# O2 Telefónica Deutschland Finanzierungs GmbH
# Munich

## Financial statements and management report
## 31 December 2016

*Translation from the German language*

Building a better working world

*O2 Telefónica Deutschland Finanzierungs GmbH*

*Munich*

## *Statement of Financial Position as of 31 December 2016*

| *Assets* | 31.12.2016 EUR | 31.12.2015 EUR | *Equity and liabilities* | 31.12.2016 EUR | 31.12.2015 EUR |
|---|---|---|---|---|---|
| **A. Fixed assets** | | | **A. Equity** | | |
| Financial assets | | | Nominal capital | 25,000.00 | 25,000.00 |
| Loans to affiliated companies | 1,100,000,000.00 | 1,100,000,000.00 | | **25,000.00** | **25,000.00** |
| | **1,100,000,000.00** | **1,100,000,000.00** | **B. Provisions** | | |
| | | | Other provisions | 69,042.00 | 48,888.42 |
| | | | | **69,042.00** | **48,888.42** |
| **B. Current assets** | | | **C. Liabilities** | | |
| Receivables and other assets | | | 1. Bonds<br>--thereof with a remaining term of more than 1 years EUR 1,100,000,000.00 (previous year: EUR 1.100,000,000.00)-- | 1,100,000,000.00 | 1,100,000,000.00 |
| Receivables from affiliated companies<br>--thereof due from shareholders EUR 11.879.825,22 (previous year: EUR 11,848,929.37)-- | 11,901,655.32 | 11,882,852.08 | 2. Trade payables<br>--thereof with a remaining term of less than one year EUR 0 (previous year: EUR 1,672.00 )-- | 0.00 | 1,672.00 |
| | | | 3. Other liabilities<br>--thereof with a remaining term of less than one year EUR 11,807,613.32 (previous year: EUR 11,807,291.66)-- | 11,807,613.32 | 11,807,291.66 |
| | **11,901,655.32** | **11,882,852.08** | | **1,111,807,613.32** | **1,111,808,963.66** |
| **C. Prepaid expenses** | **4,497,400.00** | **6,298,000.00** | **D. Deferred income** | **4,497,400.00** | **6,298,000.00** |
| **Total assets** | **1,116,399,055.32** | **1,118,180,852.08** | **Total equity and liabilities** | **1,116,399,055.32** | **1,118,180,852.08** |

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***Income Statement***
***for the Reporting Period from 1 January 2016 to 31 December 2016***

| | | 01.01.2016 - 31.12.2016 | 01.01.2015 - 31.12.2015 |
|---|---|---|---|
| | | EUR | EUR |
| 1. | Other operating income | 276,212.69 | 266,232.08 |
| 2. | Other operating expenses | -276,212.69 | -266,232.08 |
| 3. | Other interest and similar income<br>--thereof from affiliated companies EUR 225.088.369,05 (previous year: EUR 25,100,120.28)-- | 25,088,369.05 | 25,100,120.28 |
| 4. | Interest and similar expenses | -25,088,371.85 | -25,100,119.86 |
| **5.** | **Profit/Loss before profit-and-loss transfer** | **-2.80** | **0.42** |
| 6. | Expense from expected profit transfer | 2.80 | -0.42 |
| **7.** | **Profit/Loss after profit-and-loss transfer** | **0.00** | **0.00** |

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***Munich***

## ***Statement of Cash Flows***
## ***for the Financial Year from 1 January 2016 to 31 December 2016***

| | 01.01.2016-<br>31/12/2016<br>EUR | 01.01.2015-<br>31/12/2015<br>EUR |
|---|---|---|
| **1. Cash flow from operating activities** | | |
| Result for period before profit transfer | -2.80 | 0.42 |
| Increase (+)/decrease (-) in inventories, trade accounts receivable and other assets | 1,769,429.95 | 1,812,868.51 |
| Increase (+)/decrease (-) in trade accounts payable and other liabilities | -1,781,793.96 | -1,803,968.66 |
| Cash flow from operating activities | **-12,366.81** | **8,900.27** |
| **2. Cash flow from investing activities** | | |
| Interest received (+) | 23,125,000.00 | 23,125,000.00 |
| Cash flow from investing activities | **23,125,000,00** | **23,125,000.00** |
| **3. Cash flow from financing activities** | | |
| Interest paid (-) | -23,125,000.00 | -23,125,000.00 |
| Cash flow from financing activities | **-23,125,000.00** | **-23,125,000.00** |
| **4. Cash and cash equivalents at the end of the period** | | |
| Cash-effective change in cash and cash equivalents | -12,366.81 | 8,900.27 |
| Cash and cash equivalents at the beginning of the period | 33,875.21 | 24,974.94 |
| Cash and cash equivalents at the end of the period | **21,508.40** | **33,875.21** |
| **5. Composition of cash and cash equivalents** | | |
| Cash equivalents | 21,508.40 | 33,875.21 |
| Cash and cash equivalents at the end of the period | 21,508.40 | 33,875.21 |

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## *Statement of Changes in Equity for the Financial Year from 1 January 2016 to 31 December 2016*

| | Nominal capital | Net income for the year | Equity |
|---|---|---|---|
| | EUR | EUR | EUR |
| **As of 1 January 2016** | **25,000.00** | **0.00** | **25,000.00** |
| **As of 31 December 2016** | **25,000.00** | **0.00** | **25,000.00** |
| **As of 1 January 2015** | **25,000.00** | **0.00** | **25,000.00** |
| **As of 31 December 2015** | **25,000.00** | **0.00** | **25,000.00** |

# O2 Telefónica Deutschland Finanzierungs GmbH, Munich

# Notes to the Financial Statements for the 2016 Financial Year

## I. GENERAL INFORMATION ON THE ANNUAL FINANCIAL STATEMENTS

Telefónica Deutschland Finanzierungs GmbH based in Munich, was established by notary deed on 26 February 2013 for the purpose of financing the Telefónica Deutschland Group. The nominal capital was paid in on 6 March 2013. Telefónica Deutschland Finanzierungs GmbH, Munich, was renamed O2 Telefónica Deutschland Finanzierungs GmbH, Munich, (referred to in the following as “TDF” or the “Company”) with effect from 7 November 2013. The company is registered at Munich Local Court under HRB 204122.

In November 2013, TDF issued a five-year unsecured bond (Senior Unsecured Bond) with a nominal value of EUR 600,000 thousand and a maturity of 22 November 2018 in the regulated market of the Luxembourg Stock Exchange.

Furthermore TDF issued in February 2014 a seven-year unsecured bond (Senior Unsecured Bond) with a nominal value of EUR 500,000 thousand and a maturity on 10 February 2021 in the regulated market of the Luxembourg Stock Exchange.

The annual financial statements of TDF for the financial year 2016 have been prepared in accordance with the accounting principles of the German Commercial Code (HGB) in the version of the Accounting Directive Implementation Act (BilRUG) as well as the GmbH Act (Act relating to limited liability companies, GmbHG).

As of 31 December 2016, the company is classified as a large corporation in accordance with section 264d in conjunction with section 267 (3) HGB.

The financial year of the company corresponds to the calendar year. (1 January to 31 December)

The income statement has been prepared using the nature of expense method in accordance with section 275 (2) HGB. The structure has been changed according to BilRuG. This change had no impact on the classification of line items itself within the income statement. Figures or additions within a table may therefore result in sums different from those shown in tables.

## II. ACCOUNTING POLICIES

### 1. Principles and comparability

The accounting policies used in the preparation of the annual financial statements for the period ending 31 December 2016 are in accordance with the provisions of sections 242 to 256a and sections 264 to 288 of the HGB as well as the relevant provisions of the GmbHG. The accounting principles and standards of valuation remained unchanged in comparison to the previous year. The requirements of the Accounting Directive Implementation Act (BilRUG) were applied for the first time in the financial year 2016.

### 2. Fixed assets

Within the financial assets, loans are shown at the lower of nominal value or fair value. Interest-free or low-interest loans are discounted to the present value.

### 3. Current assets

The receivables and other assets are shown at the lower of nominal value or fair value at the balance sheet date. Adequate allowances have been recognised to take account of all risk positions.

### 4. Prepaid expenses

This item includes payments made before the reporting date representing expense applicable to a specific period after that date.

### 5. Equity

The nominal capital is stated with its nominal value.

### 6. Provisions

Other provisions take account of all identifiable risks and uncertain obligations. They are recognised at the settlement amount considered necessary on the basis of reasonable commercial assessment. Future price and cost increases are taken into account if there are sufficient objective indications that they will occur.

### 7. Liabilities

Liabilities are recorded at their settlement amount.

### 8. Deferred income

This item includes payments received before the reporting date representing income applicable to a specific period after that date.

# III. NOTES TO THE BALANCE SHEET

## 1. Financial assets

The financial assets as of 31 December 2016 consist of two loans of EUR 600,000 thousand and EUR 500,000 thousand respectively, granted by TDF to its shareholder Telefónica Germany GmbH & Co. OHG, Munich. The terms of both loans correspond to the terms of the underlying five- and seven-year bonds which TDF issued on 22 November 2013 and 10 February 2014 respectively. The loans have fixed terms until the date of maturity of the underlying bonds on 22 November 2018 and 10 February 2021 respectively and are repayable in one amount on the due date, including all interest and costs which have not yet been paid. The underlying interest rates are 1.875 % and 2.375 % respectively and are payable annually on 22 November and 10 February respectively.

Please see the statement of changes in fixed assets for further information.

## Statement of Changes in Fixed Assets for the Reporting Period from 1 January 2016 to 31 December 2016

| | Acquisition costs | | | | Accumulated depreciation | | | | Carrying amounts | |
|---|---|---|---|---|---|---|---|---|---|---|
| | **01.01.2016** | **Additions** | **Disposals** | **31.12.2016** | **01.01.2016** | **Additions** | **Disposals** | **31.12.2016** | **31.12.2016** | **31/12/2015** |
| | **EUR** | **EUR** | **EUR** | **EUR** | **EUR** | **EUR** | **EUR** | **EUR** | **EUR** | **EUR** |
| **Financial assets** | | | | | | | | | | |
| Loans to affiliated companies | 1,100,000,000.00 | 0.00 | 0.00 | 1,100,000,000.00 | 0.00 | 0.00 | 0.00 | 0.00 | 1,100,000,000.00 | 1,100,000,000.00 |
| | 1,100,000,000.00 | 0.00 | 0.00 | 1,100,000,000.00 | 0.00 | 0.00 | 0.00 | 0.00 | 1,100,000,000.00 | 1,100,000,000.00 |

## 2. Receivables and other assets

The receivables due from affiliated companies amount to EUR 11,902 thousand (previous year: EUR 11,883 thousand), of which EUR 11,880 thousand (previous year: EUR 11,849 thousand) relates to receivables due from the shareholder Telefónica Germany GmbH & Co. OHG, Munich. These include receivables of EUR 11,807 thousand (previous year: EUR 11,807 thousand) relating to interest from the loan issued to the shareholder.

The maturity of these receivables is less than one year.

## 3. Prepaid expenses

This item includes the amortised disagios from the issuance of the bonds for the five-year bond issued in November 2013 and for the seven-year bond issued in February 2014. Amortised Issuing fees for the five-year bond for the seven-year bond are also included. All components are reversed using the straight-line method over the terms of the underlying bonds until 22 November 2018 and until 10 February 2021 respectively.

## 4. Subscribed capital

The company's share capital remains unchanged at EUR 25,000.00 and is fully paid. It is held entirely by Telefónica Germany GmbH & Co. OHG, Munich.

## 5. Provisions

The other provisions of EUR 69 thousand (previous year: EUR 49 thousand) result from consultancy and audit fees.

## 6. Liabilities

The liabilities include two bonds with a nominal value of EUR 1,100,000 thousand in total. The five-year bond issued in the amount of EUR 600,000 thousand matures on 22 November 2018. As of 31 December 2016, the seven-year bond amounting to EUR 500,000 thousand has a remaining term of less than five years with a maturity on 10 February 2021. Both bonds are guaranteed by Telefónica Deutschland Holding AG, Munich.

The other liabilities include EUR 11,807 thousand (previous year: EUR 11,807 thousand) for current interest liabilities relating to the bonds.

## 7. Deferred income

Deferred income results from the amortised differences between the nominal values of the underlying loans and the amounts paid out to Telefónica Germany GmbH & Co. OHG, Munich. The deferred items are released over the term of the underlying five- and seven-year loan.

## IV. NOTES TO THE INCOME STATEMENT

### Other operating income and expenses

The other operating income of EUR 276 thousand (previous year: EUR 266 thousand) is attributable to costs charged on to Telefónica Germany GmbH & Co. OHG, Munich. The other operating expenses of EUR 276 thousand (previous year: EUR 266 thousand) which are charged on mainly comprise bank charges and consultancy and audit fees.

### Financial result

Other interest and similar income totals EUR 25,088 thousand (previous year: EUR 25,100 thousand), of which EUR 23,287 thousand (previous year: EUR 23,299 thousand) results from interest income from the loans granted to Telefónica Germany GmbH & Co. OHG, Munich, and EUR 1,801 thousand (previous year: EUR 1,801 thousand) results from the reversal of deferred income.

The interest and similar expenses of EUR 25,088 thousand (previous year: EUR 25,100 thousand) include the interest expense from the bonds of EUR 23,287 thousand (previous year: EUR 23,299 thousand) and expenses from the release of the disagios over the term of the underlying bonds in the amount of EUR 1,801 thousand (previous year: EUR 1,801 thousand).

## V. SUPPLEMENTAL DISCLOSURES ON THE NOTES

### Supplemental disclosures on the cash flow statement

Cash and cash equivalents ("Finanzmittelfonds") comprise solely cash and cash equivalents. Cash equivalents include all other short-term highly liquid investments that can be converted into cash any time and that is held as a cash reserve. Cash equivalents with original maturities of three months or less relate to cash-pooling receivables due from Telfisa Global B.V, Amsterdam, the Netherlands that are recognised as receivables from affiliated companies.

### Employees

In financial year 2016 and in 2015 the company had no employees.

### Management

The persons were Managing Directors in the financial year:

Albert Graf, Director Corporate Finance Teléfonica Germany GmbH & Co. OHG, Fahrenzhausen.
Markus Haas, COO Telefónica Deutschland Holding AG, Munich.
Rachel Empey, CFO Telefónica Deutschland Holding AG, Munich.

The Managing Directors do not receive any payments from the company.

**Audit committee**

The audit committee in accordance with section 324 HGB comprises the following members:

Dieter, Gauglitz
Chairman
German public auditor
Munich

Eckart, Kurze
Board member
until 31.01.2017: Director Transformation Implementation; Telefónica Germany GmbH & Co. OHG, Munich
since 01.02.2017: Director Operational Efficiency; Telefónica Germany GmbH & Co. OHG, Munich

Marcel, Ritter
Board member
Director Legal, Telefónica Germany GmbH & Co. OHG, Munich

**Remuneration of governing bodies**

The members of the Audit Committee received remuneration of EUR 15 thousand for their work in 2016.

**Auditor's fee**

In accordance with section 285 no. 17 HGB, the total fee of the auditor of TDF is not disclosed since the company is part of the consolidation group of Telefónica Deutschland Holding AG, Munich, (Telefónica Deutschland Group) and the information is already included in the Consolidated Financial Statements.

**Report on Events after the Reported Period**

There were no significant events after the end of the financial year 2016.

**Consolidated financial statements**

Telefónica Deutschland Holding AG, Munich, is the company which prepares the consolidated financial statements for the smallest group of companies in which the company is included. The consolidated financial statements are published in the German Federal Gazette, where they are available for inspection and also at the Webpage www.telefonica.de. The consolidated financial statements of Telefónica Deutschland Holding AG, Munich are included in the consolidated financial statements of the Spanish parent company Telefónica S.A., Madrid, Spain. Telefónica S.A., Madrid, Spain prepares the consolidated financial statements for the largest group of companies. These consolidated financial statements are available at Telefónica S.A., Madrid, Spain, and are published on the Internet at www.telefonica.com.

**Cost reimbursement agreement**

TDF and Telefónica Germany GmbH & Co. OHG, Munich, have concluded an agreement whereby costs are reimbursed by the shareholder.

**Profit and loss transfer agreement**

On 20 March 2013, Telefónica Germany GmbH & Co. OHG, Munich, as the controlling company signed a domination agreement with TDF. In addition, TDF also signed a profit and loss transfer agreement with Telefónica Germany GmbH & Co. OHG, Munich, on 20 March 2013. This was recorded in the Commercial Register on 2 April 2013.

The negative result before profit-and-loss transfer for the financial year 2016 will be balanced by Telefónica Germany GmbH & Co. OHG, Munich, as a result of the existing control and profit and loss transfer agreement.

Munich, 03. March 2017

O2 Telefónica Deutschland Finanzierungs GmbH

- Management -

Rachel Empey Markus Haas Albert Graf

# Management Report

## O2 Telefónica Deutschland Finanzierungs GmbH, Munich

**Management Report for the Financial Year from 1 January 2016 to 31 December 2016**

### 1. Business and general conditions

O2 Telefónica Deutschland Finanzierungs GmbH, Munich (referred to as “TDF” or the “Company”) acts as the financing company for the Telefónica Deutschland Group and its operating entities. The following overall economic and legal conditions for the operating entities are thus indirectly also relevant for TDF.

*Solid economic development in Germany*

The German economy held its ground in a difficult global economic environment in 2016 and continued to develop positively. The strongest stimuli came mostly from the country’s domestic strengths. According to initial calculations by the German Federal Statistical Office, gross domestic product (GDP) adjusted for calendar effects grew by around 1.8 % in 2016 compared to the previous year. The positive outlook in terms of income and employment, low energy prices and the pension adjustment provided a considerable boost to consumer spending. On average in 2016, Germany’s economic performance was rendered by a working population of nearly 43.5 million. This is the highest level since 1991.

*Trends on the German telecommunications market bring growth potential*

The telecommunications industry is a major trailblazer for digitalisation, a process that is advancing and changing the world for the long term. This is leading to various trends in the telecommunications market:

The use of mobile devices such as smartphones, tablet computers and wearables is extremely important. The smartphone has developed from a communications device into a universal mobile companion. 61 % of people cannot imagine life without a smartphone, and the figure for 14- to 29-year-olds is as high as 70 %. Numerous services and apps, such as messaging and surfing the Internet, are now considered to be indispensable by a majority of Germans. On the one hand, smartphones are replacing products like digital compact cameras, mobile navigation devices and mp3 players. On the other hand, they are driving development on the market as interconnection with other devices opens up new growth areas. The smartphone is establishing itself as the control centre for other networked devices, and the range of potential applications is growing with every passing year. For example, smartphones can be used for the wireless transfer of music to multi-room systems, or smart TVs can be operated using an app. Household devices can also be activated and controlled remotely by smartphone. Wearables introduce additional functions and intelligent sensors to the smartphone concept.

More than 2.9 million smart watches and fitness trackers are expected to have been sold in Germany in 2016.

In addition to connecting people, the intelligent connection of things via the internet (IoT) offers numerous application and growth opportunities, such as Industry 4.0, connected cars, smart health, smart energy and smart cities. Another trend is data analytics, which is facilitating new insights as well as new business models.

*Demand for mobile data services and increased competition drives market development*

With 116 million customers (SIM cards) at the end of September 2016, the German mobile telecommunications market is the largest in the EU. The notional mobile penetration rate was 141 %, i.e. each German citizen had an average of 1.4 mobile SIM cards. The customer growth from January to September 2016 remained attributable primarily to the more valuable postpaid sector. Overall, postpaid customers accounted for 53.0 % of total connections as of the end of September 2016. This share had been 52.1 % at the end of December 2015.

The mobile telecommunications market continued to develop dynamically in 2016, driven primarily by the strong demand for attractive smartphones and smartphone tariffs. According to a survey by the industry association Bitkom, 76 % of German citizens aged 14 or older currently use a smartphone. One year ago, the figure was still just 65 %. However, a slowdown in the growth of the smartphone market can be observed, driven by its increasing saturation and the fact that smartphones are being used for longer. According to the German Association for Consumer and Communication Electronics (gfu), around 16.6 million smartphones were sold in the period from January to September 2016, equating to a drop of around 4 % compared with the previous year.

Mobile media use resulted in growing mobile data usage. According to Dialog Consult, 774 million GB of data were transmitted on mobile networks in 2016, or 31 % more than in 2015 (591 million GB).

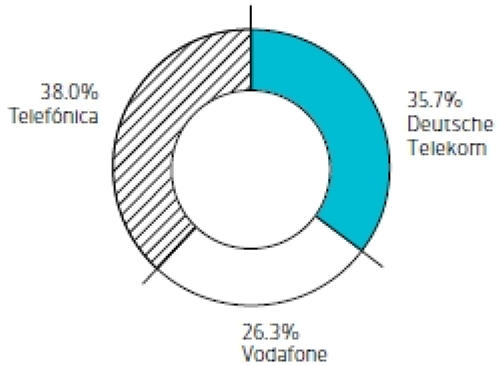
The increasing penetration of mobile end-devices with internet capability, such as smartphones or tablets, and the increasing use of mobile data services are also evident in the strong growth of revenues from mobile data in the German market: according to estimates by Analysys Mason, mobile data revenues increased by just under 7 % in 2016 compared with the previous year. By contrast, revenues from mobile telephony and SMS have fallen, driven by price decline, regulatory effects and changes in customer behaviour (›Overview of the financial year 2016).

SOURCE: COMPANY DATA, ANALYSYS MASON, BUNDESBANK, BITKOM, BMWI, FEDERAL STATISTICAL OFFICE

*The German mobile telecommunications market is an established market*

Following the merger of the Telefónica Deutschland Group with the E-Plus Group, the German mobile telecommunications market consists of three network operators and several service providers and mobile virtual network operators (MVNO). As of the end of September 2016, the Telefónica Deutschland Group had a market share of 38.0 % with around 44 million connections in total. It is therefore the largest German mobile telecommunications network operator in terms of number of customer connections.

**Market share in the mobile telecommunications market per customer (in %) at the end of September 2016**




SOURCE: COMPANY DATA/QUARTERLY REPORTS

*German fixed line market characterised by strong growth*

Intense competition also still prevails on the German market for fixed line broadband services. The number of connections increased by 5.6 % year on year; the customer base therefore grew to 31.7 million by the end of June 2016. This growth was driven in particular by cable and VDSL lines. The share of cable connections is now over 22 %, while VDSL also enjoyed strong growth. According to estimates by the market research company Analysys Mason, around 7.7 million customers were using VDSL at the end of 2016, 53 % more than one year earlier. The increased customer demand for more bandwidth is also reflected in the data volume generated per broadband connection and month. According to Dialog Consult, this increased by 17 % compared with 2015 to 37.2 GB per connection.

SOURCE: ANALYSYS MASON, DIALOG CONSULT/VATM ANALYSES AND FORECASTS, GERMAN FEDERAL NETWORK AGENCY

*Regulatory Influences on the Telefónica Deutschland Group*

As a provider of telecommunications services and an operator of telecommunications networks, the Telefónica Deutschland Group is required to meet certain regulatory requirements. As such, it is subject to supervision by the Bundesnetzagentur (BNetzA - German Federal Network Agency).

The key regulatory events affecting the Telefónica Deutschland Group in the year under review are discussed below:

*Frequencies*

*<u>BNetzA investigates frequency allocation in the 2 GHz range</u>*

Following its decision on 4 July 2014 on the frequency regulatory aspects of the Telefónica/E-Plus merger, the BNetzA is investigating the frequency allocation in the 2 GHz band. In early 2016, it started by consulting mobile network operators on the merger-related frequency allocation. On 7 March 2016, it expanded this consultation to include interested parties, which the Telefónica Deutschland Group also took advantage of until 15 April 2016. The investigation could result in reallocation in the 2 GHz band, although the Telefónica Deutschland Group does not consider there to be any justification for this. The investigation is expected to be concluded by the end of 2017 at the earliest.

*<u>BNetzA launches next steps in the further expansion of digital infrastructures</u>*

On 15 July 2016, the BNetzA published a “frequency compass” setting out the next steps in frequency regulation with a view to ensuring that new frequencies for the further expansion of digital infrastructures are provided on a needs-related basis. In addition to the frequency allocation investigation discussed above, the areas for action include the timely provision of the 2 GHz frequency allocations that are set to expire at the end of 2020 (UMTS frequencies) and other frequencies (e.g. 3.5 GHz), as well as the treatment of service providers, MVNOs and new market participants. The Telefónica Deutschland Group and other interested parties issued statements on these plans in good time. The BNetzA used the frequency compass to develop points of reference for the provision of frequencies for the expansion of digital radio infrastructures and opened these up for commentary from December 2016 to 1 March 2017, in which the Telefónica Deutschland Group will participate.

*Telecommunications market*

*<u>EU revises legal framework for telecommunications (telecoms review)</u>*

On 14 September 2016, the European Commission presented a proposal for a European Electronic Communications Code that would fundamentally revise the legal framework for the communications industry. The core aspects include extending the regulatory targets to include “encouraging investment in very high-capacity networks” and considerations on the regulation of OTT services. The proposal also contains regulations on frequency usage, access regulation and the future institutional framework. Although it sets out a right course of action, the proposal also involves uncertainties, meaning that a conclusive assessment of the opportunities and risks is not yet possible. The proposal will form part of the EU legislative process in 2017. The EU regulations are not expected to be finalised before 2018 and would then have to be implemented into national law.

*<u>EU issues new Payment Services Directive II</u>*

The EU has issued a revised Payment Services Directive II. It supersedes the Payment Services Directive I and must be implemented into national law by 13 January 2018. Particularly relevant areas for the Telefónica Deutschland Group are the revised provisions on billing for third-party digital goods via phone bills. In future, the exemption from payment services supervision in this area will apply for amounts only up to EUR 50 per transaction and a maximum of EUR 300 per month where no payment services licence is held. The new legislation also introduces reporting obligations to the German Federal Financial Supervisory Authority. These changes could result in adjustments to and restrictions on billing for such services, as well as implementation costs.

*<u>New net neutrality and transparency requirements under the<br>Telecoms Single Market Regulation (TSM-R)</u>*

The TSM-R, which came into force in November 2015, contains provisions on net neutrality and transparency that have been required to be observed since 30 April 2016. BEREC, a body of European regulators, published guidelines for implementing the provisions on 30 August 2016. These provide for a restrictive interpretation of the provisions; among other things, this affects the regulations on bandwidth disclosures and involves sales risks. It remains to be seen how the BNetzA will apply these guidelines in its regulatory practice.

*BNetzA issued transparency regulation*

To strengthen the position of consumers, the BNetzA issued a regulation containing measures aimed at increasing the transparency of mobile and fixed line telephone and internet services. Among other things, the regulation includes provisions on cost control, the review and documentation of contractually agreed data transfer rates and the provision of information on contract content to customers prior to conclusion. The regulation has been promulgated in December 2016. The provisions will come into force on 1 June 2017, in some parts, only on 1 December 2017.

*Section 111 TKG amended under the Act for Better Information Sharing to Combat International Terrorism*

The Gesetz zum besseren Informationsaustausch bei der Bekämpfung des internationalen Terrorismus (German Act for Better Information Sharing to Combat International Terrorism) came into force in late July 2016. This also amends section 111 of the Telekommunikationsgesetz (TKG – German Telecommunications Act), which stipulates which customer data must be collected and stored before a connection is activated. From 1 July 2017, this section will require the accuracy of the customer data collected to be checked by means of certain identification documents or other methods having been determined by the BNetzA in December 2016 before a prepaid SIM card is activated. The possibility that these regulations will entail considerable complexity in data collection and restrictions in sales opportunities for the industry cannot be ruled out.

*Charges*

*The Telefónica Deutschland Group adjusts roaming tariffs*

The TSM-R, which came into force in November 2015, sets out changes to the existing roaming regulation. It provides for an end to roaming charges for end customers on top of their domestic tariff ("roam like at home") in two phases. Since 30 April 2016, EU roaming is subject to the respective domestic tariff plus charges in the amount of the current maximum wholesale charges. There were discussions between the BNetzA and the Telefónica Deutschland Group regarding the requirements of the regulation that are open to interpretation. In order to settle these discussions, the Telefónica Deutschland Group voluntarily declared itself willing to adjust its own tariffs. From 15 June 2017, providing that the wholesale roaming market is subject to new regulation, the domestic tariff plus charges in the amount of the maximum wholesale charges applicable at the respective date may only be charged above a fair use threshold that is still to be defined. The European Commission has published a corresponding proposal, which was finally adopted in December 2016. The wholesale roaming market also requires new regulation. In November 2015, the European Commission initiated a corresponding review of the wholesale roaming market in order to assess what measures are required to enable the elimination of roaming charges for consumers from 15 June 2017.

The Commission submitted a report and a legislative proposal on this in June 2016, which was then amended several times. Having consulted several proposals for wholesale roaming caps, an agreement has been reached on 1 February 2017 on EU level, which still needs to be officially approved by the EU member states and the EU Parliament.

*BNetzA prepares decision on MTR and FTR*

The mobile termination rates (MTR) of 1.66 euro cents per minute expired at the end of November 2016. The regulatory decision for the new rates issued by the BNetzA on 30 August 2016 provides for a new cost benchmark for calculating the MTR in the form of pureLRIC (LRIC = long-run incremental costs), which could lead to significant reductions. The Telefónica Deutschland Group has appealed the decision purely as a precautionary measure. In response to the rate application by the Telefónica Deutschland Group on 21 September 2016, the BNetzA defined new rates in a preliminary decision on 30 November 2016: The rates will be reduced to 1.1 euro cents per minute from 1 December 2016, 1.07 euro cents per minute from 1 December 2017 and 0.95 euro cents per minute from 1 December 2018. Before a final decision is taken by the BNetzA, the rates will be subject to national consultation and the European Commission will then be notified.

The current fixed termination rates (FTR) of 0.24 euro cents per minute expire at the end of December 2016. For the new rates, the BNetzA consulted nationally on drafts of a regulatory decision for Deutsche Telekom and for the alternative local exchange carriers and notified the European Commission accordingly. The drafts also provide for pureLRIC as the new cost benchmark, which could lead to significant reductions. Applications for the approval of FTR from 1 January 2017 were submitted by Telekom Deutschland in September and by the alternative local exchange carriers – including the Telefónica Deutschland Group – in late October 2016. Preliminary rate approval for Telekom Deutschland was granted in December 2016 with significant price reductions, and the preliminary approvals for the alternative local exchange carriers are expected by mid-February 2017 at the latest, with the latter taking retroactive effect from 1 January 2017.

*BNetzA takes final decision on local loop access for local vectoring*

BNetzA has completed its proceedings on local loop access for local vectoring in consultation with the European Commission and took its final decision on 1 September 2016. This significantly increases the proliferation of vectoring in the Telekom Deutschland network, which will benefit the Telefónica Deutschland Group through the conversion of its own local loop access platform to future-oriented bitstream connections.

## 2. Areas of operation

TDF was established as a wholly owned subsidiary of Telefónica Germany GmbH & Co. OHG, Munich, on 26 February 2013. It is thus part of the Telefónica Deutschland Group. TDF handles major financing activities of the Telefónica Deutschland Group. The necessary resources can be financed and procured by way of issuing bonds eligible for trading on the capital market. The Company is authorised to carry out all activities and measures which appear to be appropriate for directly or indirectly serving the business purpose of the entire company. In particular, TDF is authorised to establish and acquire other companies, to obtain equity participations in other companies, to manage such companies or restrict its activities to managing such participations.

In November 2013, TDF issued a five-year unsecured bond (Senior Unsecured Bond) with a nominal value of EUR 600,000 thousand and a maturity on 22 November 2018 in the regulated market of the Luxembourg Stock Exchange. The annual nominal interest of the bond is 1.875 %. Furthermore as of 10 February 2014 and in the same market place TDF issued a seven-year unsecured bond (senior unsecured bond) with a nominal value of EUR 500,000 thousand, an annual nominal interest of 2.375% and a maturity on 10 February 2021.

The bonds represent unsecured and senior liabilities of TDF, which are of equal ranking with each other and with all other unsecured and senior liabilities of TDF, unless these liabilities enjoy priority as a result of mandatory stipulations. Each bond is repaid on the due date in the amount of its specified denomination, unless it has been previously repaid or purchased and invalidated.

The bonds are guaranteed by Telefónica Deutschland Holding AG, Munich.

The net proceeds from each bond were directly passed from TDF to Telefónica Germany GmbH & Co. OHG, Munich, based on loan agreements with concurrent terms and conditions.

## 3. Net assets, results of operations and financial position

### Net assets

The assets are presented in the following table:

| Balance sheet item | 31 Dec. 2016 EUR thousand | 31 Dec. 2015 EUR thousand | Change EUR thousand |
|---|---|---|---|
| Financial assets | 1,100,000 | 1,100,000 | 0 |
| Receivables and other assets | 11,902 | 11,883 | 19 |
| Prepaid expenses | 4,497 | 6,298 | -1,801 |
| **Total Assets** | **1,116,399** | **1,118,181** | **-1,782** |

The financial assets as of 31 December 2016 consist of two loans of EUR 600,000 thousand and EUR 500,000 thousand respectively, granted by TDF to its shareholder Telefónica Germany GmbH & Co. OHG, Munich. The terms of both loans correspond to the terms of the underlying five- and seven-year bonds which TDF issued on 22 November 2013 and 10 February 2014 respectively. The loans have fixed terms until the date of maturity of the underlying bonds on 22 November 2018 and 10 February 2021, respectively and are repayable in one amount on the due date, including all interest and costs which have not yet been paid.

The receivables and other assets of EUR 11,902 thousand (previous year: EUR 11,883 thousand) mainly include short-term interest receivables from Telefónica Germany GmbH & Co. OHG in the amount of EUR 11,807 thousand (previous year: EUR 11,807 thousand). The underlying interest rates are 1.875 % and 2.375 % respectively and are payable annually on 22 November and 10 February respectively. The slight increase in receivables and other assets to EUR 11,902 thousand (previous year: EUR 11,883 thousand) mainly results from the increase in other receivables from affiliated companies from cost allocation, which increased from EUR 42 thousand as of 31 December 2015 to EUR 73 thousand as of 31 December 2016. By contrast, cash pooling receivables with Telfisa Global B.V, Amsterdam, the Netherlands, fell from EUR 34 thousand at 31 December 2015 to EUR 22 thousand as of 31 December 2016.

As of 31 December 2016, the prepaid expenses include the amortised disagios from the issuance of the bonds for the five-year bond issued in November 2013 and for the seven-year bond issued in February 2014. Amortised Issuing fees for the five-year bond and for the seven-year bond are also included. The change in prepaid expenses results from the straight-line reversal of the components over the terms of the underlying bonds until 22 November 2018 and until 10 February 2021 respectively.

Equity and liabilities are presented in the following table:

| **Balance sheet item** | **31 Dec. 2016 EUR thousand** | **31 Dec. 2015 EUR thousand** | **Change in EUR thousand** |
|---|---|---|---|
| Equity | 25 | 25 | 0 |
| Bonds | 1,100,000 | 1,100,000 | 0 |
| Other provisions | 69 | 49 | 20 |
| Trade payables | 0 | 2 | -2 |
| Other liabilities | 11,807 | 11,807 | 0 |
| Deferred income | 4,497 | 6,298 | -1,801 |
| **Total Equity and liabilities** | **1,116,399** | **1,118,181** | **-1,782** |

The company's share capital remains unchanged at EUR 25 thousand and is fully paid. It is held entirely by Telefónica Germany GmbH & Co. OHG, Munich.

The other provisions of EUR 69 (previous year: 49) thousand relate to consultancy and audit fees.

The liabilities include two bonds with a nominal value of EUR 1,100,000 thousand in total. Thereof the five-year bond amounts to EUR 600,000 thousand, with a maturity on 22 November 2018. Both bonds had a remaining term of less than five years as of 30 June 2016 and are guaranteed by Telefónica Deutschland Holding AG, Munich.

The other liabilities include current interest liabilities relating to the bonds that will not be paid until the following year.

The deferred income results from the amortised differences respectively between the nominal values of the underlying loans and the amounts paid out to Telefónica Germany GmbH & Co. OHG, Munich. The deferred items are released over the term of the underlying five- and seven-year loan.

**Results of operations**

In the financial year ending 31 December 2016, TDF reported a loss before profit-and-loss transfer of EUR 2.80 (previous year a profit before profit-and-loss transfer of EUR 0.42), which was assumed by Telefónica Germany GmbH & Co. OHG, Munich, as a result of an existing domination and profit and loss transfer agreement. As expected a result for the year of EUR 0,00 was realized.

The main profit and loss items are as follows:

| **Profit and loss item** | **1 Jan. 2016 - 31 Dec. 2016 EUR thousand** | **1 Jan. 2015 - 31 Dec. 2015 EUR thousand** | **Change EUR thousand** |
|---|---:|---:|---:|
| Other operating income | 276 | 266 | 10 |
| Other operating expenses | -276 | -266 | -10 |
| Other interest and similar income | 25,088 | 25,100 | -12 |
| Interest and similar expenses | -25,088 | -25,100 | 12 |
| **Profit/Loss before profit-and-loss transfer** | **0** | **0** | **0** |
| Income from loss assumption / expense from profit transfer | 0 | 0 | 0 |
| **Result of the Year after profit-and-loss transfer** | **0** | **0** | **0** |

The other operating income of EUR 276 thousand (previous year: EUR 266 thousand) is attributable to costs charged on to Telefónica Germany GmbH & Co. OHG, Munich. The other operating expenses of EUR 276 thousand (previous year: EUR 266 thousand) which are charged on mainly comprise bank charges and consultancy and audit fees.

Other interest and similar income totals EUR 25,088 thousand (previous year: EUR 25,100 thousand) and chiefly results from interest income from the loans granted to Telefónica Germany GmbH & Co. OHG, Munich, in the amount of EUR 23,287 thousand (previous year: EUR 23,299 thousand) and from the reversal of deferred income in the amount of EUR 1,801 thousand (previous year: EUR 1,801 thousand).

Interest and similar expenses of EUR 25,088 thousand (previous year: EUR 25,100 thousand) include interest expense from the bonds of EUR 23,287 thousand (previous year: EUR 23,299 thousand) and expenses from the release of the disagios over the term of the bonds in the amount of EUR 1,801 thousand (previous year: EUR 1,801 thousand).

## Financial position

### Principles and goals of financial management

Risk control and a central management are the fundamental principles of financial management at the TDF. The goal of financial management is to continually ensure sufficient financial liquidity and stability. Risk controls are used in order to anticipate potential risks and counteract them using corresponding measures. At present, there are no circumstances which would indicate that TDF cannot meet its financial obligations.

The composition of cash and cash equivalents and the relevant movements are shown in the separate cash flow statement.

Cash and cash equivalents contain receivables from cash pooling with Telfisa Global B.V., Amsterdam, Netherlands.

During the financial year 2016, TDF reported a negative cash flow from operating activities in the amount of EUR 12 thousand, in 2015 TDF reported a positive cash flow from operating activities in the amount EUR 9 thousand. The development towards a negative cash flow in the comparative period mainly resulted from the increase of the receivables from affiliated companies partial compensated by the increase of other provisions.

In the 2016 financial year, TDF reported a positive cash flow from investing activities in the amount of EUR 23,125 thousand that resulted from the interest payments from the borrower Telefónica Germany GmbH & Co. OHG, Munich.

The outgoing payments in the cash flow from financing activities amounted to EUR 23,125 thousand as of 31 December 2016 and resulted from the interest payments for the bonds issued.

As of 31 December 2015, TDF has an unused credit line of EUR 6 thousand (previous year: EUR 6 thousand).

## 4. Opportunity and risk report

The activities of TDF are currently restricted exclusively to the financing of the Telefónica Deutschland Group. The main elements of the assets of TDF are the loans granted to Telefónica Germany GmbH & Co. OHG, Munich. The economic existence of TDF is thus primarily dependent on whether Telefónica Germany GmbH & Co. OHG, Munich is able to meet its obligations in relation to these loans. All interest and capital payments relating to all debt securities currently issued by TDF are secured by a full and unlimited guarantee by the guarantor Telefónica Deutschland Holding AG, Munich. This guarantee is enforceable in accordance with the law of the Federal Republic of Germany.

Accordingly, the risks and opportunities of TDF as well as the measures and processes for handling these risks and opportunities are essentially the same as those applicable for the Telefónica Deutschland Group. The main Group risks are summarised in the following.

*General financial market risks*

The Telefónica Deutschland Group is exposed to various financial market risks as part of its business activity.

If these financial risks occur, they could have a negative impact on the net assets, financial position and results of operations of the Telefónica Deutschland Group.

The Telefónica Deutschland Group has developed guidelines for risk management processes and for the use of financial instruments including the clear separation of responsibilities with respect to financial activities, invoicing, financial reporting and associated controlling. Derivative financial instruments are used solely to manage interest and currency risks. The Telefónica Deutschland Group has developed guidelines derived from established standards for the evaluation of risks and monitoring with regard to the use of financial derivatives.

*Market risk*

Market risk is the risk that changes in market prices such as changes in exchange rates and interest rates will affect the value of financial instruments or the earnings of the Telefónica Deutschland Group.

*Interest rate risk*

Interest risks arise predominantly from floating-rate cash pooling accounts and deposits of the Telefónica Deutschland Group at Telfisa Global B.V., Netherlands, as well as through loan agreements as borrower and interest swaps.

In November 2013 and February 2014, interest rate swaps were signed by Telefónica Germany GmbH & Co. OHG, Munich, in each case in connection with the issue of bonds for a partial amount of the bonds' nominal values. On the basis of these interest swaps contract, the Telefónica Germany GmbH & Co. OHG, Munich pays a variable interest rate on a nominal amount and receives a fixed interest rate on the same amount in return. These interest rate swaps compensate, to the level of their nominal amounts, the effects of future market interest rate changes on the fair value of the underlying fixed-interest financial liabilities from the bond issues (fair value hedge).

*Credit risk*

Credit risk describes the risk of financial losses from the inability of contractual partners to repay or service debts in accordance with the contract. The Telefónica Deutschland Group's maximum credit risk corresponds with the carrying amount of the financial assets (without considering any guarantees or securities).

The Telefónica Deutschland Group considers the management of the commercial credit risk to be critical in order to achieve its goals for sustainable growth of the business and the customer base in harmony with its risk management guidelines. Suitable processes have been established for the management and monitoring of credit risk, including ongoing monitoring of the expected risks and the level of default.

This approach for credit risk management is based on the ongoing monitoring of the expected risks and the level of default. To control the credit risk, the Telefónica Deutschland Group regularly conducts an analysis of the maturity structure of trade receivables and only reports adjustments for doubtful receivables with a credit risk.

In accordance with Telefónica corporate policy, the Telefónica Deutschland Group has concluded cash pooling and deposit agreements with Telfisa Global B.V., a subsidiary of the Telefónica, S.A. Group, with regard to its cash surpluses and deposits its cash surpluses there. Telefónica, S.A. is rated by international rating agencies with an investment grade rating.

*Liquidity risk*

Liquidity risk describes the risk that the Telefónica Deutschland Group may be unable to sufficiently comply with its financial obligations. To safeguard liquidity, cash inflows and outflows are permanently monitored and controlled centrally on the basis of detailed financial planning. The Telefónica Deutschland Group works on its liquidity management closely with the Telefónica, S.A. Group and, in accordance with the corporate policy, has concluded cash pooling and deposit agreements with Telfisa Global B.V., Netherlands. In addition to operating liquidity, the opportunities arising on the financial markets are continuously examined with a view to ensuring the financial flexibility of the Telefónica Deutschland Group.

*Capital management*

The Telefónica Deutschland Group strives to guarantee the sustainability of its business and to maximise its enterprise value by continuously monitoring its cost of capital. In particular, the Telefónica Deutschland Group monitors its equity ratio and OIBDA (Operating Income Before Depreciation and Amortization, interest and tax).

**Risk management and risk reporting**

In the course of our business activities, we are confronted with various business, financial and other (global) risks. We perform our services on the basis of the organisational, strategic and financial decisions made and precautions taken by us.

Every business activity involves risks that can prejudice the process of goal-setting and goal fulfilment. These risks arise from the uncertainty of future events – often due to insufficient information – and have the result that objectives can be missed. If risks are not recognised and dealt with they can endanger the successful development of the corporation. In order to react appropriately to this fact, the corporate management has introduced a risk management process. This is intended to guarantee immediate and complete transparency with regard to new risks and changes to existing risks.

Risk management is an immanent component of the decision-making process with the Telefónica Deutschland Group. The process ensures that risk evaluations are taken into account for the decision-making and measures are taken early to minimise and deal with the risks. This is done on the basis of the evaluation, communication and management of risks by all managers of the corporation. A lower limit for the recognition of risks is generally not set. The risk management department compiles the corporation’s risk registry, which also covers the subsidiaries. As part of the creation of the risk registry it is ensured that risks of a similar type or of cumulative effect are combined and thus provided for overall consideration.

In addition, this bottom-up approach – i.e. the identification of risks by the operating units – is supplemented by a top-down approach in order to ensure a comprehensive perspective of risks that covers all companies. The purpose of the top-down approach is ensure that risks that can only be identified at the highest management level or when considering the Group-wide perspective are included in a discussion with the units with operational responsibility. This is intended to facilitate complete qualification and comprehensive management as well as evaluating relevance for future reports. Risk Management remains in continuous contact with all business divisions and with our risk coordinators in order to track and assess risks and their management and development on an ongoing basis. The employees responsible are given individual training so as to ensure a uniform, structured process for recording and assessing risks. In addition, all employees have the option of participating in basic training to raise their general awareness of risk management.

Risks are evaluated with regard to their effect on our business goals both from an operational and a financial viewpoint. The risk registry is based on a data base that contains all identified risks, their current status, measures already taken and defined action plans.

In a formal forward-looking process, the risk registry of Telefónica Deutschland Group is subject of regular reporting to the Management Board. The Supervisory Board (Audit Committee) is regularly informed about risks and their development.

Opportunities are not recorded in the risk management system.

*Risk evaluation*

The following section describes the risks that could have a significant negative impact on our financial position, our competitiveness or our ability to implement our objectives. The risks are presented and assessed in line with the net principle, i.e. taking account of any risk mitigation measures performed.

Based on the combination of the potential level of damages and the estimated probability of occurrence, the individual risk points are divided into three categories (significant, moderate and minor risks). All risks with a very high potential level of damages are seen as critical for the corporation, and here the estimated probability of occurrence is not taken into account. With an increasing probability of occurrence the risk points with a high or medium potential level of damages also fall into this category.

Minor risks are not included in the reporting to the Management Board and therefore are not included in the risk summary in the following section. Such risks are identified, documented and administered by the relevant management levels as part of the risk management process.

For internal use and for reporting within the Telefónica Deutschland Group, risks are divided into business risks, operational risks, financial risks and other (global) risks, and this categorisation is also used as the basis for this section of the report. The main risk areas relating to business risks, operational risks and financial risks are specified within the respective categories according to their order of priority.

In addition, our company may be affected by other or additional risks that we are not currently aware of or that we do not consider to be material based on our current knowledge. It also cannot be ruled out that risks that are currently regarded as more minor may change within the forecast period with the effect that they could potentially have a greater impact that risks that are currently regarded as more significant.

We have summarised the risks according to their risk areas as follows:

- Business risks
  - Competitive markets and changing customer demands
  - Regulatory environment
  - Insurances
- Operational risks
  - Service quality
  - Supplier defaults
  - Termination of essential contracts
  - Dependence on services of the major shareholder Telefónica and of KPN
  - Legal risks
- Financial risks
  - Taxes
  - Other (global) risks

**Opportunity management**

The consistent use of entrepreneurial opportunities for future growth in revenue and OIBDA as well as their early and continuous identification, analysis and management is a significant task of the management of the Telefónica Deutschland Group.

The opportunities and growth potential ascertained in the strategic goal-setting process are prioritised as part of an annual planning process in close cooperation with the individual business areas and relevant strategic goals are derived from this. To measure the strategic implementation, specific financial objectives in the form of key finance-related monitoring figures (KPIs) are defined at the level of the organisation units.

Opportunity management is a significant component of the entire process for strategic goal setting. It occurs both as part of the budget creation for the coming twelve months as well as within the long-term planning.

Opportunities are neither recognized in the risk register nor quantified.

Mayor opportunities are summarized as follows:

- Greater demand for mobile data and LTE
- Expansion of the LTE network
- Cooperation with Telekom Deutschland GmbH in the fixed network
- Digital innovation
- Digitalisation of service processes
- Belonging to the Telefónica, S. A. Group
- Opportunities for higher synergies

**Accounting-Related Internal Control and Risk Management System**

The following statements contain information in accordance with section 289 (5) HGB.

The primary goal of our accounting-related internal control and risk management system is to ensure proper financial reporting in the sense of ensuring that the Financial Statement comply with all relevant provisions.

The risk management system also includes an accounting-related perspective with the aim of ensuring the reliability of financial reporting. The accounting-related internal control system (“ICS”) introduced by us also complies with the German Commercial Code (HGB). Establishing and effectively maintaining appropriate internal controls for financial reporting is the responsibility of the Management Board and is performed taking company-specific requirements into account.

The conceptual framework for preparing the Financial Statement primarily consists of the uniform group-wide accounting guidelines and the chart of accounts, both of which must be applied consistently by all companies of the Telefónica Deutschland Group. New laws, accounting standards and other official pronouncements are analysed on an ongoing basis with regard to their relevance and effects on the proper preparation of the Financial Statement.

The data basis for the preparation of the Financial Statement consists of the financial statement information reported by Telefónica Deutschland, its subsidiaries and joint ventures, which in turn is based on the accounting entries recorded within the companies. The financial reporting of the individual companies is performed either by the Finance & Accounting department of Telefónica Germany GmbH & Co. OHG or in close cooperation with it. For certain topics requiring specialist knowledge, such as the valuation of pension obligations, we draw upon the support of external service providers. The Consolidated Financial Statements are prepared within our consolidation system on the basis of the reported financial statement information. The steps to be taken when preparing the Consolidated Financial Statements are subject to both manual and system-based controls at all levels.

Employees involved in the financial reporting process are already examined in terms of their professional suitability before they are hired, and are provided with regular training. The financial statement information must go through certain approval processes at every level. Critical task areas in the financial reporting process are divided appropriately in order to ensure the effective separation of duties, and the dual control principle generally applies. Further control mechanisms include target/performance comparisons and analyses of the composition of content and changes in individual items, both in the financial statement information reported by individual group companies and in the Consolidated Financial Statements. In the accounting-related IT systems, access authorisations are defined in order to ensure that accounting-related data is protected from unauthorised access, use and change.

However, every control system is subject to certain limitations on its effectiveness. Irrespective of the specific features of an ICS, there can be no absolute certainty with regard to its ability to prevent or detect all incorrect accounting disclosures.

The appropriateness and effectiveness of the ICS are assessed annually by the Management Board of Telefónica Deutschland. Our Internal Audit department continuously reviews compliance with guidelines, the reliability and functionality of our ICS and the appropriateness and effectiveness of our risk management system and reports on this to the Management Board of Telefónica Deutschland.

The Audit Committee is involved in the ICS. In particular, the Audit Committee is responsible for monitoring the accounting process, the effectiveness of the ICS, the risk management and internal audit systems, as well as the audit of the financial statements. It also reviews the documents for the Annual Financial Statements of TDF and discusses the financial statements with the Management Board and the external auditor.

As part of its risk-oriented audit approach, the external auditor expresses an opinion on the effectiveness of the parts of the ICS that are relevant for financial accounting and reports to the Supervisory Board in the course of the discussion of the financial statements.

For the company conceptual framework described above is supplemented by a HGB chart of accounts.

As the parent company, the Telefónica Deutschland Holding AG is included in the aforementioned Group-wide accounting-related internal control system.

## 5. Employees

The Company did not have any employees in the financial year 2016.

## 6. Essentials of the remuneration system

The Managing Directors do not receive any payments from TDF.

## 7. Forecast report 2017

The forecast report describes the probable development of TDF in the course of the financial year 2017. The report contains comments and information regarding future events. Forward-looking comments and information are based on expectations and assumptions of the Company at the time when this management and forecast report is published, on the basis of known and unknown opportunities and risks. The success of the Company, the business strategy and also the results of the Company are influenced by a wide range of factors outside the control of the Company.

If such opportunities or risks occur or if uncertain factors materialise, or if it becomes apparent that one of the underlying assumptions was not correct, the actual development of the Company may differ (positively as well as negatively) from the expectations and assumptions in the forward-looking comments and information set out in this forecast report. Forecasts available in the public domain regarding the development of the overall economy and the sector have only been detailed to an extent which is relevant for understanding the comments regarding the probable development of the Company. They must not impair the perception of the comments regarding the probable development of the Company.

As a result of the close personnel and economic links between TDF and the Telefónica Deutschland Group, TDF is subject to the same business and framework conditions as well as the same regulatory environment as the Telefónica Deutschland Group. The future development of TDF is very much dependent on the capital requirements and the form of financing chosen by the Telefónica Deutschland Group. The assessment of the future development of TDF is therefore based on forecasts of the business developments of the Telefónica Deutschland Group, which is summarised as follows.

*Economic outlook*

The leading economic research institutes expect economic growth in Germany to continue in 2017. They are forecasting an 1.4 % increase in gross domestic product. According to the economic institutes, private and public consumer spending will remain the pillars of the German economy in 2017. As in 2016, the favourable conditions on the labour market, sustained positive income expectations and the low-interest environment will provide a considerable incentive for private households to make purchases. In the public sector, the main drivers are additional spending on refugee accommodation, support and integration.

Any escalation at international trouble spots still poses a risk to the consumer economy, and thus also to overall economic development in Germany. It remains to be seen how the planned withdrawal of the United Kingdom from the European Union (Brexit) and Donald Trump's victory in the US presidential election will affect the European, and above all the German, economy.

Growth in economic performance of 1.4 % is forecast for the euro area in 2017.

SOURCE: GFK KONSUMKLIMA, FOCUS ECONOMICS, BUNDESBANK, COLOGNE INSTITUTE FOR ECONOMIC RESEARCH

*GDP growth 2015 –2017 for Germany and the Euro area*

| in % | **2015** | **2016** | **2017** |
|---|---|---|---|
| Deutschland | 1.7 | 1.8 | 1.4 |
| Euroraum | 1.5 | 1.6 | 1.4 |

*Market expectations*

In addition to connecting people, the intelligent connection of things via the internet (IoT) offers numerous application and growth opportunities, such as Industry 4.0, connected cars, smart health, smart energy and smart cities. Another trend is data analytics, which is facilitating new insights as well as new business models.

Smartphones and tablets are becoming the trailblazers for the digital revolution of an all-round digital lifestyle in Germany. At the same time, the growing proliferation of data-based communications services, i.e. "over-the-top" (OTT) applications such as WhatsApp, Skype, Facebook, or Apple Facetime as well as video streaming providers, is increasing data usage.

This all means further growth in the transmitted data volume. This means that the monetisation of mobile data business will remain a strong focus of mobile telecommunications providers.

At the same time, the negative trend for mobile voice and SMS in the "traditional telecommunications sector" will continue as a result of further price pressure and changing customer behaviour. Analysts expect revenues in the market for mobile services in Germany to remain more or less stable until 2017. (Source: Company data, Analysys Mason, BITKOM)

*Outlook 2017*

Telefónica Deutschland achieved significant commercial and operational success in 2016 and will continue to build on these achievements in 2017. We see key opportunities as well as external risk factors for the year ahead. 2016 saw a clear focus on customer base development and data monetisation in the premium segment of the German mobile market, with the first price increases for a number of years. We successfully launched our new premium portfolio O2 Free in October 2016, with customers responding well to the concept of 'more-for-more' and continuous mobile data access. We expect to drive operating momentum with O2 Free in 2017, selling the new portfolio to new customers as well as using it to develop the existing customer base. The new offer will also help us counteract the drag from the remaining legacy base and OTT effects.

In contrast, the non-premium segment remained dynamic, albeit with signs of easing competitive pressure in the fourth quarter of 2016. We remain cautiously optimistic about this development and its implications for the positioning of our own brands. Nevertheless, we expect strong partner trading in the non-premium segment to continue resulting in a retail-to-wholesale mix-shift, which already weighed on mobile service revenue in 2016. The price competition amongst providers in the non-premium postpaid segment is also driving pre- to postpaid migration. In addition, the new federal prepaid legislation, which requires customer identification for prepaid products, could further impact the prepaid market from July 2017.

However, in 2017 regulatory topics present the largest headwind to mobile service revenue. As of 1 December 2016 the BNetzA cut mobile termination rates from 1.66 to 1.1 Eurocents, and the European roaming legislation will bring the roaming glide path to zero in July 2017. The roaming regulation applies to all European mobile telecommunication operators. Roaming revenue exhibits a strong seasonality due to customer travel patterns, with a major portion falling into the second half of the year. Altogether, termination and roaming effects will result in a drag on 2017 mobile service revenue of approx. 3-4% year-on-year. Excluding these regulatory effects, we expect the underlying mobile service revenue to be slightly negative to flat year-on-year in 2017. We base our expectations for 2017 on the assumption of a sustained rational market structure and a stable economic environment. As in 2016, fixed-line revenues will continue to be negatively affected by the progressive decommissioning of the ULL broadband access infrastructure.

We are also upgrading our total synergy target from approx. EUR 800 million to approx. EUR 900 million operating cash flow (Opex-Capex) synergies in 2019. This upgrade is driven by improved visibility and the realisation of further synergy opportunities identified during the integration process, such as additional Opex savings from FTE restructuring and network integration, as well as infrastructure optimisation and simplification initiatives. Capex synergies continue to result primarily from the roll-out of one LTE network. In 2017 we are expecting to reach a cumulated savings level of approx. EUR 670 million or 75% of our new total target, with a further EUR 160 million of incremental Opex and revenue-related in-year savings. Savings in 2017 will result mainly from the network consolidation and the effects of the ongoing FTE restructuring. We are also expecting to realise a further 80 million of Capex-related synergies.

This translates into expected flat to mid-single-digit year-on-year percentage growth in OIBDA (post Group-Fees, pre exceptionals1), predominantly driven by synergies. This includes an expected impact from the European roaming regulation and the termination rate effects of approximately 4-5% year-on-year. Our estimation of regulatory impacts is based on the expectation of a rational customer response to the new European roaming legislation. We will continue to invest in our market positioning in a rational manner and our estimation of ongoing commercial investment needs for 2017 is equally based on the assumptions of a continued rational market structure. Handsets are considered broadly neutral for margin development.

In terms of Capex development Telefónica Deutschland is focusing on the network consolidation and the roll-out of LTE in 2017, resulting in an expected capital expenditure of around EUR 1 billion.

The company leverage2 target of ‘at or below 1.0x Net Debt/OIBDA over the medium term remains unchanged and will be continually reviewed, as we manage the cash flows resulting from the integration. Nevertheless, we have strong confidence in our ability to generate Free Cash Flow, which also gives us confidence in our dividend outlook. We continue to view ourselves as a dividend-paying company, supporting a high payout ratio in relation to Free Cash Flow. We reiterate our dividend outlook, with a proposal of EUR 0.25/share for the financial year 2016 and projected dividend growth over 3 years (2016-18). We will consider expected future synergies when making dividend proposals.

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[1] Exceptional effects such as restructuring costs are excluded from our 2017 OIBDA guidance. We have calculated a comparable for 2016, which includes the operating lease-related effects from the sale of Telefónica Deutschland’s passive tower infrastructure in April 2016, as if it had occurred on 1 January 2016.

[2] Leverage is defined as net financial debt divided by the OIBDA of the last twelve months before exceptional effects.

During the first two years of the merger process the corporate strategy of Telefónica Deutschland was based on the concept of 'MIT': Momentum, Integration and Transformation. Having successfully completed a majority of integration milestones, our focus is now shifting from integration to transformation. The focus range of our corporate strategy thus narrows to 'M+T': Momentum and Transformation. Maintaining momentum in the market will remain the first operational priority of Telefónica Deutschland. Furthermore, our long-term strategic transformation will be based around the core principles of digitalisation, simplification and automation. We are a beneficiary and driver of digitalisation, and the integration process has afforded us the opportunity to rethink existing mechanisms and to further embrace simplification and automation. We will continue to invest in the transformation of our business into the leading digital 'onlife' telco. The resulting operational efficiency will drive profitability and Free Cash Flow generation in the mid-term, and thus total shareholder return.

**Management summary**

Currently, TDF in its capacity as a financing company restricts its activities exclusively to financing the Telefónica Deutschland Group. In 2013 and 2014 and in line with its business purpose, TDF successfully issued two bonds with a nominal value of EUR 600,000 thousand and EUR 500,000 thousand and a maturity on 22 November 2018 and 10 February 2021 respectively. TDF transferred the proceeds based on the same conditions in the form of two loans to Telefónica Germany GmbH & Co. OHG, Munich. The bonds are guaranteed by Telefónica Deutschland Holding AG, Munich. TDF does not currently employ any staff itself. Due to the close personnel and economic links, the probable business development of the Company as well as the main opportunities and risks correspond to those applicable for Telefónica Deutschland Holding AG. On the basis of the issuances which have been carried out, management of TDF overall considers that the business development is positive and expected generally no essential modifications in the net assets, results of operations and financial positions compared to 2016. Furthermore, we expect that due to existing cost sharing and loan agreements with Telefónica Germany GmbH & Co. OHG, Munich, we will be able to achieve a current year net income, prior to profit transfers, similar to the prior year, which will subsequently be paid in accordance with the control- and profit and loss transfer agreement.  Fixed Assets and Investments are also expected to remain fairly unchanged.

Munich, 03 March 2017

O2 Telefónica Deutschland Finanzierungs GmbH

- Management –

Rachel Empey        Markus Haas        Albert Graf

*Translation from the German language*

## Audit opinion

We have audited the annual financial statements, comprising the statement of financial position, the income statement, the statement of cash flows, the statement of changes in equity and the notes to the financial statements, together with the bookkeeping system, and the management report of O2 Telefónica Deutschland Finanzierungs GmbH, Munich, for the fiscal year from 1 January 2016 to 31 December 2016. The maintenance of the books and records and the preparation of the annual financial statements and the management report in accordance with German commercial law are the responsibility of the Company's management. Our responsibility is to express an opinion on the annual financial statements, together with the bookkeeping system, and the management report based on our audit.

We conducted our audit of the annual financial statements in accordance with Sec. 317 HGB ["Handelsgesetzbuch": "German Commercial Code"] and German generally accepted standards for the audit of financial statements promulgated by the Institut der Wirtschaftsprüfer [Institute of Public Auditors in Germany] (IDW). Those standards require that we plan and perform the audit such that misstatements materially affecting the presentation of the net assets, financial position and results of operations in the annual financial statements in accordance with German principles of proper accounting and in the management report are detected with reasonable assurance. Knowledge of the business activities and the economic and legal environment of the Company and expectations as to possible misstatements are taken into account in the determination of audit procedures. The effectiveness of the accounting-related internal control system and the evidence supporting the disclosures in the books and records, the annual financial statements and the management report are examined primarily on a test basis within the framework of the audit. The audit includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the annual financial statements and management report. We believe that our audit provides a reasonable basis for our opinion.

Our audit has not led to any reservations.

In our opinion, based on the findings of our audit, the annual financial statements comply with the legal requirements and give a true and fair view of the net assets, financial position and results of operations of the Company in accordance with German principles of proper accounting. The management report is consistent with the annual financial statements, complies with the legal requirements and as a whole provides a suitable view of the Company's position and suitably presents the opportunities and risks of future development.

Munich, 3 March 2017

Ernst & Young GmbH
Wirtschaftsprüfungsgesellschaft

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|---|---|
| Dahmen | Vogel |
| Wirtschaftsprüfer | Wirtschaftsprüferin |
| [German public auditor] | [German public auditor] |