

Morgan Stanley

‘Impact Of The Economic Crisis On The Spanish Telecommunication sector’

(Organized by ENTER/NEREC, 16 June 2009)

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Agenda: A Stock Market Approach

How is the crisis affecting the sector and how are operators reacting?

Prospects for investments in telecommunications networks **Stocks**

What will be the impact of announced regulatory measures?: **MTRs**

Main challenges and opportunities for Spanish telecommunications operators
and stocks in the current economic downturn?

How is the crisis affecting the sector and how are operators reacting?

Wireless Market Slowing Down, Volatile Share of Net Adds

Euro Calendar Quarters	Mar-07 1Q07	Jun-07 2Q07	Sep-07 3Q07	Dec-07 4Q07	Mar-08 1Q08	Jun-08 2Q08	Sep-08 3Q08	Dec-08 4Q08	Mar-09 1Q09
Subscribers (mn)									
Telefonica	21.814	22.103	22.420	22.827	23.008	23.225	23.436	23.605	23.615
Vodafone	14.893	15.179	15.473	15.810	16.039	16.210	16.386	16.538	16.910
Orange	11.058	10.692	10.921	11.091	11.084	11.175	11.224	11.374	11.426
Yoigo	0.101	0.161	0.240	0.427	0.559	0.627	0.756	0.970	1.100
Total	47.866	48.135	49.054	50.155	50.690	51.237	51.802	52.487	53.051
Subscribers - % growth									
Telefonica	8%	7%	7%	6%	5%	5%	5%	3%	3%
Vodafone	10%	9%	10%	9%	8%	7%	6%	5%	5%
Orange	5%	0%	1%	0%	0%	5%	3%	3%	3%
Yoigo				1679%	453%	289%	215%	127%	97%
Total	8%	6%	7%	7%	6%	6%	6%	5%	5%
% share of net adds									
Telefonica	45%	107%	34%	37%	34%	40%	37%	25%	2%
Vodafone	52%	106%	32%	31%	43%	31%	31%	22%	66%
Orange	-7%	-136%	25%	15%	-1%	17%	9%	22%	9%
Yoigo	9%	22%	9%	17%	25%	12%	23%	31%	23%

Source.- Morgan Stanley Research

Prepaid Growing Again and Lowering ARPU Further

Euro Calendar Quarters	Mar-07 1Q07	Jun-07 2Q07	Sep-07 3Q07	Dec-07 4Q07	Mar-08 1Q08	Jun-08 2Q08	Sep-08 3Q08	Dec-08 4Q08	Mar-09 1Q09
Contract subscribers - % growth									
Telefonica	13%	13%	13%	12%	11%	10%	9%	7%	4%
Vodafone	31%	19%	16%	16%	14%	13%	11%	8%	7%
Orange	7%	9%	11%	10%	11%	11%	9%	8%	7%
Yoigo				1710%	376%	222%	166%	104%	111%
Total	17%	15%	14%	14%	13%	12%	10%	8%	7%
Prepaid subscribers - % growth									
Telefonica	1%	-1%	-1%	-1%	-2%	-2%	-2%	-2%	0%
Vodafone	-8%	-2%	3%	2%	0%	0%	0%	-1%	3%
Orange	3%	-8%	-9%	-10%	-11%	-2%	-4%	-4%	-1%
Yoigo				1657%	518%	351%	256%	144%	87%
Total	-2%	-3%	-2%	-3%	-4%	-2%	-2%	-2%	1%
Blended ARPU growth (%)									
Telefonica	0%	-1%	-2%	-4%	-4%	-6%	-7%	-7%	-10%
Vodafone	2%	3%	0%	-2%	1%	-10%	-9%	-13%	-18%
Orange	-4%	-2%	1%	1%	0%	-1%	-3%	-3%	6%
Average proforma	-1%	0%	-1%	-2%	-1%	-6%	-6%	-8%	-12%

Source.- Morgan Stanley Research

Consumption And Prices Coming Down

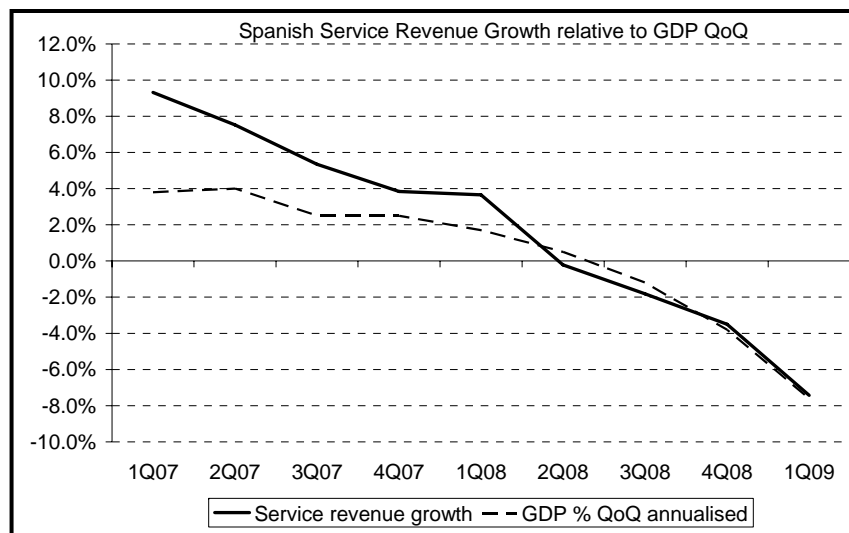
Euro	Mar-07	Jun-07	Sep-07	Dec-07	Mar-08	Jun-08	Sep-08	Dec-08	Mar-09
	1Q07	2Q07	3Q07	4Q07	1Q08	2Q08	3Q08	4Q08	1Q09
MoU									
Telefonica	160	159	168	156	151	159	163	152	142
Vodafone	185	187	191	186	183	190	184	178	167
Orange	130	135	139	145	141	144	147	148	149
Average	158	160	166	162	158	164	165	159	152
Growth					0%	2%	-1%	-2%	-4%
Ppm (€c)									
Telefonica	12.9	13.4	13.1	13.0	12.9	12.7	12.4	12.4	12.3
Vodafone	14.3	14.6	14.2	13.9	14.0	13.4	14.0	13.2	13.1
Orange	14.1	14.9	15.5	13.5	13.5	13.8	14.0	12.5	11.3
Average	14.2	14.8	14.8	13.7	13.7	13.6	14.0	12.8	12.2
Growth					-3%	-8%	-6%	-6%	-11%

Source.- Morgan Stanley Research

With Service Revenues Following QoQ GDP Growth

Euro Calendar Quarters	Mar-07 1Q07	Jun-07 2Q07	Sep-07 3Q07	Dec-07 4Q07	Mar-08 1Q08	Jun-08 2Q08	Sep-08 3Q08	Dec-08 4Q08	Mar-09 1Q09
Service revenue growth									
Telefonica	6.9%	5.5%	3.3%	2.6%	2.0%	0.5%	-2.1%	-2.6%	-7.3%
Vodafone	17.0%	12.5%	8.9%	6.6%	5.1%	-2.5%	-2.2%	-5.8%	-8.6%
Orange	1.9%	3.5%	4.2%	1.9%	5.2%	2.4%	-0.4%	-1.2%	-5.4%
Total pro forma	9.3%	7.5%	5.3%	3.8%	3.7%	-0.2%	-1.8%	-3.5%	-7.4%
GDP %YoY	4.0%	3.9%	3.6%	3.2%	2.7%	1.8%	0.9%	-0.7%	-2.9%
GDP % QoQ annualised	3.8%	4.0%	2.5%	2.5%	1.7%	0.5%	-1.2%	-3.8%	-7.6%

Source.- Morgan Stanley Research



Source.- Morgan Stanley Research

Wireline Revenues More Resilient But Not Immune

- Telefonica wireline clean revenues 1-2% up in the first three quarters of 2008...
- ... 1% down in the 4Q08...
- ... and 'only' 3% down in the 1Q09
- **Line loss** going up due to migration to Full Unbundled schemes from other wholesale schemes (bitstream, SULL)...
- ...and some **fixed to mobile and cable competition**, but not so much due to the economy
- **Broadband market giving signs of lower growth** as now higher penetration (close to 60% of households)...
- ...but also the **economy is weighing down**...
- ...**reducing broadband market growth** from +20% in 1Q08 to +10% in 1Q09

How Companies Are Reacting: Costs and Capex Cuts (Telefonica Case Study – Stable OpFCF)

- 1Q09 clean mobile margins widening YoY
- Despite 7% service revenue decline and 9% total revenue fall
- Variable costs: 60% cost reduction due to lower MTRs and lower equipment sales (commercial activity)
- 40% of total cost reduction is ‘proper’ cost cutting (SAC, SRC, SG&A, etc)
- Capex to sales 4% in 1Q09 against 7% in 1Q08

Domestic wireless (TEM Spain) detailed quarterly opex and OIBDA estimates 2008-2009e (€ millions)									
	1Q08	2Q08	3Q08	4Q08	1Q09	2Q09	3Q09	4Q09	FY 09
OIBDA - Spain									
Total opex	1,350	1,320	1,378	1,371	1,227	1,197	1,226	1,266	
OIBDA reported	1,048	1,099	1,106	1,012	945	1,017	1,073	933	3,968
Margin reported	43.7	45.4	44.5	42.5	43.5	45.9	46.7	42.4	44.7
Opex clean of USO									
Opex clean of USO	1,350	1,320	1,319	1,371	1,203	1,197	1,226	1,266	
OIBDA clean	1,048	1,099	1,165	1,012	969	1,017	1,073	933	3,992
Margin clean	43.4	45.4	46.9	42.5	44.6	45.9	46.7	42.4	44.9
Revenue and Opex change YoY (€ mn)									
Total revenue change YoY (€ mn)					(226)	(205)	(185)	(185)	
Service revenue change YoY (€ mn)					(151)	(180)	(159)	(133)	
Clean OIBDA change YoY (€ mn)					(79)	(82)	(92)	(79)	
Total Opex change YoY (€ mn)					(147)	(123)	(93)	(106)	
Opex change YoY exc intx and handsets (€ mn)					(54)	(33)	(29)	(22)	
% over total revenues					2.5%	1.5%	1.25%	1.00%	
Cost reduction due to Intx and lower equipment sales:									
Interconnection revenue chg YoY (€ mn)	(22.0)	(33.0)	(27.0)	(47.0)	(57.0)	(60.4)	(61.0)	(57.2)	
Interconnection cost chg YoY (€ mn)	(11.0)	(16.5)	(13.5)	(23.5)	(28.5)	(30.2)	(30.5)	(28.6)	
Total handsets acquired	2,963.8	3,032.2	2,808.2	3,132.6	2,510.0	2,619.2	2,602.9	2,761.0	
Acquisition price	123.3	123.3	123.3	123.3	120.0	120.0	120.0	120.0	
Cost of sales	365.4	373.9	346.3	386.2	301.2	314.3	312.3	331.3	
Cost of sales change YoY (€ mn)	0.6	21.1	(2.9)	31.0	(64.2)	(59.6)	(33.9)	(54.9)	
Total cost cut from Intx/equipment (€ mn)	(10.4)	4.6	(16.4)	7.5	(92.7)	(89.8)	(64.4)	(83.5)	
Source: Company data, Morgan Stanley Research e = Morgan Stanley Research estimates									

Prospects for investments in telecommunications **Stocks**

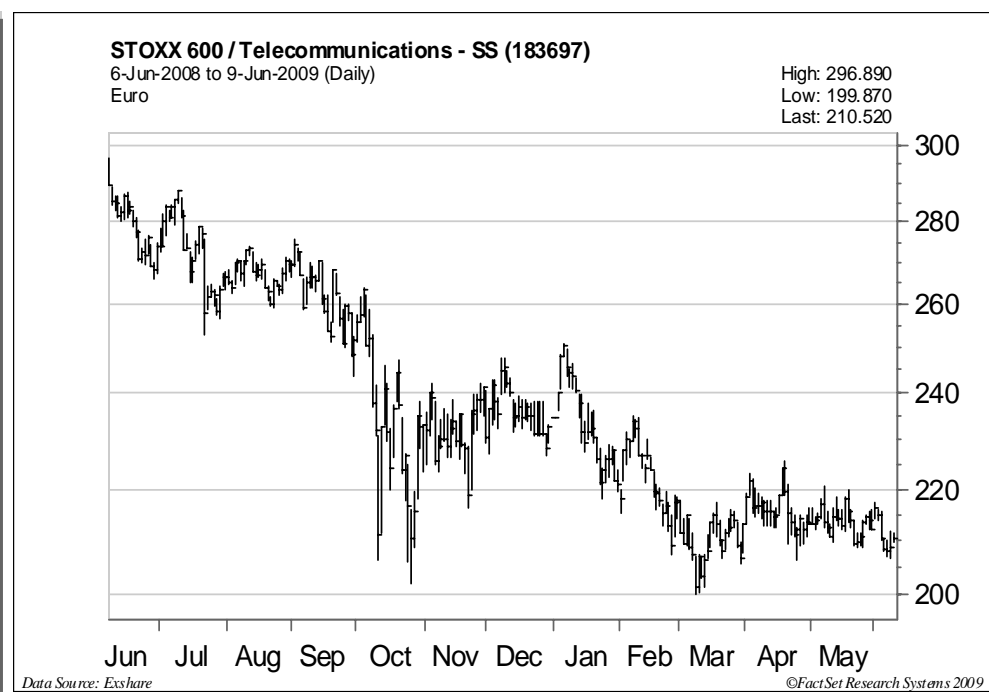
(...which somehow it has an influence on investments in infrastructure too)

Sector Flat Throughout Market Rally From March

Stock market performance last 12 months



Telecoms absolute performance last 12 months



Defensive Nature: Laggard In Market Rallies

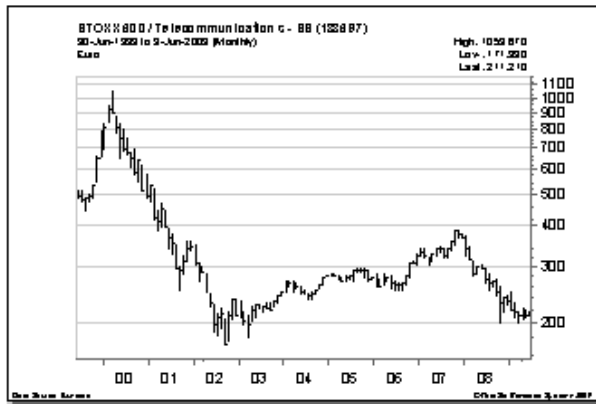
- **Defensive nature** from more resilient business, solid cash flow and attractive shareholder returns...
- ...**but lower growth** expected than for more cyclical sectors...
- ...making the **sector attractive when markets are down** and uncertainty is up...
- ...but a **clear laggard when the market bounces back** like from March 2009 (market bottom)

Telecoms relative performance last 12 months



Leaving The Sector At Historically Low Valuations

Sector absolute performance last 10 years: Trading now around the lows after the bubble



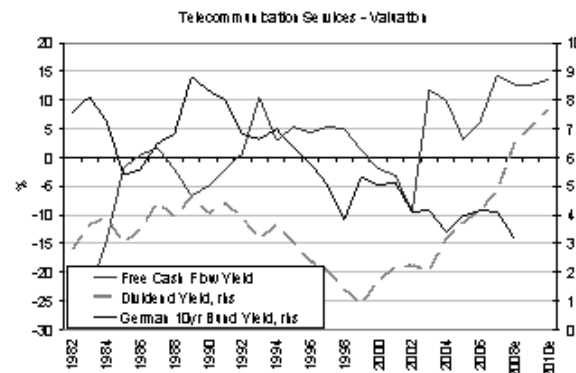
Source: FactSet

Metrics comparison with the bottom in March 03 after the bubble: the sector is even cheaper now

	Mar-03	Jun-10
EV/EBITDA	5.2	4.6
P/E	12.0	8.0
FCFE Yield	11.0%	12.6%
DY	4.5%	7.2%

Source: Company data, Morgan Stanley Research

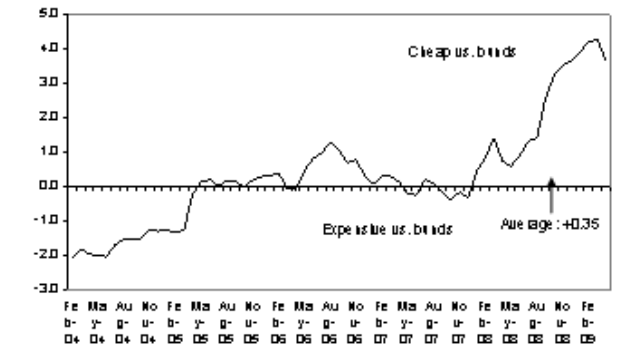
Lowest gap between FCFE yield and Dividend yield in 20 years: Sector risk premium should be very small



Source: MSCI, Worldscope, IBES, Morgan Stanley Research

Source: Morgan Stanley Research

Telecoms DY gap against the Bund Yield (%)
2004-2009: Big valuation mismatch against debt



Source: Morgan Stanley Research

- **P/E:** Price to Earnings
- **FCFE yield:** Free cash flow to market capitalisation
- **DY:** Dividend to market capitalisation

How Will Perform The Sector From Now On?

- Market direction is key when discussing on relative performance...
- ...but we see the rally extended until the Autumn with a market correction after that and until 1Q/2Q 2010 (earnings trough)...
- ...what should allow for the sector to outperform the markets once the rally gets exhausted...
- ...and definitely offering a great downside protection, i.e. downside is very limited thanks to high dividend yield and attractive valuation

What will be the impact of announced regulatory measures?
Focused on mobile termination rates (MTRs)

Lowering Termination Rates: Direct Impact Easy To Estimate

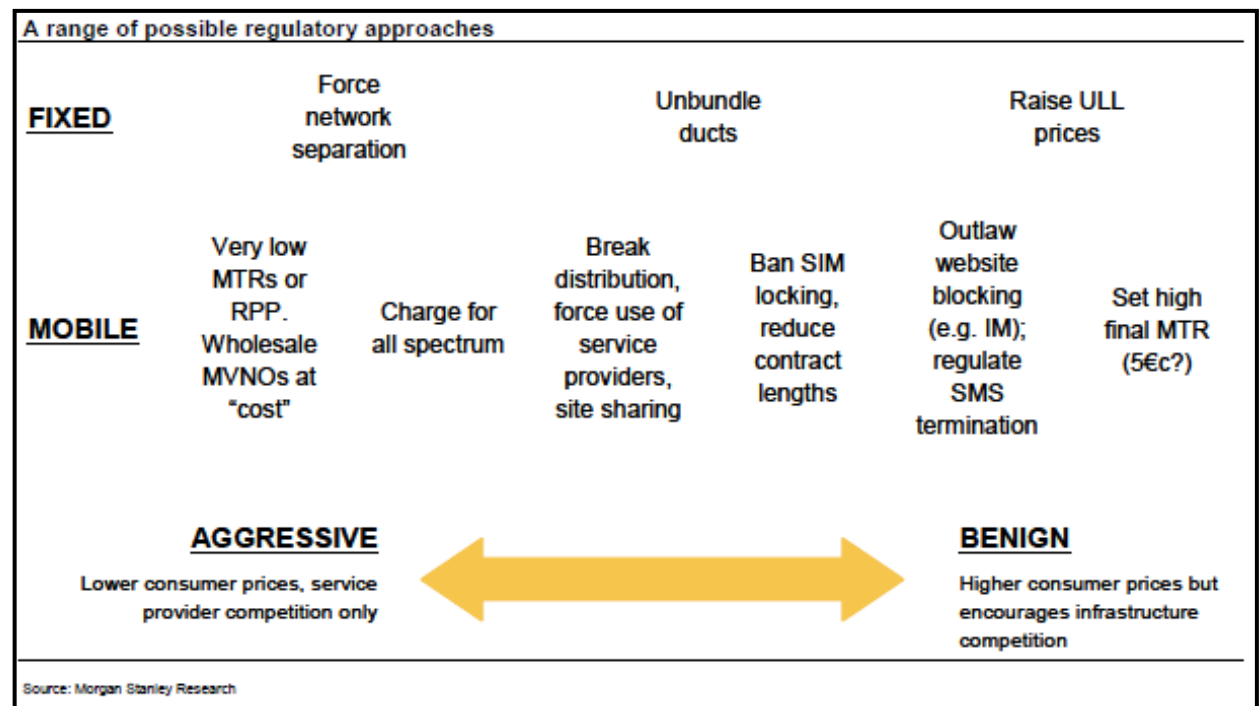
- Termination rates is what operators pay for terminating the call in other operator's network.
- EC recommending to cut MTRs to €1.5-3.0 cents per minute by 2012 from currently €7 cents in Spain (similar to EU average)
- This is a 70% cut in 3 years applying to 15-20% of the revenues and 10-15% of the EBITDA (earnings before interest, taxes, D&A)
- Therefore**lowering mobile revenues by 10-15% and EBITDA by 7-10% what should imply above 15% cut in FCF from the mobile business

Lowering Termination Rates: Indirect Impact Could Be Tougher

- Average price per minute now is around €15 cents with the most aggressive tariffs at €8-9 cents per minute, unable to come down much more as already very close to MTR
- If MTR comes down to €1.5-3.0 cents or even to zero (Bill & Keep), retail prices might come down massively with the following implications:
 - Leading operators would **lose the advantage from current on-net tariffs** at €0-5 cents. Telefonica on-net represents around 45% of total mobile traffic with very high margin
 - Bundles with **500-1000 minutes for €20-30 per month would make sense** like in the US as the cost per minute would drastically be reduced allowing for **€3-5 cent/min retail prices**
 - ...but could multiply by 5-6 times the current level of MOU and investments might be required to cope with increased demand...**lowering the already very high ROCE**
 - And give rise to a shaky period of **rebalance in market shares** in the market:
 - » **Leading operators losing market share** to the challengers as they lower tariffs
 - » **Challengers suffering more upfront** as having a higher proportion of earnings from termination, and having some execution risk in the process of lowering tariffs to gain share

No Disruptive Regulation Expected In Times Of Economic Crisis

- In the current economic environment we doubt that the regulator will take aggressive decisions...
- ...that might be seen as disruptive and creating further economic hurdles...
- ...that could lead to further cost cutting and headcount cut plans by the larger operators...
- ...now that most markets are perceived as competitive



Challenges And Opportunities

- **In the Stock Market:**

- » Prove defensive nature
- » Protect cash flows through cost cutting and capex optimisation
- » Focus on shareholder returns
- » Only small and selective acquisitions

- **In the Industry:**

- » Migrate successfully from network provider to 'service provider'
- » Bundle voice (fixed and mobile), broadband, TV content and added value services
- » Focus on customers more than technologies and grow ARPUs
- » Reduce churn and retain the higher added value customers
- » Investments in fibre aligned with expected demand optimising cash flow usage
- » Mobile broadband opportunity without cannibalising fixed broadband
- » Increase asset turnover as unit margins should come down due to lower margins from new services

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(as of April 30, 2009)

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	Count	% of Total	Count	% of Total IBC	% of Rating Category
Overweight/Buy	668	30%	205	35%	31%
Equal-weight/Hold	1005	45%	272	46%	27%
Not-Rated/Hold	33	1%	8	1%	24%
Underweight/Sell	521	23%	108	18%	21%
Total	2,233		593		

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