# MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

## TELEFONICA CELULAR DEL PARAGUAY S.A.

### Results of Operations

*Six months ended June 30, 2014 and 2013*

| | Six months ended June 30, | | Impact on comparative results for period | |
|---|---|---|---|---|
| | **2014** | **2013** | **Amount of variation** | **Percent change** |
| | *(in millions of* PYG*, except percentages, subscribers, employees and ARPU)* | | | |
| Revenues | 1,606,169 | 1,586,342 | 19,827 | 1% |
| Cost of sales | -547,295 | -515,644 | (31,651) | 6% |
| **Gross profit** | **1,058,874** | **1,070,698** | **(11,824)** | **(1)%** |
| Sales and marketing | -282,570 | -267,719 | (14,851) | 6% |
| General and administrative expenses | -278,046 | -172,191 | (105,855) | 61% |
| **Operating profit** | **498,258** | **630,788** | **(132,530)** | **(21)%** |
| Interest expense | -59,132 | -48,739 | (10,393) | 21% |
| Interest income | 6,240 | 3,404 | 2,836 | 83% |
| Foreign exchange gains (loss), net | 50,973 | -124,992 | 175,965 | (141)% |
| **Profit before tax** | **496,359** | **460,461** | **35,898** | **8%** |
| Charge for taxes | -93,264 | -101,593 | 8,329 | (8)% |
| **Net profit** | **403,095** | **358,868** | **44,227** | **12%** |
| | | | | |
| **Operating Data:** | | | | |
| | | | | |
| **Number of mobile subscribers** | **3,794,480** | **3,930,447** | **(135,967)** | **(3)%** |
| Postpaid | 883,243 | 941,558 | (58,315) | (6)% |
| Prepaid | 2,911,237 | 2,988,889 | (77,652) | (3)% |
| **Monthly churn %** | | | | |
| Postpaid handset | 1.6% | 2.2% | (0.6)% | (27)% |
| Postpaid datacard | 3.5% | 4.2% | (0.7)% | (16)% |
| Total postpaid | 1.8% | 2.4% | (0.7)% | (29)% |
| Prepaid handset | 2.5% | 3.7% | (1.3)% | (34)% |
| Prepaid datacard | 12.0% | 6.3% | 5.6% | 89% |
| Total prepaid | 2.5% | 3.8% | (1.3)% | (33)% |
| Total monthly churn (1) | 2.3% | 3.5% | (1.1)% | (33)% |
| **Monthly ARPU (US$) (2)** | | | | |
| Postpaid | 25.2 | 23.5 | 1.7 | 7% |
| Prepaid | 7.4 | 8.3 | (0.9) | (11)% |
| Total monthly ARPU (3) | 11.5 | 11.9 | (0.4) | (4)% |
| **Number of employees** | **745** | **733** | **12.0** | **2%** |

(1) Our total monthly churn is individually calculated by reference to our aggregate prepaid and postpaid customers.
(2) ARPU is calculated based on a historical exchange rate of 4389 to US$1.00.
(3) Our total ARPU is individually calculated by reference to our aggregate prepaid and postpaid customers.

*Revenue*

Total revenue increased by 1% for the six months ended June 30, 2014 to Gs.1,606,169 million from Gs.1,586,342 million for the six months ended June 30, 2013. Growth in revenue was impacted primarily by growth in TV subscriptions and the type and number of value-added services purchased by customers, which trended toward an increasing level of higher-revenue generating value-added services. Our recurring revenue from value-added services represents 50% of total recurring revenue for the six months ended June 30, 2014, the same level as the six months ended June 30, 2013.

Additionally, the cable TV business has contributed revenue of Gs. 58,380 million during the six months ended June 30, 2014.

*Customer base*

As of June 30, 2014, our total mobile customer base was 3,794,480, a decrease of 3% from 3,930,447 as of June 30, 2013, with prepaid customers accounting for 76.7% or 2,911,237 of our total mobile customers at such time. The decrease in customer was compensated by an increase in ARPU for postpaid customers. Additionally we have been investing in improvements in the quality of our networks and increased capacity and coverage which we believe has helped to maintain our customers during the period despite the high level of penetration in the Paraguayan market. Strengthening our distribution network has also helped making our products more accessible.

*Cost of sales*

Cost of sales increased by 6% for the six months ended June 30, 2014 to Gs.547,295 million from Gs.515,644 million for the six months ended June 30, 2013. Our cost of sales primarily related to the increased cost of transmission and bandwidth as we continued to focus on data penetration and the expansion of our networks, an increase in cable TV programing costs in line with incremental revenue from Tigo Home, an increase in bad debt as a result of the migration of customers from prepaid to postpaid, obsolescence due to change in handset portfolio mix (an increase in high-end smartphones and datacards) and depreciation due to 3G network expansion. Interconnection and roaming costs decreased despite the growth in revenue described above.

Gross profit margin decreased to 65.9% for the six months ended June 30, 2014 from 67.5% for the six months ended June 30, 2013, resulting primarily from higher telephone and equipment sales, which are typically sold for low or no margin, representing a larger portion of revenue as well as an increase in content revenue and its related costs and the depreciation of the fixed assets and amortization of intangible assets coming from the 2012 purchase of Cablevision (our cable TV business).

*Sales and marketing*

Sales and marketing expenses increased by 6% for the six months ended June 30, 2014 to Gs.282,570 million from Gs.267,719 million for the six months ended June 30, 2013. Sales and marketing costs were comprised mainly of commissions to dealers for the sale of prepaid reloads, smartphone subsidies aimed at obtaining and maintaining customers, as well as general advertising and promotion costs, point of sale materials for our retail outlets and staff costs. The increase in sales and marketing costs was mainly attributable to increased handset subsidies to increase smartphone penetration and our postpaid customer base. As a percentage of revenue, sales and marketing expenses increased to 17.6% for the six months ended June 30, 2014 from 16.9% for the six months ended June 30, 2013.

*General and administrative expenses*

General and administrative expenses increased by 61% for the six months ended June 30, 2014 to Gs.278,046 million from Gs.172,191 million for the six months ended June 30, 2013. The increase was mainly attributable to higher billing costs and higher network maintenance costs as a result of our continued network expansion as well as a higher technical service fee. As a percentage of revenue, general and administrative expenses increased to 17.3% for the six months ended June 30, 2014 from 10.9% for the six months ended June 30, 2013.

*Operating profit*

Operating profit decreased by 21% for the six months ended June 30, 2014 to Gs.498,258 million from Gs.630,788 million for the six months ended June 30, 2013. The operating margin decreased from 39.8% for the six months ended June 30, 2013 to 31% for the six months ended June 30, 2014. This decrease was mainly as a result of the higher subsidies and sales commissions related to data mobile plans and TV plan sales and telephone and equipment sales representing a larger portion of revenue, handset subsidies related to these higher sales and the lower operating margin of the Cablevision businesses.

*Net finance costs*

Net finance costs, which include interest expense, net of interest income, increased by 17% for the six months ended June 30, 2014 to Gs.52,892 million from Gs.45,335 million for the six months ended June 30, 2013. This increase was mainly due to interest accretion on financing of football rights.

*Foreign exchange gain (loss)*

Exchange gains, net increased by 141% for the six months ended June 30, 2014 to Gs.50,973 million from a net loss of Gs. 124,992 million for the six months ended June 30, 2013. Exchange gains and losses resulted primarily as a result of movements in the PYG/USD exchange rate resulting in a revaluation of our U.S. dollar borrowings, trade payables and cash and cash equivalents. The majority of our borrowings and cash and cash equivalents are denominated in U.S. dollars. The PYG/USD exchange rate moved from 4,488 as of June 30, 2013 to 4,384 as of June 30, 2014.

*Charge for taxes*

The charge for taxes decreased by 8%, to Gs. 93,264 million for the six months ended June 30, 2014, from Gs. 101,593 million for the six months ended June 30, 2013, due primarily to a higher depreciation of fixed assets in the six months ended June 30, 2014 compare to the same period of 2013. The effective tax rate for the six months ended June 30, 2014 was 19% compared to 22% for the six months ended June 30, 2013.

*Net profit for the period*

Net profit for the six months ended June 30, 2014 increased by 12% to Gs.403,095 million compared to a net profit of Gs.358,868 million for the six months ended June 30, 2013 principally as a result of higher revenues, less charge for taxes and gain on foreign exchange offset by a higher cost of sales and higher G&A expenses. Trend Information

Our strategy is to maintain our voice and SMS revenue and market share while growing our revenue in value-added products and services such as mobile internet access, content downloads, and music and video streaming. For the six months ended June 30, 2014, value-added services represents 50% of recurring revenue, the same level as the six months ended June 30, 2013. Data usage is increasing among consumers as a result of an increasingly digital lifestyle. At the same time, smartphone market penetration is increasing as a result of lower prices and more phone options available to consumers. We expect innovation to be an important driver of growth in the years ahead. Although these new services tend to have lower profit margins than our core communications business, we aim to limit any drop in margins by controlling costs and through economies of scale. New competitors entering our markets and/or price competition could erode the profitability of our mobile operations, however.

**Liquidity and Capital Resources**

Historically we have relied, and in the future we intend to continue to rely, primarily on cash from operations and external financings to fund our operations, capital expenditures and working capital requirements.

We intend to continue to focus on investments in property, systems and equipment (fixed assets) and working capital management, including timely collection of accounts receivable and efficient management of accounts payable.

***Capital Expenditures***

Our capital expenditures on property, plant and equipment, licenses and other intangible assets for the six months ended June 30, 2014 and 2013 amounted to Gs.177,166 million and Gs.125,398 million, respectively.

***Financing***

As of June 30, 2014, our total outstanding indebtedness and other financing was Gs.1,530,605 million. As of December 31, 2013, our total outstanding indebtedness and other financing was Gs.1,517,345 million.

Our interest expense for the six months ended June 30, 2014 was Gs.59,132 million and for the six months ended June 30, 2013 was Gs.48,739 million.

***Dividends***

After analyzing our results of operations, our board of directors makes a recommendation to our shareholders on the amount of dividends, if any, that should be paid. The shareholders then resolve in a shareholders' meeting the amount of dividends, if any, that should be paid to shareholders. At the same time they decide whether the amount not paid as dividends should be retained as retained results of the Company or directed to a legal reserve account. Our dividend policy historically has been to pay dividends to our shareholders up to the level of free cash generated after debt repayments which is not required to fund our operations and not in excess of yearly net income. For the six months ended June 30, 2014 we paid dividends to our shareholders Gs.488,941 million against Gs.1,001,279 for the same period of 2013.

***Cash Flows***

The table below sets forth our cash flows for the periods indicated:

| | **Six months ended June 30,** | |
|---|---|---|
| | **2014** | **2013** |
| | **(in PYG Million)** | |
| Net cash provided by operating activities ………………….. | 551,427 | 391,656 |
| Net cash used in investing activities ……………………….. | (303,537) | (141,962) |
| Net cash used in financing activities ……………………….. | (533,241) | (1,045,938) |
| **Net (decrease) increase in cash and cash equivalents** …… | **(308,645)** | **(820,931)** |
| Cash and cash equivalents at the end of the period ……..…. | 858,348 | 354,534 |

*Six months ended June 30, 2014 and 2013*

For the six months ended June 30, 2014 cash provided by operating activities was Gs.551,427 million compared to Gs.391,656 million for the six months ended June 30, 2013. The increase was mainly due to a lower increase in trade receivables and inventories as well as a higher EBITDA.

Cash used in investing activities was Gs.303,537 million for the six months ended June 30, 2014 compared to Gs.141,962 million for the six months ended June 30, 2013 mainly due to higher investments in PP&E and intangibles assets for 3G and Cable TV networks expansion.

Cash used in financing activities was Gs.533,241 million for the six months ended June 30, 2014 compared to Gs.1,045,938 million for the six months ended June 30, 2013. The lower cash used for financing activities for the six months ended June 30, 2014 was mainly as a result of lower dividend paid compare to the same period of 2013.

The net decrease in cash and cash equivalents for the six months ended June 30, 2014 was Gs.308,645 million compared to a decrease of Gs.820,931 million for the six months ended June 30, 2013. We had closing cash and cash equivalents of Gs.326,822 million as of June 30, 2014 compared to Gs.250,903 million as of June 30, 2013.