

# Telefonica SA (TEF.MC)

## A Game of Two Halves: Downgrades in 1H; Inflection in 2H

- **Pain before gain** — We see significant near term downside risk to consensus estimates as we are 7% below on 2013E EBITDA on FX headwinds and tough comps in Spain, (new consumption taxes, last year's move away from subsidies) which will offset the early benefit from 'Movistar Fusión'. We see inflection in Spain and other key markets during 2013.
- **More cuts to consensus estimates**— Currencies have already moved against TEF in recent months with the latest 32% devaluation of the VEF. We expect further weakness in ARS as our economists see scope for a c. 30% devaluation in the next three months. Overall, we model forex headwinds on revenues of 6% in 2013.
- **Fusión should work, in time** — The market should rightly welcome the operational improvement driven by the migration of customers to Fusión and churn is bound to come down. However, expectations for a dramatic improvement in EBITDA trends in 2013 are pre-mature and the market needs to consider the impact from higher VAT in Spain (from 4Q12 onwards) and the tough comps from the elimination of handset subsidies in March 2012. We modestly raise 13E margin estimates on lower churn.
- **Valuation in the eye of the beholder** — Given our estimates are significantly below consensus, TEF trades at a 5-10% premium on our headline valuation comps vs. the sector on EV/EBITDA and FCF yield multiples. On an adjusted basis (leases & pensions), TEF trades in line with the sector even on our 2013 estimates, which we think would be attractive if the business shows operational inflection.
- **Neutral/ Reiterate Least preferred** — we reiterate our Neutral stance on the stock and our price target of €10.00. We see scope for TEF to start paying dividends (starting with the interim payment in November), though we model €0.50/share dividend, below the company's 2013 target of €0.75.
- **Telecoms Conference** – Our 13<sup>th</sup> Annual European and Emerging Markets Telecoms Conference is being held at the Radisson Mayfair Hotel, London from 19 March to 21 March. Please register your attendance by clicking [here](#). Registration closes next week.

### Telefonica SA (EUR)

Year to 31 Dec	2010A	2011A	2012E	2013E	2014E
Sales (€M)	60,737.0	62,837.0	61,961.8	55,993.8	56,035.9
Net Income (€M)	7,930.0	7,879.7	5,552.5	4,655.6	4,951.4
Diluted EPS (€)	1.76	1.75	1.25	1.02	1.09
Diluted EPS (Old) (€)	1.76	1.75	1.25	0.97	0.99
PE (x)	5.4	5.5	7.7	9.4	8.8
EV/EBITDA (x)	4.0	4.5	4.8	5.0	4.7
DPS (€)	1.40	1.30	0.00	0.50	0.50
Net Div Yield (%)	14.6	13.6	0.0	5.2	5.2

- Company Update
- Estimate Change

<b>Neutral</b>	<b>2</b>
Price (18 Feb 13)	€9.57
Target price	€10.00
Expected share price return	4.5%
Expected dividend yield	2.6%
<b>Expected total return</b>	<b>7.2%</b>
Market Cap	€43,535M
	US\$58,178M

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



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### See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

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TEF.MC: Fiscal year end 31-Dec						Price: €9.57; TP: €10.00; Market Cap: €43,553m; Recomm: Neutral					
Profit & Loss (€m)	2010	2011	2012E	2013E	2014E	Valuation ratios	2010	2011	2012E	2013E	2014E
Sales revenue	60,737	62,837	61,962	55,994	56,036	PE (x)	5.4	5.5	7.7	9.4	8.8
Cost of sales	-26,015	-29,336	-27,794	-24,895	-24,636	PB (x)	1.8	2.0	1.9	1.7	1.5
Gross profit	34,722	33,501	34,168	31,099	31,400	EV/EBITDA (x)	4.0	4.5	4.8	5.0	4.7
Gross Margin (%)	57.2	53.3	55.1	55.5	56.0	FCF yield (%)	12.6	15.2	13.3	9.5	12.9
EBITDA (Adj)	22,977	22,180	20,841	19,143	19,571	Dividend yield (%)	14.6	13.6	0	5.2	5.2
EBITDA Margin (Adj) (%)	37.8	35.3	33.6	34.2	34.9	Payout ratio (%)	80	74	0	49	46
Depreciation	-7,904	-8,762	-8,957	-8,598	-8,584	ROE (%)	44.2	23.4	18.8	17.3	16.7
Amortisation	-1,399	-1,384	-1,390	-1,384	-1,371	Cashflow (€m)					
EBIT (Adj)	13,674	12,034	10,494	9,160	9,617	EBITDA	22,977	22,180	20,841	19,143	19,571
EBIT Margin (Adj) (%)	22.5	19.2	16.9	16.4	17.2	Working capital	2,694	2,134	-108	13	-421
Net interest	-2,649	-2,941	-3,217	-3,032	-2,830	Other	-9,032	-6,848	-5,180	-4,893	-4,841
Associates	76	-635	111	120	124	Operating cashflow					
Non-op/Except	35	0	-438	0	0	Capex	-10,844	-10,224	-9,422	-9,619	-8,145
Pre-tax profit	11,136	8,458	6,951	6,249	6,911	Net acq/disposals	-5,192	-3,050	4,770	0	0
Tax	-3,829	-301	-1,907	-1,624	-1,832	Other	-1,685	904	30	30	30
Extraord./Min.Int./Pref.div.	2,895	-2,754	-868	-380	-496	Investing cashflow					
Reported net profit	10,202	5,403	4,176	4,245	4,582	Dividends paid	-6,755	-7,567	-2,853	-1,696	-2,846
Net Margin (%)	16.8	8.6	6.7	7.6	8.2	Financing cashflow					
Core NPAT	7,930	7,880	5,553	4,656	4,951	Net change in cash	-3,544	314	9,279	4,978	3,349
Per share data						Free cashflow to s/holders					
Reported EPS (€)	2.26	1.20	0.94	0.93	1.01		5,457	6,544	5,688	4,116	5,624
Core EPS (€)	1.76	1.75	1.25	1.02	1.09						
DPS (€)	1.40	1.30	0	0.50	0.50						
CFPS (€)	3.69	3.87	3.49	3.13	3.14						
FCFPS (€)	1.21	1.45	1.28	0.90	1.24						
BVPS (€)	5.36	4.82	5.14	5.79	6.29						
Wtd avg ord shares (m)	4,512	4,511	4,453	4,551	4,551						
Wtd avg diluted shares (m)	4,512	4,511	4,453	4,551	4,551						
Growth rates											
Sales revenue (%)	7.1	3.5	-1.4	-9.6	0.1						
EBIT (Adj) (%)	2.1	-12.0	-12.8	-12.7	5.0						
Core NPAT (%)	-1.2	-0.6	-29.5	-16.2	6.4						
Core EPS (%)	-0.3	-0.6	-28.6	-18.0	6.4						
Balance Sheet (€m)											
Cash & cash equiv.	9,202	11,590	19,972	24,950	28,299						
Accounts receivables	12,426	11,331	11,632	10,795	10,911						
Inventory	1,028	1,164	1,262	1,255	1,381						
Net fixed & other tangibles	41,495	41,886	41,395	40,852	40,409						
Goodwill & intangibles	54,608	53,171	52,066	52,030	50,528						
Financial & other assets	11,016	10,481	5,310	5,401	5,495						
<b>Total assets</b>	<b>129,775</b>	<b>129,623</b>	<b>131,636</b>	<b>135,283</b>	<b>137,023</b>						
Accounts payable	9,314	9,406	9,697	8,866	8,688						
Short-term debt	11,462	13,220	13,243	12,723	12,723						
Long-term debt	51,356	55,659	56,659	58,659	58,659						
Provisions & other liab	25,959	23,956	23,666	23,215	22,901						
<b>Total liabilities</b>	<b>98,091</b>	<b>102,241</b>	<b>103,265</b>	<b>103,463</b>	<b>102,971</b>						
Shareholders' equity	24,452	21,636	22,713	26,340	28,647						
Minority interests	7,232	5,747	5,658	5,480	5,406						
<b>Total equity</b>	<b>31,684</b>	<b>27,383</b>	<b>28,371</b>	<b>31,820</b>	<b>34,052</b>						
<b>Net debt</b>	<b>53,616</b>	<b>57,289</b>	<b>49,930</b>	<b>46,432</b>	<b>43,083</b>						
Net debt to equity (%)	169.2	209.2	176.0	145.9	126.5						

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For definitions of the items in this table, please click [here](#).

## Earnings risks offsets mid-term recovery

We expect forex headwinds to drive big cuts to EBITDA, which will not be offset by improvement in net debt levels, as TEF has net cash/ low debt levels in Venezuela, Argentina and Brazil. We also believe that Spanish competitive intensity and weak demand will continue to be a drag on numbers, even as TEF improves its relative position. Since the management reshuffle in 3Q11, TEF has made significant progress in repositioning its operations. All the recent strategic decisions seem spot on in our view: the repricing in Spain; reducing leverage by cutting dividends, selling assets and through the IPO of TEF De. We see scope for the operational recovery across the footprint to drive medium-term revenue growth, but 2013 will still be a transitional year, with good news likely to come in 2H, while 1H should be dominated by downward earnings revisions. We reiterate our Neutral rating on the stock and DCF-based price target of €10/share.

## Sensible strategy takes time to deliver

Despite our initial reservations, we recognise that since the main organisational changes announced 6<sup>th</sup> September 2011, TEF has taken significant steps to address the problems of the group. Deleveraging is the main emphasis for the market, but arguably the operational turnaround is more significant for the medium term.

- **Deleveraging:** TEF cut its dividend targets twice in December 2011 and again in May 2012 in order to address leverage. It has exited or partly sold down its stakes in Zon, PT, and China Unicom, sold Atento, and IPOed TEF De. The threat to its rating is now subsiding, while its diversified portfolio could allow for a premium rating to the sovereign (reducing tail risks). We expect net debt to fall from €56.3bn in 2011 to €46.4bn in 2013E.
- **Operational turnaround:** In Spain, TEF was losing market share consistently between 2008 and 2011. It partly addressed the problem by cutting mobile and broadband prices in 4Q11, but more decisively in 4Q12 through the launch of Fusion. In LatAm, TEF lost share during 2008-11 after raising its margins significantly (6pp in 9M of 2010) at the expense of market share. That has also reversed in most markets. The UK business has repositioned and stabilised market share, while TEF De continues to outperform competitors.
- **Investment:** TEF has increased capex, despite the pressure to deleverage and is likely to benefit from these investments in the medium term. In Spain, we expect Jazztel and TEF to launch/ expand commercial investments in FttH in May 2013.

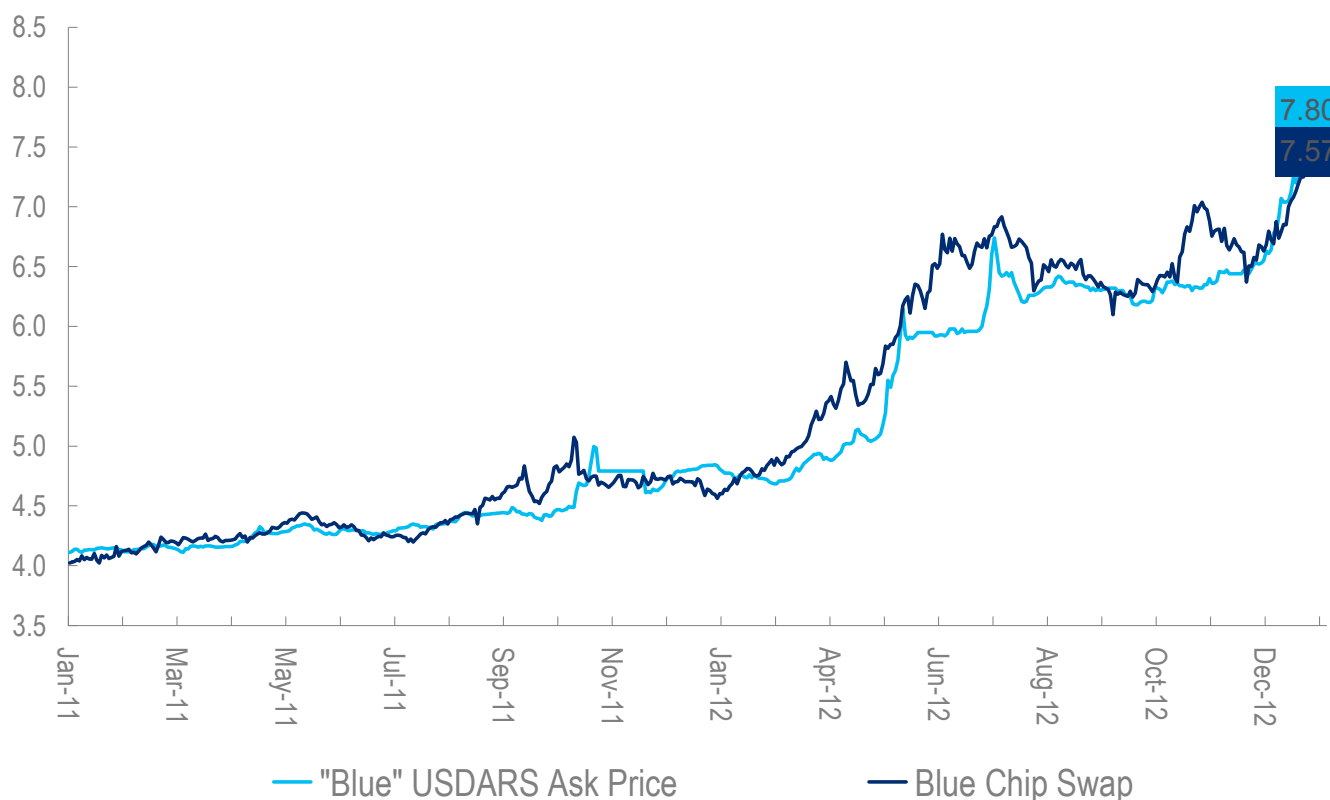
**Even though we see merits to the operational shift, we continue to expect margins will remain under pressure in 2013 (though less so than in 2012).**

## Forex headwinds accelerate

Most Eurozone-based operators are likely to face headwinds from the appreciation of the Euro. For Southern European names, the impact is much more significant given the weakness in LatAm currencies to which they are greatly exposed. PT is most exposed to Brazil in terms of EBITDA, but the high leverage at Oi provides some offset (as net debt also comes down). TEF and TI see a significant impact on EBITDA from weaker BRL and ARS (which is likely to see an even steeper decline) and in the case of TEF, the likely devaluation of the VEF. EBITDA will likely come under pressure, while net debt levels do not benefit (a negative impact instead) as there is limited debt exposure to LatAm (in TI's case there is net cash).

In **Argentina**, Citi economists note that the unofficial rate (Blue) is trading at ARS7.80/\$, reaching a 57% spread to the official rate. Further weakness in the currency in 2013 is likely as the official rate is likely to eventually converge with the parallel and inflation remains a real threat. Citi economists assign a 40% probability of a devaluation in the next three months either via a dual exchange rate regime (10%); fixing the exchange rate for an indefinite period to ARS 7.5-8.0/\$ (10%) or creating a second exchange rate (intermediate between current and parallel rate) and allowing for the official rate to converge (20%). In our model, we assume a depreciation of the currency to ARS6.5/\$ in 2013; ARS5.6/\$ average for the year. Argentina contributed 6.1%/4.7% of group revenues/EBITDA in 3Q12.

Figure 1. The parallel (blue) rate has depreciated dramatically in recent months



Source: Bloomberg, Reuters

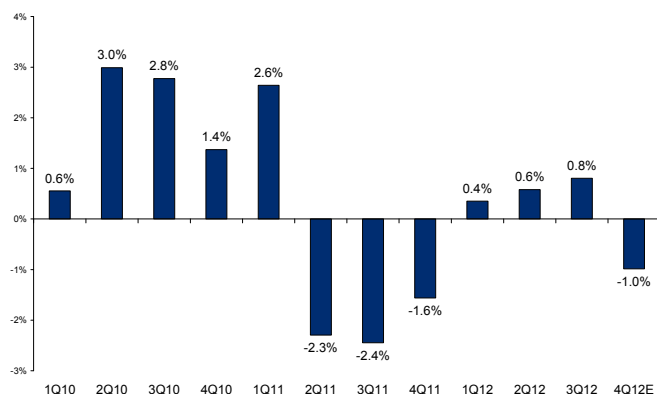
**Venezuela:** On February 8<sup>th</sup>, the official VEF/\$ exchange rate was devalued for the fifth time since the currency controls were put in place in 2003. The VEF peg fell by 32% from VEF4.3/\$ to VEF6.3/\$. Venezuela contributed 5.1%/7.2% of group revenues/EBITDA in 3Q12. We note **the VEF/\$ is trading rate is 22.6 in the parallel market.**

**Brazil:** The BRL was also weak during 4Q12, though it has since stabilised and does not suffer from the same structural pressures. However, the depreciation means that the average forex is 10% lower in our numbers in 2013 vs. 2012. Brazil generates 21% of group revenues and EBITDA.

**UK:** Finally, we also expect a 5% drag from the **EURG/GBP** rate in 2013 vs. 2012. The UK generated 11% of revenues and 8.5% of EBITDA in 3Q12.

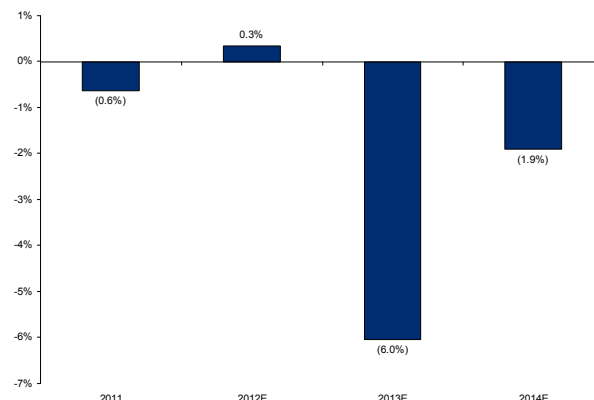
Overall, we expect group revenues to be negatively impacted by **c. 6% in 2013E**, a significant drag compared to previous years. We expect an additional 2% negative impact in 2014E: see Figure 3 below.

Figure 2. Quarterly benefit (drag) from forex for group revenues



Source: Citi Research and Company Reports

Figure 3. Annual benefit (drag) from forex for group revenues

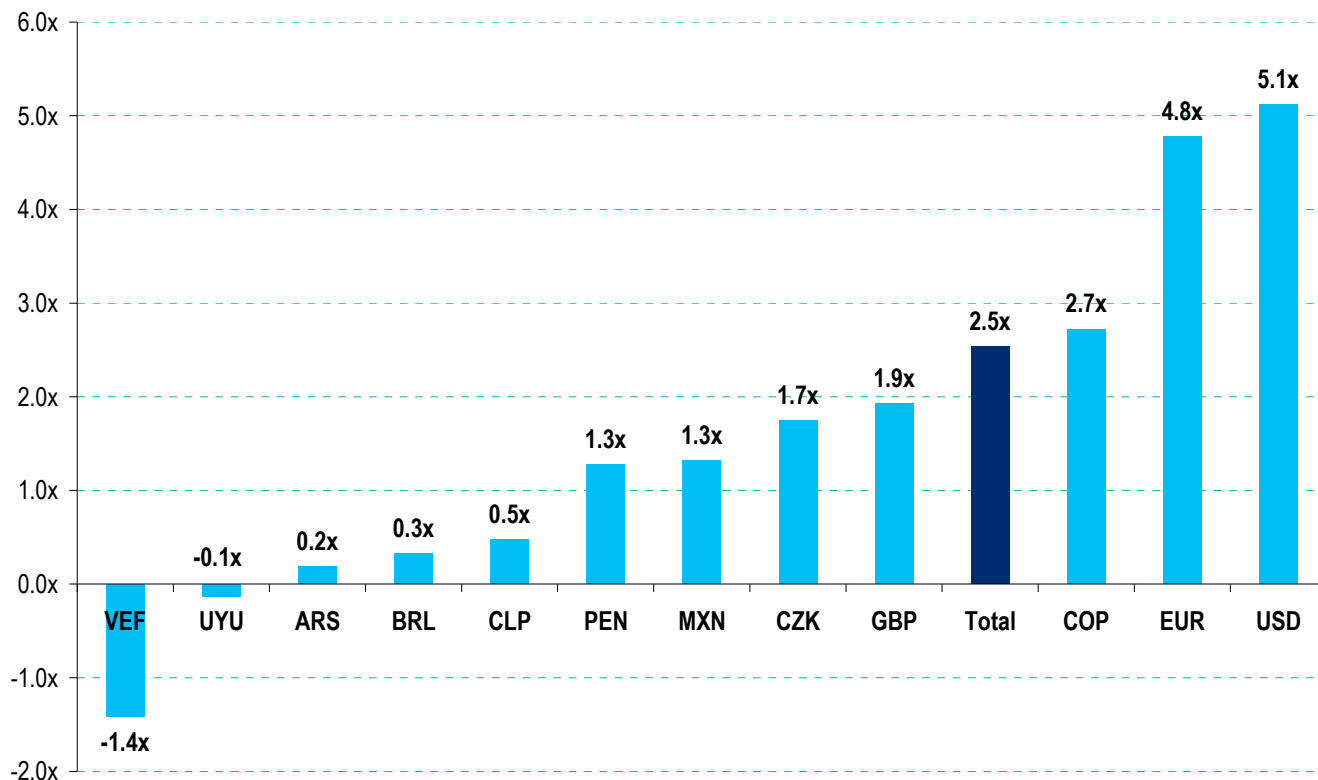


Source: Citi Research and Company Reports

**Based on TEF's expected negative impact on net financial assets, we estimate a VEF12bn net cash and financial assets position at the end of 2012**

In our view, TEF is unlikely to see a benefit to net debt from the depreciation and devaluations of these currencies. We show the leverage mix as of 2011 and it is clear that despite efforts to reduce currency risk, TEF's leverage in LatAm currencies is low. For 2012, TEF has provided information on the impact of the VEF devaluation on net financial assets, which are expected to decline by €873m. That would imply a VEF12bn net cash and financial assets position (c. €2.8bn pre/€1.9bn post devaluation). TEF also has lower leverage in Brazil and Argentina than the rest of the group. On the other hand, It should benefit from the GBP-denominated debt exposure. Overall, the currency moves should act as a headwind to TEF's deleveraging process.

Figure 4. Net debt to EBITDA by currency for 2011

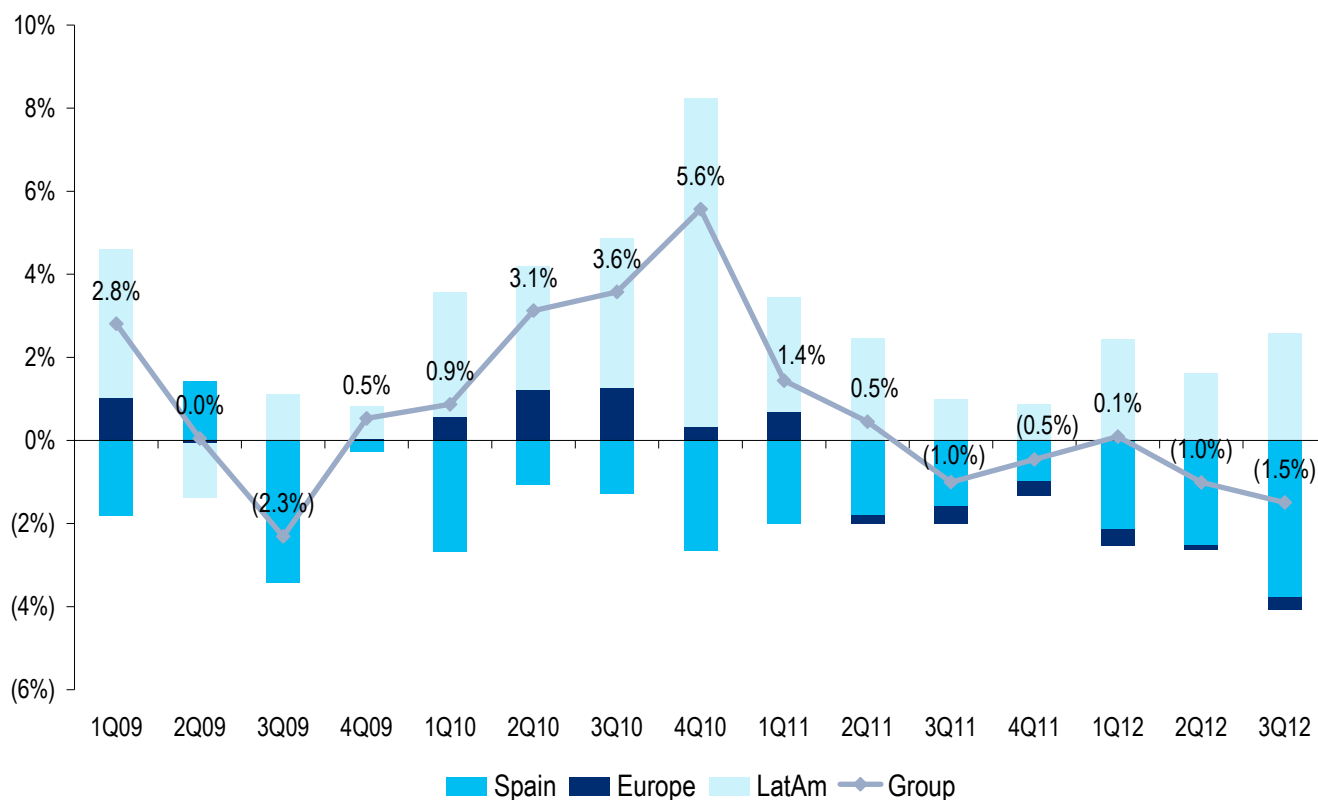


Source: TEF Annual Report; Citi Research

### We expect organic growth trends to show improvement

TEF's organic revenue growth has deteriorated in recent quarters, but that is mainly down to Spain, where the price cuts have driven significant deterioration in fixed revenue growth. We believe that as comps improve during 2013, TEF's organic growth should start to improve in 2013, but will remain negative in real terms as inflation is a key driver of revenue growth but also of currency weakness in LatAm. We therefore believe that for TEF to report growth in hard currencies, it will need to accelerate organic growth close to mid-single-digits for the group.

Figure 5. Organic revenue growth for the group and by region (%)



Source: Company reports, Citi Research

## Spectrum- an added headwind

We model €1.5bn on spectrum costs for TEF in 2013, mainly coming out of the UK (€900m), Czech Republic (€100m) and LatAm (€500m). In the Czech Republic, we also see the risk from a new entrant emerging from the auction process (see [Telefonica O2 Czech Republic: Will The Incumbents Give PPF An 800MHz Xmas Present?](#)).

## Citi vs. consensus estimates

Market estimates have been coming down over the recent period, but we see further downside risk as the consensus updates for forex around full year results and/or as changes to pegs are announced. We are c.8%/7% below consensus on Revenues/ EBITDA in 2013.

Figure 6. We are c. 8%/7% below consensus on Revenues/ EBITDA in 2013E

	Cons.			Citi			Δ%		
	2012E	2013E	2014E	2012E	2013E	2014E	2012E	2013E	2014E
<b>Sales</b>	<b>62,407</b>	<b>60,925</b>	<b>61,184</b>	<b>61,962</b>	<b>55,994</b>	<b>56,036</b>	<b>(0.7%)</b>	<b>(8.1%)</b>	<b>(8.4%)</b>
<b>EBITDA</b>	<b>21,197</b>	<b>20,678</b>	<b>20,756</b>	<b>20,841</b>	<b>19,143</b>	<b>19,571</b>	<b>(1.7%)</b>	<b>(7.4%)</b>	<b>(5.7%)</b>
EBIT	11,081	10,610	10,644	10,494	9,160	9,617	(5.3%)	(13.7%)	(9.7%)
Pretax Income	7,535	7,791	8,043	7,389	6,249	6,911	(1.9%)	(19.8%)	(14.1%)
Net Income	5,370	5,602	5,812	4,176	4,245	4,582	(22.2%)	(24.2%)	(21.2%)
<b>Net Income - Adjusted</b>	<b>5,346</b>	<b>5,564</b>	<b>5,707</b>	<b>5,553</b>	<b>4,656</b>	<b>4,951</b>	<b>3.9%</b>	<b>(16.3%)</b>	<b>(13.2%)</b>
EPS	1.19	1.22	1.26	1.14*	0.93	1.01	(3.8%)	(23.3%)	(20.0%)
<b>Dividend per Share</b>	<b>0.12</b>	<b>0.67</b>	<b>0.74</b>	<b>0.00</b>	<b>0.50</b>	<b>0.50</b>	<b>n/m</b>	<b>(25.0%)</b>	<b>(32.2%)</b>
Net Debt	52,222	48,500	45,190	51,953	48,791	45,299	(0.5%)	0.6%	0.2%
<b>Capex</b>	<b>9,106</b>	<b>9,327</b>	<b>8,906</b>	<b>9,422</b>	<b>9,619</b>	<b>8,145</b>	<b>3.5%</b>	<b>3.1%</b>	<b>(8.5%)</b>

Source: Bloomberg consensus, Citi Estimates. \*ex goodwill and extraordinary

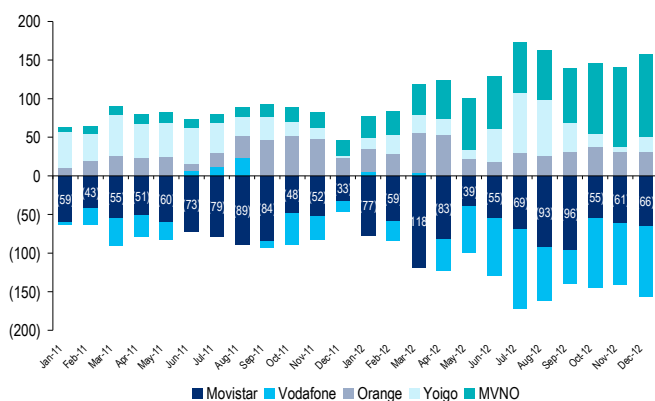
## Convergence should work, but take some time

Since its launch, we see Fusion as having revolutionised the Spanish telecom market and having helped TEF deliver an operational recovery in both broadband and mobile. We believe that the strategy will pay dividends in the medium term, especially as the base is migrated to FttH products, where TEF will have a competitive advantage over other players. TEF managed to reach 1m Fusion customers in mid December (2.5 months after the launch of the service on October 1<sup>st</sup>), which is equivalent to c.20% of TEF's retail broadband base.

TEF has managed to reduce MNP deficit by c.40% during October and November and we expect the trend would have improved in December and into 2013. Even though Vodafone has effectively matched TEF's offers, Fusion is clearly performing better than competition. We expect churn will come down materially as customers move to bundles, which should have a positive impact on margins in the medium term. However, Fusion comes at the cost of discounted pricing and we expect revenue erosion will only marginally improve in 4Q12 and 2013, despite easier comps (TEF cut mobile prices in 4Q12).

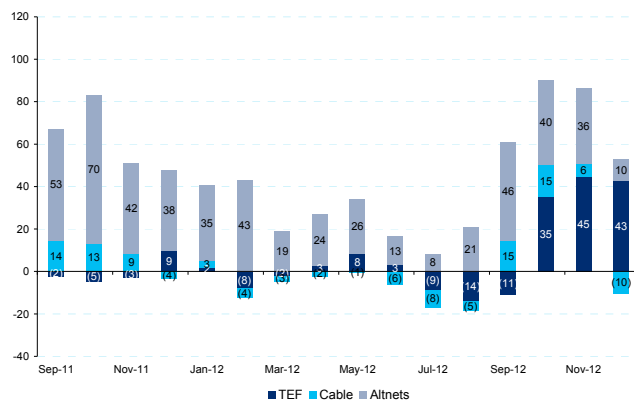
We also see potential from the medium-term migration of the customer base to FttH products, where TEF is likely to have an even more dominant position vs competition.

Figure 7. Mobile Number Portability balance by operator (000s)



Source: CMT, Citi Research

Figure 8. Broadband net adds by operator (000s)



Source: CMT, Citi Research

We think revenues will remain under pressure and though EBITDA trends could improve, we believe the benefits from Fusion will be mitigated by the impact of VAT increases and the elimination of handset subsidies in Spanish mobile in March 2012 – this will make comps from 2Q13 tougher.

- **Handset leasing move:** In March 2012, Movistar changed its mobile offers and moved away from subsidy based model, introducing financing options instead. The move helps margins as the cost of the handset is removed from opex and is effectively recognised as working capital outflow. Despite this benefit, domestic EBITDA came down by 14.4%/12.5% in 2Q/3Q respectively.
- **VAT increase:** There was a general increase implemented on September 1<sup>st</sup> 2012. The standard rate increased from 18% to 21%. Some telecom related services like pay TV saw steeper increases (from 8% to 21%). We have seen in other countries that VAT increases (even if automatically passed through to the customer as is the case in Spain) have a significant negative impact on demand.

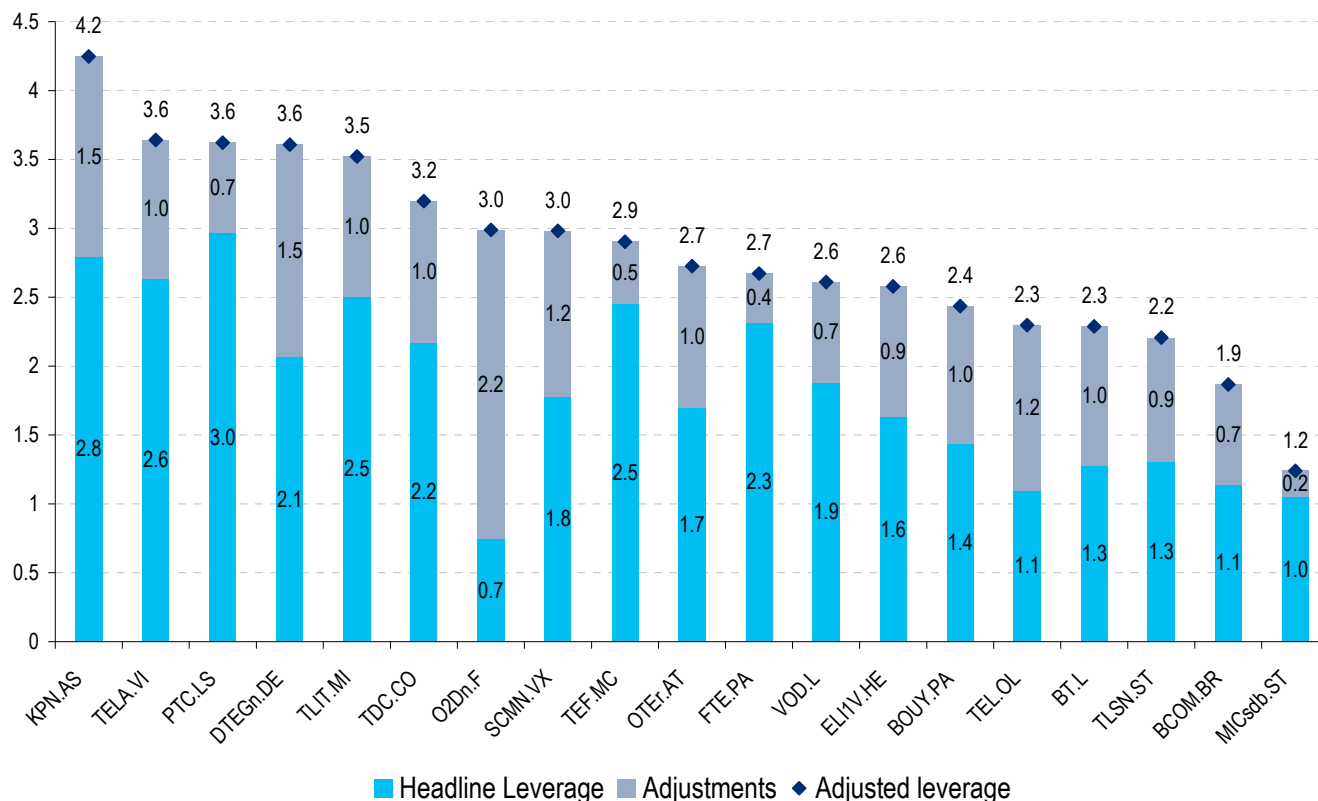
## Low risk from leverage

Even on our numbers, TEF is close to its net debt to EBITDA targets of 2.5x adjusted (2.35x financial) leverage for 2013. Although that is higher than the sector average (of c.2.0x) TEF's underlying leverage (including operating leases, pensions etc) is below the sector average of 3.0x under that metric. We believe that TEF could be one of the biggest beneficiaries of sale and lease agreements in the coming years. For more details on our analysis ['Telecom Operating Leases: Is the Skeleton About to Come Out of the Closet?'](#)

We therefore see modest tail risk from leverage, despite the headwinds from currency and the downgrades we anticipate in our numbers. TEF's leverage ratios are not expected to improve during 2013, but to remain broadly in line with the company's ceiling. In our estimates, we do not include any benefits from tower sales to net debt (from proceeds) and EBITDA (gains on the sale of assets), which could see TEF comfortably reaching its target.

Figure 9. Headline and Adjusted Net Debt/EBITDA in 2013E as of January 17th

Adjusted leverage captures pensions; capital leases; NPV of operating leases and other movements (hedging instruments subtracted)



Source: Citi Research

**Latin America IPO not inevitable:** TEF eliminated its dividend for 2012 and announced its plan to manage the company's asset portfolio through the IPO of TEF De, sold part its stake in China Unicom and its entire stake in Atento. As part of the portfolio rationalisation, management expressed their intention to evaluate their options in LatAm. We believe that TEF will only consider an IPO of its LatAm operations (or part of the operations) if the credit rating or the leverage targets are at risk. We believe that TEF is unlikely to be forced to exercise this option, even as our estimates suggest significant headwinds. The main benefit is that TEF would get instant improvement in its consolidated financial ratios. However, we see three reasons why TEF should avoid this.

- **Holding company discount:** Assuming TEF decides to IPO its entire (or a large part of its) LatAm operation, then c. 60% of its EBITDA (or equivalent to 60% of its EV) will be listed, with only Spain, UK and Ireland from the main businesses belonging exclusively to the group. As a result, we are concerned that TEF's shares would suffer as some of the most desirable assets in the group will be better captured through its subsidiaries.

- **Group fees may not be adequately valued:** For TEF De, we estimate the group fees received by TEF are worth c. €1.3bn or 15x current level of fees. If more businesses are listed, the value of the group fees would become core to the TEF investment case. Group fees are extremely valuable and deserve a premium multiple as they are in effect cash; tend to grow; and get paid ahead of minorities (which only get the residual). Therefore, even in difficult years when profitability at the subsidiary may be under pressure, group fees could be unaffected. The market is unlikely, in our view, to give TEF sufficient benefit for receiving group fees.
- **Leasing is a better option:** We see an acceleration of the sale of towers and/or potentially an IPO of TEF's sizeable tower portfolio as a much better alternative. As we highlighted in our operating leases report, these assets could command a premium valuation to where telecom businesses are being valued by the market. We estimate that for medium- to long-duration lease agreements, the sale of towers could be done at a premium to the 12x multiple we used in our analysis.

## Forecast revisions

We update our estimates for 2013 to reflect the incremental weakness of forex since the start of the year (mainly GBP), but also make other modest changes. Overall, we reduce group revenues by 1%-2% in 2013/14E and keep EBITDA broadly flat. We have reduced our D&A assumptions to better capture the effect of the weaker forex. As a result, both taxes and net income increase by c.4%.

Figure 10. Forecast revision table with key metric for TEF group (€m)

	New			Prior			Δ%		
	2012E	2013E	2014E	2012E	2013E	2014E	2012E	2013E	2014E
<b>Revenues</b>									
Spain	15,021	13,663	13,550	15,021	13,663	13,550	0.0%	0.0%	0.0%
Latam	30,034	27,855	28,001	30,065	28,568	28,360	(0.1%)	(2.5%)	(1.3%)
Europe	15,006	14,338	14,344	15,011	14,725	14,770	(0.0%)	(2.6%)	(2.9%)
Other	1,900	138	141	1,900	138	141	0.0%	0.0%	0.0%
<b>Total</b>	<b>61,962</b>	<b>55,994</b>	<b>56,036</b>	<b>61,997</b>	<b>57,094</b>	<b>56,821</b>	<b>(0.1%)</b>	<b>(1.9%)</b>	<b>(1.4%)</b>
<b>EBITDA</b>									
Spain	6,590	5,894	5,998	6,590	5,648	5,839	0.0%	4.3%	2.7%
Latam	10,305	9,528	9,503	10,313	9,773	9,616	(0.1%)	(2.5%)	(1.2%)
Europe	3,956	3,892	4,244	3,956	3,988	4,364	0.0%	(2.4%)	(2.7%)
Other	(10)	(171)	(175)	(10)	(171)	(175)	0.0%	0.0%	0.0%
<b>Total</b>	<b>20,841</b>	<b>19,143</b>	<b>19,571</b>	<b>20,849</b>	<b>19,238</b>	<b>19,644</b>	<b>(0.0%)</b>	<b>(0.5%)</b>	<b>(0.4%)</b>
<b>EBITDA margins</b>									
Spain	43.9%	43.1%	44.3%	43.9%	41.3%	43.1%			
Latam	34.3%	34.2%	33.9%	34.3%	34.2%	33.9%			
Europe	26.4%	27.1%	29.6%	26.4%	27.1%	29.5%			
<b>Total</b>	<b>33.6%</b>	<b>34.2%</b>	<b>34.9%</b>	<b>33.6%</b>	<b>33.7%</b>	<b>34.6%</b>			
Depreciation & amortisation	(10,347)	(9,983)	(9,955)	(10,347)	(10,260)	(10,219)	(0.0%)	(2.7%)	(2.6%)
<b>EBIT (clean)</b>	<b>10,494</b>	<b>9,160</b>	<b>9,617</b>	<b>10,501</b>	<b>8,977</b>	<b>9,426</b>	<b>(0.1%)</b>	<b>2.0%</b>	<b>2.0%</b>
Margin, %	16.9%	16.4%	17.2%	16.9%	15.7%	16.6%			
Exceptionals	(920)	0	0	(482)	0	0	90.9%	NM	NM
Interest	(3,217)	(3,032)	(2,830)	(3,220)	(3,051)	(2,865)	(0.1%)	(0.6%)	(1.2%)
Associates	111	120	124	111	120	124	0.0%	0.0%	0.0%
Tax	(1,907)	(1,624)	(1,832)	(1,908)	(1,571)	(1,772)	(0.0%)	3.4%	3.4%
Minorities	(386)	(380)	(496)	(386)	(375)	(495)	(0.1%)	1.2%	0.2%
<b>Net income</b>	<b>4,176</b>	<b>4,245</b>	<b>4,582</b>	<b>4,616</b>	<b>4,101</b>	<b>4,419</b>	<b>(9.5%)</b>	<b>3.5%</b>	<b>3.7%</b>
<b>Reported EPS (€)</b>	<b>0.94</b>	<b>0.93</b>	<b>1.01</b>	<b>1.04</b>	<b>0.88</b>	<b>0.91</b>	<b>(9.5%)</b>	<b>5.5%</b>	<b>10.8%</b>
<b>Adjusted EPS (€)</b>	<b>1.25</b>	<b>1.02</b>	<b>1.09</b>	<b>1.25</b>	<b>0.97</b>	<b>0.99</b>	<b>(0.0%)</b>	<b>5.2%</b>	<b>10.5%</b>
<b>DPS (€)</b>	<b>0.00</b>	<b>0.50</b>	<b>0.50</b>	<b>0.00</b>	<b>0.50</b>	<b>0.50</b>	<b>NM</b>	<b>0.0%</b>	<b>0.0%</b>
Cash tax paid	(1,674)	(1,410)	(1,697)	(1,675)	(1,363)	(1,640)	(0.0%)	3.4%	3.4%
P'ments rel to commitments	(790)	(852)	(714)	(790)	(852)	(714)	0.0%	0.0%	0.0%
Mvmt in working capital	(108)	(87)	(521)	(108)	(83)	(528)	(0.7%)	5.0%	(1.4%)
Capex excl spectrum	(8,588)	(8,130)	(8,145)	(8,591)	(8,262)	(8,236)	(0.0%)	(1.6%)	(1.1%)
Capex on spectrum	(834)	(1,489)	0	(834)	(1,513)	0	0.0%	(1.6%)	NM
<b>Free cash flow (excl. spectrum)</b>	<b>6,522</b>	<b>5,605</b>	<b>5,624</b>	<b>6,520</b>	<b>5,602</b>	<b>5,625</b>	<b>0.0%</b>	<b>0.1%</b>	<b>(0.0%)</b>
<b>Net financial (debt)/cash</b>	<b>(51,953)</b>	<b>(48,791)</b>	<b>(45,299)</b>	<b>(52,024)</b>	<b>(49,163)</b>	<b>(45,826)</b>	<b>(0.1%)</b>	<b>(0.8%)</b>	<b>(1.1%)</b>
	2.49	2.55	2.31	2.50	2.56	2.33			

Source: Citi Research

## Sum of Parts

We use a ROCE-fade DCF valuation for TEF, which is also backed up by our Sum of Parts valuation. We value Spain at 4.5x 2013E EV/EBITDA; LatAm at 4.9x and Europe at 5.6x.

Figure 11. Telefonica's Sum of Parts Valuation (€m)

Operation	Stake end-2012	Total EV	Net (debt) 2013E	Total MV	Telefonica MV	% of EV	EV/EBITDA 2013E	EBITDA Price Driver 2013E
<b>Spain</b>								
Fixed	100%	20,845	0	20,845	20,845	23.3%	4.5x	4,632 4.5x 2013E EBITDA
Mobile	100%	5,676	0	5,676	5,676	6.3%	4.5x	1,261 4.5x 2013E EBITDA
<b>Total</b>		<b>26,521</b>	<b>0</b>	<b>26,521</b>	<b>26,521</b>	<b>29.6%</b>	<b>4.5x</b>	<b>5,894</b>
<b>Latin America</b>								
Brazil (Vivo and Telesp)	73.8%	20,139	(316)	19,822	16,092	18.0%	4.6x	4,412 Market value + 10% premium
Argentina Fixed	100%	979	0	979	979	1.1%	3.5x	280 3.5x 2013E EBITDA
Argentina Mobile	100%	1,941	0	1,941	1,941	2.2%	3.5x	554 3.5x 2013E EBITDA
Chile Fixed	97.9%	2,699	(518)	1,527	1,495	1.7%	6.5x	415 6.5x 2013E EBITDA
Chile Mobile	100%	3,753	0	3,753	3,753	4.2%	6.5x	577 6.5x 2013E EBITDA
Colombia Fixed	70%	1,545	(1,300)	245	171	0.2%	6.0x	257 6.0x 2013E EBITDA
Colombia Mobile	70%	1,970	0	1,970	1,379	1.5%	6.0x	328 6.0x 2013E EBITDA
Peru Fixed	98.3%	2,897	(704)	2,592	2,549	2.8%	6.5x	446 6.5x 2013E EBITDA
Peru Mobile	100%	2,866	0	2,866	2,866	3.2%	6.5x	441 6.5x 2013E EBITDA
Mexico - Wireless	100%	2,040	0	2,040	2,040	2.3%	6.0x	340 6.0x 2013E EBITDA
Venezuela - Wireless	100%	3,090	0	3,090	3,090	3.5%	3.0x	1,030 3.0x 2013E EBITDA
Central America	100.0%	975	0	975	975	1.1%	6.5x	150 6.5x 2013E EBITDA
Ecuador	100%	1,119	0	1,119	1,119	1.3%	6.5x	172 6.5x 2013E EBITDA
Other	100%	811	0	811	811	0.9%	6.5x	125 6.5x 2013E EBITDA
<b>Total</b>		<b>46,822</b>	<b>(2,839)</b>	<b>43,730</b>	<b>39,259</b>	<b>43.9%</b>	<b>4.9x</b>	<b>9,528</b>
<b>Europe</b>								
UK	100%	9,009	0	9,009	9,009	10.1%	6.0x	1,501 6.0x 2013E EBITDA
Germany	77%	7,916	(980)	6,936	6,641	7.4%	6.0x	1,314 Market value + Group Fees
Ireland	100%	572	0	572	572	0.6%	4.5x	127 4.5x 2013E EBITDA
Czech Rep (Cesky Telecom)	69.4%	4,040	49	4,089	2,838	3.2%	4.9x	818 Market value
Other	100%	209	0	209	209	0.2%	5.5x	38 5.5x 2013E EBITDA
<b>Total</b>		<b>21,745</b>	<b>(931)</b>	<b>20,815</b>	<b>19,269</b>	<b>21.5%</b>	<b>5.6x</b>	<b>3,892</b>
<b>Associates and other</b>								
Telecom Italia - Telco SPA	46.18%	2,179	(2,500)	0	0	0.0%		Market value
Portugal Telecom	2.00%			3,855	77	0.1%		Market value
Lycos Europe	32.10%			19	6	0.0%		Market value
Hispasat	0.00%				50	0.1%		Book value, end 08
China Unicom	5.00%			27,440	1,372	1.5%		Market value
BBVA	0.98%			41,035	402	0.4%		Market value
DTS	22.00%			58	13	0.0%		Market value
<b>Total</b>				<b>73,381</b>	<b>1,920</b>	<b>2.1%</b>		
<b>Enterprise Value</b>					<b>86,969</b>			
Net debt not included above			(42,663)	(42,663)	(42,663)	(47.7%)		
Dividend adj (ex-2012)					0.0%			
Unfunded pension liabilities			(2,359)	(2,359)	(2,359)	(2.6%)		
NPV of tax/synergy					2,513			
<b>Equity value</b>					<b>44,461</b>	<b>49.7%</b>		
Shares outstanding (mn)					4,551			
<b>Per share value (EUR)</b>					<b>9.8</b>			

Source: Citi Research

## Telefonica SA

### Company description

Telefónica (TEF) is the incumbent fixed and mobile operator in Spain. It has a significant presence in 15 countries and operations in around 40 countries including a leading position in Latin America. The company is committed to handing back excess cash flow to shareholders.

### Investment strategy

Our rating on Telefónica is Neutral. The level of overall cash generation is threatened by economic and competitive issues in Spain, where Telefonica's returns and margins are among the highest in the European industry. Latin America has been a successful investment for the company and its top-line growth has started to recover.

### Valuation

Our valuation of TEF and €10.00 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 9.0% 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.

## Appendix A-1

### Analyst Certification

The research analyst(s) primarily responsible for the preparation and content of this research report are named in bold text in the author block at the front of the product except for those sections where an analyst's name appears in bold alongside content which is attributable to that analyst. Each of these analyst(s) certify, with respect to the section(s) of the report for which they are responsible, that the views expressed therein accurately reflect their personal views about each issuer and security referenced and were prepared in an independent manner, including with respect to Citigroup Global Markets Inc and its affiliates. No part of the research analyst's compensation was, is, or will be, directly or indirectly, related to the specific recommendation(s) or view(s) expressed by that research analyst in this report.

## IMPORTANT DISCLOSURES

### Telefonica SA (TEF.MC)

#### Ratings and Target Price History

##### Fundamental Research

Analyst: Georgios Ierodiaconou  
Covered since November 1 2012



Date	Rating	Target Price	Closing Price
1 5-Mar-10	2M	*18.01	17.71
2 18-May-10	*1M	*17.23	15.39
3 15-Jun-10	1M	*16.93	15.97
4 3-Aug-10	*2M	*17.23	17.51
5 14-Oct-10	*2L	17.23	19.15
6 19-Jan-11	*2M	17.23	17.63

\* Indicates change

Date	Rating	Target Price	Closing Price
7 21-Apr-11	2M	*16.24	17.33
8 22-Sep-11	2M	*13.29	12.92
9 7-Oct-11	Stock rating system changed		
10 8-Oct-11	*2	13.29	14.71
11 24-Nov-11	2	*12.80	12.66
12 18-Apr-12	2	*11.32	10.91

Date	Rating	Target Price	Closing Price
13 22-May-12	2	*10.50	9.99
14 1-Jun-12	2	*9.50	9.00
15 26-Jul-12	2	*9.00	8.95
16 12-Oct-12	2	*10.50	10.15
17 10-Dec-12	2	*10.00	9.93

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 November 1 2012



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

\* Indicates change

Rating/target price changes above reflect Eastern Standard Time

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Citigroup Global Markets Limited were mandated as Joint Bookrunner on the IPO of Telefonica Deutschland AG.

**BEST IDEAS UNIVERSE:** The best ideas universe from which Telefonica SA (covered by Georgios Ierodiaconou) were chosen comprises: BT Group PLC (BT.L, £2.75), Vodafone Group PLC (VOD.L, £1.68), Deutsche Telekom AG (DTEGn.DE, €8.19), Tele2 AB (TEL2b.ST, SKr104.0), SES S.A. (SESFd.PA, €23.05), Belgacom SA (BCOM.BR, €20.9), Telefonica SA (TEF.MC, €9.75), Freenet (FNTGn.DE, €15.88), Kabel Deutschland (KD8Gn.DE, €68.44), Eutelsat Communications (ETL.PA, €26.41), Telecom Italia SpA (TLIT.MI, €0.62), TeliaSonera AB (TLSN.ST, SKr43.36), France Telecom (FTE.PA, €7.56), Portugal Telecom (PTC.LS, €4.04), KPN NV (KPN.AS, €3.25), OTE (OTEr.AT, €6.42), Elisa Oyj (ELI1V.HE, €15.91), Inmarsat plc (ISA.L, US\$6.61), United Internet AG (UTDI.DE, €17.5), Mobistar SA (MSTAR.BR, €19.0), Telekom Austria (TELA.VI, €5.24), Swisscom AG (SCMN.VX, SFr416.9), Telecom Italia SpA(savings shares) (TLITn.MI, €0.54), Telenet Group Holding NV (TNET.BR, €38.16), Telenor ASA (TEL.OL, NKr122.7), Bouygues SA (BOUY.PA, €20.45), Zon (ZON.LS, €3.47), TalkTalk Telecom Group PLC (TALK.L, £2.57), Virgin Media (VMED.O, £44.97), Virgin Media (VMED.L, £29.07), Sonaecom (SNC.LS, €1.56), TDC (TDC.CO, Dkr41.68), Jazztel (JAZ.MC, €5.96), Millicom Intl Cellular (MICsdb.ST, US\$532.0), Ziggo N.V. (ZIGGO.AS, €25.64), Colt Group SA (COLT.L, €1.16) and Telefónica Deutschland Holding AG (O2Dn.F, €5.86). All prices as of 15 Feb 2013.

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Citi Research Global Fundamental Coverage	49%	38%	12%	7%	86%	7%
% of companies in each rating category that are investment banking clients	53%	49%	45%	60%	49%	55%

#### Guide to Citi Research Fundamental Research Investment Ratings:

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**Risk rating** takes into account both price volatility and fundamental criteria. Stocks will either have no risk rating or a High risk rating assigned.

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Prior to October 8, 2011, the firm's stock recommendation system included a risk rating and an investment rating. **Risk ratings**, which took into account both price volatility and fundamental criteria, were: Low (L), Medium (M), High (H), and Speculative (S). **Investment Ratings** of Buy, Hold and Sell were a function of the Citi Research expectation of total return (forecast price appreciation and dividend yield within the next 12 months) and risk rating. Additionally, analysts could have placed covered stocks "Under Review" in response to exceptional circumstances (e.g. lack of information critical to the analyst's thesis) affecting the company and/or trading in the company's securities (e.g. trading suspension). Stocks placed "Under Review" were monitored daily by management and as practically possible, the analyst published a note re-establishing a rating and investment thesis. For securities in developed markets (US, UK, Europe, Japan, and Australia/New Zealand), investment ratings were: Buy (1) (expected total return of 10% or more for Low-Risk stocks, 15% or more for Medium-Risk stocks, 20% or more for High-Risk stocks, and 35% or more for Speculative stocks); Hold (2) (0%-10% for Low-Risk stocks, 0%-15% for Medium-Risk stocks, 0%-20% for High-Risk stocks, and 0%-35% for Speculative stocks); and Sell (3) (negative total return). For securities in emerging markets (Asia Pacific, Emerging Europe/Middle East/Africa, and Latin America), investment ratings were: Buy (1) (expected total return of 15% or more for Low-Risk stocks, 20% or more for Medium-Risk stocks, 30% or more for High-Risk stocks, and 40% or more for Speculative stocks); Hold (2) (5%-15% for

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