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Letter from the Chairman of the Board of Directors



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To Our Shareholders

Let me review the activities and results of the Telefónica Czech Republic¹ Group in the first half of 2012.

I am pleased that, despite the highly competitive market environment and the still challenging economic climate, we are on a good track to delivering on our full year targets which we communicated at the beginning of the year. Instrumental in that is our portfolio of products and services, which is popular with customers, and the successful execution of several projects focused on reducing the churn rate and our customers' consumption. We also continued in the transformation of our business in order to maintain its high operating efficiency. With respect to all this, I regard our results for the past half-year as very good.

In the mobile segment we maintained a strong growth in the contract customer base due to new customers signing up, migrating customers from the prepaid service and reducing the rate of churn. The churn rate in the second quarter was less than 0.9%, which is the lowest in last three years. This result has been driven by our successful retention and customer care initiatives, which also delivered a growth of 64 thousand in the number of contract customers in the first half of the year. Observing the market trends and the growing demand from customers for smartphones, we continued with our marketing activities supporting the sale of these devices. The share of our mobile customers using smartphones in the total mobile customers was already 23% at the end of June. We brought to the market a new range of tariffs SMART NEON, which combines voice, unlimited on-net SMS and Internet in Mobile. We believe that this service, which responds to the growing demand for mobile internet, will help us maintain our customer base and revenues. In addition, just before the summer time, we introduced a new roaming tariff offering one rate for all incoming and outgoing calls as well as SMS in all EU and some other most visited countries in Europe. This rate is the best in market and I believe it will help us to foster roaming traffic and revenues.

In the fixed access segment we continued to offer broadband internet based on the VDSL technology. Our existing customers with ADSL connections willingly migrated to VDSL, which helped us manage the pressure of the ARPU (average revenue per user) in broadband internet, and reduce the churn.

The popularity of our VDSL proposition has been clearly reflected in 80% fixed data traffic growth in comparison with periods before its launch. The growth in the number of customers using the so-called naked broadband internet also slowed down the rate of decline in the number of fixed lines. In the first half of the year, their number went down by 42 thousand, which is 28.5% less than in the same period last year. In the area of ICT services we continue to focus on and market our proposition of off-the-shelf and customised ICT solutions to corporate customers (managed services, cloud solutions, network security, virtual desktop), with the view of reducing our dependency on one-off projects for the government. This will help stay on the path of revenue growth and improve our profitability in the future. Additionally, our competitive advantage of having O2 Exclusive in our portfolio and the global know-how of Telefónica in this area, which generates economies of scale, are beginning to show in our results.

In Slovakia we continued with the successful marketing of our simple and transparent tariffs. New services for higher-consumption customers were added to the portfolio. A new tariff O2 Paušál gives the customer the benefit of free unlimited SMS, a bonus towards a purchase of a mobile phone and flat rates to all local networks. This assured that Telefónica Slovakia could again report a strong customer base growth for the first half of the year, together with improved financial performance. Its results augment the consolidated results of the Telefónica CR Group and reflect positively on the Group's financial performance.

In the first half of 2012 we continued in the transformation of our business so that we can better manage the operating expenditure in all its areas. We completed the next phase of the restructuring programme, which focuses on the implementation of a more effective organisation structure through reducing the number of hierarchical levels of management across the company. We also focused on making our processes more efficient and simple. I regard these actions as key, given the present pressures on our revenues. I am confident that they will help us remain highly profitable in our operations; the improved operating profitability will be a boost to our competitiveness and will help us retain the value in our business.

Reviewing our financial results I am pleased to see that the improving revenue trends, which we registered already in the second half of last year, carried on also in this half-year. The improved situation is the result of the stabilisation of the consumption of mobile services in the residential segment as a result of our retention and customer value management efforts. The positive trend in the mobile non-SMS data revenues and the continued strong revenue growth in Slovakia generated a positive effect. The competitive pressures in the SME and corporate segments, on the other hand, continued to adversely affect our mobile revenues. Still, the rate of decline in the consumption in these two segments did slow down as a result of our initiatives in the area of customer value management and of the O2 Exclusive proposition.

The consolidated business revenues went down 2.8% in the first half of the year to CZK 25.2 billion. In the second quarter alone, however, the revenues declined only 2.4%, which is an improvement in the fourth consecutive quarter. The Czech mobile segment revenues recorded a 4.5% drop to CZK 12.3 billion, while the fixed access revenues dropped 6.3% year on year in the first half of the year, down to CZK 10.6 billion. Revenues in Slovakia increased 27% to EUR 92.8 million. Operating profit OIBDA saw a 5.8% year-on-year drop to CZK 9.7 billion. The OIBDA margin excluding brand and management fees was a solid 40.5%, which is the result of our commitment to operating efficiency, improved profitability in Slovakia, the positive effect of the sale of our 80% share in our subsidiary

Informační linky and the higher commercial costs invested in future growth. Investments amounted to CZK 2.2 billion, and were directed mostly in building up the capacity and quality of our 3G network including backhaul network, improvements in the quality of our fixed broadband network and selected improvements in the optical fibre network.

With regard to the results achieved in the first half and the outlook for the second half of the year, I am pleased to be in the position to confirm our year-end targets: we expect the revenues to decline at a rate slower than 5.7%, which we experienced in 2011, a limited drop in the OIBDA margin excluding brand fees and management fees, and our investments to fit within the limit of CZK 6.2 billion, which represents roughly a 10% growth on the year 2011.



Luis Malvido

Chairman of the Board of Directors