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10-I-098
February 7, 2011

Press Release: Rating Action

JCR Affirms A Ratings on Telefonica and Telefonica Europe; Outlook Stable

Issuer: Telefonica, S.A.

FC (Foreign Currency Long-Term Senior Debts): A (Stable)

Issuer: Telefonica Europe B.V.

Issues	*Amount (bn)*	*Issue Date*	*Due Date*	*Coupon*	*Rating*
Yen Bonds First Series	JPY 15	Jul. 19, 2007	Jul. 19, 2012	2.11%	A
Yen Floating Rate Bonds First Series	JPY 15	Jul. 19, 2007	Jul. 19, 2012	6M Yen LIBOR+0.4%	A

Guarantee: Guaranteed by Telefonica, S.A.

JCR has affirmed the A rating on the foreign currency long-term senior debts of Telefonica, S.A. (Telefonica).

The rating primarily reflects the company’s prominent position in the telecommunications markets in Spain, other European countries and emerging Latin American countries, geographically diversified revenue structure, and high earnings capacity reinforced by its growing Latin American business. On the other hand, the rating is constrained by its high interest-bearing debt relative to the earnings capacity and the intensifying competitive pressure mainly in the European telecommunications market.

The rating outlook has been kept stable. Telefonica has been retaining its high earnings capacity by making up for the slack performance of its home market Spain with its continued business expansion in Latin America. The Latin American business, while requiring continued investment for further growth, may continue to strengthen the company’s earnings capacity, given the region’s brighter economic prospects and the growing market penetration of wireless telephony, as well as stronger competitive position established with the full integration of Vivo, the largest Brazilian wireless operator. Telefonica’s balance sheet structure slightly deteriorated as the ratio of net financial debt (sum of net interest bearing debt, commitments and guarantees) to EBITDA at the end of September 2010 rose to 2.4 from 2.1 at the end of 2009 due in part to the acquisition (EUR 7.5 billion) in July 2010 of 50% stake in Brasilcel (the parent company of Vivo) held by Portugal Telecom and due in part to exchange rate fluctuations (mainly due to the Venezuelan bolivar devaluation and the Colombian peso appreciation). JCR hold a view that the ratio will gradually improve, sustained by the high earnings capacity with no major capital and M&A investments planned in the foreseeable future.

JCR has also affirmed the A ratings on the bonds issued by Telefonica Europe B.V. (Telefonica Europe). The ratings are supported by the guarantees provided by its parent company Telefonica. Telefonica Europe was incorporated in the Netherlands as Telefonica's wholly-owned subsidiary. Its principal activity is to act as a financing arm for the Telefonica group.

(1) Prominent market position established in European and emerging Latin American countries

Telefonica, based in Spain, is one of the world's leading telecommunications companies that also provides a broad range of information and telecommunications services in the UK, Germany, Ireland, the Czech Republic and Slovakia, and in 14 emerging Latin American countries. It has successfully integrated its acquired telecommunications companies and integrated into three regional units: Telefonica Espana, Telefonica Europe and Telefonica Latin America. Its total revenue in 2010 was estimated at more than EUR 61 billion and had the world's fifth-largest customer base in terms of accesses as of end 2009. The total access number of wireless and wired telephony, Internet, pay TV and wholesale accesses increased to 281.8 million at the end of September 2010. In recent years, wireless telephony contracts, broadband Internet and wholesale accesses posted marked gains.

In Spain, the group retains its overwhelming position in the traditional wireline and wireless telephony market as of September 2010 with market shares of around 70% and 40% respectively. In Latin America, it primarily operates wireless telephony business and has both wired and wireless telephony operations in Brazil, Argentina, Chile, Colombia and Peru, competing for top market shares with few other competitors. Particularly in Brazil, Telefonica put Vivo under its control and solidify its competitive position through enhanced alliance with its subsidiary Telesp, the Sao Paulo-based fixed-line operator. Since the wireless telephony penetration rate in Latin America is still at a developing stage, the market is expected to continue expanding in keeping with brighter regional economic prospects. In Europe where competition is fierce, it strengthened its operational base in the UK, Germany, the Czech Republic and Ireland following acquisition of O2 in 2006. It retains its leading position in each of the markets. Telefonica has also been strengthening its strategic alliance with China Unicom and Telecom Italia through direct or indirect shareholding. Telecom Italia runs a leading wireless telephony subsidiary in Brazil.

(2) High earnings generation capacity to be strengthened on the expansion of Latin American business

Telefonica stayed resilient to the global economic downturn thanks to its diversified revenue structure as its earnings suffered only limited impacts. The solid earnings performance of Latin American business made up for the poorer earnings in Spain stemming from the lingering economic downturn. This should boost the geographically diversified revenues structure, 40% of which came from Latin American business as of September 2010. Earnings capacity remains high as estimated EBITDA margin averaged 38.3% in the three years to 2009, higher than those of other comparable international telecommunications operators. JCR holds that Telefonica will be able to strengthen its high earnings capacity, helped by its prosperous Latin American business with sustained profitability in Spain and other European countries. Telefonica's Brazilian business, next only to Spain's, can hope to benefit from synergetic effects stemming from Vivo and Telesp full integration.

Telefonica's consolidated revenues in the January-September period of 2010 totaled EUR44.3

billion, up 6.0% year-on-year (2.5% in organic growth terms excluding exchange rate fluctuations), on increased accesses brought by intensified marketing activities. The total number of accesses at the end of September 2010 grew 4.9% year-on-year (7.1% in organic growth terms) to 281.8 million. The gain came from an increased number of wireless telephony contracts amid the growing demand for smartphone and good results generated by the company's strategy to distribute bundles of voice, broadband and television package services. The churn rate kept stable at around 2% year-on-year underpinned by the company's adoption of customer loyalty programs and commitments to improve its service quality. Reduction of mobile termination rate, particularly in European countries, put downward pressure on average monthly revenue per user, but a part of the decreased was compensated by growing demand for mobile data services brought by strong take-up of smartphones and mobile broad band. Intensified marketing activities put upward pressure on operating expenses, but operating income in the nine-month period of 2010 surged 36.8% to EUR 13.6 billion, as the equity stake held in Vivo yielded EUR 3.8 billion in revaluation EBITDA gain. Without this gain, operating income was about the same as that of a year earlier.

(3) Relatively higher net financial debt/EBITDA ratio is likely to improve on the back of strong earnings capacity with limited M&A and capex

Telefonica has a relatively larger financial debt than peers because its aggressive M&A activities were mainly financed with debts. Its high level of cash flow was also mainly used for M&A investment and higher shareholder remuneration, with debt repayment kept moderate. Following the acquisition of O2, the net financial debt surged to 2.9 fold of EBITDA at the end of 2006. As the group has not been engaged in large-scale acquisitions since 2006 and has adopted a policy to focus on smaller deals to strengthen its existing operating base, its net financial debt/EBITDA ratio has stayed within the 2.0-2.5 target set by Telefonica since 2007. Following the acquisition of Vivo and changes in scope of consolidation as well as exchange rate fluctuations, the financial debt increased slightly. The ratio of net financial debt to EBITDA rose to 2.4 at the end of September 2010 from 2.1 at the end of 2009. JCR holds that the ratio is likely to improve in the coming years, given the group's high earnings capacity with limited M&A and capex plans. Telefonica maintains a good access to the capital market and has cash and unused credit facilities enough to cover its debt due in 2011.

Toshihiko Naito, Chief Analyst
Makoto Ikushima, Analyst

The primary rating methods applied to the ratings are posted on JCR's website (http://www.jcr.co.jp) "Corporate Rating Methodology." The rating methods are subject to change or addition. However, the changes and additions including those that have been made in the past are posted in chronological order. Please refer to the rating methods above after checking by comparing the date of press release about the ratings with the release date of the rating methods (effective date of each of such rating methods)