (chairman), Mr. Peter Erskine, Ms. Sabina Fluxà Thienemann, Mr. Gonzalo Hinojosa Fernández de Angulo and Mr. Pablo Isla Álvarez de Tejera. During 2016, the Nominating, Compensation and Corporate Governance Committee met eleven times, and as of the date of this Annual Report, it had met two times in 2017.

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***Regulation and Institutional Affairs Committee***

The Regulation and Institutional Affairs Committee was created in 2016 by merging the Regulation Committee and the Institutional Affairs Committee. The main objective of the Regulation and Institutional Affairs Committee is to monitor the main regulatory matters which affect us. Additionally, the Regulation and Institutional Affairs Committee acts as a communication and information channel between our management team and our Board of Directors concerning regulatory matters. Another responsibility is to review, report and propose to the Board of Directors the principles that are to govern the Group's Sponsorship and Patronage Policy, to monitor such policy, and to individually approve sponsorships or patronages the amount or importance of which exceed the limit set by the Board and which require its approval. The Committee is also responsible for promoting the development of the Telefónica Group's Corporate Reputation and Responsibility project and its institutional affairs.

The members of the Regulation and Institutional Affairs Committee are Mr. Julio Linares López (chairman), Ms. Eva Castillo Sanz, Mr. Gonzalo Hinojosa Fernández de Angulo, Mr. Antonio Massanell Lavilla, Mr. Ignacio Moreno Martínez and Mr. Francisco Javier de Paz Mancho. During 2016, the Regulation Committee met once while the Institutional Affairs Committee met four times. Additionally, since the Regulation and Institutional Affairs Committee has been in place, there were seven meetings during 2016 and as of the date of this Annual Report the Committee has met two times in 2017.

***Service Quality and Customer Service Committee***

The Service Quality and Customer Service Committee is responsible for monitoring and reviewing the standards of quality of the main services we provide. The Service Quality and Customer Service Committee evaluates the level of quality of the services we provide to our customers. The members of the Service Quality and Customer Service Committee are Mr. Antonio Massanell Lavilla (chairman), Ms. Eva Castillo Sanz, Mr. Gonzalo Hinojosa Fernández de Angulo, Mr. Julio Linares López and Mr. Ignacio Moreno Martínez. During 2016 the Service Quality and Customer Service Committee met four times and as of the date of this Annual Report has met once in 2017.

***Strategy and Innovation Committee***

In 2016, the Strategy Committee and the Innovation Committee merged into a new Committee, the so-called Strategy and Innovation Committee. Without prejudice to any other tasks that the Board of Directors may assign thereto, the primary duty of this new Committee is to support the Board of Directors in the analysis and implementation of the global strategy policy of the Telefónica Group. The Strategy and Innovation Committee is also responsible for advising and assisting in all matters regarding innovation. Its main object is to examine, analyze and periodically monitor the Group's innovation projects, provide guidance and help ensure the implementation and development of innovation initiatives across the Group. The members of the Strategy and Innovation Committee are Mr. Peter Erskine

(chairman), Mr. José María Abril Pérez, Ms. Eva Castillo Sanz, Mr. Juan Ignacio Cirac Sasturain, Mr. Gonzalo Hinojosa Fernández de Angulo, Mr. Peter Löscher and Mr. Antonio Massanell Lavilla. The Strategy Committee met four times during 2016 and the Innovation Committee met three times. Since the Strategy and Innovation Committee was created in 2016, it met seven times, and as of the date of this Annual Report, it met two times in 2017.

### *Biographies of Directors*

Mr. José María Álvarez-Pallete López serves as our Executive Chairman and Chairman of our Board of Directors. He is currently a trustee of the Telefónica Foundation and he has served, from September 11, 2011, to September 2012, as Chairman of Telefónica Europe. He began his career at Arthur Young Auditors in 1987. In 1988, he joined Benito & Monjardín/Kidder, Peabody & Co., where he held various positions in the research and corporate finance departments. In 1991, he held the “Associate” training course in New York and participated in investment projects of the GE Group in Spain. In 1995, he joined Compañía Valenciana de Cementos Portland, S.A. (Cemex) as head of the Investor Relations and Analysis department. In 1996 he was promoted to Chief Financial Officer of Cemex Group in Spain, and in 1998, to Chief Administration and Financial Officer of Cemex in Indonesia, headquartered in Jakarta, and he was appointed member of the Board of Cemex Asia, Ltd. In February 1999 he joined the Telefónica Group as General Manager of Finance for Telefónica International, S.A. In September of the same year he was promoted to Chief Financial Officer of Telefónica. In July 2002, he was appointed Chairman and Chief Executive Officer of Telefónica Internacional, S.A.; in July 2006 General Manager of Telefónica Latin America, and in March 2009, Chairman of Telefónica Latin America. He has been the Chairman of Telefónica Europa since September 2011 and a member of Telefónica’s, S.A. Board of Directors since July 2006. Since September 2012 and until April 2016, Mr. Álvarez-Pallete served as Chief Operating Officer. He has also been Chairman of the Board of Directors of Telefónica Internacional S.A.U. and of the Supervisory Board of Brasilcel, N.V and Cesky Telecom and Vice-Chairman of the Board of Directors of Telesp, S.A. and Telefónica Móviles México, S.A. He was member of the Board of Directors of the following companies: Telecomunicações de Sao Paulo; Telefónica Datacorp, S.A.; Telefónica del Perú, S.A.A.; Colombia Telecomunicaciones, ESP; Telefónica Móviles México; Telefónica Larga Distancia de Puerto Rico, S.A.; Admira Media; Inmobiliaria Telefónica; TPI; Telefónica Móviles; Telefónica Holding Argentina; Telefónica de España; Telefónica O2 Europe; Portugal Telecom and China Netcom. He was Alternate Director of the following companies: Telefónica Chile, S.A.; Telefónica Móviles Colombia, S.A.; Telefónica de Argentina, S.A.; and Telefónica Móviles Chile. He has also been Chairman of Antares, Fonditel, Telfisa and Telefónica North América, and Vice-Chairman of Telefónica del Perú. He has been awarded as ‘CFO Europe Best Practices’ at Mergers & Acquisitions in 2000, and in 2003 as Member of Merit of the Carlos III Foundation of the Iberian-American Forum. On July 2007, Mr. Álvarez-Pallete was appointed as “Gold Master in Executive Leadership” and on 2011 he received the Personality of the year in Economics Award granted by “El Economista”. On December 2013 he received the Excellence 2013 Award and Fast Company magazine named him one of the 100 most creative Personalities in Business during 2014. Mr. Álvarez-Pallete holds a degree in Economics from the Complutense University in Madrid. He also studied Economics at the Université Libre i Belgique and holds an International Management Program from the Pan-American Institute of Executive Business Administration (IPADE) and a Diplome of Advanced Studies (DEA) from the Department of Financial Economics and Accounting of the Complutense University of Madrid.

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Mr. Isidro Fainé Casas serves as Vice-Chairman of our Board of Directors. For over 40 years, Mr. Fainé has worked in several financial institutions, including amongst others: Banco Atlántico, S.A., (1964), Banco de Asunción (Paraguay) (1969), Banca Riva y García, S.A. (1973), Banca Jover, S.A. (1974), and Banco Unión, S.A. (1978). In 1982, he joined "la Caixa" as Deputy Executive General Manager, subsequently taking on various positions of responsibility. In April 1991, he was appointed Deputy Executive Managing Director and in 1999 rose to General Manager of the bank, before becoming Chairman from June 2007 to June 2014. Mr. Fainé is currently Chairman of the Board of trustees of the Fundación Bancaria Caixa d'Estalvis i Pensions de Barcelona "la Caixa", of Criteria Caixa, S.A.U., and of the Spanish Confederation of Savings Banks (CECA). He is also Chairman of the European Savings Banks Group (ESGB) and Chairman of Gas Natural, SDG, S.A. Additionally, he is Deputy Chairman of the World Savings Banks Institute (WSBI). Furthermore, he is a member of the Boards of Directors of Banco Português de Investimento, S.A. (BPI), of the Bank of East Asia and of Suez Environnement Company. He is currently the Chairman of the Spanish Confederation of Executives (CEDE), the Spanish Chapter of the Club of Rome and the Círculo Financiero. Mr. Fainé holds a Doctorate degree in Economics, a Diploma in Senior Management from IESE Business School and an ISMP certificate in Business Administration from Harvard University. He is a member of the Royal Academy of Economics and Finance and of the Royal Academy of Doctorate Holders.

Mr. José María Abril Pérez serves as Vice-Chairman of our Board of Directors. From 1975 to 1982 he served as Financial Manager of Sociedad Anónima de Alimentación (SAAL). Since then, and until he joined the Banco Bilbao Vizcaya Argentaria Group (BBVA), he was Financial Manager of Sancel-Scott Ibérica, S.A. In 1985 he joined Banco Bilbao, S.A. as Managing Director of Investment Corporate Banking. From January to April 1993, he was appointed Executive Coordinator of Banco Español de Crédito, S.A. In 1998, he became General Manager of the Industrial Group of BBV. In 1999, he was appointed member of the Executive Committee of the BBV Group. He has also been a member of the Board of Directors of Repsol, S.A., Iberia, S.A., Corporación IBV, and Vice-Chairman of Bolsas y Mercados Españoles, S.A. In 2002 he became Managing Director of the Wholesale and Investment Banking Division and a member of the Executive Committee of Banco Bilbao Vizcaya Argentaria, S.A., and he is now in retirement. He holds a degree in Economics from the University of Deusto (Bilbao, Spain) and he was professor of such University for nine years.

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Mr. Julio Linares López serves as Vice-Chairman of our Board of Directors since September 2012 and was our Chief Operating Officer from December 2007 to September 2012. He is also trustee of the Telefónica Foundation. In May 1970, he joined our Research and Development Center, where he held several positions until he was appointed head of our Technology Department in 1984. In April 1990, he was appointed General Manager of Telefónica Research and Development, S.A. In December 1994, he became Deputy General Manager of the Marketing and Services Development department in the commercial area and subsequently, Deputy General Manager for Corporate Marketing. In July 1997, he was appointed Chief Executive Officer of Telefónica Multimedia, S.A. and Chairman of Telefónica Cable and Producciones Multitemáticas, S.A. in the Telefónica multimedia business. In May 1998, he was appointed General Manager of Strategy and Technology in Telefónica, S.A. In January 2000, he was appointed Executive Chairman of Telefónica de España, S.A., being also president of certain Telefónica subsidiaries such as TELYCO or Cable, positions which he held until December 2005 when he was appointed our Managing Director for Coordination, Business Development and Synergies in Telefónica, S.A., a member of its Board of Directors and Secretary of the Executive Committee. In June 2005, Mr. Linares was appointed Chairman of the Supervisory Board of Cesky Telecom. Mr. Linares was a Director of Telecom Italia until December 13, 2013. From December 2007 to September 2012, he was CEO of Telefónica, S.A. He is currently member of the GSM Association Board. He is a trustee of the Mobile World Capital Barcelona Foundation and of the CEDE (Confederación Española de Directivos y Ejecutivos) Foundation. He is also a member of the Association Management Board for Managerial Progress, member of the Executive Committee and the Board and Chairman of the Digital Society Committee of the CEOE (Confederación Española de Organizaciones Empresariales). Furthermore, he is a member of COIT (Official College of Telecommunications Engineering), AEIT (Spanish Association of Telecommunications Engineers) and member of the Advisory council of the Higher Technical School of Engineers Telecommunications. Mr. Linares holds a degree in Telecommunications Engineering from the Polytechnic University of Madrid (Universidad Politécnica de Madrid).

Mr. César Alierta Izuel serves as a Director of our Board of Directors and the Chairman of Telefónica Foundation. Mr. Alierta began his career in 1970 as general manager of the capital markets division at Banco Urquijo, S.A. in Madrid, where he worked until 1985. Subsequently, he founded and served as Chairman of Beta Capital Sociedad de Valores, S.A. which he combined as from 1991 with his post as Chairman of the Spanish Financial Analysts' Association (Instituto Español de Analistas Financieros). Between 1996 and 2000, he was Director and Chairman of Tabacalera, S.A. At that time Tabacalera, S.A. changed its name into Altadis, S.A. (following its merger with the French Group, Seita-Société Nationale D'Exploitation Industrielle des Tabacs et Allumettes) and he became Director and Chairman of Altadis, S.A. He has also been a member of the Board of Directors of the Madrid Stock Exchange (Bolsa de Madrid), Plus Ultra Compañía de Seguros y Reaseguros, S.A., Telefónica Internacional and Iberia, S.A. In January 1997, Mr. Alierta was appointed as a Director of Telefónica and on July 26, 2000, he was appointed as our Executive Chairman, serving until April 2016. Mr. Alierta is Director of China Unicom (Hong Kong) Limited since October 15, 2008, and of International Consolidated Airlines Group (IAG) since September 2010. He is also a trustee of Fundació Bancaria Caixa d'Estalvis i Pensions de Barcelona ("la Caixa"). Mr. Alierta has been a Director of Telecom Italia from November 8, 2007, to December 13, 2013. Mr. Alierta holds a Law degree from the University of Zaragoza and an MBA from Columbia University (New York) and is currently a member of the Columbia Business School Board of Overseers, and Chairman of the Social Board of the UNED (National Long Distance Spanish University).

Ms. Eva Castillo Sanz serves as a Director of our Board of Directors. Ms. Castillo began her career at the Spanish broker Beta Capital Sociedad de Valores, S.A., where she worked for five years. After that, she worked for another five years for Goldman Sachs International in London in the International Equity Markets Department. In 1997, Ms. Castillo joined Merrill Lynch as head of Equity Markets for Spain and Portugal. In 1999, she was promoted to Country Manager for Spain and Portugal and in 2000 she became Chief Executive Officer of Merrill Lynch Capital

Markets Spain. After that, Ms. Castillo was appointed Chief Operating Officer for EMEA Equity Markets. In October 2003, she was appointed head of Global Markets & Investment Banking in Spain and Portugal, as well as president of Merrill Lynch Spain. Until December 2009, she headed Global Wealth Management business operations in Europe, the Middle East and Africa, including Merrill Lynch Bank (Suisse) and the International Trust and Wealth Structuring business. She was a member of the Merrill Lynch EMEA Executive Committee, the Global Wealth Management Executive and Operating Committees. Ms. Castillo was Chairwoman of Telefónica Europe and a member of Telefónica's Executive Committee from September 2012 to February 2014. From February 2011 to February 2013, Ms. Castillo was member of the Board of Directors of Old Mutual, Plc. and since May 2010 until January 2014 she was Chairperson of the Board of Telefónica Czech Republic, a.s. Currently, Ms. Castillo is the Chairperson of the Supervisory Board of Telefónica Deutschland Holding AG, member of the Board of Directors of Bankia, S.A., of Visa Europe and of the Telefónica Foundation. She is also a member of the Board of the Comillas-ICAI Foundation and member of the Board of Entreculturas Foundation. Ms. Castillo holds degrees in Business and Law (ICADE – E3) from the Universidad Pontificia de Comillas of Madrid.

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Mr. Juan Ignacio Cirac Sasurain serves as a Director of our Board of Directors. Mr. Cirac began his career as full professor at the Applied Physics Department of Castilla La Mancha University, after which he became a research associate at the Joint Institute for Laboratory Astrophysics of University of Colorado (1993-1994). In 1996, he was tutoring at Institut für Theoretische Physik of Leopold Franzens Universität Innsbruck, until 2001, since when Mr. Cirac became Director of the Theory Division of Max-Planck Institut für Quantenoptik and member of the Max Planck society. Since 2002, he held the title of Honorarprofessor at Technical University of Munich and during 2014 and 2015 Mr. Cirac was the Managing Director of the Technical University of Munich. Since 2016, Mr. Cirac is a speaker of the International Max-Planck Research School Quantum Science and Technology. Among other activities since 2015 he is a member of the Advisory Board of the Institute for the Interdisciplinary Information Sciences at Tsinghua University, and a member of the Advisory Board of the Russian Quantum Center since 2012. Mr. Cirac is also a member of the Advisory Board of Annalen der Physik, as well as of the Review Panel, QSIT of Swiss National Science Foundation. He has received several awards, such as the Hamburg Prize for Theoretical Physics, the Medal of Honor of Fundación García Cabrerizo or the Wolf Prize in Physics. He holds degree in Theoretical Physics from Universidad Complutense de Madrid as well as a Ph.D. in Physics from such University. He is specialized in Theoretical Quantum Optics, Quantum Information, Atomic Physics, and Quantum Many- Body Physics.

Mr. José Javier Echenique Landiribar serves as a Director of our Board of Directors. Mr. Echenique has been a Board Member and General Director of Allianz-Ercos as well as a General Director of BBVA Group, where he was responsible for wholesale business like Global Investment Banking or Global Corporate Banking among others. He has also been Member of the Board of Directors of Telefónica Móviles, S.A. and Telefónica Móviles México. Mr. Echenique was President of Banco Guipuzcoano as well as Board of Sevillana de Electricidad, S.A., Acesa and Hidroeléctrica del Cantábrico, Corporation IBV and Metrovacesa. Furthermore, he used to be Member of the Board of Corporación Patricio Echeverría, Grupo BBVA Seguros, Grupo Edhardt, Uralita, Grupo Porres (Mexico) and Abertis Infraestructuras, S.A. Mr. Echenique is currently Vice-President of the Board of Directors of Banco Sabadell, S.A. He is also Board Member of Repsol, S.A., ACS Actividades de Construcción y Servicios, S.A., ACS Servicios, Comunicaciones y Energía, S.L. and Grupo Empresarial ENCE, S.A. He holds degrees in Economics and Actuarial Sciences from Basque Country University (UPV), where he was a professor of Social Security's Quantitative Techniques of the Economic Sciences School of Bilbao for several years.

Mr. Peter Erskine serves as a Director of our Board of Directors. He began his career in the field of marketing in Polycell and in Colgate Palmolive. He worked for several years at the Mars Group, serving as Vice-Chairman for Europe of Mars Electronics. In 1990 he was appointed Vice-Chairman of Marketing and Sales of Unitel. From 1993 to 1998, he held a number of senior positions, including Director of British Telecom (BT) Mobile and President and Chief Executive Officer of Concert. In 1998 he became Managing Director of BT Cellnet. Subsequently, in 2001 he became Chief Executive Officer and a Director of the Board of Directors of Telefónica Europe, Plc. In 2006 he became Executive Chairman of Telefónica Europe, Plc (until December 31, 2007, after which he became a Non-Executive Director) and from July 2006 until December 2007 he served as General Manager of the business unit Telefónica Europe. In January 2009 he joined the Board of Ladbrokes Plc. as a Non-Executive Director until December 2015, becoming Chairman in May 2009. He stood down from the Board in December 2015, having taken a lead role in the merger of Ladbrokes PLC with Gala Coral Group. Currently, he is Chairman of the Henley Business School Strategy Board, member of the Council of Reading University and also serves as a member of the University's Strategy and Finance Committee. Since May 2016, he serves as member of the Supervisory Board of Telefónica Deutschland Holding AG. In 1973, he received a degree in Psychology from Liverpool University and he holds an Honorary Doctorate from University of Reading.



Ms. Sabina Fluxà Thienemann serves as a Director of our Board of Directors. Ms. Fluxà has also completed a High Business Management Program at IESE. In January 2005, she joined Iberostar Group, where she is currently the Co-Vice Executive President and CEO. She is also Regional Advisory Board Member of BBVA and Member of the Board of Directors of APD Illes Balears, as well as the Sponsor of Iberostar Foundation and Eneavor Foundation. She has received from ESADE a degree in Business Management and Administration and an MBA.

Mr. Luiz Fernando Furlán serves as a Director of our Board of Directors. He is currently a member of the Board of Directors of Telefônica Brasil, S.A., BRF-Brasil Foods, S.A. (Brazil) and AGCO Corporation (USA). Throughout his career he has been a member of the Board of Directors of several companies in Brazil and abroad such as Chairman of Sadia, S.A., Co-Chairman of BRF-Brasil Foods, S.A., member of the Advisory/ Consultive Board of Panasonic (Japan) and Wal-Mart (USA) and a member of the Advisory/Consultive Board of Abertis Infraestructuras, S.A. (Spain). From 2003 to 2007 he was Minister of Development, Industry and Foreign Trade of Brazil. He holds a degree in Chemical Engineering from the Industrial Engineering Faculty of São Paulo and in Business Administration from University of Santana (São Paulo), with specialization in financial administration from Fundação Getúlio Vargas (São Paulo).

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Mr. Gonzalo Hinojosa Fernández de Angulo serves as a Director of our Board of Directors and of Telefónica del Perú, S.A.A. He began his career in 1966 in Cortefiel, S.A. and served in several management positions since then. From 1976 to 1985 Mr. Hinojosa was General Manager of Cortefiel, S.A. and from 1985 until 2005 he served as Chief Executive Officer of Cortefiel Group, a post which he combined with his appointment as Chairman from 1998 until 2006. From 1991 through 2002, he served as a Director of Banco Central Hispano Americano, S.A. and as a Director of Portland Valderribas, S.A. He has also served as a Director of Altadis, S.A. (1998-2007). He received on 1986 Manager of the Year by Revista Mercado and the Best Manager award by the Marketing School on 1988. He was also awarded as Best Manager of Madrid in 1991 and the GQ 2005 Prize to the best professional career. Mr. Hinojosa has a degree in Industrial Engineering from the Industrial Engineers Technical School of the Polytechnic University of Madrid (Escuela Técnica Superior de Ingenieros Industriales de la Universidad Politécnica de Madrid).

Mr. Pablo Isla Álvarez de Tejera serves as a Director of our Board of Directors. Mr. Isla began his career in 1989 as a State's Attorney (abogado del Estado), holding the first position of his class. He joined the Body of State's Attorneys that year and was assigned to the Spanish Ministry of Transportation, Tourism and Communications. In 1991 he moved to the General Management of the Legal Services of the Spanish Government (Dirección General del Servicio Jurídico del Estado). From 1992 to 1996, Mr. Isla served as General Manager of the Legal Services Department of Banco Popular, S.A. In 1996, he was appointed General Manager of the National Heritage Department of the Treasury Department of Spain (Ministerio de Economía y Hacienda). He also served as General Secretary of Banco Popular Español, S.A. from 1998 to 2000. In July 2000, Mr. Isla was appointed Chairman of the board of Grupo Altadis and Co-Chairman of such company. In June 2005, Mr. Isla was appointed the Deputy Chairman and Chief Executive Officer of Inditex, S.A. Since 2011, Mr. Isla is the current Chairman and CEO of Inditex, S.A. Mr. Isla has a degree in Law from the Complutense University of Madrid.

Mr. Peter Löscher serves as a Director of our Board of Directors. Mr. Löscher was the President of Global Human Health and a Member of the Executive Board of Merck & Co., CEO of GE Healthcare Bio – Sciences and Member of GE's Corporate Executive Council. He was also COO and member of the Board of Amersham Plc. Senior leadership position in Aventis and Hoeschst. From 2014 to 2016, he was the CEO of Renova Management AG. Currently, Mr. Löscher is Chairman of the Supervisory Board of OMV Aktiengesellschaft, and of Sulzer AG, and Member of the Supervisory Board of Deutsche Bank AG. He is also Honorary Professor at Tongi University Shanghai and he holds the Grand Decoration of Honor in Gold of the Republic of Austria, the Order of Friendship of the Russian Federation and is Knight Commander of the Order of Civil Merit of Spain. Mr. Löscher studied Economics at Vienna University of Economics, where he also got his MBA, and Business at the Chinese University of Hong Kong. He completed the Advanced Management Program (AMP) at Harvard Business School and an Honorary Doctorate of Engineering from Michigan State University and is Doctor Honoris Causa of Slovak University of Engineering in Bratislava.

Mr. Antonio Massanell Lavilla serves as a Director of our Board of Directors. In 1971 he joined the Caja de Ahorros y Pensiones de Barcelona ("La Caixa"), where he held several posts and in 1990, he was appointed Assistant Manager and Secretary of the Steering Committee, and from 1999 to June 2011 he served as Executive General Assistant Manager. From 1990 to 1992 he served as member of the board of Directors of Sociedad Española de Medios de Pago, S.A. and as Chairman of the Steering Committee of Sistema 6000 de la Confederación Española de Cajas de Ahorros. He was appointed Director of Visa Spain (1995-1998), Director of Autema (1991-2003), Director of Inmobiliaria Colonial (1992-2003), Director of Baqueira Beret (1998-2006), Director of Occidental Hotels Management, B.V. (2003-2007), Chairman of Port Aventura Entertainment, S.A. (2009-2012) and Vice Chairman of Mediterránea Beach & Golf

Community, S.A. (2009-2016). He also served as Chairman of Barcelona Digital Centre Tecnològic (former Fundación Barcelona Digital) and as member of the Board of Directors of Boursorama, S.A. Mr. Massanell has been Deputy Chairman of Caixa Bank since June 2014. He is currently member of the Board of Directors of SAREB (Sociedad de Gestión de Activos Inmobiliarios procedentes de la Reestructuración Bancaria), member of the Supervisory board of ERSTE Group Bank AG, as well as Director of Repsol, S.A. He is also Non-Executive Chairman of Cecabank. He is Vice-Chairman of the Board of Trustees of COTEC, Chairman of the Barcelona Centre Financer Europeu association, member of the Plenary Body of the Chamber of Commerce of Barcelona and member of Euro Retail Payments Board (ERPB). Mr. Antonio Massanell Lavilla holds a degree in Economics from the University of Barcelona.

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Mr. Ignacio Moreno Martínez serves as a Director on our Board of Directors. Previous posts include head of Corporate Banking and Private Equity at Banco de Vizcaya, Banco Santander de Negocios, and Mercapital. He also served as Deputy General Manager of Corporate and Institutional Banking at Corporación Bancaria de España, S.A. – Argentaria, Chief Executive Officer of Desarrollo Urbanístico Chamartín, S.A., and Chairman of Argentaria Bolsa, Sociedad de Valores. In addition, he also served as General Manager of the Chairman’s Office at Banco Bilbao Vizcaya Argentaria, S.A., Chairman Executive Officer of Vista Capital Expansión, S.A., SGEER – Private Equity and Chairman Executive Officer of N+1 Private Equity. Mr. Moreno is currently Chairman of Testa Residencial, Socimi, S.A., of Metrovacesa Suelo y Promoción, S.A., Metrovacesa Promoción y Arrendamiento, S.A., and representative of Sociedad Cardomana Servicios y Gestiones, S.L. in the Board of Directors of Secuoya Grupo de Comunicación, S.A. Mr. Moreno is also Senior Advisor of BC Partners Ltd. Mr. Moreno holds a degree in Economics and Business Studies from the University of Bilbao, and a Master’s degree in Marketing and Sales Management from the Instituto de Empresa and an MBA from INSEAD.

Mr. Francisco Javier De Paz Mancho serves as a Director of our Board of Directors. From 1984 to 1993 he was the General Secretary of Juventudes Socialistas and the member of the PSOE Executive. From 1990 to 1993, he was general secretary of the Spanish Consumers Association (Unión de Consumidores de España, UCE). From 1993 to 1996, he served as General Manager of Internal Trade of the Spanish Ministry of Tourism and Commerce and Director of Tabacalera, S.A. From 1994 to 1996, he was Chairman of the Observatory of Trading of the Spanish Ministry of Tourism and Commerce (Observatorio de la Distribución Comercial del Ministerio de Comercio y Turismo); from 1996 to 2004, he was Corporate Strategy Manager of the Panrico Donuts Group and Deputy Chairman. From 1998 to 2004, he served as Director of Mutua de Accidentes de Zaragoza (MAZ). From 2004 to 2006, he was Director of Tunel de Cadí, S.A.C. and from 2003 to 2004, he served as Chairman of the Patronal Pan y Bollería Marca (COE). From 2004 to 2007, he was Chairman of the National Company MERCASA. He has also been a member of the Board of Directors of Altadis, S.A., and of the Economic and Social Board and its Permanent Commission. From July 2006 to November 2014, he has been a member of the Executive Committee of the Chambers Board (Consejo Superior de Cámaras) and from 2008 to 2012 he has been the Chairman of Atento Inversiones y Teleservicios, S.A.U. Currently, he is Director of Telefónica de Argentina, S.A. Telefónica Brasil, S.A. and Telefónica Móviles México, S.A. de C.V. He is also Chairman of Telefónica Ingeniería de Seguridad, S.A.U. Mr. de Paz has a diploma in Publicity and Information and undertook studies in Law. He completed a Programa de Alta Dirección de Empresas from the IESE Business School (Instituto de Estudios Superiores de la Empresa, University of Navarra).

Mr. Wang Xiaochu serves as a Director of our Board of Directors. Prior to joining Telefónica, Mr. Wang served as Deputy Director General and Director General of the Hangzhou Telecommunications Bureau in Zhejiang province; Director General of the Tianjin Posts and Telecommunications Administration; Chairman and Chief Executive Officer of China Mobile (Hong Kong) Limited; Vice President of China Mobile Communications Corporation; an Executive Director, Chairman and Chief Executive Officer of China Telecom Corporation Limited; President and Chairman of China Telecommunications Corporation; and Chairman and Non-executive Director of China Communications Services Corporation Limited. Furthermore, Mr. Wang serves as the Chairman of China United Network Communications Group Company Limited, and as an Executive Director, Chairman and Chief Executive Officer of China Unicom (Hong Kong) Limited. He is a professor level senior engineer, graduated from Beijing Institute of Posts and Telecommunications in 1989 and he received a doctorate degree in Business Administration from the Hong Kong Polytechnic University in 2005.

Executive Officers/Management Team

At February 23, 2017, our executive management team consisted of the following individuals:

| Name                                     | Position   | Appointed | Age |
|--|--|-----------|-----|
| Mr. José María Álvarez-Pallete López     | Chairman of the Board of Directors and Chief Executive Officer | 2016      | 53  |
| Mr. Guillermo Ansaldo Lutz               | Chief Global Resources Officer                                 | 2011      | 55  |
| Mr. Ramiro Sánchez de Lerín García-Ovies | General Legal Secretary and Secretary to the Board             | 2005      | 62  |
| Mr. Angel Vilá Boix                      | Chief Strategy and Finance Officer                             | 2011      | 52  |
| Mr. Mariano de Beer                      | Chief Commercial Digital Officer                               | 2017      | 46  |
| Mr. Juan Francisco Gallego Arrechea      | General Manager of Internal Audit                              | 2016      | 50  |

Biographies of the Executive Officers and Senior Management

We present below the biographies of our executive officers and senior management who do not also serve on our Board of Directors.

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Mr. Guillermo Ansaldo Lutz serves as Chief Global Resources Officer (CGRO) of Telefónica Global Resources operating unit since September 2011, he is also member of the Executive Committee of Telefónica. From 1989 to 2000 he worked for McKinsey & Company holding different positions in Spain and Argentina. In 1995, he was appointed partner of McKinsey & Company in Argentina. From 2000 to 2004 he was the Chief Executive Officer of Telefónica de Argentina, S.A. and since April 2005, he held the position of Chief Executive Officer of Telefónica de España, S.A. From December 2007 to September 2011 he was Chairman and Chief Executive Officer of Telefónica de España, S.A. He holds a degree in Industrial Engineering from the Universidad de Buenos Aires and an MBA from The Amos Tuck School of Business Administration, Dartmouth College.

Mr. Ramiro Sánchez de Lerín García-Ovies serves as our General Secretary and Secretary to our Board of Directors. He is also a member of the Executive Committee. He began his career in Arthur Andersen, first working for its audit department and later for its tax department. In 1982, he became a State's Attorney (Abogado del Estado) and started working for the local tax authorities in Madrid (Delegación de Hacienda de Madrid). Afterwards he was assigned to the State Secretariat for the European Communities and later to the Foreign Affairs Ministry. He has been General Secretary and Secretary of the Board of Elosúa, S.A., Tabacalera, S.A., Altadis, S.A. and Xfera Móviles, S.A. He has also held teaching positions in Instituto Católico de Administración y Dirección de Empresas (ICADE), Instituto de Empresa and Escuela de Hacienda Pública.

Mr. Ángel Vilá Boix is Chief Strategy and Finance Officer and member of the Executive Committee at Telefónica, S.A. He currently is a Board member in listed subsidiaries Telefónica Germany and Telefónica Brazil, as well as a Trustee in the Telefónica Foundation. Mr. Vilá joined Telefónica in 1997. He held positions of Group Controller, CFO of Telefónica Internacional, Group Head of Corporate Development and Chief Financial and Corporate Development Officer. In 2015 he was appointed Chief Strategy and Finance Officer. In his tenure, Ángel Vilá has executed landmark corporate transactions such as the acquisitions of O2, Vivo, EPlus, GVT, Telco/TI or the Telefonica Germany IPO. Prior to joining Telefónica, he held positions at Citigroup, McKinsey&Co, Ferrovial and Planeta. In the financial sector, he has served in the Board of directors of Banco Bilbao Vizcaya Argentaria (BBVA) and on the Advisory Panel of Macquarie MEIF Infrastructure funds. In the TMT sector, he was Chairman of Telefónica Contenidos, Vice Chairman of Telco Spa (Italy) and Board member of Endemol, Digital+, Atento, Telefonica Czech, CTC Chile, Indra SSI and Terra Lycos. Institutional Investor nominated Ángel Vilá as the Best CFO in European Telecoms in 2015. He was also honored with the Thomson Reuters Extel Pan-European Awards as No.1 CFO in Spain both in 2013 and 2014, as well as No.1 CFO for Telecommunications in Europe in 2014. Mr. Ángel Vilá holds a MBA from Columbia Business School where he studied with a Fulbright La Caixa fellowship. He was distinguished in the Beta Gamma Sigma Honor Society and the Dean's List. Prior to Columbia University, he graduated in Industrial Engineering from Universitat Politècnica de Catalunya in Barcelona.

Mr. Mariano de Beer is the Chief Commercial Digital Officer of Telefónica S.A. In this role, he is responsible for driving revenue growth globally, developing a holistic view for the consumer and enterprise segments, curating the commercial offer and evolving the channels to ensure the best commercial experience for Telefónica customers. He is in charge of innovation within the group. Mr. De Beer is member of the Telefónica Group Executive Committee. During the last years, he has held the position of President of Microsoft Brazil and most recently President of Microsoft Latam – New Markets, after a solid, successful career in the telecommunications industry. Mariano joined Telefónica's team in Brazil in 1998 from McKinsey & Co., where he held a variety of positions within the company, mainly in the Residential and SME segments. In 2006, he joined the Senior Management Committee of Telefónica

International as Director of SME for Latin America, until 2008, when he returned to Brazil as CEO of Telefónica and subsequently Chairman of the Vivo Corporate Unit. After leaving Telefónica and before joining Microsoft, he worked in the RBS Brazilian conglomerate, where he led the Education Unit of the group as CEO, with the mission of expanding and strengthening the Education Project of RBS. Mariano graduated from UADE in Argentina, obtained an MBA from Georgetown University and he has completed Executive Programs at INSEAD, IESE and Stanford University School of Business.

Mr. Juan Francisco Gallego Arrechea is the Chief Audit Executive of the Telefónica Group since 2016. He began his career in Arthur Andersen, where he specialized in audit and financial consulting for business groups. In June 2000, he joined the Telefónica Group working as the Chairman of Consolidation and Accounting Policies and serving, from 2009, as Chief Accounting Officer. Mr. Gallego is speaker and member of work teams in several master programs, conferences and courses on the matter of audit, consolidation and accounting practices held by regulators, private institutions and universities. He obtained a degree in Economic Science at Universidad Complutense in Madrid.

## B. Compensation

Please see Note 21(f) and Appendix II to our Consolidated Financial Statements for information on the compensation paid to members of our Board of Directors and Executive Officers/Senior Management Team during the year 2016.

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Incentive Plans

Please see Note 19 to our Consolidated Financial Statements.

C. Board Practices

Please see “—Directors and Senior Management” above.

D. Employees

Please see “Headcount” in Note 18 to our Consolidated Financial Statements.

In 2015 Telefónica de España, S.A.U., Telefónica Móviles España, S.A.U. and Telefónica Soluciones de Informática y Comunicaciones de España, S.A.U. signed the first Collective Agreement of Related Companies (CEV). This agreement contemplated, among other elements, a plan of measures for individual suspension of the employment relationship in 2016 and 2017. In December 2016, the CEV was extended until 2018, by virtue of the provisions of this same agreement. In 2016, the expense relating to the forecast payments to meet the commitments resulting from the extension of this program was recognized. A total of 789 million euros were recorded for the Individual Suspension Plan in 2016 (2,896 million euros in 2015) (see Note 15 to our Consolidated Financial Statements).

E. Share Ownership

At February 23, 2017, the following members of our Board of Directors beneficially owned directly or indirectly an aggregate of 8,792,360 shares, representing approximately 0.1794% of our capital stock.

| Name or corporate name of director | Number of direct voting rights | Number of indirect voting rights | % of total voting rights |
|------------------------------------|--------------------------------|----------------------------------|--------------------------|
|                                    | 1,230,745                      | -                                | 0.025                    |



Mr. José María Álvarez-Pallete  
López

|   |           |         |       |
|---|-----------|---------|-------|
| Mr. Isidro Fainé Casas                      | 595,382   | -       | 0.012 |
| Mr. José María Abril Pérez                  | 157,077   | 158,211 | 0.006 |
| Mr. Julio Linares López                     | 480,889   | 8,440   | 0.010 |
| Mr. César Alierta Izuel                     | 5,505,144 | -       | 0.112 |
| Ms. Eva Castillo Sanz                       | 113,594   | -       | 0.002 |
| Mr. Juan Ignacio Cirac Sasurain             | -         | -       | 0.000 |
| Mr. José Javier Echenique<br>Landiribar     | 31,850    | 75,712  | 0.002 |
| Mr. Peter Erskine                           | 42,733    | -       | 0.001 |
| Ms. Sabina Fluxà Thienemann                 | -         | -       | 0.000 |
| Mr. Luiz Fernando Furlán                    | 38,423    | -       | 0.001 |
| Mr. Gonzalo Hinojosa Fernández<br>de Angulo | 51,135    | 206,815 | 0.005 |
| Mr. Pablo Isla Álvarez de Tejera            | 10,294    | -       | 0.000 |
| Mr. Peter Löscher                           | -         | -       | 0.000 |
| Mr. Antonio Massanell Lavilla               | 2,743     | -       | 0.000 |
| Mr. Ignacio Moreno Martínez                 | 18,311    | -       | 0.000 |
| Mr. Francisco Javier de Paz<br>Mancho       | 64,862    | -       | 0.001 |
| Mr. Wang Xiaochu                            | -         | -       | 0.000 |

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At February 23, 2017, members of our executive management team (excluding members of our Board of Directors listed above) beneficially owned an aggregate of 1,172,069 of our shares, representing approximately 0.024 % of our capital stock.

None of our directors or executive officers beneficially owned shares representing one percent or more of our share capital at February 23, 2017.

None of our directors and executive officers held options in respect of shares representing one percent or more of our share capital at February 23, 2017.

Please see “Share-based payment plans” in Note 19 to our Consolidated Financial Statements.

Item 7. Major Shareholders and Related Party Transactions

A. Major Shareholders

General

At February 23, 2017, we had 5,037,804,990 shares outstanding, each having a nominal value of 1.00 euro per share. All outstanding shares have the same rights.

At February 23, 2017, according to information provided to us or to the Spanish National Securities Commission (Comisión Nacional de Mercado de Valores or the “CNMV”), beneficial owners of 3% or more of our voting stock were as follows:

| Name of Beneficial Owner   | Number of Shares |             | Percent |
|--|------------------|-------------|---------|
|  | Direct           | Indirect    |         |
| Banco Bilbao Vizcaya Argentaria, S.A.(1)                                       | 318,861,940      | -           | 6.32%   |
| Fundación Bancaria Caixa d’ Estalvis i Pensions de Barcelona (“la Caixa”)(2) - |                  | 259,651,258 | 5.15%   |

|                    |   |                   |
|--------------------|---|-------------------|
| Blackrock, Inc.(3) | - | 336,154,823 6.70% |
|--------------------|---|-------------------|

(1) Based on the information provided by Banco Bilbao Vizcaya Argentaria, S.A. as at December 31, 2016 for the 2016 Annual Report on Corporate Governance.

(2) Based on information provided by Fundació Bancaria Caixa d' Estalvis i Pensions de Barcelona ("la Caixa") as at December 31, 2016 for the 2015 Annual Report on Corporate Governance. The indirect shareholding is held by Caixabank, S.A. which owns 259,461,788 shares and by Vidacaixa, S.A. de Seguros y Reaseguros which owns 189,470 shares.

(3) According to the form on Schedule 13G filed on January 30, 2017 with the SEC. Though the reported beneficial ownership Blackrock, Inc. has sole voting power with respect to 304,764,164 shares (representing 6.04% of Telefónica's share capital as of the date of this Annual Report) and has shared power to vote with respect to 24,700 shares (representing 0.66% of Telefónica's share capital as of the date of this Annual Report).

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To the extent that our shares are represented by account in the book-entry form, we do not keep a shareholder registry and our ownership structure cannot be known precisely. Based on the information available to us there is no individual or corporation that directly or indirectly through one or more intermediaries may exercise any type of control over us. Nevertheless, we have certain shareholders whose holdings are considered material.

### Ownership Limitations

There are no limitations with respect to the ownership of our assets or share capital except those related to assets derived from the application of the reciprocity principle. Article 6 of the General Telecommunications Law, or the GTL, provides for the application of the reciprocity principle under existing international treaties or agreements signed and ratified by Spain. The Spanish government, upon request, may authorize exceptions to the reciprocity principle contained in the GTL.

### B. Related Party Transactions

During 2014, 2015 and 2016 and through the date of this Annual Report, the Directors and senior executives did not enter into any transaction with Telefónica, S.A. or any Telefónica Group company other than those in the Group's normal trading activity and business.

Our Board of Directors' Regulations grant the Board of Directors the exclusive power to authorize any transactions with major shareholders or with our directors. Prior to authorizing any such transaction, our Board will receive an opinion from the Nominating, Compensation and Corporate Governance Committee addressing the fairness of the transaction to our shareholders and us. Any of our directors that may have an interest in the proposed transaction must abstain from voting on the proposed transaction.

Please see Note 10 to our Consolidated Financial Statements for further information.

### Related Party Transactions with Significant Shareholders

Two of our major shareholders are financial institutions (see “—Major Shareholders—General” above). We have entered into related party transactions with both companies within our ordinary course of business, and always on arm's length terms. During 2016 and through the date of this Annual Report, the executed transactions were generally loans, capital markets or derivative transactions provided to us by these financial institutions and agreements for us to provide

telecommunications and broadband services to such institutions.

Please see Note 10 to our Consolidated Financial Statements for further information.

#### Intra-Group Loans

We are the parent company of the Telefónica Group and operate through our subsidiaries and affiliated companies. We coordinate group policies, including financial policy and, in some cases, actual financial management is conducted by us. Most of the transactions we perform with other members of the Telefónica Group relate to financing transactions, including covering their needs for funds and providing interest rate and exchange rate hedges.

At December 31, 2016, as recorded in our parent company accounts, we loaned a total of 5,671 million euros (9,142 million euros at December 31, 2015) to companies of the Telefónica Group while companies of the Telefónica Group and their associates loaned us a total of 49,583 million euros (48,738 million euros at December 31, 2015), of which 10,620 million euros (8,560 million euros at December 31, 2015) was loaned to us by Telefónica Europe, B.V. and 34,742 million euros (36,937 million euros at December 31, 2015) was loaned to us by Telefónica Emisiones S.A.U., our financing subsidiaries devoted to raising funds in the capital markets, 3,577 million euros (2,571 million euros at December 31, 2015) was loaned by us to Telfisa Global, B.V., our financing subsidiary charged with centralizing and managing the cash pooling of our subsidiaries in Latin America, Europe and the United States and 644 million euros (145 million euros at December 31, 2015) was loaned to us by Telefónica Participaciones, S.A.U..

With respect to the balances with associated companies, the line item “Non-current financial assets” on the consolidated statement of financial position at December 31, 2016, includes “Loans to Associates” amounting to 16 million euros (21 million euros at December 31, 2015).

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C. Interests of Experts and Counsel

Not applicable.

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Item 8. Financial Information

Consolidated Financial Statements

Please see Item 18.

Legal Proceedings

Telefónica and its group companies are party to several legal proceedings which are currently in progress in the courts of law and the arbitration bodies of the various countries in which we are present.

Based on the advice of our legal counsel we believe it is reasonable to assume that these legal proceedings will not materially affect the financial condition or solvency of the Telefónica Group.

The following unresolved legal proceedings or those underway in 2016 are highlighted (see Note 17 to the Consolidated Financial Statements for details of tax-related cases):

**Appeal against the decision by Agência Nacional de Telecomunicações (“ANATEL”) regarding the inclusion of interconnection and network usage revenues in the Fundo de Universalização de Serviços de Telecomunicações**

Vivo Group operators (currently Telefônica de Brasil), together with other cellular operators, appealed ANATEL’s decision of December 16, 2005, to include interconnection and network usage revenues and expenses in the calculation of the amounts payable into the Fund for Universal Access to Telecommunications Services (“FUST”) – a fund which pays for the obligations to provide Universal Service -with retroactive application from 2000. On March 13, 2006, Regional Federal Court no. 1. granted a precautionary measure which stopped the application of ANATEL’s decision. On March 6, 2007, a ruling in favor of the wireless operators was issued, stating that it was not appropriate to include the revenues received by transfer from other operators in the taxable income for the FUST’s calculation and rejecting the retroactive application of ANATEL’s decision. On January 26, 2016, ANATEL filed an appeal to overturn this decision with Brasilia Regional Federal Court no. 1.

At the same time, Telefônica Brasil and Telefónica Empresas, S.A., together with other wireline operators through ABRAFIX (Associação Brasileira de Concessionárias de Serviço Telefonico Fixo Comutado) appealed ANATEL's decision of December 16, 2005, also obtaining the precautionary measures requested. On June 21, 2007, Federal Regional Court no. 1 ruled that it was not appropriate to include the interconnection and network usage revenues in the FUST's taxable income and rejected the retroactive application of ANATEL's decision. ANATEL filed an appeal to overturn this ruling on April 29, 2008, before Brasília Federal Regional Court no. 1, which was dismissed on May 10, 2016. ANATEL filed an appeal against this dismissal.

The fixed operators filed an appeal to clarify that revenues obtained through interconnection and dedicated line operation should not be included in the calculation of the amounts payable to the FUST. In addition, the court was also requested to rule on two grounds which had not been analyzed in the initial decision: (i) that the FUST has become obsolete, among other reasons, by the advance of mobile telephony; and (ii) that amounts collected are not applied to the purpose for which the FUST was created, since only a very low percentage of the revenues collected by the FUST is used to finance fixed telephony. Although the petition for clarification was dismissed on August 23, 2016, the court noted that the FUST should not be funded with revenues from interconnection and dedicated line operation.

The amount of the claim is quantified at 1% of the interconnection revenues.

**Public civil procedure by the São Paulo government against Telefônica Brasil for alleged reiterated malfunctioning in services provided**

This proceeding was filed by the Public Ministry of the State of São Paulo for alleged reiterated malfunctioning in the services provided by Telefônica Brasil, seeking compensation for damages to the customers affected. A general claim was filed by the Public Ministry of the State of São Paulo, for 1 billion Brazilian reais (approximately 225 million euros), calculated on the company's revenue base over the last five years.

In April 2010, a ruling against the Telefónica Group was issued in first instance. The full impact of this proceeding will not be known until there is a final ruling, and the total amount of persons affected by and party to the proceeding is known. At that moment, the amount of the indemnity will be established, ranging between 1 billion and 60 million reais (approximately, between 225 and 13 million euros), depending on the number of parties. On May 5, 2010, Telefônica Brasil filed an appeal before the São Paulo Court of Justice, suspending the effect of the ruling.



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On April 13, 2015, the appeal was judged in favor of Telefónica, by unanimous vote, reversing the earlier decision in first instance.

The Public Prosecutor filed an extraordinary petition for review at the High Court of Brasilia which refused to consider the petition due to the lack of legal requirements. A new appeal may be filed against such refusal.

**Appeal against the Decision of the EC dated January 23, 2013 to sanction Telefónica for the infringement of Article 101 of the Treaty on the functioning of the European Union**

On January 19, 2011, the EC initiated formal proceedings to investigate whether Telefónica, S.A. (Telefónica) and Portugal Telecom SGPS, S.A. (Portugal Telecom) had infringed European Union anti-trust laws with respect to a clause contained in the sale and purchase agreement of Portugal Telecom's ownership interest in Brasilcel, N.V., a joint venture in which both were venturers and which was the owner of the Brazilian company Vivo.

On January 23, 2013, the EC passed a ruling on the formal proceedings. The ruling imposed a fine on Telefónica of 67 million euros, as the EC ruled that Telefónica and Portugal Telecom committed an infraction of Article 101 of the Treaty on the Functioning of the European Union for having entered into the agreement set forth in Clause Nine of the sale and purchase agreement of Portugal Telecom's ownership interest of Brasilcel, N.V.

On April 9, 2013, Telefónica filed an appeal for annulment of this ruling with the European Union General Court. On August 6, 2013, the European Union General Court notified Telefónica of the response issued by the EC, in which the EC reaffirmed the main arguments of its ruling and, specially, that Clause Nine includes a competition restriction. On September 30, 2013, Telefónica filed its reply. On December 18, 2013, the EC filed its appeal.

A hearing was held on May 19, 2015, at the European Union General Court.

On June 28, 2016, the European Union General Court ruled. Although it declares the existence of an infringement of competition law, it annuls Article 2 of the contested Decision and requires the EC to reassess the amount of the fine imposed. The General Court considers that the EC has not neutralized the allegations and evidences provided by Telefónica on services in which there was not potential competition or were outside the scope of Clause Nine.

Telefónica understands that there are grounds for believing that the ruling does not suit at law; consequently, it filed an appeal to the Court of Justice of the European Union, on September 11, 2016.

On November 23, 2016, the EC filed its response against the Telefónica's appeal. On January 30, 2017, Telefónica filed its response.

**Claim of consumers association "FACUA" against Telefónica de España in connection with the increase of the price of Movistar Fusión**

On September 5, 2016, notification was given to Telefónica de España of a claim filed against it by the consumers association ("FACUA").

Through such claim, the association exercises an action to protect consumers' and users' collective interests stipulated in articles 11 of the Civil Procedure Act (*Ley de Enjuiciamiento Civil*) and 24.1 of the Consumer and Users Protection Act (*Ley General de Defensa de los Consumidores y Usuarios*) on the basis of alleged disloyalty towards the consumers, arising from the raising of the prices of the product "Movistar Fusión" from May 5, 2015, by an amount of 5 euros per month.

The claim contains a declaratory statement stating that disloyalty arises from misleading advertising regarding the price rise and a prohibitory injunction, requesting that Telefónica de España be ordered not to apply such price rise and to prohibit its future application to all customers who became customers of Movistar Fusión prior to May 5, 2015. It contains, besides, a third statement, requesting Telefónica de España to be condemned to repay the excess amounts collected as a result of the rise in prices to those customers who have chosen to maintain the service contracted, together with accrued interest on such amount.

The claim was filed for an undetermined amount, given the impossibility of determining *a priori* the total amount of the claim. On October 28, 2016, Telefónica de España filed the response. A hearing will be held on March 7, 2017.

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**Decision by the High Court regarding the acquisition by Telefónica of shares in Český Telecom by way of tender offer**

Venten Management Limited ("**Venten**") and Lexburg Enterprises Limited ("**Lexburg**"), were minority shareholders of CESKY TELECOM. In September 2005 both companies sold their shares to Telefónica in a mandatory tender offer. Subsequently Venten and Lexburg, in 2006 and 2009, respectively, filed actions against Telefónica claiming a higher price than the price for which they sold their shares in the mandatory tender offer.

On August 5, 2016, the hearing before the High Court in Prague took place in order to decide the appeal against the second decision of the Municipal Court, which had been favourable to Telefónica's position (as was also the case with the first decision of the Municipal Court). At the end of the hearing, the High Court announced the Second Appellate Decision by which it reversed the second decision of the Municipal Court and ordered Telefónica to pay 644 million Czech koruna (approximately 23 million euros) to Venten and 227 million Czech koruna (approximately 8 million euros) to Lexburg, in each case plus interest.

On December 28, 2016, the decision was notified to Telefónica. Telefónica has filed an extraordinary appeal, requesting the suspension of the effects of the decision.

**Other contingencies**

Telefónica is currently conducting internal investigations covering various countries regarding possible violations of applicable anti-corruption laws. Telefónica has been in contact with governmental authorit