

## Telefonica SA (TEF.MC)

### Alert: Is another VEF devaluation due?

**Event** — With elections due in October, Chavez's pre-election spending spree has increased the budget deficit, with Bloomberg reporting that another post-election devaluation may be necessary to narrow the deficit. According to Bloomberg, consensus is looking for a 31% devaluation of the Bolivar peg from VEF4.3/\$ currently to VEF6.2/\$ at the start of 2013. The last devaluation in January 2010 was of a bigger magnitude (50% from VEF2.15/\$),

**Exposure** — Venezuela contributes 5.5% of group revenues; 7.1% of OIBDA and 9.2% of OpFCF in our 2012 estimates. Given that TEF has accumulated a significant cash position, we estimate the weight on net income and FCF to be much higher: at c.12%

**Implications for estimates** — In our estimates we already assume an almost 50% devaluation to VEF8/\$ in 2013, but assume the devaluation will happen mid year (VEF6.1/\$ average). However, we anticipate some pressure to consensus estimates. Given the cash position is likely to close the year close to €2bn (based on annual reports, net cash was €1.1bn at year end 2011), we also expect net debt will increase by c.€1bn.

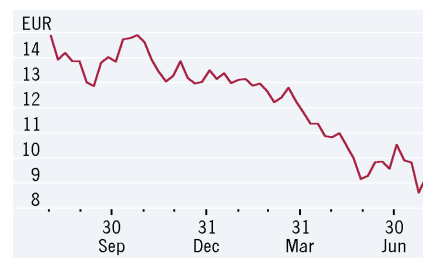
**And credit** — Our 2013 estimates have TEF's leverage coming down to 2.25x net financial debt/OIBDA or 2.4x including commitments. This is 0.1x lower than the ceiling, but we suspect there may be pressure on TEF from the rating agencies to reduce leverage more aggressively. We assume a €0.50/share dividend vs TEF's intention to resume dividend payments at €0.75. A devaluation would reduce financial flexibility by c.€2.5bn, of which €1.5bn comes from the lower OIBDA.

**Keep Neutral/ Least Preferred list** — We reiterate our DCF-based price target of €9.0/share. We believe that TEF is moving in the right direction by prioritising deleveraging and focusing on improving operational trends. We also believe that the bulk of earnings downgrades are behind it. But in our view TEF does not offer compelling value, while it remains exposed to the sovereign crisis and potential credit events that could drive further downside.

#### ■ Company Update

<b>Neutral</b>	<b>2</b>
Price (01 Aug 12)	€9.31
Target price	€9.00
Expected share price return	-3.3%
Expected dividend yield	0.0%
<b>Expected total return</b>	<b>-3.3%</b>
Market Cap	€42,370M
	US\$52,130M

#### Price Performance (RIC: TEF.MC, BB: TEF SM)



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## Telefonica SA

### Valuation

Our valuation of TEF and €9.0 target price are based at a 10% equity discount on our 25-year DCF, which fades the ROCE close to the cost of capital in the longer term. We use a WACC of 9.5% and 1.5% perpetuity growth rate from year 25.

### Risks

Downside risks that could impede the share price from reaching our target price include: acquisitions, changes in regulation, macro issues including currency fluctuations. Growth rates in the many different Latin American markets may diverge markedly from our expectations. If the impact of these risk factors is less negative than we anticipate, then the share price might rise above our target price.

Upside risks include a sale of non core assets like China Unicom shares; consolidation of the Spanish mobile market; lower financing costs on improvement in the perception of Spanish sovereign risk.

## Telefonica SA

(TEF.MC; €9.31; 2)

**Catalyst and Thesis** — A natural Southern European hedge to our TI long. TEF's earnings momentum is weak on poor Spanish performance (which we expect to deteriorate further in 2012) and weakening LatAm margins. TEF's shareholder returns are still at risk of another cut, especially if we see VEF devaluation/ ARS depreciation.

## Appendix A-1

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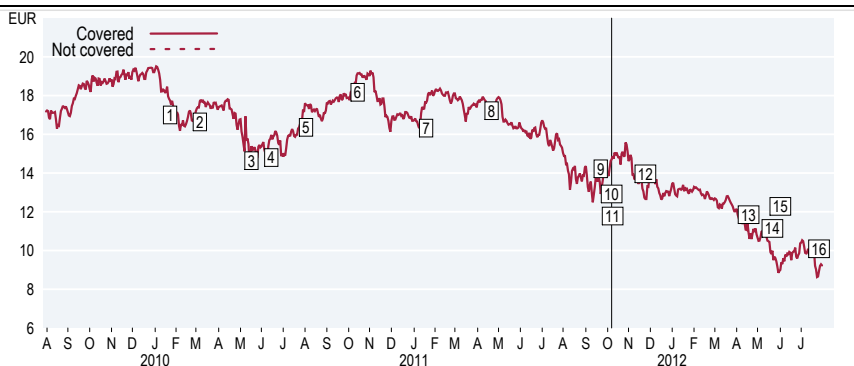
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Analyst: Georgios Ierodiaconou  
Covered since December 10 2010



Date	Rating	Target Price	Closing Price
1 22-Jan-10	*2M	*18.21	17.74
2 5-Mar-10	2M	*18.01	17.71
3 18-May-10	*1M	*17.23	15.39
4 15-Jun-10	1M	*16.93	15.97
5 3-Aug-10	*2M	*17.23	17.51
6 14-Oct-10	*2L	17.23	19.15

\* Indicates change

Date	Rating	Target Price	Closing Price
7 19-Jan-11	*2M	17.23	17.63
8 21-Apr-11	2M	*16.24	17.33
9 22-Sep-11	2M	*13.29	12.92
10 7-Oct-11	Stock rating system changed		
11 8-Oct-11	*2	13.29	14.71
12 24-Nov-11	2	*12.80	12.66

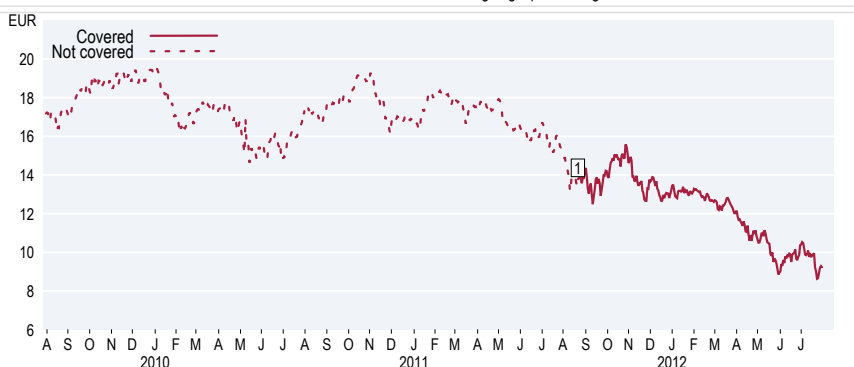
Date	Rating	Target Price	Closing Price
13 18-Apr-12	2	*11.32	10.91
14 22-May-12	2	*10.50	9.99
15 1-Jun-12	2	*9.50	9.00
16 26-Jul-12	2	*9.00	8.95

Rating/target price changes above reflect Eastern Standard Time

### Telefonica SA (TEF.MC)

#### Ratings and Target Price History Best Ideas Research Relative Call (3 Month)

Analyst: Georgios Ierodiaconou  
Covered since December 10 2010



Date	Rating	Target Price	Closing Price
1 22-Aug-11	*ADD LP	-	13.78

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