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CAPITAL AUTOMOTIVE REIT  
Form 424B5  
August 03, 2001

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PROSPECTUS SUPPLEMENT TO PROSPECTUS DATED MARCH 18, 1999

[CAPITAL AUTOMOTIVE REIT LOGO]

3,350,000 Common Shares

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Our common shares are traded on the Nasdaq National Market under the symbol "CARS." The last reported sale price on August 2, 2001 was \$17.01 per share.

The underwriters have an option to purchase a maximum of 502,500 additional common shares to cover over-allotments of shares.

INVESTING IN OUR COMMON SHARES INVOLVES RISKS. SEE "RISK FACTORS" ON PAGE S-4.

	PRICE TO PUBLIC	UNDERWRITING DISCOUNTS AND COMMISSIONS	PROCEEDS TO COMPANY
	-----	-----	-----
Per Share.....	\$17.00	\$0.88	\$16.12
Total.....	\$56,950,000	\$2,948,000	\$54,002,000

Delivery of the common shares will be made on or about August 8, 2001.

Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved of these securities or determined if this prospectus supplement or the accompanying prospectus is truthful or complete. Any representation to the contrary is a criminal offense.

CREDIT SUISSE FIRST BOSTON  
 CIBC WORLD MARKETS  
 FRIEDMAN BILLINGS RAMSEY  
 RAYMOND JAMES  
 BB&T CAPITAL MARKETS  
 FERRIS, BAKER WATTS  
 Incorporated

The date of this prospectus supplement is August 2, 2001.

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YOU SHOULD RELY ONLY ON THE INFORMATION CONTAINED IN THIS DOCUMENT OR TO WHICH WE HAVE REFERRED YOU. WE HAVE NOT AUTHORIZED ANYONE TO PROVIDE YOU WITH INFORMATION THAT IS DIFFERENT. THIS DOCUMENT MAY ONLY BE USED WHERE IT IS LEGAL TO SELL THESE SECURITIES. THE INFORMATION IN THIS DOCUMENT MAY ONLY BE ACCURATE ON THE DATES OF THIS DOCUMENT.

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### ABOUT THIS PROSPECTUS SUPPLEMENT

References to "we," "us" or "our" refer to Capital Automotive REIT or, if the context requires, Capital Automotive L.P., which we refer to as the "Partnership," and our business and operations conducted through the Partnership and/or directly or indirectly owned subsidiaries. The term "you" refers to a prospective investor. We are the sole general partner of the Partnership, and as of June 30, 2001, owned approximately 71.8% of the units of partnership interest in the Partnership. Units of the Partnership held by limited partners (other than us) are redeemable, at the option of the holder, for cash, or we may assume the redemption obligations of the Partnership and acquire the units in exchange for our common shares on a one-for-one basis.

In this prospectus supplement, we use the term "dealerships" to refer to franchised automobile dealerships, motor vehicle service, repair or parts businesses and related businesses, which are the types of businesses that are operated on our properties and the term "dealer group" to refer to a group of related persons and companies who sell us properties. We also use the terms "dealer group," "tenant," or "operators of dealerships" to refer to the related persons and companies that lease our properties.

### RISK FACTORS

Our prospectus supplement and the accompanying prospectus, including our documents incorporated herein by reference, contain forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. Also, documents which we subsequently file with the SEC and are incorporated herein by reference will contain forward-looking statements. When we refer to forward-looking statements or information, sometimes we use words such as "may," "will," "could," "should," "plans," "intends," "expects," "believes," "estimates," "anticipates" and "continues." In particular, the risk factors included or incorporated by reference in this prospectus supplement and accompanying prospectus describe forward-looking information. The risk factors are not all-inclusive, particularly with respect to possible future events. Other parts of, or documents incorporated by reference into, our prospectus supplement and accompanying prospectus may also include forward-looking information. Many things can happen that can cause our actual results to be different than those described. These factors include, but are not limited to:

- risks that our growth will be limited if we cannot obtain additional capital;
- risks of financing, such as our ability to consummate additional financings on terms which are acceptable to us and the ability to meet existing financial covenants;
- risks that acquisitions may not be consummated;
- risks that our tenants will not pay rent or that our operating costs will be higher than expected;
- risks related to the automotive industry, such as the ability of our

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tenants to compete effectively in the automotive retail industry and the ability of our tenants to perform their lease obligations as a result of changes in any manufacturer's production, inventory, marketing or other practices;

- environmental and other risks associated with the acquisition and leasing of automotive properties; and
- risks related to our status as a real estate investment trust, commonly referred to as a REIT, for federal income tax purposes, such as the existence of complex regulations relating to our status as a REIT, the effect of future changes in REIT requirements as a result of new legislation and the adverse consequences if we fail to qualify as a REIT.

Given these uncertainties, readers are cautioned not to place undue reliance on these forward-looking statements or those incorporated into this prospectus supplement and the accompanying prospectus from our Current Report on Form 8-K/A filed on January 19, 2001. We also make no promise to update any of the forward-looking statements, or to publicly release the results if we revise any of them. You should carefully review the risks and the risk factors incorporated by reference into this prospectus supplement and the accompanying prospectus, as well as the other information in this prospectus supplement and the accompanying prospectus before buying our common shares.

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### SUMMARY

This summary may not contain all of the information that is important to you. You should carefully read the entire prospectus supplement and the accompanying prospectus, especially the "Risk Factors" section on page S-4 of this prospectus supplement and the "Where You Can Find Available Information" section on page 59 of the accompanying prospectus, as well as the documents incorporated by reference in this prospectus supplement and in the accompanying prospectus, before making an investment decision. Unless otherwise expressly stated or the context otherwise requires, all information in this prospectus supplement assumes that the underwriters' over-allotment option is not exercised.

### STRATEGY AND GENERAL INFORMATION

We are a self-administered and self-managed real estate company operating as a REIT for federal income tax purposes. Our primary business strategy is to purchase real estate (land, buildings and other improvements), which we simultaneously lease to operators of franchised automobile dealerships and motor vehicle service, repair, parts or other related businesses under long-term, triple-net leases. Triple-net leases typically require the tenant to pay all operating expenses of a property, including, but not limited to, all real estate taxes, assessments and other government charges, insurance, utilities, repairs and maintenance. We focus on buying properties from dealer groups that have a long history of operating multi-site, multi-franchised dealerships, generally targeting the largest dealer groups in terms of revenues in the largest metropolitan areas in the U.S. in terms of population.

Industry sources estimate that the real property and improvements associated with the approximately 22,250 franchised automobile dealerships throughout the U.S. are worth in excess of \$50 billion, of which we estimate approximately \$15 to \$18 billion would meet our acquisition criteria. We believe that we are the only real estate company to focus exclusively on acquiring dealership properties. At this time, we are not aware of any other entity that is pursuing, or intends to pursue, our strategy of acquiring dealership

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properties and simultaneously leasing the properties to dealer groups on a long-term, triple-net basis.

Our sale-leaseback acquisition structure allows dealer groups to achieve liquidity and diversify their investments while maintaining ownership and control of the operations of the dealership. Dealer groups frequently use the proceeds received upon the sale of property to us for future growth, including acquisitions, expansions or funding of other lines of business. Sellers also can achieve the flexibility to pursue personal goals such as estate and other tax planning.

As of June 30, 2001, we had invested approximately \$1.1 billion in 251 properties located in 27 states, comprising approximately 1,644 acres of land and containing approximately 9.2 million square feet of buildings and improvements. Our tenants operate 376 motor vehicle franchises on our properties, representing 39 brands of motor vehicles. As of June 30, 2001, all of our properties (excluding one parcel valued at approximately \$500,000 and acquired with another property at no additional cost), were 100% leased under long-term leases which were performing and in full force and effect.

### BUSINESS OBJECTIVE

The objective of our business strategy is to provide long-term, predictable, stable cash flow in order to maximize shareholder value.

We believe that developments in, and the nature of, the automotive retail industry help provide us with this steady cash flow because:

- The primary source of profits for many dealerships has shifted from new motor vehicle sales to used motor vehicle sales, parts and service. Revenues from used motor vehicle sales, parts and service tend to increase during economic downturns as consumers generally retain their vehicles longer or consider the purchase of less expensive used vehicles. In general, this shift has made the dealership less dependent on new motor vehicle sales and more stable in all economic environments.

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- The recent consolidation of the ownership of dealerships has allowed us to target larger dealer groups which typically offer a greater diversity of brands of motor vehicles, thus minimizing the potential adverse impact of changes in consumer preferences or manufacturer-specific issues.
- Franchise agreements, under which dealerships operate, often limit the ability of the dealership to move its location, which makes long-term leases attractive and increases the likelihood that our tenants will renew their leases.

To achieve this objective of long-term, predictable, stable cash flow, we are:

- diversifying both geographically and by brand of motor vehicles offered by franchised automobile dealerships operated by our tenants in order to minimize the potential adverse impact of economic downturns in certain markets, changes in consumer preferences or manufacturer-specific issues;
- utilizing credit underwriting and monitoring standards for prospective and existing tenants that focus on credit history, liquidity, tangible net worth, historical profitability and rent and other cash flow coverage ratios, and, in connection with our real estate analysis, stressing market valuation, location, market characteristics, retail dynamics, age and condition of improvements and environmental condition;

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- acquiring only properties that are zoned for dealership operations, and simultaneously with our purchase, leasing the properties to dealer groups on a long-term, triple-net basis;
- requiring cross-guarantees (or guarantees by a parent) of all leases within a dealer group; and
- minimizing interest rate risk by generally matching the term of our leases with that of our debt as well as the types of leases with the types of debt (fixed or variable) in order to maintain an investment spread over the lease term.

### RECENT DEVELOPMENTS

PROPERTIES SUBJECT TO ACQUISITION AGREEMENT. On July 20, 2001, we entered into an agreement with a seller to purchase nine automotive retail properties located in seven states for approximately \$102.4 million. We expect to pay for the properties with approximately \$48.7 million in long-term debt and approximately \$53.7 million from the net proceeds of this offering. These properties are expected to have initial lease terms of 15 years, with multiple renewal options exercisable at the option of the tenant. The pending acquisition, which is expected to close during the third quarter of 2001, is subject to our completion of due diligence and to customary closing conditions. We believe that this acquisition will be accretive to our FFO and AFFO on a diluted basis in 2002. An explanation of FFO and AFFO is set forth below under "-- Funds from Operations and Adjusted Funds from Operations Increases." There can be no assurance that we will complete this acquisition on the terms described or at all.

RECENT PROPERTY ACQUISITIONS. During the second quarter of 2001, we completed a total of approximately \$32.5 million of acquisitions in six separate transactions. The acquisitions included three dealership properties, two of which are operated by an existing tenant, and facility improvements and two construction fundings with existing tenants. We paid for the acquisitions with approximately \$31.8 million drawn on our short-term credit facilities and units of the Partnership valued at approximately \$0.7 million at the time of acquisition. These acquisitions added approximately 181,000 square feet of buildings and improvements on approximately 24 acres of land in five states (California, New Jersey, Oregon, Texas and Virginia). These properties have initial lease terms ranging from 10 to 20 years, with a weighted average initial lease term of 12.1 years. The leases, in general, have renewal options exercisable at the option of the tenant ranging from a total of 20 to 40 years.

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RENTAL REVENUE INCREASES. Our rental revenue for the three months ended June 30, 2001 increased 13% to \$28.4 million, as compared to \$25.0 million for the same quarter in 2000. Our rental revenue for the 12 months ended June 30, 2001 increased 16% to \$108.7 million, as compared to \$93.9 million for the 12 months ended June 30, 2000. The increases were primarily attributable to the growth of our real estate portfolio and the timing of our property acquisitions, from which we generate our rental income.

FUNDS FROM OPERATIONS AND ADJUSTED FUNDS FROM OPERATIONS INCREASES. Our FFO for the three months ended June 30, 2001 increased 14% to \$15.1 million, as compared to \$13.2 million for the same quarter in 2000. Our FFO for the 12 months ended June 30, 2001 increased 13% to \$56.8 million, as compared to \$50.5 million for the 12 months ended June 30, 2000. AFFO, which is FFO excluding straight-lined rents, for the three months ended June 30, 2001 increased 12% to \$14.2 million, as compared to \$12.7 million for the same quarter in 2000. AFFO for the 12 months ended June 30, 2001 increased 11% to \$53.9 million, as

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compared to \$48.5 million for the 12 months ended June 30, 2000.

FFO is defined under the revised definition adopted in October 1999 by the National Association of Real Estate Investment Trusts (NAREIT) as net income (loss) before minority interest (computed in accordance with GAAP) excluding gains (or losses) from sales of property, plus depreciation and amortization of assets unique to the real estate industry, and after adjustments for unconsolidated partnerships and joint ventures. NAREIT developed FFO as a relative measure of performance and liquidity of an equity REIT in order to recognize that income-producing real estate historically has not depreciated on the basis determined under GAAP. FFO does not represent cash flows from operating activities in accordance with GAAP (which, unlike FFO, generally reflect all cash effects of transactions and other events in the determination of net income) and should not be considered an alternative to net income as an indication of our performance or to cash flow as a measure of liquidity or ability to make distributions. We consider FFO a meaningful, additional measure of operating performance primarily because it excludes the assumption that the value of the real estate assets diminishes predictably over time, and because industry analysts have accepted it as a performance measure. Comparison of our presentation of FFO, using the NAREIT definition, to similarly titled measures for other REITs may not necessarily be meaningful due to possible differences in the application of the NAREIT definition used by other REITs.

**QUARTERLY DIVIDEND INCREASES.** On July 17, 2001, we announced our 14th consecutive increase in the quarterly dividend on our common shares. The amount of the quarterly dividend for the quarter ended June 30, 2001 was increased to \$0.387 per share from \$0.386 per share for an annualized rate of \$1.548 per share. The dividend is payable on August 21, 2001 to shareholders of record on August 10, 2001. You will be entitled to receive the dividend for the second quarter 2001 as long as you continue to be a holder of record on the record date for the dividend.

**RECENT FINANCING COMMITMENT.** On June 6, 2001, we received a commitment for \$150.0 million of secured financing from Toyota Financial Services. The commitment can be drawn down in multiple fundings under one or more debt instruments. We anticipate drawing upon this commitment to fund a portion of the purchase price of the properties described under "-- Properties Subject to Acquisition Agreement" above, as well as future acquisitions, and to repay amounts outstanding under our short-term credit facilities. Borrowings under the commitment are subject to customary conditions precedent and lender's satisfaction with the loan documentation.

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### THE OFFERING

Securities offered.....	3,350,000 common shares, plus up to an additional 502,500 common shares to cover the underwriters' over-allotment option.
Shares and units to be outstanding after this offering.....	33,515,684(1)
Use of proceeds.....	We will use the net proceeds from the offering, including any net proceeds received upon exercise of the underwriters' over-allotment option, to fund a portion of the purchase price of the properties described under "-- Recent Developments -- Properties Subject to Acquisition Agreement" above. See "Use of Proceeds" on page S-14.

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Risk factors..... See the "Risk Factors" section on page S-4 and other information contained herein for a discussion of factors you should carefully consider before deciding to invest in our common shares.

Nasdaq National Market symbol..... "CARS"

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(1) Based on the number of common shares and units of the Partnership outstanding as of August 2, 2001. Excludes common shares issuable upon (i) the exercise of outstanding warrants and (ii) the exercise of outstanding options under our stock incentive plan.

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### CAPITAL AUTOMOTIVE REIT

#### GENERAL

Capital Automotive REIT is a self-administered and self-managed real estate company operating as a REIT for federal income tax purposes. We own interests in real estate and conduct our operations, directly or indirectly, through the Partnership. We are the sole general partner of the Partnership and, as of June 30, 2001, owned an approximately 71.8% interest in the Partnership.

As of June 30, 2001, we had invested approximately \$1.1 billion in 251 properties located in 27 states, comprising approximately 1,644 acres of land and containing approximately 9.2 million square feet of buildings and improvements. Our tenants operate 376 motor vehicle franchises on our properties, representing 39 brands of motor vehicles.

Our principal executive offices are located at 1420 Spring Hill Road, Suite 525, McLean, Virginia 22102 and our telephone number is (703) 288-3075. Our Web site address is [www.capitalautomotive.com](http://www.capitalautomotive.com). The information contained on our Web site is not a part of this prospectus supplement or the accompanying prospectus.

#### THE AUTOMOTIVE RETAIL INDUSTRY

The automotive retail industry is the largest component of retail sales in the U.S., with sales (including sales of new and used vehicles, parts and service, and finance and insurance) during 2000 of over \$1 trillion. The industry is highly fragmented with approximately 22,250 franchised automobile dealerships. In recent years, ownership of these franchises has begun to consolidate with the emergence of large private and publicly-traded dealer groups, which we target as potential tenants. In fact, the five largest publicly-owned dealer groups in terms of new vehicle sales, AutoNation, Inc. (NYSE: AN), Sonic Automotive, Inc. (NYSE: SAH), UnitedAuto Group, Inc. (NYSE: UAG), Group 1 Automotive, Inc. (NYSE: GPI) and Lithia Motors, Inc. (NYSE: LAD), are included among our tenants.

Based on industry data, we believe that well-managed dealership operations have been profitable in all economic environments. In the past, new motor vehicle sales represented a large portion of a typical dealership's profits. Industry sources have estimated, however, that, over the past decade, only approximately 15% of a typical dealership group's profits were derived from new motor vehicle sales while approximately 85% of a typical dealer's profits were generated by used motor vehicle sales, parts and service -- areas that historically have performed well in all economic environments. During economic downturns, consumers generally retain their vehicles longer or consider the purchase of less expensive used vehicles -- both choices requiring more frequent service and replacement parts. We believe that increasing vehicle complexity,



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longer manufacturer warranties and the availability of extended new and used car warranties will also ensure that parts and service departments will continue to be primary dealership profit centers. Franchised automobile dealerships sell approximately 40% of all used vehicles. Manufacturers' certified used car programs and high-quality trade-ins allow dealerships to maintain this important revenue source. The shift in a dealership's primary source of profit from new motor vehicles sales to used motor vehicle sales, parts and service improves the stability of our tenant's operating cash flow and its ability to make lease payments in all economic environments.

The diversity of the brands of motor vehicles offered by large dealer groups is important to the stability of their cash flow. Because consumer preferences may not always align with manufacturers' products, these large dealer groups discovered that brand diversity is necessary to sustain profitability over long periods of time. Brand diversification by these large dealer groups makes them more resistant to changes in consumer preferences and other manufacturer-related issues.

Franchised automobile dealerships operate under franchise agreements with automobile manufacturers. These agreements generally grant the dealership an exclusive market area for a particular brand of motor vehicle. Because of these agreements, dealer groups are often limited in their ability to move their

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dealership locations. Accordingly, long-term leases are attractive to dealer groups and the likelihood that our tenants will renew their leases is increased.

### BUSINESS AND ACQUISITION STRATEGY

Our primary business strategy is to purchase real estate (land, buildings and other improvements), which we simultaneously lease to operators of franchised automobile dealerships and motor vehicle service, repair, parts or other related businesses under long-term, triple-net leases. Triple-net leases typically require the tenant to pay all operating expenses of a property, including, but not limited to, all real estate taxes, assessments and other government charges, insurance, utilities, repairs and maintenance. We focus on buying properties from dealer groups that have a long history of operating multi-site, multi-franchised dealerships, generally targeting the largest dealer groups in terms of revenue in the largest metropolitan areas in the U.S. in terms of population. We believe that we are the only real estate company exclusively pursuing this strategy. The objective of our strategy is to provide long-term, predictable, stable cash flow for our shareholders.

We fund the purchase of properties with cash from operations, proceeds from debt or equity financings, the assumption of existing debt, newly issued units of the Partnership, or a combination of the foregoing. We generally lease our properties to established, creditworthy tenants, for a period of 10 to 20 years. The tenant usually has the option to renew the lease on the same terms and conditions for one or more additional periods of five to 10 years each.

When we evaluate prospective tenants and potential properties for purchase, we consider such factors as:

- the management, operating experience and reputation of the dealer group;
- the dealer group's credit history, liquidity, tangible net worth, historical profitability and rent and other cash flow coverage ratios;
- the geographic area in which the property is located;

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- the market value of the land, buildings and other improvements, the potential for alternative uses and the likelihood that the properties will retain value, or potentially, appreciate in value;
- the construction quality, condition and design of the dealership buildings and other improvements located on the property;
- the environmental condition of the real estate;
- the brands of motor vehicles offered by the franchised automobile dealerships operated by the dealer group; and
- competitive conditions in the vicinity of the property.

For our existing tenants, we have a program that can fund significant facility improvements and expansions for properties in our portfolio. Under this program, the cost of the improvements is added to the existing lease, which is reset to the original term when the funding is completed. In certain circumstances, we will also provide commitments to purchase newly constructed dealerships or fund new construction.

We believe that because of the unique requirements of dealerships, these properties are a discrete sector of the national retail real estate industry. Based on industry sources, we estimate that the real property and improvements associated with franchised automobile dealerships are worth in excess of \$50 billion, of which we estimate approximately \$15 to \$18 billion would meet our acquisition criteria. We believe that these properties present attractive acquisition opportunities because they generally have zoning which permits dealership operations as well as a wide range of alternative uses and locations with frontage on and visibility from major thoroughfares. In the event that a property becomes unsuitable for dealership use, the property could typically be redeveloped for other commercial uses.

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### DEBT STRATEGY

We have adopted a policy to limit debt to approximately 65% of our assets (calculated as total assets plus accumulated depreciation). As of June 30, 2001, our debt was approximately 56.5% of our assets. This policy may be changed by our Board of Trustees at any time without shareholder approval. In addition, to minimize interest rate risk, we generally match the term of our long-term leases with that of our debt as well as the type of leases with the type of debt (fixed or variable) in order to maintain an investment spread over the lease term. We describe this process as "match-funding." Our previous intent was to substantially match-fund at least 85% of our total outstanding debt with long-term leases. Due to the current divergence between interest rates for fixed and floating rate debt, we have elected to reduce our match-funding guideline to at least 70%. This reduction provides us with additional flexibility. We may further change the guideline at any time without shareholder approval. As of June 30, 2001, approximately 83% of our debt outstanding was substantially match-funded and non-recourse to us. As of June 30, 2001, our long-term debt had a weighted average remaining term of 10.9 years, and our leases had a weighted average remaining lease term of 11.4 years.

As of June 30, 2001, we had total debt outstanding of \$626.8 million. Of this debt, approximately \$564.7 million (consisting of \$476.3 million of fixed rate and \$88.4 million of variable rate debt) was mortgage debt secured by approximately 210 of our properties. In addition, we had \$62.1 million outstanding on our revolving credit facilities. Our earliest significant debt maturity is not until 2011.

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### BUSINESS OBJECTIVE

To achieve our objective of long-term, predictable cash flow to maximize shareholder value, we are:

- diversifying geographically and acquiring properties located predominately in major metropolitan areas in order to minimize the potential adverse impact of economic downturns in certain markets;
- diversifying by brand of motor vehicles offered by franchises operated by our tenants to minimize the potential adverse impact of changes in consumer preferences or manufacturer-specific issues (for example, work stoppages causing delays in availability of specific models);
- "partnering" with those dealer groups leading the consolidation that is occurring in the automobile retail industry;
- leveraging the contacts and experience of our management to build and maintain long-term relationships with dealer groups;
- acquiring only properties that are zoned for dealership operations, and simultaneously with our purchase, leasing the properties to dealer groups on a long-term, triple-net basis, thereby minimizing brokerage, re-leasing and similar costs and, due to the historical and long-term operation of dealerships at property locations, increasing the likelihood that our tenants will renew their leases;
- requiring cross-guarantees (or guarantees by a parent) of all leases within a dealer group;
- requiring our tenants to submit financial and other information, generally quarterly, to ensure compliance with financial covenants, such as minimum tangible net worth and rental cash flow coverage ratios;
- minimizing interest rate risk by substantially match-funding our long-term leases with debt; and
- utilizing a variety of financing sources, such as the issuance of units of the Partnership, or other equity securities or debt securities, or a combination thereof.

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We believe that our business and acquisition strategy provides dealer groups with an opportunity to:

- achieve liquidity, while maintaining ownership and control of the operations of the dealerships;
- diversify their investments;
- obtain funds to expand the operations of the dealer groups;
- facilitate family and/or estate planning; and
- benefit from an attractive tax deferred real estate solution (for example, our "UPREIT" structure allows us to acquire properties in exchange for units of the Partnership, thereby giving the sellers the benefit of being able to defer some or all of the taxable gain they otherwise would have incurred on the sale of their properties, a

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structure which enhances our ability to consummate transactions).

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### SELECTED FINANCIAL INFORMATION (DOLLARS IN THOUSANDS, EXCEPT PER SHARE DATA)

The following information is unaudited and was derived from our consolidated financial statements. The information is only a summary and does not provide all of the information contained in our consolidated financial statements, including the related notes, Management's Discussion and Analysis of Financial Condition and Results of Operations, and Quantitative and Qualitative Disclosures about Market Risk, which are part of our Annual Report on Form 10-K for the year ended December 31, 2000. You should read our financial statements and other information filed with the SEC. Information as of and for the six months ended June 30, 2001 does not purport to be indicative of our financial condition or results of operations to be expected as of and for the year ending December 31, 2001.

	FOR THE SIX MONTHS ENDED JUNE 30,		FOR THE YEARS ENDED DECEMBER 31,			FOR T OCTO (DATE TO
	2001	2000	2000	1999	1998	-----
<b>OPERATING DATA:</b>						
Total revenues.....	\$ 56,481	\$ 50,440	\$ 103,151	\$ 75,873	\$ 34,931	
Depreciation and amortization expense.....	\$ 10,155	\$ 8,654	\$ 17,725	\$ 15,347	\$ 6,304	
General and administrative expense.....	\$ 3,445	\$ 3,324	\$ 6,592	\$ 6,781	\$ 5,487	
Interest expense.....	\$ 23,495	\$ 20,632	\$ 42,694	\$ 24,541	\$ 2,254	
Minority interest(1).....	\$ (5,449)	\$ (5,092)	\$ (10,328)	\$ (7,473)	\$ (4,395)	
Net income (loss).....	\$ 13,937	\$ 12,738	\$ 25,812	\$ 21,731	\$ 16,491	
Diluted earnings per share.....	\$ 0.63	\$ 0.61	\$ 1.22	\$ 1.01	\$ 0.79	
<b>OTHER DATA:</b>						
FFO(2).....	\$ 29,506	\$ 26,124	\$ 53,455	\$ 44,205	\$ 27,047	
AFFO(2).....	\$ 27,869	\$ 25,095	\$ 51,096	\$ 43,243	\$ 27,047	
Weighted average number of common shares and units outstanding - diluted (000's).....	30,673	29,361	29,476	28,796	26,228	
Cash dividends declared per common share.....	\$ 0.773	\$ 0.7375	\$ 1.50	\$ 1.38	\$ 0.876	
Properties owned at end of period.....	251	231	244	230	120	
	JUNE 30,		DECEMBER 31,			
	2001	2000	2000	1999	1998	-----
<b>BALANCE SHEET DATA:</b>						
Real estate before accumulated depreciation.....	\$1,089,384	\$951,745	\$1,037,870	\$935,525	\$511,132	

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Total assets.....	1,060,277	943,221	1,021,589	942,559	583,211
Mortgage loans.....	564,707	508,631	571,519	501,510	161,997
Borrowings under credit facilities.....	62,140	9,500	14,200	--	--
Total other liabilities.....	12,235	12,037	30,109	26,066	18,659
Minority interest.....	118,687	118,249	115,728	115,384	93,898
Total stockholders' equity (deficit).....	302,508	294,804	290,033	299,599	308,657

- 
- (1) Minority interest represents income attributable to the units of the Partnership owned by limited partners (other than us) of the Partnership.
- (2) FFO and AFFO are described under "Summary -- Recent Developments -- Funds from Operations and Adjusted Funds from Operations Increases."

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### USE OF PROCEEDS

The net proceeds from the sale of common shares in this offering, after deducting the discounts and commissions to the underwriters and other estimated expenses of this offering payable by us, are estimated to be approximately \$53.7 million (approximately \$61.8 million if the underwriters' over-allotment option is exercised in full). We intend to use all of the net proceeds to fund a portion of the purchase price of the properties described under "Summary -- Recent Developments -- Properties Subject to Acquisition Agreement."

Pending their application, we may use the net proceeds to temporarily reduce amounts outstanding under our short-term credit facilities or may invest the net proceeds in short-term, income-producing investments. In the event that we do not acquire the properties, we intend to use all of the net proceeds to repay outstanding indebtedness, to fund other property acquisitions or for general corporate purposes.

### CAPITALIZATION

The following table sets forth our unaudited historical capitalization as of June 30, 2001 and as adjusted to show, as if these transactions had occurred on June 30, 2001, the effects of (i) the acquisition of the properties subject to an acquisition agreement and related financings as more fully described under "Summary -- Recent Developments -- Properties Subject to Acquisition Agreement," and (ii) this offering and the application of the estimated net proceeds as described under "Use of Proceeds."

	AS OF JUNE 30, 2001	
	----- HISTORICAL -----	AS ADJUSTED -----
	(DOLLARS IN THOUSANDS)	
DEBT:		
Mortgage debt.....	\$ 564,707	\$ 613,378
Borrowings under credit facilities.....	62,140	62,140
	-----	-----
Total debt.....	626,847	675,518
MINORITY INTEREST.....	118,687	120,445
SHAREHOLDERS' EQUITY:		

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Common Shares, par value \$.01 per share, 100 million shares authorized, 21,661,583 shares issued and outstanding historical; 25,011,583 shares issued and outstanding as adjusted.....	217	251
Preferred Shares, par value \$.01 per share, 20 million shares authorized, no shares issued or outstanding historical; no shares issued or outstanding as adjusted.....	--	--
Additional paid-in capital.....	314,755	366,680
Accumulated deficit.....	(12,464)	(12,464)
	-----	-----
Total shareholders' equity.....	302,508	354,467
	-----	-----
Total capitalization.....	\$1,048,042	\$1,150,430
	=====	=====

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### PRICE RANGE OF COMMON SHARES AND DISTRIBUTION POLICY

Our common shares have traded on the Nasdaq National Market under the symbol "CARS" since February 13, 1998 (the date of our initial public offering). Listed below are the high and low sales prices of our common shares as reported on the Nasdaq National Market and the distributions declared for each of the periods indicated.

	PRICE PER SHARE		DISTRIBUTION DECLARED PER S
	HIGH	LOW	
	-----	-----	-----
2001			
Third quarter (through August 2).....	\$18.4800	\$16.810	--
Second quarter.....	18.9500	15.360	\$0.3870 (1)
First quarter.....	16.1875	12.875	0.3860
2000			
Fourth quarter.....	\$14.5625	\$12.375	\$0.3850
Third quarter.....	15.6250	12.000	0.3775
Second quarter.....	16.0625	11.500	0.3725
First quarter.....	13.0625	10.625	0.3650
1999			
Fourth quarter.....	\$14.0000	\$11.625	\$0.3600
Third quarter.....	13.7500	12.000	0.3500
Second quarter.....	13.7500	11.375	0.3400
First quarter.....	15.1875	11.250	0.3300

-----  
 (1) The Board of Trustees has declared a dividend of \$0.387 per share payable on August 21, 2001 to shareholders of record on August 10, 2001. You will be entitled to receive this dividend as long as you continue to be a holder of record on the record date for the dividend.

On August 2, 2001, the last reported sale price on the Nasdaq National Market was \$17.01 per share. As of June 30, 2001, there were approximately 250 holders of record of our common shares. We believe the total number of our beneficial shareholders to be approximately 4,000 because certain common shares are held of record by depositories, brokers and other nominees.

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We intend to continue to pay regular quarterly distributions to holders of our common shares. Future distributions, however, will be at the discretion of our Board of Trustees and will depend on our actual FFO, financial condition, capital requirements, the annual distribution requirements under the REIT provisions of the Code and such other factors as our Board of Trustees deems relevant.

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### PROPERTIES

#### GENERAL

As of June 30, 2001, we owned 251 properties, representing 376 motor vehicle franchises, with a total investment of approximately \$1.1 billion. These properties total approximately 9.2 million square feet of buildings and improvements on approximately 1,644 acres of land in 27 states. Our interest in each of the properties includes the land, buildings and improvements, related easements and rights and most fixtures. We do not own or lease any significant amount of personal property, furniture or equipment at any property. As of June 30, 2001, all of our properties (excluding one parcel valued at approximately \$500,000 and acquired with another property at no additional cost), were 100% leased under long-term leases which were performing and in full force and effect.

Our properties generally consist of the land or a leasehold interest in land and one or more retail showrooms, office space, adjacent service and repair facilities, parts and accessories departments, and in many cases, acreage set aside for used car sales, body shops, parking for inventory, vehicles awaiting service and future development. Land sizes for our properties typically range from one acre to 20 acres. The properties generally are zoned for a variety of commercial uses and typically have frontage on major transportation arteries with high traffic patterns, high visibility, signage and ease of ingress and egress.

#### TENANT AND BRAND DIVERSIFICATION

As of June 30, 2001, our properties were leased to 46 different dealer groups. Our tenants operate 376 motor vehicle franchises on these properties, representing 39 brands of motor vehicles, consisting of Acura, Audi, BMW, Buick, Cadillac, Chevrolet, Chrysler, Daewoo, Dodge, Dodge Trucks, Ford, Freightliner, GMC, GMC Truck, Honda, Hyundai, Infiniti, Isuzu, Jaguar, Jeep, Kia, Land Rover, Lexus, Lincoln-Mercury, Mazda, Mercedes-Benz, Mitsubishi, Nissan, Oldsmobile, Plymouth, Pontiac, Porsche, Saab, Saturn, Subaru, Suzuki, Toyota, Volkswagen and Volvo. No single brand of motor vehicle had an "allocated value" of 10% or more of our total real estate investments as of June 30, 2001. We allocate value to our franchises by dividing the amount we paid for a particular property by the number of franchises located on that property.

Properties operated as franchised automobile dealerships (including related motor vehicle service, repair, parts and body shops on the same parcel of land) represented approximately 90% of our total real estate investments as of June 30, 2001. In addition to these properties, we own additional properties, including raw land and properties on which our tenants operate motor vehicle service, repair, parts or other related businesses, the majority of which are operated by dealer groups. Only one tenant accounted for 8% or more of our total annualized rental revenue as of June 30, 2001. Sonic Automotive, Inc. (NYSE: SAH) and its affiliates, the tenant of 68 of our properties, accounted for 26% of our total annualized rental revenue as of June 30, 2001.

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GEOGRAPHIC DIVERSIFICATION

We invest in properties throughout the United States. As of June 30, 2001, we owned properties in 27 states, with approximately 70% of our total real estate investments in the top 50 metropolitan areas in terms of population and approximately 97% of our total real estate investments in metropolitan areas, according to the most recent data (April 2000) published by the U.S. Census Bureau on metropolitan statistical areas (MSAs) and primary metropolitan statistical areas (PMSAs). The following table specifies the metropolitan areas in which we own properties representing at least 1% of our total real estate investments as of June 30, 2001.

METROPOLITAN AREA(1)	NUMBER OF PROPERTIES	TOTAL REAL ESTATE INVESTMENT	PERCENTAGE OF REAL ESTATE I
Washington, DC-MD-VA-WV.....	25	\$ 146,768,227	13.4
Houston, TX.....	23	146,158,077	13.4
Dallas, TX.....	10	60,644,040	5.5
Charlotte-Gastonia-Rock Hill, NC-SC.....	12	59,630,515	5.4
St. Louis, MO-IL.....	9	41,876,263	3.8
Atlanta, GA.....	5	33,589,647	3.0
Fort Wayne, IN.....	9	30,472,089	2.8
Columbus, OH.....	6	25,686,579	2.3
San Antonio, TX.....	5	22,435,227	2.0
Medford-Ashland, OR.....	6	21,492,838	1.9
South Bend, IN.....	3	21,364,178	1.9
Los Angeles-Long Beach, CA.....	4	20,327,301	1.8
Daytona Beach, FL.....	7	20,100,638	1.8
Shreveport-Bossier City, LA.....	9	18,723,589	1.7
New Orleans, LA.....	3	18,539,781	1.7
Fort Worth-Arlington, TX.....	2	17,133,863	1.5
Montgomery, AL.....	3	16,964,772	1.5
Denver, CO.....	2	16,273,211	1.4
Salt Lake City-Ogden, UT.....	4	16,229,091	1.4
Cleveland-Lorain-Elyria, OH.....	5	15,983,402	1.4
Fort Myers-Cape Coral, FL.....	4	14,330,519	1.3
Las Vegas, NV-AZ.....	1	14,238,341	1.3
Chattanooga, TN-GA.....	6	13,302,118	1.2
Amarillo, TX.....	4	13,275,948	1.2
Miami, FL.....	3	12,705,731	1.1
Nashville, TN.....	2	12,000,529	1.1
Other(2).....	79	239,137,068	21.9
Total.....	251	\$1,089,383,582	100.0

(1) Derived from the most recent published data (April 2000) of the U.S. Census Bureau regarding population of MSAs and PMSAs.

(2) Represents each area in which we own properties that represents less than 1% of our total real estate investments.

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### LEASES AND LEASE EXPIRATIONS

Substantially all of our properties are leased under long-term, triple-net leases, under which the tenants typically pay all operating expenses of a property, including, but not limited to, all real estate taxes, assessments and other government charges, insurance, utilities, repairs and maintenance. We believe that our properties are covered by adequate commercial general, fire, flood and extended loss insurance provided by reputable companies, with commercially reasonable deductibles and limits.

Our properties are subject to leases with initial terms that range generally from 10 to 20 years, with a weighted average initial lease term of approximately 13.6 years. As of June 30, 2001, the weighted average remaining lease term for our leases was approximately 11.4 years. The leases typically have options to renew upon the same terms and conditions for one or more additional periods of five to 10 years each exercisable at the option of the tenant (ranging from a total of five to 40 years). With respect to the leases for properties acquired from Sonic Automotive during August 1999, Sonic Automotive is required to renew, for an additional five years, the initial terms of leases representing 75% of the total rental payments for such Sonic Automotive leases expiring in any given year. The calculation of weighted average initial lease term and weighted average remaining lease term assumes that Sonic Automotive renews leases as specified above.

The following table sets forth the schedule of lease expirations for our 235 leases in place as of June 30, 2001 for each of the 20 years beginning with 2001, assuming that (i) none of the tenants (other than Sonic Automotive) exercises or has exercised renewal options, (ii) Sonic Automotive renews leases as specified above and (iii) the number of leases Sonic Automotive renews in any given year equals 75% of the total number of Sonic Automotive leases expiring that year (rounded to the closest whole number).

YEAR OF LEASE EXPIRATION -----	NUMBER OF EXPIRING LEASES -----	TOTAL RENTAL REVENUE REPRESENTED BY EXPIRING LEASES (IN THOUSANDS) -----	PERCENT TOTAL AN RENTAL REPRESE EXPIRING -----
2001.....	--	--	
2002.....	--	--	
2003.....	--	--	
2004.....	--	--	
2005.....	--	--	
2006.....	1	\$ 154	0
2007.....	6	2,291	2
2008.....	28	14,591	13
2009.....	19	10,564	9
2010.....	7	2,582	2
2011.....	13	5,457	4
2012.....	10	3,069	2
2013.....	74	33,623	30
2014.....	52	27,716	24
2015.....	12	4,882	4
2016.....	5	1,972	1
2017.....	--	--	
2018.....	2	192	0
2019.....	1	525	0
2020.....	4	3,496	3

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2021 and thereafter..... 1 957

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FEDERAL INCOME TAX CONSEQUENCES

The following sections summarize the federal income tax issues that you may consider relevant. Because this section is a summary, it does not address all of the tax issues that may be important to you. In addition, this section does not address the tax issues that may be important to certain types of shareholders that are subject to special treatment under the federal income tax laws, such as insurance companies, tax-exempt organizations (except to the extent discussed in "-- Taxation of Tax-Exempt U.S. Shareholders" below), financial institutions and broker-dealers, and non-U.S. individuals and foreign corporations (except to the extent discussed in "-- Taxation of Non-U.S. Shareholders" below).

The statements in this section are based on the current federal income tax laws governing our qualification as a REIT. We cannot assure you that new laws, interpretations of laws or court decisions, any of which may take effect retroactively, will not cause any statement in this section to be inaccurate.

We urge you to consult your own tax advisor regarding the specific federal, state, local, foreign and other tax consequences to you of purchasing, owning and disposing of our securities, our election to be taxed as a REIT and the effect of potential changes in applicable tax laws.

TAXATION OF CAPITAL AUTOMOTIVE REIT

We elected to be taxed as a REIT under the federal income tax laws when we filed our 1998 tax return. We have operated in a manner intended to qualify as a REIT and we intend to continue to operate in that manner. This section discusses the laws governing the federal income tax treatment of a REIT and its shareholders. These laws are highly technical and complex.

In the opinion of our tax counsel, Shaw Pittman LLP, (i) we qualified as a REIT under Sections 856 through 859 of the Code with respect to our taxable years ended through December 31, 2000; and (ii) we are organized in conformity with the requirements for qualification as a REIT under the Code and our current and proposed method of operation will enable us to meet the requirements for qualification as a REIT for the current taxable year and for future taxable years, provided that we have operated and continue to operate in accordance with various assumptions and factual representations made by us concerning our business, properties and operations. We may not, however, have met or continue to meet such requirements. You should be aware that opinions of counsel are not binding on the IRS or any court. Our qualification as a REIT depends on our ability to meet, on a continuing basis, certain qualification tests set forth in the federal tax laws. Those qualification tests involve the percentage of income that we earn from specified sources, the percentage of our assets that fall within certain categories, the diversity of the ownership of our shares, and the percentage of our earnings that we distribute. We describe the REIT qualification tests in more detail below. Shaw Pittman LLP will not monitor our compliance with the requirements for REIT qualification on an ongoing basis. Accordingly, no assurance can be given that our actual operating results will satisfy the qualification tests. For a discussion of the tax treatment of us and our shareholders if we fail to qualify as a REIT, see "-- Requirements for REIT Qualification -- Failure to Qualify."

If we qualify as a REIT, we generally will not be subject to federal income tax on the taxable income that we distribute to our shareholders. The benefit of that tax treatment is that it avoids the "double taxation" (i.e., at both the

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corporate and stockholder levels) that generally results from owning stock in a corporation. However, we will be subject to federal tax in the following circumstances:

- we will pay federal income tax on taxable income (including net capital gain) that we do not distribute to our shareholders during, or within a specified time period after, the calendar year in which the income is earned;
- we may be subject to the "alternative minimum tax" on any items of tax preference that we do not distribute or allocate to our shareholders;

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- we will pay income tax at the highest corporate rate on (i) net income from the sale or other disposition of property acquired through foreclosure that we hold primarily for sale to customers in the ordinary course of business and (ii) other non-qualifying income from foreclosure property;
- we will pay a 100% tax on net income from certain sales or other dispositions of property (other than foreclosure property) that we hold primarily for sale to customers in the ordinary course of business ("prohibited transactions");
- if we fail to satisfy the 75% gross income test or the 95% gross income test (as described below under "-- Requirements for REIT Qualification -- Income Tests"), and nonetheless continue to qualify as a REIT because we meet certain other requirements, we will pay a 100% tax on (i) the gross income attributable to the greater of the amount by which we fail the 75% or 95% gross income test, multiplied by (ii) a fraction intended to reflect our profitability;
- if we fail to distribute during a calendar year at least the sum of (i) 85% of our REIT ordinary income for such year, (ii) 95% of our REIT capital gain net income for such year, and (iii) any undistributed taxable income from prior periods, we will pay a 4% excise tax on the excess of such required distribution over the amount we actually distributed;
- we may elect to retain and pay income tax on our net long-term capital gain;
- if we acquire any asset from a C corporation (i.e., a corporation generally subject to full corporate-level tax) in a merger or other transaction in which we acquire a "carryover" basis in the asset (i.e., basis determined by reference to the C corporation's basis in the asset (or another asset)), we will pay tax at the highest regular corporate rate applicable if we recognize gain on the sale or disposition of such asset during the 10-year period after we acquire such asset. The amount of gain on which we will pay tax is the lesser of (i) the amount of gain that we recognize at the time of the sale or disposition and (ii) the amount of gain that we would have recognized if we had sold the asset at the time we acquired the asset. The rule described in this paragraph will apply assuming that we make an election under Section 1.337(d)-5T(b) of the Treasury regulations upon our acquisition of an asset from a C corporation; and
- we will incur a 100% excise tax on transactions with a "taxable REIT subsidiary" that are not conducted on an arm's-length basis.

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### REQUIREMENTS FOR REIT QUALIFICATION

In order to qualify as a REIT, we must be a corporation, trust or association and meet the following requirements:

1. we are managed by one or more trustees or directors;
2. our beneficial ownership is evidenced by transferable shares, or by transferable certificates of beneficial interest;
3. we would be taxable as a domestic corporation, but for Sections 856 through 860 of the Code;
4. we are neither a financial institution nor an insurance company subject to certain provisions of the Code;
5. at least 100 persons are beneficial owners of our shares or ownership certificates;
6. not more than 50% in value of our outstanding shares or ownership certificates is owned, directly or indirectly, by five or fewer individuals (as defined in the Code to include certain entities) during the last half of any taxable year (the "5/50 Rule");
7. we elect to be a REIT (or have made such election for a previous taxable year) and satisfy all relevant filing and other administrative requirements established by the Internal Revenue Service that must be met to elect and maintain REIT status;

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8. we use a calendar year for federal income tax purposes and comply with the record keeping requirements of the Code and the related Treasury regulations; and
9. we meet certain other qualification tests, described below, regarding the nature of our income and assets.

We must meet requirements 1 through 4 during our entire taxable year and must meet requirement 5 during at least 335 days of a taxable year of 12 months, or during a proportionate part of a taxable year of less than 12 months. We were not required to meet requirements 5 and 6 during 1998. If we comply with all the requirements for ascertaining the ownership of our outstanding shares in a taxable year and have no reason to know that we violated the 5/50 Rule, we will be deemed to have satisfied the 5/50 Rule for such taxable year. For purposes of determining share ownership under the 5/50 Rule, an "individual" generally includes a supplemental unemployment compensation benefits plan, a private foundation, or a portion of a trust permanently set aside or used exclusively for charitable purposes. An "individual," however, generally does not include a trust that is a qualified employee pension or profit sharing trust under Code Section 401(a), and beneficiaries of such a trust will be treated as holding our shares in proportion to their actuarial interests in the trust for purposes of the 5/50 Rule.

We believe we have issued sufficient common shares with sufficient diversity of ownership to satisfy requirements 5 and 6 set forth above. In addition, our declaration of trust restricts the ownership and transfer of the common shares so that we should continue to satisfy requirements 5 and 6. The provisions of our declaration of trust restricting the ownership and transfer of the common shares are described in "Description of Shares of Beneficial Ownership -- Restrictions on Ownership and Transfer."

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We currently have several direct corporate subsidiaries and may have additional corporate subsidiaries in the future. A corporation that is a "qualified REIT subsidiary" is not treated as a corporation separate from its parent REIT. All assets, liabilities, and items of income, deduction, and credit of a qualified REIT subsidiary are treated as assets, liabilities, and items of income, deduction, and credit of the REIT. A qualified REIT subsidiary is a corporation, all of the capital stock of which is owned by the parent REIT. Thus, in applying the requirements described herein, any qualified REIT subsidiary of ours will be ignored, and all assets, liabilities, and items of income, deduction, and credit of such subsidiary will be treated as our assets, liabilities, and items of income, deduction, and credit. We believe our direct corporate subsidiaries are qualified REIT subsidiaries. Accordingly, they are not subject to federal corporate income taxation, though they may be subject to state and local taxation.

A REIT is treated as owning its proportionate share of the assets of any partnership in which it is a partner and as earning its allocable share of the gross income of the partnership for purposes of the applicable REIT qualification tests. Thus, our proportionate share of the assets, liabilities and items of income of the Partnership and of any other partnership or limited liability company treated as a partnership for federal income tax purposes in which we have acquired or will acquire an interest, directly or indirectly (a "Subsidiary Partnership"), are treated as our assets and gross income for purposes of applying the various REIT qualification requirements.

Tax legislation enacted in 1999 allows a REIT to own up to 100% of the capital stock of one or more taxable REIT subsidiaries, which we refer to as TRSs, beginning on January 1, 2001. A TRS is a fully taxable corporation that pays income tax at regular corporate rates on its taxable income. A TRS may earn income that would not be qualifying income if earned directly by the parent REIT. Both the subsidiary and the REIT must jointly elect to treat the subsidiary as a TRS. Overall, no more than 20% of the value of a REIT's assets may consist of securities of one or more TRSs. In addition, the TRS rules limit the deductibility of interest paid or accrued by a TRS to its parent REIT to assure that the TRS is subject to an appropriate level of corporate taxation. The rules also impose a 100% excise tax on transactions between a TRS and its parent REIT or the REIT's tenants that are not conducted on an arm's-length basis. Although we currently do not have any TRSs, we may form one or more TRSs in the future.

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INCOME TESTS. We must satisfy two gross income tests annually to maintain our qualification as a REIT:

- at least 75% of our gross income (excluding gross income from prohibited transactions) for each taxable year must consist of defined types of income that we derive, directly or indirectly, from investments relating to real property or mortgages on real property or temporary investment income (the "75% gross income test"). Qualifying income for purposes of the 75% gross income test includes "rents from real property," interest on debt secured by mortgages on real property or on interests in real property, dividends or other distributions on and gain from the sale of shares in other REITs, and gain from the sale of real property and mortgage loans; and
- at least 95% of our gross income (excluding gross income from prohibited transactions) for each taxable year must consist of income that is qualifying income for purposes of the 75% gross income test, other types of interest and dividends, gain from the sale or disposition of stock or

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securities, income from certain hedging transactions, or any combination of the foregoing (the "95% gross income test").

The following paragraphs discuss the specific application of these tests to us.

Rental Income. The Partnership's primary source of income derives from leasing properties to dealer groups. The leases generally are on a "triple-net" basis, requiring the tenants to pay substantially all expenses associated with the operation of the properties, such as real estate taxes, insurance, utilities, services, maintenance and other operating expenses and any ground lease payments.

Rents under the leases will constitute "rents from real property" only if the leases are treated as true leases for federal income tax purposes and are not treated as service contracts, joint ventures, financing arrangements or some other type of arrangement. The determination of whether the leases are true leases depends on an analysis of all surrounding facts and circumstances. In making such a determination, courts have considered a variety of factors, including the following:

- the intent of the parties;
- the form of the agreement;
- the degree of control over the property that is retained by the property owner (e.g., whether the tenant has substantial control over the operation of the property or whether the tenant was required simply to use its best efforts to perform its obligations under the agreement);
- the extent to which the property owner retains the risk of loss with respect to the operation of the property (e.g., whether the tenant bears the risk of increases in operating expenses or the risk of damage to the property); and
- the extent to which the property owner retains the burdens and benefits of ownership of the property.

We believe that each lease will be treated as a true lease for federal income tax purposes. Such belief is based, in part, on the following facts:

- the Partnership (or its subsidiaries, as the case may be) and the tenants intend for each relationship between them to be that of a lessor and lessee and such relationship will be documented by lease agreements;
- the tenants have the right to exclusive possession and use and quiet enjoyment of the properties during the term of the leases;
- the tenants bear the cost of, and are responsible for, day-to-day maintenance and repair of the properties, and dictate how the properties are operated, maintained and improved;
- the tenants bear all of the costs and expenses of operating the properties during the terms of the leases;

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- the tenants benefit from any savings in the costs of operating the properties during the terms of the leases;
- the tenants generally are required to indemnify the Partnership or its

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subsidiary against all liabilities imposed on the Partnership or its subsidiary during the term of the leases by reason of (a) injury to persons or damage to property occurring at the properties, or (b) the tenants' use, management, maintenance or repair of the properties;

- the tenants are obligated to pay rent for the period of use of the properties;
- the tenants stand to reap substantial gains (or incur substantial losses) depending on how successfully they operate the properties;
- the useful lives of the properties are significantly longer than the terms of the leases; and
- the Partnership or its subsidiary will receive the benefit of increases in value, and will bear the risk of decreases in value, of the properties during the terms of the leases.

If the IRS were to challenge successfully the characterization of the leases as true leases, the Partnership would not be treated as the owner of the property in question for federal income tax purposes and the Partnership would lose tax depreciation and cost recovery deductions with respect to such property, which in turn could cause us to fail to qualify as a REIT. See "-- Distribution Requirements."

Shareholders should be aware that there are no controlling Treasury regulations, published rulings, or judicial decisions involving leases with terms substantially similar to those contained in the leases that address whether such leases constitute true leases for federal income tax purposes. If the leases are recharacterized as financing arrangements or partnership agreements, rather than true leases, part or all of the payments that the Partnership receives from the tenants may not be considered rent or may not otherwise satisfy the various requirements for qualification as "rents from real property." In that case, we likely would not be able to satisfy either the 75% or 95% gross income test and, as a result, would lose REIT status. We received an opinion of counsel at the time of our initial public offering that the leases entered into at that time were true leases. We have also received an opinion of Shaw Pittman LLP that the leases entered into as of the date hereof are true leases. Such opinions are not binding on the IRS. We will use our best efforts to structure any leasing transaction for properties acquired in the future such that the lease will be characterized as a "true lease" and the Partnership will be treated as the owner of the property in question for federal income tax purposes. The Partnership has generally entered into leases substantially similar to those entered into at the time of the initial public offering. We will not seek an advance ruling from the IRS and do not intend to seek an opinion of counsel that the Partnership will be treated as the owner of any other leased properties for federal income tax purposes, and thus there can be no assurance that future leases will be treated as true leases for federal income tax purposes.

In addition, rent that the Partnership receives from real property that it owns and leases to tenants will qualify as "rents from real property" (which is qualifying income for purposes of the 75% and 95% gross income tests) only if several conditions are met under the REIT tax rules.

- The rent must not be based, in whole or in part, on the income or profits of any person although, generally, rent may be based on a fixed percentage or percentages of receipts or sales. The Partnership has not entered into any lease based in whole or part on the net income of any person and does not anticipate entering into such arrangements.
- Neither we nor someone who owns 10% or more of our shares may own 10% or

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more of a tenant from whom the Partnership receives rent. Our ownership and the ownership of a tenant is determined based on direct, indirect and constructive ownership. The constructive ownership rules generally provide that if 10% or more in value of our shares are owned, directly or indirectly, by or for any person, we are considered as owning the shares owned, directly or indirectly, by or for such person. The applicable attribution rules, however, are highly complex and difficult to apply, and the Partnership may inadvertently enter into leases with tenants who, through application of such rules,

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will constitute "related party tenants." In such event, rent paid by the related party tenant will not qualify as "rents from real property," which may jeopardize our status as a REIT. The Partnership will use its best efforts not to rent any property to a related party tenant (taking into account the applicable constructive ownership rules), unless we determine in our discretion that the rent received from such related party tenant is not material and will not jeopardize our status as a REIT. We believe that the Partnership has not leased property to any related party tenant.

- The rent attributable to any personal property leased in connection with a lease of property is no more than 15% of the total rent received under the lease. In general, the Partnership has not leased personal property under its current leases. If any incidental personal property has been leased, we believe that rent from the personal property would be less than 15% of total rent from that lease. If the Partnership leases personal property in connection with a future lease, it intends to satisfy the 15% test described above.
- The Partnership generally must not operate or manage its property or furnish or render services to its tenants, other than through an "independent contractor" who is adequately compensated and from whom the Partnership does not derive revenue. The Partnership may provide services directly, if the services are "usually or customarily rendered" in connection with the rental of space for occupancy only and are not otherwise considered "rendered to the occupant." In addition, the Partnership may render directly a de minimis amount of "non-customary" services to the tenants of a property without disqualifying the income as "rents from real property," as long as its income from the services does not exceed 1% of its income from the related property. The Partnership also may provide any type of services to its tenants through a TRS. The Partnership has not provided services to leased properties itself or through an independent contractor. In the future, the Partnership intends that any services provided will not cause rents to be disqualified as rents from real property.

Based on the foregoing, we believe that rent from leases should qualify as "rents from real property" for purposes of the 75% and 95% gross income tests. As described above, however, there can be no complete assurance that the IRS will not assert successfully a contrary position and, therefore, prevent us from qualifying as a REIT.

On an ongoing basis, we will use our best efforts not to cause the Partnership to:

- charge rent for any property that is based in whole or in part on the income or profits of any person (except by reason of being based on a percentage of receipts or sales, as described above);



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- rent any property to a related party tenant (taking into account the applicable constructive ownership rules), unless we determine in our discretion that the rent received from such related party tenant is not material and will not jeopardize our status as a REIT;
- derive rental income attributable to personal property (other than personal property leased in connection with the lease of real property, the amount of which is less than 15% of the total rent received under the lease); and
- perform services considered to be rendered to the occupant of the property, unless such services generate rents not in excess of 1% of all amounts received or accrued during the taxable year with respect to such property, other than through an independent contractor from whom we derive no revenue or if the provisions of such services will not jeopardize our status as a REIT.

Because the Code provisions applicable to REITs are complex, however, we may fail to meet one or more of the foregoing.

Interest Income. The Partnership may offer financing to dealer groups for the development of property used by dealerships and earn interest with respect to such financings. Those financings generally will be secured by the related real property. For purposes of the 75% and 95% gross income tests, amounts received or accrued (directly or indirectly), which are based in whole or in part on the income or profits of

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any person are generally not treated as interest. An amount received or accrued will generally be treated as interest even if it is based (1) on a fixed percentage or percentages of receipts or sales or (2) on the income or profits of a debtor if the debtor derives substantially all of its gross income from the related property through the leasing of substantially all of its interests in the property, but only to the extent the amounts received by the debtor would be characterized as "rents from real property" if received by a REIT. Furthermore, to the extent that interest from a loan that is based on the cash proceeds from the sale of the property securing the loan constitutes a "shared appreciation provision" (as defined in the Code), income attributable to such participation feature will be treated as gain from the sale of the secured property, which generally is qualifying income for purposes of the 75% and 95% gross income tests.

Interest on obligations secured by mortgages on real property or on interests in real property generally is qualifying income for purposes of the 75% gross income test. However, if the Partnership or a subsidiary receives interest income with respect to a loan that is secured by both real property and other property and the highest principal amount of the loan outstanding during a taxable year exceeds the fair market value of the real property on the date the Partnership or the subsidiary acquired the loan, the interest income from the loan will be apportioned between the real property and the other property. This apportionment may cause us to recognize income that is not qualifying income for purposes of the 75% gross income test. We intend to structure any such financing arrangement such that we will continue to qualify as a REIT.

Tax on Income From Property Acquired in Foreclosure. We will be subject to tax at the maximum corporate rate on any income from foreclosure property (other than income that would be qualifying income for purposes of the 75% gross income test), less expenses directly connected to the production of such income. "Foreclosure property" is any real property (including interests in real property) and any personal property incident to such real property:

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- that is acquired by a REIT at a foreclosure sale, or having otherwise become the owner or in possession of the property by agreement or process of law, after a default (or imminent default) on a lease of such property or on an indebtedness owed to the REIT secured by the property;
- for which the related loan was acquired by the REIT at a time when default was not imminent or anticipated; and
- for which the REIT makes a proper election to treat the property as foreclosure property.

A REIT will not be considered to have foreclosed on a property where it takes control of the property as a mortgagee-in-possession and cannot receive any profit or sustain any loss except as a creditor of the mortgagor. Generally, property acquired as described above ceases to be foreclosure property on the earlier of:

- the last day of the third taxable year following the taxable year in which the REIT acquired the property (or longer if an extension is granted by the Secretary of the Treasury);
- the first day on which a lease is entered into with respect to such property that, by its terms, will give rise to income that does not qualify under the 75% gross income test or any amount is received or accrued, directly or indirectly, pursuant to a lease entered into on or after the day that the REIT acquired the property that will give rise to income that does not qualify under the 75% gross income test;
- the first day on which any construction takes place on such property (other than completion of a building, or any other improvement, where more than 10% of the construction of such building or other improvement was completed before default became imminent); or
- the first day that is more than 90 days after the day on which such property was acquired by the REIT and the property is used in a trade or business that is conducted by the REIT (other than through an independent contractor from whom the REIT itself does not derive or receive any income).

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Tax on Prohibited Transactions. A REIT will incur a 100% tax on net income derived from any "prohibited transaction." A "prohibited transaction" generally is a sale or other disposition of property (other than foreclosure property) that the REIT holds primarily for sale to customers in the ordinary course of a trade or business. We believe that none of our assets (including those held by the Partnership and its subsidiaries) are held for sale to customers and that a sale of any such asset would not be in the ordinary course of its business. Whether a REIT holds an asset "primarily for sale to customers in the ordinary course of a trade or business" depends, however, on the facts and circumstances in effect from time to time, including those related to a particular asset. Nevertheless, we will attempt to comply with the terms of safe-harbor provisions in the Code prescribing when an asset sale will not be characterized as a prohibited transaction. We may fail to comply with such safe-harbor provisions or may own property that could be characterized as property held "primarily for sale to customers in the ordinary course of a trade or business."

Relief from Consequences of Failing to Meet Income Tests. If we fail to satisfy one or both of the 75% and 95% gross income tests for any taxable year, we nevertheless may qualify as a REIT for such year if we qualify for relief

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under certain provisions of the Code. Those relief provisions generally will be available if our failure to meet such tests is due to reasonable cause and not due to willful neglect, we attach a schedule of the sources of our income to our tax return, and any incorrect information on the schedule was not due to fraud with intent to evade tax. We may not qualify for the relief provisions in all circumstances. In addition, as discussed above in "-- Taxation of Capital Automotive REIT," even if the relief provisions apply, we would incur a 100% tax on gross income to the extent we fail the 75% or 95% gross income test (whichever amount is greater), multiplied by a fraction intended to reflect our profitability.

ASSET TESTS. To maintain our qualification as a REIT, we also must satisfy two asset tests at the close of each quarter of each taxable year.

- At least 75% of the value of our total assets must consist of cash or cash items (including certain receivables), government securities, "real estate assets," or qualifying temporary investments (the "75% asset test").
- "Real estate assets" include interests in real property, interests in mortgages on real property and stock in other REITs. We believe that the properties qualify as real estate assets.
- "Interests in real property" include an interest in mortgage loans or land and improvements thereon, such as buildings or other inherently permanent structures (including items that are structural components of such buildings or structures), a leasehold of real property, and an option to acquire real property (or a leasehold of real property).
- Qualifying temporary investments are investments in stock or debt instruments during the one-year period following our receipt of new capital that we raise through equity or long-term (at least five-year) debt offerings.
- For investments not included in the 75% asset test, (A) the value of our interest in any one issuer's securities may not exceed 5% of the value of our total assets (the "5% asset test") and (B) we may not own more than 10% of the voting power or value of any one issuer's outstanding securities (the "10% asset test").

For purposes of the second asset test, the term "securities" does not include our equity ownership in another REIT, our equity or debt securities of a qualified REIT subsidiary or a TRS, or our equity interest in any partnership. The term "securities," however, generally includes our debt securities issued by a partnership, except that non-participating debt securities of a partnership are not treated as securities for purposes of the "value" portion of the 10% asset test if we own at least a 20% profits interest in the partnership.

We intend to select future investments so as to comply with the asset tests.

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If we failed to satisfy the asset tests at the end of a calendar quarter, we would not lose our REIT status if (i) we satisfied the asset tests at the close of the preceding calendar quarter and (ii) the discrepancy between the value of our assets and the asset test requirements arose from changes in the market values of our assets and was not wholly or partly caused by the acquisition of one or more non-qualifying assets. If we did not satisfy the condition described in clause (ii) of the preceding sentence, we still could avoid disqualification as a REIT by eliminating any discrepancy within 30 days

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after the close of the calendar quarter in which the discrepancy arose.

**DISTRIBUTION REQUIREMENTS.** Each taxable year, we must distribute dividends (other than capital gain dividends and deemed distributions of retained capital gain) to our shareholders in an aggregate amount at least equal to (1) the sum of 90% of (A) our "REIT taxable income" (computed without regard to the dividends paid deduction and our net capital gain or loss) and (B) our net income (after tax), if any, from foreclosure property, minus (2) certain items of non-cash income.

We must pay such distributions in the taxable year to which they relate, or in the following taxable year if we declare the distribution before we timely file our federal income tax return for such year and pay the distribution on or before the first regular dividend payment date after such declaration.

We will pay federal income tax on taxable income (including net capital gain) that we do not distribute to shareholders. Furthermore, we will incur a 4% nondeductible excise tax if we fail to distribute during a calendar year (or, in the case of distributions with declaration and record dates falling in the last three months of the calendar year, by the end of January following such calendar year) at least the sum of (1) 85% of our REIT ordinary income for such year, (2) 95% of our REIT capital gain income for such year, and (3) any undistributed taxable income from prior periods. The excise tax is on the excess of such required distribution over the amounts we actually distributed. We may elect to retain and pay income tax on the net long-term capital gain we receive in a taxable year. See "-- Taxation of Taxable U.S. Shareholders." For purposes of the 4% excise tax, we will be treated as having distributed any such retained amount. We have made, and we intend to continue to make, timely distributions sufficient to satisfy the annual distribution requirements.

It is possible that, from time to time, we may experience timing differences between (1) the actual receipt of income and actual payment of deductible expenses and (2) the inclusion of that income and deduction of such expenses in arriving at our REIT taxable income. For example, we may not deduct recognized capital losses from our REIT taxable income. Further, it is possible that, from time to time, we may be allocated a share of net capital gain attributable to the sale of depreciated property that exceeds our allocable share of cash attributable to that sale. As a result of the foregoing, we may have less cash than is necessary to distribute all of our taxable income and thereby avoid corporate income tax and the excise tax imposed on certain undistributed income. In such a situation, we may need to borrow funds or issue preferred shares or additional common shares.

We intend to calculate our REIT taxable income based upon the conclusion that the Partnership is the owner for federal income tax purposes of all of the properties. As a result, we expect that depreciation deductions with respect to all such properties will reduce our REIT taxable income. If the IRS were to successfully challenge this position, we might be deemed retroactively to have failed to meet the distribution requirement and would have to rely on the payment of a deficiency dividend in order to retain our REIT status.

Under certain circumstances, we may be able to correct a failure to meet the distribution requirement for a year by paying deficiency dividends to our shareholders in a later year. We may include such deficiency dividends in our deduction for dividends paid for the earlier year. Although we may be able to avoid income tax on amounts distributed as deficiency dividends, we will be required to pay interest to the IRS based upon the amount of any deduction we take for deficiency dividends.

**PARTNERSHIP ANTI-ABUSE RULE.** The Treasury Department has issued a regulation (the "Anti-Abuse Rule") under the partnership provisions of the Code that authorizes the IRS, in certain "abusive"

transactions involving partnerships, to disregard the form of the transaction and recast it for federal tax purposes as the IRS deems appropriate. The Anti-Abuse Rule applies where a partnership is formed or utilized in connection with a transaction (or series of related transactions) with a principal purpose of substantially reducing the present value of the partners' aggregate federal tax liability in a manner inconsistent with the intent of the partnership provisions. The Anti-Abuse Rule states that the partnership provisions are intended to permit taxpayers to conduct joint business (including investment) activities through a flexible economic arrangement that accurately reflects the partners' economic agreement and clearly reflects the partners' income without incurring any entity-level tax. The purposes for structuring a transaction involving a partnership are determined based on all of the facts and circumstances, including a comparison of the purported business purpose for a transaction and the claimed tax benefits resulting from the transaction. A reduction in the present value of the partners' aggregate federal tax liability through the use of a partnership does not, by itself, establish inconsistency with the intent of the partnership provisions.

The Anti-Abuse Rule contains an example in which a corporation that elects to be treated as a REIT contributes substantially all of the proceeds from a public offering to a partnership in exchange for a general partner interest. The limited partners of the partnership contribute real property assets to the partnership, subject to liabilities that exceed their respective aggregate bases in such property. In addition, the limited partners have the right, beginning one year after the formation of the partnership, to require the redemption of their limited partnership interests in exchange for cash or REIT shares (at the corporation's option) equal to the fair market value of their respective interests in the partnership at the time of the redemption. The example concludes that the use of the partnership is not inconsistent with the intent of the partnership provisions and, thus, cannot be recast by the IRS. Based on the foregoing, we believe that the Anti-Abuse Rule will not have any adverse impact on our ability to qualify as a REIT. However, the Anti-Abuse Rule is extraordinarily broad in scope and is applied based on an analysis of all of the facts and circumstances. As a result, there can be no assurance that the IRS will not attempt to apply the Anti-Abuse Rule to us. If the conditions of the Anti-Abuse Rule are met, the IRS is authorized to take appropriate enforcement action, including disregarding the Partnership for federal tax purposes or treating one or more of its partners as non-partners. Any such action potentially could jeopardize our status as a REIT.

**RECORD KEEPING REQUIREMENTS.** We must maintain certain records in order to qualify as a REIT. In addition, to avoid a monetary penalty, we must request on an annual basis certain information from our shareholders designed to disclose the actual ownership of our outstanding stock. We have complied, and we intend to continue to comply, with such requirements.

**FAILURE TO QUALIFY.** If we failed to qualify as a REIT in any taxable year, and no relief provision applied, we would be subject to federal income tax (including any applicable alternative minimum tax) on our taxable income at regular corporate rates. In calculating our taxable income in a year in which we failed to qualify as a REIT, we would not be able to deduct amounts paid out to shareholders. In fact, we would not be required to distribute any amounts to shareholders in such year. In such event, to the extent of our current and accumulated earnings and profits, all distributions to shareholders would be taxable as ordinary income. Subject to certain limitations of the Code, corporate shareholders might be eligible for the dividends received deduction. Unless we qualified for relief under specific statutory provisions, we also would be disqualified from taxation as a REIT for the four taxable years

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following the year during which we ceased to qualify as a REIT. We cannot predict whether in all circumstances we would qualify for such statutory relief.

### TAXATION OF TAXABLE U.S. SHAREHOLDERS

As long as we qualify as a REIT, a taxable "U.S. shareholder" must take into account distributions out of our current or accumulated earnings and profits (and that we do not designate as capital gain dividends or retained long-term capital gain) as ordinary income. A U.S. shareholder will not qualify for

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the dividends received deduction generally available to corporations. As used herein, the term "U.S. shareholder" means a holder of common shares that for U.S. federal income tax purposes is:

- a citizen or resident of the United States;
- a corporation or partnership, including any entity treated as a corporation or partnership for federal income tax purposes, created or organized in or under the laws of the United States or of a political subdivision thereof;
- an estate whose income is subject to U.S. federal income taxation regardless of its source; or
- any trust with respect to which (A) a U.S. court is able to exercise primary supervision over the administration of such trust and (B) one or more U.S. persons have the authority to control all substantial decisions of the trust.

A U.S. shareholder will recognize distributions that we designate as capital gain dividends as long-term capital gain (to the extent they do not exceed our actual net capital gain for the taxable year) without regard to the period for which the U.S. shareholder has held its common shares. Subject to certain limitations, we will designate our capital gain dividends as either 20% or 25% rate distributions. A corporate U.S. shareholder, however, may be required to treat up to 20% of certain capital gain dividends as ordinary income.

We may elect to retain and pay income tax on the net long-term capital gain that we receive in a taxable year. In that case, a U.S. shareholder would be taxed on its proportionate share of our undistributed long-term capital gain. The U.S. shareholder would receive a credit or refund for its proportionate share of the tax we paid. The U.S. shareholder would increase the basis in its stock by the amount of its proportionate share of our undistributed long-term capital gain, minus its share of the tax we paid.

A U.S. shareholder will not incur tax on a distribution in excess of our current and accumulated earnings and profits if such distribution does not exceed the adjusted basis of the U.S. shareholder's common shares. Instead, such distribution will reduce the adjusted basis of such common shares. A U.S. shareholder will recognize a distribution in excess of both our current and accumulated earnings and profits and the U.S. shareholder's adjusted basis in its common shares as long-term capital gain (or short-term capital gain if the common shares have been held for one year or less), assuming the common shares are a capital asset in the hands of the U.S. shareholder. In addition, if we declare a distribution in October, November or December of any year that is payable to a U.S. shareholder of record on a specified date in any such month, such distribution shall be treated as both paid by us and received by the U.S.

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shareholder on December 31 of such year, provided that we actually pay the distribution during January of the following calendar year. We will notify U.S. shareholders after the close of our taxable year as to the portions of the distributions attributable to that year that constitute ordinary income or capital gain dividends.

**TAXATION OF U.S. SHAREHOLDERS ON THE DISPOSITION OF THE COMMON SHARES.** In general, a U.S. shareholder who is not a dealer in securities must treat any gain or loss realized upon a taxable disposition of the common shares as long-term capital gain or loss if the U.S. shareholder has held the common stock for more than one year and otherwise as short-term capital gain or loss. However, a U.S. shareholder must treat any loss upon a sale or exchange of common shares held by such shareholder for six months or less (after applying certain holding period rules) as a long-term capital loss to the extent of capital gain dividends and other distributions from us that such U.S. shareholder treats as long-term capital gain. All or a portion of any loss a U.S. shareholder realizes upon a taxable disposition of the common shares may be disallowed if the U.S. shareholder purchases additional common shares within 30 days before or after the disposition.

**CAPITAL GAINS AND LOSSES.** A taxpayer generally must hold a capital asset for more than one year for gain or loss derived from its sale or exchange to be treated as long-term capital gain or loss. The highest

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marginal individual income tax rate is 39.6%. On June 7, 2001, President Bush signed into law the Economic Growth and Tax Relief Reconciliation Act of 2001. That legislation reduces the highest marginal individual income tax rate of 39.6% to 39.1% for the period from July 1, 2001 to December 31, 2001, to 38.6% for the period from January 1, 2002 to December 31, 2003, to 37.6% for the period from January 1, 2004 to December 31, 2005, and to 35% for the period from January 1, 2006 to December 31, 2010. The maximum tax rate on long-term capital gain applicable to non-corporate taxpayers is 20% for sales and exchanges of assets held for more than one year. The maximum tax rate on long-term capital gain from the sale or exchange of "Section 1250 property" (i.e., depreciable real property) is 25% to the extent that such gain would have been treated as ordinary income if the property were "Section 1245 property." With respect to distributions that we designate as capital gain dividends and any retained capital gain that we are deemed to distribute, we may designate (subject to certain limits) whether such a distribution is taxable to our non-corporate shareholders at a 20% or 25% rate. Thus, the tax rate differential between capital gain and ordinary income for non-corporate taxpayers may be significant. A U.S. shareholder required to include retained long-term capital gains in income will be deemed to have paid, in the taxable year of the inclusion, its proportionate share of the tax paid by us in respect of such undistributed net capital gains. U.S. shareholders subject to these rules will be allowed a credit or a refund, as the case may be, for the tax deemed to have been paid by such shareholders. U.S. shareholders will increase their basis in their common shares by the difference between the amount of such includible gains and the tax deemed paid by the U.S. shareholder in respect of such gains. In addition, the characterization of income as capital gain or ordinary income may affect the deductibility of capital losses. A non-corporate taxpayer may deduct capital losses not offset by capital gains against its ordinary income only up to a maximum annual amount of \$3,000. A non-corporate taxpayer may carry forward unused capital losses indefinitely. A corporate taxpayer must pay tax on its net capital gain at ordinary corporate rates. A corporate taxpayer can deduct capital losses only to the extent of capital gains, with unused losses being carried back three years and forward five years.

**INFORMATION REPORTING REQUIREMENTS AND BACKUP WITHHOLDING.** We will report

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to our shareholders and to the IRS the amount of distributions we pay during each calendar year, and the amount of tax we withhold, if any. Under the backup withholding rules, a shareholder may be subject to backup withholding at the rate of up to 31% with respect to distributions unless such holder (1) is a corporation or comes within certain other exempt categories and, when required, demonstrates this fact or (2) provides a taxpayer identification number, certifies as to no loss of exemption from backup withholding, and otherwise complies with the applicable requirements of the backup withholding rules. A shareholder who does not provide us with its correct taxpayer identification number also may be subject to penalties imposed by the IRS. Any amount paid as backup withholding will be creditable against the shareholder's income tax liability. In addition, we may be required to withhold a portion of capital gain distributions to any shareholders who fail to certify their non-foreign status to us.

### TAXATION OF TAX-EXEMPT U.S. SHAREHOLDERS

Tax-exempt entities, including qualified employee pension and profit sharing trusts and individual retirement accounts and annuities ("exempt organizations"), generally are exempt from federal income taxation. However, they are subject to taxation on their unrelated business taxable income ("UBTI"). While many investments in real estate generate UBTI, the IRS has issued a published ruling that dividend distributions from a REIT to an exempt employee pension trust do not constitute UBTI, provided that the exempt employee pension trust does not otherwise use the shares of the REIT in an unrelated trade or business of the pension trust. Based on that ruling, amounts that we distribute to exempt organizations generally should not constitute UBTI. However, if an exempt organization were to finance its acquisition of common shares with debt, a portion of the income that it receives from us would constitute UBTI pursuant to the "debt-financed property" rules. Furthermore, social clubs, voluntary employee benefit associations, supplemental unemployment benefit trusts and qualified group legal services plans that are exempt from taxation under paragraphs (7), (9), (17), and (20), respectively, of Code Section 501(c) are

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subject to different UBTI rules, which generally will require them to characterize distributions that they receive from us as UBTI. Finally, in certain circumstances, a qualified employee pension or profit sharing trust that owns more than 10% of our shares is required to treat a percentage of the dividends that it receives from us as UBTI (the "UBTI Percentage"). The UBTI Percentage is equal to the gross income we derive from an unrelated trade or business (determined as if it were a pension trust) divided by our total gross income for the year in which we pay the dividends. The UBTI rule applies to a pension trust holding more than 10% of our shares only if:

- the UBTI Percentage is at least 5%;
- we qualify as a REIT by reason of the modification of the 5/50 Rule that allows the beneficiaries of the pension trust to be treated as holding our shares in proportion to their actuarial interests in the pension trust; and
- we are a "pension-held REIT" (i.e., either (1) one pension trust owns more than 25% of the value of our shares or (2) a group of pension trusts individually holding more than 10% of the value of our shares collectively owns more than 50% of the value of our shares).

Tax-exempt entities will be subject to the rules described above, under the heading "-- Taxation of Taxable U.S. Shareholders" concerning the inclusion of



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our designated undistributed net capital gains in the income of our shareholders. Thus, such entities will, after satisfying filing requirements, be allowed a credit or refund of the tax deemed paid by such entities in respect of such includible gains.

### TAXATION OF NON-U.S. SHAREHOLDERS

The rules governing U.S. federal income taxation of nonresident alien individuals, foreign corporations, foreign partnerships, and other foreign shareholders (collectively, "non-U.S. shareholders") are complex. This section is only a summary of such rules. We urge non-U.S. shareholders to consult their own tax advisors to determine the impact of federal, state, and local income tax laws on ownership of common shares, including any reporting requirements.

**ORDINARY DIVIDENDS.** A non-U.S. shareholder that receives a distribution that is not attributable to gain from our sale or exchange of U.S. real property interests (as defined below) and that we do not designate as a capital gain dividend or retained capital gain will recognize ordinary income to the extent that we pay such distribution out of our current or accumulated earnings and profits. A withholding tax equal to 30% of the gross amount of the distribution ordinarily will apply to such distribution unless an applicable tax treaty reduces or eliminates the tax. However, if a distribution is treated as effectively connected with the non-U.S. shareholder's conduct of a U.S. trade or business, the non-U.S. shareholder generally will be subject to federal income tax on the distribution at graduated rates, in the same manner as U.S. shareholders are taxed with respect to such distributions (and also may be subject to the 30% branch profits tax in the case of a non-U.S. shareholder that is a non-U.S. corporation). We plan to withhold U.S. income tax at the rate of 30% on the gross amount of any such distribution paid to a non-U.S. shareholder unless (i) a lower treaty rate applies and the non-U.S. shareholder files IRS Form W-8BEN with us evidencing eligibility for that reduced rate or (ii) the non-U.S. shareholder files an IRS Form W-8ECI with us claiming that the distribution is effectively connected income.

**RETURN OF CAPITAL.** A non-U.S. shareholder will not incur tax on a distribution in excess of our current and accumulated earnings and profits if such distribution does not exceed the adjusted basis of its common shares. Instead, such a distribution will reduce the adjusted basis of such common shares. A non-U.S. shareholder will be subject to tax on a distribution that exceeds both our current and accumulated earnings and profits and the adjusted basis of its common shares, if the non-U.S. shareholder otherwise would be subject to tax on gain from the sale or disposition of its common shares, as described below. Because we generally cannot determine at the time we make a distribution whether or not the distribution will exceed our current and accumulated earnings and profits, we normally will withhold tax on the entire amount of any distribution at the same rate as we would withhold on a dividend. However, a non-U.S.

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shareholder may obtain a refund of amounts that we withhold if we later determine that a distribution in fact exceeded our current and accumulated earnings and profits.

**CAPITAL GAIN DIVIDENDS.** For any year in which we qualify as a REIT, a non-U.S. shareholder will incur tax on distributions that are attributable to gain from our sale or exchange of "U.S. real property interests" under the provisions of the Foreign Investment in Real Property Tax Act of 1980 ("FIRPTA"). The term "U.S. real property interests" includes certain interests in real property and stock in corporations at least 50% of whose assets consists of interests in real property, but excludes mortgage loans and mortgage-backed

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securities. Under FIRPTA, a non-U.S. shareholder is taxed on distributions attributable to gain from sales of U.S. real property interests as if such gain were effectively connected with a U.S. business of the non-U.S. shareholder. A non-U.S. shareholder thus would be taxed on such a distribution at the normal capital gain rates applicable to U.S. shareholders (subject to applicable alternative minimum tax and a special alternative minimum tax in the case of a nonresident alien individual). A non-U.S. corporate shareholder not entitled to treaty relief or exemption also may be subject to the 30% branch profits tax on distributions subject to FIRPTA. We must withhold 35% of any distribution that we could designate as a capital gain dividend. However, if we make a distribution and later designate it as a capital gain dividend, then (although such distribution may be taxable to a non-U.S. shareholder) it is not subject to withholding under FIRPTA. Instead, we must make-up the 35% FIRPTA withholding from distributions made after the designation, until the amount of distributions withheld at 35% equals the amount of the distribution designated as a capital gain dividend. A non-U.S. shareholder may receive a credit against its FIRPTA tax liability for the amount we withhold.

Distributions to a non-U.S. shareholder that we designate at the time of distribution as capital gain dividends which are not attributable to or treated as attributable to our disposition of a U.S. real property interest generally will not be subject to U.S. federal income taxation, except as described below under "-- Sale of Shares."

**SALE OF SHARES.** A non-U.S. shareholder generally will not incur tax under FIRPTA on gain from the sale of its common shares as long as we are a "domestically controlled REIT." A "domestically controlled REIT" is a REIT in which at all times during a specified testing period non-U.S. persons held, directly or indirectly, less than 50% in value of the stock. We anticipate that we will continue to be a "domestically controlled REIT." In addition, a non-U.S. shareholder that owns, actually or constructively, 5% or less of outstanding common shares at all times during a specified testing period will not incur tax under FIRPTA if the common shares are "regularly traded" on an established securities market. If neither of these exceptions were to apply, the gain on the sale of the common shares would be taxed under FIRPTA, in which case a non-U.S. shareholder would be taxed in the same manner as U.S. shareholders with respect to such gain (subject to applicable alternative minimum tax, a special alternative minimum tax in the case of nonresident alien individuals, and the possible application of the 30% branch profits tax in the case of non-U.S. corporations).

A non-U.S. shareholder will incur tax on gain not subject to FIRPTA if (1) the gain is effectively connected with the non-U.S. shareholder's U.S. trade or business, in which case the non-U.S. shareholder will be subject to the same treatment as U.S. shareholders with respect to such gain, or (2) the non-U.S. shareholder is a nonresident alien individual who was present in the U.S. for 183 days or more during the taxable year, in which case the non-U.S. shareholder will incur a 30% tax on his capital gains. Capital gains dividends not subject to FIRPTA will be subject to similar rules.

**BACKUP WITHHOLDING.** Backup withholding tax (which generally is withholding tax imposed at the rate of up to 31% on certain payments to persons that fail to furnish certain information under the United States information reporting requirements) and information reporting will generally not apply to distributions to a non-U.S. shareholder provided that the non-U.S. shareholder certifies under penalty of perjury that the shareholder is a non-U.S. shareholder, or otherwise establishes an exemption. As a general matter, backup withholding and information reporting will not apply to a payment of the proceeds of a sale of common shares effected at a foreign office of a foreign broker. Information reporting (but not backup

withholding) will apply, however, to a payment of the proceeds of a sale of common shares by a foreign office of a broker that:

- is a U.S. person;
- derives 50% or more of its gross income for a specified three year period from the conduct of a trade or business in the U.S.;
- is a "controlled foreign corporation" (generally, a foreign corporation controlled by U.S. shareholders) for U.S. tax purposes; or
- is a foreign partnership, if at any time during its tax year 50% or more of its income or capital interest are held by U.S. persons or if it is engaged in the conduct of a trade or business in the U.S.,

unless the broker has documentary evidence in its records that the holder or beneficial owner is a non-U.S. shareholder and certain other conditions are met, or the shareholder otherwise establishes an exemption. Payment of the proceeds of a sale of common shares effected at a U.S. office of a broker is subject to both backup withholding and information reporting unless the shareholder certifies under penalty of perjury that the shareholder is a non-U.S. shareholder, or otherwise establishes an exemption. Backup withholding is not an additional tax. A non-U.S. shareholder may obtain a refund of excess amounts withheld under the backup withholding rules by filing the appropriate claim for refund with the IRS.

#### OTHER TAX CONSEQUENCES

STATE AND LOCAL TAXES. We and/or you may be subject to state and local tax in various states and localities, including those states and localities in which we or you transact business, own property or reside. The state and local tax treatment in such jurisdictions may differ from the federal income tax treatment described above. Consequently, you should consult your own tax advisor regarding the effect of state and local tax laws upon an investment in our securities.

#### TAX ASPECTS OF OUR INVESTMENTS IN THE PARTNERSHIP AND SUBSIDIARY PARTNERSHIPS

The following discussion summarizes certain federal income tax considerations applicable to our direct or indirect investments in the Partnership and its subsidiary partnerships. The discussion does not cover state or local tax laws or any federal tax laws other than income tax laws.

CLASSIFICATION AS PARTNERSHIPS. We are entitled to include in our income our distributive share of the Partnership's income and to deduct our distributive share of the Partnership's losses only if the Partnership is classified for federal income tax purposes as a partnership rather than as a corporation or association taxable as a corporation. An organization will be classified as a partnership, rather than as a corporation, for federal income tax purposes if it (1) is treated as a partnership under Treasury regulations, effective January 1, 1997, relating to entity classification (the "check-the-box regulations") and (2) is not a "publicly traded" partnership.

Under the check-the-box regulations, an unincorporated entity with at least two members may elect to be classified either as an association taxable as a corporation or as a partnership. If such an entity fails to make an election, it generally will be treated as a partnership for federal income tax purposes. We believe that the Partnership and its subsidiaries are classified as partnerships for federal income tax purposes.

A publicly traded partnership is a partnership whose interests are traded

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on an established securities market or are readily tradable on a secondary market (or the substantial equivalent thereof). While the units will not be traded on an established securities market, they could possibly be deemed to be traded on a secondary market or its equivalent due to the redemption rights enabling the limited partners to dispose of their units. A publicly traded partnership will not, however, be treated as a corporation for any taxable year if 90% or more of the partnership's gross income for such year consists of certain passive-type income, including (as may be relevant here) real property rents, gains from the sale or other disposition of real property, interest, and dividends (the "90% Passive Income Exception").

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The Treasury Department has issued regulations (the "PTP Regulations") that provide limited safe harbors from the definition of a publicly traded partnership. Pursuant to one of those safe harbors (the "Private Placement Exclusion"), interests in a partnership will not be treated as readily tradable on a secondary market or the substantial equivalent thereof if (i) all interests in the partnership were issued in a transaction (or transactions) that was not required to be registered under the Securities Act, and (ii) the partnership does not have more than 100 partners at any time during the partnership's taxable year. In determining the number of partners in a partnership, a person owning an interest in a flow-through entity (i.e., a partnership, grantor trust, or S corporation) that owns an interest in the partnership is treated as a partner in such partnership only if (i) substantially all of the value of the owner's interest in the flow-through entity is attributable to the flow-through entity's interest (direct or indirect) in the partnership and (ii) a principal purpose of the use of the flow-through entity is to permit the partnership to satisfy the 100-partner limitation.

We believe that the Partnership has qualified for the Private Placement Exclusion since its formation and the Partnership intends to continue to qualify for the Private Placement Exclusion unless it qualifies for another exception to publicly traded partnership status. It is possible that in the future the Partnership might not qualify for the Private Placement Exclusion.

If the Partnership is considered a publicly traded partnership under the

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“Area 10,” the states of Pernambuco, Alagoas, Paraíba, Rio Grande do Norte, Ceará and Piauí.

- “Vivo Participações” are to Vivo Participações S.A. (formerly TCP) and its consolidated subsidiaries (unless the context otherwise requires); and
  - “Vivo brand” are to the brand used in Brazil in the operations of Telefônica Brasil;

Unless otherwise specified, data relating to the Brazilian telecommunications industry included in this annual report were obtained from ANATEL.

The “Glossary of Telecommunications Terms” that begins on page 134 provides the definition of certain technical terms used in this annual report.

On October 3, 2011, our shareholders approved the merger of Vivo Participações with and into us and the change of our corporate name from Telecomunicações de São Paulo S.A. – TELESP to Telefônica Brasil S.A.

As a result of such name change, the trade codes for our shares were also changed as of October 6, 2011 (inclusive), from TLPP3, for the common shares and TLPP4, for the preferred shares to VIVT3 and VIVT4, respectively, with the

subsequent change of trading name to TELEF BRAZIL. The trade code for the ADRs, VIV, on New York Stock Exchange was not changed.

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CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING STATEMENT

This annual report contains statements that constitute forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, Section 21E of the Securities Exchange Act of 1934, as amended, and the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. The forward-looking statements in this Annual Report can be identified, in some instances, by the use of words such as “will,” “expect,” “aim,” “hope,” “anticipate,” “intend,” “believe” and similar language or the negative thereof or by the forward-looking nature of discussions of strategy, plans or intentions. These statements appear in a number of places in this Annual Report including, without limitation, certain statements made in “Item 3. Key Information—D. Risk Factors,” “Item 4. Information on the Company,” “Item 5. Operating and Financial Review and Prospects” and “Item 11. Quantitative and Qualitative Disclosures about Market Risk” and include statements regarding our intent, belief or current expectations with respect to, among other things:

- statements concerning our operations and prospects;
- the size of the Brazilian telecommunications market;
  - estimated demand forecasts;
  - our capital expenditure plan;
- our ability to secure and maintain telecommunications infrastructure licenses, rights-of-way and other regulatory approvals;
  - our strategic initiatives and plans for business growth;
    - industry conditions;
  - our funding needs and financing sources;
  - network completion and product development schedules;
  - expected characteristics of competing networks, products and services;
    - the outcome of certain legal proceedings;
    - regulatory and legal developments;
  - quantitative and qualitative disclosures about market risk;
- other statements of management’s expectations, beliefs, future plans and strategies, anticipated developments and other matters that are not historical facts; and
  - other factors identified or discussed under “Item 3. Key Information—D. Risk Factors.”

Forward-looking information involves risks and uncertainties that could significantly affect expected results. The risks and uncertainties include, but are not limited to:

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the short history of our operations as an independent, private-sector, entity and the ongoing introduction of greater competition to the Brazilian telecommunications sector;

- the cost and availability of financing;
- uncertainties relating to political and economic conditions in Brazil as well as those of other emerging markets;
  - inflation, interest rate and exchange rate risks;
  - the Brazilian government's telecommunications policy;

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- the Brazilian government's tax policy;
- the Brazilian government's political instability; and
- the adverse determination of disputes under litigation.

We undertake no obligation to publicly update or revise any forward-looking statements as a result of new information, future events or otherwise. Because of these risks and uncertainties, the forward-looking information, events and circumstances discussed in this annual report might not occur. Our actual results and performance could differ substantially from those anticipated in our forward-looking statements.



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PRESENTATION OF FINANCIAL INFORMATION

We maintain our books and records in reais. We prepared our consolidated financial statements included in this annual report in accordance with International Financial Reporting Standards or IFRS.

The preparation of financial statements in conformity with IFRS requires the use of certain critical accounting estimates. It also requires management to exercise its judgment in the process of applying our accounting policies. Those areas involving a higher degree of judgment or complexity, or areas where assumptions and estimates are significant to the consolidated financial statements, are disclosed in Note 3 to our consolidated financial statements.

Our financial statements prepared in accordance with IFRS were those as of and for the year ended December 31, 2012, December 31, 2011 and December 31, 2010 which were filed with the CVM, the local securities regulator in Brazil and made publicly available. The selected financial information for the Company included in “Item 3. Key Information—A. Selected Financial Data” should be read in conjunction with, and is qualified in its entirety by, the our financial statements and “Item 5. Operating and Financial Review and Prospects” appearing elsewhere in this annual report.

The consolidated financial statements as of December 31, 2012 and 2011 and for each of the three years in the period ended December 31, 2012 are in compliance with the IFRS, as issued by the International Accounting Standards Board (IASB) and also with the pronouncements, interpretations and guidance issued by Accounting Standards Committee (Comitê de Pronunciamentos Contábeis – “CPC”) in place on December 31, 2012, which include the new pronouncements, interpretations and amendments issued by the IASB and IFRIC which entered into force as of January 1, 2012.

Our first adoption of IFRS to consolidated financial statements was for the year ended on December 31, 2010. Our financial statements as of the transition date for applying IFRS as of January 1, 2009 and the comparative period as of and for the year ended December 31, 2009 have been restated to reflect adjustments made as a result of the adoption of IFRS.

We have made rounding adjustments to reach some of the figures included in this annual report. Accordingly, numerical figures shown as totals in some tables may not be an arithmetic aggregation of the figures that preceded them.

Results of Vivo Participações and Vivo are consolidated into our financial statements for nine months in 2011 and for the full year ended December 31, 2012, consequently our results of operations for the years ended December 31, 2011 and 2010 are not comparable with our results of operations for the year ended December 31, 2012.

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PART I

ITEM 1. IDENTITY OF DIRECTORS, SENIOR MANAGEMENT AND ADVISERS

Not applicable.

ITEM 2. OFFER STATISTICS AND EXPECTED TIMETABLE

Not applicable.

ITEM 3. KEY INFORMATION

A. Selected Financial Data

The selected financial data presented below should be read in conjunction with our consolidated financial statements, including the notes thereto included elsewhere in this annual report. Our consolidated financial statements included herein as of and for the years ended December 31, 2012, 2011 and 2010 have been audited by Ernst & Young Terco Auditores Independentes S.S. The report of Ernst & Young Terco Auditores Independentes S.S. on the consolidated financial statements appears elsewhere in this annual report.

On March 25, 2011, the boards of directors of Vivo Participações, our former subsidiary, and Telefônica Brasil approved the terms and conditions of the corporate restructuring of both companies, which was approved unanimously by the shareholders of both companies on April 27, 2011.

The transaction consisted of the unification of the share base of fixed and mobile operators of the Telefônica group in Brazil through the merger of all shares of Vivo Participações into Telefônica Brasil, with Telefônica Brasil as the surviving entity. Telefônica Brasil exchanged each share of Vivo Participações held by shareholders of Vivo Participações for shares of Telefônica Brasil. The exchange of shares of Vivo Participações for shares of Telefônica Brasil was based on the exchange ratio of 1.55 shares of Telefônica Brasil for each share of Vivo Participações. Upon closing of the merger and the share exchange, Vivo remained our wholly owned direct subsidiary. The Company assessed the fair value of the assets acquired and the liabilities assumed from Vivo Participações as of March 31, 2011 for purposes of applying the acquisition method to the transaction as a business combination we consolidated and included Vivo Participações in our results of operations as of April 1, 2011.

On April 27, 2011, we acquired 100% of Vivo Participações, for a total of R\$31.2 billion. See Note 1 and Note 4 to our consolidated financial statements. Our consolidated financial statements include Vivo Participações and Vivo as of April 1, 2011 through the full consolidation method. Because Vivo Participações and Vivo are consolidated into our financial statements for nine months in 2011 and for the full year ended December 31, 2012, our results of operations for the years ended December 31, 2011 and 2010 are not comparable with our results of operations for the year ended December 31, 2012.

The following tables present a summary of our selected financial data at the dates and for each of the periods indicated. You should read the following information together with our audited consolidated financial statements and the notes thereto included elsewhere in this annual report and with “Item 5. Operating and Financial Review and Prospects.”

	Year ended December 31,			
Income Statement Data:	2012	2011	2010	2009

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	(in millions of reais, except for share and per share data)			
IFRS				
Net operating revenue	33,931	29,129	15,798	15,852
Cost of goods and services	(16,564 )	(15,040 )	(8,845 )	(9,236 )
Gross profit	17,367	14,089	6,953	6,616
Operating expenses, net	(10,155 )	(8,292 )	(3,391 )	(3,221 )
Equity in earnings (losses) of associates	-	-	3	19
Operating income before financial expense, net	7,212	5,797	3,565	3,414
Financial expense, net	(291 )	(140 )	(121 )	(189 )
Income before tax and social contribution	6,921	5,657	3,444	3,225
Income tax and social contribution	(2,469 )	(1,295 )	(1,046 )	(1,021 )
Net Income	4,452	4,362	2,398	2,204

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Income Statement Data:	Year ended December 31,			
	2012	2011	2010	2009
Attributable to:				
Controlling shareholders	4,453	4,355	2,398	2,204
Non-controlling shareholders	(1 )	7	—	—
Basic and diluted earnings per share:				
Common Shares	3.72	4.40	4.45	4.08
Preferred Shares	4.09	4.84	4.89	4.49
Cash Dividends per share in reais, net of withholding tax:				
Common Shares	2.57	4.78	3.62	2.56
Preferred Shares	2.82	5.26	3.98	2.81
Balance Sheet Data:	As of December 31,			
	2012	2011	2010	2009
IFRS	(in millions of reais, except where indicated)			
Property, plant and equipment, net	17,611	17,154	10,201	9,672
Total assets	70,255	65,490	19,966	20,643
Loans and financing—current portion	1,255	988	420	1,768
Loans and financing—noncurrent portion	3,756	3,959	1,405	1,752
Shareholders' equity	44,681	43,331	11,667	11,300
Attributable to:				
Controlling shareholders	44,681	43,326	11,667	—
Noncontrolling shareholders	—	5	—	—
Capital stock	37,798	37,798	6,575	6,575
Number of shares outstanding (in thousands)	1,123,269	1,123,884	505,841	505,841
Cash Flow Data:	Year ended December 31,			
	2012	2011	2010	2009
IFRS	(in millions of reais, except where indicated)			
Operating activities:				
Net cash provided by operations	9,733	8,141	4,532	4,449
Investing activities:				
Net cash used in investing activities	(3,397 )	(2,029 )	(1,658 )	(2,296 )
Financing activities:				
Net cash used in financing activities	(2,080 )	(4,729 )	(3,594 )	(1,618 )
Increase (decrease) in cash and cash equivalents	4,256	1,383	(720 )	536
Cash and cash equivalents at beginning of year	2,940	1,557	2,277	1,741
Cash and cash equivalents at end of year	7,196	2,940	1,557	2,277

## Exchange Rates

The Brazilian Central Bank allows the real/U.S. dollar exchange rate to float freely and has intervened occasionally to control the exchange rate volatility. However, the exchange market may continue to be volatile, and the real may depreciate or appreciate substantially in relation to the U.S. dollar. The Brazilian Central Bank or the Brazilian government may intervene in the exchange rate market.

Since 1999, the Central Bank has allowed the real/U.S. dollar exchange rate to float freely, and, since that time, the real/U.S. dollar exchange rate has fluctuated considerably. The real depreciated against the U.S. dollar by 15.7% in 2001 and 34.3% in 2002. Although the real appreciated by 22.3%, 8.8%, 13.4%, 9.5% and 20.7% against the U.S.

dollar in 2003, 2004, 2005, 2006 and 2007, respectively, in 2008, as a result of the international financial and economic crisis, the real depreciated against the U.S. dollar by 24.0%. In 2009 and 2010, the real appreciated against the U.S. dollar by 25.5% and 4.3%, respectively. In 2011, the real depreciated by 4.8% against the U.S. dollar. On December 31, 2011, the year-end real/U.S. dollar exchange rate was R\$1.8758 per U.S.\$1.00. In 2012, the real depreciated a further 8.94% against the U.S. dollar. On December 31, 2012, the year-end real/U.S. dollar exchange rate was R\$2.0429 per U.S. \$1.00.

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In the past, the Brazilian government has implemented various economic plans and utilized a number of exchange rate policies, including sudden devaluations, periodic mini-devaluations during which the frequency of adjustments ranged from a daily to a monthly basis, floating exchange rate systems, exchange controls and dual exchange rate markets. We cannot predict whether the Central Bank or the Brazilian government will continue to let the real float freely or intervene in the exchange rate market by returning to a currency band system or otherwise. The real may depreciate or appreciate substantially against the U.S. dollar.

The following tables set forth the exchange rate (rounded to the nearest tenth of a cent), expressed in reais per U.S. dollar (R\$/US\$) for the periods indicated, as reported by the Central Bank.

Year ended December 31,	Exchange Rate of R\$ per US\$			
	Low	High	Average(1)	Year-End
2008	1.559	2.500	1.833	2.337
2009	1.741	2.378	1.990	1.741
2010	1.655	1.880	1.759	1.665
2011	1.535	1.902	1.671	1.876
2012	1.702	2.112	1.959	2.044

Source: Central Bank of Brazil, PTAX.

(1) Represents the average of the exchange rates (PTAX) on the last day of each month during the relevant period.

Month	Exchange Rate of R\$ per US\$			
	Low	High	Average(2)	Month-End
September 2012	2.014	2.039	2.027	2.031
October 2012	2.022	2.038	2.030	2.031
November 2012	2.031	2.107	2.069	2.107
December 2012	2.044	2.112	2.078	2.044
January 2013	1.988	2.047	2.018	1.988
February 2013	1.957	1.989	1.973	1.975
March 2013 (through March 19)	1.953	1.987	1.970	1.983

Source: Central Bank of Brazil, PTAX.

(2) Represents the average of the exchange rates (PTAX) of the lowest and highest rates in the month.

On March 19, 2013, the exchange rate was R\$1.983 to US\$1.00. The real/dollar exchange rate fluctuates and, therefore, the exchange rate at March 19, 2013 may not be indicative of future exchange rates.

B. Capitalization and Indebtedness

Not applicable.

C. Reasons for the Offer and Use of Proceeds

Not applicable.

D. Risk Factors

This section is intended to be a summary of more detailed discussions contained elsewhere in this annual report. The risks described below are not the only ones we face. Additional risks that we do not presently consider material, or of which we are not currently aware, may also affect us. Our business, results of operations or financial condition could be impacted if any of these risks materializes and, as a result, the market price of our preferred shares and our ADSs could be affected.

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Risks Relating to Brazil

The Brazilian government has exercised, and continues to exercise, significant influence over the Brazilian economy. This influence, as well as Brazilian political and economic conditions, could adversely affect us and the trading price of our preferred shares and ADSs.

In the past, the Brazilian government has intervened in the Brazilian economy and made changes in policy and regulations. The Brazilian government's actions to control inflation and affect other policies have often involved wage and price controls, currency devaluations, capital controls, and limits on imports, among other things. Our business, financial condition, results of operations and the market price of our preferred shares and ADSs may be adversely affected by changes in government policies, especially those related to our sector, such as changes in telephone fees and competitive conditions, as well as general economic factors, including:

- currency fluctuations;
- exchange control policies;
- internal economic growth;
- inflation;
- energy policy;
- interest rates;
- liquidity of domestic capital and lending markets;
- tax policies; and
- other political, diplomatic, social and economic developments in or affecting Brazil.

Uncertainty over the possibility of the Brazilian government implementing changes in policy or regulation affecting these or other factors in the future may contribute to economic uncertainty in Brazil and heightened volatility in the Brazilian securities markets and securities issued abroad by Brazilian companies. In addition, possible political crises may affect the confidence of investors and the public in general, which may result in economic deceleration and affect the trading prices of shares issued by companies listed on the stock exchange, such as us.

Our business may be vulnerable to the current disruptions and volatility in the global financial markets.

The international economy remains subject to risks and adjustments arising from the international financial crisis. The international financial system remains susceptible to unfavorable credit and liquidity conditions. Foreign and national financial institutions, including some of the largest commercial banks, investment banks, mortgage lenders, guarantors and mortgage insurance companies, could continue to experience significant difficulties, including runs on their deposits and inadequate liquidity. Therefore, the prices of financial assets are likely to continue to reflect risk aversion, with increased volatility.

In an attempt to increase liquidity in the financial markets and prevent the failure of the financial system, various governments may continue to intervene in their financial systems, and perform tax adjustments. There is no assurance, however, that these measures will be successful in stabilizing conditions in international financial markets.



Despite the extent of the above-mentioned interventions, global investor confidence could remain low, the global financial markets could remain volatile and access to credit could still be lacking. The continuation or worsening of disruption and volatility in the global financial markets may have a material adverse effect on our ability to access the capital markets under appropriate financial conditions, which may adversely affect our operations. Furthermore, an environment of economic downturn may negatively affect the financial stability of our customers, which could result in a general reduction in Brazil's economic activity and the consequent loss of income for us.

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Political instability may have an adverse impact on the Brazilian economy and on our business.

Political crisis in Brazil may affect the confidence of investors and the public in general, as well as the development of the economy. Political crises may have an adverse impact on the Brazilian economy, our business, financial condition, results of operations and the market price of our preferred shares and ADSs.

Inflation and government efforts to curb inflation may contribute to economic uncertainty in Brazil, adversely affecting our business and results of operations.

Brazil has historically experienced high rates of inflation. Inflation and certain government's measures taken in the attempt to curb inflation have had significant negative effects on the Brazilian economy. In 2012, inflation measured by the Consumer Price Index (Índice de Preços ao Consumidor), or IPCA, reached 5.8%, below the upper limit established by the CMN, of 6.5%, but above the central inflation target of 4.5%. In 2013, the Brazilian monetary policy will continue to use the IPCA as a reference for the inflation target. The inflation target for 2013 is set at 4.5%, similar to 2012. If inflation rises beyond this target, the basic interest rates may also rise, directly affecting the cost of our debt and indirectly reducing the demand for products and services related to telecommunications. In 2013, factors that may adversely affect consumer inflation are, among others, the international commodities prices, the impact of buoyant domestic economic activity on domestic prices and the indexation of prices and tariffs.

Since 2006, telephone fees for fixed line services have been indexed to the Index of Telecommunication Service, or IST, reduced by a productivity factor. The IST is a basket of national indexes that reflects the industry's operating costs. As a result, this index serves to reduce potential discrepancies between our industry's revenue and costs, and thus reduce the apparent adverse effects of inflation upon our operations.

The fee rate increase authorized by ANATEL, which references the IST, is reduced by a factor of productivity and applied cumulatively after a period of 12 months. This may cause increases in costs and salaries above and below our revenues, with adverse impacts on our profitability. Increases in interest rates may have a material adverse effect on our business.

The Monetary Policy Committee of the Brazilian Central Bank (Comitê de Política Monetária do Banco Central do Brasil), or COPOM, sets the target of the basic interest rate for the Brazilian financial system based on an expectation of convergence between the future inflation rate and the central inflation target. On December 31, 2012, the basic interest rate was 7.25% per year, compared to 11% per year on December 31, 2011. Further increases in the basic interest rate may occur throughout 2013 with adverse effects on our business. According to current market consensus, inflation measured by the IPCA will be higher than the established inflation target of 4.50% for 2013. As a result, the Central Bank may increase the SELIC rate (the Central Bank's overnight rate) in 2013 to align inflation with the inflation target, which may adversely affect our business.

Fluctuations in exchange rates may adversely affect our ability to meet liabilities denominated or linked to foreign currencies or reduce our income in foreign currency, and may have a material adverse effect on the market value of our preferred shares and ADSs.

The exchange rate between the U.S. dollar and the Brazilian real has experienced significant fluctuations in recent years. Between 2000 and 2003, the real was devalued 67% against the U.S. dollar and gained 40% between 2004 and 2010, considering the annual average exchange rates. Between 2001 and 2012, the real appreciated by 11.9 % against the U.S. dollar.

As of December 31, 2012, 19.9 % of our R\$ 7.97 billion total financial debt was denominated in U.S. dollars and UMBNDES. As of December 31, 2012, we had currency hedges in place to cover all of our financial foreign

currency-denominated bank debt.

Part of the costs relating to our network infrastructure and services provided by outside vendors is payable or linked to payment by us in U.S. dollars. By contrast, our revenue is generated in reais, except income derived from hedging transactions, international long-distance interconnection and services to customers outside of Brazil.

To the extent that the value of the real decreases relative to the U.S. dollar or the euro, our commitments linked to fluctuations in exchange rates or payable in foreign currencies become more expensive. In return, our accounts receivable denominated in foreign currencies appreciate, which could adversely affect our revenue and expenses.

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However, 99.9% of the net balance of the transactions denominated in foreign currencies is covered by hedge transactions. Since May 2010, the company began using net balance coverage, which is the coverage for net positions in foreign exchange exposures generated by invoices issued or received in foreign currencies, substantially reducing the company's risk to fluctuations in exchange rates. By periodically receiving invoices for the net balance coverage and determining the coverage of exposures, the company's corporate market risk department monitors its foreign exchange exposure and commitments linked to foreign currencies so as not to achieve a significant amount of exposure.

It should be noted that the IST, the current index applicable to telecommunication fees for fixed-line services, does not adequately reflect the true effect of exchange rate fluctuations. Thus, since 2006, telecommunication revenue, when converted to U.S. dollars, does not adequately reflect the true effect of exchange rate fluctuations, so that our results of operations could be adversely affected. See "—A. Selected Financial Data—Exchange Rates" for more information on exchange rates.

Political, economic and social developments and the perception of risk in other developed and emerging countries may adversely affect the Brazilian economy, our business, and the market price of Brazilian securities, including our preferred shares and ADSs.

The market for securities issued by Brazilian companies may be influenced, to varying degrees, by economic conditions in both emerging and developed market countries. The reaction of investors to developments in other countries may have an adverse impact on the market value of securities of Brazilian companies. Crises in other emerging countries or the economic policies of other countries may reduce investor demand for securities of Brazilian companies, including our preferred shares. Any of the foregoing developments may adversely affect the market value of our preferred shares and hinder our ability to access the capital markets and finance our operations in the future on acceptable terms and costs, or at all.

Exchange controls and restrictions on remittances abroad may adversely affect holders of our preferred shares and ADSs.

Brazilian law allows that, whenever there is a significant imbalance in Brazil's balance of payments or a significant possibility that such imbalance will exist, the Brazilian government may impose temporary restrictions on capital outflows. Such restrictions could hinder or prevent the holders of our preferred shares or the custodian of our shares in Brazil, Citibank N.A. (acting as the agent for the depositary), from remitting dividends abroad. The Brazilian government imposed restrictions on capital outflows for a six-month period at the end of 1989. If similar restrictions are introduced in the future, they would likely have an adverse effect on the market price of our preferred shares and ADSs.

Risks Relating to the Brazilian Telecommunications Industry and Us

Extensive government regulation of the telecommunications industry and our concession may limit, in some cases, our flexibility in responding to market conditions, competition and changes in our cost structure or impact our fees.

Our business is subject to extensive government regulation, including any changes that may occur during the period of our authorization to provide telecommunication services. ANATEL, which is the main telecommunications industry regulator in Brazil, regulates, among other things:

- industry policies and regulations;
- licensing;

- fees and tariffs;
- competition, including, therefore, our ability to grow by acquiring other telecommunications businesses;
- telecommunications resource allocation;
- service standards;

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- technical standards;
- quality standards;
- interconnection and settlement arrangements; and
- universal service obligations.

Brazil's telecommunications regulatory framework is continuously evolving. The interpretation and enforcement of regulations, the assessment of compliance with regulations and the flexibility of regulatory authorities are all marked by uncertainty. We operate under authorization from the Brazilian government, and our ability to retain this authorization is a precondition to our success. However, because of the regulatory framework, we cannot provide assurances that ANATEL will not adversely modify the terms of our authorization. Furthermore, according to the terms of our operating authorizations, we are obligated to meet certain requirements and to maintain minimum quality, coverage and service standards. Failure by us to comply with these requirements may result in the imposition of fines or other government actions, including the termination of our operating authorizations. Any partial or total revocation of any of our operating authorizations would have a material adverse effect on our business, financial condition, revenues, results of operations and prospects. In recent years, ANATEL has also been reviewing and introducing changes in the applicable regulation, especially regarding the interconnection fees among telecommunications service providers in Brazil. Interconnection fees, which are fees charged by telecommunications service providers to each other to interconnect to each other's networks, are an important part of our revenue base. To the extent that changes to the rules governing interconnection fees reduce the amount of interconnection fees we are able to collect, our businesses, financial conditions, revenues, results of operations and prospects could be materially adversely affected.

Therefore, our businesses, results of operations, revenues and financial conditions could be negatively affected by the actions of the Brazilian authorities, including, in particular, the following:

- the introduction of new or stricter operational and/or service requirements;
- the granting of operating licenses in our areas;
- delays in the granting of, or the failure to grant, approvals for rate increases; and
- antitrust limitations imposed by ANATEL and CADE.

Our concession may be terminated by the Brazilian government under certain circumstances.

We operate our business under a concession granted by the Brazilian government. According to the terms of the concession, we are obligated to meet certain universal service requirements and to maintain minimum quality and service standards. For example, ANATEL requires that we satisfy certain conditions with respect to, among other things, expansion of our network to provide public pay-phone service for all locations with populations in excess of 100, expansion of our network to provide private individual telephone service for all locations with populations in excess of 300, and, with respect to quality of service, targets for the number of call completions. Our ability to satisfy these terms and conditions, as well as others, may be affected by factors beyond our control. Our failure to comply with the requirements of our concession may result in the imposition of fines up to R\$50.0 million or other government actions, including the termination of our concession. Any partial or total revocation of our concession would have a material adverse effect on our financial condition and results of operations. Moreover, the concession agreements establish that all assets owned by the company and which are indispensable to the provision of the services described in such agreements are considered reversible assets and are deemed to be part of the concession

assets. The assets will be automatically returned to ANATEL upon expiration of the concession agreements, according to the regulation in force at that time. On December 31, 2012, the net book value of reversible assets is estimated at R\$6.7 billion, which is comprised of switching and transmission equipment and public use terminals, external network equipment, energy equipment and system and operation support equipment.

The expiration date of the original concession agreements was December 31, 2005, but it has since been renewed as of December 22, 2005 for an additional 20-year term. The current concession agreements contain a provision allowing ANATEL to review the concession terms in 2015 and 2020. This provision permits ANATEL to

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update the renewed concession agreements with respect to network expansion, modernization and quality of service targets in response to changes in technology, competition in the marketplace and domestic and international economic conditions.

Important mergers and acquisitions in the market should increase competition in the upcoming years.

Some of the main telecommunication groups in Brazil went through a series mergers and acquisitions in 2012. In December 2011, Sky Brasil (a Brazilian subsidiary of DirecTV), announced the purchase of Acom Comunicações, a Brazilian television and internet company, which was approved by regulators in 2012. Along with the acquisition of Acom, Sky Brasil also acquired grants to operate new 4G spectrum areas in June 2012.

In May 2012, entrepreneur George Soros acquired Sunrise Telecomunicações, a Brazilian pay-TV provider that is now expanding into mobile services. Sunrise Telecomunicações spent US\$9.3 million to acquire two 4G spectrum licenses covering 134 cities in the state of São Paulo. Furthermore, during the last quarter of 2012, Vivendi S.A. decided to sell Global Village Telecom or GVT as part of a review of its business portfolio in the telecommunications industry, including videogames and music. GVT currently sells phone, video and broadband services in 120 cities in Brazil. On March 14, 2013 Vivendi decided to stop de process to sell GVT.

Mergers and acquisitions may change the market dynamic, cause competitive pressure and force small competitors to find partners and may impact our business, in terms of operations, financial condition, marketing strategies and offering of products and promotions.

We face increasing competition from telecom service providers.

The telecommunication industry in Brazil is growing rapidly, partly as a result of increased competition. Our competitors have been using aggressive promotion techniques to increase their client base and, as a result, market share. New marketing strategies stimulate clients to increase their voice and data usage, by offering unlimited network-to-network minutes and daily and prepaid data options. While in 2012 there has been an increase in growth of our mobile client base, there has been a decrease in the number of fixed services added.

Further, in 2012 there has also been an increase in competition regulation aimed at stimulating competition, increasing the adoption of services and reinforcing the quality of services delivered.

Brazilian antitrust regulation is based on Law No. 12,529 of November 30, 2011, which generally prohibits any practice or transactions aimed at restricting free competition, dominating the relevant market of goods or services, arbitrarily increasing profits, or abusively exercising a dominant market position. The new antitrust law has altered several practices in Brazil; particularly, it established a pre-merger notification regime with a new turnover thresholds and extended the maximum period for merger review procedures to 330 days from 240 days. We cannot continue to expand our growth through acquisition of other service providers given the antitrust objections of ANATEL along with the fact that we currently already render SMP service all over the country. Consolidation of other competitors in the telecommunications market will increase the competitive pressure on us due to the increase in their economies of scale and reduction of operational costs, and we may be unable to respond adequately to pricing pressures resulting from consolidation, which would adversely affect our business, financial condition and results of operations.

Our results of operations may be negatively affected by the application of the SMP rules.

Under the SMP regime, our cellular subsidiaries receive payments for the use of their networks in accordance with a network usage payment plan, which includes outbound long-distance calls. Until June 30, 2004, SMP service providers were able to opt to establish a price cap or freely negotiate our interconnection charges. In early 2005,



ANATEL began permitting free negotiations for mobile interconnection, or VU-M, fees and by July 2005, local-fixed concessionaires and mobile operators had reached a provisional agreement with respect to VU-M fees for local calls, or VC1 (the agreement guaranteed a 4.5% increase in mobile operators' fees). ANATEL approved that provisional agreement and, in March 2006, approved another provisional agreement of a 4.5% increase for VU-M fees for long-distance calls, or VC2, VC3, and international calls, among the same operators that had made the VC1 agreement in July 2005. The current rule is the free negotiation of fees, subject to ANATEL regulations. In July 2007, ANATEL approved a provisional agreement among us and the fixed-line operators Telemar, Brasil Telecom, CTBC Telecom and Sercomtel and the mobile operators for interconnection fees for VC1, VC2 and VC3 calls that provides for an annual adjustment of approximately 1.97% to interconnection fees in Region I (Telemar's Region)

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and an annual adjustment of approximately 2.25% in Region II (Brasil Telecom's Region) and Region III (Telefônica's Region).

ANATEL also issued Regulation No. 460/2007 regarding Number Portability, implementing and developing fixed and wireless Number Portability in Brazil effective as of March 2009, with most costs being borne by the operators. For SMP, Number Portability is applied for wireless codes of access of the same registration area. As of December 2011, there were 242.2 million cell phones in Brazil. From the period beginning in September 2008, when Number Portability became effective, until December 31, 2012, over 3.1 million users had transferred out of, and another 3.1 million users had transferred into, our subsidiaries as their mobile operator. For fixed service operators, Number Portability is applied for fixed codes of access of the same local area. There can be no assurance that this regulation will not have material adverse effects on the results of our operations.

On July 18, 2012, Vivo was notified by ANATEL that it would be required to present an improvement plan, subject to ANATEL's approval, for the improvement of SMP services provided. The plan is aimed to improve services, in particular: (1) call completions; (2) service interruptions; and (3) user satisfaction. Our competitors were also required to present their own improvement plans to ANATEL. Vivo presented its improvement plan to ANATEL and received approval on September 10, 2012.

We cannot predict whether the current regulatory regime will remain in place or whether any future regulatory change or requirements will have an adverse effect on our results of operations. We cannot assure you that our service plan will continue to be approved by ANATEL or that the interconnection rates we negotiated will be upheld or that future negotiations will be as favorable as those that were previously set by ANATEL. If the readjustments that we negotiated are cancelled or if freely negotiated interconnection fees in the future are less favorable to us, our business, financial condition, revenues, results of operations and prospects will be adversely affected.

If the inflation adjustment index currently applied to our prices is changed, the new index may not adequately reflect the true effect of inflation on our prices, which could adversely affect our results of operations.

The Brazilian government currently uses the General Price Index, or the IGP-DI (the Índice Geral de Preços Disponibilidade Interna), an inflation index developed by the Fundação Getúlio Vargas, a private Brazilian economic organization, in connection with the prices charged in the wireless telecommunications industry. ANATEL regulates the telecommunication industry based on an economic cost model that analyzes companies' total costs based on a theoretical company's costs and other factors. In connection with this model, the Brazilian government used a different inflation adjustment mechanism, the IST index. Under Resolution No. 438/2006, ANATEL will determine the reference cost of using mobile networks (RVU-M) for SMP providers who have significant market power, which will be used in the arbitration case by ANATEL to determine the VU-M fee. In addition, Resolution No. 600/2012, determined that RVU-M, which is calculated based on a cost model, will go into effect on February 24, 2016. As a result, we expect there to be a decrease in 2014 of 75% of VU-M, in effect on December 31, 2013 and in 2015 of 50% of the VU-M. The inflation adjustment of the RVU-M value uses the IST index. In the auctions by SMP of new radio frequency bands, ANATEL has been using the IST index for determining the value of the installments to be paid for the licenses. If this new inflation adjustment mechanism, or any other mechanism chosen by the Brazilian government in the future, does not adequately reflect the true effect of inflation on our prices, our results of operations could be adversely affected.

ANATEL's new regulation regarding interconnection and network usage fees could have an adverse effect on our results.

We are regulated by ANATEL, which issues new regulations every year affecting many of our areas of operations. Such new regulations could have an adverse effect on our results of operations because: (1) our interconnection

charges could drop significantly, thereby reducing our revenues; (2) ANATEL may allow more favorable prices for economic groups without significant market power; (3) the prices we charge in some regions in which we operate are higher than those in certain other regions, and consolidation of those prices, competitive pressures and other factors would reduce our average prices and thereby reduce our revenues; (4) the granting of new licenses may increase competition in our area from other operators, which could adversely affect our market share, thereby reducing our revenues; (5) the inclusion in the calculation of operating profits the remuneration received for the use of the SMP network will increase the cost of renewing licenses; and (6) in ANATEL's general plan of updating the telecommunications regulation, ANATEL targets several areas of vital importance for the mobile telecommunications business, such as regulation to improve the quality of services that can cause the rise of

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operational costs, regulation of the virtual mobile operation (MVNO) that can cause an increase in competitive pressure, regulation against significant market power (“Poder de Mercado Significativo–PMS”) arising from VU-M fee unification among SMP providers of the same economic group having significant market power, that can reduce our revenues, and regulation of multimedia communication (SCM), that can cause an increase in competitive pressure. For a detailed description of the regulations issued by ANATEL and their impact on our business, see “Item 4B. Business Overview—Regulation of the Brazilian Telecommunications Industry.”

The industry in which we conduct our business is continually changing and evolving technologically.

The telecommunications industry is subject to rapid and significant technological changes. Our future success depends on our ability to anticipate and adapt in a timely manner to technological changes. We expect that new products and technologies will emerge and that existing products and technologies will be further developed.

The advent of new products and technologies could have a variety of consequences. These new products and technologies may reduce the price of our services by providing lower-cost alternatives, or they may also be superior to, and render obsolete, the products and services we offer and the technologies we use, thus requiring investment in new technology.

We are subject to certain risks related to conditions and obligations that could be imposed by ANATEL for the participation in the spectrum auction for LTE services.

In August 2010, ANATEL established a new policy regulating the 2.5 GHz spectrum, which requires MMDS (Multichannel Multipoint Distribution Service) companies, including us, to return, by 2013, a significant portion of the spectrum we currently own and to offer cable TV on a primary basis.

On June 12 and 13, 2012, ANATEL held a public bidding for 273 4G lots in the 2,500 to 2,690MHz frequencies. We acquired the “X” band, with a nationwide coverage, for R\$1.05 billion. Given the rules of the public bidding process, which limited the total spectrum each service provider could hold within this frequency, we agreed to relinquish bands “P,” “T” and “U.” used for MMDS services within 18 months of obtaining the “X” band. Sky and TIM will have preferred rights for the acquisition of the “T” and “U” and for the “P” bands, respectively in the cities of Curitiba and Rio de Janeiro and Oi will have preferred rights for the acquisition of the “P” band in the cities of São Paulo and Porto Alegre.

In order to meet the coverage requirements in the 2.5 GHz frequency, cities will have the services available according to the following timetable:

- by April 30, 2013: cities that will be host to the Confederation Cup in 2013
- by December 31, 2013: host and sub-host cities to the World cup in 2014;
- by May 31, 2014: state capitals, the Federal District and cities with over 500,000 residents;
  - by December 31, 2015: cities with over 200,000 residents;
  - by December 31, 2016: cities with over 100,000 residents;
- by December 31, 2017: cities with between 30,000 and 100,000 residents; and
  - by December 31, 2019: cities with fewer than 30,000

ANATEL also held a public bidding for the 450 MHz frequency, in order to meet voice and data demand with mobile technology in rural areas. In the absence of interested participants, those granted rights under the 4G bid were required to take over the infrastructure set up in rural areas, which will be regulated in 2013 according to the frequency acquired.

Under band “X,” which we acquired in the bidding process, we will be required to provide infrastructure in rural areas in the states of Alagoas, Ceará, Minas Gerais, Paraíba, Pernambuco, Piauí, Rio Grande do Norte, Sergipe, and countryside of São Paulo, for a total of 2,556 municipalities. The timetable for providing infrastructure in the rural areas requires that 30% of municipalities have infrastructure set up by June 2014, 60% by December 2014 and 100% by December 2015, with a transmission rate of 256Kbps and by December 31, 2017, all of these municipalities will be expected to have 1Mbps. Service providers will be allowed to use other frequencies previously granted to it to meet these requirements.

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After receiving the ANATEL study on the occupation of the 700 MHz frequency, published in early January 2013, the communications minister, published Ordinance No. 14, with guidelines for accelerated access to the Brazilian System of Digital Terrestrial Television - SBTVD-T and to broaden the availability of the radio frequency spectrum for meeting the goals set forth by the National Broadband - PNBL. The ordinance also establishes that the FCC develop a proposal to regulate use of the band. The proposal will be put to public consultation, giving conditions for the bidding possibly occur in the second semester of 2013.

Also, targets established by ANATEL associated with a fast paced implementation of networks could impact (i) the ability to obtain municipal licenses for the construction of new sites at the speed necessary to achieve the coverage targets, (ii) the capacity of suppliers to deliver the equipment necessary for this expansion, with possible impact on their prices, subject to targets to acquire national technology, and (iii) lack of workers to meet the expected implementation pace.

Certain of our debt agreements contain financial covenants, and any default under such debt agreements may have a material adverse effect on our financial condition and cash flows.

Certain of our existing debt agreements contain restrictions and covenants and require the maintenance or satisfaction of specified financial ratios and tests. Failure to meet or satisfy any of these covenants, financial ratios or financial tests could result in an event of default under these agreements.

The telecom industry, including us, may be harmed by restrictions regarding the installation of new antennas for mobile services.

Currently, there are approximately 250 municipal laws that restrict the installation of new antennas for mobile service, which has been a barrier to the expansion of mobile networks. Those laws are meant to regulate issues related to urban aspects and the alleged effects of the radiation and radiofrequencies of the antennas. There are initiatives for the approval of a federal law establishing new guidelines to create a consolidated plan for the installation of antennas, however as long as the municipal laws remain unchanged, we will continue to run the risk of having limited quality of service in certain areas and may be unable to meet the quality and coverage targets provided for in regulations and service agreements with ANATEL.

The installation of additional antennas is also limited as a result of media and other reports, which have suggested that radio frequency emissions from base stations may cause health problems. These concerns could have an adverse effect on the wireless communications industry and, possibly, expose wireless providers, including us, to litigation. According to the World Health Organization (WHO), there is no evidence in the latest medical research that shows any relationship between radio frequency emissions of base stations and health concerns. However, expansion of our network may be affected by perceived risks if we experience problems in finding new sites, which in turn may delay expansion and may affect the quality of our services. On July 2, 2002, ANATEL published Resolution No. 303 that limits emission and exposure for fields with frequencies between 9 kHz and 300 GHz. In addition, the Brazilian government developed specific legislation for the deployment of radio frequency transmission stations that supersedes the existing state and municipal laws. In May 2009, the Brazilian government published Law No. 11934/2009 that limits the exposure for fields with frequencies up to 300 GHz. The new law uses the exposition limits determined by the International Commission on Non-Ionizing Radiation Protection (ICNIRP) and recommended by the WHO.

In May 2011, the specialized body of the WHO for research on cancer (IARC) classified electromagnetic fields of mobile telephony as “possibly carcinogenic,” a classification which also includes products such as coffee and pickled foods. The WHO subsequently indicated, in fact sheet no. 193, published in June 2011, that to date it cannot be confirmed that the use of a mobile telephone has adverse effects on health, although it also announced that in 2012 an official assessment of this risk will be conducted, taking into account all scientific evidence available.

New laws may create additional transmission regulations, which in turn, could have an adverse effect on our business. Also, health concerns may affect our ability to capture or retain customers, may discourage the use of the mobile telephone and may result in the adoption of new measures by governments or any other regulatory interventions, any of which could materially and adversely affect our business, results of operations and financial condition.

We face risks associated with litigation.

We are party to a number of lawsuits and other proceedings. An adverse outcome in, or any settlement of, these or other lawsuits could result in significant costs to us. In addition, our senior management may be required to devote substantial time to these lawsuits, which they could otherwise devote to our business. See “Item 8. Financial Information—A. Consolidated Statements and Other Financial Information—Legal Matters.”

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We may be required to record impairment charges relating to goodwill and long-lived assets in the future.

For IFRS purposes, we are required to test our goodwill for impairment at least annually. The excess of the book value of a company over its market value may indicate that impairment exists. This impairment test is described in Note 3 to our audited consolidated financial statements. The Company has substantial goodwill with a carrying value of R\$10.2 billion as of December 31, 2012. It is possible that we may be required to record impairment charges relating to our goodwill in future periods, and this would have an adverse effect on our results of operations.

In addition, we are required to record impairment charges on long-lived assets, including property, plant and equipment and finite-lived intangible assets (including licenses) if the carrying value of these assets exceeds the recoverable amount expected from their use. This impairment test is also described in Note 3 to our audited consolidated financial statements included in this annual report.

Risks Relating to the Preferred Shares and the ADSs

Holders of our ADSs may face difficulties in serving process on or enforcing judgments against us and other persons.

We are organized under the laws of Brazil, and all of our executive officers and our independent public accountants reside or are based in Brazil. Also, eight of our fifteen directors reside or are based in Brazil. Substantially all of our assets and those of these other persons are located in Brazil. As a result, it may not be possible for holders of the ADSs to effect service of process upon us or these other persons within the United States or other jurisdictions outside Brazil or to enforce against us or these other persons judgments obtained in the United States or other jurisdictions outside Brazil. Because judgments of U.S. courts for civil liabilities based upon the U.S. federal securities laws may only be enforced in Brazil if certain conditions are met, holders may face greater difficulties in protecting their interests due to actions by us, our directors or executive officers than would shareholders of a U.S. corporation.

Holders of our Preferred Shares and ADSs generally do not have voting rights.

In accordance with Brazilian Corporate Law and our bylaws, holders of our preferred shares, and therefore of our ADSs, are not entitled to vote at meetings of our shareholders, except in limited circumstances set forth in “Item 10. Additional Information—B. Memorandum and Articles of Association.”

Holders of our Preferred Shares might be unable to exercise preemptive rights with respect to the preferred shares unless there is a current registration statement in effect which covers those rights or unless an exemption from registration applies.

Holders of our preferred shares will not be able to exercise the preemptive rights relating to the preferred shares underlying your ADSs unless a registration statement under the U.S. Securities Act of 1933, as amended, or the Securities Act, is effective with respect to the shares underlying those rights, or an exemption from the registration requirements of the Securities Act is available. We are not obligated to file a registration statement. Unless we file a registration statement or an exemption from registration applies, holders of our preferred shares may receive only the net proceeds from the sale of their preemptive rights by the depositary, or if the preemptive rights cannot be sold, they will lapse and you will not receive any value for them. For more information on the exercise of these rights, see “Item 10. Additional Information—B. Memorandum and Articles of Association—Preemptive Rights.”

An exchange of ADSs for preferred shares risks the loss of certain foreign currency remittance and Brazilian tax advantages.



The ADSs benefit from the certificate of foreign capital registration, which permits Citibank N.A., as depositary, to convert dividends and other distributions with respect to preferred shares into foreign currency, and to remit the proceeds abroad. Holders of ADSs who exchange their ADSs for preferred shares will then be entitled to rely on the depositary's certificate of foreign capital registration for five business days from the date of exchange. Thereafter, they will not be able to remit non-Brazilian currency abroad unless they obtain their own certificate of foreign capital registration, or unless they qualify under Resolution No. 2,689 of the Central Bank of Brazil, dated January 26, 2000 and issued by BACEN, which entitles certain investors to buy and sell shares on Brazilian stock exchanges without obtaining separate certificates of registration.

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If holders of ADSs do not qualify under Resolution No. 2,689, they will generally be subject to less favorable tax treatment with respect to our preferred shares. There can be no assurance that the depositary's certificate of registration or any certificate of foreign capital registration obtained by holders of ADSs will not be affected by future legislative or regulatory changes, or that additional Brazilian law restrictions applicable to their investment in the ADSs may not be imposed in the future.

Holders of our preferred shares will be subject to, and holders of our ADSs could be subject to, Brazilian income tax on capital gains from sales of preferred shares or ADSs.

Brazilian Law No. 10,833 provides that gains on the disposition of assets located in Brazil by nonresidents of Brazil, whether to other nonresidents or to Brazilian residents, will be subject to Brazilian taxation. The preferred shares are expected to be treated as assets located in Brazil for purposes of the law, and gains on the disposition of preferred shares, even by nonresidents of Brazil, are expected to be subject to Brazilian taxation.

Based on the fact that the ADSs are issued and registered abroad, we believe that gains on the disposition of ADSs made outside of Brazil by nonresidents of Brazil to another non-Brazilian resident would not be subject to Brazilian taxation, since they would not fall within the definition of assets located in Brazil for purposes of Law 10,833. However, considering the general and unclear scope of Law No. 10,833 and the absence of judicial court rulings in respect thereto, we cannot be assured that such an interpretation of this law will prevail in the courts of Brazil. If the income tax is deemed to be due, the gains may be subject to income tax in Brazil at a rate of 15.0% (general taxation) or 25.0% (if the nonresident seller is located in a tax haven, a country which does not impose any income tax, which imposes it at a maximum rate lower than 20.0%, or in which the laws impose restrictions on the disclosure of ownership composition or securities ownership or the identification of the effective beneficiary of income attributed to nonresident holders). See "Item 10. Additional Information—E. Taxation—Brazilian Tax Considerations."

### Certain Factors Relating to Our Controlling Shareholder

Our controlling shareholder has strong influence over our business.

Telefónica S.A., or Telefónica, our principal shareholder, currently owns directly and indirectly approximately 91.76% of our voting shares and 73.81% of our total capital. See "Item 7. Major Shareholders and Related Party Transactions—A. Major Shareholders" and "Item 7. Major Shareholders and Related Party Transactions—B. Related Party Transactions." As a result of its share ownership, Telefónica has the power to control us and our subsidiaries, including the power to elect our directors and officers and to determine the outcome of any action requiring shareholder approval, including corporate reorganizations and the timing and payment of our dividends. Given this degree of control over our company, circumstances could arise under which the interests of Telefónica could be deemed to be in conflict with the interests of our other shareholders.

## ITEM 4.

### INFORMATION ON THE COMPANY

#### A. History and Development of the Company

##### General

We were incorporated on May 22, 1998, as a corporation (sociedade anônima) organized under the laws of the Federative Republic of Brazil, as a result of the restructuring and privatization of Telebrás, discussed below. We are incorporated under the name Telefônica Brasil S.A. (and, before our merger with Vivo Participações on October 3, 2011, under the name Telecomunicações de São Paulo S.A. – TELESP).

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We are registered with the CVM as a publicly held company and our stock is traded on the BM&FBOVESPA under the symbol “VIVT3” (formerly TLPP3) for common shares and “VIVT4” (formerly TLPP4) for preferred shares. We are also registered with the SEC in the United States and our ADSs are traded on the New York Stock Exchange, or the NYSE under the symbol “VIV” (formerly TSP). Our headquarters are located at Avenida Engenheiro Luis Carlos Berrini, 1376, 04571-936, São Paulo, SP, Brasil. Our telephone number is 55-11-3430-8901 and our website is [www.telefonica.com.br/ir](http://www.telefonica.com.br/ir). The information on our website is not part of this annual report on Form 20-F.

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As of December 31, 2012, we had 381,335,671 outstanding common shares, with no par value per share, and 741,933,573 preferred shares, with no par value per share. Our shareholders' equity was in the amount of R\$44.7 billion as presented under IFRS.

We provide fixed-line telecommunications services in the state of São Paulo under concession agreements granted in 1998 by the Brazilian government in connection with the restructuring and privatization of the Telebrás System, as described below. The concession, which was renewed in December 2005, authorizes us to provide fixed-line telecommunications services in a specific region, which includes all of the state of São Paulo except for a small area (Sector 33), where a previously existing fixed-line service provider, CTBC Telecom, which was not part of the Telebrás System, continues to operate independently.

In addition to the services that we provide under the concession agreements of 1998, we also provide international and interregional long-distance services, as permitted under Act No. 23,395 of March 1, 2002, pursuant to which ANATEL also acknowledged the completion of our network expansion and achievement of universal service targets as of September 30, 2001.

We also provide multimedia communication services (serviços de comunicação multimedia), or SCM, such as audio, data, voice and other sounds, images, texts and other information. ANATEL granted the SCM license with Act No. 33,791 of February 14, 2003, which authorized the rendering of the service in all of the state of São Paulo, except for Sector 33.

On March 14, 2007, ANATEL conceded to A. TELECOM S.A., one of our wholly owned subsidiaries, the license to offer Pay TV services through DTH ("Direct to the Home," a special type of service that uses satellites for the direct distribution of television and audio signals for subscribers). We began offering Pay TV services on August 12, 2007.

On October 31, 2007, the board of ANATEL approved, from a regulatory perspective, the association between Grupo Abril and the company, which involved, among other transactions, the acquisition of all of the operations of Multichannel Multipoint Distribution Service, or MMDS, a special license that allows us to offer Pay TV and broadband services through our subsidiary Telefonica Sistemas de Televisão S.A. The transaction continues to be analyzed by ANATEL, solely with respect to antitrust matters, and is pending review by CADE.

In 2008, we pioneered the launch of Internet access through fiber optic cables ("Fiber to the Home"), or FTTH to noncommercial customers. Aside from the offer of an Internet connection with high-speed capabilities of 30 Mbps and 100 Mbps, various bundles have also been offered, including Wi-Fi, Digital TV, 2,000 minutes of local and intra-state calls, anti-virus protection, call identification, technical assistance and specific call center assistance.

On February 16, 2009, ANATEL extended the authorization for the use of the spectrum frequencies associated with the MMDS in the cities of São Paulo, Curitiba, Rio de Janeiro and Porto Alegre through 2024.

According to data regarding market share published by ANATEL, we are among the leading providers of cellular telecommunications services in Brazil, with the help of our wholly owned direct subsidiary Vivo, the leading cellular operator in Brazil. Vivo provides cellular service in the states of Acre, Alagoas, Amapá, Amazonas, Bahia, Ceará, Espírito Santo, Goiás (including the Federal District), Maranhão, Mato Grosso, Mato Grosso do Sul, Pará, Paraíba, Paraná, Pernambuco, Piauí, Rio de Janeiro, Rio Grande do Norte, Rio Grande do Sul, Rondônia, Roraima, Santa Catarina, São Paulo, Sergipe, Tocantins and Minas Gerais.

As of December 31, 2012, our telephone network included 10,646 thousand fixed-lines in service, 76,137 thousand mobile accesses, 3,733 thousand broadband clients and 600 thousand Pay TV clients.

## Historical Background

### The Restructuring and Privatization

After the incorporation of Telecomunicações Brasileiras S.A.–Telebrás in 1972, Telebrás and its operating subsidiaries (collectively, the “Telebrás System”) acquired almost all of the telephone companies in Brazil and monopolized the provision of public telecommunications services in virtually all areas of the country.

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In May 1998, just before its privatization under the General Telecommunications Law, the Telebrás System was restructured to form, in addition to Telebrás, 12 new holding companies. Virtually all assets and liabilities of Telebrás were transferred to the new holding companies, or the “new holding companies.”

In July 1998, the federal government privatized the Telebrás System, selling substantially all its shares in the new holding companies, including TelespPar and its shares in TSP and CTBC Borda, to private sector buyers. As a result of a subsequent reorganization of SP Telecomunicações on January 10, 1999, one of its subsidiaries, SPT Participações S.A., or SPT, became the controlling shareholder of TelespPar.

### The Reorganization of TelespPar

On November 30, 1999, the shareholders of TelespPar approved a reorganization involving a series of mergers, whereby TelespPar became the telecommunications services company operating under our current name, Telefônica Brasil S.A. (formerly Telecomunicações de São Paulo S.A. – TELESP prior to our merger with our direct subsidiary, Vivo Participações).

### Ceterp’s Acquisition

On December 20, 1999, we began the acquisition, through a public auction from the municipal government of the City of Ribeirão Preto, in the State of São Paulo, of 51.0% of the voting shares and 36.0% of the total share capital of Centrais Telefônicas de Ribeirão Preto S.A., or Ceterp. Ceterp provided fixed-line and cellular services in the State of São Paulo, outside the Telebrás System, and had been one of our minor competitors.

On December 27, 2000, Ceterp was merged with and into us.

### The Spin-off of Certain Data Transmission Operations

On August 3, 2000, our wholly owned subsidiary, Telefônica Empresas S.A., was created with the corporate goal of providing Switched Package Network services, and, on January 30, 2001, the independent Brazilian corporation, Telefônica Data Brasil Holding S.A. (TDBH), was created through a shareholder-approved spin-off of the data transmission operations performed by Telefônica Empresas S.A. A merger of the company and TDBH was effective in July 2006. See “—The SCM Restructuring.”

### Attainment of ANATEL Targets

Our business, services and tariffs have been regulated by ANATEL since June 16, 1997, in accordance with various decrees, decisions, plans and regulatory measures. We became the first operator to achieve ANATEL’s service targets. As a result, ANATEL granted us a license to offer domestic and international long-distance services to our customers. Accordingly, on May 7, 2002, we began providing international long-distance services and, on July 29, 2002, we began providing interregional long-distance service. See “—B. Business Overview—Regulation of the Brazilian Telecommunications Industry—Obligations of Telecommunications Companies—Network Expansion and Quality of Service” for information relating to ANATEL’s network expansion and universal service targets.

On January 29, 2003, the board of directors of ANATEL granted us the authorization to provide SCM service nationwide. We may now offer voice and data services through various points of presence composed of networks and telecommunication circuits.

On July 6, 2003, mobile telephony operators started to implement a long-distance carrier selection, or CSP that enables customers to choose the long-distance carrier for each domestic long-distance call (VP2 and VP3) or

international call, in accordance with the SMP rules. As a result, the company, having acknowledgment of the revenue from these long-distance services, started to pay the mobile telephony operators for the use of their networks.

On September 4, 2004, the rules dictated by Resolution No. 373, dated as of June 3, 2004, were implemented to carry out the reconfiguration of the local areas for the STFC. As a consequence, all calls previously billed at domestic long-distance rates (DC level – Áreas Conurbadas) are now billed at lower rates as local calls. In São Paulo, this modification involved 53 municipalities, of which 39 are in Greater São Paulo (Grande São Paulo).

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### IP Network Asset Acquisition

On December 10, 2002, after receiving approval from ANATEL, our Board of Directors approved a proposal to acquire certain assets from Telefónica Data S.A. (formerly T-Empresas), one of the companies of the Telefónica group, including the following services: (i) an Internet service that allows our customers to access our network through remote dial-up connection and (ii) services that allow customers of Internet Service Providers, or ISPs, to have access to broadband Internet. The purpose of this asset acquisition was to capitalize on synergies that would assist in developing our network and provide a quick response to market competitors.

### Acquisition and Reorganization of Atrium

On December 30, 2004, we acquired indirect control of Atrium Telecomunicações Ltda. from Launceston Partners CV. Atrium provided various types of telecommunications services in Brazil, including Internet and intranet services, telecommunications management services and the sale and rental of telecommunications systems and related equipment. The acquisition was carried out through the purchase of the total share capital of Santo Genovese Participações Ltda., which held 99.99% of the representative share capital of Atrium.

On November 21, 2005, we approved the corporate reorganization of our wholly owned companies, A. TELECOM S.A. (formerly Assist Telefónica S.A.), Santo Genovese Participações Ltda., or Santo Genovese and Atrium Telecomunicações Ltda., or Atrium, which was implemented and became effective on March 1, 2006.

### The SCM Restructuring

On March 9, 2006, our board of directors and the boards of directors of TDBH and Telefónica Empresas S.A., a wholly owned subsidiary of TDBH (“T-Empresas” and together with us and TDBH, the “T-Companies”), approved the restructuring of the T-Companies’ SCM and data transmission activities, or the SCM Restructuring.

The terms and conditions of the SCM Restructuring are set forth in an agreement among the T-Companies dated as of March 9, 2006. The SCM Restructuring consisted of (i) the merger of TDBH into our company (the “Merger”); and (ii) the spin-off of all T-Empresas’ assets and activities except its SCM assets and activities outside Sectors 31, 32 and 34 of Region III of Annex II of the General Concession Plan (the “Spin-off”) and assets and activities related to the data center.

Following the approval of this restructuring: (i) TDBH was dissolved; (ii) its shareholders received shares of our common or preferred stock, or ADSs, as appropriate; (iii) we succeeded TDBH in all of its rights and obligations; and (iv) T-Empresas became our wholly owned subsidiary. The transfer to TELESP of the spun-off components of T-Empresas did not result in any increase or decrease in the net equity of TELESP, nor in the number of shares that comprise its capital stock.

With respect to TDBH’s Merger into us, certain minority shareholders tried to suspend our general shareholders meeting by contesting the appraisal of the share exchange ratio provided by NM Rothschild & Sons (Brasil) Ltda. by obtaining an injunction from the 14th civil chamber of the central forum of the district court of São Paulo. The injunction was lifted on July 28, 2006, and the merger became legally effective. The main action (Ação Ordinária No. 583.00.2006.156920-5) has not yet been resolved in the lower court.

On January 31, 2008, the shareholder of Telefónica Empresas S.A., which is the company, resolved to change Telefónica Empresas S.A.’s corporate name to Telefónica Data S.A.



Agreement of Convergence, Purchase and Sale of Operations, Assets, Stock and Other Obligations with the Abril Group

On October 29, 2006, we entered into an agreement with Abril Comunicações S.A., TVA Sistema de Televisão S.A., Comercial Cabo TV São Paulo Ltda., TVA Sul Paraná Ltda., and TVA Radioenlaces Ltda. (the “Abril Group”), whereby we combined our telecommunications and broadband services with the broadband and cable services of Tevecap S.A., or TVA, the second largest Brazilian pay TV provider with operations in the states of Paraná, Rio Grande do Sul, São Paulo and Rio de Janeiro. Through this transaction, we broadened our services to meet our users’ increasing demand, combining the Abril Group’s expertise in content and media production and placement with the expertise of the Telefónica Group in the telecommunications segment.

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On October 31, 2007, the board of directors of ANATEL concluded the regulatory review of the association between Grupo Abril and the company, approving the transaction, which involves (i) the acquisition of all of the operations of MMDS (Multichannel Multipoint Distribution Service) and broadband, and (ii) the acquisition of a significant stake, within the limit of the foreseen effective laws and regulations, in the cable television dealers controlled by Grupo Abril within and outside of the State of São Paulo. This decision was published on November 19, 2007. Antitrust clearance is still pending from ANATEL and CADE competition authorities.

On November 23, 2007, our shareholders ratified the Agreement, its amendments and annexes, and approved the implementation of the deal and the signing of all documents necessary for its complete formalization.

As a result of this transaction, Navytree Participações S.A., or Navytree became a wholly owned subsidiary of TELESP, and our provision of broadband services became centralized.

On June 10, 2008, our shareholders approved a change in the corporate name of Navytree to Telefônica Televisão Participações S.A., or TTP.

### Corporate Reorganization involving Ajato

On October 14, 2008, Telefonica Sistema de Televisão S.A., TST and TTP purchased from Abril Comunicações S.A. all shares of Mundial Voip Telecomunicações Ltda., EPP, which had its corporate name changed to Ajato Telecomunicação Ltda., or Ajato. As a result of the merger of TTP into the company on November 11, 2008, Ajato's shares are currently held by TST and us.

### Corporate Reorganization involving DABR and TTP

On October 21, 2008, our board of directors and the shareholders of TTP and Telefônica Data Brasil Participações Ltda., or DABR approved a corporate reorganization that consisted of the merger of TTP and DABR into us.

On November 11, 2008, the merger of TTP and DABR was approved by our shareholders. As a result of this restructuring, TTP and DABR were dissolved and we assumed all the rights and obligations of TTP and DABR.

The reorganization allowed us to increase synergies, reduce managerial risk, simplify the corporate administrative structure and reduce costs, while also providing tax benefits expected to reduce TELESP's income tax and other taxes assessed on revenue and income, thereby improving our cash flows. The reorganization and the goodwill amortization were structured so as to avoid any assumption of indebtedness by us and to minimize any negative impact on our future results.

### Corporate Restructuring involving TS Tecnologia

On May 22, 2009, Telefônica Data S.A., our subsidiary, merged with its controlled subsidiary, TS Tecnologia da Informação Ltda., or TS Tecnologia, in accordance with the values recorded on the books and an appraisal report. This merger caused TS Tecnologia to be extinguished, and Telefônica Data S.A. became the successor to all of the assets and liabilities of TS Tecnologia.

### Corporate Restructuring involving A.TELECOM S.A.

On December 9, 2009, our Board of Directors approved the submission to a shareholder vote of the corporate reorganization proposal consisting of the partial spin-off of A.TELECOM S.A., or A.TELECOM, and the subsequent merger of the spun-off part of A.TELECOM into us.

On December 30, 2009, A.TELECOM's shareholders approved the spin-off of part of A.TELECOM and the subsequent merger of the spun-off part into us. On the same date, our shareholders approved the merger of the spun-off part into us.

This corporate restructuring created synergies for us and A.TELECOM providing both of us with better administrative, operating and regulatory efficiencies regarding telecommunication integrated services, thus benefiting both of us and our respective shareholders.

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### Corporate Restructuring involving Brasilcel

#### Acquisition of Brasilcel N.V. stocks by Telefónica S.A.

On July 28, 2010 Telefónica S.A. and Portugal Telecom SG SGPS, S.A. entered into an agreement for the acquisition by Telefónica of 50% of shares of Brasilcel N.V., or Brasilcel, owned by Portugal Telecom. As a result, Telefónica indirectly acquired the shares of Vivo Participações held by Portugal Telecom. Prior to this agreement, Brasilcel's shares were held by Telefónica (50%) and by Portugal Telecom (50%) and, in 2002, it was used for the joint venture between both shareholders to jointly hold shares and control of Vivo Participações and other mobile phone companies which were later added under Vivo Participações and in Vivo.

On December 21, 2010, Brasilcel was merged into Telefónica, which held direct and indirect stakes in Vivo Participações' capital stock representing approximately 60%.

Due to the acquisition of control of Vivo Participações and pursuant to the terms provided for in Article 254-A of Brazilian Corporate Law and the procedures established in article 29 of CVM Instruction 361 applicable to tender offers (OPA) by sale of control, as defined by item III of article 2 of CVM Instruction 361, on February 17, 2011 Telefónica through its subsidiary SP Telecomunicações Ltda., or SPTelecom, launched a public tender offer for the shares with voting rights of Vivo Participações (common shares) held by noncontrolling interests. Those shares were acquired at 80% of the value paid by Telefónica to Portugal Telecom SG SGPS S.A., for each common share with voting rights of Vivo Participações owned by Brasilcel.

On March 18, 2011, when the public tender offers were made, SP Telecom acquired 10,634,722 common shares of Vivo Participações, representing 2.65% of its shares, resulting in the Telefonica group's ownership of 62.1% of Vivo Participações.

#### Introduction of the Vivo Brand

In April 2003, Brasilcel launched in Brazil the brand name "Vivo," under which TCP, TCO, TLE, TSD and Celular CRT operate. The creation of the Vivo brand constituted a consolidation of the commercial models throughout the entire country into a common commercial strategy and replaced the different brands under which the different companies offered their services in their respective states. The commercial strategy of Vivo is to increase its customer base as well as revenues by retaining customers and maintaining their distribution channels. The launching of the Vivo brand was accompanied by customer loyalty programs and other measures designed to contribute to the success of the commercial strategy. Guided by a common management team, Vivo designs marketing, promotional and other initiatives common to all companies in the Vivo group and then tailors those activities to the particular markets of those companies.

#### Agreement with Telefónica and Telecom Itália

In October 2007, TELCO S.p.A. (a company in which Telefónica holds a corporate interest of 42.3%) acquired 23.6% of the capital stock of Telecom Itália. Telecom Itália also holds an interest in the capital stock of TIM. However, Telefónica did not acquire any right to directly participate in the operations of TIM as a result of the acquisition of the corporate interest in Telecom Itália by TELCO S.p.A.

As a result, any transaction involving us and TIM is considered an ordinary mobile network business transaction, which is regulated by ANATEL, as provided in the Act 68,276, dated October 31, 2007 and in the Act 3,804, dated July 7, 2009, both issued and published by ANATEL.

Corporate Restructuring involving Vivo Participações

On July 28, 2010, in accordance with the material fact disclosed to the public by Telefónica S.A., our controlling shareholder, Telefónica S.A. and Portugal Telecom executed a purchase agreement for the acquisition by Telefónica S.A. (directly or through any of the companies within its group) of 50% of the capital stock of Brasilcel (a company jointly owned by Telefónica and Portugal Telecom, which owns shares representing approximately 60% of the capital stock of the Brazilian company Vivo Participações).

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On December 27, 2010, the company and Vivo Participações, jointly announced the approval by their respective boards of directors of a proposal for corporate restructuring involving the merger of shares of Vivo Participações into us, aiming for the consolidation of the shareholding positions of both companies.

Other than the concentration of the shareholding position herein mentioned, the purpose of the corporate restructuring was to simplify the organizational structure of the companies, both of which were publicly held companies and listed on BM&FBOVESPA and with American Depositary Receipts traded in the United States. The restructuring allowed their respective shareholders to participate in one unified company with greater liquidity and with shares traded on Brazilian and foreign stock exchanges. Moreover, the corporate restructuring provided for the rationalization of the cost structure of the two companies and facilitated the integration of businesses and the generation of synergies, thus positively impacting both companies.

The simplified organization chart below demonstrates the corporate structure of the companies before and after the implementation of this reorganization.

The corporate structure before the merger of shares is as follows:

Upon completion of this corporate restructuring, Telefónica, S.A. held the shares of the Brazilian holding companies previously held indirectly by Telefónica, S.A., through the holding of Brasilcel, N.V., as a result of a transaction implemented abroad. The merger of shares did not change the composition of the ultimate control of the companies involved.

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The corporate structure after the merger is as follows:

Vivo Participações was merged into us, and the holders of the merged shares of Vivo Participações received new shares to which they were entitled in the company. In accordance with Brazilian Corporate Law, as well as the bylaws of both companies, financial advisors and specialized companies were retained for the preparation of studies regarding the transaction and the subsequent preparation of valuation reports of the companies that were used as reference for the determination of the exchange ratio of shares and the increase in capital stock resulting from the merger of shares, as well as for the purposes of article 264 of Brazilian Corporate Law regarding the exchange ratio between the shares.

The corporate restructuring was approved by ANATEL on March 24, 2011. Before the corporate restructuring, the Brazilian entities, TBS Celular Participações Ltda., Portelcom Participações S.A. and PTelecom Brasil S.A. (jointly, the “Holdings BR”), were merged into Vivo Participações. The Holdings BR had as its main asset the shares of Vivo Participações and were controlled by Brasilcel. The merger of Holdings BR did not result in any change in the number and the composition of classes of shares of Vivo Participações, and did not affect the participation of the shareholders of Vivo Participações.

Acquisition of Vivo Participações by Telefônica Brasil and corporate restructuring

In order to unify the shareholder base of the companies in our group, simplify the organizational structure, rationalize costs, integrate businesses and, consequently, generate synergies provided for in the strategy of Telefônica, on December 27, 2010, the boards of directors of Vivo Participações and Telefônica Brasil approved the terms and conditions of a restructuring, which provided for the merger of Vivo Participações into Telefônica Brasil. Following recommendations of the CVM, independent special committees were created to negotiate the exchange ratio of shares and determine the other conditions of the corporate restructuring proposal, which was later submitted along with its recommendations to the boards of directors of both companies.

The proposal was submitted to ANATEL for authorization and was approved at a meeting of the board of directors of ANATEL on March 24, 2011.

On March 25, 2011, the boards of directors of Vivo Participações and Telefônica Brasil approved the terms and conditions of the corporate restructuring, which were approved unanimously by the shareholders of the two companies on April 27, 2011.

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Before the start of the corporate restructuring, the holding companies (composed of TBS Celular Participações Ltda., Portelcom Participações S.A. and Brazil PTelecom S.A.), controlled by Telefónica S.A. and whose main purpose was to hold shares of Vivo Participações, were merged into Vivo Participações as a preliminary phase for the first stage of the restructuring.

The first stage of the transaction consisted of the unification of the share base of the fixed and mobile operators of the Telefonica group in Brazil, through the merger of shares of Vivo Participações into Telefônica Brasil. Vivo Participações was merged in its entirety into Telefônica Brasil and holders of shares of Vivo Participações received the new shares of Telefônica Brasil. The exchange of shares of Vivo Participações for shares of Telefônica Brasil was based on the exchange share ratio of 1.55 shares of Telefônica Brasil for each share of Vivo Participações. This followed the recommendations of the independent special committees.

Due to the merger of Vivo Participações into us, our capital was increased by R\$31.2 billion, reflecting the economic value of the shares issued as a result of the merger, based on an economic value appraisal of Vivo Participações prepared by Planconsult Consultoria Ltda., or Planconsult.

Telefónica's strategy in the first stage of the corporate restructuring was to maximize the potential of its operations in Brazil. Therefore, Telefônica Brasil became the direct shareholder of Vivo Participações, and indirect shareholders of Vivo. Through the creation of this umbrella investment structure, the noncontrolling shareholders of both companies were equally benefited by the added values generated by the combination of the telecommunications business. This is a basic movement in business so as to improve its converging market strategy, including combined mobile and fixed-line offers. This reorganization created the necessary conditions to begin the process of obtaining operational and financial synergies.

Additionally, as a consequence of this merger, on July 6, 2011, Vivo Participações filed a statement with the SEC in order to cancel the registration American Depositary Shares, or ADS, program since all its ADSs were converted into ADSs of Telefônica Brasil, plus payment currency in lieu of fractional Telefônica Brasil ADSs. The SEC approved the deregistration on July 7, 2011.

The second and third stages of the corporate restructuring, disclosed to the market on June 15, 2011, sought to continue the simplification process of the organizational structure of the companies, so as to: (i) focus all authorizations for the rendering of SMP services (originally held by Vivo Participações and Vivo), and (ii) simplify the current corporate structure, eliminating the structure of Vivo Participações, which due to the concentration of commitments, became a holding company.

In the second stage, held on October 1, 2011, assets, rights and obligations of Vivo Participações relating to mobile operations in Minas Gerais were awarded to Vivo, a subsidiary of Vivo Participações. As a result, Vivo became the only mobile operator in the group.

After ANATEL's approval of the third stage of corporate restructuring, on August 16, 2011, Telefônica Brasil absorbed Vivo Participações' equity, extinguishing Vivo Participações on October 3, 2011, which simplified and rationalized our cost structures.

### SMP Authorizations and Corporate Restructuring

On June 14, 2011, the board of directors of Vivo Participações approved a proposal for the merger of authorizations to provide SMP services (then owned by Vivo Participações in the State of Minas Gerais and Vivo in other Brazilian States). As a result, the operations and authorizations for the provision of SMP services were unified under Vivo. On the same date, the proposal for merger of SMP authorizations as well as for simplifying the corporate structure was



filed with ANATEL. The form proposed for this simplified corporate structure was the transfer of businesses, including property, rights and obligations related to provision of SMP services, as well as the authorizations for the provision of SMP in the State of Minas Gerais held by Vivo Participações, to Vivo, which would result in Vivo being a wholly owned direct subsidiary of the company and the mobile operator group that owns the SMP authorizations in other Brazilian states. After the transfer, Vivo Participações was to become a holding company and immediately merge into us, thus simplifying and rationalizing the cost structure of the companies involved and subsequently extinguish its corporate existence. On August 16, 2011, ANATEL approved the corporate restructuring pursuant to Act. No. 5,703, published on August 18, 2011.

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On September 12, 2011, in compliance with Brazilian Corporate Law, an independent firm prepared a valuation report of Vivo Participações' net assets based on its book value as of August 31, 2011 containing part of Vivo Participações' assets relating to the operations of SMP in the state of Minas Gerais that were transferred to Vivo and the assets of Vivo Participações merged into us. Vivo Participações' valuation as of August 31, 2011 was R\$10.3 billion.

On September 13, 2011, the board of directors of Vivo Participações approved, ad referendum of the shareholders: (i) the valuation report of Vivo Participações, containing part of the assets corresponding to the SMP operations in the State of Minas Gerais, which led to a capital increase in Vivo in the amount of R\$833.0 million, through the subscription of shares of Vivo Participações; and (ii) the Protocol of Merger and Instrument of Justification of Vivo Participações into Telecomunicações de São Paulo S.A. – TELESP, for the merger of Vivo Participações into us, preceded by the transfer of commercial establishments, including the assets, rights and obligations related to provision of SMP, as well as authorizations for the provision of SMP in the state of Minas Gerais held by Vivo Participações.

On October 1, 2011, our shareholders approved the valuation report of Vivo Participações. The net assets of Vivo Participações in Minas Gerais transferred to Vivo amounted to R\$833.0 million, which were used for the capital increase in Vivo through the subscription of shares by Vivo Participações, paid via the transfer of assets.

On October 3, 2011, our shareholders approved the merger of Vivo Participações into us. On the same date, we changed our name from Telecomunicações de São Paulo S.A. – TELESP to Telefônica Brasil S.A., to reflect its nationwide operations.

On October 18, 2011, ANATEL approved transfer of the authorization for the provision of SMP services in the state of Minas Gerais to Vivo.

Provision of STFC outside the state of São Paulo by Vivo

On August 18, 2011, ANATEL approved the authorization for Vivo to provide STFC services to the general public. On October 7, 2011, Vivo began providing fixed-line services through mobile technology, or FWT outside the state of São Paulo.

On August 18, 2011, ANATEL consented to the transfer of our authorization for STFC services in local, domestic long-distance and international long-distance modes outside the state of São Paulo in Regions I and II to Vivo, which authorization was published on September 8, 2011. As a result, Vivo began to offer STFC across its area, except for the state of São Paulo, using the network elements and some radio frequencies that support the provision of SMP.

Plan for the purchase of shares issued by the company.

On August 11 and 15, 2011, the company informed its shareholders and the market in general, respectively, of approval by the Board of Directors, of the acquisition of preferred and common shares issued by the company for subsequent cancellation, disposal or maintenance in treasury, without capital reduction, in order to add value for shareholders. For this repurchase, there was use of part of the capital reserve existing as of June 30, 2011, excepting the reserves mentioned in article 7, letter (a) to (d) of CVM Rule No. 10/80.

The repurchase started on the date of the resolution, and remains effective until October 20, 2011, and acquisitions are on BM&FBOVESPA, at market prices. The Executive Board was responsible for establishing the maximum quantity of shares to be acquired, whether in a sole or a series of transactions, as well as the definition of the parameters to carry out the acquisitions, observing applicable legal limits and the established maximum number of up to 2,700,000 preferred shares and 2,900,000 common shares.

On November 5, 2012, the company announced to its shareholders and the market in general that its board of directors had approved a plan for repurchase of preferred and common shares issued by the company, without a capital reduction, to add value to shareholders. On June 30, 2012, we used a portion of our capital reserves for this repurchase, pursuant to Article 7 sections (a)-(d) of CVM Rule No.10/80.

The repurchase started on the date of the resolution, and remained effective until November 4, 2013, and acquisitions were on BM&FBOVESPA, at market prices. Our board of executive officers was responsible for

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establishing the maximum quantity of shares to be acquired, whether in a sole or a series of transactions, and defining the parameters used to carry out the acquisitions, observing applicable legal limits and the established maximum number of up to 24,257,777 preferred shares and 2,894,534 common shares.

Call option of the remaining shares of Lemontree and GTR-T

On June 6, 2012, the company exercised its call option in relation to (1) the remaining 71,330,508 common shares corresponding to 51% of the voting capital of Lemontree Participações S.A., or Lemontree, which holds Commercial Cabo TV São Paulo S.A., a company engaged in cable TV services in the state of São Paulo; and (2) the remaining 923,778 common shares of GTR Participações Ltda., or GTR-T, which holds 50.9% of the common shares of TVA Sul Paraná S.A., a company engaged in cable TV services outside the state of São Paulo, these shares were previously held by the Abril Group.

The call option represents the closing of the acquisition process of the remaining shares of Lemontree and GTR-T, which started with the partial exercise of the option on September 29, 2011 and the acquisition of the common shares of Lemontree, representing 49% of its voting capital.

The call option was provided for in the Private Agreement for Convergence, Purchase and Sale of Businesses, Assets, Shares and Other Covenants, entered into on October 29, 2006 between us and the Abril Group, which approved by our shareholders on November 23, 2007. The exercise of the call option was subject to the reduction or elimination of the regulatory restrictions applicable to the company, which was granted along with the revocation of the concession agreement limitations in order to have the company and its subsidiaries authorized to provide cable TV services in the same concession area as those for which it provides STFC services in the São Paulo region.

Following the exercise of the call option, Telefônica Brasil S.A. holds 100% of Lemontree and GTR-T and, indirectly, of the companies engaged in cable TV services located in São Paulo, Curitiba, Foz do Iguaçu and Florianópolis.

Corporate Structure and Ownership

Our current general corporate and shareholder structure is as follows:

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ON: common shares.

PN: preferred shares.

Restructuring Telefônica Brasil's subsidiaries

On March 15, 2012, our board of directors approved a corporate restructuring of our wholly owned subsidiaries to rationalize the provision of services rendered by these subsidiaries and the concentration of the provision of telecommunication services into a single company.

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The restructuring will be implemented by a process of partial division and merger, involving only our wholly owned subsidiaries, A. TELECOM, TData, TST, Ajato and Vivo. As a result of the restructuring, value added services provided by several wholly-owned subsidiaries of the company will be unified under Telefonica Data S.A. and other telecommunications services will be unified under the company, which, as a final step to the corporate restructuring, will merge these subsidiaries. Following the merger, value added service will be provided by Telefonica Data S.A. and the company will provide other telecommunication services.

In addition to streamlining services, the corporate restructuring (now possible because of legislative changes applicable to STFC providers) aims to simplify our current organizational structure and assist the integration of business and the generation of synergies arising therefrom.

This corporate restructuring can only be implemented with consent from ANATEL. As of the date of this annual report, there is no expected date for ANATEL's consent.

## Capital Expenditures

Year ended December 31, 2012

In 2012, we invested R\$6,117.1 million in projects that sustain our current annual results and competitive position in the medium-term. A significant portion of resources was allocated to allow quality growth in our services. The investments in maintaining quality and expanding our client base represented 87% of the total amount invested by us in 2012 (excluding the purchase of new licenses).

To meet the needs of an increasingly connected society, significant investments were made to support the strong growth of our fixed and mobile data users or dedicated high speed services for our corporate clients. We continue to invest in expanding the backbone of national data transmission to meet the increase in mobile data traffic throughout the country.

The following table sets forth our capital expenditures for each year in the three-year period ended December 31, 2012.

Telefônica Brasil	Year ended December 31,		
	2012	2011	2010
	(in millions of reais)		
Network	3,845.8	3,381.0	2,039.7
Technology / Information Systems	562.3	612.5	266.1
Others(1)	1,709.0	1,408.0	135.6
Total capital expenditures	6,117.1	5,401.5	2,441.4

(1) Consists primarily of free handset rentals, network construction, furniture and fixtures, office equipment and store layouts and an amount of R\$811.8 million in 2011 and R\$1,050.2 million in 2012 related to the acquisition of licenses.

Year ended December 31, 2011

In 2011, we invested in projects that support our current results and prepare the company for the competitive landscape in the medium-term. A significant proportion of resources were allocated to enable growth associated with the services we provide.

To meet the needs of an increasingly connected society, significant investments were made to support the strong growth of data customers, whether fixed and mobile data services or dedicated high-speed services to the corporate market, as well as the increase in capillarity of our fiber optics network in São Paulo. We also invested in the expansion of the national data transmission backbone to meet increasing demand for mobile data traffic nationwide.

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Year ended December 31, 2010

In 2010, we were focused in voice services in order to comply with ANATEL's targets and to provide quality service for clients. Also, in order to achieve a consolidated position in the broadband market, during 2010 the focus of our capital expenditure were expanding, modernizing and upgrading our ADSL network and improving our systems and processes of customers' relations, marketing and sales.

B. Business Overview

The concessions granted by the Brazilian government in 1998 and renewed in 2005, with the effective date starting in January 2006, allow us to provide fixed-line telecommunications services to a region that includes most—approximately 95%—of the state of São Paulo. The portion of the state of São Paulo that is excluded from our concession represents approximately 1.5% of total lines in service and 2.2% of the state's population. This concession is operated by CTBC Telecom.

Our concession region is Region III, which comprises 622 municipalities, including the city of São Paulo, with an aggregate population of approximately 41.3 million. Of the municipalities in Region III, 72 have a population in excess of 100,000. The city of São Paulo has a population of approximately 11 million. According to a plan established by the federal government, whereby the government granted licenses to four providers of fixed-line telecommunications services, the state of São Paulo was divided into four sectors, including Sectors 31 (our predecessor company's area before the reorganization), 32 (the area corresponding to Ceterp before our acquisition), 33 (corresponds to the portion of the state of São Paulo that we do not service) and 34 (area corresponding to CTBC Borda do Campo before the reorganization). Through transactions that took place in November 1999 and December 2000, CTBC Borda do Campo and Ceterp merged into our company, which now holds concessions for Sectors 31, 32 and 34. Sector 33 is held by CTBC Telecom. On November 21, 2008, the Federal government combined the three sectors for which we hold concessions into a single sector, designated as Sector 31.

On May 7, 2002, we began offering international long-distance services and on July 29, 2002, we started offering interregional service. The conditions for the provision of interregional and international long-distance services outside the concession area contemplate that providers already operating services under a selection code (a two-digit code to be input by the caller as a prefix to the number dialed, representing a long-distance operator) would keep such code under the new licenses authorizing operation outside the applicable concession area. Accordingly, we continue using the provider selection code "15" that permits our callers to make calls using our services even though they are outside our concession area. All interregional and international cellular calls, whether in our concession area or that of another provider, need to dial a carrier selection code using Personal Mobile Service—SMP, through which mobile services users choose the provider for interregional and international long-distance calls, and which requires dialing our code "15" to use our services. See "—Network Services."

Since our merger with Vivo Participações, we provide mobile telecommunications services in all of the Brazilian states and in the Federal District, representing a total of approximately 8.5 million square kilometers and a population of approximately 194 million people. Our wholly-owned subsidiary, Vivo, became a national operator when, on September, 2007, it acquired a license to operate within 6 states located in the Northeast region (Alagoas, Ceará, Pernambuco, Piauí, Paraíba and Rio Grande do Norte) and when it acquired Telemig.

According to data regarding market share published by ANATEL, we are among the leading providers of mobile telecommunication services in Brazil, through our subsidiary Vivo, the leading mobile service operator in Brazil. Vivo is a cellular operator in the states of Acre, Alagoas, Amapá, Amazonas, Bahia, Ceará, Espírito Santo, Goiás (also encompassing the area of Federal District), Maranhão, Mato Grosso, Mato Grosso do Sul, Pará, Paraíba, Paraná, Pernambuco, Piauí, Rio de Janeiro, Rio Grande do Norte, Rio Grande do Sul, Rondônia, Roraima, Santa Catarina, São

Paulo, Sergipe, Tocantins and Minas Gerais.

#### Areas of Operation

In Areas 1 and 2, Vivo uses a frequency range known as “A,” “L” and “J” bands that covers 100% of the municipalities in its authorized areas in the state of São Paulo. On December 31, 2012, Vivo had 20.5 million mobile lines in service in these areas, which represented a 4.4% net increase from December 31, 2011, and a market share of approximately 32.5% in São Paulo.



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In Area 3, Vivo uses a frequency range known as “A,” “L” and “J” bands that covers 100% of the municipalities and 100% of the population in the states of Rio de Janeiro and Espírito Santo. On December 31, 2012, Vivo had 10.4 million mobile lines in service in this area, which represented a 3.3% net increase from December 31, 2011, and a market share of approximately 37.7% in those states.

In Area 4, Vivo uses a frequency range known as “A,” “E” and “J” bands that covers 71.6% of the municipalities and 92.4% of the population in the state of Minas Gerais. On December 31, 2012, Vivo had 8.3million mobile lines in service in this area, which represented a 4.4% net increase from December 31, 2011, and a market share of approximately 32.4% in Minas Gerais.

In Area 5, Vivo uses a frequency range known as “B” band that covers 67.1% of the municipalities in the states of Paraná and Santa Catarina and 93.9% of the population of Paraná and Santa Catarina. On December 31, 2012, Vivo had 4.6million mobile lines in service in this area, which represented a 0.8% net increase from December 31, 2011, and a market share of approximately 20.1% in those states.

In Area 6, Vivo uses a frequency range known as “A,” “L” and “J” bands that covers 82.5% of the municipalities and 97.7% of the population in the state of Rio Grande do Sul. On December 31, 2012, Vivo had 6.4million mobile lines in service in this area, which represented a 5.9% net increase from December 31, 2011, and a market share of approximately 41.0% in that state.

In Areas 7 and 8, Vivo is the leading mobile operator, by number of customers, in its authorization area and uses a frequency range known as “A,” “B,” “L” and “J” bands that covers 61.2% of the municipalities in the states of Acre, Federal District, Goiás, Mato Grosso, Mato Grosso do Sul, Rondônia, Tocantins, Amazonas, Amapá, Maranhão, Pará and Roraima which covers 87.2% of the population in these states. On December 31, 2012, Vivo had 17.0 million mobile lines in service in these areas, which represented a 10.4% net increase from December 31, 2011, and a market share of approximately 34.8% in those states.

In Area 9, Vivo uses a frequency range known as “A,” “L” and “J” bands that covers 69.1% of the municipalities and 89.3% of the population in the States of Bahia and Sergipe. On December 31, 2012, Vivo had 5.9 million mobile lines in service in this area, which represented a 8.1% net increase from December 31, 2011, and a market share of approximately 29.8% in those states.

In Area 10, Vivo a frequency range known as “L” and “J” bands that covers 37.9% of the municipalities and 73.4% of the population in the States of Alagoas, Ceará, Pernambuco, Piauí, Paraíba and Rio Grande do Norte. On December 31, 2012, Vivo had 3.1 million mobile lines in service in this area, which represented a 24.1% net increase from December 31, 2011 and a market share of approximately 8.1% in those states.

On September 18, 2007, with ANATEL’s approval, Vivo acquired the “L” band lots, except for lot 16 (area of Londrina, Paraná, in Region V) and lot 20 (area of Northern Brazil in Region VIII). The “L” band comprises lots in frequency ranges 1895 to 1900 MHz and 1975 to 1980 MHz, with 5 + 5 MHz bandwidth. As a result, Vivo managed to complete its last coverage gap and will soon be operating in the entire Brazilian territory. On December 20, 2007, with ANATEL’s approval, Vivo acquired the “J” band lots with 10 + 10 MHz bandwidth, with the exception of the lots in the state of Minas Gerais then acquired by Telemig Celular and now operated by Vivo.

On December 14 and 15, 2010, Vivo acquired 23 lots in the remaining SMP band auction. Vivo acquired lots in almost all regions of Brazil, which allowed us to reach spectrum capacity of 70 Mhz or higher in all regions where we operates (excluding 23 municipalities in and around Franca in the state of São Paulo, where the spectrum is 50 Mhz). On the same date, Vivo also acquired 23 lots in the “H” band. As a result, Vivo improved its capacity to provide services throughout the national territory and now operates in the 900 MHz and 1,800 MHz frequencies in a broad

way.

On June 12 and 13, 2012, Vivo acquired the “X” band lot in an auction held by ANATEL, for a total amount of R\$1.05 billion. As a result, Vivo will enhance its ability to provide service with 4G technology in all of Brazil and will be operating in the frequency range of 2,500 MHz with band of 20 + 20 Mhz. In addition to the 2,500 MHz band, the lot also includes the 450 MHz band for the rural areas of the states of Alagoas, Ceará, Minas Gerais, Paraíba, Pernambuco, Piauí, Rio Grande do Norte, São Paulo and Sergipe.

The following table sets forth population, gross domestic product, or GDP, and per capita income statistics for each state in Vivo’s service regions at the dates and for the years indicated:

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Area	Frequency Range (MHz)	On December 31, 2012			Last Available IBGE Data from 2010		
		Population (in thousands)(1)	Percent of Brazil's population(1)		GDP (in millions of reais) (2)	Percent of Brazil's GDP (2)	Per capita income (in reais) (2)
São Paulo State	450, 850, 900, 1800, 1900, 2100 and 2500	41,262	21.63 %		1,247,596	33.09 %	30,243
Paraná State	850, 900, 1800, 1900, 2100 and 2500	10,445	5.48 %		217,290	5.76 %	20,814
Santa Catarina State	850, 900, 1800, 1900, 2100 and 2500	6,248	3.28 %		152,482	4.04 %	24,398
Goiás State	850, 900, 1800, 1900, 2100 and 2500	6,004	3.15 %		97,576	2.59 %	16,252
Tocantins State	850, 900, 1800, 1900, 2100 and 2500	1,383	0.73 %		17,240	0.46 %	12,462
MatoGrosso State	850, 900, 1800, 1900, 2100 and 2500	3,035	1.59 %		59,600	1.58 %	19,644
Mato Grosso do Sul State	850, 900, 1800, 1900, 2100 and 2500	2,449	1.28 %		43,514	1.15 %	17,766
Rondônia State	850, 900, 1800, 1900, 2100 and 2500	1,562	0.82 %		23,561	0.62 %	15,098
Acre State	850, 900, 1800, 1900, 2100 and 2500	734	0.38 %		8,477	0.22 %	11,567
Amapá State	850, 900, 1800, 2100 and 2500	670	0.35 %		8,266	0.22 %	12,361
Amazonas State	850, 900, 1800, 2100 and 2500	3,484	1.83 %		59,779	1.59 %	17,173
Maranhão State	850, 900, 1800, 2100 and 2500	6,575	3.45 %		45,256	1.20 %	6,889
Pará State	850, 900, 1800, 2100 and 2500	7,581	3.97 %		77,848	2.06 %	10,259
Roraima State	850, 900, 1800, 2100 and 2500	450	0.24 %		6,341	0.17 %	14,052
Federal District	850, 900, 1800, 1900, 2100 and 2500	2,570	1.35 %		149,906	3.98 %	58,489
Bahia State	850, 900, 1800, 1900, 2100 and 2500	14,017	7.35 %		154,340	4.09 %	11,007
Sergipe State		2,068	1.08 %		23,932	0.63 %	11,572

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	450, 850, 900, 1800, 1900, 2100 and 2500							
Rio de Janeiro State	850, 900, 1800, 1900, 2100 and 2500	15,990	8.38	%	407,123	10.80	%	25,455
Espírito Santo State	850, 900, 1800, 1900, 2100 and 2500	3,515	1.84	%	82,122	2.18	%	23,379
Rio Grande do Sul State	850, 900, 1800, 1900, 2100 and 2500	10,694	5.61	%	252,483	6.70	%	23,606
Alagoas State	450, 900, 1800, 1900, 2100 and 2500	3,120	1.64	%	24,575	0.65	%	7,874
Ceará State	450, 900, 1800, 1900, 2100 and 2500	8,452	4.43	%	77,865	2.07	%	9,217
Pernambuco State	450, 900, 1800, 1900, 2100 and 2500	8,796	4.61	%	95,187	2.52	%	10,822
Piauí State	450, 900, 1800, 1900, 2100 and 2500	3,118	1.63	%	22,060	0.59	%	7,073
Paraíba State	450, 900, 1800, 1900, 2100 and 2500	3,767	1.97	%	31,947	0.85	%	8,481
Rio Grande do Norte State	450, 900, 1800, 1900, 2100 and 2500	3,168	1.66	%	32,339	0.86	%	10,208
Minas Gerais State	450, 850, 900, 1800, 2100 and 2500	19,597	10.27	%	351,381	9.32	%	17,932
Vivo		190,756	100.00	%	3,770,085	100.00	%	19,766

(1) According to Censo 2010 published by IBGE in 2011 (latest data available).

(2) According to the most recent IBGE data (2010). Nominal Brazilian GDP was R\$3,770,085 million as of December 2010 calculated by IBGE, subject to revision.

As of December 31, 2012, we had 318 of our own sales outlets throughout Brazil, which also provide customer support for our existing customers. In addition, we also have 11,720 sales outlets run by authorized dealers. As of December 31, 2012, we had the highest number of sales outlets among all our competitors.

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We aim to increase our services in strategic cities and locations where there is currently no sales outlets for our services. As of December 31, 2012, we had 50 partners, including Telesales and Door to Door services, with approximately 1,200 salespeople reaching out to potential customers, in particular for Vivo fixed-line, post-paid and data services.

We also have an on-line store and an authorized e-commerce operation for the sale of services over the Internet.

In 2012, prepaid mobile service customers counted on approximately 600 thousand points of sale to purchase credit, including our own stores, authorized agents, lottery stores, post offices, bank branches and small retailers, such as pharmacies, newspaper stands, libraries, bakeries, gas stations, bars and restaurants. Pre-paid phones can be charged by purchasing cards with credit or digitally. Recharge is also offered through credit and debit cards, call center, Vivo PDV (M2M using a cell phone for transferring the recharge credit), personal recharge (recharge of the cell phone itself), as well as certain accredited Internet websites.

### Overview

Our services consist of:

- voice services, including activation, monthly subscription, measured service and public telephones;
- interconnection charges (or network usage charges), which are amounts we charge other cellular and fixed-line service providers for the use of our network;
  - intraregional, interregional and international long-distance voice services;
  - data services, (including broadband services) and mobile value added services;
- Pay TV services through DTH (direct to home), satellite technology and land based wireless technology MMDS (multichannel multipoint distribution service) and cable;
  - the sale of wireless devices and accessories;
  - network services, including rental of facilities, as well as other services.

In March 2002, ANATEL certified our compliance with the 2003 universal service targets and authorized us in April 2002 to start providing local and intraregional services in certain regions in which we were not operational and interregional and international long-distance services throughout Brazil. See “—Competition” and “—Regulation of the Brazilian Telecommunications Industry—Obligations of Telecommunications Companies.”

We provide interconnection services to cellular service providers and other fixed telecommunications companies through the use of our network. In April 1999, we also began to sell handsets and other telephone equipment through A. TELECOM S.A. (formerly Assist Telefónica S.A.), our wholly owned subsidiary. Until January 2001, we provided data transmission services, but spun-off our data transmission operations into TDBH. In March 2006, we began the restructuring of our multimedia communications services (serviços de comunicação multimídia) and data transmission activities. See “—A. History and Development of the Company—Historical Background—The SCM Restructuring.”

The monthly and usage fees for our fixed services (local and long-distance) were initially determined in our concession agreements. From March 2007 until July 31, 2007, the billing system was converted to a minute basis and the former measurement based on pulses was discontinued for all customers. Our concession agreements also set forth

criteria for annual fee adjustments. We derive a substantial portion of our revenue from services subject to this price adjustment. The method of price adjustment is essentially a price cap. ANATEL annually applies a price index correction that reflects the inflation index of the period and a productivity factor to our local and long-distance fees. Since 2006, the inflation index has been replaced by the IST, which reflects variations in telecommunications companies' costs and expenses. ANATEL has complied with the fee range set by the concession agreements.

We also provide mobile services for voice, internet and value-added services, including voicemail, voice mail translation in a speech-to-text service ("Vivo Torpedo Recado"), caller identification, voice minutes in unlimited bundles to other mobile phones to post-paid customer, ring back tones ("Vivo Som de Chamada"), data services

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through WAP protocol and 3G (with a pre-paid data plan special to smartphones), and innovative services such as multi-media backup and cloud based services to save the short messages (“Vivo Torpedo Center”). We also offer direct Internet through data plans for Smartphones, Tablets and other data enabled devices. We developed a new interface—Vivo Services Store (“Loja de Serviços Vivo”) to sell all the services provided by Vivo, from bundles of SMS to content download such as music, video and games.

We offer wireless roaming services through agreements with local mobile service providers throughout Brazil and other countries, allowing our subscribers to make and receive calls while outside of our concession areas. We provide reciprocal roaming rights to the customers of the mobile service providers with which we have such agreements.

### Local Service

Fixed local service includes activation, monthly subscription, measured service and public telephones. Measured service includes all calls that originate and terminate within the same local area or municipality of our concession region, which we refer to as “local calls.” Excluding the portion of our region that was serviced by Ceterp before its acquisition in December 1999, we were the only supplier of local fixed-line and intraregional long-distance telecommunications services in our region until July 1999. At that time, licenses were auctioned to permit a competitor to provide local fixed-line and intraregional long-distance telecommunications services in our region, including the area formerly served by Ceterp. Vésper São Paulo S.A. received authorization and began operations in December 1999. Embratel, GVT, Oi and Tim also provide local services in our concession region. See “—Competition.”

We became the first telephone service concessionaire in Brazil to offer fixed local services outside its concession region (the State of São Paulo). In May 2003, we achieved the network expansion and universal service targets established by ANATEL, and began providing fixed local services to six other states in Brazil, including Sergipe, Espírito Santo, Rio Grande do Sul, Paraná, Santa Catarina and certain areas in Rio de Janeiro. In May 2004, we began providing local fixed telephone services in seven other states in Brazil, including those in the capitals of Pará, Roraima, Amapá, Rondônia, Maranhão, Tocantins and Acre. In May 2005, we also began to provide fixed local telephone services in the capitals of the following states: Ceará, Amazonas, Pernambuco, Rio de Janeiro, Bahia, Mato Grosso do Sul and Mato Grosso. Since May 2006, we have also been providing fixed local telephone services in Brasília (Federal District) and Goiânia, the capital of the State of Goiás. Currently, our main markets outside our concession region are Rio de Janeiro, Espírito Santo, Minas Gerais, Bahia, Pernambuco, Ceará, Federal District, Goiás, Rio Grande do Sul, Paraná and Santa Catarina.

### Intraregional Long-Distance Service

Intraregional long-distance services consists of all calls that originate in one local area or municipality and terminate in another local area or municipality of our concession region. We were the sole provider of intraregional long-distance services in our region until July 3, 1999, when the federal government also authorized Embratel and Intelig to provide intraregional long-distance services. Currently, our main competitors in this service are Embratel, Tim, Oi and GVT.

### Interregional and International Long-Distance Fixed Service

On March 1, 2002, ANATEL acknowledged that we had satisfied its network expansion and universal service targets two years before the scheduled date. As a result, on April 25, 2002, ANATEL published an order that allowed us to be the first fixed-line telephone company to provide the full range of STFC and granted us a concession to develop interregional long-distance services in Region III and an authorization to develop services in the local, intraregional, interregional and international markets throughout Brazil.

We began operating international long-distance services in May 2002 and interregional long-distance services in July 2002. Interregional long-distance services consists of state-to-state calls within Brazil. International long-distance services consists of calls between a point in Brazil and a point outside Brazil.

Data Services—Fixed Broadband

The fixed broadband service was launched in 1999 with the Speedy brand, initially with ADSL technology, which uses the same copper pair that is used in the provision of voice services, to provide fast Internet service.



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Currently, the product portfolio of broadband speeds on ADSL range from 256 Kbps (kilobytes per second) up to 8 Mbps (mega bits per second). In 2011, Telefonica has 100% coverage of the municipalities in its concession area and is the first operator in Brazil to reach this mark. In addition, throughout 2011, Speedy reached the milestone of 3.6 million subscribers.

In 2010, Telefonica Brasil began selling the product Popular Broadband (Banda Larga Popular), which is an initiative in the State of São Paulo to deliver affordable broadband for low-income populations. This product has a speed of 1 Mbps.

In 2011, the company and the Ministry of Communications signed the National Broadband Plan (Plano Nacional de Banda Larga) commitment which defines conditions for the provision of broadband retail and wholesale customer, as well as the conditions of communication, quality and supervision.

Broadband services provided under the National Broadband Plan can be provided starting with 90 days after it becomes effective. However, the company voluntarily launched its services under the National Broadband Plan in July 2011 in municipalities where Vivo's 3G network was already available. On September 28, 2011, the company began providing fixed broadband services for retail and wholesale customers. The Company also agreed to offer retail broadband for a price of up to R\$35.00 to the consumer or a broadband and fixed telephony package for a price of up to R\$65.00 to the consumer. Broadband services offered under the National Broadband Plan for retail customers have a minimum speed of 1 Mbps and may have limits on the amount of downloads available. Wholesale services were available in 350 municipalities and can be used by local governments and companies registered under the tax system called "SIMPLES." Broadband services offered under the National Broadband Plan for wholesale customers are available in multiples of 2 Mbps, limited to 8 Mbps for local governments and 20 Mbps for corporate users.

We also provide fixed broadband services using coaxial cable at speeds ranging from 8 Mbps to 30 Mbps through cable internet (allowing for speeds from 2 Mbps to 16 Mbps) and optical fiber (FTTH). Optical fiber is the most advanced technology currently available and it allows for speeds of up to 100 Mbps.

### Pay TV services

On March 14, 2007, ANATEL has granted A. TELECOM S.A., one of our wholly-owned subsidiaries, the license to offer pay TV services via DTH. We began offering pay TV services on August 12, 2007.

On October 31, 2007, ANATEL's council approved, from a regulatory perspective, the agreement between us and the Abril Group, which involved, among other transactions, the acquisition by us of all of the Abril Group's MMDS operations (a special license that allows us to offer pay TV through our subsidiary, Telefonica Sistemas de Televisão S.A.). The transaction remains under consideration by ANATEL only with respect to antitrust factors, and will ultimately be reviewed by CADE. In November 2012, ANATEL authorized our provision of conditional access services to subscribers of our TV services. The provision of conditional access service to TV subscribers and the revisions to the concession agreement for such services were ratified by the Brazilian government on February 5, 2013.

As of December 31, 2012, we reached 600 thousand pay TV users, through both DTH and MMDS technologies. We currently offer DTH to the entire state of São Paulo, and MMDS in the cities of São Paulo, Rio de Janeiro, Curitiba and Porto Alegre.

### Network Services

Brazil is divided into four regions in relation to fixed telecommunication services with the following incumbent service providers (which initially received concessions from ANATEL): (i) Region I, that encompasses the North, Northeast and Southeast regions of Brazil, except the State of São Paulo, where concessions are granted to Oi (Telemar) and CTBC Telecom; (ii) Region II, that encompasses the South and Center-West regions of Brazil, where concessions are granted to Oi (Brasil Telecom), CTBC Telecom and Sercomtel; (iii) Region III, that encompasses the State of São Paulo, where concessions are granted to us and CTBC Telecom; and (iv) Region IV, that encompasses the whole country and in which the concession for long-distance calls is granted to Embratel.

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In 2005, after meeting the targets imposed in the concession agreement two years before the expected date, Telefonica started to operate long-distance services in every municipality in Brazil. For the operation of local services in Regions I and II, the company expanded its network to the main Brazilian cities, providing services in these markets with infrastructure based on new-generation platforms.

In 2007, the company developed solutions and invested significant resources to adapt its network to the requirements of Number Portability determined by ANATEL. Number Portability is a service mandated by ANATEL that provides customers with the option of keeping the same telephone number when switching telephone service providers. The implementation of Number Portability in the State of São Paulo was effectively initiated in September 2008 and fully implemented in March 2009.

By the end of 2011, for local services, we were present in the main cities of Regions I and II, namely: Porto Alegre, Curitiba, Brasília, Rio de Janeiro, Vitória, Belo Horizonte, Salvador, Florianópolis, Fortaleza, Recife, Goiânia and Uberlândia. For the provision of data services, we had networks in fourteen cities in these regions.

We have continuously adapted and expanded our network topology aiming to develop new business opportunities in the State of São Paulo through offering services to other telecommunications companies. The result was a significant increase in the number of providers that use our wholesale services.

Other important adaptations have been implemented in the network topology to meet the regulatory requirements and to integrate several calling areas in the State of São Paulo, thus allowing customers to make local calls that had previously been categorized as long-distance calls. The integration of new cities into local areas is annually determined by ANATEL and we are fully complying with ANATEL's determinations.

Competition for long-distance services has continuously increased and by the end of 2012 there were a total of 40 different operators available through the Service Provider Selection Code (Código de Seleção de Prestadora), or CSP. Satellite services for providing circuits in remote areas for wholesale and large customers have been also implemented.

### Other Services

Currently, we provide a variety of other telecommunications services that extend beyond basic telephone service, including extended maintenance, caller identification, voicemail, cell phone blockers, computer support, antivirus software for our Internet service subscribers, and posto informático (a solution with a fixed monthly fee consisting of a computer, broadband access and technical support twenty-four hours, seven days a week), among others.

### Interconnection

In July 2005, ANATEL published new rules regarding interconnection systems that substantially changed the interconnection model. These changes include: (i) an obligation to publish on the Internet an interconnection public offer for all types of interconnection services, in addition to the interconnection between fixed-line service providers and mobile service providers; (ii) offers of interconnection for Backbone Internet Providers; (iii) the establishment of criteria for the treatment of fraudulent calls; and (iv) the reduction of time in which new interconnection solicitations are answered. These reforms have facilitated market entry for new operators.

The interconnection public offer had been amended following negotiations with providers and changes in the services rendered and regulatory requirements. We have adopted procedures to reduce the time necessary to answer customers' interconnection requests, as well as to monitor and comply with quality levels set by ANATEL for interconnection services with a current availability level of 99.8%.

In 2006, we completed the implementation of the interconnection with mobile service providers in the most intensive traffic areas, assuring the proper billing for such calls and reducing interconnection costs.

In 2007, ANATEL published the new version of the Regulation of Fixed Network Compensation Rates, which primarily modified the rules for interconnection rates and calculation methods. Local and long-distance tariffs that were flat at all times became variable according to the rules for public service tariffs. A 20% increase was applied to tariffs of non incumbents.

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In addition to the necessary adaptations in its network concerning the Number Portability, the company, in conjunction with other operators, implemented a systematic solution including several interoperable processes which enables the correct forwarding of calls.

According to SMP regulations, the VU-M price is subject to free negotiation between parties and once an agreement is reached it must be homologated by ANATEL to take effect. The agreement currently in effect was executed in 2009.

Starting in November 2009, the licenses of each mobile operator were consolidated by region, resulting in the consolidation of tariffs and in the reduction of interconnection fees for long-distance traffic within its network.

On May 7, 2012, the Brazilian government published Resolution No. 588/2012, which approved the new Regulation Compensation Network. Among the main changes compared to its predecessor resolution include the change in collection of the TU-RL on time considering the low incidence of 2 minutes per call TU-RL, changes in the interconnection regime for the partial Bill & Keep 25 % to 75% through December 31, 2013 and integral Bill & Keep beginning on January 1, 2014 and change in value of the TU-RIU to 25% of the fare LDN step 4 in 2012 and 20% after 2013.

On November 12, 2012, the Brazilian government published Resolution No. 600/2012 approving the General Competition Plan, or PGMC, which introduced the study of relevant markets in Brazil and applied asymmetric measures to the companies considered to have significant market power. It focused on the wholesale market, introducing new obligations regarding network desegregation, infrastructure sharing and interconnection. Particularly with regard to interconnection, the PGMC introduced a new tariff reduction schedule for use of mobile networks for 2014 (75% of value of 2013) and 2015 (50% of 2013), and programming the adoption of the RIC model in 2016. In terms of balancing traffic model, the PGMC kept the full Bill and Keep model with operators that have significant market power and established a partial Bill and Keep model with operators without significant market power through 2016, at which time all operators will follow the full Bill and Keep model.

At the end of 2012, Telefonica had 210 local and long-distance interconnection agreements and 102 agreements for provision of local traffic and long-distance.

### I-Telefónica

I-Telefónica is a free Internet access service provider launched in September 2002 by our subsidiary A. TELECOM S.A. (formerly Assist Telefónica). The product is available in 622 cities in the State of São Paulo and over 1,500 cities in all of Brazil. The service delivers high-quality, stable Internet access that is structured to ensure that our clients do not encounter a busy signal when connecting to the Internet. I-Telefónica permits us to increase the range of our services and better supply our customers by offering an entry-level option to the Internet market.

### Authorization to Provide Multimedia Services

On January 29, 2003, ANATEL granted our SCM license nationwide, allowing A. TELECOM S.A. (formerly Assist Telefónica), our wholly owned subsidiary, to provide voice and data services through points-of-presence (POPs), which are comprised of private telecommunications networks and circuits. In addition to A. TELECOM S.A., ANATEL granted SCM licenses to T-Data (formerly T-Empresas) and Emergia.

### Authorizations for pay TV via satellite

On March 14, 2007, ANATEL granted A. TELECOM S.A. authorization to provide services of pay TV via satellite (Direct to Home – DTH). DTH is one of the special types of subscription TV services that utilize satellites for the direct

distribution of television and audio signals for subscribers. The launching of the commercial transaction occurred on August 12, 2007.

Authorization for Multichannel Multipoint Distribution Service (MMDS)

On October 31, 2007, the board of ANATEL concluded its regulatory review of the agreement between Grupo Abril and the company, approving the transaction from a regulatory perspective, which involved, among other transactions, the acquisition of all of the operations of MMDS. The approval was granted on November 19, 2007 and the transaction continues to be reviewed for antitrust issues by CADE.

On February 16, 2009, ANATEL extended the authorization until 2024 for the use of the spectrum frequencies associated with the MMDS in São Paulo, Curitiba, Rio de Janeiro and Porto Alegre. ANATEL is currently analyzing the price to be paid for the spectrum usage.

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In November 2012, ANATEL approved the adoption of service licenses for subscription television by the Telefonica group to the conditional access service.

### The STFC Concession Agreement

The company is authorized to provide STFC services to render local and domestic long-distance call originated in Region III, which comprises the State of São Paulo, except for Sector 31, established in the General Plan of Grants.

The current concession agreement, dated December 22, 2005, was renewed on January 1, 2006, and will be valid until December 31, 2025. On December 15, 2010, ANATEL released a public consultation proposing the amendment of clause 3.2 of the concession agreement, which resulted in the approval of Resolution No. 559 published on December 27, 2010. Resolution No. 559 establishes that the current concession agreement can be reviewed by ANATEL on May 2, 2011, December 31, 2015, and December 31, 2020. Based on the amended clause 3.2, ANATEL may establish new requirements and targets for universal and high-quality telecommunication services, according to the conditions present at the time of review.

On June 30, 2011, the company renewed its concession agreement and entered into new contracts for local and long-distance services with ANATEL pursuant to the concession agreement, with new conditions imposed on the company to change the basis of calculation of the biannual concession costs. The most relevant modifications discussed by ANATEL's board include: (i) suppression of clause 14.1 which prohibits service providers from controlling cable TV operators within their concession area; (ii) amendment of clause 3.2, which provides for a biennial concession fee, to include interconnection revenue in its calculation basis; (iii) broadening of ANATEL's supervisory powers; (iv) the possibility of off-setting cost of universalization in the calculation of the concession burden; (v) the inclusion of the AICE tariff adjustment formulas; (v) the possibility of remote monitoring of services; (vi) limiting the price of AICE subscription to 60% of the basic subscription; and (vii) free price determination.

The concession agreement establishes that all assets owned by the company and which are indispensable to the provision of the services described in such agreement are considered reversible assets and are deemed to be part of the concession assets. These assets will be automatically returned to ANATEL upon expiration of the concession agreement.

Every two years, during the agreement's new 20-year period, publicly held companies will have to pay a renewal fee which will correspond to 2% of the revenue of the previous year, resulting from the application of basic service plans and alternative STFC, net of taxes and social contributions. The first payment of this biennial fee occurred on April 30, 2007, based on 2006 revenue, the second payment occurred on April 30, 2009, based on 2008 revenue and the third payment occurred on April 30, 2011, based on 2009 revenue. The next payment is scheduled for 2013 based on 2012 revenue. See Note 1 to our Consolidated Financial Statements.

On April 8, 2008, we signed an amendment to the concession contracts to substitute the obligation to install telecommunications service posts with an obligation to roll out broadband network infrastructure throughout the municipalities serviced by such concessionaires.

ANATEL granted on August 18, 2011 consent to the transfer from the company to Vivo of the concessions for the provision of local STFC services, domestic long-distance and international long-distance services in Regions I and II of the General Plan of Grants (outside São Paulo). On September 8, 2011, the extract of the authorization term was published on the D.O.U. for the transfer of STFC licenses in Regions I and II to Vivo. As a result, Vivo began to offer the STFC through the GSM technology across its area, except for the State of São Paulo.

In November 2000, ANATEL adopted certain regulations for the issuance of new licenses, which are authorizations to provide wireless communication services through SMP, personal mobile service, to compete with the then existing cellular operators in the various regions of Brazil. These regulations divided Brazil into three main regions covering the same geographic area as the concessions for the fixed-line telecommunication services. ANATEL organized auctions for three new licenses for each of those regions. The new licenses provided that the new services would be operated in the 1800 MHz radio frequency bands which were denominated as the “C” band (which was later transformed into extension bands), the “D” band, “E” band and “M” band. These new licenses were auctioned by ANATEL and awarded during the first quarter of 2001, at the end of 2002, in September 2004, in March 2006, in September 2007, in December 2007 and in December 2010.



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### Services for Corporate Customers

We offer our corporate clients' comprehensive telecommunications solutions and IT support designed to address specific needs and requirements of companies operating in all types of industry (retail, manufacturing, services, financial institutions, government, etc.).

Our clients are assisted by our highly qualified professionals who are capable of meeting the specific needs of each company with voice, data, broadband and computer services solutions. We work to consistently achieve greater quality and efficiency in our services and increase our level of competitiveness in the market.

### Rates and Taxes

#### Rates

#### Overview

We generate revenue from (i) activation and monthly subscription charges, (ii) usage charges, which include measured service charges, and (iii) network usage charges and other additional services.

Rates for telecommunications services are subject to comprehensive regulation by ANATEL. See “—Regulation of the Brazilian Telecommunications Industry.” Since the relative stabilization of the Brazilian economy in mid-1994, two major changes in rates for local and long-distance services have occurred: in 1996 to compensate for accumulated effects of inflation and in 1997 to eliminate the cross-subsidy between local and long-distance services.

Concession agreements, which were valid from 1998 until December 31, 2005, and subsequently renewed under a new contract for an additional 20 years until 2025 (all of our relevant concession agreements were renewed), establish a price cap for annual rate adjustments.

According to the new contract, we readjust charges based on a service basket of fees, as follows:

- Local services, where rates are established pursuant to a service basket of fees that includes rates for the measured traffic and subscription fees. In the case of a price adjustment, each one of the items within the local fee basket has a different weight and, as long as the total local fee price adjustment does not exceed the rate of increase in the Telecommunication General Price Index, or IST, minus a productivity factor as established in the concession agreements, each individual fee within the basket can exceed the IST variation by up to 5%.
- Installation of residential and commercial lines and public telephone services, with adjustments limited to the rate of increase in the IST minus a productivity factor as established in the concession agreements.
- Domestic long-distance services, with rate adjustments divided into intraregional and interregional long-distance services, which are calculated based on the weighted average of the traffic, and taking into account time and distance. For these categories, each fee may individually exceed the rate of increase in the IST by up to 5%; however, the total adjustments in the basket of fees cannot exceed the rate of increase in the IST minus a productivity factor as established in the concession agreements. See “—Regulation of the Brazilian Telecommunications Industry.”

Our rates for international services are not subject to regulation and are not required to follow the price cap for annual rate adjustment described above for other services. Therefore, we are free to negotiate our fees for international calls based on the international telecommunications market, where our main competitor is Embratel.

#### Local Rates

Our revenue from local service consists principally of activation charges, monthly subscription charges, measured traffic charges and public telephone charges. Users of measured traffic, both residential and non-residential, paid for local calls depending on usage, which until July 2007 was measured in pulses and from then on has been measured in minutes. The first minute is accounted for at the moment a call is connected to its destination.

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Under current ANATEL regulations, residential customers who sign up for the basic plan monthly fee receive an allowance of 200 minutes per month.

Our local concession contracts set forth two mandatory plans for local fixed service, and allow for the concession company to design other alternative pricing plans of its own. Customers will have a choice between the two mandatory plans, any other alternative plan or a combination of basic and alternative plans. The main differences between the two main mandatory plans are as follows:

- Local Basic Plan: for clients that make mostly short-duration calls (up to three minutes), during regular hours; and
- Mandatory Alternative Plan (PASOO): for clients that make mostly longer-duration calls (above three minutes), during regular hours and/or that use the line for dial-up service to the Internet.
- Individual Special Class Access (AICE) – plan created specifically for families enrolled in the Brazilian government’s social program.

The following table outlines the basic billing requirements and rates for the local Basic Plan and the Mandatory Alternative Plan:

Characteristics of Plan	Basic Plan	Mandatory Alternative Plan
Monthly Basic Assignment		
Allowance (minutes included in the Residential Assignment)	200 minutes	400 minutes
Commercial Assignment Allowance (minutes included in the Commercial Assignment)	150 minutes	360 minutes
Local Call Charges		
Regular Hours		
Completing the call (minutes deducted from the allotment)	–	4 minutes
Completing the call after the terms of the allotment Sector 31	–	R\$0.15980
Local Minutes–charges in excess use of the allotment Sector 31	R\$0.10423	R\$0.03994
Minimum time billing	30 seconds	–
Reduced Hours		
Charge per answered call (minutes deducted from allotment)	2 minutes	4 minutes
Charge per answered call after the allotted duration Sector 31	R\$0.20847	R\$0.15980

The fees for Local Basic Plan Service were approved by ANATEL’s Act No. 5,834 of August 24, 2011 and readjusted through Act 8401 of December 21, 2011. The Alternative Plan under Mandatory Service Provisions (Oferta Obrigatória) (PASOO) was approved by Resolution No. 450, on December 7, 2006, being that the readjustment of the tariffs follows the same rule established for the local basic plan.

In addition, Resolution No. 547, published on November 29, 2010, established that the company’s fees for both the Local Basic Plan and Mandatory Alternative Plan (PASOO) will be unified following the unification of sectors 31, 32 and 34 into one single sector (sector 31), as defined by the Presidential Decree regarding the new General Plan of Grants published in the D.O.U. on November 21, 2008. This unification also applies to Basic Plan tariffs of fixed-to-mobile calls and long-distance calls and presumes the preservation of revenue earned on each item of the Basic Plan.

Resolution No. 586 established that families enrolled in the Brazilian government's social program may have access to fixed telephone services under the special class individual access plan. The subscription to the plan costs R\$13.65 and allows for 90 minutes of local fixed line calls. Any exceeding fixed calls or calls to mobile or long distance phones may be made once pre-paid credits are purchased. The price of mobile and long distance calls are determined pursuant to a standard plan.

Besides the Basic Service Plans, the company may offer alternative plans with any pricing design it chooses. However, ANATEL must be notified of these alternative plans before the publication and implementation of any such plan.

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Clause 12.1 of the STFC concession agreement provides that the Local Basic Plan can be readjusted for periods of not less than 12 months taking into consideration the inflation index “IST” reduced by a fraction of the company’s productivity (named “Fator X,” which is calculated by ANATEL based on Resolution No. 507/08). The Mandatory Alternative Plan (PASOO) follows the same readjustment formula as the Local Basic Plan. Other alternative service plans are readjusted based on the IST.

On December 24, 2011, ANATEL’s Act No. 8,401 approved new local tariffs for our areas of concession. The average readjustment in the local service basket was 0.66%. The tariffs were applied to customers as demonstrated below:

- Residential customers were charged a monthly subscription fee for the provision of service of R\$41.38;
- Commercial clients and nonresidential customers (PBX) were charged a monthly subscription fee for the provision of service of R\$70.76;
  - Local minute tariffs were charged at R\$0.10423 per minute in Sector 31; and
  - Activation fees of R\$113.81 were charged in Sector 31.
- On February 5, 2012, ANATEL published new amounts for basic fixed telephone calls and long distance calls. The rates were adjusted by the Telecommunication Services Index, resulting in a 0.568% adjustment applied linearly to all rates for national long distance and local calls.

### Intraregional and Interregional Long-Distance Rates

Intraregional long-distance services consists of all calls that originate in one local area or municipality of our concession region and terminate in another local area or municipality of our concession region. All other calls are denominated interregional long-distance calls. Rates for intraregional and interregional long-distance calls are computed on the basis of the time of day, day of the week, duration and distance of the call, and also may vary depending on whether special services, including operator assistance, are used.

On July 29, 2002, after we received the concession from ANATEL to provide interregional long-distance services in Region III and authorization to provide interregional long-distance services throughout Brazil, we launched several new options of interregional calling plans relating to consumer “Code 15,” which is the selection code dialed by customers who may choose a long-distance provider with each call and may result in different prices based upon frequency of use and customer calling patterns.

### International Long-Distance Rates

On May 7, 2002, we began operating international long-distance services. International long-distance call charges are computed on the basis of the time of day, day of the week, duration and destination of the call, and also may vary depending on whether special services are used or not, including operator assistance.

We have developed alternative rate plans for our residential and corporate customers.

### Network Usage Charges

We earn revenue from any fixed-line or mobile service provider that either originates or terminates a call within our network. We also pay interconnection fees to other service providers when we use their network to place or receive a call. Under the General Telecommunications Law, all fixed-line telecommunications service providers must provide

interconnection upon the request of any other fixed-line or mobile telecommunications service provider. The interconnection agreements are freely negotiated among the service providers, subject to a price cap and in compliance with the regulations established by ANATEL, which includes not only the interconnection basic principles covering commercial, technical and legal aspects, but also the traffic capacity and interconnection infrastructure that must be made available to requesting parties. If a service provider offers to any party an interconnection fee below the price cap, it must offer the same fee to any other requesting party on a non-discriminatory basis. If the parties cannot reach an agreement on the terms of interconnection, including the interconnection fee, ANATEL can establish the terms of the interconnection. See “—Regulation of the Brazilian Telecommunications Industry—Obligations of Telecommunications Companies.”

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In accordance with ANATEL regulations, we must charge interconnection fees to the other telephone service providers based on the following:

- Fee for the use of our local network—we charge long-distance services providers a network usage charge for every minute used in connection with a call that either originates or terminates within our local network.
- Fee for the use of our long-distance network—we charge the service providers a network usage charge on a per-minute basis only when the interconnection access to our long-distance network is in use.
- Fee for the rental of certain transmission facilities used by another service provider to place a call.

Beginning in 2006, with the 20-year renewal of the concession contracts, the rules in respect of local network fees, or TU-RL, were changed. Beginning on January 1, 2008, local network fees were supposed to be calculated based on a long-term cost model (LRIC—Long Run Incremental Costs).

Through Resolution No. 464, published on April 27, 2007, ANATEL postponed the adoption of the LRIC model to April 30, 2009. Nevertheless, ANATEL is still working on the necessary studies to implement this cost model, as this model is part of its General Plan for Updating the Telecommunications Regulations in Brazil, published on November 12, 2008.

On May 7, 2012, ANATEL published Resolution No. 588/2012, which approved the change in TU-RL rate during the reduced rate period and considering the 2-minute TU-RL per call, in addition to the change in TU-RIU value to 25% of the LDN rate in 2012 and 20% in 2013. Furthermore, through December 31, 2013, rates will only be charged on calls that exceed the 75% limit of traffic between networks. Beginning in 2014, service providers' will no longer pay other companies for calls made between networks.

Cellular telecommunications services in Brazil, unlike those in the United States, are offered on a “calling party pays” basis, under which the subscriber pays only for calls that he or she originates. Additionally, a subscriber pays roaming charges on calls originated and terminated outside his or her home registration area. Calls received by a subscriber are paid for by the party that places the call in accordance with a rate based on per-minute charges. For example, a fixed-line service customer pays a rate based on per-minute charges for calls made to a cellular service subscriber. The lowest base rate per minute, or “VC1,” applies to calls made by a subscriber in a registration area to persons in the same registration area. Calls to mobiles outside the registration area, but within the mobile authorization area, are charged at a higher rate, “VC2.” Calls to mobiles outside the mobile authorization area are billed at the highest rate, “VC3.” When a fixed-line service customer calls a mobile subscriber, we charge the fixed-line service customer per-minute charges based on VC1, VC2 or VC3 rates. In turn, we pay the cellular service provider the cellular network usage charge.

Our revenue from network services also includes payments by other telecommunications service providers for the use of part of our network arranged on a contractual basis. Other telecommunications service providers, including providers of trucking and paging services, may use our network to connect a central switching office to our network. Some cellular service providers use our network to connect cellular central switching offices to the cellular radio-based stations. We also lease transmission lines, certain infrastructure and other equipment to other providers of telecommunications services.

On November 12, 2012, the Brazilian government published Resolution No. 600/2012 approving the General Competition Plan, or PGMC, which introduced the study of relevant markets in Brazil and applied asymmetric measures to the companies considered to have significant market power. It focused on the wholesale market, introducing new obligations regarding network desegregation, infrastructure sharing and interconnection. Particularly with regard to interconnection, the PGMC introduced a new tariff reduction schedule for use of mobile networks for

2014 (75% of value of 2013) and 2015 (50% of 2013), and programming the adoption of the RIC model in 2016. In terms of balancing traffic model, the PGMC kept the full Bill and Keep model with operators that have significant market power and established a partial Bill and Keep model with operators without significant market power through 2016, at which time all operators will follow the full Bill and Keep model.

#### Data Transmission Rates

We receive revenue from charges for data transmission, which includes our broadband service “Speedy,” the rental of dedicated analog and digital lines for privately leased circuits to corporations and others that were provided by us and Telefonica Data. See “—A. History and Development of the Company—Historical Background—The Spin-off of Certain Data Transmission Operations” and “—A. History and Development of the Company—Historical Background—The SCM Restructuring.”

#### Taxes

The cost of telecommunications services to each customer includes a variety of taxes. The principal tax is a state value-added tax, the Imposto sobre Circulação de Mercadorias e Serviços, or “ICMS,” which the Brazilian states impose at varying rates from 7% to 35% on certain revenues from the sale of goods and services, including telecommunication services.



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- Federal Social Contributions: Contribuição para o Programa de Integração Social or “PIS,” and Contribuição para o Financiamento da Seguridade Social or “COFINS,” are imposed on gross operating revenue at a combined rate of 3.65% for telecommunications services (consisting of the COFINS amounts of 3.0% and PIS amount of 0.65%) and 9.25% for other services (consisting of the COFINS amounts of 7.6% and PIS amount of 1.65%). PIS is a tax designed to share business profits with employees through a mandatory national savings program, and is financed by monthly deposits collected as a percentage of gross operating revenue. COFINS is a tax designed to finance special social programs created and administered by the Brazilian government. Revenue related, among other things, to investments, dividends and sales of fixed assets are not subject to PIS and COFINS.
- Contribution for the Fund for Universal Access to Telecommunications Services—“FUST.” FUST was established in 2000 to cover the cost exclusively attributed to fulfilling obligations (including free access to telecommunications services by governmental institutions) of universal access to telecommunications services that cannot be recovered with efficient service exploration or that are not the responsibility of the concessionaire. Contribution to FUST are due at the tax rate of 1% of gross operating telecommunications services revenue (except for interconnection revenue and excluding ICMS, PIS and COFINS), and it may not be passed on to customers.
- Contribution to the Fund of Telecommunications Technological Development—“FUNTTEL.” FUNTTEL is a federal social contribution and was established in 2000, to stimulate, among others, technological innovation and to enhance human resources development so as to increase the competitiveness of the Brazilian telecommunications industry. Contribution to FUNTTEL is due at the tax rate of 0.5% of gross operating telecommunications services revenue (except interconnection revenue and excluding canceled sales, discounts, ICMS, PIS and COFINS), and it may not be passed on to customers.
- Contribution to the Fund for Telecommunications Regulation—“FISTEL.” FISTEL is a federal tax applicable to telecommunications transmission equipment which serves to provide funds to cover the expenses incurred by the Federal Government in performing inspections of telecommunication services and in developing the means and improving the techniques necessary for carrying out these inspections. The fees owed to FISTEL, known as the FISTEL Taxes, are: (i) an installation inspection fee assessed on telecommunications central offices upon the issuance of their authorization certificates and (ii) an annual operations inspection fee that is based on the number of authorized central offices in operation at the end of the previous calendar year.

## Billing

We send each customer a monthly bill covering all of the services provided during the prior period. Telephone service providers are required under Brazilian law to offer their customers the choice of at least six different payment dates for each month.

We have a billing and collection system with respect to local, national and international long-distance voice, subscriptions, broadband, data, IT services, outsourcing, television and third-party services. Payments of bills are effected under agreements with various banks. The types of payments are by debit the customer's account, direct payment to a bank, Internet and other collection agencies (including lottery-playing facilities, drugstores and supermarkets). We aim to avoid losses in the implementation of new processes and the roll-out of new products through the monitoring of billing, collection and recovery controls. The billing process is audited by the Associação Brasileira de Normas Técnicas (Brazilian Association of Technical Standards), or ABNT, under the applicable rules of the Sarbanes Oxley Act. The actions are followed closely by our Revenue Assurance Team, which measures every risk of loss of revenue detected along the billing and collection chain. These risks are managed to minimize revenue losses.

Our subsidiary Vivo uses Atlys, a billing solution that combines software and hardware resources, from the supplier company Netcraker as the billing system for centralized billed invoicing in the city of São Paulo. The billing system operates through batch processing concept using Vivo customers' voice and data traffic. This system functions by segregating voice and data traffic on a daily basis, according to which of seven total billing preferences a customer elects. Each cycle has a specific due date for each of the consumer and corporate segments.

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For prepaid services, Vivo uses the Next Generation Intelligence Network (NGIN) platform, a prepaid platform, from the supplier company Eisa, which also works in a centralized way in the city of São Paulo. In order for the NGIN platform to process correctly, the same system for billed invoicing is used. This system separates the module for customer information, called Care, which is a services platform, from the Voice and Data traffic processing module used, called Core, which is a tariff platform.

In November 2011, Vivo began developing a project to optimize its operational processes and reduce the period between the cut and due date of bills, and this project was concluded in April 2012, reducing billing cycles to six months cycles.

In 2012, we started several initiatives to integrate fixed and mobile processes and systems. The first was part of our organizational structure when in the first quarter of 2012, we combined both fixed and mobile departments optimizing and focusing resources. In that year we also certificated mobile billing processes by the ABNT. Another strong initiative related to process and system integration is the traffic mediation system project. Started during the last semester of 2012, that project will transfer, through the second quarter of 2013, all fixed lines traffic to the same platform as the mobile lines, reducing the risk of revenue loss, achieving better operational levels and unifying best practices.

### Co-billing

In accordance with the Brazilian telecommunications regulations, we use a billing method called “co-billing” for both services, fixed and mobile. This method allows billing from other phone service providers to be included within our own invoice. Our customers can receive and subsequently pay all of their bills (including the fees for the use of services of another telephone service provider) by using one invoice. To allow for this method of billing, we provide billing and collection services to other phone service companies. We have co-billing agreements (“co-billing in”) with national and international long-distance phone service providers. Similarly, we use the same method of co-billing to bill our services on the invoices of other fixed and mobile providers. This service is charged to the Long-distance Operator, per CDR (Call Detail Record) placed in invoice.

We use direct billing through the national registry of clients for customers who use our long-distance services through operators that have no joint billing agreement with us.

### Value Added Services (VAS)

Entertainment, information and online interactivity services are available to all Vivo customers through agreements with content suppliers. These agreements are based on a revenue-sharing model through the processes of billed and prepaid categories, with all divergences between these categories being demonstrated to the content suppliers.

### Third-party Services

In fixed as well as mobile billing process is made inclusion third-party services into the bill, collection and transfer. This service is charged to the contractor.

### Collection

We have policies dealing with accounts of defaulting customers according to each ANATEL regulation. For mobile service, we apply the SMP regulation, for fixed service we apply the STFC and for TV we apply Resolution No. 488 “Protection and defense of the rights of subscription TV service subscribers.”

For mobile customers, as a general rule, if the payment is more than 15 days overdue, service can be partially suspended by blocking calls that generate costs to the user. If payment is more than 30 days overdue after the partial suspension, the service can be fully suspended, disabling all call services, until payment is made. We offer an installment payment plan for those clients with past due balances. However, if accounts are not paid after 45 days after the total suspension, the contract can be cancelled and reported to credit protection agencies.

For fixed customer, as a general rule, if the payment is more than 30 days overdue, service can be partially suspended. If payment is late for more than 30 days after the partial suspension, service can be fully suspended until payment is made. We offer an installment payment plan for those clients with past due balances. However, if

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accounts are not paid after 30 days of total suspension, the contract can be cancelled and reported to credit protection agencies.

For TV customer, as a general rule, if the payment is late, service can be fully suspended 15 days after the customer is notified of the overdue bill. If payment is more than 15 days overdue, after the suspension, service can be cancelled and reported to credit protection agencies.

After the cancellation of the contract, for mobile and fixed services, the accounts are directed to independent collection agencies.

The amounts receivable overdue by 105 days, except for accounts receivables from interconnection fees, government and corporate customers, are considered provisions for doubtful accounts. The write-offs are made in accordance with Brazilian regulations, which permits a bad debt write-off for late payments of R\$0 to R\$5,000 if they are over 180 days late or R\$5,001 to R\$30,000 if they are over 365 days late. Write-offs of late payments of over R\$30,001 that are open for more than 365 days require the commencement of a lawsuit.

During 2012, the monthly average of partial suspensions, for both mobile and fixed services, was 2,338,142 lines and the monthly average of total suspensions was 474,447 lines. For TV services, the monthly average of suspension was 18,797 terminals. The provision for doubtful accounts in 2012 was 1.30% of the total gross revenue.

## Network and Facilities

Our network consists of an access layer that connects our clients through our metal or optical networks, which are connected to voice and data centers. These centers are interconnected locally or remotely through transmission equipment connected predominantly with fiber optics and occasionally through a microwave network, which together form a network layer that enables connectivity between the various central aggregate services platforms as well as interconnection with other carriers. Our network strategy is based on the expansion of the Access Network (fiber optics) to allow greater coverage and broadband (high-speed) services for our customers, as well as to develop an integrated multiservice network and multimedia applications. As a telecommunication service provider, we do not manufacture equipment for the construction of our networks and facilities. We buy the equipment from qualified suppliers and through this equipment we implement our networks and facilities through which we supply our services. The following table sets forth selected information about our network in aggregate:

	At and for the year ended December 31,									
	2012		2011		2010		2009		2008	
Wireline access lines										
Installed access lines (millions)	14.8		14.7		14.6		14.5		14.7	
Access lines in service (millions) (1)	10.5		11.0		11.3		11.3		11.7	
Average access lines in service (millions)	10.7		11.1		11.3		11.5		11.8	
Access lines in service per 100 inhabitants	25.1		26.5		27.5		27.1		28.7	
Percentage of installed access lines connected to digital switches	100.0	%	100.0	%	100.0	%	100.0	%	100.0	%
Number of public telephones (thousands)	199.2		215.8		250.7		250.5		250.3	
Broadband access lines (millions)	3.7		3.6		3.3		2.6		2.5	

	Year ended December 31,				
	2012	2011	2010	2009	2008
Mobile access lines					
Cellular lines in service at year-end (in millions)	76.1	71.5	60.3	51.7	44.9
Contract customers (in millions)	18.8	16.1	12.6	9.8	8.6
Prepaid customers (in millions)	57.3	55.4	47.7	42.0	36.4

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Growth in cellular lines in service during year	6.4	%	18.7	%	16.5	%	15.1	%	20.2	%
Churn(2)	41.9	%	34.2	%	32.0	%	30.5	%	31.3	%
Estimated covered population (in millions)(3)	193.9		192.4		190.7		191.5		189.6	
Penetration at year-end(4)	132.7	%	123.9	%	104.6	%	90.5	%	79.1	%
Market share(5)	29.1	%	29.5	%	29.7	%	29.78	%	29.8	%

(1)Data includes public telephone lines.

(2)Churn is the number of customers that leave us during the year, calculated as a percentage of the simple average

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(3)Number of people within our region that can access our cellular telecommunications signal.

(4)Number of cellular lines in service in our region, including those of our competitors, divided by the population of our Region.

(5)Percentage based on all lines in service in our region at year-end.

Technology

In order to offer a greater variety of integrated services, we have incorporated a series of new technologies in our voice and data networks.

Voice network is being modernized with the use of new generation technology that enables redundancy and reliability needed to meet all voice services for both fixed and mobile terminals. In addition, we are deploying IMS Core and allowing the inclusion of new convergent services.

An example of this evolution is a new service called “Hosted Voice,” in which customers will have basic features and advanced PBX and also Unified Communication through the data network (IP/VPN). This solution reduces the amount of equipment in the customer environment by centralizing control and intelligence service.

There are great market opportunities for service convergence in Brazil. Products like cellular based residential phones were the first step towards seamless interactions among mobile, landlines, data services and television. As almost every service is evolving to IP Technology, IP Backbones became a strategic asset to support convergence initiatives.

To reach this goal, the integration of mobile and fixed Backbones IP were essential. We have designed a very robust architecture, unifying our mobile and fixed IP/MPLS infrastructures, using two physically distinct Backbones to guarantee service reliability to our clients. Moreover, absorbing other existing networks into both backbones, we have been able to simplify the network and reduce operational costs.

As internet traffic evolves to heavier content and users become more demanding about quality, a content delivery network was the answer to improve user experience in an environment as unreliable as the wide web. Telefonica Brasil’s CDN was a global initiative to offer delivery nodes in several countries and help clients deliver video, application updates, live events and other data with much better quality. In Brazil, CDN has already been deployed and transmitted London Olympics through Terra Provider, with great success. The delivery networks have the potential to bring us closer to a very valuable point on the Internet market value chain: the content.

A new design of Local Area Network (LAN) , using Top of Rack implementations, is currently being deployed and has the potential to reduce the quantity of equipment on site and drastically remove cabling. Top of Rack architecture reaches those goals by placing small switches inside server racks, where cables are kept confined. From the rack to the site’s Core Switches, only one pair of fiber is sufficient.

During 2012, we were faced with various security threats, particularly from the Anonymous group. We were able to protect our services and infrastructures through several security solutions deployed in the network. Some expanded capacity of protection mechanism already in place; others gave a more detailed vision to Security Office acts when an attack breaks. Simultaneously, we worked to integrate different security solutions in place in fixed and mobile operations, to simplify the environment, improve security and reduce costs.

Particularly destructive were denial of service attacks, or DDOS, pursuant to which hackers attempt to shut down services by consuming all resources. Several Brazilian websites, mainly financial institutions and government, pages

were seriously affected by these attacks. We were able to protect both our infra-structure through the use of an Anti-DDOS solution that was already being deployed, as well as offer the same protection to our clients, which created great value. Today, Anti-DDOS is a commercial product, offered to the corporate market.

In the Value Added Services, we have been adopting new technologies to increase the speed with which we market new and enhanced services. Since 2009, we have deployed a new Service Delivery Platform (SDP) into the network, to evolve our environment through a secure and scalable solution that offers the most different value added services, including eHealth and Financial services. In 2011, we gave another step towards the evolution of our value added services environment, with the implementation of the Next Generation Intelligent Network platform (ngIN),



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enabling voice call notification and call handling based services. Through the exposure of WebServices and APIs (Application Programming Interfaces), we introduced the Telecommunications market to Service Providers that have no Telecom specific knowledge, which explains the increasingly rapid growth of the quantity and quality of our Value Added Service offering. In addition, for the delivery of valued added services into the enterprise market, also offer another platform named Torpedo Empresas, which allow the Brazilian Banks and Financial Entities to deliver their own services, such as bank accounts notifications, financial transaction notifications and the delivery of access tokens to their customers.

In 2007, we initiated the implementation of the FTTH network (available through fiber optic cables running to the subscriber's home – GPON technology) with a coverage of 1.2 million Home Passed offering. Actually, a range of different speeds up to 100Mbps, and high definition IPTV service (HDTV). In December 2012, we surpassed the mark of 3.1 million xDSL broadband clients connected in service, 45% of which had speeds equal to or greater than 2Mbps. To reach this number of clients, we constantly search for market differentials such as new integrated services, speed upgrades and servicing of new localities, among others.

We offer the IPTV service through a partnership with TVA through the FTTH network using a new platform that is a reference in the world (Global Video Platform). We made several improvements in the platform, such as the inclusion of Instant Channel Change (ICC), Picture in Picture (PiP) providing a better user experience. In 2013, we will continue the improvements started in Global Video Platform aiming to increase competitiveness in the ITS market. Additional services, such as pay-per-view and video on demand (VOD), are also available. This platform consists of pay TV with video broadcast offered through the use of the IP protocol.

The IPTV platform also offers games, interactive and connectivity services through third party contents, furthermore offers Over The Top (OTT) contents, for the broadband users, through the applications developed for smart TVs, smart phones with Google's Android and Apple's iOS, besides STBs and PCs.

We also offer digital television service via satellite (DTH) to the subscribers in the State of São Paulo that receive broadcast/PPV content through a Ku band antenna and standard Set Top Box (with Smart Card), also available with a Personal Video Record (PVR) service.

Our development plan contemplates the use of the most advanced technology available, focusing on integration with the Internet and an increase in the number of multimedia transmission services, with an emphasis on xDSL, FTTH (GPON), NGN, DWDM, ROADM and retransmittal technologies of TV over IP protocol (IPTV), satellite (DTH), and the continuous evolution of TV services.

Since 2012, "Speedy" is also offered under the Very-High-Speed Digital Subscriber Line technology (VDSL2), which allows broadband accesses of up to 25Mbps. These technologies provide high-speed Internet access through regular telephone lines. Yet in 2012, we started the implementation of Multi-Service Access Nodes (MSAN) in order to modernize the wireline network of some distant areas, integrating voice, broadband and data services on a single cabinet.

In 2012, we had a breakthrough in the M2M market, with the deployment of a new and revolutionary solution within the Brazilian market, introducing an M2M Global Platform that allows our B2B customers to have access to a Management Web Portal user interface in the internet to access online and real-time information regarding their devices. Some of the competitive advantages of the deployed solution against our previous service and the competition's are the Self-management of the acquired SIM Cards, to control, assign plans and tariffs or even block the use of the network by the device. In 2013, we will continue to evolve the offer, adding new functionalities.

In 2011, we launched the HSPA+ technology, commercially known as 3GPlus. This technology was firstly commercially launched in November, 2011 in São Paulo (and its extended metropolitan area with area code 11) but now is offered in 100% across our WCDMA coverage, allowing customers who have compatible terminals to achieve up to three times the value of traditional 3G's rate.

We began construction of the LTE system in a brand new spectrum and toward a data-centric network.

#### Competition

In 2012, competition continued to increase in the market for small/medium enterprises and in the residential market due to an expansion of the coverage area of the main competitors, improvements on their portfolios, and also

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due to an increase in their commercial activity and offers for both fixed and mobile services, adding downward pressure to prices and pushing for higher discounts.

We face intense competition in all the areas in which we operate, principally from other cellular service providers and also from fixed-line operators. Many of these competitors are part of a large, national or multinational group and therefore have access to financing, new technologies and other benefits that are derived from being a part of such a group.

Our main mobile service competitor in the states of São Paulo, Paraná and Santa Catarina is TIM Celular or TIM. The main fixed-line operator in this area is Brasil Telecom S.A. (in 2008, the Brazilian Government published Decree No. 6654/2008 of revision of the fixed-line general concession plan (Plano Geral de Outorgas, or PGO), allowing fixed-line concessionaires to operate in more than one region of the country. This change allowed Telemar Norte Leste S.A. to buy Brasil Telecom.

In the state of Espírito Santo service area, the principal cellular competitor is Oi and in the Rio de Janeiro service area, the principal competitor is Claro. Claro is controlled by a consortium led by the Telecom Américas Ltd. (controlled by América Móvil S.A. de C.V.). Claro began providing cellular telecommunications services in this Region at the end of 1998. The principal fixed-line operator in this area is Telemar Norte Leste S.A. Oi is the third competitor and is integrated with Telemar (a fixed-line operator) and TIM is the fourth competitor.

In the Central, Western and Northern region the principal competitors are: Claro, in the region encompassing the states of Mato Grosso do Sul, Mato Grosso, Goiás, Tocantins, Rondônia and Acre and the Federal District, and TIM, in the region encompassing the states of Amazonas, Roraima, Pará and Amapá. In the state of Maranhão the principal cellular competitor is Oi. The main fixed-line operators in this area are: Brasil Telecom S.A., in the region encompassing the states of Mato Grosso do Sul, Mato Grosso, Goiás, Tocantins, Rondônia and Acre and the Federal District, and Telemar Norte Leste S.A.—Telemar, in the region encompassing the states of Amazonas, Roraima, Pará, Amapá and Maranhão.

In the Bahia service areas, the principal cellular competitor is Claro and in the Sergipe, the main competitor is Oi. Other cellular competitors are Oi and TIM, which also operate in the state of Minas Gerais. The principal fixed-line competitor in this area is Telemar Norte Leste S.A.

In the Ceará, Pernambuco, Paraíba, Alagoas, Rio Grande do Norte and Piauí service areas, the principal cellular competitor is TIM. Other cellular competitors are Oi and Claro. The principal fixed-line competitor in this area is Telemar Norte Leste S.A.

In Rio Grande do Sul, the principal cellular competitor is Claro, which operates in several regions in Brazil, including Vivo-Rio Grande do Sul's region. Other cellular competitors are Brasil Telecom S.A. and TIM. The main fixed-line competitor in this area is Brasil Telecom.

In Minas Gerais, currently, there are four other wireless service providers operating within the authorization area of Vivo. Our subsidiary Vivo faces competition from the following operators: (a) TIM, the "B" band frequency range operator that launched its services in December, 1998 (TIM is primarily owned by Telecom Italia and operates in the entire State of Minas Gerais using GSM and WCDMA technologies); (b) Oi, the "D" band operator that launched its services in June 2002 (Oi is a subsidiary of Tele Norte Leste Participações S.A. (Telemar) and operates in the entire State of Minas Gerais using GSM and WCDMA technology); (c) Claro, the "E" band operator that launched its services in the fourth quarter of 2005 (Claro is controlled by América Móvil and operates a GSM and WCDMA technology network); and, (d) CTBC Celular, an "A" band and 3G band operator (CTBC Celular is controlled by CTBC, a fixed-line operator and uses GSM and WCDMA technologies).

Our subsidiary Vivo also compete with certain other wireless telecommunications services in specific segments, such as mobile radio (including digital trunking technology, offered by Nextel), paging and beeper services, which are used by some operators in the areas of Vivo as a substitute for cellular telecommunications services. These competing wireless telecommunications services are generally less expensive than mobile telecommunications services. In December 2010, through the auction 002/2010/ANATEL, NEXTEL was awarded 12 SMP licenses (11 spectrum licenses in “H” band (3G band) and 1 spectrum license in “M” band (1800 MHz band)).

Satellite-operated services which provide nationwide coverage, are also available in Brazil. Although these services have the advantage of covering much larger areas than those covered by the cellular telecommunications

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services, they are considerably more expensive than the cellular telecommunications services we offer and do not provide competitive coverage inside buildings.

Our main competitors for the provision of fixed services are: America Móvil / Telmex group (which includes NET, Claro and Embratel), TIM (which includes Intelig and Tim Fiber) and GVT. Our competitors employ varied strategies to gain market share. For instance, GVT expanded its operations to other major cities in the State of São Paulo, with a strategy based on ultra-broadband services, low price, high-quality customer service, and a new TV product, targeting high-income residential clients and small and medium businesses. NET improved its TV portfolio with a new on-demand video product (NOW) and continued its strategy of aggressive broadband prices, offering promotionally 10 Mb for the price of 1 Mb, which increased our churn up to 7% in some regions, against an average of 2.3%. TIM acquired a large optical-fiber network from AES (Atimus), and constituted a new company called TIM Fiber, which is expected to begin to offer high-speed fixed broadband in the city of São Paulo and other 11 cities nearby, making this market even more competitive. In the segment of low-income customers, we face competition from Embratel in TV services and NET in both TV and broadband services.

At Telefonica, we continue to develop and expand our product offerings, particularly those with great potential for future growth, such as broadband Internet services, pay-TV, and information technology services. Speedy maintained its position as market leader in the State of São Paulo with more than 3.7 million customers as of December 31, 2012 and over 2.8% growth compared with the same date in 2011. Additionally, our broadband service over high-speed optical fiber reached over 112 thousands households, a growth over 100%, contributing to lower churn with a high trend of bundling.

The strategy of low cost long-distance calls initiated by TIM for on-net calls on a “billing per call” basis continued the success already observed in 2010, and led Claro and our subsidiary Vivo to start making similar offers. These low-cost mobile long-distance rates contribute to the losses of fixed-lines of the incumbents. Nevertheless, the total market of fixed-lines grew 2% compared to the previous year, supported by FWT offers in locations not covered by copper networks and by the growth of fixed-lines provided by non-incumbent companies sometimes bundled for free.

Our subsidiary Vivo has also launched a FWT service which offers fixed-phones using the wireless network. With Vivo’s FWT service, we aim to leverage the fixed-phones sales, mainly outside the state of São Paulo, where we have reduced fixed network capacity. This solution can also reduce the cost of providing this service to enterprises located nationwide, such as banks, which we already have in our portfolio of clients.

We continue with our strategy in the corporate market as a provider of complete infrastructure solutions for information technology customers, integrating hardware packages, voice, data, Internet and network services. Additionally, we launched the service “OnVideo,” a product that allows the client to watch movies directly from a TV with digital video technology on demand. The service “At Home,” which provides home automation (a solution that integrates home electrical devices, thus offering improved convenience, comfort, energy efficiency and security), completed its third year in 2012.

### Seasonality

Our business and results of operations are not materially affected by seasonal fluctuations in the consumption of our services.

### Regulation of the Brazilian Telecommunications Industry

### General

Our business, including the services we provide and the rates we charge, is materially affected by comprehensive regulation under the General Telecommunications Law and various administrative rules thereunder. Our companies that operate under a concession are authorized to provide specified services and have certain obligations, according to the Plano Geral de Metas de Universalização, or General Plan on Universal Service Targets and the Plano Geral de Metas de Qualidade, or General Plan on Quality Targets.

ANATEL is the regulatory agency established by the General Telecommunications Law. ANATEL is administratively and financially independent from the Brazilian government. Any proposed regulation by ANATEL

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is subject to a period of public comment and, occasionally, public hearings, and its decisions may be challenged in the Brazilian courts.

### Concessions and Authorizations

Concessions are licenses to provide telecommunications services that are granted under the public regime, while authorizations are licenses to provide telecommunications services granted under the private regime.

Companies that provide services under the public regime, known as the concessionary companies, are subject to certain obligations as to quality of service, continuity of service, universality of service, network expansion and modernization.

Companies that provide services under the private regime, known as the authorized companies, are generally not subject to the same requirements regarding continuity or universality of service; however, they may be subject to certain network expansion and quality of service obligations set forth in their authorizations.

Companies that operate under the public regime include us, Embratel, Oi, CTBC Telecom and Sercomtel. The primary public regime companies provide fixed-line telecommunications services in Brazil that include local, intraregional, interregional and international long-distance services. All other telecommunications service providers, including the other companies authorized to provide fixed-line services in our concession region, operate under the private regime.

Public regime companies, including us, can also offer certain telecommunications services in the private regime, of which the most significant are data transmission services.

**Fixed-line Services—Public Regime.** Our current concession agreements for the local, intraregional and interregional long-distance services were extended on December 22, 2005, for an additional period of 20 years.

Our current concession agreements contain a provision, amended by ANATEL on June 30, 2011, providing that they may be amended on December 31, 2015, and December 31, 2020 to establish new conditions and new targets for universal access and quality, taking into consideration the conditions prevailing at the time, and defining, in the case of universal access targets, complementary resources, as provided by article 81 of Law No. 9,472 of 1997.

Under the renewed concession agreements and during the 20-year renewal period, we are required to pay a biennial fee equal to 2% of the gross revenue of the previous year, net of taxes and social contributions, arising from the rendering of basic service plans and alternative STFC in our concession area. See “—Obligations of Telecommunications Companies.” Each of the foregoing regulatory terms and conditions affecting (or potentially affecting) the current concession agreements, as well as current obligations under the existing concession agreements, may impact our business plan and results of operations.

**Fixed-line Services—Private Regime.** The Brazilian telecommunications regulation delegates to ANATEL the power to authorize private regime companies to provide local and intraregional long-distance services in each of the three fixed-line regions and to provide intraregional, interregional and international long-distance services throughout Brazil. ANATEL has already granted authorizations to private regime operators to operate in Region III, our concession region. ANATEL also granted other private regime companies authorizations to operate in other fixed-line regions and authorizations to provide intraregional, interregional and international long-distance services throughout Brazil in competition with Embratel. Several companies have already applied for authorization, and ANATEL may authorize additional private regime companies to provide intraregional, interregional and international long-distance services. See “—Competition.”

Since 2002 we provide local and interregional services in Regions I and II and Sector 33 of Region III, and international long-distance services in Regions I, II and III.

In accordance with the General Telecommunications Law, a concession relates to the provision of telecommunication services under the public regime, as determined by the public administration. A concession may only be granted upon a prior auction bidding process. As a result, regulatory provisions are included in the relevant concession agreements and the concessionaire is subject to public service principles of continuity, changeability and equal treatment of customers. In addition, ANATEL is empowered to direct and control the performance of the services, to apply penalties and to declare the expiration of the concession and the return of assets of the



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concessionaire to the government authority upon termination of the concession. Another distinctive feature is the right of the concessionaire to maintain certain economic and financial standards. The concession is granted for a fixed period of time and is generally renewable only once.

An authorization is a permission granted by the public administration under the private regime, which may or may not be granted upon a prior auction bidding process, to the extent that the authorized party complies with the objective and subjective conditions deemed necessary for the rendering of the relevant type of telecommunication service in the private regime. The authorization is granted for an indeterminate period of time. Under an authorization, the government does not guarantee to the authorized company the economic-financial equilibrium, as is the case under concessions.

## SMP Licenses

Before January 2000, ANATEL had only authorized two mobile service providers in each of the ten franchise areas under “A” band and “B” band. “A” band and “B” band mobile service providers were granted concessions pursuant to the Lei Mínima, or the Minimum Law. Each concession was a specific grant of authority to supply cellular telecommunications services, subject to certain requirements contained in the applicable list of obligations appended to each concession. If a mobile service provider wishes to offer any telecommunications services other than those authorized by its authorized concession, it may apply to ANATEL for an authorization to offer such other services.

In November 2000, ANATEL adopted certain regulations for the issuance of new licenses, which are authorizations to provide wireless communication services through SMP, personal mobile service, to compete with the then existing cellular operators in the various regions of Brazil. These regulations divided Brazil into three main regions covering the same geographic area as the concessions for the fixed-line telecommunication services. ANATEL organized auctions for three new licenses for each of those regions. The new licenses provided that the new services would be operated in the 1800 MHz radio frequency bands which were denominated as the “C” band (which was later transformed into extension bands), the “D” band, “E” band and “M” band. These new licenses were auctioned by ANATEL and awarded during the first quarter of 2001, at the end of 2002, in September 2004, in March 2006, in September 2007, in December 2007 and in December 2010. In September 2007, ANATEL organized auctions for 15 new licenses in the 1900 MHz radio frequency bands which were denominated Band “L.” Vivo acquired 13 spectrum licenses in band “L.” In December 2007, ANATEL organized auctions for 36 new licenses in the 1900-2100 MHz radio frequency bands (3G licenses) which were denominated bands “F,” “G,” “I” and “J.” Vivo acquired seven spectrum licenses in Band “J” and Vivo Participações acquired two spectrum licenses in Band “J.” In December 2010, ANATEL organized auctions for 165 new licenses in the “H” band, extension bands, and available frequencies at “A,” “D,” “E,” “M” and TDD bands. Vivo was awarded 23 licenses (14 spectrum licenses in 1800 MHz bands (“D,” “E,” “M” and extension bands) and 9 spectrum licenses in 900 MHz extension bands).

On February 3, 2003, TCO replaced its SMC Concession Contracts for Personal Mobile Service Agreements (Termos de Autorização do Serviço Móvel Pessoal) in Regions I (subrange of “B” frequencies) and II (subrange of “A” frequencies) of the General Plan of Grants. On December 10, 2002, Telerj Celular, Telest Celular, Telebahia Celular, Telergipe Celular, Celular CRT, Global Telecom and TELESP Celular replaced its SMC Concession Contracts for Personal Mobile Service Agreements, or SMP, in Regions I (subrange of “A” frequencies), II (subrange of “A” and “B” frequencies) and III (subrange of “A” frequencies) of the General Granting Plan. On July 27, 2006, ANATEL published Act 59867 authorizing the incorporation of TCO, Teleacre, Telegoiás, Teleron, Telems, Telemat, NBT, Telerj, Telest, Telebahia, Telergipe, Celular CRT and TC by GT, as well as the transfer of the respective SMP service authorization titles and of the SMP radio-frequency rights-of-use titles. Act 59867 also provides for the automatic termination of the authorizations for Multimedia Communication Services (Serviços de Comunicação Multimídia, or SCM) of TCO, Teleacre, Telegoiás, Teleron, Telems, Telemat, NBT, Telerj, Telest, Telebahia, Telergipe, Celular CRT and TC, upon each of their respective incorporations.

In order to transfer our services to SMP, we were required to comply with several technical and operational conditions, including, among other things, the adoption of a carrier selection code for long-distance calls originating from our network.

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Our authorizations consist of two licenses—one to provide mobile telecommunications services, and another to use the frequency spectrum for a period of 15 years. The frequency license is renewable for another 15-year period upon the payment of an additional license fee.

Our new SMP licenses include the right to provide cellular services for an unlimited period of time but restrict the right to use the spectrum according to the schedules listed in the old licenses (Vivo-Rio Grande do Sul (“A” band) until 2022 (renewed in 2006); Vivo-Rio de Janeiro (“A” band) until 2020 (renewed in 2005); Vivo-Espírito Santo (“A” band) until 2023 (renewed in 2008); Vivo-Bahia (“A” band) and Vivo-Sergipe (“A” band) until 2023 (renewed in 2008); Vivo-São Paulo (“A” band) until 2023 or 2024, for the cities of Ribeirão Preto and Guatapar (renewed in 2008); Vivo-Paraná/Santa Catarina (“B” band) until 2013; Vivo-Federal District (“A” band) until 2021, (renewed in 2006); Vivo-Acre (“A” band), Vivo-Rondnia (“A” band), Vivo-Mato Grosso (“A” band) and Vivo-Mato Grosso do Sul (“A” band) until 2024 (renewed in 2008); Vivo-Gois/Tocantins (“A” band) until 2023 (renewed in 2008); Vivo-Amazonas/Roraima/Amap/Par/Maranho (“B” band) until 2013; Vivo (Minas Gerais) (“A” band) until 2023 (renewed in 2007) and Vivo (for the cities where CTBC Telecom operates in the state of Minas Gerais) (“E” band) until 2020). Spectrum rights may be renewed only once over a 15-year period.

In September 2007, ANATEL organized auctions of new SMP licenses in the remaining radio frequency bands “D” and “E,” in the 1.8 GHz frequency band “M,” and fifteen licenses in the 1.9 GHz frequency band “L,” previously allocated to fixed operators. Vivo acquired 13 spectrum licenses in band “L.” The following Terms of Authorization for band “L” have been signed: Vivo-Rio Grande do Sul (“L” band) until 2022 (renewed in 2006) or 2022 for the cities of the metropolitan area of Pelotas; Vivo-Rio de Janeiro (“L” band) until 2020 (renewed in 2005); Vivo-Espírito Santo (“L” band) until 2023 (renewed in 2008); Vivo-Bahia (“L” band) and Vivo-Sergipe (“L” band) until 2023 (renewed in 2008); Vivo-So Paulo (“L” band) until 2023 or 2024, for the cities of Ribeiro Preto and Guatapar (renewed in 2008) or 2022 for the cities where CTBC Telecom operates in the state of So Paulo; Vivo-Paran (excluding the cities of Londrina and Tamarana)/Santa Catarina (“L” band) until 2013; Vivo-Federal District (“L” band) until 2021, (renewed in 2006); Vivo-Acre (“L” band), Vivo-Rondnia (“L” band), Vivo-Mato Grosso (“L” band) and Vivo-Mato Grosso do Sul (“L” band) until 2024 (renewed in 2008) or 2022 for the city of Paranaba of Mato Grosso do Sul; Vivo-Gois/Tocantins (“L” band) until 2023 (renewed in 2008) or 2022 for the cities where CTBC Telecom operates in the state of Gois and Vivo-Alagoas/Cear/Paraba/Piaui/Pernambuco/Rio Grande do Norte (“L” band), until 2022. Spectrum rights may be renewed only once over a 15-year period.

In December 2007, ANATEL organized auctions for 36 new licenses in the 1900-2100 MHz radio frequency bands (3G licenses), denominated as bands F, G, I and J. Vivo was awarded seven spectrum licenses in band “J” and Vivo Participaes was awarded two licenses. The following Terms of Authorization for “J” band have been signed: Vivo-Rio Grande do Sul (including the cities of the metropolitan area of Pelotas) (“J” band) until 2023; Vivo-Rio de Janeiro (“J” band) until 2023; Vivo-Espírito Santo (“J” band) until 2023; Vivo-Bahia (“J” band) and Vivo-Sergipe (“J” band) until 2023; Vivo-So Paulo (including the cities of Ribeiro Preto and Guatapar and the cities where CTBC Telecom operates in the state of So Paulo) (“J” band) until 2023; Vivo-Paran (including the cities of Londrina and Tamarana)/Santa Catarina (“J” band) until 2023; Vivo-Federal District (“J” band) until 2023; Vivo-Acre (“J” band), Vivo-Rondnia (“J” band), Vivo-Mato Grosso (“J” band) and Vivo-Mato Grosso do Sul (including the city of Paranaba) (“J” band) until 2023; Vivo-Gois (including the cities where CTBC Telecom operates in the state of Gois)/Tocantins (“J” band) until 2023; Vivo-Alagoas/Cear/Paraba/Piaui/Pernambuco/Rio Grande do Norte (“J” band), until 2023; Vivo-Amazonas/Roraima/Amap/Par/Maranho (“J” band) until 2023; Vivo (including the cities where CTBC Telecom operates in the state of Minas Gerais) (“J” band) until 2023. Spectrum rights may be renewed only once over a 15-year period.

In December 2010, ANATEL organized auctions for 165 new licenses in the “H” band, extension bands, and available frequencies at “A,” “D,” “E,” “M” and TDD bands. Vivo was awarded 23 licenses (14 spectrum licenses in 1800 MHz bands (“D,” “E,” “M” and extension bands) and 9 spectrum licenses in 900 MHz extension bands):

- “M” band (1800 MHz) of the Federal District and the states of Paraná, Santa Catarina, Rio Grande do Sul, Goiás, Tocantins, Mato Grosso do Sul, Mato Grosso, Rondônia and Acre;
  - 1800 MHz extension band of the state of São Paulo;
- “D” band (1800 MHz) of the cities of Pelotas, Morro Redondo, Capão do Leão and Turuçu in the state of Rio Grande do Sul;

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- “E” band (1800 MHz) of the states of Alagoas, Ceará, Paraíba, Piauí, Pernambuco and Rio Grande do Norte;
  - 900 MHz extension band of the state of Rio de Janeiro;
  - 900 MHz extension band of the state of Espírito Santo;
- 900 MHz extension band of the states of Goiás, Tocantins, Mato Grosso do Sul, Mato Grosso, Rondônia, Acre and the Federal District, with the exception of the cities of Paranaíba, in the state of Mato Grosso do Sul, and the cities of Buriti Alegre, Cachoeira Dourada, Inaciolândia, Itumbiara, Paranaiguara and São Simão, in the state of Goiás;
- 900 MHz extension band of the state of Rio Grande do Sul, with the exception of the cities of Pelotas, Morro Redondo, Capão do Leão and Turuçu;
- 900 MHz extension band of the cities of the registration area number 43 of the state of Paraná, with exception of the cities of Londrina and Tamarana;
- 900 MHz extension band of the states of Paraná and Santa Catarina, with exception of the cities of the registration area number 43 of the state of Paraná and the cities of Londrina and Tamarana;
  - 900 MHz extension band of the state of Bahia;
  - 900 MHz extension band of the state of Sergipe;
- 900 MHz extension band of the states of Amazonas, Amapá, Maranhão, Pará and Roraima;
- 1800 MHz extension band of the state of São Paulo, with exception of the cities of the metropolitan region of São Paulo and the cities where CTBC Telecom operates in the state of São Paulo;
  - 1800 MHz extension band of the states of Amazonas, Amapá, Maranhão, Pará and Roraima;
  - 1800 MHz extension band of the city of Paranaíba, in the state of Mato Grosso do Sul;
- 1800 MHz extension band of the cities of Buriti Alegre, Cachoeira Dourada, Inaciolândia, Itumbiara, Paranaiguara and São Simão, in the state of Goiás;
- other 1800 MHz extension band of the cities of Buriti Alegre, Cachoeira Dourada, Inaciolândia, Itumbiara, Paranaiguara and São Simão, in the state of Goiás;
  - 1800 MHz extension band of the states of Rio de Janeiro, Espírito Santo, Bahia and Sergipe;
  - 1800 MHz extension band of the states of Amazonas, Amapá, Maranhão, Pará and Roraima;
- 1800 MHz extension band of the states of Alagoas, Ceará, Paraíba, Piauí, Pernambuco and Rio Grande do Norte;
- 1800 MHz extension band of the city of Paranaíba, in the state of Mato Grosso do Sul, and the cities of Buriti Alegre, Cachoeira Dourada, Inaciolândia, Itumbiara, Paranaiguara and São Simão, in the state of Goiás;
  - 1800 MHz extension band of the cities of Londrina and Tamarana, in the state of Paraná; and

- 800 MHz (Band A in the North), 1800 MHz (extension subbands in Region II, within the states of São Paulo and Espírito Santo, Ceará and Pernambuco) and TDD (National coverage).

On December 1, 2011 ANATEL carried out the bidding of frequency blocks (Notice No. 001/2011/PVCP/SPV-ANATEL), divided into 54 lots, in the bands: 800 MHz (Band A in the North), 1800 MHz (subbands extension in Region II, within the states of São Paulo and Espírito Santo, Ceará and Pernambuco) and TDD (national coverage),

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totaling approximately R\$592 million, considered the minimum bidding price. This auction offered remaining lots from Notice No. 002/2010/SPV-ANATEL, held in December 2010, in which Vivo was one of the largest winners in the auction by acquiring radio frequency bands 900 MHz and 1,800 MHz.

Of the 54 lots under auction, 15 were sold, totaling revenue of R\$237 million to the government, representing a premium of 0.69%.

Our subsidiary Vivo was unable to participate in this auction because it has already reached maximum spectral capacity in most concession areas. As a result, if Vivo had purchased any lot in these areas, it would have exceeded its spectrum cap as established by applicable regulations. Under these new licenses:

- services are to be provided using the 1800 MHz frequency bands (“D” band, “E” band and “M” band), 1900 MHz frequency bands (“L” band), 1900–2100 MHz frequency bands (“F” band, “G” band, “H” band, “I” band and “J” band) and extension bands;
  - each operator may optionally provide domestic and international long-distance services in its licensed area;
- existing cellular service providers as well as new entrants into the Brazilian telecommunications market can bid for “D” band, “E” band, “M” band, “L” band, “F” band, “G” band, “I” band and “J” band licenses;
- according to the Invitation Document 002/2010/ANATEL, a single SMP operator in one geographic area will only be authorized to have radio frequency bands up to the total maximum limit of 80 MHz or 85 MHz, depending on the circumstances, while observing the following limits for each band:

I – (12.5 + 12.5) MHz, for the 800 MHz bands;

II – (2.5 + 2.5) MHz, for the 900 MHz bands;

III – (25 + 25) MHz, for the 1800 MHz bands;

IV – (15 + 15) MHz, for the 1900 MHz and 2100 MHz bands;

V – 5 MHz, for the TDD extensions of 1900 MHz band;

- as a result, Nextel and other new 3G operators were given preferential status in the “H” band ((10 + 10) MHz) segment of the auction. Vivo, TIM and Claro were eligible to enter bids for the remaining SMP frequencies. Oi acquired the band “H” lot 8 (for the cities in the states of Mato Grosso do Sul and Goiás). CTBC acquired the band “H” lot 5 (for the cities in the state of Minas Gerais) and Nextel acquired the other band “H” lots; and
- a cellular operator, or its respective controlling shareholders, may not have geographical overlap between licenses.

On June 12 and 13, 2012, ANATEL held a public bidding for 273 4G lots in the 2,500 to 2,690MHz frequencies. We acquired the “X” band, with a nationwide coverage, for R\$1.05 billion. Given the rules of the public bidding process, which limited the total spectrum each service provider could hold within this frequency, we agreed to relinquish bands “P,” “T” and “U.” used for MMDS services within 18 months of obtaining the “X” band. Sky and TIM will have preferred rights for the acquisition of the “T” and “U” and for the “P” bands, respectively in the cities of Curitiba and Rio de Janeiro and Oi will have preferred rights for the acquisition of the “P” band in the cities of São Paulo and Porto Alegre.

In order to meet the coverage requirements in the 2.5 GHz frequency, cities will have the services available according to the following timetable:

- by April 30, 2013: cities that will be host to the Confederation Cup in 2013
- by December 31, 2013: host and sub-host cities to the World cup in 2014;
- by May 31, 2014: state capitals, the Federal District and cities with over 500,000 residents;



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- by December 31, 2015: cities with over 200,000 residents;
- by December 31, 2016: cities with over 100,000 residents;
- by December 31, 2017: cities with between 30,000 and 100,000 residents; and
- by December 31, 2019: cities with fewer than 30,000 residents.

ANATEL also held a public bidding for the 450 MHz frequency, in order to meet voice and data demand with mobile technology in rural areas. In the absence of interested participants, those granted rights under the 4G bid were required to take over the infrastructure set up in rural areas, which will be regulated in 2013 according to the frequency acquired.

Under band “X,” which we acquired in the bidding process, we will be required to provide infrastructure in rural areas in the states of Alagoas, Ceará, Minas Gerais, Paraíba, Pernambuco, Piauí, Rio Grande do Norte, Sergipe, and interior of São Paulo, for a total of 2,556 municipalities. The timetable for providing infrastructure in the rural areas requires that 30% of municipalities have infrastructure set up by June 2014, 60% by December 2014 and 100% by December 2015, with a transmission rate of 256Kbps and by December 31, 2017, all of these municipalities will be expected to have 1Mbps. Service providers will be allowed to use other frequencies previously granted to it to meet these requirements.

After receiving the ANATEL study on the occupation of the 700 MHz frequency, published in early Jan/2013, the communications minister, published Ordinance No. 14, with guidelines for accelerated access to the Brazilian System of Digital Terrestrial Television - SBTVD-T and to broaden the availability of the radio frequency spectrum for meeting the goals set forth by the National Broadband - PNBL. The ordinance also establishes that the FCC develop a proposal to regulate use of the band. The proposal will be put to public consultation, giving conditions for the bidding possibly occur in the second semester of 2013.

On July 18, 2012, ANATEL notified us that we would be required to present an improvement plan for SMP services. We presented our plan and it was approved by ANATEL on September 10, 2012.

Obligations of Telecommunications Companies

We and other telecommunications service providers are subject to obligations concerning quality of service, network expansion and modernization. The concession telecommunication companies are also subject to a set of special restrictions regarding the services they may offer, which are listed in the Plano Geral de Outorgas (PGO), or General Plan of Grants, and special obligations regarding network expansion and modernization contained in the General Plan on Universal Service Targets.

In 2008, the presidential decree published with the General Plan of Grants increased the flexibility of telecommunications provider groups as STFC concessionaires by allowing such providers to provide services in up to two General Plan of Grants regions. Before this decree, telecommunications provider groups holding STFC concessions could offer STFC services in only one region under the public regime.

Any breach by the companies of telecommunications legislation or of any obligation set forth in their authorizations may result in a fine of up to R\$50 million.

The mobile service authorizations of our subsidiary Vivo involve obligations to meet quality of service standards the system’s ability to make and receive calls, call failure rates, the network’s capacity to handle peak periods, failed

interconnection of calls and customer complaints. ANATEL published the method for collecting these quality service standards data on April 23, 2003 (ANATEL Resolution No. 335/03 and 317/02). In July 2010, ANATEL published Public Consultation No. 27/2010, revising the General Plan of Standards of Quality of the SMP.

To restructure the process of assessing the quality of mobile service, with the inclusion of new processes and measurement of new indicators to check the quality of mobile broadband and the quality perceived by the user, and the modernization of existing indicators, ANATEL issued on October 28, 2011 (published in the D.O.U. on October 31, 2011), Resolution No. 575/2011, which approved the Regulation for the Management of Quality of Provision of Personal Mobile Service (SMP-RGQ).

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The new Regulation provides for the assessment of the network connection and their respective data transmission rate, assessing aspects of availability, stability and connection speed for the data network. In addition, the rule established the formation of GIPAQ (Group Deployment Process Quality Measurement), which will be responsible for implementing the processes on the quality indicators for the “Instant Transmission Rate Guarantee “and “Average Transmission Rate Guarantee.”

The methodology and procedures regarding the collection of data connection indicators will be defined by a group composed of providers, ANATEL and Quality Authority (EAQ), which shall be responsible for implementing these processes and which will be hired by the mobile operators, as a group, starting with February 29, 2012. All costs associated with implementing the new procedures for measuring quality will be borne by the providers of SMP services. The impacts of the regulations are still being evaluated, particularly its financial aspects.

### Restrictions on Companies to Provide STFC in the Public Regime

Public regime companies are also subject to certain restrictions on alliances, joint ventures, mergers and acquisitions, including:

- a prohibition on holding more than 20% of the voting shares in any other public regime company, unless previously approved by ANATEL, according to ANATEL’s Resolution No. 101/99; and
- a prohibition on public regime companies to provide similar services through related companies.

### Network Expansion and Quality of Service

We are subject to the General Plan for Universal Service Targets (Plano Geral de Metas para a Universalização) and the General Plan of Quality Targets (Plano Geral de Metas de Qualidade), each of which respectively requires that we undertake certain network expansion activities with respect to our fixed-line services and meet specified quality of service targets. The timing for network expansion and benchmarks for quality of service are revised by ANATEL from time to time.

The decree altering the General Plan for Universal Service Targets rescinded in 2008 the obligation of telecommunications concessionaires to install telecommunications service centers (providing calling and data access to walk-in customers) and substituted such obligation with an obligation to roll out broadband network infrastructure throughout the municipalities serviced by such concessionaires. In compliance with the decree, in 2011, all municipalities in Brazil had infrastructure for broadband networking. This obligation made us implement an additional network infrastructure in 257 of the 622 municipalities in our concession region.

Moreover, we have, as have other telecommunications concessionaires, committed to provide free Internet access to public schools during the term of our concession grant (until 2025).

If a public regime company does not fulfill its obligations under the General Plan for Universal Services and the General Plan for Quality Targets, there are various monetary penalties that may be imposed by ANATEL. A company may lose its license if ANATEL considers it incapable of providing basic services under the two General Plans.

### General Plan for the Universalization of the Fixed Switched Service (PGMU III)

On June 30, 2011 the Brazilian government published Decree No. 7,512 related to the General Plan for the PGMU III. The PGMU III sets new targets for Telefone de Uso Público (public phones) density in rural and poor areas and goals related to AICE and bidding for the 450 MHz and 2500 MHz spectrum ranges (to, respectively, meet the needs of

rural regions and develop fourth generation mobile telephony). Also according to the new PGMU, the backhaul used to meet the commitments of universalization was characterized as a reversible asset.

On October 25, 2012, ANATEL published Resolution No. 598/2012, which addresses population density, setting deadlines to meet access requests and benchmarks for use of the public telephone plant and the establishment of a list of agencies that can request access to its location. Review of deadline for proposing service plans and the establishment of universal obligations disclosure.

ANATEL approved other resolutions and consents in 2012:

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- Resolution No. 581/2012: Regulates conditioned services, cable television services, multichannel, multipoint, signal distribution, satellite television and audio services, and subscription television services.
- Resolution No. 582/2012: Aims to adopt the Model Authorization Form conditioned services (SeAC)
- Resolution No. 586/2012: Revokes Regulation No. 427 and sets forth new rates for low income families of R\$13.65, including taxes, for fixed line services including 90 minutes for local calls between fixed lines. This new plan went into effect on June 8, 2012.
- Resolution No. 588/2012: Regulates network compensation for the STFC. This regulation revised the method of charging for TU-RL during the reduced time period for calls under two minutes of duration, and the change in Bill & Keep regime.
- Resolution No. 589/2012: Approves administrative sanctions for service providers violating concession agreements and other grants of service from governmental authorities.
- Resolution No. 590/2012: Regulates the use of industrial dedicated lines and sets forth new rules for providers with significant market power and reduces the standard circuit reference rate by approximately 30%. These reference rates are used in instances arbitration or other forms of alternative dispute resolutions. In addition, ANATEL granted service providers a four month period during which to adopt these rules. We have filed a claim against ANATEL to question the legality of retroactively applying this new regulation and to address ANATEL's definition of significant market power as we understand there to be competition in the areas indicated by them.
- Resolution No. 596/2012: Regulates limits, procedures and criteria for the review of services provided, the implementation of network infrastructure as well as the use of resources for numbering radio frequencies. This regulations sets forth access to on-line systems, technological advancements by service providers in order to obtain information.
- Resolution No. 600/2012: Approved the competition goals plan (PGMC). The main goals of PGMC are focused on the wholesale marked and network infrastructure sharing, including: (1) passive infrastructure for transport and access networks; (2) call termination in mobile networks; (3) roaming (4) fixed network infrastructure for the transmission of data through copper cables in transmissions of 10mbps; and (5) wholesale fixed network infrastructure for local and long distance transmission of data under 35mbps.
- Resolution No. 604/2012: Approved the change to the SMP regulation for successive calls made to the same mobile number to be considered one single call for billing purposes. Successive calls are those made within 120 seconds of each other to and from the same phone numbers.

Other Regulatory Issues

On November 21, 2008, the Brazil Government published decree 6,654/2008, for the revision of the fixed-line General Plan of Grants, allowing fixed-line concessionaires to operate in more than one region of the country. This change allowed Telemar Norte Leste S.A.—Telemar or Oi— to acquire Brasil Telecom.

In 2007, ANATEL published Resolution No. 477/2007, effective on February 13, 2008, relating to alterations in the regulation of SMP, which has contributed to an increase in our operating costs. In the new regulation, ANATEL notes areas of vital importance for mobile business, such as the necessity for retail stores in the cities within an operator's coverage areas, increases in the validity periods of prepaid cards and places limits on the period of time during which customers may not leave service plans. These new regulations may have an adverse effect on our revenues and results

of operations. To minimize the impacts resulting from these regulatory changes, we had already prepared ourselves during the last quarter of 2007, to meet and comply with the terms set forth by the new regulation, mainly those related to the customer service which affect procedures and required significant changes to our systems. In 2009, we continued establishing retail stores in the cities within our coverage areas, pursuant to the provisions of Resolution No. 477/2007. In 2009, we also established mediation centers to attend to users with hearing and speech impediments, pursuant to the provisions of Resolution No. 477/2007. Our plans for achieving the goals set by this new regulation was extend to August 13, 2011 and all goals relating to Resolution No. 477/2007 were achieved by the company and certified by ANATEL. Because ANATEL considers Vivo to be affiliated with Telefônica Brasil, which already provides wire line long-distance services in the state of São Paulo and was awarded a license to provide these services nationwide, ANATEL will not award a wire line long-distance license to Vivo. Though we and other mobile operators have requested that ANATEL revise the current SMP regime, there can be no assurance it will do so.

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ANATEL granted on August 18, 2011 prior consent to the company to transfer to Vivo its authorizations for STFC service in local mode, domestic long-distance and international long-distance in Regions I and II of the General Plan of Grants (outside of São Paulo). On September 8, 2011 the Extract of the Authorization Term was published in the D.O.U. with the transfer of the STFC licenses in Regions I and II to Vivo. As a result, Vivo began to offer the STFC across its area, except for the State of São Paulo, using basically the network elements and some radio frequencies that support the provision of the SMP.

Under the SMP regime, we receive revenues from interconnection fees paid to us by wire line long-distance operators due to long-distance traffic originating and terminating on our network. While Vivo is not obligated to use Telefônica Brasil's fixed-line network due to the affiliation relationship, it also cannot receive its own fixed-line license in the event of disagreements with Telefônica Brasil since Telefônica Brasil has the fixed nationwide license and an affiliate cannot have the same type of license in the same area. Since Vivo is not permitted to have a fixed license, Vivo is only able to receive interconnection fees from wireline carriers that have traffic originating or terminating on their network but not from wireless carriers using their fixed-line network. Some of our wireless competitors are also unable to earn such a fixed license due to their affiliations. For example, Oi cannot have a fixed license because it is affiliated with Telemar and Claro cannot have a fixed license because it is affiliated with Embratel. Tim has a fixed license because is not affiliated with any fixed operator, but in July 2009, ANATEL published Act No. 3804/2009 determining the conditions to be followed to guarantee total separation between Tim (Telecom Italia) and our subsidiaries.

On March 24, 2011, ANATEL approved the corporate restructuring of Vivo Participações and Vivo, which are now controlled by the company and not by Brasilcel. The operation resulted in the final merger of shares of Vivo Participações into the company. See "Item 4. History and Development of the Company—A. Historical Background—Corporate Restructuring Involving Vivo Participações"

On August 18, 2011, through Act 5,703/2011, dated August 16, 2011, ANATEL approved the merger of Vivo Participações into the company, with the transfer of the SMP authorizations and respective authorizations terms held by Vivo Participações to Vivo, as well as the resignation by Vivo of its SCM authorization.

In October 2012, the board of directors of ANATEL approved the inclusion of interconnection, facilities, operational and other commodity revenues to the basis for calculating the amount owed in the renewal of the authorization terms for radio frequencies. In addition, according to the concession agreements for fixed line services, we are required to pay an amount equal to 2% of our net revenues for basic and alternative service plans, every two years.

In July 2012, we received notice that a cost model was being revised for fixed-line as well as mobile operations. Concurrently, ANATEL published a request for comments and suggestions regarding the preparation and implementation of the cost model.

### New Regulations for Restricted Access Services— SeAC

On September 12, 2011, the Brazilian Congress adopted Law 12,485/2011 as a result of Bill 116, which establishes a new legal framework for audiovisual communication with restricted access. This law opens the Pay TV market by enabling telecom operators to offer audiovisual content to subscribers through their networks, creating a new service called Restricted Access Services (Serviço de Acesso Condicionado, or SeAC). The absence of restrictions on foreign capital to be invested in SeAC providers, as well as the elimination of restrictions for the provision of other telecommunications services through STFC, allow us to provide Pay TV services, as well as other telecommunication services previously limited under the General Telecommunications Law.

According to Law 12,485/2011, the SeAC service will replace current cable subscription TV services, subscription TV, MMDS and DTH and will be regulated by ANATEL. As a result of this law, ANATEL introduced in December 2011 the proposed regulations for Pay TV services through Public Consultation No. 65/2011, including license grants, installation and licensing of stations and mandatory distribution programming channels. The Public Consultation was finalized on February 2, 2012 and resulted in Resolution No. 581, issued by ANATEL on March 28, 2012, as well as the new Authorization Terms of the SeAC (which were subject to Public Consultation No. 5/12 and were available for comments until the first week of February).



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Law No. 12,485/2011 also established an annual payment to Condecine (Contribuição para o Desenvolvimento da Indústria Cinematográfica) to be made by providers of telecommunication services and amended Law No. 5,070/1966 by revising the amount due as Inspection Fee (Taxa de Fiscalização de Funcionamento) for telecommunication stations from 45% to 33% of the Installation Fee (Taxa de Fiscalização de Instalação). The amount due to Condecine is approximately 12% of the Installation Fee for telecommunication services and must be paid yearly by March 31 of each year.

As a result of Law No. 12,485/2011, the National Cinema Agency (Agência Nacional do Cinema, or Ancine) issued one public consultation by the end of 2011 and one public consultation in 2012 to regulate the registration of economic agents before Ancine. Both public consultations remain under Ancine's review and are expected to be issued in 2012, as they will become the regulatory framework for the SeAC.

### Interconnection Regulation

Under the General Telecommunications Law, all mobile telecommunications service providers must provide interconnection upon the request of any other mobile or fixed-line telecommunications service provider. More specifically, telecommunications service providers are classified as providers of either collective or restricted services. All cellular operators, including SMP service providers, are classified by ANATEL as collective service providers. All providers of collective services are required to provide interconnection upon request to any other collective service provider. Since 2005, telecommunications service providers have been permitted to freely negotiate the terms and conditions upon which interconnection will be provided, subject to price caps and other rules established by ANATEL. For example, providers must enter into agreements regarding, among other things, tariffs, commercial conditions and technical issues with all parties on a nondiscriminatory basis and starting in 2005, to have a more homogeneous system and to accelerate the negotiation of interconnection contracts, ANATEL has required a standard interconnection network from STFC and SMP Operators through an offer made publicly and equitably.

If parties to an interconnection agreement cannot agree upon the terms and conditions of interconnection, ANATEL may determine those terms and conditions by arbitration. Interconnection agreements must be approved by ANATEL and may be rejected if they are contrary to the principles of free competition and the applicable regulations. ANATEL has adopted, from time to time, various regulations governing interconnection rules. The following are the material regulations currently applicable to our business:

- the new General Regulation of Interconnection (“Regulamento Geral de Interconexão”–Resolution No. 410/2005, or “RGI”);
  - the Regulation of Separation and Allocation of Costs (Resolution No. 396/2005);
- Resolution No 590/2012 – Regulates the use of industrial dedicated lines and sets forth new rules for providers with significant market power and reduces the standard circuit reference rate by approximately 30%. These reference rates are used in instances arbitration or other forms of alternative dispute resolutions. In addition, ANATEL granted service providers a four month period during which to adopt these rules. We have filed a claim against ANATEL to question the legality of retroactively applying this new regulation and to address ANATEL's definition of significant market power as we understand there to be competition in the areas indicated by them.
- the Regulation of Remuneration of Use of SMP Providers Networks (Resolution No. 438/2006). In November 2010, ANATEL published Resolution No. 549/2010 modifying Resolution No. 438/2006 and providing that the groups that include SMP operators with participation rates lower than 20% in the market of mobile telephony combined in each one of the regions of the General Plan of Authorizations of SMP (PGA-SMP), are considered groups who lack

significant market power in the offer of mobile interconnection, in their respective areas of authorization;

- the Regulation of Fixed and Wireless Number Portability (Resolution No. 460/2007, effective March 2009);
  - the new Regulation of SMP (Resolution No. 477/2007, effective February 13, 2008);
- the Regulation of Terms of Separation and Allocation of Costs (Resolutions No. 480/2007, 483/2007 and 503/2008);

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- the general plan of update of the regulation of the telecommunications in Brazil (“Plano Geral de Atualização da Regulamentação das Telecomunicações do Brasil” – Resolution No. 516/2008, or “PGR”);
- the general norms of customer interaction service by telephone, with the objective of improving the quality of services (Decree No. 6523/2008);
  - the Methodology of the Calculation of the WACC (Resolution No. 535/2009);
- amendment of the regulation of the 3400 MHz to 3600 MHz band, allowing it to apply additionally to mobile services (Resolution No. 537/2010);
- the regulation of the Broadband Power Line (BPL), allowing this service to apply to multimedia communication (SCM) (Resolution No. 527/2009);
- related Invitation Document No. 002/2007/SPV-ANATEL regarding the auction organized in December 2007 of new licenses for the 1900-2100 MHz radio frequency bands (3G licenses), denominated bands “F,” “G,” “I” and “J,” which stated that, within a maximum allowed period of eighteen months from the publication of the Terms of Authorization (it occurred on April 30, 2008), the authorizations resulting from this auction would be combined with the existing SMP authorizations of the bid winners when pertaining to the same region of the general authorization plan of SMP. In accordance with this Invitation Document, in January 2010, ANATEL published an act determining the unification of our SMP authorizations in Regions II (states of Paraná, Santa Catarina, Rio Grande do Sul, Goiás, Tocantins, Mato Grosso do Sul, Mato Grosso, Rondônia, Acre and the Federal District) and III (state of São Paulo) of the PGA-SMP, with only one SMP authorization for each of these Regions (Terms of Authorization No. 005/2010 and 006/2010, signed in January 2010, for Region II and III, respectively). Vivo acquired spectrum licenses in band “J” in regions where it possesses SMP licenses. Moreover, the Invitation Document modified the rule for the renewal of radio frequency licenses and requires the inclusion in the calculation of the operating profits both the profits arising from remuneration for the use of the SMP network and the profits of the service plans;
- related Invitation Document No. 002/2010/ANATEL, regarding the auction organized in December 2010 of new licenses for the 1900-2100 MHz radio frequency band denominated the “H” band, for extension bands and for available frequencies at “A,” “D,” “E,” “M” and TDD bands, which modified the rule for the renewal of radio frequency licenses and requires the inclusion in the calculation of the operating profits both the profits arising from remuneration for the use of the SMP network and the profits of the service plans;
- the regulation for the exploration of SMP by means of Virtual Network, which makes possible the creation of the “agent” and the Authorized of Mobile Virtual Network (Resolution No. 550/2010). In accordance with this regulation approved by ANATEL, Mobile Virtual Network Operators may operate either as agents or as virtual network licensees. An agent represents the personal mobile service provider through the establishment of a representation agreement, which must be ratified by ANATEL. The agent’s activity is not defined as a “telecommunications service” so this is of significant interest to companies that operate in other sectors such as large retailers, banks and football teams. However, the activity of the virtual network licensee does fall within the definition of “telecommunications service” and is thus subject to all applicable rules;
- the assignment of the bands of 451 MHz to 458 MHz and 461 MHz to 468 MHz to the Personal Mobile Service, Fixed Switched Telephone Service and to the Multimedia Communication Service, for access to the services of telephony and data in broadband, particularly in rural areas (Resolution No. 558/2010);
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the assignment of the bands of 2500 MHz to 2690 MHz to the Personal Mobile Service and Fixed Switched Telephone beyond Multimedia Communication Service and Pay Television by means of Multichannel Multipoint Distribution Service (MMDS) for which it was previously assigned (Resolution No. 544/2010);

- the regulation for evaluation of the efficiency of use of the radio frequency spectrum (Resolution No. 548/2010);  
and
- the addition of a ninth digit in the numbers of the mobile telephones of area 11, raising the capacity of numeration in the metropolitan region of São Paulo and eliminating definitively the problem of scarcity of numeration in this area (Resolution No. 553/2010).

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- Resolution No. 588/2012 – Regulates network compensation for the STFC. This regulation revised the method of charging for TU-RL during the reduced time period for calls under two minutes of duration, and the change in Bill & Keep regime.
- Resolution No. 600/2012 – Approved the competition goals plan (PGMC). The main goals of PGMC are focused on the wholesale market and network infrastructure sharing, including: (1) passive infrastructure for transport and access networks; (2) call termination in mobile networks; (3) roaming (4) fixed network infrastructure for the transmission of data through copper cables in transmissions of 10mbps; and (5) wholesale fixed network infrastructure for local and long distance transmission of data under 35mbps.
- with an aim to restructure the process of assessing the quality of mobile service, with the inclusion of new processes and measurement of new indicators to verify the quality of mobile broadband and the quality perceived by the user, and the modernization of existing indicators, ANATEL issued on October 28, 2011 (published in the D.O.U. on October 31, 2011), Resolution No. 575/2011, which approved the Regulation for the Management of Quality of Provision of Personal Mobile Service (SMP-RGQ). The new Regulation innovates by providing assessments of the network connection and their respective data transmission rate, especially aspects of availability, stability and connection speed data network. In addition, the resolution established the formation of “GIPAQ” (Group Deployment Process Quality Measurement), which will be responsible for implementing the processes on the quality indicators for the “Guaranteed Instant Transmission Rate” and “Guaranteed Average Transmission Rate.” The methodology and procedures regarding the collection of indicator data for data connections will be defined by this group, composed of providers, ANATEL and a “Quality Measurement Authority” (EAQ), which shall be responsible for implementing these processes and will be hired by the service providers until February 29, 2012. All costs associated with implementing the new procedures for measuring quality will be paid by providers of the SMP and the impacts of the Regulations are still being evaluated, mainly its financial aspect. Also, through the issuance of Resolution No. 574/2011, which approved the Rules of Quality Management (SCM-SCM RGQ) on October 28, 2011 (published in the D.O.U. on October 31, 2011), ANATEL set targets for service quality, as well as updated definitions for indicators and their calculation methods.
- the Regulation on criteria for adjustment of tariffs for calls from the STFC involving access the SMP or SME, approved by Resolution No. 576/2011, dated October 28, 2011, establishes criteria for the gradual readjustment of VCs until 2014. With respect to VU-M fees, for the period before the effectiveness of the cost model established by this Resolution, ANATEL defined transition rules if no pact is reached regarding the VU-M fees. A reduction factor (R) to be applied in the formula for readjustment of the calls involving the PSTN access the Personal Mobile Service.
- $VC_t \leq VC_{t0} \times (1-R-FA) \times (IST_t / IST_{t0})$ , where R corresponds to the “Reduction Factor” (Fator de Redução) and FA to the “Damping Factor” (Fator de Amortecimento), the percentage of which depends on inflation in the corresponding period.

The Reduction Factor to be applied in the next readjustment of the VC rate for fixed-mobile calls will follow the schedule below:

- for the first readjustment, ANATEL will apply a Reduction Factor of 18%;
- for readjustments to follow, ANATEL will apply a Reduction Factor of 12%; and
- if the cost model has not yet produced results, the third readjustment will be subject to a Reduction Factor of 10%.

The “Damping Factor” has the following scale: 0 if inflation is less than 10%; 0.01 if inflation is between 10% and 20% and 0.02 if inflation is above 20%.

For the VU-M fees, they remain freely negotiated and in case there is no agreement as a result of the new VC determined according the formula above, any reduction of these fees will be applied to the VU-M fee up to the VU-M / VC1 ratio to achieve 70%. From this level, the reduction will also be assessed in other components of the VCs, maintaining this ratio.

According to Resolution No. 600, ANATEL established that the RVU-M 2014 should be at most 75% of the amount applicable at the end of 2013 and the RVU-M 2015 should be at most 50% of the amount applicable at the end of 2013. Beginning in February 2016, VU-M will be measured based on cost modeling.

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### Rate Regulation

With respect to our Basic Plan and certain roaming charges incurred in connection with alternative service plans, our authorizations continue to provide for a price cap mechanism to set and adjust rates on an annual basis. The cap is the value with the rate of inflation deducted from the productivity estimated by ANATEL. The price cap is revised annually to reflect the rate of inflation as measured by the IGP DI. However, mobile operators are able to freely set the rates for alternative service plans.

The initial price cap agreed to by ANATEL and us in our authorizations had been based on the previously existing or bidding prices, and was adjusted annually on the basis of a formula contained in our authorizations. The price cap has been revised to reflect the rate of inflation as measured by the IGP DI.

Other telecommunications companies that interconnect with and use our network must pay certain fees, primarily an interconnection fee. The interconnection fee is a flat fee charged per minute of use. Since 2005, ANATEL has permitted free negotiations for mobile interconnection, or VU-M, fees and by July 2005, local-fixed concessionaires and mobile operators had reached a provisional agreement with respect to VU-M fees for local calls, or VC1 (the agreement guaranteed a 4.5% increase in fees). ANATEL approved that provisional agreement, and in March 2006, approved another provisional agreement for VU-M fees for long-distance calls, VC2, VC3 and international, among the same operators that made the VC1 agreement.

In July 2007, ANATEL approved a provisional agreement among the fixed-line operators Telefônica, Telemar, Brasil Telecom, CTBC Telecom and Sercomtel and the mobile operators for interconnection fees for VC1, VC2 and VC3 calls that provides for an annual adjustment of 1.97143% to interconnection fees in Region I (Telemar's Region) and an annual adjustment of 2.25356% in Region II (Brasil Telecom's Region) and Region III (Telefônica's Region).

In January 2008, ANATEL approved a provisional agreement among the fixed-line long-distance operator Embratel and the mobile operators for interconnection fees for VC2 and VC3 calls, taking into consideration the period since January 2004, that provides for an annual adjustment of 4.5% as of March 2006 and an annual adjustment of 1.97143% or 2.25356% as of July 2007.

In July 2008, ANATEL approved a provisional agreement among the fixed-line operators Telefônica, Telemar, Brasil Telecom, CTBC Telecom and Sercomtel and the mobile operators for interconnection fees for VC1, VC2 and VC3 calls that provides for an annual adjustment of 1.89409% to interconnection fees in Region I (Telemar's Region) and an annual adjustment of 2.06308% in Region II (Brasil Telecom's Region) and Region III (Telefônica's Region).

In March 2009, ANATEL approved a provisional agreement among the fixed-line long-distance operator Embratel and the mobile operators for interconnection fees for VC2 and VC3 calls, for the period from 2007 to 2008, that provides for an annual adjustment of 1.89409% in Region I (Telemar's Region) or 2.06308% in Region II (Brasil Telecom's Region) and Region III (Telefônica's Region) as of July 2008.

In September 2009, even though it had a provisional agreement between the fixed-line operators Telefônica, Telemar, Brasil Telecom and Sercomtel and the mobile operators, without CTBC Celular, ANATEL decided not to approve the readjustment of the local (VC1) and long-distance (VC2 and VC3) fixed-to-mobile calls. In February 2010, this readjustment of the VC1, VC2 and VC3, relative to the period from 2008 to 2009, was approved by ANATEL and the provisional agreement of VU-M fee readjustment (68.5% of the approved readjustment of approximately 0.97% for the VC1) could be applied.

In June 2010, ANATEL approved a provisional agreement among the fixed-line long-distance operator Embratel and the mobile operators for interconnection fees for VC2 and VC3 calls, for the period from 2008 to 2009, for the

application of the VU-M fee readjustment (68.5% of the approved readjustment of approximately 0.97% for the VC2 and VC3).

By the end of 2011, our subsidiary Vivo entered into an agreement with Oi (Regions I and II) and us (Region III) for the recognition of the VU-M fee paid at the time and agreed to maintain this amount for an additional 24 months, based on the VC1 readjustment pleaded by both these companies to ANATEL. However, these fees were not approved by ANATEL due to the publication of ANATEL's Resolution No. 576/2011, which addresses the criteria for adjustment of fees for calls from fixed-lines involving access to the SMP or SME. On January 25, 2012,



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ANATEL published Act No. 486, with the new fees for VC1, VC2 and VC3 (with an average reduction of 10.78%) and, on February 22, 2012, ANATEL published Act No. 1,055 with new VU-M fees (with an average reduction of 14%). However, Oi obtained an injunction in Federal Court to have its readjustment request analyzed by ANATEL. This decision is subject to appeal. See “—Interconnection Regulation.”

Also, ANATEL published the Invitation Document No. 002/2007/SPV-ANATEL, which relates to the December 2007 auction of new licenses for the 1900-2100 MHz radio frequency bands (3G licenses). Under this Invitation Document, the authorizations resulting from the auction of will be combined with the existing authorizations belonging to the bid winners when pertaining to the same region of the general authorization plan of SMP (PGA-SMP) in the period of eighteen months from the publication of the Terms of Authorization (which occurred on April 30, 2008).

As a result, ANATEL published in January 2010 an act determining the merger of our SMP authorizations in Regions II (State of Paraná, Santa Catarina, Rio Grande do Sul, Goiás, Tocantins, Mato Grosso do Sul, Mato Grosso, Rondônia, Acre and the Federal District) and III (state of São Paulo) of the PGA-SMP, with an SMP authorization for each one of these Regions (Terms of Authorization No. 005/2010 and 006/2010, signed in January 2010 for Regions II and III, respectively).

Moreover, ANATEL determined that the value of the VU-M fee should be unified for each Region of the PGA-SMP and freely negotiated beginning on November 1, 2009 (eighteen months from April 30, 2008). Until this date, mobile operators charged a VU-M fee for authorization of the SMP. In February 2010, ANATEL defined the VU-M fee to be paid for Oi (fixed and mobile operators) and Brasil Telecom (fixed and mobile operators) to Claro, TIM, Vivo and Vivo Participações (the latter being the result of the ANATEL-authorized merger of Telemig Celular S.A. into Vivo Participações in March 2010), for the region of the PGA-SMP, as a result of the unification of the SMP authorizations.

In 2007, ANATEL developed a new model which will be in use starting with a date yet to be determined by ANATEL to determine values of reference in connection with remuneration for use of mobile networks—RVU-M—of SMP providers having significant market power, which will be used in the case of arbitration by ANATEL of the value of VU-M. ANATEL did not implement this new model in 2010, as provided by Resolution No. 480/2007, and has not yet defined the new date expected for such implementation. See “—SMP Licenses” for more information on the status of this agreement.

ANATEL launched on August 25, 2011 the “Project Cost Model” (Projeto Modelo de Custos). The project is associated, among other things, with determining fees for the use of the fixed telephony network and the calculation of reference values of the VU-M fee and EILD (Industrial Use of Dedicated Lines) for telecommunications service providers.

At launch, ANATEL signed a US\$8.22 million agreement with the consortium of Advisia, Analysis Mason and Grant Thornton, which has two years to perform work in support of ANATEL. This consortium won the international bidding process conducted by the International Telecommunication Union (ITU).

The cost model is of great relevance to ANATEL in carrying out public sector policies, as its development will allow access to cost management information of the different business areas and product lines of telecommunications services providers, contributing to the improvement of regulation of the sector as a whole.

## Internet and Related Services in Brazil

In Brazil, Internet service providers, or ISPs, are deemed to be suppliers of value-added services and not telecommunications service providers. ANATEL’s Resolution No. 190 requires cable operators to act as carriers of third-party Internet service providers. The Brazilian House of Representatives is considering a law that would penalize

Internet service providers for knowingly providing services that allow illegal goods or services to be sold on the Internet, and would impose confidentiality requirements on Internet service providers regarding nonpublic information transmitted or stored on their networks.

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### Customer Service

In 2012 Telefônica Brasil expanded its differentiation customer service model by initiating a large segmentation process that recognizes customer decision of keeping both connections, fixed and mobile, into the same company, delivering a unique experience as soon as 2013 first semester.

Customer service segmentation model allows the company to improve its multichannel strategy. In 2012 there was a substantial progress regarding electronic channels adoption such as Vivo SMS, which was used by more than 2.5 million customers per month. Numbers kept on growing at the same speed of previous years, reaching 70% share of received contacts.

Concerning customer service quality, PROCON-SP's ranking demonstrated that Telefônica Brasil reached the best position among its largest competitors, which shows that the company is taking the right decisions to ensure customers' satisfaction. Moreover, in the last three years the company has been presenting meaningful improvements on internal processes that led to a positive impact on the volume of requests received by Market Regulatory Agencies, such as Fundação PROCON-SP. As a result, for the first time in the last five years, the operator was not ranked as the most complained company at PROCON's March report (based on 2011 numbers).

According to ANATEL's ranking, in 2012 Vivo managed to continue as the top telecommunications mobile company in Brazil by having the smallest complaint ratio, as well as reaching number 1 position in regards to Attendance Performance Index (IDA) – the company placed best in 43 out of 44 months of evaluation. Similar results were reported by SINDEC (National System of Consumer Protection Information), which gathers information of Procons from all over the country and that showed a 7.2% complaints reduction in comparison to the previous year. Not enough, it has the best KPIs among its competitors as stated by the second edition of the project “Consumer Defense Public Indicators”, published by Ministry of Justice. Furthermore, it was considered the company with the best resolution rate in relation to other players in the telecom industry reaching 83.7%, as well as the operator with the highest level of forum agreements with 80.1%.

All these results were supported by Telefônica Brasil actions towards quality and expansion of the customer service channels, aiming to improve customers experience and get closer to their needs, therefore keeping its leadership position in the telecom market.

### Marketing and Sales

During 2012, we integrate channels to offer standardized solutions and customer service along with innovation and best practices for the sale of fixed and mobile services.

We bring our solutions to our clients through the following sales channels:

- **Vivo Own Stores:** focused on individual clients and located on strategic points, our own stores provide a highly trained team built up to guarantee the best sales experience for the customer. The main drive of this channel is innovation. As a result, most stores have available self assistance services for value added services and recharges. We also offer special treatment for Premium clients with scheduled appointments via the Internet to assure “no waiting in line.”
- **Indirect channels:** are divided in two types: resale and retail. The resale channel is composed by certified companies in the telecommunications segments providing our full portfolio and an adequately sized network for our services to attend the geographic dimensions of the market. Our presence is also established in the retail channel especially for prepaid, recharges and data services.

- Recharge channels: are represented by small companies in various market sectors throughout the country. They became the largest channel for prepaid users and provide new means of virtual recharge for customers.
- Telesales: sales through active and passive telemarketing call centers, employing highly trained sales associates, focused on fixed and data services.

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- Internet: “Portal Telefônica,” with online information on our products and services specifically targeted toward our corporate clients; we also offer the option of selling services via online chat through highly trained partners and appropriate tools.
- Online Store: currently offers mobile services to clients with home delivery, payment in installments and different prices of handsets. In 2012, we launch a new online store covering all the services portfolio of fixed and mobile, and offering improvements in navigation, quality purchase, reduction in SLA, etc. supported by a communications marketing strategy.
- Door-to-door sales: aiming to approach corporate and individual clients, we dispose physical channels of assistance, such as door-to-door sales of services by outsourced small companies and own team consultants. Main focus in fixed and data services.
- Person-to-person sales: our business management team offers customized sales services, ensuring high customer loyalty and a strong customer relationship resulting from customized consulting telecommunication and IT services and technical and commercial support.

## Our Network

In 2012, the company continued the consolidation of a robust network, capable of delivering to the customer its expectation. Advanced in the migration of TDM to NGN core, reaching 41.1% of fixed traffic, modernization of switches and adaptation of the infrastructure of datacenters. For example, we began of the implementation of project that exchange optical cabinets (ARO) for MSAN.

The FWT is the result of the integration between the mobile and the fixed environments and allowed the company to explore the fixed telephony service in regions outside São Paulo region. It grew more than 500% in 2012.

During 2012, the number of broadband accesses in the fixed network increased by 300,000 customers. The company’s portfolio related to xDSL broadband products includes speeds from 250 kbps to 25Mbps. The product “Banda Larga Popular”, which is an initiative of the state of São Paulo, provides broadband at affordable prices to low-income population, with speeds that range from 250 kbps to 1Mbps. Last year, the product reached 1 million and 200 thousand clients. The company also offers broadband services provided via coaxial cable, with speeds that range from 8 Mbps to 100 Mbps.

Using the platform called DLM ASSIA, which improves the diagnosis and stability of our customers and to increase the index of assertiveness in recommending upgrade speed, were performed more than 300,000 upgrades for 2012, thus seeking the loyalty of the customer base and increase the revenue.

Another important characteristic of the network is the availability of FTTH, the most advanced optical fiber broadband technology available. It allows the use of data rates until 200Mbps. By the end of 2012, the company had over 115 thousand clients using this technology. From these, five thousand customers also use the IPTV service — a system through which television services are delivered using the Internet Protocol.

In 2012, the “Vivo Speedy” service reached 3.85 million customers. The service is provided using xDSL, optic fibers and coaxial cables.

In 2011, we launched the HSPA+ technology, commercially known as 3GPlus, working across our 3G network. This technology was commercially launched in November, 2011 in São Paulo (and its extended metropolitan area with area code 11). In 2012, the service was extended to national coverage 3G. The 3G Plus allowing customers who have

compatible terminals to achieve even higher transmission rates, reaching up to three times the value of traditional 3G's rate.

During the year 2012, we continue to expand strongly our 3G network, reaching around 3100 municipalities or 86.21% of the population covered by this technology. With 2G technology reaching 3,740 municipalities or about 90.96% of the population at the end of 2012

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Our advanced network management technology ensures global management and supervision of all our network processes and network performance. The network management centers are located in São Paulo, Brasília and Minas Gerais. These centers monitor all regions of the country, but with different functions.

The network management center of São Paulo monitors the critical network operational parameters of the countrywide transmission backbone, IP networks and broadband networks. The network management center in Brasília monitors the critical operational parameters of core networks and services platforms. The network management center in Minas Gerais monitors the critical operational parameters of the access network (radio network) and infrastructure. These centers are able to identify abnormalities in both our network and in third-part networks, using failure and signaling monitoring systems. In addition, quality and service standards are constantly monitored. The network management centers are integrated with maintenance and operations teams that maintain and operate cellular network elements, as well as cellular infrastructure and transmission, in addition to the radio network elements and computing bases, service platforms and communications backbones.

Our network is prepared to provide continuity of service for our customers in the event of network interruptions. We have developed contingency plans for potential catastrophes in our switching centers, power supply interruptions and security breaches.

Pursuant to the terms of our authorization to perform our services, we are obligated to meet certain requirements for service quality. See “—Regulation of the Brazilian Telecommunications Industry—Obligations of Telecommunications Companies.”

### Contract Customers for Mobile Services

Since October 1994, cellular telecommunications service in Brazil has been offered on a “calling party pays” basis, under which customers pay only for calls that they originate. In addition, customers pay roaming charges on calls made or received outside their home registration area.

Customer charges are calculated based on the customer’s calling plan, the location of the party called, the place from which the call originates and certain other factors, as described below. Our Region is divided into areas designated for payment purposes, called registration areas, as follows:

- Areas 1 & 2: 9 areas in the state of São Paulo;
- Area 3: 5 areas, comprising 1 area in the metropolitan area of Rio de Janeiro, two areas in upstate Rio de Janeiro and two areas in the state of Espírito Santo;
- Area 4: 7 areas in the state of Minas Gerais;
- Area 5: 9 areas, comprising 6 areas in the state of Paraná and 3 areas in the state of Santa Catarina;
- Area 6: 4 areas in the state of Rio Grande do Sul;
- Areas 7 & 8: 18 areas, comprising 9 areas in Brasília and the states of Goiás, Mato Grosso do Sul, Mato Grosso, Rondônia, Acre and Tocantins and 9 areas in the states of Amapá, Amazonas, Maranhão, Pará and Roraima;
- Area 9: 6 areas, comprised of 5 areas in the state of Bahia and 1 area in the state of Sergipe; and
- Area 10: 9 areas in the states of Pernambuco, Alagoas, Paraíba, Rio Grande do Norte, Ceará and Piauí.

### Interconnection Charges

We earn revenue from any call that originates from another cellular or fixed-line service provider network connecting to one of our customers. We charge the service provider from whose network the call originates a network usage charge for every minute that our network is used in connection with the call. See “—Operating Agreements—Interconnection Agreements.” Tariff adjustments are subject to agreement between the operators and then subject to approval by ANATEL.



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### Bill and Keep

ANATEL adopted partial “Bill and Keep” rules for interconnection charges in July 2003. The rules provided that an SMP operator paid for the use of another SMP operator’s network in the same registration area only if the traffic carried from the first operator to the second exceeded 55% of the total traffic exchanged between them. In that case, only those calls that surpassed the 55% level were subject to payment for network usage. Under Resolution No. 438 published in 2006, ANATEL eliminated the rule of the partial “Bill and Keep.” The current rule is “full billing,” in which the SMP operator pays the entire call termination fee of the other mobile network. The rule of the partial “Bill and Keep” was maintained between SMP and SME (trunking) networks.

On May 7, 2012, ANATEL approved a change in the interconnection service to a partial Bill and Keep model through the end of 2013 and an integral Bill and Keep model beginning in 2014.

On November 12, 2012, the Brazilian government published Resolution No. 600/2012 approving the General Competition Plan, or PGMC, which introduced the study of relevant markets in Brazil and applied asymmetric measures to the companies considered to have significant market power. It focused on the wholesale market, introducing new obligations regarding network desegregation, infrastructure sharing and interconnection. Particularly with regard to interconnection, the PGMC introduced a new tariff reduction schedule for use of mobile networks for 2014 (75% of value of 2013) and 2015 (50% of 2013), and programming the adoption of the RIC model in 2016. In terms of balancing traffic model, the PGMC kept the full Bill and Keep model with operators that have significant market power and established a partial Bill and Keep model with operators without significant market power through 2016, at which time all operators will follow the full Bill and Keep model.

### Roaming Fees

We receive revenue pursuant to roaming agreements with other cellular service providers. When a customer of another cellular service provider makes a call within our area, that service provider pays us for the call at the applicable rate. Conversely, when one of our customers makes a cellular call outside of our Region, we must pay the charges associated with that call to the cellular service provider in whose Region the call originates. See “—Roaming Agreements.”

### Wireless Device Sales

Through our stores and authorized dealers we sell only GSM and WCDMA devices such as handsets, smartphones, broadband USB modems and netbooks that are certified to be compatible with the Vivo network and service. We have special offers on smartphones, USB modems and other data devices for customers of bundled packages. Our current handset suppliers are Motorola, LG, Samsung, Nokia, Sony, Alcatel, ZTE, HTC, Apple, BlackBerry and Huawei.

### Operating Agreements

We have agreements with major fixed-line and mobile operators in Brazil to lease physical space, real estate, air conditioning, energy, security and cleaning services. We also lease transmission capacity necessary to complete the construction of our network infrastructure.

### Interconnection Agreements

The terms of our interconnection agreements include provisions with respect to the number of connection points and traffic signals. See “—Regulation of the Brazilian Telecommunications Industry—Obligations of Telecommunications Companies” and “—Regulation of the Brazilian Telecommunications Industry—Interconnection Regulation.”

We believe that our subsidiaries have adequate interconnection agreements with necessary fixed-line operators to provide services. We also believe that our subsidiaries have all the necessary interconnection agreements with long-distance carriers.

#### Roaming Agreements

We provide international GSM roaming in over 200 destinations worldwide by means of over 500 roaming agreements.

#### Fraud Detection and Prevention

In 2012, we consolidated efforts to reach our target for reduction of amounts and financial loss expenses for our operations related to fraud in mobile operations, reaching a 20.1% reduction compared to the previous year.

During 2012, we continued our work in combating the two main types of fraud, as follows:

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- **Subscription fraud:** type of fraud that occurs when the emission of one or more qualifications without the consent of the real “owner” of documents with the main objective of not paying the phone bill. Fraud can occur through subscription data and information from individuals or companies obtained illegally.
- **Identity Fraud:** also known as “social engineering,” the term identity fraud characterizes in the mobile operation the use the service provider phone channels (Call Center) with the use of real data from clients for false identification, allowing undue changes to be made in the customer’s line.

For mobile operations in identifying fraud, we had a decrease of 86.1% compared to expenses in the previous year and we had a decrease of 16.4% in subscription fraud compared to our 2012 budget. In 2012, we had a decrease of 7.7% in costs with fraud, compared to the amount budgeted for the year.

## Disclosure Pursuant to Section 219 of the Iran Threat Reduction and Syria Human Rights Act

Section 219 of the Iran Threat Reduction and Syria Human Rights Act of 2012 added Section 13(r) to the Exchange Act. Section 13(r) requires an issuer to disclose in its annual or quarterly reports filed with the SEC whether the issuer or any of its affiliates has knowingly engaged in certain activities, transactions or dealings with the Government of Iran, relating to Iran or with designated natural persons or entities involved in terrorism or the proliferation of weapons of mass destruction during the period covered by the annual or quarterly report. Disclosure is required even when the activities were conducted outside the United States by non-U.S. entities and even when such activities were conducted in compliance with applicable law.

The following information is disclosed pursuant to Section 13(r). None of these activities involved U.S. affiliates of Telefónica.

## Roaming Agreements

Various subsidiaries of our controlling shareholder, Telefonica S.A., have entered into roaming agreements with Iranian telecommunication companies. Pursuant to such roaming agreements these subsidiaries’ customers are able to roam in the particular Iranian network (outbound roaming) and customers of such Iranian operators are able to roam in Telefonica S.A.’s relevant subsidiary’s network (inbound roaming). For outbound roaming, these subsidiaries pay the relevant Iranian operator roaming fees for use of their network by our customers, and for inbound roaming the Iranian operator pays the relevant subsidiary roaming fees for use of our network by its customers.

Telefonica Brasil S.A. and Vivo S.A. do not have any contractual relationship with these Iranian operators; however, as part of the Telefonica Group, they adhere to the roaming agreements with Telefonica S.A.’s subsidiaries described below.

Telefonica S.A.’s subsidiaries were party to the following roaming agreements with Iranian in 2012:

- (1) Telefónica Móviles España (“TME”), Telefonica S.A.’s Spanish directly wholly-owned subsidiary, has respective roaming agreements with (i) Mobile Telecommunication Company of Iran (“MTCI”), (ii) MTN Irancell (“Irancell”), (iii) Telecommunication Kish Company (“TKC”) and (iv) Taliya (“Taliya”).

During 2012, TME recorded the following revenues related to these roaming agreements: (i) 182,564 euros from MCI, (ii) 3,325 euros from Irancell, (iii) none from TKC and (iv) none from Taliya.

TME also holds a Roaming Hub through its 55% directly-owned subsidiary, Link2One, a.e.i.e. (“L2O”). Under this agreement, L2O provides a roaming hub service to Irancell enabling the latter to maintain a relationship with other

members of the hub. Some members of the hub are also entities of the Telefónica Group. Under this roaming hub service, for 2012, L2O has billed Irancell 115,462 euro but as of the date of this Annual Report TME has not yet received payment.

- (2) Telefónica Germany GmbH & Co. OHG (“TG”), Telefonica S.A.’s German 76.83% indirectly-owned subsidiary, has a roaming agreement with MCI. TG recorded 220,714 euros in roaming revenues under this agreement in 2012.
- (3) Telefónica 02 Ireland Limited (“TIR”), Telefonica S.A.’s Irish directly wholly-owned subsidiary, has a roaming agreement with MCI. TIR recorded 1,459 euros in roaming revenues under this agreement in 2012.
- (4) Telefónica Czech Republic, a.s. (“TCR”), Telefonica S.A.’s Czech 69.41% indirectly-owned subsidiary, has a roaming agreement with MCI. TCR recorded 29,629 euros in roaming revenues under this agreement in 2012.
- (5) Telefónica UK Ltd (“TUK”), Telefonica S.A.’s English directly wholly-owned subsidiary, has a roaming agreement with Irancell. TUK recorded 131 euros in roaming revenues under this agreement in 2012.
- (6) Pegaso Comunicaciones y Sistemas, S.A. de C.V. (“TUK”), Telefonica S.A.’s Mexican directly wholly-owned subsidiary, has a roaming agreement with Irancell. TUK recorded US\$46 in roaming revenues under this agreement in 2012.

The net profit recorded by Telefonica S.A.’s subsidiaries pursuant to these agreements did not exceed the related revenues recorded thereunder.

The purpose of all of these agreements is to provide Telefonica Group’s customers with coverage in areas where the Group does not own networks. For that purpose, Telefonica S.A.’s subsidiaries intend to continue maintaining these agreements.

#### International Carrier Agreement

Telefónica International Wholesale Services, S.L. (“TIWS”), Telefonica S.A.’s Spanish indirectly wholly-owned subsidiary, has entered into an international carrier agreement with Telecom Infrastructure Company of Iran (“TICI”).

Pursuant to this agreement, both companies interconnect its networks to allow for international exchange of traffic. TIWS recorded 4,885 euros in revenues under this agreement in 2012. The net profit recorded by TIWS pursuant to this agreement did not exceed such revenues.

The purpose of this agreement is to allow exchange of international traffic. Consequently TIWS intends to continue maintaining this agreement.

#### C. Organizational Structure

On December 31, 2012, our voting shares were controlled by three major shareholders: SP Telecomunicações Participações Ltda. with 50.47%, Telefonica S.A. with 25.68% and Telefônica Internacional S.A. with 15.43%. Telefónica Internacional is the controlling shareholder of SP Telecomunicações and, consequently, holds directly and indirectly 43.36% of our common shares and 38.78% of our preferred shares. Telefónica Internacional is a wholly owned subsidiary of Telefônica, S.A. of Spain.

#### Subsidiaries

A. TELECOM S.A. (formerly Assist Telefônica) is our wholly owned subsidiary. A. TELECOM was formed in Brazil on October 29, 1999, and it is engaged primarily in providing telecommunications and data services and internal telephone network maintenance for customers. The principal services are as follows: (i) digital condominium which is a value-added service for commercial buildings, integrated solution for equipment and services for voice transmission, data and images on commercial buildings under a Building Local Exchange Carrier (“BLEC”) model; (ii) installation, maintenance, exchange and extension of new points of internal telephony wire in companies and dwellings under a basic plan of maintenance (BPM); and (iii) provision of free ISP service under the brand name “I-Telefônica.” In addition, on December 30, 2004, we entered into a transaction to acquire indirect control of Atrium Telecomunicações Ltda. The transaction was approved by our shareholders on January 19, 2005. The acquisition was carried out through the purchase of the total share capital of Santo Genovese Participações Ltda., which held 99.99% of the representative share capital of Atrium. On March 1, 2006 then-subsiary Santo Genovese Participações Ltda., having merged into its subsidiary Atrium Telecomunicações Ltda., was acquired by A. TELECOM S.A. and both Santo Genovese Participações Ltda. and Atrium Telecomunicações Ltda. ceased to exist. A. TELECOM remained a wholly owned subsidiary of Telefônica Brasil, and began carrying out the activities formerly performed by Atrium. See “—B. Business Overview—Overview.”

From the second half of 2006, A. TELECOM began providing pay TV services, fully focusing on the development of this new product line. In February 2008, A. TELECOM became an owned subsidiary of Telefônica Televisão Participações S.A. (TTP). In November 2008, TTP was merged into TELESP and A. TELECOM became a wholly owned subsidiary of TELESP. See “—A. History and Development of the Company—Historical Background—Corporate Reorganization involving DABR and TTP.”

Telefônica Data S.A.’s business purpose is to render telecommunications services such as the development, implementation and installation of projects related to integrated business solutions and telecommunications consulting, as well as activities related to the rendering of technical assistance and equipment and telecommunications network maintenance services.

Telefônica Empresas, currently (“Telefônica Data”), became a wholly owned subsidiary of the company after the corporate reorganization that was carried out in July 2006. See “—A. History and Development of the Company—Historical Background—The SCM Restructuring.” In July 2008, Telefônica Data became a wholly owned subsidiary of TTP. In November 2008, TTP was merged into TELESP and Telefônica Data became a wholly owned subsidiary of TELESP. See “—A. History and Development of the Company—Historical Background—Corporate Reorganization involving DABR and TTP.”

Telefônica Sistema de Televisão S.A. (“TST”) is a company that provides pay television services through the Multipoint Multichannel Distribution Services (“MMDS”) modality.

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Vivo is a company that provides mobile services in the states of Acre, Alagoas, Amapá, Amazonas, Bahia, Ceará, Espírito Santo, Goiás (also encompassing the area of Distrito Federal, or the Federal district), Maranhão, Mato Grosso, Mato Grosso do Sul, Pará, Paraíba, Paraná, Pernambuco, Piauí, Rio de Janeiro, Rio Grande do Norte, Rio Grande do Sul, Rondônia, Roraima, Santa Catarina, São Paulo, Sergipe, Tocantins and Minas Gerais. See “—A. History and Development of the Company.”

Ajato Telecomunicações Ltda. The corporate purpose of Ajato Telecommunications Ltd is to provide telecommunications and IT services, access to telecommunications network, internet and radio, including telemarketing, image and data services, trade lease, import, export, maintenance and repair for those equipment.

Aliança Atlântica Holding B.V. based in Netherlands, Amsterdam, with a 50% interest owned by Telefonica Brasil, holds cash from the sale of Portugal Telecom's shares in June 2010 and a small interest in Zon Multimedia, a company of Portugal Telecom Group which provides pay-TV services, internet, distribution of audiovisual content, cinema and telecommunications services.

Companhia AIX de Participações. This company is engaged in the Refibra consortium, as a leader, as well as in both direct and indirect development of activities related to the construction, conclusion and operation of underground fiber optic networks. Currently, Telefônica Brasil holds a 50% interest in this company.

Companhia ACT de Participações is engaged in the Refibra consortium, as a leader, as well as in activities related to providing technical assistance for the preparation of the network conclusion project by providing studies to make it more profitable, as well as to inspect the activities in progress related to the project. Currently, Telefônica Brasil holds a 50% interest in this company.

GTR Participações e Empreendimentos S.A.'S business purpose is to hold equity interest in other companies, which are engaged in providing cable and pay-TV services, telecommunications services in general, the production, purchase, licensing, import and distribution of television programs, either its own or third parties', spare parts and equipment, management and rendering of telecommunications and pay-TV service platforms.

TVA Sul Paraná S.A.'s business purpose is to provide cable and pay-tv services, telecommunications services in general, produce, purchase, license, import and distribute television programs, either its own or third parties', spare parts and equipment, manage, update and exploit telecommunications and pay-TV service platforms and publish journals.

Lemontree Participações S.A.'s business purpose is to hold equity interest in other companies, which are engaged in providing cable and pay-TV services, telecommunications services in general, the production, purchase, licensing, import and distribution of television programs, either its own or third parties', spare parts and equipment, management, updating and exploitation of telecommunications and pay-TV services platforms, and data management and trading.

Comercial Cabo TV São Paulo S.A.'s business purpose is to provide cable and pay-TV services, advisory and consultancy services in telecommunications in general, to produce, purchase, license, import and distribute television programs, either its own or third parties', spare parts and equipment, manage, update and exploit telecommunications and pay-TV service platforms, and to engage in all types of marketing and advertisement.

## Associated Companies

Since June 30, 2000, we have consolidated under the Brazilian Corporate Law Method, and since January 1, 2009, under IFRS, the operations of Aliança Atlântica Holding B.V., an investment company incorporated under the laws of the Netherlands, that had as its main asset a 0.61% interest in the equity capital of Portugal Telecom, which was

disposed of in June 2010. As of December 31, 2012, we held a 50% share ownership in Aliança Atlântica Holding B.V. and Telefónica S.A. held the remaining 50%. Aliança Atlântica Holding B.V. is currently in the process of liquidation and, as a result, its remaining assets are being appraised.

Furthermore, since December 31, 2003, we have also consolidated under the Brazilian Corporate Law Method, and since January 1, 2009, under IFRS, our investment under proportional consolidation in Companhia AIX de Participações, or AIX. At December 31, 2012, we held a 50% share ownership in AIX and Telemar Participações S.A. held the remaining 50%. AIX was formed in 2001 to explore, directly and indirectly, activities related to the execution, conclusion and commercial exploitation of underground cables to fiber optic. See Note 1 to the

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consolidated financial statements included in this annual report starting at page F-12. We also consolidate on a proportionate consolidate, as required under the Brazilian Corporate Law Method and under IFRS, Companhia ACT de Participações, in which we hold a 50% interest.

From January 1, 2013 with the entry into force of IFRS 11, we will present all these investments in affiliates ("associates") in our consolidated financial statements by the equity method.

D. Property, Plants and Equipment

Our main physical properties for providing fixed services involve the segments of switching (public switching telephone network-PSTN), transmission (optic and wireless systems), data communication (multiplex devices, IP network), infrastructure (Energy systems and air conditioned) and external Network (fiber optic and metallic cables), which are distributed in many buildings in the State of São Paulo and in the main cities out of the State of São Paulo. Some of these buildings are also used in administrative and commercial areas.

Our properties are located throughout the State of São Paulo. At December 31, 2012, we used 2,174 properties in our operations, 1,414 of which we own, and we have entered into standard leasing agreements to rent the remaining properties.

Pursuant to Brazilian legal procedures, liens have been attached to several properties pending the outcome of various legal proceedings to which we are a party. See "Item 8. Financial Information—A. Consolidated Statements and Other Financial Information—Legal Proceedings."

Our principal physical property for mobile services consists of transmission equipment, switching equipment, base stations, and other communication devices, such as voicemail, prepaid service, Short Message Service, Home Location Registers, Signaling Transfer Point, Packet Data Switching Network and gateways. All switches, cell sites, administrative buildings, administrative facilities, warehouses and stores are insured against damages for operation risks.

As of December 31, 2012, our subsidiary Vivo had 206 cellular switches and other equipment installed in 57 owned spaces, 10 leased spaces and 26 shared spaces. We lease most of the sites in which our cellular telecommunications network equipment is installed. The average term of these leases is five years (subject to renewal for additional five-year terms) and ten years in the Northeast. Our 27,044 base stations and other network equipment are installed in cell sites, administrative buildings and administrative facilities. In addition, our subsidiary owns 13 administrative building and we lease 35 administrative areas, 14 kiosks and 303 retail stores.

At December 31, 2012 the net book value of our property, plant and equipment amounted R\$17.6 billion (R\$17.2 billion at December 31, 2011).

ITEM 4A. UNRESOLVED STAFF COMMENTS

We received comments from the Staff of the SEC relating to our Annual Report on Form 20-F for the year ended December 31, 2010, and to the Form 6-K filed on August 14, 2012 for the six months ended June 30, 2012. As of the date of filing of this Annual Report, Staff comments regarding the accounting treatment of certain transactions entered into in 2010, 2011 and 2012, pursuant to which we assigned the right to operate and sold certain towers to third parties, and agreed to share the use of such towers thereafter, remain unresolved. We believe the transactions have been properly accounted for and we are working with the staff to resolve their comments.

ITEM 5. OPERATING AND FINANCIAL REVIEW AND PROSPECTS



A. Operating Results

The following discussion should be read in conjunction with our consolidated financial statements and accompanying notes and other information appearing elsewhere in this annual report and in conjunction with the financial information included under “Item 3. Key Information—A. Selected Financial Data.” We prepared our consolidated financial statements included in this annual report in accordance with IFRS.

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### Overview

Our results of operations are principally affected by the following key factors.

#### Brazilian Political and Economic Environment

The Brazilian economy has experienced different rates of growth this decade. According to IBGE, the Brazilian GDP expanded 1% in 2012, compared to 2.7% in 2011.

Consumer prices, as measured by the IPCA, registered a variation of 5.8% in 2012. Accordingly, growth in consumer prices was higher than the inflation target established by the Central Bank, of 4.5%. In 2010 and 2011, the variations of IPCA were 5.9% and 6.5%, respectively. Inflation, as measured by the General Price Index, or the IGP-DI, calculated by Fundação Getúlio Vargas, which includes wholesale, retail and home-building prices, increased 11.3% and 5% in 2010 and 2011, respectively. In 2012, the IGP-DI increased 8.1%.

As a result of the deceleration of inflation and of the economic activity, Central Bank reduced the basic interest rate during 2012. As a result, the SELIC rate decreased to 7.25% by the end of 2012, from 11% in 2011.

Brazil finished 2012 with a trade balance surplus of US\$ 19.4 billion, compared to US\$ 29 billion in 2011. Exports decreased by 13.5% to US\$ 242 billion, and imports decreased 24.5% to US\$ 223 billion. Financial inflows into the country increased, with foreign direct investments of US\$ 65.3 billion, compared to US\$66.7 billion in 2011. Portfolio investments decreased to US\$ 8.3 billion in 2012, in comparison to US\$ 35.3 billion in 2011. The positive performance of external accounts allowed international reserves to increase by US\$ 26.6 billion to the record level of US\$378.6 billion.

Despite the worsening in domestic economic data, such as inflation, external accounts, and interest rates, increased risk aversion in the international capital markets led to a lower country risk in 2012. The J.P. Morgan Emerging Markets Bond Index Plus (EMBI + Brazil), which tracks total returns for traded external debt instruments in the emerging markets, decreased to 142 basis points by the end of 2012 from 180 basis points at the end of 2011.

Despite this fact, the real depreciated against the U.S. dollar in 2012 by 8.94%. The exchange rate on December 31, 2012 was R\$2.044/US\$1.00, from R\$1.876/US\$1.00 on December 31, 2011.

Our business is directly affected by trends in the international economy and the Brazilian economy. If the Brazilian economy enters a period of continued recession, then demand for telecommunications services is likely to decline. Similarly, depreciation of the Brazilian real against the U.S. dollar may reduce the purchasing power of Brazilian consumers and, as a consequence, negatively affect the ability of our customers to pay for our telecommunications services.

#### Impact of Inflation on Our Results of Operations

Before 2006, the fees we charged our customers were periodically adjusted by ANATEL based on the inflation rates measured by the General Price Index (IGP-DI).

Starting in 2006, telephone fees were indexed to the IST, which is a basket of national indexes that reflect the telecommunications sector's operating costs. Such indexing will thus reduce inconsistencies between revenue and costs in our industry and therefore reduce the adverse effects of inflation on our business. The IST for the last 12 months is 4.92% according to the last data published by ANATEL with reference to December 2011.

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The table below shows the Brazilian general price inflation (according to the IGP-DI, IPCA and the IST) for the years ended December 31, 2008 through 2012:

	Inflation Rate (%) as Measured by IGP-DI(1)	Inflation Rate (%) as Measured by IPCA(2)	Inflation Rate (%) as Measured by IST(3)
December 31, 2012	8.1	5.8	4.9
December 31, 2011	5.0	6.5	4.9
December 31, 2010	11.3	5.9	5.6
December 31, 2009	(1.4 )	4.3	2.1
December 31, 2008	9.1	5.9	6.6

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- (1) Source: IGP-DI, as published by the Fundação Getúlio Vargas.
- (2) Source: IPCA, as published by the Instituto Brasileiro de Geografia e Estatística.
- (3) Source: IST, as published by the Agência Nacional de Telecomunicações.

Regulatory and Competitive Factors

Our business, including the services we provide and the rates we charge, is subject to comprehensive regulation under the General Telecommunications Law. As a result, our business, results of operations and financial conditions could be impacted by the actions of the Brazilian authorities, including:

- delays in the granting, or the failure to grant, approvals for rate adjustment;
- the granting of licenses to new competitors in our region; and
- the introduction of new or stricter requirements for our operating concession.

A series of new regulations became effective in 2012. See “Item 4. Information on the Company—B. Business Overview.” The most important among these regulations were:

- Resolution no 581/2012 – Regulation of SeAC
- Resolution no 582/2012 – Model Authorization Form SeAC
- Resolution no 586/2012 – Regulation of AICE
- Resolution no 588/2012 – Network Payment Regulation STFC
- Resolution no 589/2012 – Regulation of Administrative Sanctions
- Resolution no 590/2012 – Regulation of EILD
- Resolution no 596/2012 – Regulation of Fiscalization
- Resolution no 598/2012 – Regulation of Universal Service Obligations
- Resolution no 600/2012 – Regulation of PGMC
- Resolution no 604/2012 – Regulation for Successive Calls

We expect the following issues to become effective as new regulations or to be subject of one or more Public Notices in 2013, with an exact timeline yet to be determined by ANATEL.

- New Regulation of STFC
- New Regulation of SCM

- RGQ STFC
- Regulation of Rural Area Service
- Review of the Regulation of Infrastructure Sharing
  - Review of Regulation of TUPs
  - New Regulation of SMP
- Public Consultation of the Fator X

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Number Portability came into effect in Brazil in September 2008. Number Portability allows clients within a limited geographic locale to relocate or change their telephone operator without the need to change their telephone number (for either a fixed or mobile line). Number Portability rights for all of our clients became effective in March 2009.

In addition to regulatory considerations, our business is affected by competition from other telecommunications providers. We began to face competition in our region in July 1999, and we anticipate that competition will contribute to declining prices for fixed-line telecommunications services and increasing pressure on operating margins. Our future growth and results of operations will depend significantly on a variety of factors, including:

- Brazil's economic growth and its impact on the greater demand for services;
- the costs and availability of financing; and
- the exchange rate between the real and other currencies.

## Foreign Exchange and Interest Rate Exposure

We face foreign exchange risk due to our foreign currency-denominated indebtedness, accounts payable (including our capital expenditures, particularly equipment) and receivables in foreign currency. A real devaluation may increase our cost of debt and certain commitments in a foreign currency. Our revenue is earned in reais, and we have no material foreign currency-denominated assets, except income from hedging transactions, interconnection of international long-distance services and services rendered to customers outside Brazil. Equity investments in foreign companies also suffer effects with variations in the exchange rate.

On December 31, 2012, 19.92% of our R\$7.967 billion of financial indebtedness was denominated in U.S. dollars and UMBNDES. See Note 18 to the Consolidated Financial Statements. Devaluation of the real causes exchange losses on foreign currency-denominated indebtedness and commitments and exchange gain on foreign currency-denominated assets and corporate stakes in foreign companies.

We use derivative instruments to limit our exposure to exchange rate risk. Since September 1999, we have hedged all of our foreign currency-denominated bank debt using swaps. Since May 2010, the company began using net balance coverage, which is the coverage for net positions in foreign exchange exposures, or assets (issued invoices) minus liabilities (received invoices) for foreign exchange exposures, substantially reducing the company's risk to fluctuations in exchange rates. However, we remain exposed to market risk resulting from changes in local interest rates, principally the CDI – Certificate of Interbank Deposits (Certificado de Depósito Interbancário), which is an index based upon the average rate of operations transacted among the banks within Brazil). This exposure to the CDI is present in long derivatives positions and financial investments, which are indexed to percentages of the CDI. Substantially, most of our debt is exposed to long term interest rates. On December 31, 2012, R\$2.912 billion of our indebtedness was subject to the variations of the TJLP, which remained stable since July 2009, and R\$1.587 billion was subject to the variation of the U.S. dollar and UMBNDES. However, the portion in U.S. dollars of our foreign currency debt is swapped under hedging arrangements for variable-rate real-denominated obligations based on the CDI. We invest our excess cash mainly in short-term instruments that earn interest based on the CDI. See Note 36 to the Consolidated Financial Statements and "Item 11. Quantitative and Qualitative Disclosures about Market Risk."

Since we have foreign currency derivatives with notional amounts substantially equivalent to our borrowings and invoices issued and received denominated in foreign currency, we do not have material exchange rate exposure with respect to these contracts. However, we could still continue to have exchange rate exposure with respect to our planned capital expenditures, approximately 17.4% of which are indexed in foreign currencies (mostly U.S. dollars). We systematically monitor the amounts and time of exposure to exchange rate fluctuations and may contract for

hedging positions, when appropriate, at our discretion.

#### Discussion of Critical Accounting Estimates and Policies

The preparation of financial statements included in this annual report in accordance with IFRS involves certain assumptions and estimates that affect the amounts presented for revenue, expenses, assets and liabilities and disclosures of contingent liabilities in the notes to the financial statements. Therefore, the uncertainty relating to these assumptions and estimates could lead to results that require a significant adjustment to the accounting value of

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assets or liabilities affected in future periods. Although we review these estimates and assumptions in the ordinary course of business, the presentation of our financial condition and results of operation often requires our management to make judgments regarding the effects on our financial condition and results of operations of matters that are inherently uncertain. Actual results may differ from those estimated under different variables, assumptions or conditions. Note 3 of our Consolidated Financial Statements includes methods used in the preparation of those financial statements and includes a summary of the significant accounting policies. To provide an understanding of how we form the foregoing judgments and estimates, we have summarized certain critical accounting policies below.

### Accounting for long-lived assets, including goodwill

Property, plant and equipment and intangible assets, other than goodwill, are recorded at acquisition cost. Property, plant and equipment and intangible assets with definite useful lives are depreciated or amortized on a straight-line basis over their estimated useful lives. Intangible assets with indefinite useful lives, including goodwill, are not amortized, but are, instead, subject to an impairment test on a yearly basis and whenever there is an indication that such assets may be impaired.

Accounting for long-lived assets and intangible assets involves the use of estimates for determining the fair value at their acquisition dates, particularly for assets acquired in business combinations and for determining the useful lives of the assets over which they are to be depreciated or amortized as well as their residual value. We believe that the estimates we make to determine an asset's useful life and residual value are "critical accounting estimates" because they require our management to make estimates about future technological developments and alternative uses for assets.

### Impairment of nonfinancial assets

An impairment loss exists when the accounting value of an asset or cash-generating unit exceeds its recoverable amount, which is the higher between the fair value less selling costs and the value in use. The estimated fair value less selling costs is based on the information available from transactions involving the sale of similar assets or the market price less additional costs regarding the disposition of such asset. The value in use is based on the model of discounted cash flow. Cash flows are derived from the budget and do not include activities of reorganization for which the company has not yet been committed or significant future investments that will improve the group of assets of the cash-generating unit subject to the test. The recoverable amount is sensitive to the discount rate used in the method of discounted cash flows as well as to the projected future cash flow and the expected future growth rate used for the purposes of determining terminal value. Furthermore, additional factors, such as technological obsolescence, the suspension of certain services and other circumstantial changes are taken into account.

### Post-retirement benefit plan

The cost of defined benefit retirement plans and other post-employment medical care benefits and the present value of pension obligations are determined using actuarial valuation methods. The actuarial valuation methods involves the use of assumptions about discount rates, expected return rates of assets, expected future salary increases, mortality rates, health care costs trend rates and future increases in retirement benefits and pensions. The obligation of a defined benefit is highly sensitive to changes in these assumptions. All assumptions are reviewed at each year-end. The mortality rate is based on mortality tables available in the country. Future increases in wages and retirement benefits and pensions are based on expected future inflation for Brazil.

### Fair value of financial instruments

When the fair value of financial assets and liabilities presented on the balance sheet cannot be obtained in active markets, it is determined using valuation techniques, including the method of discounted cash flow. The data obtained



for the use of these methods are based as much on the information prevailing in the market as possible. However, when it is not feasible to obtain such information in the market, a certain assumption level is required to establish the fair value. The assumption includes consideration of the data that was used, such as the liquidity risk, credit risk and volatility. Changes in the assumptions regarding these factors could affect the presented fair value of financial instruments.

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### Taxes

There are uncertainties regarding the interpretation of complex tax regulations and the amount and timing of future taxable income. We record provisions based on reasonable estimates for possible auditing by tax authorities from the jurisdictions in which we operate. The value of these provisions is based on several factors such as experience from previous tax audits and different interpretations of tax regulations by the taxable entity and the competent tax authority in charge. Such differences of interpretation may arise in a wide variety of subjects, depending on the prevailing conditions in the domicile of the company. As a result, we may be required to pay more than our provisions or to recover less than the assets recognized.

The Company and subsidiaries evaluate the recoverability of deferred tax asset based on estimates of future results. This recoverability ultimately depends on the ability of the company and subsidiaries to generate taxable profits over the period in which the temporary difference is deductible. The analysis considers the reversal period of deferred tax liabilities, as well as estimates of taxable profits, based on updated internal projections reflecting the latest trends.

Determining the proper classification of the tax items depends on several factors, including an estimate of the period and the realization of the deferred tax asset and the expected date of payments of these taxes. The actual flow of receipt and payment of income tax could differ from estimates made by the company and subsidiaries, as a result of changes in tax laws or of unexpected future transactions that may impact tax balances.

### Provisions for tax, labor, civil and regulatory proceedings

We record provisions for tax, labor, civil and regulatory claims. The assessment of the likelihood of loss includes assessing the available evidence, the hierarchy of laws, the available jurisprudence, the most recent court decisions and its materiality in the legal system as well as the evaluation of the case by external counsels. Provisions are reviewed and adjusted to take into account changes in circumstances such as the applicable prescriptive period, results from tax inspections or additional exposure identified based on newly issued court decisions. A significant change in these circumstances or assumptions could result in a corresponding increase or decrease the amount of our provisions.

### Revenue recognition

#### Customer Loyalty Program

We have a customer loyalty program that allows customers to accumulate points when generating traffic for the use of our mobile services. The accrued points may be exchanged for handsets or services, provided the customer has a minimum stipulated balance of points. The consideration received is allocated to the cost of the handsets or services redeemed at their fair value. The fair value of the points is calculated by dividing the discount value granted as a result of the customer loyalty program by the amount of points needed to carry out the redemption. The fair value accrued on the balances of generated points is deferred and recognized as income upon redemption of points.

For determining the quantity of points to be recognized, we apply statistical techniques, which take into consideration assumptions such as estimated redemption rates, expiration rates, cancellation of points and other factors. These estimates are subject to variations and uncertainties due to changes in the redemption behavior of the customers.

A change in the assumptions regarding these factors could affect the estimated fair value of the points under the customer loyalty program and it could affect the apportionment of revenue among the elements and, as a result, revenues in future years.

### Multiple-element arrangements

Bundled offers that combine different elements are assessed to determine whether it is necessary to separate the different identifiable components and apply the corresponding revenue recognition policy to each element. Total package revenue is allocated among the identified elements based on their respective fair values.

Determining fair values for each identified element requires estimates that are complex due to the nature of the business.

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A change in estimates of fair values could affect the apportionment of revenue among the elements and, as a result, revenues in future years.

Sources of Revenue

The breakdown of our gross operating revenue is presented net of discounts granted. In addition, we categorized our revenue according to the following groups:

- Telephony services

Includes revenues from fixed and mobile telephony highlighting:

- Local: includes the sum of revenues from monthly subscription fees, installation fees, local services, public telephony and fixed-to-mobile revenues (VC1);
- Domestic long-distance: includes the sum of fixed-to-mobile revenues (VC2 and VC3), public long-distance telephony and domestic long-distance;
- International long-distance: includes the sum of revenues from international public telephony and international long-distance; and
  - Usage charges: which include measured service charges for calls, monthly fee and other similar charges;
- Data Transmission and value added services
  - Data Transmission: includes the sum of infrastructure rental revenues and data transmission; and
- Charges for call forwarding, call waiting, text messaging (SMS), call blocking and Data Services, such as WAP and ZAP, downloads and MMS services, which are charged only when the customer's plan excludes these services.

- Interconnection charges

- Interconnection charges (or network usage charges) are amounts we charge other cellular and fixed-line service providers for the use of our network;

- Pay TV

- Includes cable TV services, through satellite, cable or MMDS technology (multichannel multipoint distribution service);

- Sale of goods and equipment

- The sale of wireless devices and accessories; and

- Other Services

- Other services include integrated solution services offered to residential and corporate clients, such as Internet access, private network connectivity and leasing of computer equipment, and

- Other telecommunications services such as extended service, detects, voice mail, cellular blocker, among others.

#### Results of Operations

The following table sets forth certain components of our net income for each year ended December 31, 2012, December 31, 2011 and December 31, 2010 as well as the percentage change of each component. The Company acquired 100% of shares of Vivo Participações amounting to R\$31.2 billion. See Note 1 and Note 4 to our

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consolidated financial statements. The Company's consolidated financial statements include Vivo Participações and Vivo as of April 1, 2011. Vivo Participações and Vivo were included in the company's consolidated financial statements through the full consolidation method.

Because Vivo Participações and Vivo are included in our financial statements for nine months in 2011, our results of operations in 2012 are not fully comparable with our results of operations in 2011 and 2010. We have made certain changes to our accounting criteria and elected to apply these changes retroactively to part of our financial statements for the years 2011 and 2010 to make them comparable to our 2012 financial statements. Implementation of these accounting changes did not create any difference for our results of operations or shareholders' equity.

	Year ended December 31,			Percent		Percent	
	2012	2011	2010	change		change	
	(in millions of reais)			2012-2011		2011-2010	
Net operating revenue	33,931.4	29,128.7	15,798.3	16.5	%	84.4	%
Cost of services and goods	(16,564.4)	(15,039.7)	(8,844.8)	10.1	%	70.0	%
Gross profit	17,367.0	14,089.0	6,953.5	23.3	%	102.6	%
Operating expenses:							
Selling	(8,693.7)	(6,948.2)	(2,964.6)	25.1	%	134.4	%
General and administrative	(2,148.4)	(1,785.6)	(738.9)	20.3	%	141.7	%
Other operating revenues, net	687.4	442.2	312.4	55.5	%	41.5	%
Total operating expenses, net	(10,154.7)	(8,291.6)	(3,391.1)	22.5	%	144.5	%
Equity in earnings (losses) of associates	-	-	2.9	-		(100.0)	)%
Operating income before financial expense, net	7,212.3	5,797.4	3,565.3	24.4	%	62.6	%
Net financial expenses	(290.8)	(139.7)	(120.7)	108.2	%	15.7	%
Net income before income and social contribution taxes	6,921.5	5,657.7	3,444.6	22.3	%	64.2	%
Income and social contribution taxes	(2,469.3)	(1,295.5)	(1,045.8)	90.6	%	23.9	%
Net income	4,452.2	4,362.2	2,398.8	2.1	%	81.8	%
Net income attributable to:							
Shareholders of company	4,453.6	4,355.3	2,398.8	2.3	%	81.6	%
Noncontrolling interests	(1.4)	6.9	-	(120.3)	(%)	100.0	%
Net income for year	4,452.2	4,362.2	2,398.8	2.1	%	81.8	%

## Net Operating Revenue

Net operating revenues increased by 16.5% to R\$33,931.4 million in 2012 from R\$29,128.7 million in 2011 mainly due to an increase in the voice service revenue, internet services consumption and use of messages. Net operating revenues increased by 84.4% to R\$29,128.7 in 2011 from R\$15,798.2 million in 2010. The increase in 2011 reflects the consolidation of R\$13,728.1 million of net operating revenues attributable to Vivo and Vivo Participações for the months of April through December 2011. Our net operating revenues excluding Vivo and Vivo Participações decreased by 2.5% to R\$15,400.6 million in 2011, from R\$15,798.2 million in 2010, primarily due to the reduction in the traffic originated by fixed-line and to the lower fixed-voice customer base, partially offset by the increased international long-distance revenue in comparison to 2010.

## Capital Expenditures (Capex)

In 2012, the company invested R\$6,117.1 million in projects that sustain its current annual results and position the company for competitive environment in the medium term representing an increase of 6.5% compared to 2011. As a percentage over net operating revenues the ratio was from 18.5% in 2011 to 18% in 2012. A significant portion of resources was allocated to allow growth quality in our services. The investments in quality maintenance and expansion of our client base represented 87% of the total amount invested by us in 2012 (excluding the purchase of new licenses).

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To meet the needs of an increasingly connected society, significant investments were made to support the strong growth of our data users, both fixed and mobile, or dedicated high speed services for our corporate clients. We are building the future of broadband by increasing the expansion of the optical fiber network in São Paulo. We are also investing in the expansion of the backbone for national data transmission to meet the increase in mobile data traffic throughout the country.

In 2013, as already announced through a material fact on March 7, 2013, Telefonica Brasil will invest R\$5.7 billion, excluding licenses and mergers and acquisitions, in line with the Company's strategy of ensuring quality in service provision.

## Results of Operations for the Year Ended December 31, 2012 Compared to the Year Ended December 31, 2011

## Operating Revenue

Our gross operating revenue is presented net of discounts granted.

Our gross operating revenue increased 16.7% to R\$50,278.8 million in 2012 from R\$43,073.1 million in 2011, impacted by increase in telephony services and data transmission and value added services. The variations are explained as follows:

	Year ended December		Percent change	
	2012	31, 2011	2012-2011	
	(in millions of reais)			
Telephony services	26,555.1	24,254.2	9.5	%
Data transmission and value added services	14,389.8	10,929.3	31.7	%
Interconnection charges	4,453.4	3,785.0	17.7	%
Pay TV	805.3	865.4	(6.9)	%
Sale of goods and equipment	2,792.6	2,135.2	30.8	%
Other services	1,282.6	1,104.1	16.2	%
Gross operating revenue	50,278.8	43,073.2	16.7	%
Value-added and other indirect taxes	(16,347.4)	(13,944.5)	17.2	%
Net operating revenues	33,931.4	29,128.7	16.5	%

Telephony services. There was an increase of R\$2,300.9 million in revenue from telephony services, or 9.5%, explained by the increase in voice services revenue. The continued growth of prepaid recharges and increased in postpaid plans "Live Unlimited" part of that evolution.

Data transmission and value added services: Revenue from data transmission and value added services increased to R\$3,460.5 million, or 31.7% compared to 2011. This increase is a result of a significant increase in our customer base in the data access services, mainly due to strong performance in the corporate segment.

Interconnection charges: Revenue from interconnection charges increased to R\$668.4 million, a 17.7% increase in relation to 2011. This variation is mainly related to a rise in traffic of incoming calls to fixed lines especially mobile originated, as well as mobile to mobile calls.

Pay TV. Revenue from Pay TV totaled R\$805.3 million in 2012, a decrease of 6.9% in the Pay TV's gross revenue in relation to 2011. This variation is mainly due to the reduction in the commercial activity due to the launching on the new IPTV platform.



Sale of goods and equipment: Revenue from the sale of goods and equipment in 2012 totaled R\$657.4 million, an increase of 30.8% compared to 2011. The variation in 2012 is mainly a result of the increase in the sale of smartphones, a growth of postpaid customers over the course of the year and as a result of the change in the sales model for SME segment and foreign exchange. Revenues from sales of wireless devices and accessories are reported before commissions and promotional discounts, and include value-added taxes. In general, the purpose of wireless device sales is to encourage growth in customers and traffic (and not necessarily to generate profits). Accordingly, we subsidize part of the costs of wireless devices for post-paid customers.

Others services: Revenues from other services totaled R\$178.5 million, an increase of 16.2% compared to 2011. This increase is mainly a result of higher revenues from providing integrated solutions for the corporate segment.

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## Cost of Services and Goods

The following table sets forth the components of our costs of services and goods sold for 2012 and 2011, as well as the percentage change from the previous year.

	Year ended December		Percent change 2012-2011	
	2012	31, 2011		
	(in millions of reais)			
Cost of goods sold	(1,801.9 )	(1,284.3 )	40.3	%
Depreciation and amortization	(4,132.4 )	(3,582.6 )	15.3	%
Outside services and other	(3,379.6 )	(2,923.4 )	15.6	%
Interconnection charges	(4,012.1 )	(4,537.1 )	(11.6	%)
Rent, insurance, condominium fees, and leased lines	(968.7 )	(910.5 )	6.4	%
Personnel	(459.7 )	(380.1 )	20.9	%
Taxes and concession renewal fees	(1,810.0 )	(1,421.7 )	27.3	%
Cost of services and goods	(16,564.4)	(15,039.7)	10.1	%

Cost of services and goods increased by 10.1% to R\$16,564.4 million in 2012 from R\$15,039.7 million in 2011. The variations are explained as follows:

**Cost of goods sold:** Cost of wireless devices and accessories increased by 40.3% to R\$1,801.9 million in 2012, from R\$1,284.3 million in 2011. The increase in 2012 was mainly due to the increased sales of smartphones, which is linked to higher sales of postpaid and data plans, exchange and because of the change in the sales model for corporate segment.

**Depreciation and amortization:** Depreciation and amortization expenses increased by 15.3% to R\$4,132.4 million in 2012, from R\$3,582.6 million in 2011. The increase in 2012 was mainly due to investments in transmission infrastructure and network.

**Outside services and other:** Cost of third-party services and other increased by 15.6% to R\$3,379.6 million in 2012, from R\$2,923.4 million in 2011, mainly due to network maintenance and pay TV content.

**Interconnection charges:** Interconnection charges decreased by 11.6% to R\$4,012.1 million in 2012, from R\$4,537.1 million in 2011. The decrease in 2012 is mainly due to a decrease in the use of network for fixed-mobile traffic.

**Rent, insurance, condominium fees, and leased lines:** Rent, insurance, condominium fees, and leased lines increased by 6.4% to R\$968.7 million in 2012, from R\$910.5 million in 2011. The increase in 2012, was mainly due to expansion of 3G coverage.

**Personnel:** Personnel expenses increased by 20.9% to R\$459.7 million in 2012, from R\$380.1 million in 2011. The increase in 2012 was mainly explained by the collective wage increase granted in the period.

**Taxes:** Taxes increased by 27.3% to R\$1,810.0 million in 2012, from R\$1,421.7 million in 2011. The increase in 2012 was primarily attributable to growth of the customer base, reflecting the increase in Fistel spending.

## Operating Expenses

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The following table sets forth the components of our operating expenses for each of the years ended December 31, 2012 and 2011, as well as the percentage change from the prior year.

	Year ended December		Percent change 2012-2011	
	2012	31, 2011		
	(in millions of reais)			
Selling expenses	(8,693.7 )	(6,948.2 )	25,1	%
General and administrative expenses	(2,148.4 )	(1,785.6 )	20,3	%
Other net operating income	687.4	442.2	55.5	%
Total	(10,154.7)	(8,291.6 )	22.5	%

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Operating expenses increased by 22.5% to R\$10,154.7 million in 2012, from R\$8,291.6 million in 2011. The increase in 2012 reflects mainly due to an increase in selling expenses.

Selling expenses: Selling expenses increased by 25.1% to R\$8,693.7 million in 2012, from R\$6,948.2 million in 2011, mainly due to an increase in third party services is due to greater expenses with commissions, resulting from increases in data plans, which have a larger unit fee.

General and administrative expenses: General and administrative expenses increased by 20.3% to R\$2,148.4 million in 2012, from R\$1,785.7 million in 2011. The increase in 2012 reflects an increase in maintenance along with the opening of the new integrated office of the company.

Other net operating income: The net amount of other operating income increased by 55.5% to R\$687.4 million of other revenues in 2012, from R\$442.2 million of other revenues in 2011. The increase in 2012 is mainly due to revenue from sales of non-strategic assets in 2012.

**Financial Result**

For the year-end period ended on December 31, 2012, net financial expenses reached R\$290.8 million, increasing by R\$151.1 million or 108.18% when compared to the period ended December 31, 2011, mainly due to lower interest income on financial assets and the consolidation of Vivo and Vivo Participações as of April 2011. When compared with the financial expenses of the period ended December 31, 2011 including results of Vivo and Vivo Participações for the first quarter of 2011, net financial expenses for the year-end period ended on December 31, 2012 have increased R\$111.3 million or 62.0%.

**Income and Social Contribution Taxes**

We recorded expenses from income and social contribution taxes in the amount of R\$2,469.3 million in 2012, an increase of 90.6% from an expense of R\$1,295.5 million in 2011. The increase in 2012 was due to higher income before income and social contribution taxes. The effective rate of income tax and social contribution increased to 35.7% in 2012 compared with 22.9% in 2011, mainly due to lower interest on shareholders' equity payments made in 2012, which is deductible for income tax purposes.

**Results of Operations for the Year Ended December 31, 2011 Compared to the Year Ended December 31, 2010****Operating Revenue**

Our gross operating revenue is presented net of discounts granted.

Our gross operating revenue increased 90.5% to R\$43,073.2 million in 2011 from R\$22,609.1 million in 2010, impacted by the incorporation of Vivo Part and Vivo which we consolidated as of April 1, 2011. Excluding the effect of such acquisition, which totaled R\$20,349.8 million, gross operating revenue would be R\$22,723.4 million, an increase of 0.5%, or R\$114.3 million, compared to 2010. The variations are explained as follows:

	Year ended December		Percent change
	2011	2010	2011-2010
	(in millions of reais)		
Telephony services	24,254.2	15,366.0	57.8
Data transmission and value added services	10,929.3	5,028.4	117.4

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Interconnection charges	3,785.0	523.8	622.6
Pay TV	865.4	587.4	47.3
Sale of goods and equipment	2,135.2	166.5	1,182.4
Other services	1,104.1	937.0	17.8
Gross operating revenue	43,073.2	22,609.1	90.5
Value-added and other indirect taxes	(13,944.4)	(6,810.8 )	104.7
Net operating revenues	29,128.7	15,798.3	84.4

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Telephony service. Excluding the consolidation effect of Vivo Participações and Vivo in the amount of R\$9,237.8 million, there was a decrease of R\$349.6 million in the revenue, or, 2.3%, explained by the reduction in the traffic originated by fixed-line and to the lower fixed-voice customer base, partially offset by the increased international long-distance revenue in comparison to 2010.

Data transmission and value added services: Excluding the consolidation effect of Vivo Participações and Vivo in the amount of R\$5,421.0 million, the variation in 2011 totaled R\$479.9 million, an increase of 9.5% compared to 2010. This growth is explained by a significant increase in customer base in the data access services, mainly due to strong performance in the corporate segment.

Interconnection charges: Excluding the consolidation effect of Vivo Participações and Vivo in the amount of R\$3,375.9 million, the variation in 2011 totaled R\$409.1 million, which was a drop of 21.9% in relation to 2010. This variation is mainly related to reduction in incoming traffic, given the concentration in selling efforts by the operators for stimulating the on-net mobile traffic.

Pay TV. Revenue from Pay TV in 2011 totaled R\$865.4 million, an increase of 47.3% in the Pay TV's gross revenue in relation to 2010. This variation is related to consolidation of TVA's pay TV business results from the second quarter of 2011.

Sale of goods and equipment: Excluding the consolidation effect of Vivo Participações and Vivo in the amount of R\$1,953.6 million, the variation in 2011 totaled R\$181.6 million, an increase of 9.1% compared to 2010. Revenues from sales of wireless devices and accessories are reported before commissions and promotional discounts, and include value-added taxes. In general, the purpose of wireless device sales is to encourage growth in customers and traffic (and not necessarily to generate profits). Accordingly, we subsidize part of the costs of wireless devices for post-paid customers.

Others services: Excluding the consolidation effect of Vivo Participações and Vivo in the amount of R\$31.4 million, the variation in 2011 registered R\$135.7 million, an increase of 14.5% compared to 2010. This growth is mainly explained by the increased revenues from the supply of integrated solutions to the corporate segment.

#### Cost of Services and Goods

The following table sets forth the components of our costs of services and goods sold for 2011 and 2010, as well as the percentage change from the previous year.

	Year ended December		Percent change 2011-2010	
	31, 2011	2010		
	(in millions of reais)			
Cost of goods sold	(1,284.3 )	(155.7 )	724.9	%
Depreciation and amortization	(3,582.6 )	(1,687.4 )	112.3	%
Outside services and other	(2,923.4 )	(1,860.4 )	57.1	%
Interconnection charges	(4,537.1 )	(4,176.7 )	8.6	%
Rent, insurance, condominium fees, and leased lines	(910.5 )	(364.3 )	149.9	%
Personnel	(380.1 )	(257.4 )	47.7	%
Taxes and concession renewal fee	(1,421.7 )	(342.9 )	314.6	%
Cost of services and goods	(15,039.7)	(8,844.8 )	70.0	%

Cost of services and goods increased by 70.0% to R\$15,039.7 million in 2011 from R\$8,844.8 million in 2010. The increase in 2011 reflects the consolidation of R\$6,678.6 million of cost of services and goods attributable to Vivo and Vivo Participações for the months of April through December 2011. Our cost of services and goods excluding Vivo and Vivo Participações decreased 5.5% to R\$8,361.1 million in 2011 from R\$8,844.8 million in 2010. The variations are explained as follows:

Cost of goods sold: Cost of wireless devices and accessories increased by 724.9% to R\$1,284.3 million in 2011, from R\$155.7 million in 2010. The increase in 2011 reflects the consolidation of R\$1,178.7 million of cost of goods sold attributable to Vivo and Vivo Participações for the months of April through December 2011. Our cost of goods sold excluding Vivo and Vivo Participações decreased 32.2% to R\$105.6 million in 2011 from R\$155.7 million in

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2010 was mainly due to a decrease in expenses related to maintenance of terminals to access the network, among others.

**Depreciation and amortization:** Depreciation and amortization expenses increased by 112.3% to R\$3,582.6 million in 2011, from R\$1,687.4 million in 2010. The increase in 2011 reflects the consolidation of R\$1,290.0 million of depreciation and amortization attributable to Vivo and Vivo Participações for the months of April through December 2011. Our depreciation and amortization excluding Vivo and Vivo Participações increased 56.3% to R\$2,292.6 million in 2011 from R\$1,687.4 million in 2010 mainly due to expenses for higher investments in our network and amortization of licenses on acquisition of Vivo.

**Outside services, concession renewal fee and other:** Cost of third-party services increased by 57.1% to R\$2,923.4 million in 2011, from R\$1,860.4 million in 2010. The increase in 2011 reflects the consolidation of R\$527.5 million of outside services and other attributable to Vivo and Vivo Participações for the months of April through December 2011. Our outside services and other excluding Vivo and Vivo Participações increased 26.4% to R\$2,350.9 million in 2011 from R\$1,860.4 million in 2010 was mainly due to network maintenance and purchase of TV content.

**Interconnection charges:** Interconnection charges increased by 8.6% to R\$4,537.1 million in 2011, from R\$4,176.7 million in 2010. The increase in 2011 reflects the consolidation of R\$240.3 million of interconnection charges attributable to Vivo and Vivo Participações for the months of April through December 2011. Our interconnection charges excluding Vivo and Vivo Participações increased 2.9% to R\$4,296.8 million in 2011 from R\$4,176.7 million in 2010 mainly due to an increase in the use of the network for fixed-mobile traffic, among others.

**Rent, insurance, condominium fees, and leased lines:** Rent, insurance, condominium fees, and leased lines increased by 149.9% to R\$910.5 million in 2011, from R\$364.3 million in 2010. The increase in 2011 reflects the consolidation of R\$488.7 million of rent, insurance, condominium fees, and leased lines attributable to Vivo and Vivo Participações for the months of April through December 2011. Our rent, insurance, condominium fees, and leased lines excluding Vivo and Vivo Participações increased 15.8% to R\$421.8 million in 2011 from R\$364.3 million in 2010 mainly due to greater expenses with service fees for use of and towers and poles and insurance.

**Personnel:** Personnel expenses increased by 47.7% to R\$380.1 million in 2011, from R\$257.4 million in 2010. The increase in 2011 reflects the consolidation of R\$109.0 million of personnel expenses attributable to Vivo and Vivo Participações for the months of April through December 2011. Our personnel expenses excluding Vivo and Vivo Participações increased 5.3% to R\$271.1 million in 2011 from R\$257.4 million in 2010 mainly due to the collective agreement in this period under which we provided a salary readjustment in September 2011 of approximately 5%.

**Taxes:** Taxes increased by 314.6% to R\$1,421.7 million in 2011, from R\$342.9 million in 2010. The increase in 2011 reflects the consolidation of R\$1,070.1 million of taxes attributable to Vivo and Vivo Participações for the months of April through December 2011. Our taxes excluding Vivo and Vivo Participações increased 2.5% to R\$351.6 million in 2011 from R\$342.9 million in 2010 mainly due to expenses with the Fust and Funttel taxes, due to the growth in the number of new subscribers.

### Operating Expenses

The following table sets forth the components of our operating expenses for each of the years ended December 31, 2011 and 2010, as well as the percentage change from the prior year.

Year ended December		Percent change 2011-2010
2011	31, 2010	



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	(in millions of reais)			
Selling expenses	(6,948.2 )	(2,964.6 )	134.4	%
General and administrative expenses	(1,785.6 )	(738.9 )	141.7	%
Other net operating income	442.2	312.4	41.5	%
Total	(8,291.6 )	(3,391.1 )	144.5	%

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Operating expenses increased by 144.5% to R\$8,291.6 million in 2011, from R\$3,391.1 million in 2010. The increase in 2011 reflects the consolidation of R\$4,492.6 million of operating expenses attributable to Vivo and Vivo Participações for the months of April through December 2011. Our operating expenses excluding Vivo and Vivo Participações increased 12.0% to R\$3,799.0 million in 2011 from R\$3,391.1 million in 2010 mainly due to an increase in general and administrative expenses.

Selling expenses: Selling expenses increased by 134.4% to R\$6,948.2 million in 2011, from R\$2,964.6 million in 2010. The increase in 2011 reflects the consolidation of R\$3,869.5 million of selling expenses attributable to Vivo and Vivo Participações for the months of April through December 2011. Our selling expenses excluding Vivo and Vivo Participações increased 3.8% to R\$3,078.7 million in 2011 from R\$2,964.6 million in 2010 mainly due to amortization of trademarks and client portfolio on acquisition of Vivo and an increase in personnel expenses resulting from the consolidation of TVA's pay TV business and expenses with third-party services, mainly with use of the brand and publicity and advertising.

General and administrative expenses: General and administrative expenses increased by 141.7% to R\$1,785.6 million in 2011, from R\$738.9 million in 2010. The increase in 2011 reflects the consolidation of R\$1,051.5 million of general and administrative expenses attributable to Vivo and Vivo Participações for the months of April through December 2011. Our general and administrative expenses excluding Vivo and Vivo Participações generally remained stable, decreasing 0.6% to R\$734.1 million in 2011 from R\$738.9 million in 2010.

Other net operating income: The net amount of other operating income increased by 41.5% to R\$442.2 million of other revenues in 2011, from R\$312.4 million of other revenues in 2010. The increase in 2011 reflects the consolidation of R\$428.4 million of other net operating income attributable to Vivo and Vivo Participações for the months of April through December 2011. Our other net operating income excluding Vivo and Vivo Participações decreased 95.6% to R\$13.8 million in 2011 from R\$312.4 million in 2010 mainly due to an increase in amortization and other expenses.

## Financial Result

For the year-end period ended on December 31, 2011, net financial expenses reached R\$139.7 million, increasing by R\$19.0 million or 15.7% when compared to the period ended December 31, 2010, mainly due to higher net debt.

## Income and Social Contribution Taxes

We recorded expenses from income and social contribution taxes in the amount of R\$1,295.5 million in 2011, an increase of 23.9% from an expense of R\$1,045.8 million in 2010. The increase in 2011 was due to higher income before income and social contribution taxes. The effective rate of income tax and social contribution decreased to 22.9% in 2011 compared with 30.4% in 2010, mainly due to higher interest on shareholders' equity payments made in 2011, which is deductible for income tax purposes.

## B. Liquidity and Capital Resources

### General

We have funded our operations and capital expenditures mainly from operating cash flows and loans obtained from financial institutions, capital markets or development banks. As of December 31, 2012, we had R\$7.2 billion in cash and cash equivalents. Our principal cash requirements include:

- the servicing of our indebtedness;

- capital expenditures; and
- the payment of dividends.

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## Sources of Funds

Our cash flow from operations was R\$9.7 billion in 2012 compared to R\$8.1 billion in 2011. The increase in cash flow from operating activities of 19.75% in 2012 compared to 2011 was due primarily to Vivo's consolidation effect that occurred in April 2011 and increase in mobile market.

## Uses of Funds

Our cash flow used in investing activities was R\$3.4 billion in 2012 compared to R\$2 billion in 2011. The increase in cash flow used in investing activities of 70% in 2012 compared to 2011 was primarily due to consolidation of Vivo's cash and cash equivalents in April 2011, in the amount of R\$2 billion.

Our cash flow used in financing activities was R\$2.1 billion in 2012 compared to R\$4.7 billion in 2011. The decrease in cash flow used in financing activities of 55% in 2012 compared to 2011 was due primarily to lower payment of dividends in 2012 compared to 2011, partially offset by an increase of 0.7 billion in new loans obtained and debenture issued in 2012 in the amount of R\$2.8 billion compared to R\$2.1 billion in 2011.

## Indebtedness

As of December 31, 2012, our total debt was as follows:

Debt	Currency	Annual interest rate payable	Maturity	Principal amount outstanding (in thousands of reais)
Loan and Financing BNDES	R\$	TJLP + 0% to TJLP + 9.0%	2019	2,911.8
Loan and Financing BNDES	R\$	4.5% to 8.7%	2020	173.8
Loan and Financing BNDES	UMBNDDES	5.97%	2019	455.3
Loan and Financing BNB	R\$	10.0%	2016	338.6
Mediocreredito	US\$	1.75%	2014	9.3
EIB	US\$	4.18% to 4.47%	2015	795.6
Resolução 4131	US\$	4.10%	2013	326.3
Debentures	R\$	100% of the CDI + 0,75% to 112% of the CDI	2013	2,787.5
Debentures	R\$	IPCA+ 0.5% to IPCA+7.0%	2021	168.4
Others	R\$		2014	0.6
Total debt				7,967.3
Current				1,957.5
Long term				6,009.7

Interest and principal payments on our indebtedness as of December 31, 2012 due in 2013 and 2014 total R\$1,957.5 million and R\$1,300.1 million, respectively.

The agreements that govern the majority of our outstanding loans and financings contain certain standard restrictive covenants, which may provide for the acceleration of the full balance of our obligations in the event of any default. As of December 31, 2012, we were not in default of any of our obligations and therefore none of our liabilities were subject to acceleration.

#### Capital Expenditures and Payment of Dividends

Our principal capital requirements are for capital expenditures and payments of dividends to shareholders. Additions to property, plant and equipment totaled R\$ 2.4 billion, R\$2.8 billion and R\$2.4 billion for the years ended December 31, 2012, 2011 and 2010, respectively. These expenditures relate primarily to the expansion of our network. We may seek financing for part of our capital expenditures and cash management assistance from the Brazilian government, in particular from BNDES, which is the main government financing agent in Brazil, as well as from the local or foreign capital markets or from local and foreign financial institutions. See “Item 4. Information on the Company—A. History and Development of the Company—Capital Expenditures.”

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Pursuant to our bylaws and Brazilian Corporate Law, we are required to distribute a mandatory minimum dividend of 25% of “adjusted net income” (as defined below) in respect of each fiscal year, to the extent earnings are available for distribution. Holders of preferred shares are assured priority in the reimbursement of capital, without a premium, and are entitled to receive cash dividends that are 10% higher than those attributable to common shares.

Adjusted net income, as determined by Brazilian Corporate Law, is an amount equal to our net income adjusted to reflect allocations to or from (i) legal reserve, (ii) statutory reserve and (iii) a contingency reserve for anticipated losses, if any.

We may also make additional distributions to the extent that we have available profits and reserves to distribute. All of the above distributions may be made as dividends or as tax-deductible interest on shareholders’ equity. We paid dividends of R\$ 3.6 billion, R\$5.4 billion and R\$1.9 billion in 2012, 2011 and 2010, respectively.

Our management expects to meet 2013 capital requirements primarily from cash provided from our operations. Net cash provided by operations was R\$9.7 billion, R\$8.1 billion, and R\$4.5 billion in 2012, 2011 and 2010, respectively.

Adjustments to net income for purposes of calculating the basis for dividends include allocations to various reserves that effectively reduce the amount available for the payment of dividends. For the fiscal year ended December 31, 2012, the Board of Directors Meeting held on February, 21 decided to submit to the shareholders meeting a proposal to pay dividends in the amount of R\$1.4 billion, which, together with the interim dividend and interest on own capital payments made in 2012, would be more than sufficient to meet the minimum dividend required by Brazilian law. The proposal to pay dividends will be approved by a General Shareholders Meeting to be held in April 16, 2013. See “Item 3. Key Information—D. Risk Factors—Risks Relating to the Preferred Shares and the ADSs—Holders of our preferred shares and our ADSs generally do not have voting rights” and “Item 10. Additional Information—B. Memorandum and Articles of Association—Voting Rights.”

### New Accounting Pronouncement

### Recently Adopted Standards

The consolidated financial statements were prepared and are being presented in accordance with the IFRS.

We adopted all the standards, revisions of standards and interpretations issued by IASB, which entered into force as of January 1, 2012 including:

**Amendments to IAS 12, Income Tax – Recovery of Underlying Assets:** This amendment provided clarification on how to calculate deferred taxes on investment properties measured at fair value. It introduced the rebuttable presumption that deferred taxes on investment properties measured at fair value under IAS 40 should be defined considering that their book value will be recovered through sale. This amendment did not affect the Company’s operations.

**Amendments to IFRS 7, Financial Instruments: Disclosures – Enhanced Derecognition Disclosure Requirements:** This amendment requires additional disclosure on financial assets transferred, yet not derecognized, so as to enable the financial information users to understand the relation with those assets not derecognized and related liabilities. Furthermore, this amendment requires disclosures as to the ongoing involvement in the derecognized financial assets so that the user can evaluate the nature of the entity’s ongoing involvement in these derecognized assets and related risks. This amendment became effective for annual periods beginning on or after July 1, 2011.

Worth noting is that this amendment only affects disclosures – however, it is not currently applicable to the company, and has no impact on the company’s and its subsidiaries’ financial position or performance.

Recently Issued Standards

New IFRS standards and interpretations of the IFRIC (IFRS Interpretations Committee of the IASB) have been issued but their application was not mandatory.

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IAS 1 Presentation of Other Comprehensive Income Account: IAS 1 revisions affected the grouping of items presented in other comprehensive income. Items which might be reclassified (or “recycled”) to P&L at a future time (e.g. net gains on hedged net investments, exchange variation differences from translation of operations abroad, net movements of hedge of cash flows or gains on sale of assets classified as available for sale) should be presented separately from items which will never be reclassified (e.g. actuarial gains or losses on defined benefit plans). The revisions affect only the presentation, with no impacts on the financial position or performance of the company and its subsidiaries. These revisions go into effect for years beginning July 1, 2012 or thereafter and will be applied to the company’s financial statements when effective.

IAS 19 Employee Benefits (Revised): The IASB issued various revisions to IAS 19, which comprises fundamental amendments, such as the removal of the corridor method and the concept of returns expected on the plan assets, and simple clarifications on valuation and devaluation and reformulation. The Company does not expect significant impacts on its consolidated financial statements. This revised IAS will go into effect for annual periods beginning January 1, 2013 or thereafter.

IAS 28 Investments in Associates and Joint Ventures (Revised in 2011): In connection with the issuance of IFRS 11 and IFRS 12 (see below), IAS 28 is now IAS 28 - Investments in Associates and Joint Ventures and describes the application of the equity method of account for investments in joint ventures, besides the investment in associates. The Company does not anticipate any significant impacts on its consolidated financial statements. This revision will go into effect for annual periods beginning January 1, 2013 or thereafter.

IAS 32 Offsetting Financial Assets and Financial Liabilities – Revisions of IAS 32: These revisions shed light on the meaning of the phrase “currently has the legal right to set off”. These revisions also clarify the adoption of offsetting criteria set forth by IAS 32 for the clearing systems (like the clearing house systems), which apply non-simultaneous gross mechanisms for clearing. These revisions are not expected to affect the company’s and its subsidiaries’ financial position, performance or disclosures effective for annual periods beginning January 1, 2014 or thereafter.

IFRS 1 Government Loans – IFRS 1 Revisions: These revisions set the first-time application of the requirements of IAS 20 - Accounting for Government Grants and Disclosure of Government Assistance, prospectively governmental loans existing on the date of transition to IFRS. The entities may opt for applying the IFRS 9 requirements (or IAS 39, as the case may be) and IAS 20 to governmental loans, retrospectively, had the necessary information been obtained upon the initial recording of loans. The exception would give relief to the entities adopting the standard for the first time from retrospectively measuring government loans at an interest rate below market rate. The review will go into effect for annual periods beginning January 1, 2013 or thereafter. The revision will not affect the company and its subsidiaries.

IFRS 7 Disclosures – Offset Between Financial Assets and Financial Liabilities – Revisions of IFRS 7: These revisions require an entity to disclose information about the rights to offset and related agreements (e.g. agreement for guarantee). The disclosures provide users with useful information for them to assess the effect of the offsetting agreements on the financial position of an entity. The new disclosures are necessary for all financial instruments recognized and offset in accordance with IAS 32 Financial Instruments - Presentation. The disclosures also apply to financial instruments recognized which are subject to a master agreement for offsetting or alike, irrespective of being or not offset in accordance with IAS 32. The revision will go into effect for annual periods beginning January 1, 2013 or thereafter.

IFRS 9 Financial Instruments: Classification and Measurement: IFRS 9, as issued, reflects the first phase of IASB work regarding the replacement of IAS 39 and applies to the classification and measurement of financial assets and financial liabilities. The standard initially was effective for annual periods beginning January 1, 2013, however the Amendments to IFRS9 Effective Date of IFRS 9 and Disclosures for Transition, issued in December 2011, changed



the mandatory effective date to January 1, 2015. Later on, the IASB will address the recording of hedging instruments and impairment of financial assets. The adoption of the first phase of IFRS 9 will go into effect for the classification and measurement of the company's and its subsidiaries' financial assets, but will not affect the classification and measurement of financial liabilities. The Company will quantify the effect together with other phases, when the final standard is issued, comprising all the phases.

IFRS 10 Consolidated Financial Statements, IAS 27 Separate Financial Statements: IFRS 10 replaces the portion of IAS 27 – Consolidated and Separate Financial Statements which deals with the recording of consolidated financial

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statements. It also addresses issues raised by SIC-12 Consolidation – Special-purpose Entities. IFRS 10 establishes a single control model applied to all entities, including special-purpose entities. The amendments introduced by IFRS 10 will require management’s significant judgmental analysis to determine which entities are subsidiaries and therefore required to be consolidated by a parent company.

Based on preliminary analyses, IFRS 10 is not expected to have impacts on the investments currently held by the company. This standard will go into effect for annual periods beginning January 1, 2013.

**IFRS 11 Joint Ventures:** IFRS 11 replaces IAS 31 – Interests in Joint Ventures and SIC-13 –Jointly-controlled Entities – Non-monetary Contributions by Venturers. IFRS 11 eliminates the option to record jointly-controlled companies (JCC) based on a proportional consolidation. Instead, the JCC falling into the joint venture definition shall be recorded using the equity method. The application of new standard will affect the company’s financial position, eliminating the proportional consolidation of Aliança, AIX and ACT (Note 12). By applying the new standard, the investments in the aforesaid companies will be recorded using the equity method. This standard will go into effect for annual periods beginning January 1, 2013 and shall be applied retrospectively to joint ventures held on the initial application date. It is estimated that the IFRS 11 impact on the current period (which will correspond to the comparative period of the financial statements at December 31, 2013), considering certain items, consists of a decrease in revenues by R\$28,308 and a decrease in operating income by R\$1,370, since joint venture income will be presented below operating income. Current assets and current liabilities will decrease by R\$64,873 and R\$2,791, respectively, while noncurrent assets will be increased by R\$60,012, and noncurrent liabilities will be decreased by R\$2,896.

**IFRS 12 Disclosure of Interests in Other Entities:** IFRS 12 includes all disclosures previously contained in IAS 27 regarding the consolidated financial statements, as well as all disclosures previously contained in IAS 31 and IAS 28. These disclosures will be regarding interest held by an entity in subsidiaries, joint ventures, associates and structured entities. A number of new disclosures are also necessary, but there will be no impact on the company’s financial position or performance. This standard will go into effect for annual periods beginning January 1, 2013 or thereafter.

**IFRS 13 Fair Value Measurement:** IFRS 13 sets a single source of guideline in IFRS for all fair value measurements. IFRS 13 does not change the time an entity is required to use fair value, but provides guidance on how to measure fair value in accordance with IFRS, whenever fair value is required or allowed. This standard will go into effect for annual periods beginning January 1, 2013 or thereafter. The application of this standard will affect when the Company measures fair value in future financial statements.

C. Research and Development, Patents and Licenses

Research and Development

Telefônica Brasil operates in a fast-paced, dynamic and convergent industry, which demands that its products and services be continuously revamped to keep up with growth expectations. Accordingly, since 2005, the company created a new Strategic Innovation Unit that aims to develop new products and services to be tested or launched by the company in the near future.

Also, to keep pace with constant innovation, Telefônica Brasil created a business incubator that helps the organization to easily handle emerging business opportunities of large sizes or risks that otherwise would be difficult to manage in the context of current business units. In 2012, R\$0.7 million was invested in innovation.

The table below presents the Telefônica Brasil investments in development, update and modernization of systems to support the launch of new products, improve the external plant inventory quality and take advantage of the new rules for technology businesses. Seeking to continually improve and modernize its services, the company partnered with

partners specialized in R&D such as the CPqD and Telefônica Pesquisa e Desenvolvimento (TPD). In 2012, R\$22.7 million was invested in development.

R&D investments	2012	2011	2010
	(in millions of reais)		
Development	22.7	44.6	12.5
Innovation (business incubator and tests)	0.7	1.3	6.8
Total	23.4	45.9	19.3

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The partnership between Telefônica Brasil and CPqD allows Telefônica Brasil to keep informed of technical research services, development of new features in current systems, and services in the areas of consulting and training. Telefônica Brasil can benefit from the use of a specific tool that monitors and manages data of cables, optical fiber and the level of use of its external network.

The partnership between Telefônica Brasil and TPD allows the organization to transfer to an automatic model of management of the planning and operation network focused on performance.

Vivo maintains partnerships with the Universidade Federal do Rio Grande do Sul (UFRGS). Such partnerships permit Vivo to have laboratories at the universities, which conduct research and development of new technologies, and which support and push innovative processes. Vivo also solidified a partnership at the end of 2004 with the Centro de Pesquisas e Desenvolvimento em Campinas—São Paulo (CPqD), to assess and study new technologies. Vivo also relies on the research and development of our third-party suppliers.

## Patents and Licenses

Our principal intellectual property assets include:

- permission to use the trademark name “Telefônica” and all names derived from “Telefônica”;
- our name “Telefônica Brasil S.A.”;
- our commercial brand in Brazil “Vivo” and its sub-brands such as “Vivo Móvel”, “Vivo Fixo”, Vivo TV”, “Vivo Internet”, “Meu Vivo”, “Vivo Empresas,” among others;
- our past commercial brands, “Super 15” for long-distance services and “Speedy” for broadband products, “DUO” for telephone and broadband service and “TRIO” for telephone, broadband and Digital TV service.

## D. Trend Information

For 2013, we expect an improvement in the macroeconomic scenario, leveraged by an uptake in investment levels. Consumption will lead to another year of growth in the telecommunication market revenues, driven by services penetration mainly in data and TV. We expect companies in the industry to maintain the trend of consolidation and to offer integrated (bundled) services, increasing pressure on ARPUs and opening a gap between accesses and revenues growth. Data services (mobile and fixed) will be the most relevant growth driver, leveraged by the adoption of smartphone and services beyond connectivity. In the fixed-line business, we bet on the technological evolution as the way to explore the ultra-broadband and Pay TV markets value. We are well positioned to explore this opportunities, since our organization and resources are focused on developing business in these areas, always sustained by a quality of services differentiated from our competitors.

## E. Off-balance-Sheet Arrangements

None.

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## F. Tabular Disclosure of Contractual Obligations

Our contractual obligations and commercial commitments as of December 31, 2012 are as follows:

	Total	Less than 1 year	1-3 years	4-5 years	After 5 years
	(In thousands of reais, as of December 31, 2012)				
Contractual obligations					
Long-term debt (1)	7,967,229	1,957,538	2,898,636	2,816,762	294,293
Pension and other post retirement benefits	392,269	6,119	12,046	11,684	362,420
Other long-term obligations including					
leases	9,906,827	1,230,640	2,380,900	2,835,176	3,460,111
Total contractual cash obligations	18,266,325	3,194,297	5,291,582	5,662,622	4,116,824
Commercial commitments					
Suppliers	5,889,377	5,889,377	–	–	–
Other commercial commitments	–	–	–	–	–
Total commercial commitments	5,889,377	5,889,377	–	–	–

(1) Includes interest payments.

## Long-Term Debt - Principal

Year ending December 31,	Amount (in thousands of reais, as of December 31, 2012)
2014	1,300,124
2015	1,159,235
2016	439,277
2017	2,389,703
2018	427,059
2019 and forward	294,293
Total	6,009,691

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## ITEM 6. DIRECTORS, SENIOR MANAGEMENT AND EMPLOYEES

## A. Directors and Senior Management

We are managed by a Board of Directors (Conselho de Administração) and an Executive Committee (Diretoria).

## Board of Directors

Our Board of Directors comprises a minimum of 05 and a maximum of 17 members, all shareholders, serving for a term of three years. The following is a list of the current members of the Board of Directors, their respective positions and dates of their election.

Name	Position	Date of Appointment
Antonio Carlos Valente da Silva	Chairman	April 07, 2010
Santiago Fernández Valbuena	Vice-Chairman	November 7, 2011(**)
Antonio Gonçalves de Oliveira	Director	November 7, 2011(**)
Eduardo Navarro de Carvalho	Director	November 7, 2011 (**)
Fernando Abril-Martorell Hernández	Director	April 7, 2010
Fernando Xavier Ferreira	Director	April 7, 2010
Francisco Javier de Paz Mancho	Director	April 7, 2010
José Fernando de Almansa Moreno-Barreda	Director	April 7, 2010
José Manuel Fernandez Norniella	Director	May 19, 2010 (*)
Luciano Carvalho Ventura	Director	April 7, 2010
Luis Bastida Ibarguen	Director	April 7, 2010
Luis Fernando Furlan	Director	April 7, 2010
Narcís Serra Serra	Director	April 7, 2010
Paulo Cesar Pereira Teixeira	Director	November 7, 2011 (**)
Roberto Oliveira de Lima	Director	November 7, 2011 (**)

(\*) The members of the Board of Directors have the mandate until the ordinary general meeting of 2013.

(\*) The Board member José Manuel Fernandez Norniella was appointed by the Board of Directors in May 19, 2010, as provided by Article 150 of Law 6,404/76, replacing Mr. Juan Carlos Ros Brugueras. His election was ratified at the General Shareholders' Meeting of August 12, 2010.

(\*\*) The Board members Santiago Fernández Valbuena, Antonio Gonçalves Oliveira, Eduardo Navarro de Carvalho, Paulo Cesar Pereira Teixeira and Roberto Oliveira de Lima were appointed by the Board of Directors at a meeting dated November 07, 2011, as provided by Article 150 of Law 6,404/76. Their elections were ratified at the General Shareholders' Meeting of April 11, 2012.

Set forth below are brief biographies of our directors:

Antonio Carlos Valente da Silva is 60 years old and acts as Chairman of the Board of Directors of Telefônica Brasil S.A. since December 2006, Chief Executive Officer of Telefônica Brasil S.A. since January 2007 and member of the Committee of Appointments, Compensation and Corporate Governance of Telefônica Brasil S.A. He is the Chief Executive Officer of Vivo S.A., A. Telecom S.A., Telefônica Data S.A., Telefônica Sistemas de Televisão S.A., AJato Telecomunicação Ltda, Lemontree Participações S.A., GTR-T Participações e Empreendimentos S.A., Comercial Cabo TV São Paulo S.A. and TVA Sul Paraná S.A.. He is also the President of the Board of Trustees of Fundação Telefônica, Vice-President Director of SP Telecomunicações Participações Ltda., Chairman of the Board of Directors

of Telefônica Factoring do Brasil Ltda., member of the Control Committees of Media Networks Brasil Soluções Digitais Ltda. and of Telefônica Serviços Empresariais do Brasil Ltda. He was the Chief Executive Officer of Vivo Participações S.A. from May 10, 2011 until October 03, 2011, date on which Vivo Participações S.A. was merged into the Company. He was also a member of the Board of Directors of Telefônica Internacional S.A. He is the President of Telebrasil (Brazilian Association of Telecommunications), President of Sinditelebrasil (National Union of Fixed and Mobile Telephone Service Operators), President of Febratel (Brazilian Federation of Telecommunications), President of Ahciet (Asociación Iberoamericana de Centros de Investigación y Empresas de Telecomunicaciones) in the period from 2007 to 2011, President of the Official Spanish Chamber of Commerce in Brazil and President of the Euro-chambers in Brazil (an association that gathers the main Chambers of

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Commerce in the European Union). He is also a member of the CDES (Economic and Social Development Council of the Presidency of the Republic of Brazil), member of the Advisory Council of CPqD, (Telecommunications Research and Development Center), member of the Executive Committee of ABDIB (Brazilian Infrastructure and Base Industries Association), and member of COINFRA (FIESP's Infrastructure Commission). He was the Chief Executive Officer of Telefônica in Peru until November 2006 and Chairman of the Board of Directors of Telefônica Móviles S.A., Telefônica Móviles Peru Holding S.A.C., Telefônica Peru Holding S.A.C. and Telefônica Multimedia S.A.C. He was also the First Vice-President of the Association for Private and Public Utilities Companies (ADEPSEP) and director of the Official Spanish Chamber of Commerce in Peru (COCEP). Prior to his appointment as Chief Executive Officer of Telefônica in Peru, he was in charge for the regulatory management of Grupo Telefônica in Latin America. He was a Vice-President of the Brazilian National Telecommunications Agency (Anatel), member of the Management Board of Anatel, chief and member of several Brazilian delegations at international conferences and, in the period from 2002 to 2003, he was President of the Latin-American Forum for Telecommunications Regulators (Regulatel), an institution that gathers regulatory agencies of nineteen countries in Latin America. He was the Chairman of the Board of Telest, (Telecommunications of Espírito Santo State), was a member of the board of directors of Perdigão S/A and of Paranapanema. He also occupied several managing positions in the Telebrás System, in the areas of Telecommunication Systems Engineering, Technical Operating Planning and Corporate Planning. He worked for the Communications Ministry, being a member of the team that carried out the restructuring of the Brazilian Telecommunications System. Antonio Carlos Valente has a B.S. degree in Electrical Engineering from PUC/RJ, has large experience in the telecommunications market, in which he has been working since 1975. He has an MBA degree from PUC/RJ, has concluded several specialization courses in telecommunication systems in Brazil and abroad, and several specialization courses in Business Management, including Corporate Strategy at MIT/Sloan.

Santiago Fernández Valbuena is 54 years old and acts as Vice-Chairman of the Board of Directors. President of Telefónica Internacional, S.A. He is Chief Executive Officer of SP Telecomunicações Participações Ltda. Since 2012 he has been a member of the board of directors of Telefonica S.A. In 2010, he acted as Finance, Strategy and Development Officer of the company. From 2005 to 2010, he was Finance and Corporate Development Officer. He was a member of the executive Board of Portugal Telecom and Endemol Holding (Netherlands). Since 2008, he is President of the Control and Audit Committee and Board Member of Ferrovia. From 2006 to 2008, he was a Board Member of Gecina. From 1999 to 2007, he was Vice President of Metrovacesa, S.A.

Antonio Gonçalves de Oliveira is 68 years old and is a member of our Board of Directors and Control and Audit Committee. Mr. Oliveira is also a member of the Board of Directors of Paranapanema S.A. and the fiscal committee of Klabin S.A. He was a member of the Board of Directors of Vivo Participações since March 2001 and Control and Audit Committee since July 2005. Mr. Oliveira was also a member of the Board of Directors of TELESP Celular S.A. and a member of the Board of Directors or Control and Audit Committee of the following businesses: Tele Sudeste Celular Participações S.A., Telemig Celular Participações S.A., Telemig Celular S.A., Tele Leste Celular Participações S.A., Tele Centro Oeste Celular Participações S.A. and Celular CRT Participações S.A., until these companies ceased to exist. Mr. Oliveira was the chairman of the Fiscal Council of Bahia's Electricity Company (Companhia de Eletricidade da Bahia), or COELBA, from April 2006 to April 2008, chairman of the Association of Friends of the Museum of Contemporary Art of USP (Associação de Amigos do Museu de Arte Contemporânea da USP), or AAMAC, from 2006 to 2010, member of the Fiscal Counsel of Iguatemi Shopping Centers, from 2007 to 2008, and Melpaper, from 2009 to 2010, and a member of the Council of Representatives of the Federation of Industries of São Paulo (Federação das Indústrias do Estado de São Paulo), or FIESP. Mr. Gonçalves de Oliveira is a member of the Advisory Board of The Welfare Fund for Employees of Banco do Brasil (Caixa de Previdência dos Funcionários do Banco do Brasil), or PREVI, from 2008 to 2012 and was a member of the Council of Social and Economic Development of the Brazilian government and the Working Group for Small and Medium Enterprises also sponsored by the Brazilian government. He was leader of ADEBIM (Associação de Empresas Brasileiras para a Integração de Mercados), member of the Steering Committee and Management of the Banco do Povo de Estado de São Paulo and Chairman of the Deliberative Board of the Association of Brazilian Companies for Market Integration



(Associação Nacional dos Funcionários do Banco do Brasil), or ANABB, for eight years. In the role of sociologist, was president of the Association of Sociologists of the State of São Paulo, for 6 years, and director, for 4 years, the Latin American Association of Sociology. Mr. Oliveira was the executive coordinator of the National Movement of Micro and Small Enterprise (Movimento Nacional da Micro e Pequena Empresa). Mr. Gonçalves holds a degree in Social Sciences, a master's degree in Communication Sciences and a post-graduate degree in Sociology of Organizations from the University of São Paulo (Universidade de São Paulo) in Brazil. He also holds a specialist title in Human Resources from Fundação Getulio Vargas in São Paulo and extension courses on business

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management topics. Mr. Oliveira is Certified Counselor by the Brazilian Institute of Corporate Governance, IBGC, due to its experience in supervisory boards and management boards.

Eduardo Navarro de Carvalho is 50 years old and is a member of our Board of Directors and President of the Service Quality and Marketing Committee. He is currently Director of Strategy and Alliances at Telefónica SA and member of the Executive Committee of Telefónica SA. Previously, he was responsible for Strategic Planning and Regulatory at Telefónica Internacional. From 1999 and 2005, he served as Vice President of Corporate Strategy and Regulatory Group at Telefonica in Brazil, participating in the Steering Committee of several companies of the Telefónica Group in Brazil. He worked for five years as a consultant at McKinsey & Company (1994-1999), during which he led projects in Brazil, Spain, Portugal and South Africa, focusing on strategies in the areas of Industry, Infrastructure and Telecommunications. He began his professional experience in the steel industry, where he worked from 1986 and 1994 in Group ARBED in Brazil. He graduated in Metallurgical Engineering from the Federal University of Minas Gerais, Brazil.

Fernando Abril-Martorell Hernández is 50 years old and serves on our Board of Directors. He is also CEO of Prisa, a member of the Board of Directors of ENCE (the Spanish pulp producer). From 1987 to 1997, Mr. Abril-Martorell Hernández performed several functions at JP Morgan, in New York, London and Madrid, including treasury department manager and member of the managing committee. Mr. Abril-Martorell Hernández joined the Telefónica group in January of 1997, as corporate finance general manager, having represented the group's interests in the Brazilian telecommunications industry privatization process. From December 1998 to June 2000, he served as chief executive officer and chief financial officer of Telefónica Publicidad e Información (TPI). He was COO and a member of the Board of Directors of the Telefónica Group from August 2000 to September 2003. In 2005, he joined Credit Suisse Group in Spain as Managing Director and Chief Executive Officer. Mr. Abril-Martorell Hernández holds a degree in law and business sciences from ICAI-ICADE (Instituto de Postgrado y Formación Continua), Spain.

Fernando Xavier Ferreira is 64 years old and acts as a member of our Board of Directors. Mr. Ferreira is a member of our Audit and Control Committees. He is Vice President of "COINFRA" (Conselho Superior de Infra-Estrutura da FIESP), an executive officer of "ABDIB" (Associação Brasileira da Infra-Estrutura e Indústrias de Base), member of the Board of Directors of Boa Vista Serviços, Triunfo Participações e Investimentos-TPI, Alupar and Ouro Verde, and served as the chief executive officer of Telecomunicações de São Paulo S.A. (predecessor to Telefônica Brasil S.A.) and SP Telecomunicações Holding Ltda. He was president of the Supervisory Board of Brasilcel N.V., president of the Boards of Directors of Vivo Participações, and Fundação Telefônica. He was a member of the Board of Directors of Telefónica Internacional S.A. Mr. Ferreira has served as president of Telecomunicações Brasileiras S.A.–Telebrás, executive secretary in the Brazilian Ministry of Communications, chairman of the Board of Directors of Embratel S.A., president of Northern Telecom do Brasil S.A., Brazilian General Director of Itaipu Brazilian Binacional, president of Telecomunicações do Paraná S.A.–Telepar and as member of ANATEL's consulting committee and member of the Board of Directors of Empresa Brasileira de Correios e Telégrafos–ECT and Portugal Telecom and Professor in the Department of Microwave in Electrical Engineering from Universidade Federal do Paraná. Participated as a member or chairman of the Board of Directors of several companies. He holds a degree in telecommunications engineering from Faculdade de Engenharia Elétrica da Universidade Católica do Rio de Janeiro, the Electric Engineering Faculty of the Catholic University of Rio de Janeiro, Brazil, which he received in 1971. He attended the Management Training Course School of Business Administration University of Western Ontario, Canada, in 1982.

Francisco Javier de Paz Mancho is 54 years old and serves as a member of our Board of Directors. Mr. Mancho is also a member of the Board of Directors of Telefónica S.A. and Telefónica de Argentina S.A. Since July 2006 he has been a member of the Executive Committee of the Superior Board of Councils. From June 2004 until December 2007, he was the President of Mercasa. He was Counselor deputy to the President and Director of the Strategic Corporate area of Panrico Donuts Group (1996–2004), General Director of the Ministry of Commerce and Tourism (1993–1996),

General Secretary of Unión de Consumidores de España (UCE). Delegate Counselor of Ciudadano magazine (1990–1993), General Secretary of Juventudes Socialistas and executive member of PSOE (1984–1993). Also, he has acted in the following capacities: counsel of Túnel del Cadí (2004–2006), President of Patronal Pan and Bollería Marca (COE) (2003–2004), counsel of Mutua de Accidents of Zaragoza (MAZ) (1998–2004), counsel of Panrico Group (1998–2004), President of Observatorio de la Distribucion Comercial del Ministerio de Comercio y Turismo (1994–1996), Member of the Social and Economic Council and Permanent Commission (1991–1993 and 1996–2000) and counsel of Tabacalera, S.A. (1993–1996). Mr. Mancho holds degrees in Information and Publicity and a degree in law studies from the Executive Management Program of IESE (Universidad de Navarra).

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José Fernando de Almansa Moreno-Barreda is 64 years old and is a member of our Board of Directors and President of the Nominations, Compensation and Corporate Governance Committee. He is a member of the Board of Directors of Telefónica and President of the Board's International Affairs Committee. He is also a member of the Board of Directors of Telefónica de Peru S.A., Telefónica Latinoamérica S.A., Telefónica Moviles México S.A. de CV, and BBVA Bancomer Mexico. He was a member of the Board of Directors of Telefonica Argentina S.A. Mr. Almansa joined the Spanish Diplomatic Corps in 1974 and served from 1976 to 1992 as Embassy Secretary of the Spanish Embassy in Brussels, Cultural Counselor of the Spanish Representation to Mexico; Chief Director for Eastern European Affairs and Atlantic Affairs Director in the Spanish Foreign Affairs Ministry; Press and Political Counselor to the Spanish Permanent Representation to the North Atlantic Council in Brussels; Minister-Counselor of the Spanish Embassy in the Soviet Union; General Director of the National Commission for the 5th Centennial of the Discovery of the Americas and Deputy General Director for Eastern Europe Affairs in the Spanish Foreign Affairs Ministry. In January 1993, Mr. Almansa was appointed Chief of the Royal Household by His Majesty King Juan Carlos I. He held this post until December 2002 and is currently Personal Adviser to His Majesty King Juan Carlos I. Mr. Almansa holds a law degree from the Universidad de Deusto, Bilbao, Spain. He is a sponsor, among other affiliations, of the Foundations Reina Sofía, Conde de Barcelona, Diputación de San Andrés de los Flamencos - Carlos de Amberes Foundation, Padre Arrupe-Activa, Principe de Asturias and Euroamérica.

José Manuel Fernandez Norriella is 67 years old and he is a member of our Board of Directors and a member of the Nominations, Compensation and Corporate Governance Committee. Mr. Norriella held executive positions from 1972 to 1981 at Electromecanica, Alfa Laval and Blackstone SWG. From 1981 to 1985 he was Risk and Provisions Officer and Asea Brown Boveri S.A., from 1985 to 1993 he was Media and Provisions Officer, Real Estate Officer, Turbochargers Officer and Chief Administrative Officer of Asea Brown Boveri S.A. Mr. Norriella was a Board member at RTVE, Argentaria, Enagas, Endesa, Telvent, Campos Chilenos, Iansa, Vice President of Chilectra (Chile) and member of the Advisory Committee of Abengoa and Accenture. He was elected a Congressman for Madrid in 1993, and was also State Secretary of Commerce, Tourism and Small and Medium Enterprises, and represented Spain as an Adjunct Officer before the World Bank, International Development Bank and European Development Bank. Between 1998 and 2005, he was President of the superior Council of Commerce Chambers of Spain and member of the International Commerce Chamber. From 1998 to 2000, Mr. Norriella was Executive Vice President of Aldeasa and Executive President of Ebro Puleva from 2000 to 2005. He is currently Honorary President of Ebro Puleva, board member of Mapfre America and Telefônica Brasil S.A. He was External Counsel to Iberia since 2003 until its merger with BA, being currently an External Counsel to IAG. Mr. Norriella is also Vice President of the Board of Caja Madrid, of BFA and Executive Board Member of Bankia S.A. Mr. Norriella holds a degree in electrical engineering from Universidad Politécnica de Madrid and has a diploma in Logistics and Risks. He also received the distinction of La Gran Cruz de Isabel la Católica (Spain), Knight of the Bernardo O'Higgins Order (Chile), the Verdienstkreuz mit stern (Germany) and the Order to Civil Merit (Poland).

Luciano Carvalho Ventura is 65 years old and is member of our Board of Directors and a member of the Service Quality and Marketing Committee. He is the officer responsible for LCV Corporate Governance. He serves as a member of the Board of Directors of the Jose Alves Group and of the Grupo Itapemirim. Since 1980, he has been dedicated to corporate governance consulting and serving as an independent member of corporate boards. He is a founding member of the Instituto Brasileiro de Governança Corporativa-IBGC-Brasil (Brazilian Corporate Governance Institute) and he was a member of its Board of Directors. He was a member of the International Corporate Governance Network - England. He is professor of the course for formation of directors of the Brazilian Corporate Governance Institute and a speaker at various masters courses and seminars. He holds an MBA from Escola de Administração de Empresas de São Paulo-Fundação Getúlio Vargas, a post-graduate degree in finance from Escola de Administração de Empresas de São Paulo da Fundação Getúlio Vargas, a degree in business management from Escola de Administração de Empresas da Universidade Federal de Pernambuco, and a degree in economics from Faculdade de Ciências Econômicas da Universidade Federal de Pernambuco.

Luis Bastida Ibarguen is 67 years old and is a member of our Board of Directors and President of the Control and Audit Committee. Since 2002, he has acted as an independent consultant. During 2000 and 2001, worked in Banco Bilbao Viscaya Argentaria, where he was a member of the Steering Committee and head of the Global Asset Management Division. Mr. Bastida began working at Banco Bilbao Vizcaya Argentaria in 1988. In the period from 1994 to 2000, he was Chief Financial Officer (CFO), reporting directly to the Chairman. From 1976 to 1987, he worked at Banco Bilbao, where he had different responsibilities, mainly in areas related to finance. From 1970 to 1976, he worked for General Electric in New York and Spain. At General Electric, he was a member of the Finance Management Program and the International Management Program and worked in various capacities in the Finance

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and Strategic Planning Functions. He holds degrees in Business at the E.S.T.E. University in San Sebastián–Spain and holds an MBA from Columbia University in New York.

Luiz Fernando Furlan is 66 years old and is a member of the Boards of Directors of Telefônica Brasil S.A. (Brasil), Telefónica S.A. (Spain), AMIL Participações S.A. (Brasil), BRF–Brasil Foods S.A. (Brasil), AGCO Corporation (USA), as well as a member of the advisory board of Panasonic (Japan) and Wal-Mart (USA). Previously, he was Chairman of the Board of Directors at Sadia S.A., from 1993 to 2002 and from 2008 to 2009, company that he has held numerous executive positions from 1976 to 1993. He was Co-Chairman of the board of BRF Brasil Foods S.A. from 2009 to 2010, as well as a member of the board of Redecard S.A. from 2007 to 2010. He served two terms as Minister of Development, Industry and Foreign Trade of Brazil from 2003 to 2007. He holds a degree in Chemical Engineering from FEI (Industrial Engineering Faculty) and in Business Administration from University of Santana – São Paulo, with extension and specialization courses in Brazil and abroad.

Narcís Serra Serra is 69 years old and serves as a member of our Board of Directors and a member of the Nominations, Compensation and Corporate Governance Committee. From 1991 to 1995, he was Vice President of the Government of Spain, and from 1982 to 1991, served as Minister of Defense. From 1979 to 1982, he was the Mayor of Barcelona. Mr. Serra holds a doctorate in economics from the Universidad Autónoma de Barcelona and is President of Barcelona Institute for International Studies (IBEL).

Paulo Cesar Pereira Teixeira is 55 years old and is a member of our Board of Directors. Mr. Teixeira also acts as a General and Executive Officer and as interim Chief Financial Officer, Control and Investor Relations Officer of Telefônica Brasil S.A. He is member of Executive Committee of Vivo, Lemontree Participações S.A., TVA Sul Paraná S.A., GTR-T Participações e Empreendimentos S.A., Comercial Cabo TV São Paulo S.A., A. Telecom S.A., Telefônica Data S.A., Telefônica Sistema de Televisão S.A. and AJato Telecomunicação Ltda. He is also a member of the Board of Trustees of Fundação Telefônica. He was Chief Executive Officer of Vivo Participações from September 13, 2011 to October 3, 2011 (when it was merged into the company). He began his career in the telecommunications industry in 1985, as a member of CRT’s Directive Council. At Vivo, he was responsible for the Individual and Residential Market business unit, involved in customer relations, mobile marketing, fixed marketing, planning and commercial and regional management. From 2003 to 2011, he was the Executive Vice President of Operations at Vivo. From 1997 to 2003, he acted as Vice President of Operations for Telefônica Celular, Vice President and Enterprise Officer of the Telebrás System, board member of Tele Sudeste, Tele Leste and CRT, president of the Brazilian Roaming Association (ABR) and National Association of Cellular Providers (ACEL). Mr. Teixeira holds an electrical engineering degree from Universidade Católica de Pelotas, Brazil. He attended a New Telecommunications Techniques course at École Nationale Supérieure des Télécommunications, France, in 1992.

Roberto Oliveira de Lima is 61 years old and serves as a member of our Board of Directors and a member of the Service Quality and Marketing Committee. Mr. Lima is also a member of the Board of Directors of Edenred SARL, based in Paris/França, MIH Holdings Ltd, based in Johannesburg, Cia Brasileira de Distribuição, based in São Paulo/Brazil, Natura S.A., based in São Paulo, and Rodobens Negocio Imobiliarios, based in São Paulo/Brazil. He was the Chief Executive Officer of Vivo Participações and Vivo and Officer of TBS Celular Participações Ltda., Ptelecom Brasil S.A. and Portelcom Participações S.A. until May, 2011, all subsidiaries of Brasilcel N.V.; he was also Chief Executive Officer of Instituto Vivo. Mr. Lima was Executive Vice President of Marketing and Innovation and Vice President of IT and Products and Services Engineering of the following companies: Vivo Participações and Vivo, Tele Centro Oeste Celular Participações S.A., Telerj, Telest, Telebahia, Telergipe, Celular CRT S.A., TELESP Celular, Global Telecom, Telegoiás, Telemat, Telems, Teleacre, Teleron, NBT and TCO IP S.A. He was also Chief Executive Officer of Tele Sudeste Celular Participações S.A., Tele Leste Celular Participações S.A. and Celular CRT Participações S.A. until 2006 and Telemig Celular Participações S.A. until November, 2009. He was an Officer of Telemig Celular Participações S.A., Avista Participações Ltda., Tagilo Participações Ltda., Sudestecel Participações Ltda. and Vivo Brasil Comunicações Ltda. until November, 2009. He was Chairman of the Board of Directors of

Grupo Credicard from 1999 to 2005 and Chief Executive Officer of Banco Credicard S.A. from 2002 to 2005. Mr. Lima also held executive positions at Accor Brasil S.A., Rhodia Rhone Poulenc S.A. and Saint Gobain S.A. He holds a degree in business administration and an MBA from Fundação Getúlio Vargas, Brazil. He holds a master's degree in Finance and Strategic Planning from the Institute Superieur des Affaires, Jouy en Josas, France.

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## Executive Committee

The executive committee consists of at least four and no more than fifteen members, who may or may not be our shareholders, all of them appointed by our Board of Directors for a period of three years and who may remain in office until reappointed or replaced. Any of our executive officers may be removed at any time by a decision of the Board of Directors.

The following are the current members of the executive committee, their respective positions and the date of their appointment.

Name	Position	Date of Appointment
Antonio Carlos Valente da Silva	Chief Executive Officer	May 19, 2010
Paulo Cesar Pereira Teixeira	General and Executive Officer and as interim Chief Financial Officer, Control and Investor Relations Officer	September 13, 2011
Breno Rodrigo Pacheco de Oliveira	General Secretary and Legal Officer	June 14, 2011

Set forth below are brief biographies of our executive officers:

Breno Rodrigo Pacheco de Oliveira is 37 years old. Is General Secretary and Legal Officer of Telefônica Brasil S.A., Vivo, A. TELECOM S.A., Telefônica Data S.A., Telefônica Sistema de Televisão S.A. , AJato Telecomunicação Ltda, Lemontree Participações S.A., TVA Sul Paraná S.A., GTR-T Participações e Empreendimentos S.A. and Comercial Cabo TV São Paulo S.A. He is also a member of the Deliberative Council of Visão Prev Sociedade de Previdência Complementar and Officer of SP Telecomunicações Participações Ltda.. Mr. Oliveira is also Corporate Secretary of the Board of Directors of Telefônica Factoring do Brasil Ltda., Corporate Secretary and member of the Board of Directors of Telefônica Corretora de Seguros Ltda., member of the Control Committee of Media Networks Brasil Soluções Digitais Ltda., Telefônica Serviços Empresariais do Brasil Ltda. and Telefônica Engenharia de Segurança do Brasil Ltda. He was General Secretary and Legal Officer from February 3, 2011 to October 3, 2011 of Vivo Participações (when it was merged into the company) and of Vivo from April, 2005 to February, 2011. He holds a law degree from Universidade do Vale do Rio dos Sinos – UNISINOS, Brazil.

For the biographies of Antonio Carlos Valente da Silva and Paulo Cesar Pereira Teixeira, see “—Board of Directors.”

## B. Compensation

For the year ended December 31, 2012, the aggregate amount of compensation paid to all our Directors and Executive Officers was approximately R\$21.6 million, of which R\$16.9 million corresponded to salaries and R\$4.7 million corresponded to bonuses.

For the year ended December 31, 2012, our Directors and Officers did not receive any pension, retirement or similar benefits.

## C. Board Practices

### Board of Directors



Our Board of Directors typically meets once every three months and the Chairman may call special meetings. Our Board takes action by majority vote, provided the majority of its members in office are present, with the Chairman having, in addition to his or her regular vote, the deciding vote in the event of a tie. The specific responsibilities of the Chairman include representing the Board in the General Shareholders Meetings, chairing the General Shareholders Meetings, selecting the Secretary from among those present, and calling and chairing meetings of the Board.

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Our Board of Directors is responsible, among other things, for:

- establishing our general business policies;
- electing and removing the members of our executive committee, and establishing their responsibilities with due regard for legal and statutory provisions;
  - supervising our management and examining our corporate records;
  - calling General Shareholders Meetings;
- approving the financial statements, management reports, proposals for allocation of the company's results and the submission of such documents to the General Shareholders Meeting;
  - appointing and deposing external auditors;
  - determining the distribution of interim dividends;
  - determining the payment of interest on equity "ad referendum" of the General Shareholders Meeting;
    - authorizing the purchase of our shares to be cancelled or kept in treasury;
    - appointing and removing the person responsible for internal auditing;
    - approving the budget and annual business plan;
- deliberating on the issuance of new shares by increasing the corporate capital within the limits authorized by the bylaws;
  - approving the issuance of commercial paper and depositary receipts;
  - authorizing the sale of fixed and concession-related assets;
- approving agreements, investments and obligations in an amount greater than R\$250 million that have not been approved in the budget;
- approving employment and compensation plans, incentive policies and professional development, regulation and staffing of the company, and the terms and conditions of collective bargaining agreements to be executed with unions representing various categories of the company's employees and adhesion or disassociation from pension plans, all with respect to employees of the company; the Board of Directors can, at its own discretion, assign to the company's officers limits to deliberate on these matters;
- authorizing the acquisition of interest in other companies on a definitive basis and the encumbrance and creation of lien on or sale of an equity interest;
  - authorizing the offering of ordinary nonconvertible unsecured debentures;
- approving the organizational structure of the company; the Board of Directors can assign to the officers limits to the exercise of such powers, subject to legal and bylaws provisions;

- approving and modifying the internal regulations of the Board of Directors;
  - deliberating as to the issuance of warrants;
- deliberating, by delegation of the General Shareholders Meeting, about the following aspects related to company debentures: (i) opportunity to issue, (ii) time and conditions of expiration, amortization or redemption, (iii) time and conditions of the payment of interest, of the participation in the profits and of the premium of repayment, if any, (iv) method of subscription or placement, and (v) the type of debentures;

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- approving the establishment of technical and advisory committees for advice on matters of interest to them, to elect members of such committees and approve the committees, internal regulations, which shall contain specific rules concerning their organization, functions, powers, and compensation of members;
- authorizing the sale of property, the creation of in rem guarantees and the provision of guarantees on behalf of third parties, and setting limits on the practice of such acts by the officers;
- establishing, as an internal regulation, the limits for the officers to authorize the disposition or encumbrance of permanent assets, including those related to public telecommunications services which are disabled or inoperable;
- approving the company’s participation in consortia in general, and the terms of such participation; the Board of Directors may delegate such powers to the officers and establish limits, as it seeks to develop activities in line with the company’s purpose;
- setting the limits for the officers to authorize the practice of reasonable gratuitous acts for the benefit of employees or the community of which the company is a part of, including the donation of unserviceable assets to the company; and
  - approving the creation and closure of subsidiaries of the company, in Brazil or abroad.

The members of our Board of Directors are all shareholders, one of them being elected by the preferred shareholders in a separate voting process and the others being elected by the holders of common shares. The members of the Board of Directors are elected for a period of three years and may be reelected.

Executive Committee

Our Executive Committee is responsible for our day-to-day management and for representing us in our business with third parties. Each of our current Executive Officers has been appointed by our Board of Directors for a three-year term and may remain in office until reappointed or replaced.

Fiscal Board

Brazilian Corporate Law and our bylaws each require that we maintain a statutory Fiscal Board (Conselho Fiscal). Our statutory Fiscal Board, which is a separate and distinct entity from our outside auditors, is primarily charged with certain advisory, reporting, oversight and review functions with respect to the company’s financial statements. Our statutory Fiscal Board is also responsible for rendering opinions on management’s annual report and management proposals, including financial statements, to be submitted at shareholders meetings relating to a change in the company’s capital composition, investment plans, budget, debenture issuances or subscription bonuses, payment of dividends and consolidations, mergers and spin-offs. However, the statutory Fiscal Board, as required by Brazilian Corporate Law and our bylaws, has only an advisory role and does not participate in the management of the company. Indeed, decisions of the statutory Fiscal Board are not binding on the company under Brazilian Corporate Law.

In accordance with Brazilian Corporate Law and our bylaws, the Fiscal Board consists of a minimum of three and a maximum of five active members and an equal number of alternates.

One member of the Fiscal Board and his or her alternate must be elected by holders of preferred shares in a separate voting process. The following are the current members of the Fiscal Board:

Members	Alternates	Date Appointed
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Flavio Stamm	Gilberto Lerio	April 11, 2012
Cremênio Medola Neto	Oswaldo Vieira da Luz	April 11, 2012
Stael Prata Silva Filho	Charles Edwards Allen	April 11, 2012

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Committees

Brazilian Corporate Law does not require a corporation to maintain committees responsible for ethics, corporate governance or compensation. Nevertheless, our Board of Directors has created the following committees:

- Control and Audit Committee;
- Nominations, Compensation and Corporate Governance Committee; and
- Service Quality and Marketing Committee.

Control and Audit Committee

Our Control and Audit Committee was created by our Board of Directors in December 2002 and comprises a minimum of three and a maximum of five directors, who are not members of our executive committee, and who are appointed by the Board of Directors to serve as members of the Control and Audit Committee for the duration of their respective terms as members of the Board of Directors. The Committee has its own charter, which was approved by the Board of Directors. The Committee provides support to the Board of Directors.

According to its charter, the Control and Audit Committee shall meet four times per year and report its conclusions to the Board of Directors. We anticipate that there will be some similar functions between the Control and Audit Committee and our statutory Fiscal Board.

The Control and Audit Committee, among other responsibilities that may be required by the Board of Directors, is charged with informing and providing recommendations to the Board of Directors regarding the following:

- the appointment, termination and renewal of the independent auditors, as well as the terms and conditions of the contract with the independent auditors;
- the analysis of the company's accounts, compliance with certain legal requirements and the adoption of generally accepted accounting principles;
- the results of each internal and independent audit and management's response to the auditor's recommendations;
- the quality and integrity of the company's internal control systems;
- the performance of the independent auditors, requesting opinions on the annual reports and that the main audit reports be clear and precise; and
- any communications with the internal auditors about any significant deficiencies in our control systems and identified financial conditions.

The following are the current members of the Control and Audit Committee:

Members	Date Appointed
Luis Bastida Ibarguen	May 19, 2010
Antonio Gonçalves de Oliveira	November 07, 2011
Fernando Xavier Ferreira	February 15, 2012

Nominations, Compensation and Corporate Governance Committee

Our Nominations, Compensation and Corporate Governance Committee was established in November 1998, and was restructured in October 2004, and consists of three to five directors appointed by the Board of Directors to serve for the duration of their respective terms as members of the Board of Directors. The Nominations, Compensation and Corporate Governance Committee, among other responsibilities that may be required by the Board of Directors, is charged with informing and providing recommendations to the Board of Directors regarding the following:

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- the appointment of executive officers for our company and our subsidiaries;
- the parameters on compensation for our executive officers and administrators;
- the terms and conditions of executive officers, employment agreements;
- the review of the Board’s compensation plan and any amendments;
  - the incentive plans related to compensation;
- the compensation policy for directors and executive officers of the company; and
  - the annual corporate governance report.

The following individuals are the current members of the Nominations, Compensation and Corporate Governance Committee:

Members	Date Appointed
José Fernando de Almansa Moreno-Barreda	May 19, 2010
Antonio Carlos Valente da Silva	May 19, 2010
Narcis Serra Serra	November 05, 2012
José Manuel Fernandez Norniella	May 19, 2010

Service Quality and Marketing Committee

The Service Quality and Marketing Committee was created on December 16, 2004 and provides assistance to our Board of Directors. The Committee consists of at least three, and at most five, members of our Board selected periodically. The Committee meets from time to time, depending on the availability of its members and when called by its chair. The Committee is responsible for review and analysis of quality indices measuring our principal services and to ensure that the requisite degree of commercial assistance is furnished to our clients.

Members	Date Appointed
Eduardo Navarro de Carvalho	February 15, 2012
Luciano Carvalho Ventura	May 19, 2010
Roberto Oliveira de Lima	November 07, 2011

D. Employees

As of December 31, 2012, we had 19.614 employees. All of our employees are full-time, and are divided into the following categories: 27% in our network plant operation, maintenance, expansion and modernization; 58% in sales and marketing; and 15% in administration, finance and investor relations, human resources, inventory, technology, legal and strategic planning and management control.

Before December 1999, the SISTEL (Fundação Sistel de Seguridade Social) plan, a multi-employer defined benefit plan that supplements government-provided retirement benefits, covered the employees of the former Telebrás System and we were contingently liable for all of the unfunded obligations of the plan. In January 2000, we and the other companies that formerly belonged to the Telebrás system agreed to divide the existing SISTEL plan into 15 separate



plans, resulting in the creation of private plans covering those employees already enrolled in the SISTEL plan. In that moment, these new private pension plans were still administered by SISTEL and have retained the same terms and conditions of the SISTEL plan. The division was carried out so as to allocate liability among the companies that formerly belonged to the Telebrás system according to each company's contributions with respect to its own employees. Joint liability among the SISTEL plan sponsors will continue with respect to retired employees, who will necessarily remain members of the SISTEL plans, called PBS plan.

At the time of the privatization, employees had the right to maintain their rights and benefits in SISTEL. Under the SISTEL plan, we made monthly contributions to SISTEL equal to a percentage of the salary of each employee who was a SISTEL member. Each employee member also made a monthly contribution to SISTEL on the basis of age and salary. Pension benefits of members of SISTEL vested by the same time their retirement benefits vested

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under the government-provided retirement plan. SISTEL operates independently from us, and its assets and liabilities are fully segregated from us.

From 2000, we decided to establish defined contributions plans, and offered it to participants in our PBS's plan, defined benefit plans, as well as to employees who did not qualify for participation. Unlike the PBS's plan, which is a defined benefits plan, defined contributions plans are financed for contributions by participating employees, as well as by us as sponsor, which are credited to the individual accounts of the participants. We are responsible for all management and maintenance expenses of these plans, including the risks of death and permanent injury of the participants.

We maintained the following defined benefit plans: PBS Telesp, PBS Telesp Celular, PBS Tele Centro Oeste, PBS Teleleste, PBS Telesudeste and PBS Telemig Celular. Besides these plans were maintained defined contribution plans: Visão Telesp, Visão Telefônica Empresas, Visão Assist, Visão ATelecom, TCPPREV, Visão Celular, CelPrev Telemig Celular, VivoPrev and TCOPREV, the latter being a variable contribution plan.

The plans PBS TELESP, Visão TELESP, Visão Telefônica Empresas, Visão Assist and Visão ATelecom, previously managed by Fundação Sistel de Seguridade Social, or SISTEL, were transferred to another closed social security entity called VISÃO PREV Sociedade de Previdência Complementar on February 18, 2005.

Already in 2007, was the transfer of management of Fundação Sistel para o VISÃO PREV for the following plans: PBS Telesp Celular, TCPPREV, PBS Tele Centro Oeste Celular, TCOPREV, PBS Telesudeste Celular, Visão Celular and PBS Teleleste Celular. These 11 plans were gradually transferred to the VISÃO PREV from 31 July 2007 until 31 December 2007.

On August 21, 2007, after the approval of the board of directors of Vivo, the SPC (Secretariat for Pension Funds) approved the new plan VIVO PREV, a defined contribution plan administered by VISÃO PREV already. From 1 March 2008 to 31 May 2008, from 1 July 2009 to 30 September 2009, and October 1 to December 31, 2011, plan participants PBS Telesp Celular, TCPPREV, PBS Tele Centro Oeste Celular, TCOPREV, PBS Telesudeste Celular, Visão Celular, PBS Teleleste Celular, CelPrev Telemig Celular e PBS Telemig Celular had the opportunity to migrate to the new plan VivoPrev.

Between the events above, on December 15, 2010, filed in PREVIC (National Superintendency of Pension Funds), an agency of the Ministry of Social Security, which replaced the old SPC, the request to transfer the management plans PBS Telemig, CelPrev Telemig Celular from Fundação SISTEL de Seguridade Social to the institution VISÃO PREV Sociedade de Previdência Complementar.

In October 2011, the plans Visão TELESP, Visão Telefônica Empresas, Visão Assist, Visão ATelecom were merged and resulted in the plan VisãoTelefônica.

We also sponsor the plans Planos de Assistência Médica aos Aposentados–PAMA, or the PAMA, and PBS-A–Plano de Benefícios Sistel Assistidos, or the PBS-A, that are still managed by Fundação Sistel de Seguridade Social. Retired employees (PBS-A) and post-retirement health care benefits, or PAMA, remained as multi-employer benefit plans. The restructuring of the benefit plans took place in January 2000.

The company currently offers the following plans for employees who do not have any pension plan: Visão Telefônica plan and VIVO PREV plan. Our contributions to the VISÃO PREV plan are equal to those of the individual participants, ranging from 2% to 9% of the participant's salary and to the VIVO PREV plan, ranging from 0% to 8% of the participant's salary, depending on the percentage chosen by the participant. The average contributions of the sponsor under the Visão plan equal approximately to 5.76% and VIVO PREV plan 6.61% of the total amount of

salaries paid to participating employees. Currently, 52.15% of our employees are covered by these plans.

With the acquisition of TVA Group companies we also have the defined contribution for Abrilprev for employees of these companies. In this plan the contributions can be made by participants from 1% to 4.5% of participation salary and the counterpart of the sponsor varies of 30 % to 150% depending on company time. The average contributions within the plan sponsor's Abrilprev are approximately equal to 4.27% of the total amount of wages paid to participating employees. Currently, 57% of our employees are covered by these plans.

Finally, due to the incorporation of companies of the Group in Brazil, the company has decided during the Board Meeting of 26.11.2012 to sponsor the defined contribution plan named Visão Multi. The rules of the plan are under review for approval of a government bureau named PREVIC and the current estimate of its availability for use is the 2nd quarter of 2013.

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Approximately 12% of our employees are union members' representative in the telecommunication industry. These unions have state representation, so we have employees represented by 27 state unions. In turn, 19 of these unions are associated with the National Federation of Telecommunications Workers (Fenattel).

Our Collective Bargaining Agreement for these employees was renewed on September 1, 2012 and will expire on August 31, 2014, and in 2013 the economic clauses of the agreement must be renewed.

Our management considers relations with our work force to be satisfactory. We have never experienced a work stoppage that had a material effect on our operations.

E. Share Ownership

None of our directors or executive officers beneficially owns, on an individual basis, more than 1% of our common or preferred shares (including ADSs representing preferred shares) or of our total equity share capital.

At the General Shareholders Meeting of Telefónica S.A. (our indirect controlling shareholder), held on June 21, 2006, the application of a long-term incentive plan—"Performance Share Plan" (PSP)—for executives of Telefónica S.A. and of other entities within the Telefónica Group, which includes Telefónica Brasil S.A. was approved. The plan grants a determined number of shares of Telefónica S.A. to selected participants who fulfill the necessary requirements.

The PSP is divided into five cycles, each of three-year duration. The eligible executives, who must remain with the Telefónica Group for a minimum period of three years commencing on the date of their eligibility, will have the right to receive stipulated shares based upon their performance in achieving targeted pre-defined results. Shares will be received at the end of each cycle. Each cycle is independent of the others, with the first cycle starting on July 1, 2006 (with distribution of shares of Telefónica S.A. starting on July 1, 2009) and each subsequent cycle commencing on July 1 of each subsequent year, up to and including, the fifth cycle, which commences on July 1, 2010 (with delivery of shares of Telefónica S.A. starting on July 1, 2013).

The first distribution under the PSP took place in July 2009, with 56 executives (including 4 executives appointed pursuant to the bylaws) from Telefônica Brasil given the right to 239,867 shares of Telefónica S.A.

The second distribution under the PSP took place in July 2010, with 57 executives (including 4 executives appointed pursuant to the bylaws) from Telefônica Brasil potentially having the right to 175,534 shares of Telefónica S.A.

The third distribution under the PSP took take place in July 2011, with 51 executives (including two executives appointed pursuant to the bylaws) from Telefônica Brasil potentially having the right to receive 189,763 shares of Telefónica S.A.

The fourth distribution under the PSP did not happen because it was not achieved the minimum established in the program for the indicator valuation Telefonica's share (TSR – Total Shareholder Return).

The fifth provision related to PSP will take place in July 2013, with 38 executives (including 2 executives appointed pursuant to the bylaws) from Telefônica Brasil potentially having the right to receive 169.854 shares of Telefónica S.A., for which, on December 31, 2012, we have made a provision of R\$7.4 million.

At the General Shareholders Meeting of Telefónica S.A. (our indirect controlling shareholder), held on May 18, 2011, a new long-term incentive plan—"Performance and Investment Plan" (PIP)—for executives of Telefónica S.A. and of other entities within the Telefónica Group, which includes Telefônica Brasil S.A. was approved. The plan grants a determined number of shares of Telefónica S.A. to selected participants who fulfill the necessary requirements.

The PIP is divided into three cycles, each of three-year duration. The eligible executives, who must remain with the Telefónica Group for a minimum period of three years commencing on the date of their eligibility, will have the right to receive stipulated shares based upon their performance in achieving targeted pre-defined results. Shares will be received at the end of each cycle. Each cycle is independent of the others, with the first cycle starting on July 1, 2011 (with distribution of shares of Telefónica S.A. starting on July 1, 2014) and each subsequent cycle commencing on July 1 of each subsequent year, up to and including, the third cycle, which commences on July 1, 2013 (with delivery of shares of Telefónica S.A. starting on July 1, 2016).

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The first provision related to PIP will take place in July 2014, with 109 executives (including 5 executives appointed pursuant to the bylaws) from Telefônica Brasil potentially having the right to receive 416,384 shares of Telefônica S.A., for which, on December 31, 2012, we have made a provision of R\$6.3 million.

The second provision related to PIP will take place in July 2015, with 127 executives (including 5 executives appointed pursuant to the bylaws) from Telefônica Brasil potentially having the right to receive 520,325 shares of Telefônica S.A., for which, on December 31, 2012, we have made a provision of R\$2.6 million.

## ITEM 7. MAJOR SHAREHOLDERS AND RELATED PARTY TRANSACTIONS

### A. Major Shareholders

In accordance with our bylaws, we have two classes of capital stock authorized and outstanding: common shares (ações ordinárias) and preferred shares (ações preferenciais). Our common shares have full voting rights. Our preferred shares have voting rights only under limited circumstances. At December 31, 2012, Telefônica Internacional owned 15.43% of our common shares and SP Telecomunicações, owned 50.47% of our common shares. Since Telefônica Internacional owns 55.28% of the equity share capital of SP Telecomunicações, it has effective control over 43.33% of our outstanding common shares. Accordingly, Telefônica Internacional has the ability to control the election of our Board of Directors and to determine the direction of our strategic and corporate policies. Neither Telefônica Internacional, nor SP Telecomunicações, has any special voting rights beyond those ordinarily accompanying the ownership of our common or preferred shares.

The following tables set forth information relating to the ownership of common and preferred shares by SP Telecomunicações, Telefônica Internacional and our officers and directors. We are not aware of any other shareholder that beneficially owns more than 5% of our common shares.

Shareholder's Name	Number of common shares owned	Percentage of outstanding common shares	
SP Telecomunicações	192,595,149	50.47	%
Telefônica S.A.	97,976,194	25.68	%
Telefônica Internacional	58,859,918	15.43	%
All directors and executive officers as a group	1,548	–	

Shareholder's Name	Number of preferred shares owned	Percentage of outstanding preferred shares	
SP Telecomunicações	29,042,853	3.90	%
Telefônica S.A.	179,862,845	24.17	%
Telefônica Internacional	271,707,098	36.52	%
All directors and executive officers as a group	1,387	–	

Telefônica Internacional is a wholly owned subsidiary of Telefônica S.A., or Telefônica. Telefônica's shares are traded on various stock exchanges, including exchanges in Madrid, Barcelona, Bilbao, Valencia, London, New York, Lima and Buenos Aires. Telefônica's business operations are concentrated in a number of sectors, including fixed and mobile telecommunications services, data communications, pay TV, integrated business solutions, e-commerce,

market information and services, media content creation, production, distribution and marketing and call center services.

B. Related Party Transactions

Note 32 to our consolidated financial statements presents, in tabular format, more detailed financial information with respect to transactions and balances with related parties. We provide below a summary description of transactions with related parties.

In 1999, we entered into a service agreement with Atento Brasil S.A. (an indirect majority-owned subsidiary of Telefónica S.A.), or Atento, that is automatically extended every three years, for the provision of certain customer services, principally services related to our call center. Transactions under this service agreement with Atento Brasil involved approximately R\$979.7 million in 2012 (compared to R\$1,041.8 million in 2011).

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In April 2001, we entered into a service agreement for the provision of logistics, administrative, accounting and other services with Telefônica Serviços Empresariais do Brasil Ltda., or TGestiona, an indirect wholly owned subsidiary of Telefónica. Transactions with TGestiona under this service agreement involved approximately R\$97.7 million in 2012 (compared to R\$94.6 million in 2011).

Some international roaming services are provided by companies in the Telefonica Group.

C. Interests of Experts and Counsel

Not applicable.

ITEM 8. FINANCIAL INFORMATION

A. Consolidated Statements and Other Financial Information

See Note 20 of our Consolidated Financial Statements.

Legal Proceedings

We are party to legal proceedings incidental to the normal course of our business. The main categories of such proceedings include:

- administrative and judicial litigation with Instituto Nacional da Seguridade Social, the National Institute of Social Security, or INSS;
- administrative and judicial proceedings relating to tax payments;
- lawsuits brought by employees, former employees and trade unions relating to alleged infringements of labor rights; and
- other civil suits, including litigation arising out of the breakup of Telebrás and events preceding the breakup.

Our policy with respect to provisioning for contingencies classifies the various legal proceedings to which we are party as “probable,” “possible” and “remote.” The Company and its subsidiaries are parties to labor, tax, civil and regulatory claims and set up a provision for contingencies for which the likelihood of loss was estimated as probable. Our senior management classifies each legal proceeding into one of these three categories (probable, possible and remote) based upon the advice of internal and external counsel and specialized technical advisors in charge of each matter. Due to the level of provisioning and based on its analysis of the individual cases, our management believes that no additional liabilities related to any legal proceedings will have a material effect on our financial condition or results of operations.

Provision for Tax Matters

Federal Taxes

At December 31, 2012, the company was party to administrative and judicial proceedings relating to: (i) additional contributions to the FGTS (Unemployment Compensation Fund) on deposits made by employees ( the issue does not result in the reduction of part of FGTS deposits made by the company on behalf of its employees); (ii) claims resulting from the non-ratification of compensation and refund requests, formulated by the company;(iii) social contributions



relating to a supposed failure to pay 11% on the value of invoices, billing and receipts from service providers hired for the transfer of labor; (iv) CIDE levied on the remittance of funds abroad relating to technical services, administrative assistance and to services of similar nature, as well as royalties; (v) fixed: non-inclusion of interconnection and EILD expenses in the FUST base and Wireless carriers: non-inclusion of revenues from interconnection in the FUST tax base; (vi) contribution to Empresa Brasileira de Comunicação, created by Law No. 11652/08; (vii) TFI/TFF on mobile stations; (viii) IRRF on Interest on shareholder's equity; (ix) Public Price for Numbering Resources Management (PPNUM) by ANATEL instituted by Resolution No. 451/06; (x) IRPJ/PIS/COFINS resulting from the non-ratification of the companies' offset and refund requests; (xi) Social Investment Fund (Finsocial) offset amounts; (xii) failure to pay withholding social contribution levied on services rendered, remuneration, salaries and other salary bases; (xiii) COFINS – Requirement resulting from non-inclusion of financial income into the tax base; (xiv) additional charges to the PIS and COFINS tax base, as well as additional

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charges to COFINS required by Law No. 9718/98; and (xv) Tax on Net Income (ILL). On December 31, 2012, total consolidated provisions amounted to R\$1,860.8 million.

In the opinion of our management and our legal advisors, the chance of loss in these cases is “probable.”

### State Taxes

On December 2012, the company and its subsidiaries were party to administrative and judicial proceedings in progress referring to (i) ICMS tax credits on electric power and tax credits without documentation (ii) ICMS not levied on telecommunication services; (iii) disallowance of ICMS tax incentives for cultural projects; (iv) ICMS on TV subscription; and (v) environmental administrative fine At December 31, 2012, total consolidated provisions amounted to R\$67.4 million.

In the opinion of our management and our legal advisors, the chance of loss in these cases is “probable.”

### Municipal Taxes

On December 31, 2012, the company and its subsidiaries were party to tax claims at a municipal level, both in the administrative and judicial sphere which, based on the opinion of its legal advisors, are classified as a probable loss. At December 31, 2012, total consolidated provisions amounted to R\$16.6 million.

These proceedings relate to: (i) IPTU, (ii) ISS levied on chattel lease services and secondary and complementary activities, and (iii) Surveillance, Control and Inspection Fee (TVCF).

In the opinion of our management and our legal advisors, the chance of loss in these cases is “probable.”

### Other Provisions

At December 31, 2012, the company and its subsidiaries recorded other provisions, relating to legal claims, both in the administrative and in the judicial level, related to ISS on effective provision of services of lease, sublease, right of way or use right, whether shared or not, of railway, highway, telegraph poles, cables, ducts and conducting wires of any kind. At December 31, 2012, the consolidated provisions totaled R\$8.2 million.

In the opinion of our management and our legal advisors, the chance of loss in these cases is “probable.”

### Tax Proceedings

The following tax proceedings were pending as of December 31, 2011, and, in the opinion of our management and our legal advisors, the chance of loss in these cases is “possible.”

### Federal Taxes

At December 31, 2012, the company and its subsidiaries were a party to various administrative and judicial proceedings in the federal sphere, which are waiting to be tried at various court levels. At December 31, 2012, the total consolidated amount was R\$3,146.7 million.

Key proceedings refer to: (i) Non-compliance manifestations due to the ratification of compensation requests made by the company; (ii) fine for distribution of dividends even in view of the alleged existence of outstanding debts payable to the federal government; (iii) social security contribution (INSS) on compensation payment for salary devaluation

arising from losses caused by “Plano Verão” (Summer Plan) and “Plano Bresser” (Bresser Plan), SAT (Work Accident Insurance), Social Security and payables to third parties (INCRA and SEBRAE), supply of meals to employees, 11% retention (labor assignment); (iv) IRRF on the funds remittance abroad related to technical services and to administrative support and similar services, as well as royalties; (v) PIS levied on roaming; (vi) CPMF levied on operations resulting from the technical cooperation agreement with the National Treasury Department (STN) (offsetting through the Integrated System of Federal Government Financial Administration - SIAFI) and on foreign-exchange contracts required by the Brazilian Central Bank; (vii) IRPJ and CSLL related to deductions on revenues from reversal of provisions; (viii) Income tax and social contribution – disallowance of costs and miscellaneous expenses not substantiated; (ix) deductions of COFINS from loss in swap transactions; (x) PIS / COFINS accrual basis versus cash basis; (xi) IRPJ payable in connection with allocation of excess funds to Northeast Investment Fund (FINOR), Amazon Region Investment Fund (FINAM) or Economic Recovery Fund of

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the State of Espírito Santo (FUNRES); (xii) IRPJ on derivative operations; (xiii) IRPJ and CSLL – disallowance of expenses related to the goodwill paid in the acquisition of Celular CRT S.A., goodwill arising from the privatization process and Vivo’s corporate restructuring; and (xiv) contribution to the Brazilian company of communication, created by Law No. 11.652/08.

In the opinion of management and its legal advisors, the chances of loss in these processes are possible.

### State Taxes

On December 31, 2012, the company and its subsidiaries were a party to various administrative and judicial proceedings related to ICMS, at the state level, which are ongoing in various court levels. At December 31, 2012, the total consolidated amount was R\$5,870.4 million.

Key proceedings refer to: (i) provision of facility, utility and convenience services and rental of the “Speedy” service modem; (ii) international calls (DDI); (iii) undue credit related to the acquisition of items intended to property, plant and equipment; (iv) lack of proportionate credit reversal referring to the acquisition of property, plant and equipment items; (v) amounts unduly appropriated as ICMS tax credits; (vi) service provided outside São Paulo state with ICMS paid to São Paulo State; (vii) co-billing, (viii) tax substitution with a fictitious tax base (tax guideline); (ix) use of credits related to acquisition of electric power; (x) secondary activities, value added and supplementary services (Agreement 69/98); (xi) tax credits related to opposition/challenges referring to telecommunications services not provided or mistakenly charged (Agreement 39/01); (xii) shipment of goods with prices lower than acquisition prices (unconditional discounts); (xiii) deferred charge of ICMS - Interconnection (DETRAF – Traffic and Service Provision Document); (xiv) credits derived from tax benefits granted by other states; (xv) disallowance of tax incentives related to cultural projects; (xvi) transfers of assets among business units owned by the company; (xvii) communications service tax credits used in provision of services of the same nature; (xviii) card donation for prepaid service activation; (xix) reversal of credit from return and free lease in connection with assignment of networks (used by the company itself and exemption from public bodies); (xx) DETRAF fine, (xxi) ICMS on own consumption; (xxii) ICMS on exemption of public bodies; (xxiii) issue of invoices with negative ICMS amounts; and (xxiv) restructuring of ledger without prior authorization by the Treasury.

In the opinion of management and its legal advisors, the chance of loss is possible in these procedures.

### Municipal Taxes

At December 31, 2012, the company and its subsidiaries were party to various administrative and judicial proceedings at the municipal level, which are ongoing various court levels. At December 31, 2012, the total consolidated amount was R\$544.4 million.

Key proceedings refer to: (i) ISS – secondary activities, value added and supplementary services; (ii) withholding ISS; (iii) IPTU; (iv) Land Use Fee; (v) municipal fees; (vi) tariff for Use of Mobile Network (TUM), infrastructure lease; (vii) advertising services; (viii) services provided by third parties; (ix) business management consulting services provided by Telefonica Internacional (TISA); (x) ISS tax levied on caller ID services and on cell phone activation

In the opinion of management and its legal advisors, loss is possible in these proceedings.

### ANATEL

FUST – Universalization of Telecommunications Service

Writs of Mandamus filed separately by the fixed and mobile operators to recognize the right to: Fixed: Failure to include interconnection and EILD expenses in the FUST base and Mobile: Failure to include interconnection revenue in the FUST base, pursuant to Abridgement No. 7, of December 15, 2005, since it disagrees with the provisions of the sole paragraph, article 6, of Law No. 9,998/00, which are waiting to be tried in the court of appeals.

A number of delinquency notices referring to debit entry issued by ANATEL in the administrative level to set up the tax credit related to interconnection, EILD and other revenues that are not earned from the provision of telecommunications services.

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At December 31, 2012, the total consolidated amount was R\$1,970.8 million.

In the opinion of management and its legal advisors, there are possible chances of loss in these procedures.

FUNTTEL – Fund for the Technological Development of Telecommunications

At December 31, 2012, the company and its subsidiaries were parties to administrative and judicial proceedings which are waiting to be tried at the lower administrative court and the court of appeals. At December 31, 2012, the total consolidated amount was R\$614.3 million.

Such proceedings concern the collection of contributions to FUNTTEL on other revenues (not related to telecom services), as well as on income and expenses transferred to other operators (interconnection).

In the opinion of management and its legal advisors, the chance of success in these procedures is possible.

FISTEL – Telecommunications Supervision Fund

Due extension of the effective license period to use telephone switches in connection with use of STFC (landline phone carriers) and extension of the right to use radiofrequency in connection with wireless service (wireless carriers), ANATEL charges the Installation Inspection Fee (TFI).

This collection is based on ANATEL's understanding that such extension would represent a taxable event for TFI. The Company and its subsidiaries understand that such collection is unjustified, and separately challenged the aforesaid fee in court. At December 31, 2012, total consolidated amount was R\$1,589.5 million, without the respective deposit in full.

In the opinion of management and its legal advisors, there are possible chances of loss in these procedures.

PPNUM – Price Relative to the Public Administration of Numbering Resources

Our subsidiary Vivo, along with other wireless carriers in Brazil, are challenging in court the tariff charged by ANATEL for use by such carriers of the numbering resources managed by the agency. When charged by ANATEL, Vivo made a judicial deposit referring to the amounts payable. On April 23, 2009, the carriers received a favorable sentence and the lawsuit is currently waiting to be tried at the court of appeals. At December 31, 2012, total amount was R\$2.1 million.

In the opinion of management and its legal advisors, there are possible chances of loss in these procedures.

Labor Litigation

We are also a defendant in several legal proceedings filed by former employees and outsourced employees (alleging joint or several liability), who claim, among other things, deficient overtime payment, unequal compensation, retirement wage supplements, health and security hazard compensation, free extension of health plan benefits to retirees of Company; and proceedings regarding our outsourcing practices.

In addition, we are also a defendant in a public civil action filed by the Federal Ministry of Labor which concerns our retaining of third-party companies to perform our core business. Although the likelihood of loss in this action is "possible," no value amount has been attributed to this action because currently we are unable to calculate the total

amount we will owe in the event we lose and, as a result, we have not recorded any amounts.

#### Civil Claims

There are several civil claims against us. We have recorded R\$795.3 million in provisions for these proceedings where the risks are deemed probable, including the civil proceedings described below and the regulatory and antitrust proceedings that follow:

- Expansion Plan–PEX. We are defendants in proceedings related to the possible right of individuals who purchased our shares in connection with our network expansion plan after 1996, to receive additional shares from us. These claims are in various levels of the court system. The chance of loss in such proceedings is

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classified on a case-by-case basis according to the facts presented in each proceeding. For the proceedings in which the chance of loss was classified as “probable,” we recorded a provision of R\$31.3 million.

- **Service Complaints.** We and our subsidiaries are defendants in certain civil actions, in various court levels, regarding claims related to our services and our ordinary course of business initiated by individual customers, civil associations on behalf of customers or by the PROCON foundation, as well as by the Federal and State Public Prosecutor’s Offices. We recorded a provision of R\$377.6 million for these claims. We are also defendants to civil actions in which the risk of loss is classified as “possible” in the amount of R\$1,236.3 million.
- **Consumer Relations Claims.** We are defendants in several civil actions initiated by individual customers in which the claims are the same or very similar from to other and, when considered individually, are not material, to which we recorded a provision of R\$78.7 million, calculated on the basis of on the statistical analysis of our historical losses in such proceedings.

There are several civil claims against us, for which we have not recorded provisions, though which we deem to be notable, including:

- **Pension Benefit Plan Spin-Off.** Sistel Participants Association in São Paulo (ASTEL) ) and National Federation of Associations of Retirees and Pensioners and Participants in Pension Funds in Telecom (FENAPAS), they filed with two distinct - same object though - public civil action against the company, Sistel Foundation and others, claiming the annulment of the spin-off of the PBS pension benefit plan that occurred in 2000 which caused the creation of the specific TELESP–PBS pension benefit plan, and corresponding allocation of resources resulted from the technical superavit and fiscal contingencies existing at that time. The chance of loss in both of them is possible based on the opinion of our legal advisors. The amount involved in both cases cannot yet be determined until an expert appraisal report is conducted since it includes the spun-off portion of Sistel related to the telecommunication operators from the former “Telebrás System.”
- **Community Telephone Plan–PCT.** We are subject to civil public action proposals claiming the possible right for indemnity of associates and entities hired for the construction of community networks connected to the network of fixed telephony operators and have not received shares for their financial investment in the municipality of Mogi das Cruzes, involving a total amount of approximately R\$236.2 million. Based on the opinion of our legal advisors, the chance of loss is possible. The appellate court has ruled in our favor and changed the lower court decision. The plaintiff filed an appeal to the Supreme Court which is awaiting resolution.
- **Services Quality Class Action.** The Public Prosecutor Office of the State of São Paulo commenced a class action suit claiming moral and property damages suffered by all consumers of telecommunication services from 2004 to 2009 due to the bad quality of service and failures of the communications system. The Public Prosecutors Office suggested a total award against the company of R\$1 billion. A judgment was rendered on April 20, 2010 imposing the payment of damages to all consumers who proved to be eligible for the award. Alternatively, if clients do not prove themselves eligible in a number compatible with the severity of the damage after a period of one year, the judgment establishes that R\$60 million should be deposited in a special fund for protection of diffuse customer interests (Fundo Especial de Defesa de Reparação de Interesses Difusos Lesados). It is not possible to estimate how many consumers may present themselves in this procedure nor the values to be claimed by them. The parties filled an appeal and the effects of the sentence were suspended. Despite the possible degree of risk, no value amount was attributed to this action because currently we are unable to calculate the total amount to be paid by us in the event we lose and, as a result, we have not recorded any provisions.
- **Ownership of Caller ID.** Lune Projetos Especiais Telecomunicação Comércio e Ind. Ltda., a Brazilian company, filed on November 20, 2001 lawsuits against 23 wireless telecommunications operators, including TELESP Celular



Participações and its subsidiaries. The lawsuits allege that those operators violated patent No. 9202624-9, related to Equipamento Controlador de Chamadas Entrantes e do Terminal do Usuário, or Caller ID, granted to Lune by the Brazilian Intellectual Property Agency–INPI, on September 30, 1997. Lune called on the operators to cease to provide Caller ID services and sought payment from them for the unauthorized use of the Caller ID system in an amount equivalent to the payment of fees received by such operators for use of the Caller ID system. On October 5, 2011, the law suit was judged groundless against the

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Phone Companies. Vivo will file an appeal due to this decision. This decision is not final, and will be tried before the Court and Superior Court of Justice. However, Lune's right to use patent No. 9202624-9 was suspended by a federal judge in response to a lawsuit filed against Lune and INPI by Ericsson Telecomunicações S.A., TC and Telerj Celular (formerly Vivo subsidiaries before our corporate restructuring) filed identical lawsuits against Lune and INPI and those lawsuits are still pending before the courts. In connection with this proceeding, a third company, Sonintel, and its two partners also brought an Ação de Oposição, whereby they reinvoked their rights to a previous patent related to Caller ID, and to which the above mentioned patent (No. 9202624-9) was linked. We believe, based on the opinion of outside counsel that the likelihood of an unfavorable outcome with respect to Lune's claim against us is possible. We are unable to determine at this time the extent of any potential liabilities with respect to this claim.

- Validity of Prepaid Plan Minutes. We and our subsidiaries, together with other Brazilian wireless telecommunications operators, are defendants in various lawsuits brought by the public prosecutor's office and consumer protection associations challenging the imposition of a deadline for the use of purchased prepaid minutes. The plaintiffs allege that purchased prepaid minutes should not expire after any specified deadline. Conflicting decisions have been issued by the courts reviewing this matter. Although we believe that our criteria for imposing the deadline is in compliance with ANATEL's rules, we believe, based on the opinion of outside counsel, that the likelihood of an unfavorable outcome with respect to this claim is possible.

Regulatory and Antitrust Litigation

ANATEL

Administrative Proceedings for Noncompliance with Regulatory Obligations Brought by ANATEL – PADOs. As of December 31, 2012, the fixed service division was involved in several administrative proceedings brought on grounds of alleged breach of obligation established by federal regulation, involving risk of loss that is classified as probable. The amount involved and the provision recorded for the proceedings involving a risk of loss classified as probable was, in December 31, 2012, R\$265.0 million. We are also defendants to such administrative proceedings in which the risk of loss classified as possible is in the amount of R\$1,081.6 million.

Our subsidiary Vivo is also part of several administrative and legal actions brought by ANATEL that allege non compliance with regulatory requirements related to SMP service, in the total amount of approximately R\$42.6 million. Based on the opinion of our counsel, we believe that the likelihood of unfavorable outcomes with respect to these claims is probable. We are also defendants to such administrative proceedings in which the risk of loss classified as possible in the amount of R\$39.4 million.

On August 6, 2007, Global Village Telecom Ltda (GVT), Intelig Telecomunicações Ltda (Intelig), Transit of Brazil Ltda. and Easytone Telecomunicações Ltda., brought an administrative action under the Brazilian System of Competition Defense (Sistema Brasileiro de Defesa da Concorrência), or SBDC, against Claro SA (Claro), Tim Brazil Services and Telecommunications SA (TIM), TNL SCS SA (Hi) and Vivo, for alleged anticompetitive practices and price fixing, alleging price fixing related to the VUM rate charged to competitors. On August 21, 2008, the Secretariat of Economic Law (Secretaria de Direito Econômico), or SDE, initiated administrative

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proceedings in order to assess whether the practices alleged were in breach of Law No. 8.884/94, the applicable Brazilian antitrust and price fixing legislation.

The SDE and federal prosecutors have issued advice recommending: (i) removal of the antitrust charge against all represented parties, (ii) the exclusion of Hi as defendants in the price fixing investigation, (iii) the conviction of Vivo, TIM and Claro for price fixing. The process is the Administrative Council for Economic Defense (Conselho Administrativo de Defesa Econômica), or CADE, awaiting trial.

Based on the opinion of our counsel, we believe the risk of an adverse judgment in the aforementioned administrative proceedings related to price fixing to be possible, and we estimate that the penalty for this conduct may range from 0.1% to 0.5% of the gross revenues of Vivo for 2006. However, in the unlikely event CADE were to find that Vivo engaged in anticompetitive practices, a position already rejected by SDE and MPF, it is estimated that the fine could range from 10% to 15% of the gross revenues of Vivo in 2006.

Notably, a new law governing antitrust, Law No. 12,529/12, recently came into force on May 29, 2012, and as there have been few cases decided by CADE applying the new criteria, the estimates above are based on previous case law and our analysis of the new law.

### Dividends and Dividend Distribution Policy

#### Priority and Amount of Preferred Dividends

The Brazilian Corporate Law generally requires that the bylaws of each Brazilian corporation specify a minimum percentage of the distributable profits comprising dividends and/or interest on shareholders' equity, or distributable amount, of the corporation for each fiscal year that must be distributed to shareholders as dividends. See "Item 10. Additional Information—B. Memorandum and Articles of Association." Moreover, each Brazilian company may issue new preferred shares for public distribution only if one of the following terms applies to the preferred shares: (i) the right to receive dividends equivalent to at least 25% of the net profit for the fiscal year, to be calculated in accordance with Article 202 of the Brazilian Corporate Law as follows: (a) priority in the receipt of dividends corresponding to at least 3% of the book value per share and (b) the right to an equal share of the profits attributable to the holders of common shares, after the holders of common shares have received a dividend equal to a minimum of 3% of the book value per share; or (ii) the right to receive dividends, at least 10% higher than those paid for each common shares; or (iii) tag-along rights of at least 80% of the price paid in the sale of control to be paid by the controlling shareholder and also including the right to receive dividends at least equal to the dividend paid to common shares.

According to our bylaws, we are required to distribute as dividends of each fiscal year ending on December 31, to the extent amounts are available, an aggregate amount equal to at least 25% of adjusted net income as a mandatory dividend. The annual dividend distributed to holders of our preferred shares is 10% higher than the dividend distributed to our common shareholders.

Under the Brazilian Corporate Law, a company is allowed to withhold payment of the mandatory dividend in respect of common shares and preferred shares if:

- management and the fiscal board report to the shareholders meeting that the distribution would be incompatible with the financial circumstances of the company; and
  - the shareholders ratify this decision at the shareholder's meeting. In this case:
-

management must forward to the CVM within five days of the shareholders meeting an explanation justifying the decision at the shareholders meeting; and

- the profits that were not distributed are to be recorded as a special reserve and, if not absorbed by losses in subsequent fiscal years, are to be paid as dividends as soon as the company's financial situation permits.

For the purposes of the Brazilian Corporate Law, net profits are defined as net income after income tax and social contribution for the fiscal year, net of any accumulated losses from prior fiscal years and any amounts allocated to beneficiary parties', employees' and management's participation in a company's profits and founders' shares.

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Under Brazilian Corporate Law, and in accordance with our bylaws, adjusted net income is an amount equal to our net income adjusted to reflect allocations to or from (i) legal reserves, (ii) statutory reserves, and (iii) contingency reserves for anticipated losses, if any.

At each annual shareholders meeting, the Board of Directors is required to suggest the allocation of net profits obtained during the preceding fiscal year. Under Brazilian Corporate Law, we are required to maintain a legal reserve, to which 5% of our net profits must be allocated for each fiscal year, until the reserve amounts to 20% of our paid-in capital. Net losses, if any, shall be charged against the accumulated profits, profit reserves and legal reserve, following this order.

Brazilian Corporate Law also provides for an additional allocation of net profits to special accounts, which is also recommended by management and subject to approval by shareholders at the annual shareholders meeting, including the amount of net profits that may be allocated to the contingency reserve for anticipated losses that are deemed probable in future years. Any amount so allocated in a previous year must be either:

- reversed in the fiscal year in which the loss was anticipated, if the loss does not in fact occur; or
- written-off if the anticipated loss occurs.

Net profits may also be allocated to the unrealized income reserve in case the total amount of mandatory dividends exceeds the amount of realized income. Such allocation should also be suggested by management and subject to approval by shareholders at the shareholders meeting. For such purpose, realized income is the balance of net profits exceeding the sum of:

- the positive net result of equity adjustment; and
- earnings net from transactions or the accounting of assets and liabilities at market value which must be realized after the end of the subsequent fiscal year.

The amounts available for distribution are determined on the basis of financial statements prepared in accordance with the accounting practices adopted in Brazil.

If the minimum dividend to be paid to the holders of preferred shares is not paid for the period set forth in our bylaws, which in no event shall be longer than three years, the holders of preferred shares will be entitled to full voting rights until such dividend is paid in full.

## Payment of Dividends

We are required by law and our bylaws to hold an annual shareholders meeting until April 30 of each year at which, among other issues, the allocation of net profits obtained during the preceding fiscal year and the declaration of dividends by decision of common shareholders are decided, acting on the recommendation of the executive officers, as approved by the Board of Directors. The payment of annual dividends is based on the financial statements prepared for each fiscal year ending December 31. Under the Brazilian Corporate Law, dividends are required to be paid within 60 days following the date the dividend is declared to shareholders of record on the declaration date, unless a resolution by the shareholders sets forth another date of payment, which must occur before the end of the fiscal year.

A shareholder has a three-year period from the dividend payment date to claim dividends in respect of its shares, after which we have no liability for the payment. Because our shares are issued in book-entry form, dividends with respect to any share are automatically credited to the account holding the share and no action is required on part of the

shareholder. We are not required to adjust the amount of paid-in capital for inflation.

If a shareholder is not a resident of Brazil, he or she must register with the Central Bank of Brazil to be eligible to receive dividends, sales proceeds or other amounts with respect to his or her shares outside of Brazil. Our preferred shares underlying ADSs are held in Brazil by a Brazilian custodian, Citibank N.A., as the agent for the depositary, which is the registered owner of our shares.

Payments of cash dividends and distributions, if any, will be made in Brazilian currency to the custodian on behalf of the depositary, which will then convert those proceeds into U.S. dollars and will provide for U.S. dollars to

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be delivered to the depositary for distribution to holders of ADSs. If the custodian is unable to immediately convert the Brazilian currency received as dividends into U.S. dollars, the amount of U.S. dollars payable to holders of ADSs may be adversely affected by devaluations of the Brazilian currency that occur before dividends are converted and remitted. Dividends in respect of the preferred shares paid to resident and non resident shareholders, including holders of ADSs, are not currently subject to Brazilian withholding tax.

## Additional Payments on Shareholders' Equity

Law No. 9,249, dated December 26, 1995, as amended, provides for distribution to shareholders of interest on shareholders' equity, which may be computed against the amount of dividends to be distributed to the shareholders. A company may treat these payments as financial expenses for income tax and social contribution purposes. This interest is limited to the daily pro rata variation of the TJLP, a nominal long-term interest rate determined by the federal government that includes an inflation factor and cannot exceed the greater of:

- 50% of net income (before deducting income taxes and the interest on shareholders' equity) for the period in respect of which the payment is made, or
- 50% of the sum of retained earnings and profit reserves.

Any payment of interest in respect to preferred shares to shareholders (including the holders of ADSs) is subject to Brazilian withholding tax at a rate of 15%, or 25% in the case of a shareholder domiciled in a tax haven, and these payments may be included, at their net value, as part of any mandatory dividend. If payment of interest on shareholders equity is made for a beneficiary located outside of Brazil, the Tax on Exchange Transactions ("IOF") triggers at a rate of zero. See "Item 10. Additional Information—E. Taxation—Brazilian Tax Considerations—Distributions of Interest on Capital."

We declare and pay dividends and/or interest on shareholders' equity as required by Brazilian Corporate Law and our bylaws. The declaration of annual dividends, including dividends in excess of the mandatory distribution, requires approval by the vote of a majority of the holders of common shares, and depends on many factors. These factors include our results of operations, financial condition, cash requirements, future prospects and other factors deemed relevant by shareholders. Our shareholders have historically acted on these matters based on recommendations by the Board of Directors. Within the context of tax planning, we may determine in the future that it is to our benefit to distribute interest on shareholders' equity.

The following table sets forth the dividends or interest on shareholders' equity paid to holders of our common and preferred shares since 2008 in reais.

Year	Description (Dividends or Interest on Shareholders' Equity)(1)	Common Shares (per share/in R\$)	Preferred Shares
2012	Div/Int	2.567510	2.824261
2011	Div/Int	4.783035	5.261339
2010	Div/Int	3.616248	3.977873
2009	Div/Int	2.556431	2.812074
2008	Div/Int	4.539838	4.993823

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(1) Interest on shareholders' equity is net of withholding taxes.

Dividends and Interest on Shareholders' Equity

On December 9, 2009, the Board of Directors approved, subject to the shareholders' approval, a payment of interest on shareholders' equity for our common and preferred shares in the amount of R\$174.3 million. The actual payment occurred on April 26, 2010.

On April 7, 2010, at the General Shareholders Meeting, the shareholders approved the distribution of dividends to the common and preferred shares in the total amount of R\$1,252 million declared on the basis of the closing balance sheet on December 31, 2009. The actual payment was made as follows:



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- an initial installment of R\$800 million, with payment due June 30, 2010. The actual payment occurred on April 26, 2010; and
- the remaining portion of R\$451.6 million, with payment due December 21, 2010. The actual payment occurred on December 13, 2010.

On September 29, 2010, the Board of Directors approved the distribution of interim dividends of R\$196.4 million based on earnings accumulated in our existing balance sheet as of June 30, 2010. The actual payment occurred on December 13, 2010.

On September 29, 2010, the Board of Directors approved, subject to shareholder approval, a payment of interest on shareholders equity for the common and preferred shares totaling R\$331.5 million. The actual payment occurred on December 13, 2010.

On December 14, 2010, the Board of Directors approved, subject to shareholder approval, a payment of interest on shareholders equity for the common and preferred shares totaling R\$171.7 million. The actual payment occurred on May 20, 2011.

On March 18, 2011, at the General Shareholders Meeting, the shareholders approved the distribution of dividends to the common and preferred shares in the total amount of R\$1,694 million declared on the basis of the closing balance sheet on December 31, 2010. The actual payment was made as follows:

- an initial installment of R\$1,429 million which the payment occurred on May 20, 2011; and
- the remaining portion of R\$264.7 million which payment occurred on November 3, 2011.

On September 13, 2011, the Board of Directors approved the distribution of interim dividends of R\$382.4 million based on earnings accumulated in our existing balance sheet as of June 30, 2011. The actual payment occurred on November 3, 2011.

On September 13, 2011, the Board of Directors approved, subject to shareholder approval, a payment of interest on shareholders equity for the common and preferred shares totaling R\$1,250 million. The actual payment occurred on November 3, 2011.

On December 12, 2011, the Board of Directors approved, subject to shareholder approval, a payment of interest on shareholders equity for the common and preferred shares totaling R\$617.0 million. The actual payment occurred on May 1, 2012.

On April 11, 2012, at the General Shareholders Meeting, the shareholders approved the distribution of dividends to the common and preferred shares in the total amount of R\$1,953 million declared on the basis of the closing balance sheet on December 31, 2011. The actual payment was made as follows:

- an initial installment of R\$1,075.6 million which the payment occurred on May 01, 2012; and
- the remaining portion of R\$877.4 million which payment occurred on December 12, 2012.

On November 05, 2012, the Board of Directors approved the distribution of interim dividends of R\$1,122.5 million based on earnings accumulated in our existing balance sheet as of June 30, 2012. The actual payment occurred on December 12, 2012.

On January 10, 2013, the Board of Directors approved the distribution of interim dividends of R\$1,650 million based on earnings accumulated in our existing balance sheet as of September 30, 2012. This amount was paid on February 18, 2013.

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## Reverse Stock Split

In a special General Shareholders Meeting held on May 11, 2005, our shareholders approved the reverse stock split of all of our shares, under the terms of Article 12 of the Brazilian Corporate Law, at the ratio of 1,000 existing shares per one share of the same type and class. When the shares began trading on BM&FBOVESPA in unitary form on June 27, 2005, each of our ADRs, which previously represented 1,000 preferred shares, became one preferred share.

## Cancellation of Treasury Stock

On March 9, 2006, a special meeting of the shareholders approved the cancellation of 1,562,387 shares of treasury stock, consisting of 1,258,508 common shares and 303,879 preferred shares. These treasury shares had been acquired as a result of a reverse stock split.

## B. Significant Changes

None.

## ITEM 9. THE OFFER AND LISTING

## A. Offer and Listing Details

The trading market for our common and preferred shares is BM&FBOVESPA.

Our preferred shares began trading on BM&FBOVESPA, on September 21, 1998 and are traded on BM&FBOVESPA under the symbol "VIVT4" (formerly TLPP4)." Our common shares trade under the symbol "VIVT3" (formerly TLPP3). At December 31, 2012, we had approximately 1,125.6 million common and preferred shares held by approximately 2.3 million common and preferred shareholders.

In the United States, the preferred shares trade in the form of ADRs, each representing one preferred share, issued by Citibank N.A, as depositary, pursuant to a Deposit Agreement, among us, the depositary and the registered holders and beneficial owners from time to time of ADRs. The ADRs commenced trading on the NYSE on November 16, 1998 and are traded on NYSE under the symbol "VIV" (formerly TSP). The following table sets forth the reported high and low closing sales prices for ADRs on the NYSE for the periods indicated.

Year ended	NYSE		BM&FBOVESPA		BM&FBOVESPA	
	HIGH	LOW	HIGH	LOW	HIGH	LOW
	(in US\$ per ADS)		(in reais per preferred share)		(in reais per common share)	
December 31, 2008	21.72	18.62	52.12	44.94	39.95	33.84
December 31, 2009	25.53	23.74	43.54	42.12	39.29	36.00
December 31, 2010	24.53	22.70	42.03	38.60	39.30	36.22
December 31, 2011	28.33	25.74	52.97	47.47	48.00	43.50
December 31, 2012	31.22	21.17	56.92	43.45	51.69	37.53
Year ended December 31, 2011						
First quarter	25.34	23.07	42.60	37.80	42.30	36.24
Second quarter	30.40	25.00	46.99	39.48	43.90	37.02
Third quarter	31.77	25.84	52.50	43.06	46.88	37.30
Fourth quarter	29.34	25.39	52.97	46.55	48.00	40.50

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Year ended December 31, 2012						
First quarter	31.02	27.02	56.59	47.50	50.98	42.77
Second quarter	31.22	23.31	56.92	47.30	51.69	43.20
Third quarter	25.66	21.35	51.60	43.45	47.88	39.40
Fourth quarter	24.08	21.17	49.28	43.54	43.65	37.53

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Month ended	NYSE		BM&FBOVESPA		BM&FBOVESPA	
	HIGH	LOW	HIGH	LOW	HIGH	LOW
	(in US\$ per ADS)		(in reais per preferred share)		(in reais per common share)	
September 30, 2012	23.07	21.37	46.63	43.45	41.30	39.40
October 31, 2012	22.40	21.45	45.70	43.54	40.94	37.53
November 30, 2012	23.35	21.80	48.95	44.79	42.76	39.33
December 31, 2012	24.08	21.17	49.28	45.20	43.65	39.35
January 31, 2013	25.79	24.32	52.55	49.62	47.47	43.00
February 29, 2013	26.59	24.43	52.57	48.14	46.10	43.00
March 2013 (through March 19)	27.66	26.41	54.12	52.04	48.24	45.41

## B. Plan of Distribution

Not applicable.

## C. Markets

## Trading on the BM&amp;FBOVESPA

The Brazilian Securities, Commodities and Futures Exchange (BM&FBOVESPA S.A. – Bolsa de Valores, Mercadorias e Futuros), or BM&FBOVESPA, is a Brazilian publicly traded company formed in 2008 through the integration between the São Paulo Stock Exchange (Bolsa de Valores de São Paulo) and the Brazilian Mercantile and Futures Exchange (Bolsa de Mercadorias & Futuros). BM&FBOVESPA is one of the largest exchanges in the world in market capitalization, the second in the Americas and the leader in Latin America.

Trading on the exchange is conducted by authorized members. Trading sessions take place every business day, from 10:00 a.m. to 5:00 p.m. or from 11:00 a.m. to 5:30 p.m. during daylight savings time in the U.S., on an electronic trading system called Megabolsa. Trading is also conducted between 5:45 p.m. and 7:00 p.m., or between 6:15 p.m. and 8:00 p.m. during daylight savings time in Brazil, in an after-market system connected to both traditional brokerage firms and brokerage firms operating on the Internet. This after-market trading is subject to regulatory limits on price volatility of securities traded by investors operating on the Internet.

To better control the excess of volatility in market conditions, BM&FBOVESPA has adopted a “circuit breaker” system pursuant to which trading sessions may be suspended for a period of 30 minutes or one hour whenever the indices of these stock exchanges fall below the limits of 10% and 15%, respectively, relative to the index of the previous trading day. In the event the stock exchange index falls by 20% in comparison to the previous trading day, BM&FBOVESPA may determine the suspension of trading sessions for a certain period which will be at its sole discretion.

At December 31, 2012, the aggregate market capitalization of the 364 companies listed on BM&FBOVESPA was approximately US\$1,235 billion. Although all the outstanding shares of an exchange-listed company may trade on a Brazilian stock exchange, in most cases, less than half of the listed shares are actually available for trading by the public, the remainder being held by small groups of controlling entities or persons that rarely trade their shares. For this reason, data showing the total market capitalization of Brazilian stock exchanges tends to overstate the liquidity of the Brazilian equity securities market.

## Regulation of Brazilian Securities Markets

The Brazilian securities market is regulated by the CVM, as provided for by the Brazilian Securities Exchange Act and Corporate Law. The National Monetary Council is responsible for supervising the CVM's activities, granting licenses to brokerage firms to govern their incorporation and operation, and regulating foreign investment and exchange transactions, as provided for by the Brazilian Securities Exchange Act and Law No. 4595 of December 31, 1964. These laws and regulations provide for, among other things, disclosure requirements, criminal sanctions for insider trading and price manipulation, protection of minority shareholders, the procedures for licensing and supervising brokerage firms and the governance of Brazilian stock exchanges.

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Under Brazilian Corporate Law, a company is either publicly held and listed, a companhia aberta, or privately held and unlisted, a companhia fechada. All listed companies are registered with the CVM and are subject to reporting requirements to periodically disclose information and material facts. A company registered with the CVM may trade its securities either on the Brazilian exchange markets, including the BM&FBOVESPA, or in the Brazilian over-the-counter market. Shares of companies listed on BM&FBOVESPA may not simultaneously trade on the Brazilian over-the-counter market. The over-the-counter market consists of direct trades between persons in which a financial institution registered with the CVM serves as an intermediary. No special application, other than registration with the CVM (and, in case of organized over-the-counter markets, in the applicable one), is necessary for securities of a public company to be traded in this market. To be listed on the BM&FBOVESPA, a company must apply for registration with the BM&FBOVESPA and the CVM.

Trading in securities on the BM&FBOVESPA may be suspended under a request from a company in anticipation of a material announcement. Trading in the securities of a particular company may also be suspended under the initiative of BM&FBOVESPA or the CVM, among other reasons, due to the belief that the company has provided inadequate information regarding a material event or has provided inadequate responses to inquiries by the CVM or the BM&FBOVESPA.

Brazilian securities law, the Brazilian Corporate Law and the regulations issued by CVM, CMN and the Central Bank provide, among other things, disclosure requirements and restrictions on insider trading, price manipulation and protection of minority shareholders.

### Corporate Governance Practices

We are a sociedade anônima, a corporation incorporated under the laws of Brazil, and are subject to the corporate governance provisions of the Brazilian Corporate Law. We comply with the regulatory requirements of the Brazilian Corporate Law regarding the independence of our Board of Directors, the establishment and composition of certain board committees and the adoption and disclosure of corporate governance guidelines.

We comply with several requirements of Brazilian and international laws to promote strong corporate governance, reduce investor uncertainties and enhance disclosure of material and other information.

With the approval of our Board of Directors and/or Officers, we implemented several measures over the last few years designed to improve our transparency and disclosure practices. We believe these measures will benefit our shareholders, and current and future investors as well as the marketplace in general. Among the measures we have implemented, we have:

- created a disclosure policy for material facts and corporate actions (Política de Divulgação de Ato e Fato Relevante);
- created a policy for internal controls related to financial information (Normativa sobre Registro, Comunicação e Controle de Informação Financeiro-Contábil);
  - created Service Quality and Marketing Committee;
  - created Control and Audit Committee;
  - created Nominations, Compensation and Corporate Governance Committee;
  - created a policy to denounce fraud within the company (Canal de Denúncias);

- created a policy for prior approval of contracting audit services (Normativa sobre Aprovação Prévia de Serviços a serem Prestados pelo Auditor Externo);
  - created an internal rule of conduct relating to the securities market (Regulamento Interno de Conduta);
- created an Ethics Code in respect of handling financial information (Normas de Conduta para Financeiros); and
- created a policy regarding communication of information to the securities market (Normativa sobre Comunicação de Informação aos Mercados).



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As determined by the Brazilian Corporate Law, the compensation of senior management is approved by our shareholders at an annual shareholders meeting. The Nominations, Compensation and Corporate Governance Committee provides information and recommendations to the Board of Directors regarding the criterion for compensation.

Our rules relating to insider trading are determined in our internal rules and the corporate laws. Senior management and members of our Board of Directors and any other employee exposed to sensitive information are subject to the restrictions imposed by such rules. In addition to the prohibition on trading of our shares by such individuals when in possession of insider information, the rules establishes blackout trading periods for those periods when insider information is available. As an example, the month before the formulation and approval of our annual financial statements by our Board of Directors is considered a blackout period under the charter. In addition, the charter sets forth instructions for dealing with conflicts of interest and mandates disclosure of any such situation.

Code of Business Conduct and Ethics

Although adoption of a code of ethics is not required by Brazilian Corporate Law, we implemented a code of ethics regulating the conduct of our managers in connection with the registration and control of financial and accounting information and their access to privileged and nonpublic information and data to comply with the requirements of the Sarbanes-Oxley Act and NYSE rules. See “Item 16B. Code of Ethics.”

In addition to complying with the rules of corporate governance applicable to us under Brazilian law, we intend to gradually comply with substantially all of the new rules established by the NYSE and the SEC applicable to domestic U.S. companies.

D. Selling Shareholders

Not applicable.

E. Dilution

Not applicable.

F. Expenses of the Issue

Not applicable.

ITEM 10. ADDITIONAL INFORMATION

A. Share Capital

Not applicable.

B. Memorandum and Articles of Association

Set forth below is certain information relating to our capital stock and a summary of certain significant provisions of our bylaws and the Brazilian Corporate Law.

General

We are registered with the Junta Comercial de São Paulo, the Board of Trade of São Paulo, or JUCESP, under No. 35.3.001588-14. According to Section 2 of our bylaws, our main corporate purpose is to provide telecommunications services and to develop those activities necessary or useful for the performance of these services, in accordance with the concessions, authorizations and permits granted to us.

There are no provisions in our bylaws with respect to:

- an officer's power to vote on proposals in which the officer has a personal interest;
- an officer's power to vote on his own compensation, even in the absence of an independent quorum;

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- age limits for retirement of officers;
- required shareholding to qualify as a manager (officer); or
- anti-takeover mechanisms or other procedures designed to delay, defer or prevent changes in our control.

Brazilian Corporate Law forbids a director to interfere in any business of the company when there is any conflicting interest between him and the company.

Brazilian Corporate Law no longer requires ownership of shares in order for a person to qualify as a member of the Board of Directors (conselho de administração) of a corporation (sociedade por ações), however our bylaws require that our directors own shares of the company.

Issuance of commercial paper and incurrence of certain debt shall be preceded by approval from our Board of Directors, according to the provisions set forth in section 17 of our bylaws.

Our capital stock comprises preferred shares and common shares, all without par value. At December 31, 2012, there were 261,308,985 outstanding preferred shares and 31,208,300 outstanding common shares. Our share capital may be increased by resolution of the Board of Directors, up to the limit authorized by our bylaws. Any increase above the capital must be approved by a general shareholders meeting.

The preferred shares are nonvoting, except under limited circumstances. They are given priority in the reimbursement of capital, without premium, and are entitled to receive a dividend 10% higher than that attributable to common shares.

Pursuant to Law No. 10,303/01, the following changes were introduced to the Brazilian Corporate Law:

- preferred shares representing 10% of our total number of outstanding shares would be entitled to appoint a representative to our Board of Directors;
  - disputes among our shareholders would be subject to arbitration, if provided for in our bylaws;
- a tender offer at a purchase price equal to fair value for all outstanding shares would be required upon a delisting or a substantial reduction in liquidity of our shares as a result of purchases by the controlling shareholders;
- any sale of control would require the shareholders to tender for the minority shareholders' common shares and, if provided for in our charter, for the minority shareholders' preferred shares, at a purchase price at least equal to 80% of the price per share with voting rights paid to the controlling shareholder;
- shareholders would be entitled to withdraw from us upon a spin-off only if it entailed a change in the corporate purpose, a reduction in mandatory dividends or the participation in a centralized group of companies;
- the controlling shareholders, the shareholders that elect members to our Board of Directors and Fiscal Board, the members of our Board of Directors and Fiscal Board and our Executive Officers would be required to disclose any purchase or sale of our shares to the CVM and BM&FBOVESPA; and
  - we would be permitted to satisfy our information disclosure requirements through the Internet.

Voting Rights

Each common share entitles the holder to one vote at general shareholders meetings. Preferred shares do not entitle the holder to vote at shareholders meetings, except under specific circumstances and with respect to certain matters, as specified below. Holders of preferred shares are only entitled to attend and to discuss, but not to vote on, the issues discussed at our general shareholders meetings.

The appointment of one member of our statutory Fiscal Board, including the alternate member, takes place at the annual ordinary general shareholders meeting, upon separate vote of the holders of preferred shares, for the

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position available at the Fiscal Board. The election of a member of the Board of Directors by preferred shareholders also occurs on a separate vote, with no participation of the controlling shareholder.

Brazilian Corporate Law provides that certain nonvoting shares, such as our preferred shares, shall be entitled to voting rights in the event a corporation fails for three consecutive fiscal years to pay any fixed or minimum dividends to which nonvoting shares are entitled. In this case, the voting rights of these shares shall extend until the date on which the payment of the accrued and unpaid dividend is made.

Preferred shares are entitled to full voting rights with respect to:

- the election of one member to the Board of Directors and Fiscal Board in a straight vote;
- bylaw modifications that seek to limit preferred shareholders' voting rights in respect of selecting new Board members in a straight vote;
- any agreements for the rendering of management services (including technical assistance services) between us and any foreign affiliate of our controlling shareholder;
- resolutions amending certain provisions of our bylaws; and
- any resolution submitted to the general shareholders meeting during our liquidation process.

Any change in the preference, benefits, conditions of redemption and amortization of preferred shares or the creation of a more favored class would require approval or ratification by holders of a majority of the preferred shares at a special meeting of the preferred shareholders. This meeting would be called by publication of a notice in two Brazilian newspapers during three days, at least 30 days before the meeting; however, it would not generally require any other form of notice.

In any circumstances in which holders of preferred shares are entitled to vote, each preferred share will entitle the holder to one vote.

## Preemptive Rights

Each shareholder has a general preemptive right to subscribe for shares of the same class in any capital increase, in an amount sufficient to keep the same proportional participation of each shareholder in the total capital of the corporation. A minimum period of 30 days following the publication of the capital increase notice shall be observed by the corporation for the exercise of the preemptive right by the shareholder. The right of participation in capital increases is assignable under Brazilian Corporate Law. However, the bylaws of a publicly held company that allows capital increases may provide for the issuance, without granting any preemptive rights to prior shareholders, of stocks, debentures convertible into stocks, or subscription bonuses, the placement of which shall be made:

- upon sale on a stock exchange or public subscription;
- through an exchange of shares in a public offering, with the purpose of acquiring control of another company; or
- for the use of certain tax incentives.

In the event of a capital increase, which would maintain or increase the proportion of capital represented by preferred shares, holders of ADSs, or of preferred shares, would have preemptive rights to subscribe only to our newly issued

preferred shares. In the event of a capital increase, which would reduce the proportion of capital represented by preferred shares, holders of ADSs, or of preferred shares, would have preemptive rights to subscribe to our new preferred shares, in proportion to their shareholdings and to our new common shares only to the extent necessary to prevent dilution of their interest.

#### Redemption and Right of Withdrawal

According to the Brazilian Corporate Law, dissenting shareholders in a shareholders meeting shall have a right of redemption, with reimbursement of the value of their shares, in case the following matters are approved:

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- (i) creation of a new class of preferred shares or an increase in preferred shares of an existing class, without maintaining the proportion with the remaining classes;
- (ii) change in the preferences, advantages and conditions of redemption or amortization of one or more classes of preferred shares, or the creation of a class with more favorable rights or preferences;
  - (iii) reduction of the mandatory dividend;
  - (iv) merger into another company or consolidation with another company;
  - (v) participation in a group of companies;
  - (vi) change in the purpose of the corporation; and
  - (vii) split-up of the corporation.

It is important to point out that (a) in items (i) and (ii), only the holders of shares of the affected type or class will be entitled to redemption; (b) in items (iv) and (v), the holders of shares of a type or class with liquidity and dispersion in the market will not have the right; and (c) in item (vii), the dissenting shareholders shall only have a right of redemption if the split-up implies a change in the corporate purpose, a reduction of the compulsory dividend or participation in a group of companies.

Reimbursement must be required by the dissenting shareholders within 30 days after the publication of the minutes of the general shareholders meeting or special meeting, as the case may be. Within 10 days after the expiration of the period, management is authorized to call a general shareholders meeting to ratify or reconsider the decision, if management understands that the payment of reimbursement to the dissenting shareholders who have exercised their redemption right may jeopardize the financial stability of the company. A shareholder who fails to exercise the right within the assigned term shall no longer be entitled to redemption.

According to the Brazilian Corporate Law, the amount to be reimbursed may only be lower than the share net value ascertained in the last balance sheet approved by the general shareholders meeting if this amount is based on the economic value of the corporation, to be duly appraised. If the decision of the general shareholders meeting takes place more than 60 days after the issuance of the last approved balance sheet, the shareholder shall be entitled to demand, together with the reimbursement, the preparation of a special balance sheet that complies with the time frame previously described.

C. Material Contracts

On June 30, 2011, we have renewed our concession agreement with ANATEL and consolidated our existing material contracts related to the concession of public telecommunications service granted by ANATEL into two new contracts (each filed as an Exhibit to this Annual Report). One of these contracts authorizes the company to provide commuted fixed telephone service (Sectors 31) and the other contract authorizes the company to provide long-distance telephone services (Sector 31). These contracts will expire on December 31, 2025.

Telefônica Brasil had also authorization to provide local and long-distance telephone services under the private system (all sectors, except Sector 31), which was granted in 2002, for an unlimited period of time. On September 5, 2011, these Authorization Terms were transferred to Vivo. Telefônica Brasil and VIVO have Multimedia Communication Service Authorization Terms, which are also material contracts. Based on this Authorization Terms, the companies are allowed to provide broadband services in the State of São Paulo (Telefônica) and all over Brazilian territory (Vivo\*).

The Term was signed on April 17, 2003 and March 19, 2004 for an undetermined period of time and is still currently in effect.

\*The Authorization Term was granted to Global Telecom, an incorporated company.

In line with the General Plan of Authorization, which had split the country into three regions, Vivo holds three Authorization Terms for the provision of Personal Mobile Services, SMP, with national coverage. The regions were split as follows: Region I: states of Rio de Janeiro, Espírito Santo, Minas Gerais, Amazonas, Roraima, Amapá, Pará, Maranhão, Bahia, Sergipe, Piauí, Ceará, Rio Grande do Norte, Paraíba, Pernambuco and Alagoas, Region II: states



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of Paraná, Santa Catarina, Rio Grande do Sul, Goiás, Tocantins, Mato Grosso do Sul, Mato Grosso, Rondônia, Acre and Federal District and Region III: State of São Paulo.

In Region I, Vivo holds the Terms of Service Authorization n ° 078/2012 of 07/02/2012, in Region II, VIVO SA holds the Terms of Service Authorization n ° 005/2010 of 29/01/2010, and in Region III, VIVO SA holds the Terms of Service Authorization n ° 006/2010 of 29/01/2010.

The authorization is a legal requirement for the provision of telecommunications services in the region covered thereby. Licenses for personal mobile services (SMP) carry the right to provide mobile services for an unlimited period of time. However, the use of spectrum is restricted in accordance with the specific license conditions. All Telefónica's Brazilian mobile authorizations were granted to Vivo as follows:

- Vivo-Rio Grande do Sul except Pelotas, Capão do Leão, Morro Redondo e Turuçu ("A" band) until 2022 (renewed in 2007);
  - Vivo-Rio de Janeiro ("A" band) until 2020 (renewed in 2005);
  - Vivo-Espírito Santo ("A" band) until 2023 (renewed in 2008);
  - Vivo-Bahia ("A" band) and Vivo-Sergipe ("A" band) until 2023 (renewed in 2008);
- Vivo-São Paulo ("A" band) until 2023 (renewed in 2008); or 2024, for the cities of Ribeirão Preto and Guatapar (renewed in 2009);
  - Vivo-Paraná/Santa Catarina ("B" band) until 2013;
  - Vivo-Distrito Federal ("A" band) until 2021 (renewed in 2006);
- Vivo-Acre ("A" band), Vivo-Rondnia ("A" band), Vivo-Mato Grosso ("A" band) and Vivo-Mato Grosso do Sul ("A" band) until 2024 (renewed in 2009);
  - Vivo-Gois/Tocantins ("A" band) until 2023 (renewed in 2008);
  - Vivo-Amazonas/Roraima/Amap/Par/Maranho ("B" band) until 2013;
  - Vivo Minas Gerais\* ("A" band) until 2023 (renewed in 2008);
- Vivo for the cities in which CTBC Telecom operates in the state of Minas Gerais\* ("E" band) until 2020;

\* On October 1, 2011, assets, rights and obligations of Vivo Participaes relating to mobile operations in Minas Gerais were awarded to Vivo, a subsidiary of Vivo Participaes.

License renewals for "A" and "B" bands must be requested 30 months in advance of the expiry date. Spectrum rights may be renewed only once, for a 15-year period. After this period, the license must be renegotiated.

License renewals for the "E" band must be requested between 36 and 48 months in advance of the expiry date. Spectrum rights may be renewed only once, for a 15-year period. After this period, the license must be renegotiated.

In December 2007, ANATEL auctioned off nationally 15 blocks in the 1900 MHz band (“L” band). Vivo won 13 through Brasil, except in the northern region and the towns of Londrina and Tamarana in the state of Paraná. The spectrum licenses, along with the related renewal dates, are as follows:

- Vivo-Rio Grande do Sul (“L” band) until 2022 (renewed in 2007) including cities in the Pelotas metropolitan area;
  - Vivo-Rio de Janeiro (“L” band) until 2020 (renewed in 2005);
  - Vivo-Espírito Santo (“L” band) until 2023 (renewed in 2008);
  - Vivo-Bahia (“L” band) and Vivo-Sergipe (“L” band) until 2023 (renewed in 2008);
- Vivo-São Paulo (“L” band) until 2023 (renewed in 2008), the cities of Ribeirão Preto, Guatapara and Bonfim Paulista (renewed in 2009) until 2024, and the cities where CTBC Telecom operates in the state of Sao Paulo until 2022;
  - Vivo-Parana (excluding the cities of Londrina and Tamarana)/Santa Catarina (“L” band) until 2013;
    - Vivo-Federal District (“L” band) until 2021 (renewed in 2006);

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- Vivo-Acre (“L” band), Vivo-Rondônia (“L” band), Vivo-Mato Grosso (“L” band) and Vivo-Mato Grosso do Sul (“L” band) until 2024 (renewed in 2008) and the city of Paranaíba de Mato Grosso do Sul until 2022;
- Vivo-Goiás/Tocantins (“L” band) until 2023 (renewed in 2008) and the cities where CTBC Telecom operates in the state of Goiás until 2022; and
  - Vivo-Alagoas/Ceará/Paraíba/Piauí/Pernambuco/Rio Grande do Norte (“L” band) until 2022;

License renewals for the “L” band must be requested between 36 and 48 months in advance of the expiry date. Spectrum rights may be renewed only once, for a 15-year period. After this period, the license must be renegotiated.

In April 2008, ANATEL auctioned off 36 blocks 2100 MHz band (3G licenses). Vivo obtained nine in the “J” band through Brasil, enabling it to provide nationwide coverage in 3G. The spectrum licenses, along with the related renewal dates, are as follows:

- Vivo-Rio Grande do Sul (including cities in the Pelotas metropolitan area) (“J” band) until 2023;
  - Vivo-Rio de Janeiro (“J” band) until 2023;
  - Vivo-Espírito Santo (“J” band) until 2023;
  - Vivo-Bahia (“J” band) and Vivo-Sergipe (“J” band) until 2023;
- Vivo-São Paulo (including the cities of Ribeirão Preto, Guataporá and Bonfim Paulista and the cities where CTBC Telecom operates in the state of São Paulo) (“J” band) until 2023;
  - Vivo-Paraná (including the cities of Londrina and Tamarana)/Santa Catarina (“J” band) until 2023;
    - Vivo-Federal District (“J” band) until 2023;
- Vivo-Acre (“J” band), Vivo-Rondônia (“J” band), Vivo-Mato Grosso (“J” band) and Vivo-Mato Grosso do Sul (including the city of Paranaíba) (“J” band) until 2023;
- Vivo-Goiás (including the cities where CTBC Telecom operates in the state of Goiás)/Tocantins (“J” band) until 2023;
  - Vivo-Alagoas/Ceará/Paraíba/Piauí/Pernambuco/Rio Grande do Norte (“J” band) until 2023;
    - Vivo-Amazonas/Roraima/Amapá/Pará/Maranhão (“J” band) until 2023; and
- Vivo-Minas Gerais\* (including the cities where CTBC Telecom operates in the state of Minas Gerais) (“J” band) until 2023

\* On October 1, 2011, assets, rights and obligations of Vivo Participações relating to mobile operations in Minas Gerais were awarded to Vivo, a subsidiary of Vivo Participações.

License renewals for the “J” band must be requested between 36 and 48 months in advance of the expiry date. Spectrum rights may be renewed only once, for a 15-year period. After this period, the license must be renegotiated.

In December 2010, ANATEL auctioned off 169 licenses in the 900 MHz, 1800 MHz and 2100 MHz frequencies. Vivo secured 23 blocks, 14 in 1800 MHz frequency band “D”, “E”, “M” and extension bands, and 9 in the 900 MHz extension bands, giving it nationwide coverage in the 1800 MHz frequency band. The spectrum licenses are up for renewal in 2023.

- "M" Band (1800 MHz) in the Federal District and the states of Paraná, Santa Catarina, Rio Grande do Sul, Goiás, Tocantins, Mato Grosso do Sul, Mato Grosso, Rondônia and Acre;
  - Extension of the 1800 MHz band throughout the State of São Paulo;
- "D" Band (1800 MHz) in the cities of Pelotas, Morro Redondo, Capão do Leão and Turuçu in the state of Rio Grande do Sul;
- "E" Band (1800 MHz) in the states of Alagoas, Ceará, Paraíba, Piauí, Pernambuco and Rio Grande do Norte;
  - Extension of the 900 MHz band in the State of Rio de Janeiro;

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- Extension of the 900 MHz band in the State of Espírito Santo;
- Extension of the 900 MHz band in the States of Goiás, Tocantins, Mato Grosso do Sul, Mato Grosso, Rondônia and Acre and the Federal District, with the exception of the cities of Paranaíba in the state of Mato Grosso do Sul and the cities of Buriti Alegre, Cachoeira Dourada, Inaciolândia, Itumbiara, Paranaiguara and São Simão, in the state of Goiás;
- Extension of the 900 MHz band in the State of Rio Grande do Sul, with the exception of the cities of Pelotas, Morro Redondo, Capão do Leão and Turuçu;
- Extension of the 900 MHz band in the cities of registry area number 43 in the state of Paraná with the exception of the cities of Londrina and Tamarana;
- Extension of the 900 MHz band in the States of Paraná and Santa Catarina with the exception of the cities of registry area number 43 in the state of Paraná and the cities of Londrina and Tamarana;
  - Extension of the 900 MHz band in the state of Bahia;
  - Extension of the 900 MHz band in the state of Sergipe;
- Extension of the 900 MHz band in the states of Amazonas, Amapá, Maranhão Pará and Roraima;
- Extension of the 1800 MHz band in the state of São Paulo, with the exception of the cities in the metropolitan area of São Paulo and the cities where CTBC Telecom operates in the state of São Paulo;
  - Extension of the 1800 MHz band in the States of Amazonas, Amapá, Maranhão Pará and Roraima;
  - Extension of the 1800 MHz band in the city of Paranaíba in the state of Mato Grosso do Sul;
- Extension of the 1800 MHz band in the cities of Buriti Alegre, Cachoeira Dourada, Inaciolândia, Itumbiara, Paranaiguara and São Simão, in the state of Goiás;
- Another extension of the 1800 MHz band in the cities of Buriti Alegre, Cachoeira Dourada, Inaciolândia, Itumbiara, Paranaiguara and São Simão, in the state of Goiás;
  - Extension of the 1800 MHz band in the states of Rio do Janeiro, Espírito Santo, Bahia and Sergipe;
  - Extension of the 1800 MHz band in the states of Amazonas, Amapá, Maranhão Pará and Roraima;
- Extension of the 1800 MHz band in the states of Alagoas, Ceará, Paraíba, Piauí, Pernambuco and Rio Grande do Norte;
- Extension of the 1800 MHz band in the city of Paranaíba in the state of Mato Grosso do Sul, and the cities of Buriti Alegre, Cachoeira Dourada, Inaciolândia, Itumbiara, Paranaiguara and São Simão, in the state of Goiás;
  - Extension of the 1800 MHz band in the cities of Londrina and Tamarana in the state of Paraná;

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In April 2012, ANATEL auctioned off 273 licenses in the 450 MHz, and 2500 MHz frequencies. Vivo secured 1 block in 2500 MHz frequency band “X” (20 + 20 MHz) in a national basis, which came along with the right to use (and the obligations of) the 450 MHz frequency band in the states of Alagoas (AL), Ceará (CE), Minas Gerais (MG), Paraíba (PB), Pernambuco (PE), Piauí (PI), Rio Grande do Norte (RN) and Sergipe (SE), as well as the areas identified by the National Codes 13, 14, 15, 16, 17, 18 e 19, in the state of São Paulo (SP)

- Vivo Brasil (“X” Band – 2500 MHz) until 2027 (associated to SMP service);
- Vivo AL, CE, MG, PB, PE, PI, RN, SE (450 MHz) until 2027 (associated to STFC and SCM services);
- Vivo in the areas identified by the National Codes 13, 14, 15, 16, 17, 18 e 19, in the state of São Paulo (SP), until 2027 (associated to SMP and SCM services).

All the licenses referenced above may be renewed, only once, for an additional term of fifteen years upon payment of 2% of operator’s net revenues from usage charges in the region described above in the year prior to the year when payment is due, and every two years during the extension period.

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On October 14, 2011 a credit facility totaling R\$3.0 billion was obtained from BNDES. These funds will be invested in the expansion and improvement of the current network, implementation of infrastructure necessary for new technology, in the period from 2011 to 2013, as well as in the construction of a data center in Tamboré (State of São Paulo) and in social projects. The agreement has a term of eight years and has a grace period which expires on July 15, 2014, until when only interest will be paid, on a three-month basis. After this period, interest and amortization of the principal will be paid in 60 consecutive monthly installments.

D. Exchange Controls

There are no restrictions on ownership of preferred shares or common shares by individuals or legal entities domiciled outside of Brazil.

The right to convert dividend or interest payments and proceeds from the sale of shares into foreign currency and to remit such amounts outside Brazil is subject to restrictions under foreign investment legislation which generally requires, among other things, that the relevant investments have been registered with the Central Bank and the CVM. The restrictions on the remittance of foreign capital abroad may hinder or prevent the custodian for the preferred shares represented by ADSs or holders of preferred shares from converting dividends, distributions or the proceeds from any sale of these preferred shares into U.S. dollars and remitting the U.S. dollars abroad. Holders of ADSs could be adversely affected by delays in, or refusal to grant any, required government approval to convert Brazilian currency payments on the preferred shares underlying the ADSs and to remit the proceeds abroad.

Resolution No. 1,927 of the CMN provides for the issuance of depositary receipts in foreign markets in respect of shares of Brazilian issuers. It restates and amends Annex V to Resolution No. 1,289 of the National Monetary Council, known as the Annex V Regulations. The ADS program was approved under the Annex V Regulations by the Central Bank and the CVM before the issuance of the ADSs. Accordingly, the proceeds from the sale of ADSs by holders outside Brazil are free of Brazilian foreign investment controls, and holders of the ADSs may be entitled to favorable tax treatment. See “—E. Taxation—Brazilian Tax Considerations.”

Under Resolution No. 2,689 of the CMN, foreign investors registered with the CVM may buy and sell Brazilian securities, including the preferred shares, on Brazilian stock exchanges without obtaining separate certificates of registration for each transaction. Registration is available to qualified foreign investors, which principally include foreign financial institutions, insurance companies, pension and investment funds, charitable foreign institutions and other institutions that meet certain minimum capital and other requirements. Resolution No. 2,689 also extends favorable tax treatment to registered investors. See “—E. Taxation—Brazilian Tax Considerations.”

Pursuant to Resolution No. 2,689 foreign investors must (i) appoint at least one representative in Brazil with the ability to perform actions regarding the foreign investment; (ii) complete the appropriate foreign investor registration form; (iii) obtain registration as a foreign investor with the CVM; and (iv) register the foreign investment with the Central Bank.

The securities and other financial assets held by a foreign investor pursuant to Resolution No. 2,689 must be registered or maintained in deposit accounts or under the custody of an entity duly licensed by the Central Bank or by the CVM or be registered in register, clearing and custody systems authorized by the Central Bank or by the CVM. In addition, the trading of securities is restricted to transactions carried out on the stock exchanges or over-the-counter markets licensed by the CVM.

Registered Capital

Amounts invested in preferred shares by a non-Brazilian holder who qualifies under Resolution No. 2,689 and obtains registration with the CVM, or by the depositary representing an ADS holder, are eligible for registration with the Central Bank. Such registration (the amount so registered is referred to as registered capital) allows the remittance outside Brazil of foreign currency, converted at the commercial market rate, acquired with the proceeds of distributions on, and amounts realized through, dispositions of such preferred shares. The registered capital per preferred share purchased in the form of ADS, or purchased in Brazil and deposited with the depositary in exchange for ADS, will be equal to its purchase price (stated in U.S. dollars). The registered capital per preferred share withdrawn upon cancellation of an ADS will be the U.S. dollar equivalent of (i) the average price of a preferred share on the Brazilian stock exchange on which the most preferred shares were traded on the day of withdrawal or (ii) if no preferred shares were traded on that day, the average price on the Brazilian stock exchange on which the most preferred shares were traded in the 15 trading sessions immediately preceding such withdrawal. The U.S.



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dollar equivalent will be determined on the basis of the average commercial market rates quoted by the Central Bank on such date or dates.

An electronic registration has been issued in the name of the depositary with respect to the ADSs and is maintained by the custodian on behalf of the depositary. Pursuant to the registration, the custodian and the depositary are able to convert dividends and other distributions with respect to the preferred shares represented by ADSs into foreign currency and remit the proceeds outside Brazil. If a holder of ADSs exchanges such ADSs for preferred shares, such holder will be entitled to continue to rely on the depositary's registration for five business days after such exchange, following which such holder must seek to obtain its own electronic registration with the Central Bank. Thereafter, any holder of preferred shares may not be able to convert into foreign currency and remit outside Brazil the proceeds from the disposition of, or distributions with respect to, such preferred shares, unless such holder is a duly qualified investor under Resolution No. 2,689 and obtains its own electronic registration.

If the holder does not qualify under Resolution No. 2,689 by registering with the CVM and the Central Bank and appoints a representative in Brazil to act directly in the Brazilian market to acquire preferred shares, the holder will be subject to a less favorable Brazilian tax treatment than a holder of ADSs. Regardless of registration under Resolution No. 2,689, residents of tax havens are subject to less favorable tax treatment than other foreign investors. See “—E. Taxation—Brazilian Tax Considerations.”

Under current Brazilian legislation, the federal government may impose temporary restrictions on remittances of foreign capital abroad in the event of a serious imbalance or an anticipated serious imbalance of Brazil's balance of payments. For approximately six months in 1989 and early 1990, the federal government froze all dividend and capital repatriations held by the Central Bank that were owed to foreign equity investors, to conserve Brazil's foreign currency reserves. These amounts were subsequently released in accordance with federal government directives. There can be no assurance that the federal government will not impose similar restrictions on foreign repatriations in the future.

### E. Taxation

The following discussion contains a description of the material Brazilian and U.S. federal income tax consequences of the acquisition, ownership and disposition of preferred shares or ADSs by certain holders. This summary is based upon the tax laws of Brazil and the United States as of the date of this annual report, which are subject to change, possibly with retroactive effect, and to differing interpretations. You should consult your own tax advisors as to the Brazilian, U.S. federal or other tax consequences of the acquisition, ownership and disposition of preferred shares or ADSs, including, in particular, the effect of any state, local or non-U.S., non-Brazilian tax laws.

Although there is presently no income tax treaty between Brazil and the United States, the tax authorities of the two countries have had discussions that may culminate in such a treaty. No assurance can be given, however, as to whether or when a treaty will enter into force or how it will affect the U.S. holders of preferred shares or ADSs.

#### Brazilian Tax Considerations

The following discussion summarizes the material Brazilian tax consequences of the acquisition, ownership and disposition of preferred shares or ADSs by a U.S. holder not deemed to be domiciled in Brazil for Brazilian tax purposes (a “U.S. holder”). This discussion does not address all the Brazilian tax considerations that may be applicable to any particular non-Brazilian holder, and each non-Brazilian holder should consult its own tax advisor about the Brazilian tax consequences of investing in preferred shares or ADSs.

#### Taxation of Dividends

Dividends paid by us in cash or in kind from profits generated on or after January 1, 1996 (i) to the depositary in respect of preferred shares underlying ADSs or (ii) to a U.S. holder or other non-Brazilian holder in respect of preferred shares will generally not be subject to Brazilian withholding tax. We do not have any undistributed profits generated before January 1, 1996. If payment of dividends is made to a beneficiary located outside of Brazil, the Tax on Exchange Transactions, described below applies at a rate of zero.

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### Distributions of Interest on Shareholders' Equity

Brazilian corporations may make payments to shareholders characterized as interest on shareholders' equity as an alternative form of making dividend distributions. Amounts paid as interest on shareholders' equity (net of applicable withholding tax, as described below) may be treated as payments with respect to the dividends we are obligated to distribute to our shareholders in accordance with our bylaws (estatuto social) and Brazilian Corporate Law. The rate of interest may not be higher than the federal government's TJLP, as determined by the Central Bank from time to time (6% per annum for 2011, first and second quarter for 2012 and 5.5% per annum for third and fourth quarter 2012). The total amount distributed as interest on shareholders' equity may not exceed the greater of (i) 50% of net income (before taking the distribution and any deductions for income taxes into account) for the year with respect to which the payment is made and (ii) 50% of retained earnings for the year before the year with respect to which the payment is made. Payments of interest on shareholders' equity are decided by the shareholders on the basis of recommendations of the company's Board of Directors. See "Item 8. Financial Information—A. Consolidated Statements and Other Financial Information—Dividends and Dividend Distribution Policy—Additional Payments on Shareholders' Equity."

Distributions of interest on shareholders' equity paid to Brazilian and non-Brazilian holders of preferred shares, including payments to the depositary in respect of preferred shares underlying ADSs, are deductible by us for Brazilian corporate income tax purposes. These payments to U.S. holders or other non-Brazilian holders are subject to Brazilian withholding tax at the rate of 15%. If the recipient of the payment is domiciled in a tax haven jurisdiction, the rate will be 25%.

If payment of interest on shareholders' equity is made for a beneficiary located outside of Brazil, the IOF applies at a rate of zero.

Distributions of interest on shareholders' equity with respect to the preferred shares, including distributions to the depositary with respect to the preferred shares underlying the ADSs, may be converted into U.S. dollars and remitted outside of Brazil, subject to applicable exchange controls.

No assurance can be given that our Board of Directors will not recommend that future distributions of profits will be made by means of interest on shareholders' equity instead of by means of dividends.

### Taxation of Gains

Gains realized outside Brazil by a U.S. holder or other non-Brazilian holder on the disposition of property located in Brazil, including preferred shares, to another non-Brazilian holder are subject to Brazilian tax. In this case, gains would be subject to a 15% withholding tax rate, except if the beneficiary is located in a low-tax jurisdiction, as defined by Brazilian law, in which case the applicable rate would be 25%.

Our understanding is that ADSs do not qualify as property located in Brazil and, therefore, are not subject to Brazilian taxes upon disposition to other non-Brazilian holders. Insofar as this understanding has not been tested through the administrative or judicial courts, however, we are unable to evaluate what the final ruling on the matter will be. If Brazilian tax authorities determine that the ADSs are properly located in Brazil, gains may be subject to income tax in Brazil.

Gains realized by U.S. holders or other non-Brazilian holders on dispositions of preferred shares in Brazil or in transactions with Brazilian residents may be free from Brazilian tax, taxed at a rate of 25% or taxed at a rate of 15%, depending on the circumstances:

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Gains on the disposition of preferred shares obtained upon cancellation of ADSs are not taxed in Brazil if the proceeds are remitted abroad within five business days of cancellation, unless the investor is a resident of a jurisdiction that, under Brazilian law, is deemed to be a tax haven.

- Gains realized on the disposition of preferred shares through transactions with Brazilian residents or through transactions in Brazil off the Brazilian stock exchanges are generally subject to tax at a rate of 15%, or 25% in the case of a non-Brazilian holder residing in a tax haven jurisdiction.
- Gains realized on preferred shares through transactions on Brazilian stock exchanges (including the organized over-the-counter market) are generally subject to tax at a rate of 15%, as of January 2005, unless the investor

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is entitled to tax-free treatment for the transaction under Resolution No. 2,689 of the National Monetary Council Regulations, as described immediately below. Non-Brazilian holders residing in a tax haven jurisdiction may be subject to tax at a rate of up to 25%.

Resolution No. 2,689 extends favorable tax treatment to a U.S. holder or other non-Brazilian holder of preferred shares who has (i) appointed a representative in Brazil with power to take action relating to the investment in preferred shares, (ii) registered as a foreign investor with the CVM and (iii) registered its investment in preferred shares with the Central Bank. Under Resolution No. 2,689, securities held by foreign investors must be maintained under the custody of, or in deposit accounts with, financial institutions duly authorized by the Central Bank and the CVM. In addition, the trading of securities is restricted under Resolution No. 2,689 to transactions on Brazilian stock exchanges or qualified over-the-counter markets. The preferential treatment generally afforded under Resolution No. 2,689 to investors in ADSs is not available to residents of tax havens. All preferred shares underlying ADSs qualify under Resolution No. 2,689.

There can be no assurance that the current preferential treatment for U.S. holders and other non-Brazilian holders under Resolution No. 2,689 will be maintained.

Gain on the disposition of preferred shares is measured by the difference between the amount realized on the sale or exchange and the acquisition cost of the shares sold, measured in Brazilian currency, without any correction for inflation. Although the matter is not free from doubt, there are arguments to sustain the position that the acquisition cost of shares registered as an investment with the Central Bank is calculated on the basis of the foreign currency amount registered with the Central Bank. See “—D. Exchange Controls—Registered Capital.”

Gains realized by a U.S. holder or other non-Brazilian holder upon the redemption of preferred shares will be treated as gains from the disposition of such preferred shares to a Brazilian resident occurring off a stock exchange and will accordingly be subject to tax at a rate of 15%, unless the non-Brazilian holder is domiciled in a tax haven jurisdiction, in which case the applicable rate would be 25%.

As of January 1, 2005, the purchase price of preferred shares sold on the Brazilian stock exchange and on the Brazilian non-organized over-the-counter market is subject to withholding tax at a rate of 0.005%, except in the case of non-Brazilian holders entitled to tax-free treatment for the transaction under Resolution No. 2,689. This tax may be offset against the 15% income tax due on the gains realized upon the sale of the shares.

Any exercise of preemptive rights relating to the preferred shares or ADSs will not be subject to Brazilian taxation. Gains on the sale or assignment of preemptive rights relating to the preferred shares will be treated differently for Brazilian tax purposes depending on (i) whether the sale or assignment is made by the depositary or the investor and (ii) whether the transaction takes place on a Brazilian stock exchange. Gains on sales or assignments made by the depositary on a Brazilian stock exchange are not taxed in Brazil, but gains on other sales or assignments may be subject to tax at rates up to 15%, or 25% in the case of residents of tax haven jurisdictions.

The deposit of preferred shares in exchange for the ADSs is not subject to Brazilian income tax if the preferred shares are registered under Resolution No. 2,689 and the respective holder is not in a tax haven jurisdiction. If the preferred shares are not so registered or the holder is in a tax haven jurisdiction, the deposit of preferred shares in exchange for ADSs may be subject to Brazilian capital gains tax at a rate of 15%.

The withdrawal of preferred shares in exchange for ADSs is not subject to Brazilian tax. On receipt of the underlying preferred shares, a U.S. holder or non-Brazilian holder entitled to benefits under Resolution No. 2,689 will be entitled to register the U.S. dollar value of such shares with the Central Bank as described above, under “—D. Exchange Controls—Registered Capital.” If a U.S. holder or other non-Brazilian holder does not qualify under Resolution No.

2,689, such person will be subject to the less favorable tax treatment described above in respect of exchanges of preferred shares. Brazil's tax treaties do not grant relief from taxes on gains realized on sales or exchanges of preferred shares.

**Beneficiaries Residing or Domiciled in Tax Havens or Low-Tax Jurisdictions**

With limited exceptions, any income derived from operations by a beneficiary that resides or is domiciled in a country considered to be a tax haven is subject to income tax to be withheld by the source at a rate of 25% instead of 15%. The increased rate also applies for capital gains paid to residents of low-tax jurisdictions.

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In accordance with Law No. 9,959, non-Brazilian holders of ADSs or preferred shares who are residents of tax havens have been excluded from the tax incentives granted to holders of ADSs and investors under Resolution No. 2,689 since January 1, 2000 and are subject to the same tax treatment applicable to holders that are residents of or domiciled in Brazil.

### Tax on Financial Transactions (IOF Tax)

IOF, or “IOF/Exchange Tax,” is a tax on the conversion of reais into foreign currency and on the conversion of foreign currency into reais. As a general rule, the inflow of funds related to investments carried out on the Brazilian financial and capital markets by a non-Brazilian holder that has registered its investment in Brazil with the Central Bank is subject to the IOF/Exchange Tax at a rate of 6.0%. However, if the inflow is related to an investment in the stock exchange or in over-the-counter markets, IOF/Exchange will trigger at the rate of 0%. Foreign exchange transactions related to outflows of funds in connection with investments carried out on the Brazilian financial and capital markets are subject to the IOF/Exchange Tax at a rate of zero, which also applies to payments of dividends and interest on shareholders’ equity. With the exception of these transactions, the rate applicable to most foreign exchange transactions is 0.38%. Other rates may apply to particular transactions and the Brazilian government may increase the rate at any time by up to 25.0% on the future foreign exchange transaction amount.

An “IOF/Bonds Tax” is due on transactions involving bonds and securities, including those carried out on a Brazilian stock exchange. The rate of the IOF/Bonds Tax applicable to the transfer of shares with the sole purpose of enabling the issuance of ADSs is currently 1.5%. The Brazilian government may increase the rate of the IOF/Bonds Tax at any time by up to 1.5% per day of the transaction amount, but only in respect of future transactions.

### Other Brazilian Taxes

There are no Brazilian inheritance, gift or succession taxes applicable to the ownership, transfer or disposition of preferred shares or ADSs by a non-Brazilian holder except for gift and inheritance taxes levied by some states in Brazil on gifts made or inheritances bestowed by individuals or entities not resident or domiciled in Brazil or in the relevant state to individuals or entities that are resident or domiciled within this state in Brazil. There are no Brazilian stamp, issue, registration, or similar taxes or duties payable by holders of preferred shares or ADSs.

### U.S. Federal Income Tax Considerations

The following are the material U.S. federal income tax consequences to U.S. Holders described herein of owning and disposing of preferred shares or ADSs, but this is not a comprehensive description of all of the tax considerations that may be relevant to a particular person’s decision to hold such securities. The discussion applies only to U.S. Holders that hold preferred shares or ADSs as capital assets for U.S. federal income tax purposes and it does not describe all of the tax consequences that may be relevant to holders subject to special rules, such as:

- certain financial institutions;
- dealers or traders in securities who use a mark-to-market method of tax accounting;
- persons holding preferred shares or ADSs as part of a hedge, “straddle,” integrated transaction or similar transaction;
- persons whose functional currency for U.S. federal income tax purposes is not the U.S. dollar;
- entities classified as partnerships for U.S. federal income tax purposes;

- persons liable for the alternative minimum tax or the Medicare contribution tax;
  - tax-exempt organizations;
- persons that own or are deemed to own 10% or more of our voting stock;
- persons who acquired our ADSs or preferred shares pursuant to the exercise of any employee stock option or otherwise as compensation; or
- persons holding preferred shares or ADSs in connection with a trade or business conducted outside of the United States.



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If an entity that is classified as a partnership for U.S. federal income tax purposes holds preferred shares or ADSs, the U.S. federal income tax treatment of a partner will generally depend on the status of the partner and upon the activities of the partnership. Partnerships holding preferred shares or ADSs and partners in such partnerships should consult their tax advisers as to the particular U.S. federal income tax consequences of holding and disposing of the preferred shares or ADSs.

This discussion is based on the Internal Revenue Code of 1986, as amended (the “Code”), administrative pronouncements, judicial decisions and final, temporary and proposed Treasury regulations, all as of the date hereof. These laws are subject to change, possibly on a retroactive basis. It is also based in part on representations by the depositary and assumes that each obligation under the Deposit Agreement and any related agreement will be performed in accordance with its terms.

You are a “U.S. Holder” if, for U.S. federal income tax purposes, you are a beneficial owner of preferred shares or ADSs and if you are:

- a citizen or resident of the United States;
- a corporation, or other entity taxable as a corporation, created or organized in or under the laws of the United States, any state therein or the District of Columbia; or
- an estate or trust the income of which is subject to U.S. federal income taxation regardless of its source.

THE SUMMARY OF U.S. FEDERAL INCOME TAX CONSEQUENCES SET OUT BELOW IS INTENDED FOR GENERAL INFORMATION PURPOSES ONLY. U.S. HOLDERS OF PREFERRED SHARES OR ADSs ARE URGED TO CONSULT WITH THEIR OWN TAX ADVISERS WITH RESPECT TO THE PARTICULAR TAX CONSEQUENCES TO THEM OF OWNING OR DISPOSING OF PREFERRED SHARES OR ADSs, INCLUDING THE APPLICABILITY AND EFFECT OF STATE, LOCAL, NON-U.S. AND OTHER TAX LAWS AND POSSIBLE CHANGES IN TAX LAWS.

In general, if you own ADSs, you will be treated as the owner of the underlying shares represented by those ADSs for U.S. federal income tax purposes. Accordingly, no gain or loss will be recognized if you exchange ADSs for the underlying shares represented by those ADSs.

The U.S. Treasury has expressed concerns that parties to whom American depository shares are released before shares are delivered to the depositary (“pre-release”) or intermediaries in the chain of ownership between holders and the issuer of the security underlying the American depository shares may be taking actions that are inconsistent with the claiming of foreign tax credits by holders of American depository shares. Such actions would also be inconsistent with the claiming of the reduced rate of tax, described below, applicable to dividends received by certain noncorporate holders. Accordingly, the creditability of Brazilian taxes, and the availability of the reduced tax rate for dividends received by certain noncorporate holders, each described below, could be affected by actions taken by such parties or intermediaries.

This discussion assumes that we are not, and will not become, a passive foreign investment company, as described below.

## Taxation of Distributions

Distributions paid on ADSs or preferred shares will generally be treated as dividends to the extent paid out of current or accumulated earnings and profits (as determined under U.S. federal income tax principles). Because we do not

maintain calculations of our earnings and profits under U.S. federal income tax principles, it is expected that distributions generally will be reported to U.S. Holders as dividends. Subject to applicable limitations and the discussion above regarding concerns expressed by the U.S. Treasury, dividends paid by qualified foreign corporations to certain noncorporate U.S. Holders may be taxable at the rates applicable to long-term capital gains. A foreign corporation is treated as a qualified foreign corporation with respect to dividends paid on stock that is readily tradable on a securities market in the United States, such as the New York Stock Exchange where our ADSs are traded. You should consult your tax advisers regarding the availability of the reduced tax rate on dividends in your particular circumstances.

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The amount of a dividend will include any amounts withheld by us in respect of Brazilian taxes. The amount of the dividend will be treated as foreign-source dividend income to you and will not be eligible for the dividends-received deduction generally allowed to U.S. corporations under the Code. Dividends will be included in your income on the date of your, or in the case of ADSs, the depository's, receipt of the dividend. The amount of any dividend income paid in reais will be a U.S. dollar amount calculated by reference to the exchange rate in effect on the date of such receipt regardless of whether the payment is in fact converted into U.S. dollars. If the dividend is converted into U.S. dollars on the date of receipt, you should not be required to recognize foreign currency gain or loss in respect of the dividend income. You may have foreign currency gain or loss if the dividend is converted into U.S. dollars after the date of receipt.

Subject to applicable limitations that may vary depending upon your circumstances and subject to the discussion above regarding concerns expressed by the U.S. Treasury, Brazilian income taxes withheld from dividends on preferred shares or ADSs will be creditable against your U.S. federal income tax liability. The rules governing foreign tax credits are complex and, therefore, you should consult your tax adviser regarding the availability of foreign tax credits in your particular circumstances. Instead of claiming a credit, you may, at your election, deduct such Brazilian taxes in computing your taxable income, subject to generally applicable limitations under U.S. law. An election to deduct foreign taxes instead of claiming foreign tax credits must apply to all taxes paid or accrued in the taxable year to foreign countries and possessions of the United States.

### Sale, Redemption or Other Disposition of Preferred Shares or ADSs

For U.S. federal income tax purposes, gain or loss you realize on the sale, redemption or other disposition of preferred shares or ADSs will generally be capital gain or loss, and will generally be long-term capital gain or loss if you held the preferred shares or ADSs for more than one year. The amount of your gain or loss will equal the difference between your tax basis in the preferred shares or ADSs disposed of and the amount realized on the disposition, in each case as determined in U.S. dollars. If a Brazilian tax on gains is withheld on the sale or disposition of preferred shares or ADSs, a U.S. Holder's amount realized will include the gross amount of the proceeds of such sale or disposition before deduction of the Brazilian tax. See “—Brazilian Tax Considerations—Taxation of Gains” for a description of when a disposition may be subject to taxation by Brazil. Such gain or loss will generally be U.S.-source gain or loss for foreign tax credit purposes. U.S. Holders should consult their tax advisors as to whether the Brazilian tax on gains may be creditable against the holder's U.S. federal income tax on foreign-source income from other sources. In lieu of claiming a foreign tax credit, U.S. Holders may make an election to deduct foreign taxes, including the Brazilian tax, in computing their taxable income, subject to generally applicable limitations under U.S. law. An election to deduct foreign taxes instead of claiming foreign tax credits applies to all taxes paid or accrued in the taxable year to foreign countries and possessions of the United States.

### Other Brazilian Taxes

You should note that any Brazilian IOF Tax (as discussed above under “—Brazilian Tax Considerations”) will not be a creditable foreign tax for U.S. federal income tax purposes, although you may be entitled to deduct such tax, subject to applicable limitations under U.S. law. You should consult your tax advisers regarding the U.S. federal income tax consequences of the payment of Brazilian IOF Tax, including whether you may claim a deduction for such tax or should instead include the amount of tax paid in your initial basis in the preferred shares or ADSs.

### Passive Foreign Investment Company Rules

We believe that we were not a “passive foreign investment company” (“PFIC”) for U.S. federal income tax purposes for our 2012 taxable year. However, because PFIC status depends on the composition of a company's income and assets and the market value of its assets from time to time, there can be no assurance that we will not be a PFIC for any

taxable year. If we were a PFIC for any taxable year during which a U.S. Holder held preferred shares or ADSs, gain recognized by such U.S. Holder on a sale or other disposition (including certain pledges) of the preferred shares or ADSs would be allocated ratably over the U.S. Holder's holding period for the preferred shares or ADSs. The amounts allocated to the taxable year of the sale or other disposition and to any year before we became a PFIC would be taxed as ordinary income. The amount allocated to each other taxable year would be subject to tax at the highest rate in effect for individuals or corporations, as appropriate, for such taxable year, and an interest charge would be imposed on the amount allocated to such taxable year. Further, to the extent that any distribution received by a U.S. Holder on its preferred shares or ADSs exceeds 125% of the average of the annual distributions on preferred shares or ADSs received by a U.S. Holder during the preceding three years or such

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holder's holding period, whichever is shorter, that distribution would be subject to taxation in the same manner as gain, described immediately above. Certain elections may be available that would result in alternative treatments (such as mark-to-market treatment) of the preferred shares or ADSs. U.S. Holders should consult their tax advisers to determine whether any of these elections would be available and, if so, what the consequences of the alternative treatments would be in those holders' particular circumstances.

Information Reporting and Backup Withholding

Payments of dividends and sales proceeds that are made within the United States or through certain U.S.-related financial intermediaries generally are subject to information reporting and may be subject to backup withholding unless (i) you are an exempt recipient or (ii) in the case of backup withholding, you provide a correct taxpayer identification number and certify that you are not subject to backup withholding.

The amount of any backup withholding from a payment to you will be allowed as a credit against your U.S. federal income tax liability and may entitle you to a refund, provided that the required information is timely furnished to the Internal Revenue Service.

Certain U.S. Holders who are individuals may be required to report information relating to their ownership of securities of a non-U.S. person, subject to certain exceptions (including an exception for securities held in certain accounts maintained by U.S. financial institutions). U.S. Holders are urged to consult their tax advisers regarding the effect, if any, of these rules on their ownership and disposition of preferred shares or ADSs.

**U.S. HOLDERS OF OUR PREFERRED SHARES OR ADSs SHOULD CONSULT THEIR OWN TAX ADVISERS AS TO THE BRAZILIAN, U.S. FEDERAL, STATE, LOCAL AND OTHER TAX CONSEQUENCES OF THE OWNERSHIP AND DISPOSITION OF OUR PREFERRED SHARES OR ADSs BASED UPON THEIR PARTICULAR CIRCUMSTANCES.**

F. Dividends and Paying Agents

Not applicable.

G. Statement of Experts

Not applicable.

H. Documents on Display

We are subject to the information requirements of the Exchange Act, except that as a foreign issuer, we are not subject to the proxy rules or the short-swing profit disclosure rules of the Exchange Act. In accordance with these statutory requirements, we file or furnish reports and other information with the SEC. Reports and other information filed or furnished by us with the Commission may be inspected and copied at the public reference facilities maintained by the Commission at 100 F Street NE, Washington, D.C. 20549. Copies of such material may be obtained by mail from the Public Reference Section of the Commission, 100 F Street NE, Washington, D.C. 20549, at prescribed rates. You may also inspect these reports and other information at the offices of the New York Stock Exchange, 11 Wall Street, New York, New York 10005, on which our ADSs are listed.

In addition, the Commission maintains a website that contains information filed electronically, which can be accessed over the Internet at <http://www.sec.gov>.

We also file financial statements and other periodic reports with the CVM. Copies of our annual report on Form 20-F and documents referred to in this annual report and our bylaws will be available for inspection upon request at our offices at Avenida Engenheiro Luis Carlos Berrini, 1371 - 32° Andar, 04571-936, São Paulo, SP, Brasil.

I. Subsidiary Information

Not applicable.

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ITEM 11. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

We are exposed to several market risks as a result of our commercial operations, debts obtained to finance our activities and financial derivative instruments, including exchange rate risk, interest rate risk, debt acceleration risk and credit risk. To help us manage our risks, we conduct a valuation of our financial assets and liabilities in relation to market values based on available information and appropriate valuation methodologies. However, the interpretation of market information, as well as the selection of methodologies, requires considerable judgment and reasonable estimates to produce adequate realization values. As a result, our valuation estimates do not necessarily indicate the amounts which will be realized in the current market. The use of different market approaches and/or methodologies for the estimates may have a significant effect on the estimated realization values.

We also enter into derivative instruments to manage the risks to which we are exposed in accordance with our risk management policy. All of our derivative instruments are intended to provide coverage against the risk of variation in foreign exchange, therefore, any changes in risk factors generate an opposite effect on the hedged item. We do not hold derivative instruments for speculative purposes.

To further assist our risk management, we conduct fair value analyses of our derivative financial instruments, as well as sensitivity analyses of our risk variables and our net exposure risk. For more details of the results of our valuation analysis, risk management strategies, and sensitivity analysis of our derivative financial instruments, please see Note 36 to our 2012 consolidated financial statements.

ITEM 12. DESCRIPTION OF SECURITIES OTHER THAN EQUITY SECURITIES

The depositary, Citibank N.A, collects its fees for delivery and surrender of ADSs directly from investors depositing shares or surrendering ADSs or from intermediaries acting for them. The depositary also collects fees for making distributions to investors by deducting those fees from the amounts distributed or by selling a portion of distributable property to pay the fees. The depositary may collect its annual fee for depositary services by directly billing investors or by charging the book-entry system accounts of participants acting for them. The depositary may generally refuse to provide fee-attracting services until its fees for those services are paid.

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Persons depositing or withdrawing shares must pay:	For:
Up to U.S. \$5.00 per 100 ADSs (or fraction thereof)	<ul style="list-style-type: none"> <li>· Issuance of ADSs upon deposit of Shares, excluding issuances as a result of distributions</li> <li>· Delivery of Deposited Securities against surrender of ADSs</li> <li>· Distribution of cash dividends or other cash distributions (i.e., sale of rights and other entitlements)</li> <li>· Distribution of ADSs pursuant to (i) stock dividends or other free stock distributions, or (ii) exercise of rights to purchase additional ADSs</li> <li>· Distribution of securities other than ADSs or rights to purchase additional ADSs (i.e., spin-off shares)</li> <li>· Depository Services</li> </ul>
Registration or transfer fees	<ul style="list-style-type: none"> <li>· Registration of Shares or other Deposited Securities on the share register and applicable to transfers of Shares or other Deposited Securities to or from the name of the Custodian, the Depository or any nominees upon the making of deposits and withdrawals, respectively</li> </ul>
Expenses of the depository	<ul style="list-style-type: none"> <li>· Cable, telex and facsimile transmissions and delivery expenses as are expressly provided in the Deposit Agreement</li> <li>· Conversion of foreign currency</li> </ul>
Taxes (including applicable interest and penalties) and other governmental charges	<ul style="list-style-type: none"> <li>· As necessary</li> </ul>
Fees and expenses incurred by the Depository in connection with compliance with exchange control regulations and other regulatory requirements applicable to Shares, Deposited Securities, ADSs and ADRs	<ul style="list-style-type: none"> <li>· As necessary</li> </ul>
Fees and expenses incurred by the Depository, the Custodian, or any nominee in connection	<ul style="list-style-type: none"> <li>· As necessary</li> </ul>



with the servicing or delivery of Deposited  
Property

During 2012, we received from the Bank of New York Mellon, our former depository, US\$13,356,361.55 for continuing annual stock exchange listing fees, standard out-of-pocket maintenance costs for the ADRs (consisting of the expenses of postage and envelopes for mailing annual and interim financial reports, printing and distributing dividend checks, electronic filing of U.S. Federal tax information, mailing required tax forms, stationery, postage, facsimile, and telephone calls), any applicable performance indicators relating to the ADR facility, underwriting fees and legal fees.

On January 28, 2013, we entered into a deposit agreement with Citibank N.A., pursuant to which Citibank N.A. became our depository beginning with the fiscal year ending December 31, 2013.

Citibank N.A has agreed to reimburse us for expenses related to establishment and maintenance expenses of the ADS program. The depository has agreed to reimburse us for our continuing annual stock exchange listing fees. The depository has also agreed to pay the standard out-of-pocket maintenance costs for the ADRs, which consist of the



as of December 31, 2012, our internal control over financial reporting was adequate and effective.

Our independent registered public accounting firm, Ernst & Young Terco, has issued an attestation report on the effectiveness of our internal control over financial reporting as of December 31, 2012. The report on the audit of our internal control over financial reporting is included herewith.

**Attestation Report of the Registered Public Accounting Firm**

Ernst & Young Terco, the independent registered public accounting firm that has audited our consolidated financial statements, has issued an attestation report on the effectiveness of our internal control over financial reporting as of December 31, 2012. This attestation report appears on page F-3.

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Changes in Internal Control over Financial Reporting

Our internal audit department periodically evaluates our internal controls for the main cycles, documenting by flow charts the processes used in each cycle, identifying opportunities and suggesting improvements for the existing control mechanisms. There was no change in our internal control over financial reporting that occurred during the period covered by this annual report that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

ITEM 16. [RESERVED]

ITEM 16A. AUDIT COMMITTEE FINANCIAL EXPERT

Our Control and Audit Committee is comprised of a minimum of three and a maximum of five nonexecutive directors. See “Item 6. Directors, Senior Management and Employees—C. Board Practices—Committees—Control and Audit Committee.” Our Board of Directors has designated Luis Bastida Ibarguen, an independent member of our Board of Directors under Brazilian rules and a member of our Control and Audit Committee, as the Company’s “audit committee financial expert,” as such term is defined by the SEC. We anticipate that there will be some similar functions between the Control and Audit Committee and our statutory Fiscal Board (Conselho Fiscal), the latter of which meets the requirements of the general exemption from the listing standards for audit committees set forth in Exchange Act Rule 10A-3(c)(3). See “Item 16D. Exemptions from the Listing Standards for Audit Committees Procedures.”

ITEM 16B. CODE OF ETHICS

Fully aware of the impact it may have on its stakeholders, Telefônica established ethical principles of conduct as a means of ensuring honesty, integrity and trust, as well as respect for the law and human rights in all its activities. These Business Principles were approved in 2006 and serve as an official code of conduct for all the Group’s operations worldwide.

The principles govern our activities and relationships, generating greater trust among our audiences and optimizing long-term value for shareholders and society as a whole. We encourage all employees to familiarize themselves with these rules and obey them, and we invest in like-minded partners and suppliers. After the integration of Telefônica and Vivo, the conduct codes of the two companies were submitted to an assessment, with a view to establishing common minimum standards applicable to the new company. The result of this work will be submitted to the Business Principles Committee, comprising the Corporate Communications, Corporate Institutional Relations, Human Resources, Legal Investor Relations, President’s Secretariat and Audit areas. The Committee’s role is to make decisions related to compliance with the Business Principles and to mitigate previously mapped risks that have a direct impact on the company’s strategy and reputation.

All company employees have access to the standards governing decision making, purchase and contracting processes. Additionally, they have access to confidential channels through which they may make anonymous reports, ask questions and seek advice on questions related to the business principles.

ITEM 16C. PRINCIPAL ACCOUNTANT FEES AND SERVICES

Ernst & Young Terco acted as our independent auditor for the fiscal years ended December 31, 2012, December 31, 2011 and December 31, 2010. The chart below sets forth the total amount billed to us by Ernst & Young Terco for services performed in the years 2012, 2011 and 2010, and breaks down these amounts by category of service:

2012	2011	2010
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	(in thousands of reais)		
Audit Fees	11,589	7,002	4,474
Audit-Related Fees	2,772	1,305	755
Tax Fees	–	58	17
All Other Services	–	–	–
<b>Total</b>	<b>14,361</b>	<b>8,365</b>	<b>5,246</b>

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For the years ended December 31, 2012, December 31, 2011 and December 31, 2010, we paid our auditors, Ernst & Young Terco for auditing services rendered in the total amount of R\$14,361 thousands, R\$8,365 thousand and R\$5,246 thousand, respectively.

### Audit Fees

Audit fees are fees billed for the audit of our annual consolidated financial statements prepared for purposes of filing with the SEC and to the audit with respect to processes required by Sarbanes-Oxley, with the purpose of certifying the effectiveness over our internal controls.

### Audit-Related Fees

Refers to the auditing services and review with respect to our compliance with the targets established by ANATEL, as well as relates to auditing interim financial statements of subsidiaries for the purpose of restructuring process.

### Tax Fees

Refers to accounting services with respect to the preparation of tax returns.

### All Other Fees

Not applicable.

### Pre-Approval Policies and Procedures

Our Control and Audit committee evaluates the results of all audit and audit-related services provided by our auditors. Our Control and Audit committee has the authority to approve services to be provided by our auditors that are not specifically included within the scope of the audit. Our Board of Directors, with advice from the Control and Audit Committee, is responsible for authorizing the audit services provided by Ernst & Young Terco, the present auditor of the company. Nonaudit services are required to be pre-approved by the Control and Audit Committee pursuant to the policy for pre-approval of nonaudit services.

## ITEM 16D. EXEMPTIONS FROM THE LISTING STANDARDS FOR AUDIT COMMITTEES PROCEDURES

Brazilian Corporate Law requires that we have a statutory Fiscal Board (Conselho Fiscal). Our statutory Fiscal Board meets the requirements of the general exemption set forth in Exchange Act Rule 10A-3(c)(3). See “Item 6. Directors, Senior Management and Employees—C. Board Practices—Fiscal Board.” Our statutory Fiscal Board is primarily charged with certain advisory, oversight and review functions with respect to the company’s financial statements; however, the statutory Fiscal Board, as required by Brazilian Corporate Law, has only an advisory role and does not participate in the management of the company. Indeed, decisions of the statutory Fiscal Board are not binding on the company under Brazilian Corporate Law. Our Board of Directors, under Brazilian Corporate Law, is the only entity with the legal capacity to appoint and retain any independent registered public accounting firm, and decide the budget appropriation with respect to such auditors.

Since Brazilian Corporate Law does not specifically grant our statutory Fiscal Board the power to establish receipt, retention and complaint procedures regarding accounting, internal control and audit matters, or create policies for the confidential, anonymous treatment of employee concerns regarding accounting or auditing matters, we have established a Control and Audit Committee as a best corporate governance practice to address these various issues. See “Item 6. Directors, Senior Management and Employees—C. Board Practices—Committees—Control and Audit

Committee.”

We do not believe that our use of a fiscal board in accordance with Brazilian Corporate Law in combination with our Control and Audit Committee, as opposed to the provisions set forth in Exchange Act Rule 10A-3(b), materially adversely affects the ability of the Conselho Fiscal to act independently, satisfy the other applicable requirements of Exchange Act Rule 10A-3 or to fulfill its fiduciary and other obligations under Brazilian law.

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ITEM 16E. PURCHASES OF EQUITY SECURITIES BY THE ISSUER AND AFFILIATED PURCHASERS

None.

ITEM 16F. CHANGE IN REGISTRANT'S CERTIFYING ACCOUNTANT

Not applicable.

ITEM 16G. CORPORATE GOVERNANCE

Principal Differences Between U.S. and Brazilian Corporate Governance Practices

On November 4, 2003, the SEC approved new corporate governance rules established by the NYSE. Pursuant to these rules, foreign private issuers that are listed on the NYSE, such as our company, must disclose any significant ways in which its corporate governance practices differ from those followed by U.S. companies under the listing rules of the NYSE.

The significant differences between our corporate governance practices and the NYSE corporate governance standards are as follows:

Independence of Directors and Independence Tests

The Brazilian Corporate Law and our bylaws require that our directors be elected by our shareholders at a general shareholders meeting. Fourteen of our directors were appointed by our common shareholders, and one director was appointed by representatives of our minority preferred shareholders. Ten of our directors are independent in accordance with rules generally accepted in Brazil.

Both the Brazilian Corporate Law and CVM establish rules in relation to certain qualification requirements and restrictions, investiture, compensation, duties and responsibilities of companies' executives and directors. We believe these rules provide adequate assurances that our directors are independent and such rules would permit us to have directors that would not otherwise pass the independence tests established by the NYSE.

Executive Sessions

According to the Brazilian Corporate Law, up to one-third of the members of the Board of Directors can be elected to executive positions. The remaining nonmanagement directors are not expressly empowered to serve as a check on management, and there is no requirement that those directors meet regularly without management. Notwithstanding, our Board of Directors consists of thirteen nonmanagement directors, ten of whom are independent directors in accordance with rules generally accepted in Brazil, and as such, we believe we are in compliance with this standard.

Control and Audit Committee/Additional Requirements

Brazilian Corporate Law and our bylaws each require that we have a statutory Fiscal Board (Conselho Fiscal). See "Item 6. Directors, Senior Management and Employees—C. Board Practices—Fiscal Board." Our statutory Fiscal Board meets the requirements of the general exemption from the listing standards for audit committees set forth in Exchange Act Rule 10A-3(c)(3). See "Item 16D. Exemptions from the Listing Standards for Audit Committees Procedures." Our statutory Fiscal Board is primarily charged with certain advisory, oversight and review functions with respect to the company's financial statements. However, the statutory Fiscal Board, as required by Brazilian Corporate Law, has only an advisory role and does not participate in the management of the company. Indeed, decisions of the statutory Fiscal



Board are not binding on the company under Brazilian Corporate Law. See “Item 6. Directors, Senior Management and Employees—C. Board Practices—Fiscal Board.”

In addition to our statutory Fiscal Board, we have established a Control and Audit committee as a best corporate governance practice to comply with the requirements of the Sarbanes-Oxley Act as described in Item 6C of this annual report. We anticipate that there will be some similar functions between the Control and Audit Committee and our statutory Fiscal Board.

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ITEM 16H. MINE SAFETY DISCLOSURE

Not applicable.

PART III

ITEM 17. FINANCIAL STATEMENTS

We have responded to Item 18 in lieu of responding to this Item.

ITEM 18. FINANCIAL STATEMENTS

Reference is made to pages F-1 through F-123.

ITEM 19. EXHIBITS

Exhibit number	Description
1.1	Bylaws of Telefônica Brasil S.A., as amended (unofficial English translation).
2(a)	Deposit Agreement dated as of January 28, 2013, among Telefônica Brasil S.A., Citibank N.A., as Depositary, and Owners and Beneficial Owners of American Depositary Receipts issued thereunder.(1)
4(a).1	Contract and Justification of the Merger of Telefónica Data Brasil Holding S.A. into Telecomunicações De São Paulo S.A. – TELESP and Partial Spin-Off of Telefónica Empresas S.A. dated March 9, 2006.(2)
4(a).2	Credit facility with BNDES dated October 14, 2011.(3)
4(b).1	Certificate of Authorization to Provide Multimedia Communication Service between Agência Nacional de Telecomunicações – ANATEL and Global telecom S.A. dated March 19, 2004 (English language summary).
4(b).2	Authorization Term of the Personal Mobile Service (Region II) between Agência Nacional de Telecomunicações – ANATEL and Vivo S.A. dated January 18, 2010 (English language summary).
4(b).3	Authorization Term of the Personal Mobile Service (Region III) between Agência Nacional de Telecomunicações – ANATEL and Vivo S.A. dated January 18, 2010 (English language summary).
4(b).4	Certificate of Authorization to Provide Commuted Fixed Telephone Service in Local Modality (Regions I and II) between Agência Nacional De Telecomunicações and Vivo S.A. dated September 5, 2011 (English language summary).
4(b).5	Certificate of Authorization to Provide Commuted Fixed Telephone Service in National Long-Distance Modality (Regions I and II) between Agência Nacional de Telecomunicações – ANATEL and Vivo S.A. dated September 5, 2011 (English language summary).

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- 4(b).6 Certificate of Authorization to Provide Commuted Fixed Telephone Service in International Long-Distance Modality (Regions I and II) between Agência Nacional de Telecomunicações – ANATEL and Vivo S.A. dated September 5, 2011 (English language summary).
- 4(b).7 Authorization Term of the Personal Mobile Service (Region I) between Agência Nacional de Telecomunicações – ANATEL and Vivo S.A. dated February 7, 2012 (English language summary).
- 4(b).8 Grant Authorization Term for Spectrum Blocks Associated with Personal Mobile Service (Region III) between Agência Nacional de Telecomunicações – ANATEL and Vivo S.A. dated October 16, 2012 (English language summary).

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- 4(b).9 Grant Authorization Term for Spectrum Blocks Associated with Personal Mobile Service (Region II) between Agência Nacional de Telecomunicações – ANATEL and Vivo S.A. dated October 16, 2012 (English language summary).
- 4(b).10 Grant Authorization Term for Spectrum Blocks Associated with Personal Mobile Service (Region III) between Agência Nacional de Telecomunicações – ANATEL and Vivo S.A. dated October 16, 2012 (English language summary).
- 4(b).11 Grant Authorization Term for Spectrum Blocks Associated with Personal Mobile Service and Multimedia Communication (Areas identified by the National Codes 13, 14, 15, 16, 17, 18 and 19, in the state of São Paulo) between Agência Nacional de Telecomunicações – ANATEL and Vivo S.A. dated October 16, 2012 (English language summary).
- 4(b).12 Grant Authorization Term for Spectrum Blocks Associated with Personal Mobile Service and Multimedia Communication (States of Alagoas, Ceará, Minas Gerais, Paraíba, Pernambuco, Piauí, Rio Grande do Norte and Sergipe) between Agência Nacional de Telecomunicações – ANATEL and Vivo S.A. dated October 16, 2012 (English language summary).
- 8.1 List of Subsidiaries
- 11.1 Code of Ethics of Telefônica Brasil S.A.(4)
- 12.1 Section 302 Certification of the Chief Executive Officer.
- 12.2 Section 302 Certification of the Chief Financial Officer.
- 13.1 Section 906 Certification of the Chief Executive Officer.
- 13.2 Section 906 Certification of the Chief Financial Officer.

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(1) Incorporated by reference to our Registration Statement of American Depositary Receipt shares on Form F-6 (No. 333-185518) filed with the Commission on December 17, 2012.

(2) Incorporated by reference to our form CB filed with the Commission on March 14, 2006.

(3) Incorporated by reference to our annual report on Form 20-F (No. 001-14475) filed with the Commission on April 20, 2012.

(4) Incorporated by reference to our annual report on Form 20-F (No. 001-14475) filed with the Commission on April 16, 2007.

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GLOSSARY OF TELECOMMUNICATIONS TERMS

The following explanations are not intended as technical definitions, but to assist the reader in understanding certain terms as used in this Annual Report.

**1xRTT:** 1x Radio Transmission Technology, the CDMA 2000 1x technology, which, pursuant to the ITU (International Telecommunication Union) and in accordance with the IMT-2000 rules, is the 3G (third generation) technology.

**AICE:** Acesso Individual Classe Especial is a mandatory plan offered by the telecommunication providers to low-income customers. Includes different pricing schemes for the Basic Plan (Plano Básico) and the Mandatory Offer Alternative Plan (Plano Alternativo de Oferta Obrigatória).

**AMPS:** Advanced Mobile Phone System, a radio interface technology for cellular networks based on spectral spreading of the radio signal and channel division in the frequency domain.

**ADSL:** Asymmetric digital subscriber line. ADSL technology allows more data to be sent over existing copper telephone lines.

**Analog:** A mode of transmission or switching that is not digital, e.g., the representation of voice, video or other modulated electrical audio signals which are not in digital form.

**BLEC:** Building local exchange carrier. A BLEC is a service provider that delivers telecommunication services within a specific building. BLECs aggregate traffic at the particular site and employ a single broadband connection for local access.

**CDMA:** Code Division Multiple Access, an aerial interface technology for cellular networks based on spectral spreading of the radio signal and channel division in the code domain.

**CDMA 2000 1xEV-DO:** 3G (third generation) access technology with data transmission speed of up to 2.4 megabytes per second.

**Cellular service:** A cellular telecommunications service provided by means of a network of interconnected low-powered base stations, each of which covers one small geographic cell within the total cellular telecommunications system service area.

**CSP:** long-distance carrier selection.

**Digital:** A mode of representing a physical variable such as speech using digits 0 and 1 only. The digits are transmitted in binary form as a series of pulses. Digital networks allow for higher capacity and higher flexibility through the use of computer-related technology for the transmission and manipulation of telephone calls. Digital systems offer lower noise interference and can incorporate encryption as a protection from external interference.

**DTH:** A special type of service that uses satellites for the direct distribution of television and audio signs for subscribers.

**FATOR X:** A measurement of the company's productivity, calculated by ANATEL, which is discounted by the inflation rate and is used for the calculation of the annual rate adjustment applicable to telecommunications companies.

FTTH: Internet access through Fiber Optic (“Fiber to the Home”).

FWT: Fixed-phones using the wireless network (“Fixed Wireless Telephone”).

GSM: Global System for Mobile Communications, a service rendered by concession from ANATEL for a specific frequency range.

Internet: A collection of interconnected networks spanning the entire world, including university, corporate, government and research networks from around the globe. These networks all use the IP (Internet Protocol) communications protocol.

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IP (Internet protocol): An interconnection protocol for sub-networks, in particular for those with different physical characteristics used by the Internet.

IPTV: Pay TV with video broadcast offered through the use of the IP protocol.

MMDS: (Multichannel Multipoint Distribution Service): It's a wireless telecommunications technology, used for general-purpose broadband networking or, more commonly, as an alternative method of cable television programming reception.

Net additions: total number of new customers acquired in any period minus the reduction in the number of customers.

Network: An interconnected collection of elements. In a telephone network, these consist of switches connected to each other and to customer equipment. The transmission equipment may be based on fiber optic or metallic cable or point-to-point radio connections.

Network usage charge: Amount paid per minute charged by network operators for the use of their network by other network operators.

PBX (Private Branch Exchange): Telephone switchboard for private use, but linked to a telephone network.

PGA-SMP: Plano Geral de Autorizações do Serviço Móvel Pessoal, or General Plan of Authorizations for the Personal Mobile Services.

PGO: Plano Geral de Outorgas, or General Plan of Grants.

PUC: Prestação Utilidade Comodidade, which are convenience services offered to fixed-line customers, such as caller ID, voicemail, call forwarding, etc.

SCM: Serviço de Comunicação Multimídia or multimedia communication services.

SMP: Serviço Móvel Pessoal or Personal Mobile Service, a service rendered pursuant to an authorization granted by ANATEL to provide mobile service in a specific frequency range.

SMS: text messaging services for wireless devices, which allow customers to send and receive alphanumeric messages.

STFC: Serviço Telefônico Fixo Comutado, or the transmission of voice and other signals between determined fixed points.

Switch: Devices used to set up and route telephone calls either to the number called or to the next switch along the path. They may also record information for billing and control purposes.

TDMA: Time Division Multiple Access, a radio interface technology for cellular networks based on spectral spreading of the radio signal and channel division in the time domain.

Universal service: The obligation to supply basic service to all users throughout a national territory at reasonable prices.

VOIP: Voice over Internet Protocol, is a technology for transmitting voice using the Internet.

VOD: Video on demand systems allow users to select and watch/listen to video or audio content on demand.

VU-M: Valor de Remuneração de Uso de Rede do Serviço Móvel Pessoal, or Compensation Value for Network Use of Personal Mobile Service.

WAP: Wireless Application Protocol, an open and standardized protocol started in 1997, which allows access to Internet servers through specific equipment, a WAP Gateway at the carrier, and WAP browsers in customers' wireless devices.



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WCDMA: Wide-Band Code-Division Multiple Access, a technology for wideband digital radio communications of Internet, multimedia, video and other bandwidth-demanding applications.

Wireless devices: wireless appliances that we sell, including cellular handsets, wireless handheld devices and wireless broadband cards.

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SIGNATURES

The registrant hereby certifies that it meets all of the requirements for filing on Form 20-F and that it has duly caused and authorized the undersigned to sign this annual report on its behalf.

TELEFÔNICA BRASIL S.A.

By: /s/ Antonio Carlos Valente da Silva  
Name: Antonio Carlos Valente da  
Silva  
Title: Chief Executive Officer

By: /s/ Paulo Cesar Pereira Teixeira  
Name: Paulo Cesar Pereira Teixeira  
Title: General and Executive  
Officer and as interim Chief  
Financial Officer, Control and  
Investor Relations Officer

Date: March 20, 2013

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Telefônica Brasil S.A.

Consolidated Financial statements

As of and for the years ended December 31, 2012, 2011 and 2010

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors and Shareholders of Telefônica Brasil S.A.

We have audited the accompanying consolidated balance sheets of Telefônica Brasil S.A. and subsidiaries as of December 31, 2012 and 2011, and the related consolidated statements of income, comprehensive income, changes in the shareholders' equity, and cash flows for each of the three years in the period ended December 31, 2012. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Telefônica Brasil S.A. as of December 31, 2012 and 2011, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2012, in conformity with International Financial Reporting Standards as issued by International Accounting Standards Board.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), Telefônica Brasil S.A.'s internal control over financial reporting as of December 31, 2012, based on criteria established Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated February 21, 2013 expressed an unqualified opinion thereon.

São Paulo, February 21, 2013

ERNST & YOUNG TERCO  
Auditores Independentes S.S.

/s/ Alexandre Hoepfers  
Alexandre Hoepfers  
Partner

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors and Shareholders of Telefônica Brasil S.A.

We have audited Telefônica Brasil S.A. and subsidiaries internal control over financial reporting as of December 31, 2012, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). Telefônica Brasil S.A. and subsidiaries' management is responsible for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting included in the accompanying Management's annual report on internal control over financial reporting. Our responsibility is to express an opinion on the company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, Telefônica Brasil S.A. and subsidiaries maintained, in all material respects, effective internal control over financial reporting as of December 31, 2012, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Telefônica Brasil S.A. and subsidiaries as of December 31, 2012 and 2011, and the related consolidated statements of income, comprehensive income, changes in the shareholders' equity, and cash flows for each of the three years in the period ended December 31, 2012 and our report dated February 21, 2013 expressed an unqualified opinion thereon.

São Paulo, February 21, 2013

ERNST & YOUNG TERCO  
Auditores Independentes S.S.

Alexandre Hoepfers  
Partner

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Telefônica Brasil S.A.

Consolidated Balance sheets  
 December 31, 2012 and 2011  
 (In thousands of reais)

	Note	As of December 31,	
		2012	2011
Assets			
Current assets		16,271,942	11,810,118
Cash and cash equivalents	5	7,196,079	2,940,342
Trade accounts receivable, net	6	5,513,436	5,105,860
Inventories	7	387,809	471,721
Recoverable taxes	8.1	2,052,423	2,495,066
Escrow deposits	9	126,625	116,421
Derivative transactions	36	41,109	1,840
Prepaid expenses	10	248,337	255,056
Other	11	706,124	423,812
Noncurrent assets		53,892,725	53,679,855
Long-term portion of investments pledged as collateral		109,708	124,668
Trade accounts receivable, net	6	93,378	84,855
Recoverable taxes	8.1	738,965	1,014,959
Deferred taxes	8.2	1,029,598	1,428,878
Escrow deposits	9	3,909,474	3,374,690
Derivative transactions	36	286,278	225,935
Prepaid expenses	10	31,396	32,138
Other	11	140,105	148,293
Investments	12	23,683	37,835
Property, plant and equipment, net	13	17,610,851	17,153,920
Intangible assets, net	14	30,009,289	30,053,684
<b>Total Assets</b>		<b>70,254,667</b>	<b>65,489,973</b>

The accompanying notes are an integral part of these Consolidated Financial Statements.

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	Note	As of December 31,	
		2012	2011
Liabilities and Shareholders' Equity			
Current Liabilities		13,537,471	12,740,263
Payroll and related accruals	15	416,355	495,624
Trade accounts payable	16	5,889,377	6,037,315
Taxes payable	17	1,781,480	1,691,991
Loans and financing	18.1	1,255,323	988,413
Debentures	18.2	702,215	468,624
Dividends and interest on shareholders' equity payable	19	467,831	972,986
Provisions	20	496,790	416,313
Derivative transactions	36	29,586	51,162
Deferred revenue	21	734,573	761,268
Share fractions		389,510	389,953
Licenses	1	994,977	-
Other	22	379,454	466,614
Noncurrent Liabilities		12,036,076	9,418,925
Taxes payable	17	488,749	433,071
Deferred taxes	8.2	1,216,651	788,954
Loans and financing	18.1	3,756,001	3,959,115
Debentures	18.2	2,253,690	787,807
Provisions	20	3,846,899	3,147,085
Derivative transactions	36	26,545	78,369
Deferred revenue	21	303,362	156,266
Other	22	144,179	68,258
Shareholders' equity	23	44,681,120	43,330,785
Capital		37,798,110	37,798,110
Capital reserves		2,686,897	2,719,665
Legal reserve		1,100,000	877,322
Premium on acquisition of non-controlling interest		(70,448 )	(29,929 )
Other comprehensive Income		17,792	7,520
Additional proposed dividends		3,148,769	1,953,029
Non-controlling shareholders		-	5,068
Total Liabilities		70,254,667	65,489,973

The accompanying notes are an integral part of these Consolidated Financial Statements.



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Telefônica Brasil S.A.

## Consolidated Income Statement

For the years ended December 31, 2012, 2011 and 2010

(In thousands of reais, except earnings per share data)

	Note	2012	2011	2010
Net operating revenue	24	33,931,422	29,128,740	15,798,251
Cost of goods and services	25	(16,564,464)	(15,039,663)	(8,844,805)
Gross profit		17,366,958	14,089,077	6,953,446
Operating (expenses) income		(10,154,669)	(8,291,711)	(3,388,110)
Selling	26	(8,693,696)	(6,948,211)	(2,964,632)
General and administrative	27	(2,148,476)	(1,785,658)	(738,846)
Equity in earnings (losses) of associates	12	-	-	2,889
Other operating income, net	28	687,503	442,158	312,479
Operating income before financial expenses, net		7,212,289	5,797,366	3,565,336
Financial income	29	1,281,554	1,103,359	344,354
Financial expense	29	(1,572,369)	(1,243,051)	(465,092)
Income before income tax and social contribution		6,921,474	5,657,674	3,444,598
Income tax and social contribution	30	(2,469,293)	(1,295,475)	(1,045,762)
Net income for the year		4,452,181	4,362,199	2,398,836
Attributed to:				
Net income attributed to non-controlling shareholders		(1,392)	6,881	-
Net income attributed to controlling shareholders		4,453,573	4,355,318	2,398,836
Basic and diluted earnings per share – common		3.72	4.40	4.45
Basic and diluted earnings per share – preferred		4.09	4.84	4.89

The accompanying notes are an integral part of these Consolidated Financial Statements.

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Telefônica Brasil S.A.

Consolidated Statement of comprehensive income  
 For the years ended December 31, 2012, 2011 and 2010  
 (In thousands of reais)

	2012	2011	2010
Net income for the year	4,452,181	4,362,199	2,398,836
Unrealized losses on investments available for sale	(5,536 )	(5,170 )	(117,609 )
Taxes on unrealized losses on investments available for sale	1,882	1,758	39,987
Unrealized actuarial gains (losses) and effect of the limitation of surplus plan assets	(69,782 )	(65,176 )	(60,585 )
Taxes on unrealized actuarial gains (losses) and effect of the limitation of surplus plan assets	23,726	22,179	18,522
Gains (losses) on cash flow hedge	12,416	3,022	-
Taxes on gains (losses) on cash flow hedge	(4,221 )	(1,027 )	-
Cumulative translation adjustments of foreign currency transactions	5,731	4,520	(6,778 )
Net gains (losses) recognized in equity	(35,784 )	(39,894 )	(126,463 )
Comprehensive income for the year	4,416,397	4,322,305	2,272,373
Attributable to:			
Net income attributed to non-controlling shareholders	(1,392 )	6,881	-
Net income attributed to controlling shareholders	4,417,789	4,315,424	2,272,373

The accompanying notes are an integral part of these Consolidated Financial Statements.

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Telefônica Brasil S.A.

Consolidated Statements of changes in shareholders' equity

For the years ended December 31, 2012, 2011 and 2010

(In thousands of reais)

	Capital	Premium paid on acquisition of non- controlling interest	Special Goodwill reserve	Capital reserves	Treasury shares	Legal Reserve	Retained Earnings	Additional proposed dividend	Unrealized gains on available for sale securities, net of tax
Balances as of December 31, 2009	6,575,480	-	63,074	2,688,207	(17,719 )	659,556	(8,759 )	1,251,646	90,918
Unclaimed dividends and interest on shareholders' equity, net of taxes	-	-	-	-	-	-	134,440	-	-
Net income for the year	-	-	-	-	-	-	2,398,836	-	-
Other comprehensive income	-	-	-	-	-	-	(42,063 )	-	(77,622)
Appropriations:	-	-	-	-	-	-	-	-	-
Dividends	-	-	-	-	-	-	(196,355 )	(1,251,646)	-
Interest on shareholders' equity	-	-	-	-	-	-	(503,200 )	-	-
Withholding tax on interest on shareholders' equity	-	-	-	-	-	-	(88,800 )	-	-
Additional proposed dividend	-	-	-	-	-	-	(1,694,099)	1,694,099	-
Balances as of December 31, 2010	6,575,480	-	63,074	2,688,207	(17,719 )	659,556	-	1,694,099	13,296
Proposed additional	-	-	-	-	-	-	-	(1,694,099)	-

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dividend for 2010										
Unclaimed dividends and interest on shareholders' equity, net of taxes	-	-	-	-	-	-	107,874	-	-	
Capital increase due to the acquisition of Vivo Part. on 04/27/2011	31,222,630	-	-	47,723	-	-	-	-	-	
Withdrawal rights paid to shareholders due to the acquisition of Vivo Part.	-	-	-	-	(3 )	-	-	-	-	
Repurchase of shares	-	-	-	-	(61,617 )	-	-	-	-	
Acquisition of non-controlling shareholders	-	(29,929)	-	-	-	-	-	-	-	
Net income for the year	-	-	-	-	-	-	4,355,318	-	-	
Other comprehensive income	-	-	-	-	-	-	(42,997 )		(3,412 )	
Appropriations		-						-	-	
Dividends	-	-	-	-	-	-	(382,400 )	-	-	
Interest on shareholders' equity	-	-	-	-	-	-	(1,867,000)	-	-	
Legal Reserve	-	-	-	-	-	217,766	(217,766 )	-	-	
Additional proposed dividend	-	-	-	-	-	-	(1,953,029)	1,953,029	-	
		-								
Balances as of December 31, 2011	37,798,110	(29,929)	63,074	2,735,930	(79,339 )	877,322	-	1,953,029	9,884	
Proposed additional dividend for 2011	-	-	-	-	-	-	-	(1,953,029)	-	
Unclaimed dividends and interest on shareholders' equity	-	-	-	-	-	-	89,692	-	-	

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equity, net of taxes									
Other changes in equity	-	-	-	-	-	-	(3,240 )	-	-
Repurchase of shares	-	-	-	-	(32,768 )	-	-	-	-
Acquisition of non-controlling shareholders	-	(40,519)	-	-	-	-	-	-	-
Net income for the year	-	-	-	-	-	-	4,453,573	-	-
Other comprehensive income	-	-	-	-	-	-	(46,056 )	-	(3,654 )
Appropriations									
Dividends	-	-	-	-	-	-	(1,122,522)	-	-
Legal Reserve	-	-	-	-	-	222,678	(222,678 )	-	-
Additional proposed dividend	-	-	-	-	-	-	(3,148,769)	3,148,769	-
Balances as of December 31, 2012	37,798,110	(70,448)	63,074	2,735,930	(112,107)	1,100,000	-	3,148,769	6,230
Outstanding shares (thousand)									
Book value per share									

The accompanying notes are an integral part of these Consolidated Financial Statements.

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Telefônica Brasil S.A.

Consolidated Statements of cash flows  
 For the years ended December 31, 2012, 2011 and 2010  
 (In thousands of reais)

	2012	2011	2010
Cash flows from operations			
Income before income tax and social contribution	6,921,474	5,657,674	3,444,598
Items that do not affect cash			
Expenses (revenues) not affecting cash	6,139,975	5,683,221	2,359,272
Depreciation and amortization	5,493,159	4,585,994	1,913,494
Exchange variations from loans	(1,254 )	89,549	(638 )
Monetary variations	51,860	(30,323 )	34,580
(Gain)/ Loss from equity in earnings of associates	-	-	(2,889 )
Gain on permanent asset disposals	(1,049,692)	(482,115 )	(317,486 )
Allowance for doubtful accounts	654,273	506,581	386,340
Provision for (reversal of) trade accounts payable	(73,645 )	365,415	57,703
Provision for (write-offs and reversal of) impairment of inventories	791	(8,966 )	31,091
Pension and other post-retirement benefits plans	(3,244 )	(1,163 )	4,504
Tax, civil and labor provisions	514,840	255,420	25,578
Interest expense	551,580	416,426	240,367
Provision for dismantling costs	(7,854 )	(33,138 )	4,332
Provision for loyalty program	14,026	9,861	-
Others	(4,865 )	9,680	(17,704 )
(Increase) decrease in operating assets	(557,118 )	(479,896 )	(239,605 )
Trade accounts receivable, net	(1,070,370)	(933,558 )	87,501
Inventories	83,122	(47,355 )	39,846
Other current assets	339,327	601,573	(61,161 )
Other noncurrent assets	90,803	(100,556 )	(305,791 )
Increase (decrease) in operating liabilities	(2,771,162)	(2,719,624)	(1,032,007)
Payroll and related accruals	(79,270 )	(56,908 )	166,994
Trade accounts payable	(613,004 )	(279,721 )	(84,058 )
Taxes other than income taxes	132,911	130,058	(8,043 )
Other current liabilities	(216,292 )	(521,056 )	43,621
Other noncurrent liabilities	(76,893 )	(97,655 )	(3,031 )
Interest paid	(438,409 )	(496,103 )	(265,792 )
Income and social contribution taxes paid	(1,480,205)	(1,398,239)	(881,698 )
Cash provided by operations	9,733,169	8,141,375	4,532,258

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Telefônica Brasil S.A.

Consolidated Statements of cash flows (Continued)  
 For the years ended December 31, 2012, 2011 and 2010  
 (In thousands of reais)

	2012	2011	2010
Cash flows generated from (used in) investing activities			
Capital increase in subsidiaries and associates	-	-	(3,557 )
Acquisition of fixed and intangible assets, net of grants	(4,549,100 )	(4,653,708)	(2,126,465)
Cash from sales of fixed assets	1,136,649	610,880	292,858
Cash from sales of investment	10,069	-	178,453
Dividends and interest on shareholder's equity received	5,129	-	-
Cash and cash equivalents from consolidation of companies	-	31,095	-
Cash and cash equivalents from business combination	-	1,982,898	-
Cash used in investing activities	(3,397,253 )	(2,028,835)	(1,658,711)
Cash flows generated from (used in) financing activities			
Loans paid	(1,279,654 )	(1,426,334)	(1,742,818)
New loans obtained	2,815,825	2,123,727	74,275
Net payment on derivatives contracts	(45,413 )	56,765	(5,399 )
Dividends and interest on shareholders' equity paid	(3,493,997 )	(5,387,601)	(1,919,906)
Acquisition of non-controlling interest	(44,172 )	(33,850 )	-
Repurchase of shares	(32,768 )	(61,620 )	-
Cash used in financing activities	(2,080,179 )	(4,728,913)	(3,593,848)
Increase (decrease) in cash and cash equivalents	4,255,737	1,383,627	720,301
Cash and cash equivalents at beginning of year	2,940,342	1,556,715	2,277,016
Cash and cash equivalents at end of year	7,196,079	2,940,342	1,556,715
Changes in cash during the year	4,255,737	1,383,627	720,301

The accompanying notes are an integral part of these Consolidated Financial Statements.

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Notes to the Consolidated Financial Statements

December 31, 2012, 2011 and 2010

(In thousands of reais)

1. Operations and background

a) Shareholding controlling interest

Telefônica Brasil S.A. (“Company” or Telefônica Brasil) is headquartered at Avenida Engenheiro Luiz Carlos Berrini, 1.376, in the capital city of the state of São Paulo, Brazil. The Company is a member of Telefônica Group (Group), the telecommunications industry leader in Spain which is also present in several European and Latin American countries. At December 31, 2012 and 2011, Telefônica S.A., holding company of the Group, held total direct and indirect interest of 73.81%, excluding treasury shares, represented by 91.76% common shares and 64.60% of preferred shares outstanding.

b) Operations

The Company’s main business purposes is the rendering of fixed line telephone and data services in the state of São Paulo, under Fixed Switched Telephone Service Concession Arrangement (STFC) and authorizations, respectively. The Company and its subsidiaries are also authorized to render other telecommunications services, such as: data communication, including broadband internet, mobile telephone services (Personal Mobile Services – SMP) and pay TV services, to wit (i) by satellite all over the country; (ii) MMDS technology in the cities of São Paulo, Rio de Janeiro, Curitiba and Porto Alegre, until December 2013, due to a waiver signed by the Company to go into effect within 18 months as from June 5, 2012, as a condition to take part in the 4G auction held on June 12 and 13, 2012 (Note 1b.2); cable in the cities of São Paulo, Curitiba, Foz do Iguaçu and Florianópolis.

Service concessions and authorizations are granted by Brazil’s Telecommunications Regulatory Agency (ANATEL), under the terms of Law No. 9472, of July 16, 1997 – General Law of Telecommunications (“Lei Geral das Telecomunicações” - LGT), amended by Laws No. 9986, of July 18, 2000 and No. 12485, of September 12, 2011 (Notes 1.b.1 and 1.b.2). It operates under regulations and supplementary plans issued.

b.1. Fixed Switch Telephone Service Concession Arrangement (STFC)

The Company is a concessionaire of the STFC to render fixed line services in the local network and national long distance calls originated in sector 31 of region 3, which comprises the state of São Paulo (except for cities comprising sector 33), established in the General Service Concession Plan (PGO/2008).

The Company’s current STFC was executed on June 30, 2011, is effective from July 1, 2011 to December 31, 2025, and was granted for valuable consideration. This arrangement provides for the possibility of amendments on December 31, 2015 and December 31, 2020. This condition allows ANATEL to set up new requirements and goals for universal and quality of telecommunication services, considering the conditions in place at the time.

The service concession arrangement establishes that all assets owned by the Company and that are indispensable to the provision of the services described in the referred to arrangement are considered reversible assets and are deemed to be part of the service concession assets. These assets will be automatically returned to ANATEL upon termination of the service concession arrangement, according to the regulation in force. At December 31, 2012, estimated residual value of reversible assets was R\$6,911,508 (R\$6,698,899 at December 31, 2011), which comprised switching and transmission equipment and public use terminals, external network equipment, energy equipment and system and



operation support equipment.

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In accordance with the service concession arrangement, every two years, during the arrangement's 20-year effective term, the Company shall pay a fee which will correspond to 2% (two percent) of its prior-year STFC revenue, net of taxes and social contributions.

### b.2.SMP-related authorizations and frequencies

The business purpose of Vivo S.A. (Vivo), fully-controlled by the Company is the rendering of mobile telephone services (SMP), including the services it can provide, which are also regulated by ANATEL. It operates under regulations and supplementary plans issued.

Frequency authorizations granted by ANATEL for mobile telephone services may be renewed only once, for a 15-year period, and is subject to payment of fees equivalent to 2% (two percent), in every two years, of the Company's prior-year revenue, net of taxes and social contributions, related to the application of the Basic and Alternative Plans of Service.

#### Acquisition of frequencies of 900 and 1800 MHz

In ANATEL auctions held on December 14 and 15, 2010, Vivo won 23 lots offered for sale of sub-ranges of remainders in frequencies of 900 and 1800 MHz, pursuant to call for bid on range H and remainders N° 002/2010/PVCP/SPV-ANATEL.

On April 28, 2011, in its 604th meeting, ANATEL's board of directors decided to approve lots 41, 42, 44, 45, 76 to 84, 92, 101, 105, 107, 115, 119, 122, 124, 128 and 163 to Vivo and other winning operators the lots in the aforesaid auction.

On May 30, 2011 the decision was published in the Federal Official Gazette (DOU), and the Terms of Authorization were signed with ANATEL. Accordingly, the actual awarding of such lots allowed Vivo to increase its spectrum, operating now at frequencies of 900 and 1800 MHz on a comprehensive basis.

On the date the Terms of Authorization were signed, R\$81,175 was paid, equivalent to 10% of the total amount, and the remaining 90% was paid in December 2011, equivalent to R\$730,579. The total amount of R\$811,754 was adjusted in June 2011 in accordance with the remaining term of licenses and recorded as intangible assets (Note 14).

#### STFC Authorization for Vivo

On August 18, 2011 Act N° 7012 was published in the Federal Official Gazette, authorizing Vivo to provide STFC for the public use in general. Vivo is acting nationwide concerning this authorization, except in the State of São Paulo, where the Company operates.

#### Acquisition of frequencies of 2.5 GHz

In the auctions for sale of national frequencies of 2.5 GHz pegged to the range of 450 MHz conducted by ANATEL on June 12 and 13, 2012, Vivo won lot 3 among those offered, in accordance with public 4G auction notice No. 004/2012/PVCP/SPV-Anatel.

The amount offered for lot 3 was R\$1.05 billion.

On October 11, 2012, through Act N° 5907 of ANATEL's Board decided to approve use of radiofrequency blocks, without exclusivity, on a primary basis, in sub-bands 2550 through 2570 MHz / 2670 through 2690 MHz, in connection with the authorizations to engage Personal Mobile Service (SMP) granted to Vivo, as well as of other radiofrequencies in the 2.5 GHz band by the respective winning bids for the lots mentioned in the bid. The authorization terms of the above-mentioned radiofrequency bands were executed on October 16, 2012 and published by the Federal Official Gazette (DOU) on October 18, 2012.

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Accordingly, upon the actual awarding of such lot, Vivo increased its service provision capacity powered by 4G technology nationwide and has since then operated in frequency range of 2.5GHz, with band of 20+20 MHz. Besides the range of 2.5GHz, the acquired lot includes the range of 450 MHz for rural areas in the country of the Brazilian states of Alagoas, Ceará, Minas Gerais, Paraíba, Pernambuco, Piauí, Rio Grande do Norte, São Paulo and Sergipe.

On October 16, 2012, Vivo paid R\$105,000, an amount equivalent to 10% (ten per cent) of the total concession amount. The remaining amount of R\$994,977 (updated on December 31, 2012), shall be paid in up to 12 months, updated by the IGP-DI rate (General Price Index – Domestic Supply issued by the Fundação Getulio Vargas), or in 6 equal annual installments maturing between October 2015 and October 2020, updated by the IGP-DI rate plus interest of 1% (one per cent) per month on the adjusted amount.

In the fourth quarter of 2012, the total amount of R\$1,050,000 was adjusted in accordance with the remaining life of licenses and recorded in intangible assets (Note 14).

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Vivo explores SMP, in accordance with the authorizations given as follows:

Operations Areas	Authorization Maturity
First Area	
Rio de Janeiro	
800/900/1800/1900/2100 MHz and 2.5 GHz radio frequencies	11/29/20 (A band), 11/30/20 (L band), 4/30/23 (J band) and 10/18/27 (X band)
Espírito Santo	
800/900/1800/1900/2100 MHz and 2.5 GHz radio frequencies	4/30/23 (J band), 11/30/23 (A and L band) and 10/18/27 (X band)
Amazonas, Roraima, Amapá, Pará and Maranhão	
800/900/15r4t800/2100 MHz and 2.5 GHz radio frequencies	11/29/13 (B band), 4/30/23 (J band) and 10/18/27 (X band)
Minas Gerais (except Triângulo Mineiro )	
450/800/900/1800/1900/2100 MHz and 2.5 GHz radio frequencies	4/29/23 (A band), 4/30/23 (J band) and 10/18/27 (X band)
Minas Gerais (Triângulo Mineiro)	
450/800/900/1800/1900/2100 MHz and 2.5 GHz radio frequencies	4/28/20 (E band), 4/29/23 (J band) and 10/18/27 (X band)
Bahia	
800/900/1800/1900/2100 MHz and 2.5 GHz radio frequencies	4/30/23 (J band), 6/29/23 (A and L band) and 10/18/27 (X band)
Sergipe	
450/800/900/1800/1900/2100 MHz and 2.5 GHz radio frequencies	4/30/23 (J band), 12/15/23 (A and L band) and 10/18/27 (X band)
Alagoas, Ceará, Paraíba, Pernambuco, Piauí and Rio Grande do Norte	
450/1800/1900/2100 MHz and 2.5 GHz radio frequencies	12/7/22 (L band), 4/30/23 (E and J band) and 10/18/27 (X band)
Second Area	
Paraná and Santa Catarina	
800/900/1800/1900/2100 MHz and 2.5 GHz radio frequencies	4/8/13 (B and L band), 4/30/23 (J and M band) and 10/18/27 (X band)
Rio Grande do Sul	
800/900/1800/1900/2100 MHz and 2.5 GHz radio frequencies	12/17/22 (A and L band), 4/30/23 (J and M band) and 10/18/27 (X band)

Federal District 800/900/1800/1900/2100 MHz and 2.5 GHz radio frequencies	7/24/21 (A and L band), 4/30/23 (J and M band) and 10/18/27 (X band)
Goiás and Tocantins 800/900/1800/1900/2100 MHz and 2.5 GHz radio frequencies	4/30/23 (J and M band), 10/29/23 (A and L band) and 10/18/27 (X band)
Mato Grosso 800/900/1800/1900/2100 MHz and 2.5 GHz radio frequencies	4/30/23 (J and M band), 3/30/24 (A and L band) and 10/18/27 (X band)
Mato Grosso do Sul 800/900/1800/1900/2100 MHz and 2.5 GHz radio frequencies	4/30/23 (J and M band), 9/28/24 (A and L band) and 10/18/27 (X band)
Rondônia 800/900/1800/1900/2100 MHz and 2.5 GHz radio frequencies	4/30/23 (J and M band), 7/21/24 (A and L band) and 10/18/27 (X band)
Acre 800/900/1800/1900/2100 MHz and 2.5 GHz radio frequencies	4/30/23 (J and M band), 7/15/24 (A and L band) and 10/18/27 (X band)
Rio Grande do Sul (Pelotas, Morro Redondo, Capão do Leão and Turuçu), Mato Grosso do Sul (CTBC area) and Goiás (CTBC area) 1800/1900/2100 MHz and 2.5 GHz radio frequencies	12/7/22 (L band), 4/30/23 (D, J and M band) and 10/18/27 (X band)
Third Area São Paulo 450/800/1800/1900/2100 MHz and 2.5 GHz radio frequencies	4/30/23 (J band), 8/5/23 (A and L band) and 10/18/27 (X band)
São Paulo (Ribeirão Preto, Guatapará and Bonfim Paulista) 450/800/1800/1900/2100 MHz and 2.5 GHz radio frequencies	4/30/23 (J band), 1/20/24 (A and L band) and 10/18/27 (X band)
São Paulo (Franca and area) 450/1800/1900/2100 MHz and 2.5 GHz radio frequencies	12/7/22 (L band), 4/30/23 (J band) and 10/18/27 (X band)

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c)Subsidiaries

Vivo S.A. (Vivo): Engages in the SMP exploration, including activities necessary or useful to the completion of such services, in accordance with authorizations granted.

A. Telecom S.A. (ATelecom): Engages in the provision of the following services: (i) telecommunications management services and installation, operation and maintenance solutions for internet, intranet and extranet, (ii) commercial representation, agency, brokerage and distribution of goods, (iii) marketing, representation, leasing and maintenance of systems, equipment and telecommunications devices and computers in general, (iv) consulting services and technical support for the specification, implementation and maintenance of new voice systems, data and image (v) import and export of goods and services useful to the attainment of the corporate, and (vi) the share capital of other companies, domestic or foreign, as a partner or shareholder

Telefônica Data S.A. (TData): Engages in the provision and exploration of telecommunication services, as well as preparation, implementation and installation of projects involving the exploration of integrated business solutions, consulting services on telecommunications, activities related to technical assistance service provision, sale, rent and maintenance of telecommunication equipment and network.

Telefônica Sistema de Televisão S.A. (TSTV): Engages in the provision of pay TV services under the Multichannel Multipoint Distribution of Signals (MMDS), besides the provision of telecommunication services in general and Internet.

Ajato Telecomunicações Ltda. (Ajato): Engages in the provision of telecommunication and IT services, access to the telecommunication network, Internet, via radio, encompassing the image and data services of telemarketing, sale of rent, import, export, maintenance and repair of these equipment sets.

GTR Participações e Empreendimentos S.A. (GTR): Engages in holding equity interest in other companies whose purpose is to provide cable and pay TV services, telecommunications in general, production, acquisition, licensing, import and distribution of own or third party TV programs, spare parts and equipment, management and exploration of platforms of pay TV and telecommunication services.

TVA Sul Paraná S.A. (TVA Sul): Engages in cable and pay TV services provision, telecommunications in general, production, acquisition, licensing, import and distribution of own or third party TV programs, spare parts and equipment, management, updating and exploration of pay TV platform and telecommunications and editing of journals.

Lemontree Participações S.A. (Lemontree): Engages in holding equity interest in other companies whose purpose is to provide cable and pay TV services, telecommunications in general, production, acquisition, licensing, import and distribution of own or third party TV programs, spare parts and equipment, management and exploration of platforms of pay TV and telecommunication services and sale of data.

Comercial Cabo TV São Paulo S.A. (Comercial Cabo): Engages in cable and pay TV services, assistance and consulting on telecommunications in general, production, acquisition, licensing, import and distribution of own or third party TV programs, spare parts and equipment, management and exploration of platforms of pay TV and telecommunication services and exploration of full range of advertising and promotion.

Aliança Atlântica Holding B.V. (Aliança): Headquartered in Amsterdam, The Netherlands, with 50% interest by Telefônica Brasil, its revenues from the sale of shares of Portugal Telecom in June 2010. Until May 8, 2012 the

Company held shares in Zon Multimédia, a company of Portugal Telecom group engaged in pay TV service provision, Internet, distribution of audiovisual contents, movies and telecommunications. Such shares were sold on May 8, 2012.

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Companhia AIX de Participações (AIX): Engages in holding equity interest in the Refibra Consortium as a leader, as well as activities involving direct and indirect exploration of execution, completion and exploration of underground duct lines for fiber optics.

Companhia ACT de Participações (ACT): Engages in holding equity interest in the Refibra Consortium as a leader, as well as activities involving the provision of technical assistance for design of network completion projects, running the studies required to make it economically feasible, as well as inspecting the progress of Consortium-related activities.

The table below lists the Company's direct and indirect subsidiaries and equity held in total capital:

Subsidiaries	12/31/12	12/31/11
Vivo S.A. (a)	100%	100%
Telefônica Data S.A.	100%	100%
A.Telecom S.A.	100%	100%
Telefônica Sistema de Televisão S.A.	100%	100%
Ajato Telecomunicações Ltda.	100%	100%
GTR Participações e Empreend. S.A. (b)	100%	66.67%
TVA Sul Paraná S.A. (b)	100%	91.50%
Lemontree S.A. (b)	100%	83.00%
Comercial Cabo TV São Paulo S.A. (b)	100%	93.19%
Aliança Atlântica Holding B.V.(c)	50%	50%
Companhia AIX de Participações (c)	50%	50%
Companhia ACT de Participações (c)	50%	50%

- (a) Fully consolidated as from April 2011 (Notes 1 and 4).  
 (b) Fully consolidated as from January 2011 and wholly-owned subsidiaries as from June 2012.  
 (c) Jointly-controlled companies.

d)Share trading on stock exchanges

The Company is registered with the Brazilian Securities and Exchange Commission (CVM) as a publicly-held under category A (issuers authorized to trade any kind of securities), its shares being traded on the São Paulo Stock Exchange (BM&FBovespa). It is also registered with the Securities and Exchange Commission (SEC) in the USA, with its American Depositary Shares (ADSs) level II, listed only in preferred shares, being traded on the New York Stock Exchange (NYSE).

d.1) Shares traded on the São Paulo Stock Exchange (BM&F Bovespa)

On September 21, 1998, the Company started trading its shares on the São Paulo Stock Exchange (BM&F Bovespa), under tickers TLPP3 and TLPP4, for common and preferred shares.

In the Special Shareholders' Meeting of Vivo Participações S.A. (Vivo Part.) and Telecomunicações de São Paulo S. A. (Telesp) held on October 3, 2011, merger of Vivo Part. into Telesp was approved. On the same date, its corporate name changed to Telefônica Brasil S.A., and on October 6, 2011 the Company changed its ticker codes to VIVT3 and VIVT4 for common and preferred shares, respectively, and the stock exchange code to Telefônica Brasil (see Note 4).



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d.2) Shares traded on the New York Stock Exchange (NYSE)

On November 16, 1998, the Company started the ADR trading process on the New York Stock Exchange (NYSE), which currently has the following characteristics:

- Type of share: preferred.
- Each ADR represents 1 (one) preferred share.
- Shares are traded as ADR through code “VIV” on the NYSE.
- Foreign depository bank: The Bank of New York.
- Custodian bank in Brazil: Banco Itaú S.A.

e) Corporate events

e.1) Corporate restructuring – merger of Vivo Part. shares by Telefônica Brasil

In a meeting held on March 24, 2011, ANATEL granted previous consent for the corporate restructuring between the Company and Vivo Part. Act N° 1970, of April 1, 2011, was published in the Federal Official Gazette (DOU) on April 11, 2011.

In the Company’s Extraordinary Shareholders’ Meeting held on April 27, 2011, unanimous voting approved the Protocol of Merger of Shares and Instrument of Justification agreed between the Company and Vivo Part., each Vivo Part.’s share being replaced with 1.55 Company’ shares. The Company’s common and preferred shareholders and Vivo Part.’s common shareholders deadline to exercise their withdrawal rights was May 30, 2011. The shareholders opting for the withdrawal right were repaid the shares demonstrably held by the companies on December 27, 2010, when the material news release was published. The amounts repaid to the Company’s common and preferred shareholders and to the Vivo Part.’s common shareholders reached R\$23.06 and R\$25.30 by share, respectively, calculated at their related net equity values disclosed in the balance sheet as of December 31, 2010.

e.2) Corporate restructuring – Concentration of SMP Authorizations and Simplification of the Corporate Structure

Vivo Part. Board of Director’s Meeting held on June 14, 2011 approved the proposal for concentration of authorizations for SMP service provision (until then held by Vivo Part. in the State of Minas Gerais and by Vivo in other Brazilian states), thus consolidating the operations and the Terms of Authorization for SMP exploration at Vivo.

As a proposal for making feasible this corporate restructuring, on October 1, 2011 Vivo Part. assigned Vivo (the group’s mobile operator holding the SMP authorizations in the other Brazilian states) the commercial establishments (including the assets, rights and obligations) regarding the SMP services in the State of Minas Gerais, with Vivo Part. thus becoming the ultimate holding.

Pursuant to Law N° 6404/76, an expert company was engaged to prepare a valuation report on a portion of Vivo Part.’s net assets (as of August 31, 2011) consisting of SMP operations in the State of Minas Gerais assigned to Vivo’s assets and of Vivo Part.’s assets to be merged by the Company.



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Because Vivo Part. is the Company's wholly-owned subsidiary since April 27, 2011, whose equity already comprised the investment in Vivo shares, the merger: i) did not lead to capital increase at the Company; ii) did not bring along the replacement of shares held by noncontrolling shareholders of Vivo Part. with Company shares; and iii) did not require a valuation report on net assets at market prices for calculation of the ratio of shares replaced, in the absence of noncontrolling shareholders to be protected.

Accordingly, under the terms of article 226, paragraphs I and II of Law N° 6404/76, shares held by the Company in the net equity value of Vivo Part.'s were cancelled. On conclusion of the corporate restructuring, Vivo Part. was incorporated by the Company on October 3, 2011, and Vivo became wholly-owned subsidiary, simplifying and rationalizing the structure of costs of companies involved.

f) Agreement between Telefônica S.A. and Telecom Itália (Act N°3,804, of July 7, 2009, and Act No. 68,276, of October 31, 2007, both from ANATEL Board)

In October 2007, TELCO S.p.A. (in which Telefônica S.A. holds 42.3% interest) completed the acquisition of 23.6% of Telecom Italia. Vivo is an indirect subsidiary of Telefônica S.A. Telecom Italia holds interest in TIM Participações S.A. (TIM), a mobile telephone service company in Brazil. As a result of the acquisition of its interest in Telecom Itália, Telefônica S.A. is not directly involved in TIM operations. Furthermore, any transactions between the Company, Vivo and TIM are ordinary mobile telephone transactions regulated by ANATEL.

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2. Basis of presentation of the consolidated financial statements

2.1 - Basis for Preparation and Presentation

The Company's financial statements for years ended December 31, 2012 and 2011 are presented in thousands of reais (except where otherwise indicated) and is presented considering the Company's ability to continue as a going concern.

The Company and its subsidiaries do not have seasonal operations.

The consolidated financial statements were prepared and are presented in accordance with the International Financial Reporting Standards (IFRS), as issued by the International Accounting Standards Board (IASB), which are not different from accounting practices adopted in Brazil, which comprise CVM rules and CPC pronouncements.

In a meeting held on February 21, 2013, the Company's Board of Directors authorized these financial statements to be issued.

Some items of the balance sheet and income statement for the year ending December 31, 2011 were reclassified to allow comparability with the information of December 31, 2012.

The Company states that the consolidated financial statements are in compliance with International Financial Reporting Standards (IFRS) issued by the IASB and with the pronouncements, interpretations and guidelines issued by CPC ruling on December 31, 2012, which include the new pronouncements, interpretations and revisions of the following standards, amendments and interpretations published by IASB and by the International Financial Reporting Interpretations Committee (IFRIC) which went into effect on January 1, 2012:

Amendments to IAS 12, Income Tax – Recovery of Underlying Assets: This amendment provided clarification on how to calculate deferred taxes on investment properties measured at fair value. It introduced the rebuttable presumption that deferred taxes on investment properties measured at fair value under IAS 40 should be defined considering that their book value will be recovered through sale.

Amendments to IFRS 7, Financial Instruments: Disclosures – Enhanced Derecognition Disclosure Requirements: This amendment requires additional disclosure on financial assets transferred, yet not derecognized, so as to enable the financial information users to understand the relation with those assets not derecognized and related liabilities. Furthermore, this amendment requires disclosures as to the ongoing involvement in the derecognized financial assets so that the user can evaluate the nature of the entity's ongoing involvement in these derecognized assets and related risks. This amendment became effective for annual periods beginning on or after July 1, 2011; in Brazil, it will become effective after CPC approval and CVM ruling for publicly-held companies.

Worth noting is that this amendment only affects disclosures – however, it is not currently applicable to the Company, and has no impact on the Company's and its subsidiaries' financial position or performance.

New IFRS and interpretations of the International Financial Reporting Interpretations Committee (IFRIC) not yet effective as of December 31, 2012

At the date these financial statements were prepared, the following IFRS, amendments and IFRIC interpretations had been issued, but their application was not mandatory:

IAS 1 Presentation of Other Comprehensive Income Account: IAS 1 revisions affected the grouping of items presented in other comprehensive income. Items which might be reclassified (or “recycled”) to profit or loss at a future point of time (e.g. net gains on hedged net investments, exchange variation differences from translation of operations abroad, net movements of hedge of cash flows or gains on sale of assets classified as available for

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sale) should be presented separately from items which will never be reclassified (e.g. actuarial gains or losses on defined benefit plans). The revisions affect only the presentation, with no impacts on the financial position or performance of the Company and its subsidiaries. These revisions go into effect for years beginning July 1, 2012 or thereafter and will be applied to the Company's financial statements when effective.

**IAS 19 Employee Benefits (Revised):** The IASB issued various revisions to IAS 19, which comprises fundamental amendments, such as the removal of the corridor method and the concept of returns expected on the plan assets, and simple clarifications on valuation and devaluation and reformulation. The Company does not expect significant impacts on its consolidated financial statements. This revised IAS will go into effect for annual periods beginning January 1, 2013 or thereafter.

**IAS 28 Investments in Associates and Joint Ventures (Revised in 2011):** In connection with the issuance of IFRS 11 and IFRS 12 (see below), IAS 28 is now IAS 28 - Investments in Associates and Joint Ventures and describes the application of the equity method for investments in joint ventures, besides the investment in associates. The Company does not anticipate any significant impacts on its consolidated financial statements. This revision will go into effect for annual periods beginning January 1, 2013 or thereafter.

**IAS 32 Offsetting Financial Assets and Financial Liabilities – Revisions of IAS 32:** These revisions shed light on the meaning of the phrase “currently has the legal right to set off”. These revisions also clarify the adoption of offsetting criteria set forth by IAS 32 for the clearing systems (like the clearing house systems), which apply non-simultaneous gross mechanisms for clearing. These revisions are not expected to affect the Company's and its subsidiaries' financial position, performance or disclosures effective for annual periods beginning January 1, 2014 or thereafter.

**IFRS 1 Government Loans – IFRS 1 Revisions:** These revisions set the first-time application of the requirements of IAS 20 - Accounting for Government Grants and Disclosure of Government Assistance, prospectively governmental loans existing on the date of transition to IFRS. The entities may opt for applying the IFRS 9 requirements (or IAS 39, as the case may be) and IAS 20 to governmental loans, retrospectively, had the necessary information been obtained upon the initial recording of loans. The exception would give relief to the entities adopting the standard for the first time from retrospectively measuring government loans at an interest rate below market rate. The review will go into effect for annual periods beginning January 1, 2013 or thereafter. The revision will not affect the Company and its subsidiaries.

**IFRS 7 Disclosures – Offset Between Financial Assets and Financial Liabilities – Revisions of IFRS 7:** These revisions require an entity to disclose information about the rights to offset and related agreements (e.g. agreement for guarantee). The disclosures provide users with useful information for them to assess the effect of the offsetting agreements on the financial position of an entity. The new disclosures are necessary for all financial instruments recognized and offset in accordance with IAS 32 Financial Instruments - Presentation. The disclosures also apply to financial instruments recognized which are subject to a master agreement for offsetting or alike, irrespective of being or not offset in accordance with IAS 32. The revision will go into effect for annual periods beginning January 1, 2013 or thereafter.

**IFRS 9 Financial Instruments: Classification and Measurement:** IFRS 9, as issued, reflects the first phase of IASB work regarding the replacement of IAS 39 and applies to the classification and measurement of financial assets and financial liabilities, as set forth by IAS 39. The standard initially was effective for annual periods beginning January 1, 2013, however the standard Amendments to IFRS 9, Effective Date of IFRS 9 and Disclosures for Transition, issued in December 2011, changed the mandatory effective date to January 1, 2015. Later on, the IASB will address the recording of hedging instruments and impairment of financial assets. The adoption of the first phase of IFRS 9 will go into effect for the classification and measurement of the Company's and its subsidiaries' financial assets, but will not



affect the classification and measurement of financial liabilities. The Company will quantify the effect together with other phases, when the final standard is issued, comprising all the phases.

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IFRS 10 Consolidated Financial Statements, IAS 27 Separate Financial Statements: IFRS 10 replaces the portion of IAS 27 – Consolidated and Separate Financial Statements which deals with the recording of consolidated financial statements. It also addresses issues raised by SIC-12 Consolidation – Special-purpose Entities. IFRS 10 establishes a single control model applied to all entities, including special-purpose entities. The amendments introduced by IFRS 10 will require management’s significant judgmental analysis to determine which entities are subsidiaries and therefore required to be consolidated by a parent company.

Based on preliminary analyses, IFRS 10 is not expected to have impacts on the investments currently held by the Company. This standard will go into effect for annual periods beginning January 1, 2013.

IFRS 11 Joint Ventures: IFRS 11 replaces IAS 31 – Interests in Joint Ventures SIC-13 –Jointly-controlled Entities – Non-monetary Contributions by Venturers. IFRS 11 eliminates the option to record jointly-controlled companies (JCC) based on a proportional consolidation. Instead, the JCC falling into the joint venture definition shall be recorded using the equity method. The application of new standard will affect the Company’s financial position, eliminating the proportional consolidation of Aliança, AIX and ACT (Note 12). By applying the new standard, the investments in the aforesaid companies will be recorded using the equity method. This standard will go into effect for annual periods beginning January 1, 2013 and shall be applied retrospectively to joint ventures held on the initial application date. It is estimated that the IFRS 11 impact on the current period (which will correspond to the comparative period of the financial statements at December 31, 2013), considering certain items, consists of decrease in revenues by R\$28,308 and a decrease in operating income by R\$1,370, since joint venture income will be presented below operating income. Current assets and current liabilities will decrease by R\$64,873 and R\$2,791, respectively, while noncurrent assets will be increased by R\$60,012, and noncurrent liabilities will be decreased by R\$2,896.

IFRS 12 Disclosure of Interests in Other Entities: IFRS 12 includes all disclosures previously contained in IAS 27 regarding the consolidated financial statements, as well as all disclosures previously contained in IAS 31 and IAS 28. These disclosures regard interest held by an entity in subsidiaries, joint ventures, associates and structured entities. A number of new disclosures are also necessary, but there will be no impact on the Company’s financial position or performance. This standard will go into effect for annual periods beginning January 1, 2013 or thereafter.

IFRS 13 Fair Value Measurement: IFRS 13 sets a single source of guideline in IFRS for all fair value measurements. IFRS 13 does not change the time an entity is required to use fair value, but provides guidance on how to measure fair value in accordance with IFRS, whenever fair value is required or allowed. This standard will go into effect for annual periods beginning January 1, 2013 or thereafter. The application of this standard will have no effect on the company.

### Annual improvements – May 2012

The following improvements will not affect the Company and its subsidiaries:

IFRS 1 First-time Adoption of the International Financial Reporting Standards (IFRS): This improvement explains why an entity which discontinued the use of IFRS in the past and opted or was compelled to adopt IFRS may re-adopt IFRS 1. Should IFRS 1 not be re-adopted, the entity should retrospectively restate its financial statements as if it had never discontinued the use of IFRS.

IAS 1 Presentation of Financial Statements: This improvement clarifies the difference between additional voluntary comparative information and necessary minimum comparative information. Generally, the necessary minimum comparative information relates to the prior period.

IAS 16 Fixed Assets: This improvement explains that the main spare parts and equipment for service provision which comply with the definition of fixed assets are not inventories.

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IAS 32 Financial Instruments: Presentation: This improvement clarifies that income taxes arising from distribution to shareholders are recorded in accordance with IAS 12 Income Taxes.

IAS 34 Interim Financial Statements: This revision presents an alignment with the requirements for disclosure of total assets of the segment with total liabilities of the segment in the interim financial statements. This clarification also ensures that the interim disclosures are in line with annual disclosures.

These improvements will go into effect for annual periods beginning January 1, 2013 or thereafter.

2.2 - Bases for consolidation and significant changes at consolidation level

In the consolidation, all balances of assets, liabilities, revenues and expenses from transactions and interest in net equity between the Company and its subsidiaries were eliminated.

The main events and changes in the consolidation environment that, due to their significance, should be taken into consideration when analyzing the consolidated information for the years ended December 31, 2012 and 2011, as follows:

a)Acquisition of Vivo Part. by the Company

In the Company's Extraordinary Shareholders' Meeting held on April 27, 2011, unanimous voting approved the Protocol of Merger of Shares and Instrument of Justification agreed between the Company and Vivo Part., each Vivo Part.'s share being replaced with 1.55 Company' shares. Given this merger of shares, Company's capital increased by R\$31,222,630. The Company's consolidated financial statements include the results of Vivo Part. (merged by the Company on October 3, 2011) and Vivo since April 1, 2011. Vivo Part. and Vivo were included in the Company's consolidated financial statements under the full consolidation method.

b)Consolidation of TVA companies

As from January 1, 2011, the Company included companies GTR, TVA Sul, Lemontree and Comercial Cabo in its consolidated financial statements under the full consolidation method.

c)Acquisition of Lemontree and GTR shares

On September 29, 2011, the Company acquired 68,533,233 common shares, which represented 49% of this type of shares of Lemontree, which is the holder of 80.1% common shares of Comercial Cabo. Thus, the Company became holder of 83% interest in Lemontree and 93.19% in Comercial Cabo.

On June 6, 2012, the Company exercised its call option in relation to (a) 71,330,508 remaining common shares, corresponding to 51% of the voting capital of Lemontree, which controls Comercial Cabo, and (ii) 923,778 remaining common shares of GTR, holder of 50.9% of TVA Sul common shares, given that these shares were previously held by Abril Group. The call option was exercised at this date, and concludes the acquisition of Lemontree and GTR remaining shares, which started with the partial exercise of the call option implemented on September 29, 2011, with the acquisition of Lemontree common shares, representing 49% of its capital. Amounts corresponding to the acquisition of the remaining common shares of Lemontree and GTR, as described above, totaled R\$37,737 and R\$6,434, respectively.

These transactions were accounted for as acquisition of a non-controlling shareholders' interest for the purpose of disclosure and measurement in these financial statements.

Upon exercising this option, the Company became holder of 100% of the shares representing the voting and total capital of Lemontree and GTR and, indirectly, of the companies operating cable TV services located in the cities of São Paulo and Curitiba, Foz do Iguaçu and Florianópolis.

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d) Disposal of shares of Zon Multimédia – Serviços de Telecomunicações e Multimédia, SGPS, S.A.

On May 8, 2012, the Company disposed of 1,618,652 (1,196,395 directly and 422,257 indirectly through Aliança Atlântica) common shares representing 0.52% of Zon Multimédia – Serviços de Telecomunicações e Multimédia, SGPS, S.A. (ZON) voting capital. Consolidated net income (amount obtained from disposal of shares held and divestiture of investments) of this transaction amounted to R\$1,486.

e) Corporate Restructuring

Aiming to simplify the current organizational structure of the Company, as well as assisting the integration of business and generating synergies from a effectiveness providing services perspective, the Company filed with ANATEL on March 15, 2012 request for prior approval of corporate restructuring, which became legally viable because of legislative changes applicable to concessionaires STFC through Law No. 12,485.

The restructuring proposal could be implemented only after prior approval by ANATEL, who is currently analyzing the case.

3. Summary of significant accounting practices

a) Cash and cash equivalents: These are held to meet short-term cash commitments, and not for investment or other purposes. Cash and cash equivalents include cash, positive balances in current accounts and short-term investments redeemable within no longer than 90 days as from the date of contracts and with insignificant risk of change in market value (Note 5).

b) Trade accounts receivable, net: These are determined at the value of services provided according to the contracted conditions, net of the provision for impairment. It includes the services provided to customers who have not been billed up to the balance sheet date, as well as accounts receivable regarding sales of cell phones, simcards and accessories. The provision for impairment is set up in order to cover eventual losses, if any, and takes into consideration mainly the expected default (Note 6).

c) Inventories: These are stated at average cost of acquisition or net realizable value, whichever is lower. It includes cell phones, simcards, prepaid cards, accessories, consumables and maintenance. The net realizable value consists of the sale in the ordinary course of business, less estimated necessary costs for sale (Note 7).

The provision for impairment is set up for materials and devices deemed to be obsolete or whose quantities are greater than those usually sold by the Company in a reasonable length of time.

d) Prepaid expenses: These are presented at the values actually disbursed on services engaged and not yet incurred. Prepaid expenses are allocated to profit or loss as services are provided and economic benefits are received (Note 10).

e) Investments: Equity interest in subsidiaries (individual or joint) is valued under the equity method in the individual financial statements. In the consolidated financial statements, investments in controlled companies are fully consolidated, and investments in jointly-controlled companies are consolidated in a proportional way.

In consolidation, all balances of assets and liabilities, revenues and expenses from transactions and equity interest between the Company and its subsidiaries were eliminated.

The effects on the financial statements translation of Aliança (jointly controlled) are recognized in Company's equity as "Cumulative translation adjustments".

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f)Property, plant and equipment, net: These are stated at acquisition and/or construction cost, net of accumulated depreciation and provision for impairment, if applicable. Such cost includes the borrowing costs for long-term construction projects, whenever the recognition criteria are met, net of credits of State VAT (ICMS), which were recorded as taxes recoverable.

The costs of assets are capitalized until they are in condition expected for them to become operational.

Expenses subsequent to the entry of asset into operation are recognized immediately in profit or loss, in line with the accrual method. Expenses incurred for improvements in assets (increase in installed capacity or useful life) are capitalized.

The estimated costs to be incurred in the dismantling of towers and equipment at rented properties are capitalized in contrast with the provision for asset retirement (Note 20) and depreciated over the useful life of the equipment, which is not longer than the rental period.

The depreciation is calculated on a straight-line basis over the useful life of assets, at rates which take into consideration the estimated useful life of assets based on technical studies. The net book value and useful life of assets and depreciation methods are annually revised and prospectively adjusted, as the case may be.

A fixed asset is written off when sold or no future economic benefit is expected to arise from its use or sale. Any gain or loss from disposal of asset (calculated as the difference between net value of sale and net book value of asset) are recognized in profit or loss for the year the asset is written off.

### g)Intangible Assets (including goodwill):

These are stated at acquisition and/or construction cost, net of accumulated amortization and provision for impairment, if applicable.

They include rights of use of software acquired from third parties, licenses for concession and authorization acquired from ANATEL, customer portfolio, trademarks and other intangible assets.

The useful life of an intangible asset is determined as definite or indefinite, namely:

- Intangible assets with definite life are amortized over the economic useful life under the straight-line method and assessed to determine impairment whenever there is evidence of loss of economic value of the asset. The amortization period and method for an intangible asset with definite life are revised once a year. Changes in the estimated useful life or in the expected consumption of future economic benefits from these assets are accounted for in light of changes in the amortization period or method, as the case may be, being treated as changes in accounting estimates.
- Indefinite life intangible assets are not amortized, and a recoverability test is performed annually or when there are indications that the book value cannot be recovered. The assessment of indefinite life is annually revised to determine whether this assessment continues to be justifiable. Otherwise, the change in useful life from indefinite to definite is made on a prospective basis.

Gains and losses from write-off of an intangible asset are measured as the difference between net value from sale and the asset book value and recognized in the statement of income for the year the asset is written off.



Goodwill on acquisition of investments and supported by future profitability is treated as an indefinite life intangible asset.

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h)Leasing : The agreements containing clauses on use of specific assets and rights to use assets are assessed to identify the accounting treatment to be given from a leasing viewpoint.

Finance lease in which the Company or its subsidiaries obtain the risks and benefits relating to the ownership of the leased item is capitalized at the inception of the lease at the fair value of the leased asset or, if lower, at the present value of minimum payments of leasing. Costs are increased, where applicable, by the initial direct costs incurred in the transaction. The payments of finance lease are allocated to financial charges and reduction in leasing liability so as to obtain constant interest rates on the remaining balance of the liability.

The amounts recorded in fixed assets are depreciated for the shorter between the estimated economic useful life of assets and the stated term set in the lease agreement.

Implicit interest in liabilities accounted for is allocated to profit or loss in accordance with the length of the agreement under the effective interest rate method.

The agreements in which the lessor keeps a significant portion of risks and benefits are considered as operating lease and its effects are recognized in profit or loss for the year throughout the life of the contract.

The Company's subsidiaries have agreements classified as finance lease both as a lessor or a lessee. As a lessor, A.Telecom has equipment lease agreements (Solutions IT Product) for which it recognizes, on the date of installation, revenues at present value of the amounts of the agreement as a contra-entry to accounts receivable. As a lessee, Vivo holds agreements for rental of towers and rooftops in connection with a sale and leaseback financial transaction whose residual value remained unchanged at the time of the sale. As a result, a liability for the present value of the minimum mandatory installments and deferred revenue based on the difference between the sales price and the present value mentioned, were recognized in the current year.

The difference between the nominal value of the installments and accounts receivable/payable is recognized as financial income/expense under the effective interest rate method throughout the term of the agreement (Note 29).

i)Analysis of the recoverability of assets: In compliance with IAS 36/CPC1 (R1), the Company and its subsidiaries revise, as so required, the net book value of assets to assess events or changes in the economic, operating or technological circumstances which may indicate deterioration or impairment.

If such evidence is identified and net book value exceeds value recoverable, a provision for impairment is set up by adjusting net book value to the recoverable amount.

The value recoverable is defined as the greater between value-in-use and net selling price.

In the estimate of value-in-use of asset, the estimated future cash flows are discounted at present value, using a discount rate based on the capital cost rate "The Capital Asset Pricing Model" (CAPM) before taxes, which reflects the weighted average capital cost and specific risks of the asset.

The net selling price is determined, whenever possible, based on a firm sale contract in an arm's length transaction between knowledgeable and interested parties, adjusted by expenses attributable to the sale of the asset or, in the absence of a firm sale contract, based on the market price of an active market or on the price of the most recent transaction with similar assets.

Losses on continuing operations, including impairment of inventories, are recognized in the statement of income as expenses compatible with the function of assets.

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For assets, excluding goodwill, a valuation is made at each year end to determine whether indications of impairment previously recognized may no longer exist or have been reduced.

An impairment previously recognized is reversed only in case of change in the assumptions used to determine the recoverable value of the asset as from the most recent recognition of impairment.

The reversal is limited for the book value of the asset not to exceed its value recoverable nor the book value which would have been determined, net of depreciation, had any impairment not been recognized in assets in prior years. This reversal is recognized in the income statement.

The following criteria are applied to the assessment of impairment on the following assets:

- i.1) Goodwill: The impairment test is performed annually, at the end of the fiscal year or when circumstances indicate impairment loss of book value.

Whenever the value recoverable is lower than book value, an impairment is recognized. Goodwill impairment cannot be reversed in future fiscal years.

- i.2) Intangible assets: indefinite life intangible assets are tested for impairment once a year, whether individually or at cash generating unit level, as the case may be, or when the circumstances indicate impairment of book value.

- i.3) Determination of value in use: The main assumptions used to estimate the value in use are as follows:

- Revenues: Revenues are projected considering the growth of the customers base, the evolution of market revenues in view of GDP and the equity interest held by the Company and its subsidiaries in this market;
- Operating costs and expenses: Variable costs and expenses are projected in accordance with the dynamics of the customers base, and fixed costs are projected in line with the historical performance of the Company and its subsidiaries, as well as the historical growth of revenues; and
- Capital investments: Investments in capital goods are estimated in view of the technological infrastructure necessary to make feasible service offer.

Key assumptions are based on the historical performance of the Company and its subsidiaries and on reasonable macroeconomic assumptions based on financial market projections, documented and approved by Company management.

The recovery test of fixed and intangible assets of the Company and its subsidiaries did not lead to recognition of losses for the years ended December 31, 2012 and 2011, since the estimated market value exceeds net book value on the assessment date.

### j) Business combination and goodwill

Business combinations are accounted for under the acquisition method. The acquisition cost is measured at fair value of assets, equity instruments and liabilities incurred or assumed on the acquisition date. Identifiable assets acquired, liabilities and contingencies assumed upon business combination are initially measured at fair value on the acquisition date, regardless of the interest held by non-controlling shareholders.



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Initially, goodwill is the excess acquisition cost over net fair value of assets acquired, liabilities assumed and identifiable contingent liabilities of an acquiree on the date of acquisition. If acquisition cost is lower than fair value of the acquiree's net asset, the difference is recognized directly in the income statement.

After the initial recognition, goodwill is measured at cost, net of any accumulated impairment. For impairment test purposes, goodwill acquired on a business combination is, as from the date of acquisition, allocated to the cash generating unit expected to be benefited by combination synergies, regardless of other acquiree's assets or liabilities being attributed to such unit.

Whenever goodwill is an integral part of a cash generating unit and a portion of such unit is disposed of, the goodwill associated with the operation disposed of is included in the operating cost when determining gain or loss on disposal. Goodwill disposed of in these circumstances is determined based on the proportional values of the portion disposed of in relation to the cash generating unit kept.

### k) Financial instruments and cash and cash equivalents

#### (i) Financial assets

##### Initial recognition and measurement

Financial assets are classified as financial assets at fair value through profit or loss, as loans and receivables, investments held to maturity, financial assets available for sale or derivatives classified as effective hedge instruments, as appropriate. The Company determines the classification of its financial assets at their initial recognition, as it becomes an integral part of contractual provisions of the instruments.

Financial assets are initially recognized at fair value, plus, in case of investments not designated at fair value through profit or loss, costs of transaction directly attributable to the acquisition of the financial asset.

Sales and purchases of financial assets requiring delivery of assets within a timetable set by regulation or market convention (regular purchases) are recognized on the date of operation, i.e. the date on which the Company commits itself to purchase or sell the asset.

The Company's and its subsidiaries' financial assets include cash and cash equivalents, trade accounts receivable and other receivables, trade and non-traded financial instruments and derivative financial instruments.

##### Subsequent measurement

The subsequent measurement of financial assets depends on their classification, which may be as follows:

Financial assets at fair value through profit or loss: These include derivative financial instruments taken out by the Company which do not meet the criteria for hedge accounting set by the related standard. Financial assets at fair value through profit or loss are presented in the balance sheet at fair value, including the related gains or losses recognized in the income statement.

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Receivables: These are non-derivative financial assets, with fixed or determinable payments, not traded in an active market. After the initial measurement, such financial assets are recorded at amortized cost under the effective interest method (effective interest rate), net of impairment, if and where applicable. The amortized cost is calculated in view of any discount or premium on the acquisition and rates or costs incurred. The amortization under the effective interest method is included in the financial income line in the statement of income. Impairment is recognized as financial expenses in the statement of income, if and where applicable.

Investments held to maturity: These are non-derivative financial assets with fixed or determinable payments and fixed maturity are classified as held to maturity whenever the Company expressed the intention and financial capacity to hold them to maturity. After the initial valuation, investments held to maturity are valued at amortized cost under the effective interest method, net of impairment. The amortized cost is calculated taking into consideration any discount or premium on the acquisition and rates or costs incurred. The amortization of effective interest is included in financial income, in the income statement. Losses on impairment are recognized as financial expenses in the statement of income. The Company and its subsidiaries did not record investments held to maturity during the years ended December 31, 2012 and 2011.

Financial assets available for sale: These are non-derivative financial assets not classified as: (i) loans and receivables, (ii) investments held to maturity or (iii) financial assets at fair value through profit or loss. These financial assets include equity instruments.

After the initial measurement, financial assets available for sale are measured at fair value, and unrealized gains and accumulated losses are recognized directly in the reserve for assets available for sale in the group other comprehensive income until the investment is derecognized, except for impairment.

When the investment is derecognized or a certain impairment is determined, cumulative gains or losses previously recognized in other comprehensive income shall be accounted for in the statement of income.

The fair value of financial assets available for sale expressed in foreign currency is measured in such foreign currency and translated at the exchange rate ruling on the financial statements close date. The variations in fair value attributable to translation differences are recognized directly in net equity.

Derecognition (write-offs): a financial asset (or, as the case may be, a portion of a financial asset or portion of a group of similar financial assets) is written off whenever:

- The rights to receive cash flows from asset expire;

the Company transferred its rights to receive future cash flows from asset or took on an obligation to fully pay a third party cash flows received, without any significant delay, by operation of a “transfer” agreement; and (i) the Company substantially transferred all risks and benefit attached to the asset, or (ii) the Company neither substantially transferred nor withheld all risks and benefits attached to the asset, but transferred the control over it.

Whenever the Company has transferred its rights to receive cash flows from an asset or has entered into a transfer agreement, but has not substantially transferred or withheld all risks and benefits attached to the asset, it is recognized to the extent of the Company’s continuing involvement in this asset.

In this case, the Company also recognizes an associated liability. The transferred asset and the associated liability are measured in view of rights and obligations the Company kept.





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Continuing involvement as a guarantee over the transferred asset is measured at the original book value of the asset or at the maximum consideration the Company may require, whichever is lower.

(ii) Impairment of financial assets

The Company assesses at each reporting date whether there is objective evidence determining that the financial asset or group of financial assets is not recoverable. A financial asset or group of financial assets is considered to be non-recoverable if, and only if, there is objective evidence of lack of recoverability as a result of one or more events which have taken place after the initial recognition of the asset (“a loss event”) and such event affects the estimated future cash flows of the financial assets or group of financial assets which may reasonably be estimated.

Financial assets at amortized cost

The Company initially assesses on an individual basis whether there is clear evidence of impairment of each financial asset which is individually significant, or in conjunction for financial assets which are not individually significant. Should the Company conclude that there is no evidence of impairment of a financial asset individually assessed, whether significant or not, the asset is included in a group of financial assets with similar characteristics of credit risk, and the Company assesses in conjunction for impairment. Assets individually assessed for impairment purposes, and for which impairment is or continue to be recognized, are not included in a joint assessment of impairment.

When there is evidence of impairment, loss is measured as the difference between book value and the present value of estimated future cash flows (net of expected future credit losses not yet incurred).

Net book value of asset is reduced through a provision, and the amount of loss is recognized in the income statement. Interest income continues to be computed on the reduced book value at the original effective interest rate for the asset. Loans, together with the related provision, are written off when there are no realistic prospects for future recovery and all guarantees have been realized or transferred to the Company. If, in a subsequent year, the estimated impairment increases or decreases due to an event after the recognition of impairment, the loss previously recognized is increased or reduced by adjusting the provision. In case of future recovery of an amount written off, such recovery is recognized in the income statement.

Financial investments available for sale

The Company analyzes whether there is objective evidence that the investment is recoverable, at each balance sheet date.

For investments in equity instruments classified as available for sale, objective evidence includes a significant and extensive loss on the fair value of investments, below book cost.

When there is evidence of impairment, the accumulated loss (measured by the difference between the acquisition cost and current fair value, less impairment which has been previously recognized in the statement of income) is reclassified from equity to P&L.

Increases in fair value after recognizing impairment are recognized directly in comprehensive income.

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(iii) Financial liabilities

Initial recognition and measurement

Financial liabilities are classified as financial liabilities at fair value through profit or loss, loans and financing or derivatives classified as hedge instruments, as the case may be. The Company determines the classification of its financial liabilities upon their initial recognition.

Financial liabilities are initially recognized at fair value and, in case of loans and financing, plus the cost of transaction directly related thereto.

The Company's and its subsidiaries' financial liabilities include trade accounts payable and other accounts payable, loans, financing and derivative financial instruments.

Subsequent measurement

The measurement of financial liabilities depends on their classification, which may be as follows:

Financial liabilities at fair value through profit or loss: Financial liabilities at fair value through profit or loss include financial liabilities designated upon initial recognition at fair value through P&L. This category also includes derivative financial instruments engaged by the Company which do not meet the hedge accounting criteria set by the related standard.

The Company and its subsidiaries did not designate any financial liability at fair value through profit or loss upon initial recognition.

Loans and financing: After initial recognition, loans and financing subject to interest are subsequently measured at amortized cost under the effective interest method. Gains and losses are recognized in the statement of income upon write-off of liabilities, as well as during the amortization process under the effective interest method.

Derecognition (write-offs): a financial liability is written off as the obligation is repealed, cancelled or expired.

Whenever a financial liability is replaced with other held by the same lender under substantially different terms or the terms of an existing liability are significantly changed, such replacement or change is treated as write-off of the original liability and recognition of a new liability, and the difference in related book values is recognized in the statement of income.

(iv) Financial instruments – net disclosure

Financial assets and liabilities are disclosed net in the balance sheet if, and only if, there is a currently and enforceable legal right to offset the recognized amounts and if there is the intention to offset or realize the asset and settle the liability simultaneously.

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(v) Fair value of financial instruments

The fair value of financial instruments actively traded on stock exchanges is determined in view of purchase prices charged in the market at close of business at the balance sheet date, with no deduction of costs of transaction.

The determination of the fair value of financial instruments with no active market relies on valuation techniques. These techniques may include the use of recent transaction in the market (at arm's length); reference to current fair value of another similar instrument; analysis of discounted cash flows or other valuation models.

1) Derivative financial instruments and hedge accounting

Initial recognition and subsequent measurement

The Company and its subsidiaries use derivative financial instruments e.g. currency swaps and interest rates to provide hedge against foreign exchange rate fluctuation risks.

The derivative financial instruments designated in hedge operations are initially recognized at fair value on the date the derivative contract is entered into, and subsequently revalued also at fair value.

Derivatives are disclosed as financial assets whenever the fair value of the instrument is positive and as financial liabilities whenever the fair value is negative.

Any gains or losses from changes in fair value of derivatives over the year are recorded directly in the income statement, except for the effective portion of hedges of cash flows, which is recognized directly in equity, in other comprehensive income.

For hedge accounting purposes, the Company's and its subsidiaries' contracts were classified as cash flow hedges, when provides protection against changes in cash flows that is attributable to a particular risk associated with a recognized liability that can affect the outcome, and classified as fair value when provides protection against exposure to changes in fair value of certain liabilities identified attributable to a particular risk (exchange rate) and can affect the outcome.

Upon the initial recognition of a hedge relation, the Company and its subsidiaries formally classify and document the hedge relation to which they wish to apply hedge accounting, as well as the Company's objective and risk management strategy to complete the hedge. The documentation includes the identification of a hedge instrument or hedged transaction, the nature of hedged risk, the nature of risks excluded from the hedge relation, the prospective demonstration of effectiveness of the hedge relation and the way the Company and its subsidiaries will assess the effectiveness of the hedge instrument to offset the exposure to change in fair value of the hedged item.

These hedges are expected to be highly effective to offset change in fair value and are permanently assessed to check their effectiveness over all the base periods they were assigned to.

Cash flow hedges meeting the recording criteria are accounted for as follows: (i) the portion of gain or loss from the hedge instrument determined as effective hedge shall be recognized directly in equity (in other comprehensive income) and (ii) the ineffective portion of gain or loss from the hedge instrument shall be recognized in the statement of income.

Fair value hedges meeting the recording criteria are accounted for as follows: (i) gain or loss from changes in fair value of a hedge instrument shall be recognized in profit or loss and (ii) gain or loss from a hedged item attributable to the hedged risk shall adjust the recorded amount of the hedged item to be recognized in the

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statement of income. The changes in fair value of the hedge instrument and changes in fair value of the hedged item attributable to the hedged risk are recognized in the line of the statement of income regarding the hedged item.

### Classification between current and noncurrent

Derivative instruments not classified as effective hedge instrument are classified instead as current and noncurrent based on an assessment of cash flows engaged.

•Whenever the Company and its subsidiaries hold a derivative as economic hedge (and do not apply hedge accounting) for a period longer than 12 months after the balance sheet date, the derivative is classified as noncurrent (or segregated between current and noncurrent), consistently with the classification of the related item.

•Derivative instruments classified as effective hedge are classified consistently with the classification of the related hedged item.

The derivative instrument is segregated as current and noncurrent only when it can be reliably allocated.

### m)Borrowing Costs

Borrowing costs directly related to acquisition, construction or production of an asset which necessarily requires a period longer than 18 months to be completed for use or sale are capitalized as an integral part of the cost of the related asset.

All other borrowing costs are recorded in expenses for the period they are incurred. The borrowing costs comprise interest and other related costs incurred by an entity.

### n)Interest on shareholder's equity and dividends

#### Interest on shareholder's equity

In accordance with Brazilian law, the companies may pay interest on shareholder's equity (JSCP), which is similar to the payment of dividends, but deductible for the purpose of determining income taxes. The amount due accrued by the Company and its subsidiaries in their accounting records in compliance with Brazilian tax law is matched against the financial expenses account in the income statement for the year and, for the presentation of these financial statements, such expense is reversed by them matched against a direct charge to equity, resulting in the same accounting treatment of dividends. The distribution of interest on shareholder's equity is subject to withholding income tax at a rate of 15%.

#### Dividends

The mandatory minimum dividends are recorded in the balance sheets as legal obligations (provisions in current liabilities), and the dividends in excess of such minimum amount, still not approved by the Shareholders' Meeting, are recorded in equity as dividend reserve.

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o)Provisions

Overview

Provisions are recognized when the Company or its subsidiaries have a present obligation arising from past events, the settlement of which is expected to result in an outflow of economic benefits, at an amount that can be reliably estimated. Provisions are adjusted through the balance sheet date at the probable amount of loss, in accordance with each contingency (note 20).

Provisions for contingencies are presented at their gross amount, less the corresponding escrow deposits, and are classified as provisions for civil, labor, tax and regulatory contingencies. Escrow deposits are classified as assets if the conditions required for their net presentation with the provision are not available.

Provisions for civil, labor, tax and regulatory contingencies

The Company and its subsidiaries are parties to labor, tax, civil and regulatory claims and set up a provision for contingencies likelihood of loss of which was estimated as probable. Provisions for legal and administrative proceedings are set up based on the opinion of Company and its subsidiary management and the legal advisors thereof.

Provision for asset demobilization

It refers to costs to be incurred due to the return to the owners of the sites (locations intended for tower and equipment installation at leased property) under the same conditions at the time of execution of the initial lease agreement.

Contingent liabilities recognized in a business combination

A contingent liability recognized in a business combination is initially measured at fair value.

Subsequently, it is measured at the higher of: (i) the amount that would be recognized according to the provision policy referred to above; or (ii) the amount initially recognized less, where applicable, accumulated amortization recognized according to the revenue recognition policy.

p)Taxes, charges and contributions

Acronyms of the taxes, charges and contributions described in these financial statements are as follows:

CIDE – Contribution Tax for Intervention in the Economic Order – Federal Tax;  
COFINS – Contribution Tax on Gross Revenue for Social Security Financing – Federal Tax;  
CSLL – Social Contribution Tax on Net Income – Federal Tax;  
FISTEL – Telecommunications Inspection Fund;  
FUNTEL – Telecommunications Technology Development Fund;  
FUST – Universal Telecommunication Services Fund;  
ICMS – State VAT – State Tax;  
IOF – Tax on Financial Transactions – Federal Tax;  
IRPJ – Corporate Income Tax – Federal Tax;  
IRRF – Withholding Income Tax – Federal Tax;  
ISS – Service Tax – Local Tax;

PIS – Contribution Tax on Gross Revenue for Social Integration Program – Federal Tax;  
TFF – Inspection and Operation Fees; and  
TFI – Inspection and Installation Fees.

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Income and social contribution tax expenses comprise current and deferred tax effects, as follows:

Current income and social contribution taxes

The carrying amount of assets and liabilities related to the current tax of the last year and prior years corresponds to the amount estimated to be recovered from or paid to tax authorities. The tax rates and laws used in calculating the amounts referred to above are those in effect at the balance sheet date. In the balance sheet, current taxes are presented net of prepayments throughout the year.

Current income and social contribution taxes related to items directly recognized in equity are also recognized in equity. Management periodically assesses the tax position for the cases in which tax regulations require interpretation, and sets up provisions when necessary.

Deferred taxes

The amount of deferred taxes is obtained from the analysis of the balance sheet by taking into account temporary differences, which are those arising from differences between the tax values of assets and liabilities and their corresponding carrying amount.

Deferred tax liabilities are recognized for all taxable temporary differences, except: (i) when the deferred tax liability arises from the initial recognition of goodwill or asset or liability in a transaction other than a business combination and does not impact, at the transaction date, the book profit or income or loss for tax purposes; and (ii) on taxable temporary differences related to investments in subsidiaries, where the period of reversal of temporary differences can be controlled and it is probable that temporary differences will not be reversed in the near future.

Deferred tax assets are recognized for all deductible temporary differences and unused tax credits and losses, to the extent that taxable profit will likely be available so that deductible temporary differences can be realized and such unused tax credits and losses can be used, except: (i) when the deferred tax asset related to the deductible temporary difference arises from the initial recognition of an asset or liability in a transaction other than a business combination and does not impact, at the transaction date, the book profit or income or loss for tax purposes; and (ii) on deductible temporary differences related to investments in subsidiaries, where deferred tax assets are recognized only to the extent that it is probable that temporary differences will be reversed in the near future and taxable profit will likely be available so that temporary differences can be used.

The carrying amount of deferred tax assets is reviewed at each year end and written off to the extent that it is no longer probable that taxable profit will be available so that the deferred tax asset can be used in whole or in part.

Deferred tax assets and liabilities are measured at the tax rate that is expected to be applied to the year in which the asset will be realized or the liability settled, based on the tax rates (and tax law) that were enacted at year end.

Deferred tax assets and liabilities are not discounted to present value and are classified in the balance sheet as noncurrent, regardless of the expected realization. Tax effects of items directly recorded in equity are also recognized in equity.

Deferred tax items are recognized based on the transaction in which deferred tax was originated, in comprehensive income or directly in equity.



Deferred tax assets and liabilities are presented net if there is a legal or constructive right to offset tax assets against tax liabilities and when deferred taxes refer to the same taxable entity and are subject to the same tax authority.

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### Sales taxes

Revenue from rendering services are subject to ICMS or ISS taxation at the rates in force in each area and to cumulative regime of PIS and COFINS, for revenue from telecommunication services, at 0.65% and 3.00%, respectively. Other revenue earned by the Company and its subsidiaries, including revenue from resale of goods, under the non-cumulative regime are taxed at 1.65% and 7.60% for PIS and COFINS, respectively, and by ICMS at the rates in force in each State.

Prepaid or recoverable taxes are recorded in current or noncurrent assets according to their estimated realization.

#### q)Other assets and liabilities

An asset is recognized in the balance sheets when it is likely that its future economic benefits will flow to the Company and its subsidiaries, and its cost or value can be reliably measured.

A liability is recognized in the balance sheet when the Company and its subsidiaries have a legal or constructive obligation as a result of a past event and it is probable that an outflow of funds will be required to settle it.

Assets and liabilities are classified as current when realization or settlement thereof is probable within the next twelve months. Otherwise, these are stated as noncurrent.

#### r)Present value adjustment of assets and liabilities

Current and noncurrent monetary assets and liabilities are adjusted to present value whenever the effects are considered significant on the overall financial information. The present value adjustment is calculated using contractual cash flows and the explicit interest rate, and in certain cases the implicit interest rate, of respective assets and liabilities. As such, the interest rates accrued on revenues, expenses and costs associated with these assets and liabilities are discounted with a view to recognize them on an accrual basis. Subsequently, interest thereof is reallocated to financial income and expenses in the income statements by using the effective interest rate method in relation to the contractual cash flows. Implicit interest rates then applied were determined based on assumptions and are considered accounting estimates.

Based on the analysis performed and on its best estimates, the Company concluded that the adjustment to present value of current monetary assets and liabilities is immaterial in relation to the overall financial statements, and thus did not record any adjustment.

The Company and its subsidiaries calculated adjustment to present value according to assets and liabilities item based on the Weighted Average Cost of Capital (WACC) and Certificate of Deposits Interbank (CDI) rates.

#### s)Government Grants

The government grants are recognized when there is reasonable assurance that the benefit will be received and the corresponding conditions were met. When the benefit refers to expense item, it will be recorded in income in equal amounts throughout the expected useful life of the corresponding benefit, on a systematic basis in relation to cost of which the benefit intends to settle. When the benefit refers to assets, it is recognized as deferred income and recorded in income in equal amounts over the expected useful life of the corresponding asset. Should loans or similar assistance be made available by Governments or institutions and related to interest rate lower than the current market rate applicable, the favorable effect thereof is considered additional government subsidy.

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The Brazilian tax legislation (Provisional Executive Order (MP) No. 2199-14, of August 24, 2001, subsequently amended by Law No. 11196, of November 21, 2005), enabled legal entities holding enterprises located in areas under the supervision of the Amazon Development Authority (SUDAM) and Northeast Development Authority (SUDENE), whose activity fall under an economy sector considered a priority, under the Executive branch ruling, to claim income tax reduction under the terms thereof.

Through the acquisition of Vivo Part., the Company acquired a tax benefit consisting of a 75% income tax reduction, calculated based on the profit on exploitation of the north region of Minas Gerais and Vale do Jequitinhonha. This benefit will be effective up to 2013.

Vivo also benefits from 75% income tax reduction, calculated based on the profit on exploitation of the states, namely: Acre, Amapá, Amazonas, Maranhão, Mato Grosso, Pará, Rondônia and Roraima. This benefit will be effective up to 2013.

The profit generated by the portion subject to such benefit was excluded from calculation of dividends and may be only used in cases of capital increase or absorption of losses. The cumulative amount of incentive earnings undistributed by Vivo was R\$59,257 (R\$38,043 in 2011).

In January 2010, BNDES approved a financing line through the Investment Maintenance Program (BNDES PSI). Funds borrowed are used to improve the network capacity through acquisition of domestic equipment previously registered with BNDES (subject to Finame), and released as investments made are evidenced.

As the interest rates applied this financing are lower than those prevailing in the market, this operation qualifies under the scope of IAS 20/CPC 7. Thus, funds were initially recorded at fair value based on market rates. Adjustment arising from the comparison of the amount measured based on the rate agreed upon accounted for deferred revenue (Note 21).

t)Revenue recognition

Revenues substantially correspond to value of considerations received or receivable arising from the provision of telecommunications services and sale of goods are presented net of taxes, discounts and returns (in case of sale of goods) thereon. Revenues and expenses are stated on the accrual basis of accounting.

Revenue is recognized when it is probable that future economic benefits will flow to the Company and subsidiaries, when it can be reliably measured, costs incurred in the transaction can be measured, the risks and benefits have been substantially transferred to the buyer and when specific criteria are met for every activity of the Company and subsidiaries.

Revenues of the Company and subsidiaries comprise basically the voice portal, data and additional telecommunication services that are offered to customers through fixed-price traffic packs (paid on monthly basis) or based on customers' consumption, remuneration network usage and sales of goods.

Recognition of revenues from telecommunication services

Revenues from telecommunication services provided are recorded on the accrual basis based on the amounts agreed upon. Local and long-distance calls are billed by the measurement process under the legislation in force. The services billed on fixed monthly amounts are calculated and accounted for on a straight-line basis. Unbilled revenue between the dates of the last billing to the balance sheet date is determined and recognized in the month in which the service is provided.

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Revenues related to public phone cards sales are deferred and recognized in profit or loss based on the estimated usage of cards.

Revenues related to pre-paid mobile recharge credits, as well as taxes payable due are deferred and recognized in profit or loss to the extent services are effectively provided.

Revenues from equipment lease contracts classified as finance lease agreement are recognized on installation of equipment upon effective transfer of risk. Revenue is recognized at present value of future minimum payments provided for in contract.

Revenues from services are basically subject to the following indirect taxes: ICMS, PIS, COFINS and ISS.

### Recognition of revenue and cost to sell goods

Revenues and cost to sell goods (mobile phones, simcards and accessories) are recorded, when risks and rewards inherent to such goods are transferred to buyer. Sales made in own stores are recognized upon sale to final consumer. Revenues and costs to sell goods, made by dealers are recognized in the profit or loss when the device is activated, limited to 90 days after the date of sale (Note 24).

### Customer loyalty program

Vivo has a fidelity points program that enables customers to accumulate points while paying bills regarding the usage of the services offered. The accumulated points may be exchanged for telephone sets or services, conditional upon obtaining a minimum balance of points by customer. The consideration received is allocated to the cost of sets or services at fair value. The fair value of these points is determined by dividing the discount granted by the number of points required for the redemption based on the fidelity program. The portion of deferred revenue related to the fair value of the accumulated balance of points generated is deferred and recognized as revenue in the statement of income upon redemption of points.

Number of points to be accounted for are determined through statistical techniques that consider assumptions and historical data on expected redemption rates, such as, expiration percentage and cancellation of points. These estimates are subject to variations and uncertainties due to changes in the behavior of customers' redemptions (Note 21).

### Membership fee and promotional campaigns

Participation fees paid for promotional campaigns by customers of the Company or subsidiaries are deferred and recorded in profit or loss throughout the duration of such campaign.

### Agreements combining more than one element

Commercial packages offered by the Company that combine different elements are analyzed to determine whether it is necessary to separate the different elements identified, adopting the recognition criteria that is most adequate to each situation. The total revenue generated by the package sale is distributed among its elements, which were identified at their fair values.

The fair value determination of each element then identified implies the need for complex estimates given the nature of the business.

A possible change in fair values estimates could affect the distribution of revenues between components and consequently the deferred revenues.

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u)Financial income and expenses

These include interest and monetary and exchange variations arising from short-term investments, derivative transactions, loans, financing, debentures, adjustments to present value of transactions that generate monetary assets and liabilities and other financial transactions. These are recognized on the accrual basis when earned or incurred by the Company and subsidiaries.

v)Post-retirement benefit plans

The Company and subsidiaries individually sponsor pension funds of post-retirement benefits for active and retired employees, in addition to a multiemployer supplementary retirement plan and health care plan to former employees. The contributions are determined on actuarial bases and recorded on the accrual basis. Benefit plans are determined based on actuarial evaluations at the end of each year, in order to ensure that the contributions are sufficient to set up the required reserve for both current and future commitments.

The actuarial liabilities related to defined benefit plans were calculated using the projected unit credit method. Actuarial gains and losses are recognized immediately in equity (in other comprehensive income).

For plans with defined contribution characteristics, the obligation is limited to the contributions due, which are recognized in the profit or loss of the respective years.

The asset or liability related to defined benefit plan to be recognized in financial statements correspond to the present value of the obligation by defined benefit (using a discount rate based on long-term National Treasury Notes "NTNs"), less unvested prior service costs and less fair value of plan assets that will be used to settle the obligations. The plan assets are assets held by a privately-held supplementary pension plan entity. The plan assets are not available to the Company's creditors and cannot be paid directly to the Company. The fair value is based on information on market prices and, in case of securities quoted, on purchase price disclosed. The value of any defined benefit asset then recognized is limited to the sum of any costs of past services not yet recognized and to the present value of any economic benefits available as a reduction in future plan contribution from employers.

w)Significant accounting judgment, estimates and assumptions

The preparation of Company and subsidiaries financial statements requires that management make judgment and estimates and adopt assumptions that affect those figures reported as revenues, expenses, assets and liabilities, as well as contingent-liability disclosures, as of the financial statements date.

However, uncertainty about these assumptions and estimates could result in outcomes that require a material adjustment to the book value of the asset or liability affected in future periods.

Significant assumptions regarding the uncertainty sources of future estimates and other significant estimate-related sources of uncertainty at the balance sheet date, involving significant risk of future adjustments in assets and liabilities are discussed below.

Impairment of nonfinancial assets

Impairment loss exists when the book value of an asset or cash-generating unit exceeds its recoverable amount, which is the higher of fair value less cost of sales and value in use. The calculation of fair value less



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cost of sales is based on information available on sales transactions of similar assets or market price less additional costs to dispose of the asset. Calculation of value in use is based on discounted cash flow model. The recoverable value is sensitive to the discount rate used in discounted cash flow method, as well as to the receipt of estimated future cash flows and the growth rate used for extrapolation purposes.

### Post-retirement benefit plan

The cost of defined benefit retirement plans and other post-retirement health care benefits and the present value of retirement obligation are determined based on actuarial valuation methods. Actuarial valuations involve the use of assumptions on discount rates, expected rates of return on assets, future salary increases, death rates and future increases in pension and retirement benefits. The defined benefit obligation is highly sensitive to changes in these assumptions. All assumptions are reviewed annually.

The mortality rate is based on mortality tables available in Brazil. Future increases in wages and pension and retirement benefits are based on the expected future inflation rates for Brazil.

For more details on the assumptions used, see Note 35.

### Fair value of financial instruments

Where the fair value of financial assets and financial liabilities recorded in the balance sheet cannot be derived from active markets, their fair value is determined using valuation techniques including the discounted cash flow model. The data for these methods is based on that prevailing in the market, whenever possible. However, when this is not feasible, a certain level of judgment is required to establish the fair value. The judgments include considerations of inputs such as liquidity risk, credit risk and volatility. Changes in assumptions about these factors could affect the reported fair value of financial instruments.

### Property, Plant and Equipment and intangible assets, including goodwill

The accounting treatment of investment in fixed and intangible assets includes estimating useful life period for depreciation purposes and the fair value at the date of acquisition, particularly for assets acquired in business combinations.

Useful life determination requires estimates regarding the expected technological developments and alternative uses of assets. The hypotheses related to technological aspect and its future development imply a significant level of analysis, considering the difficulties in forecasting time and nature of future technological changes.

Where impairment is identified amounting to tangible and intangible assets, an adjustment of such amount is recorded in the profit or loss for the year. The need to record impairment loss is determined through estimates that include, among others, the analysis of the possible impairment causes and the estimated amount thereof. In this regard, factors such as technological obsolescence, suspension of certain services and other changes are also considered in circumstances that demonstrate the need to record a possible impairment.

The Company and subsidiaries periodically analyze the performance of the defined cash-generating unit in order to identify a possible impairment in goodwill. The determination of the recoverable amount of the cash-generating unit to which the goodwill is allocated also includes the use of assumptions and estimates and requires a significant level of judgment and criterion.



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Taxes

There are uncertainties regarding the interpretation of complex tax regulations and the amount and term of future taxable income. The Company and subsidiaries set up provisions based on adequate estimates, for possible audit consequences by tax authorities of the respective jurisdictions in which it operates. The value of these provisions is based on various factors such as past experience with tax audits and different interpretation of tax regulations by the taxpaying entity and the relevant tax authorities. Such differences of interpretation may arise in a wide variety of matters, depending on the conditions prevailing in the respective domicile of the Company and subsidiaries.

The Company and subsidiaries evaluate the recoverability of deferred tax asset based on estimates of future results. This recoverability ultimately depends on the ability of the Company and subsidiaries to generate taxable profits over the period in which the temporary difference is deductible. The analysis is considered the reversal period of deferred tax liabilities, as well as estimates of taxable profits, based on updated internal projections reflecting the latest trends.

Determining the proper classification of the tax items depends on several factors, including an estimate of the period and the realization of the deferred tax asset and the expected date of payments of these taxes. The actual flow of receipt and shipment of income tax could differ from estimates made by the Company and subsidiaries, as a result of changes in tax laws or of unexpected future transactions that may impact tax balances.

Provisions for tax, labor, civil and regulatory proceedings

Provisions are recognized when the Company and subsidiaries have a present obligation arising from a past event, of which settlement requires an outflow of resources rated as probable and may be reliably estimated. This obligation can be explicit or implicit, derived from, among other factors, regulations, contracts, customary practices or public commitments that expose third parties to a valid expectation that the Company and subsidiaries will assume certain responsibility. The determination of the provision is based on the best estimate of the reimbursement required to settle the corresponding obligation, considering the information available on the closing date, including the opinion of independent experts, such as legal counsel.

x)Functional and reporting currency

Company's functional and reporting currency is the Brazilian real. Transactions in foreign currency were translated at the currency exchange rate in force on the date the transaction. Assets and liabilities stated in foreign exchange were translated at the currency exchange rate in force at the balance sheet date. The exchange rate changes arising from transactions in foreign currencies are recognized in profit or loss as financial income or expenses.

y)Transactions denominated in foreign currency

The monetary assets and liabilities denominated in foreign currencies are translated to the functional currency (real) at the exchange rate in force on the transaction date and subsequently converted based on exchange rate effective on the reporting date which, at December 31, 2012, totaled: US\$1.00 = R\$2.0435, €1.00 = R\$2.693946, at December 31, 2011, totaled: US\$1.00 = R\$1.8758, €1.00 = R\$2.427098 and at December 31, 2010, totaled: US\$1.00 = R\$1.6662, €1.00 = R\$2.2264. Gains and losses resulting from the restatement of these assets and liabilities between the foreign exchange rate prevailing at the transaction and reporting dates are recognized in profit or loss.

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z)Employee profit sharing

The Company and subsidiaries have obligations arising from employment contracts, recognizing these provisions during the year. Provisions are recorded to recognize the expense regarding employee profit sharing. These provisions are calculated on the basis of qualitative and quantitative goals set by the management and accounted for in specific accounts according to function in groups of Cost of services, Selling expenses and General and administrative expenses.

aa)Transactions involving payment in shares

The Company measures the cost of transactions settled with shares issued by the Parent company, Telefónica S.A., on behalf of managing officers and employees based on the fair value of the equity instruments on granting date, using the binomial valuation model. This fair value is recorded as a debit in profit or loss over the period until the acquisition, with the recognition of the corresponding liability.

bb)Treasury shares

Own equity instruments which are reacquired (Treasury shares) are recognized at cost and deducted from shareholders' equity. No gains or losses are recognized in profit or loss on purchase, sale, issue or cancellation of the Company's own equity instruments.

cc) Noncontrolling interests

The noncontrolling interest represents the portion of profit or loss and equity of subsidiaries not owned by the Company, thus being disclosed in the consolidated balance sheet under equity.

dd) Information on operating segments

Operating segments are defined as components of a venture for which separate financial information is made available and evaluated on a regular basis by the Company's main decision maker of operations involving the allocation of funds to an individual segment and segment performance assessment. Considering the following: (i) all officers and managers' decisions are based on consolidated reports (ii) the Company's mission is to provide its customers with quality telecommunications services; and (iii) all decisions related to strategic planning, finance, shopping, short- and long-term investments are made on consolidated basis, thus the conclusion of managements that the Company and subsidiaries operate in a single operating segment of telecommunications services' provision.

ee)Cash flow statement and statement of value added

The Statement of Cash Flows was prepared according to the CPC 03/IAS 7 - Statement of Cash Flows and reflects the cash flow transactions disclosed by applying the indirect method in the current and prior periods.

The statement of value added (SVA) is disclosed as supplementary information in accordance with Brazilian Corporation Law and was prepared under the CPC09 – statement of value added. The objective is to evidence the wealth generated by the Company during the year and disclose its distribution among different agents (stakeholders).

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### 4. Acquisition of Vivo Participações S.A. (Vivo Part.)

As mentioned in Note 2.2, on April 27, 2011, shareholders' meetings at the Company and Vivo Part. approved the acquisition of 100% of shares in the latter by the Company with each share in Vivo Part. substituted by 1.55 Company shares. This transaction was recorded under the acquisition method.

The Company adopted as fair value of the shares acquired based on the economic value reported by a specialized company contracted by Management, since both companies were under common control whose value per share approximates the amount paid by SP Telecomunicações Participações Ltda. on Public Offering (IPO) of March 2011. As a consequence a percentage of 2.65% of Vivo Part's capital was acquired, previously held by minority stakeholders.

The fair values of identifiable assets acquired and liabilities assumed from Vivo Part. were measured and recognized at the acquisition date.

These values were determined through various valuation methods depending on the type of asset and / or liability considered, as well as the best available information and with the support of expert advice.

The methods and hypothesis used to determine these fair values were as follows:

#### Licenses

Fair value was established through the Multi-period Excess Earnings Method (MEEM) which is based on a calculation of discounted cash flows from economic benefits attributable to licenses, net of elimination of charges related to contributory assets in the generation of cash flows and excluding cash flows attributable to the customer base.

This method is based in the assumption that intangible assets rarely generate profit in themselves. Accordingly, cash flows attributable to licenses are those that remain after the return of all the contributory assets required to generate estimated cash flows. The fair value allocated to licenses on the acquisition date was R\$12,876,000, which is being amortized over a 27.75 year term.

#### Customer portfolio

The customer portfolio was also assessed by the MEEM method, which is based on the discounted cash flow calculation of future economic benefits attributable to the customer base, net of eliminations of obligations for contributions involving its generation. To estimate the remaining useful life of the customer base an analysis of the average duration of relations with each customer using to cancellation rate method was performed.

The objective of this analysis is to estimate a subsistence curve that projects future turnover profiles associated with the current customer base. The so-called "Iowa Curves" were considered as an approximation of customer survivor rates. The fair value allocated to the customer portfolio on the acquisition date was R\$2,042,000, which is being amortized over an average term of 8.5 years.

#### Brand

The fair value of the "Vivo" brand was calculated according to the relief-from-royalty method. In accordance with this method, the asset value is determined capitalizing the royalties that are saved due to the fact the entity holds the intellectual property. In other words, the owner of the brand makes profit as it holds an intangible asset instead of

paying royalties for use of such. The saving in royalties was determined applying the market royalty rate (expressed as a percentage of revenue) to future revenue projected to be obtained from the sale of products or services associated with that intangible asset. A market royalty rate is usually expressed as a

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percentage of net revenue that an interested owner would charge an interested user for the use of an asset it owns in a free transaction between knowing parties. The fair value allocated to the brand on the acquisition date was R\$1,642,000, which is being amortized under a 19.5 year term.

The following are the fair value, goodwill and cost of participation at the acquisition date of the identifiable assets acquired and liabilities assumed of Vivo Part. at the acquisition date:

Information (in thousands of R\$)	Fair Value
Current assets	7,244,124
Noncurrent assets	28,134,683
Deferred tax assets, net(b)	417,883
Other noncurrent assets	2,385,177
Property, plant and equipment	6,198,358
Intangible assets (a)	19,133,265
Current liabilities	(7,964,209 )
Noncurrent liabilities	(5,352,456 )
Other noncurrent liabilities (c)	(5,352,456 )
Net assets	22,062,142
Equity expenses	1,222,630
Goodwill on operation	9,160,488

- (a) Includes the fair value allocated to licenses (R\$12,876,000), to brand (R\$1,642,000) and customer portfolio (R\$2,042,000). The Company did not consider the customer portfolio or brand as tax deductible.
- (b) Includes the recognition of deferred income taxes on (a) and (c).
- (c) Includes the allocation of fair value to contingent liabilities R\$283,000.

The fair value of accounts receivable for goods sold and services rendered is the total amount of R\$2,809,561. The gross amount is R\$3,027,732. In regards of the gross amount of receivables from goods and services sold, it was considered a provision amounting to R\$218,171, in order to recognized the net expected recoverable amount estimated by the Company.

In accordance with IFRS 3(R) – Business Combinations, the acquiring party should recognize on the acquisition date contingent liabilities assumed in a business combination even when it is not probable that the settlement of such will require an outflow of funds given that such a current obligation stems from past events and that its fair value cannot be measured with certainty. In meeting the requirements relating to contingent liabilities stemming from this acquisition a provision for fair value of R\$283,000 was set up which was established based on estimated cash outflows for settlement on the acquisition date.

The costs incurred in the transaction were recognized in the income statement under other operating expenses.

From the acquisition date until December 31, 2011, Vivo Part. and Vivo's contributions to the combined operating net revenue and combined net income were R\$16,125,386 and R\$2,615,068 respectively. Additionally, if the acquisition had occurred at the beginning of 2011, combined net revenue and net income would have been R\$33,171,549 and R\$5,072,405 respectively.





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## 5. Cash and cash equivalents

	2012	2011
Cash and banks	94,454	77,404
Short-term investments	7,101,625	2,862,938
Total	7,196,079	2,940,342

Short-term investments basically correspond to Bank Deposit Certificates (CDB), which are pegged to the Interbank Deposit Certificate (CDI) rate variation, are highly liquid and are kept with first-tier financial institutions.

## 6. Trade accounts receivable, net

	2012	2011
Billed amounts	4,033,333	3,673,097
Unbilled amounts	1,675,091	1,677,708
Interconnection amounts	977,644	896,639
Gross accounts receivable	6,686,068	6,247,444
Provision for impairment	(1,079,254)	(1,056,729)
Total	5,606,814	5,190,715
Current	5,513,436	5,105,860
Non-current	93,378	84,855

The aging list of trade accounts receivable, net of the provision for impairment, is as follows:

	2012	2011
Falling due	4,299,125	4,103,377
Overdue from 1 to 30 days	718,838	631,923
Overdue from 31 to 60 days	218,930	204,775
Overdue from 61 to 90 days	188,835	115,125
Overdue from 91 to 120 days	60,648	49,815
Overdue for more than 120 days	120,438	85,700
Total	5,606,814	5,190,715

No customer represented more than 10% of net trade accounts receivable at December 31, 2012 and 2011.

Changes in the provision for impairment are as follows:

	2012	2011
Opening balance	(1,056,729)	(765,633 )
Additions (Note 26)	(654,273 )	(506,581 )
Business combination	-	(218,171 )
Consolidation of TVA	-	(3,659 )
Write-offs	631,748	437,315

Ending balance	(1,079,254)	(1,056,729)
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The subsidiary, A.Telecom, has a product called “Soluciona TI” which is the leasing of IT equipment to the

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small and medium-sized companies, receiving fixed installments over the lease agreement effective term. Considering the contractual terms, amounts related to this product were classified at December 31, 2012 and 2011 as “Finance Lease”.

Consolidated trade accounts receivable at December 31, 2012 and 2011 includes the following effects:

	2012	2011
Present value of minimum payments receivable	294,245	261,933
Unrealized financial income	7,757	8,941
Gross investment in leases receivable	302,002	270,874
Provision for impairment	(86,648 )	(69,375 )
Total receivables, net	215,354	201,499
Current	121,976	116,644
Noncurrent	93,378	84,855

Aging list of finance leases at December 31, 2012 is as follows:

Year	Gross Investment	Present Value
Falling due up to one year	200,867	200,867
Falling due up to five years	101,135	93,378
Total	302,002	294,245

There are no unguaranteed residual values resulting in benefits to the lessor or contingent payments recognized as revenue for the period.

7. Inventories

	2012	2011
Consumer materials	59,417	94,547
Materials for resale (*)	380,163	435,032
Other inventory items	4,005	6,468
Total gross	443,585	536,047
Allowance for reduction to net recoverable value and obsolescence	(55,776 )	(64,326 )
Total current	387,809	471,721

(\*) Includes, among others, mobile telephones, IT equipment and simcard (chip) in the inventory.

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Below, we present the changes in the allowance for reduction to net recoverable value and obsolescence:

	2012	2011
Opening balance	(64,326 )	(99,696 )
Additions	(35,972 )	(37,462 )
Write-offs	44,522	95,149
Business combination	-	(18,852 )
Consolidation of TVA	-	(3,465 )
Ending balance	(55,776 )	(64,326 )

The costs of goods sold, including the amount of the allowance for reduction to the net recoverable value and obsolescence, are shown in note 25.

## 8. Deferred and recoverable taxes

## 8.1 Recoverable taxes

	2012	2011
Withholding taxes	141,620	152,919
Recoverable income tax and social contribution	528,111	1,143,988
ICMS (state VAT) (a)	1,631,088	1,665,896
ICMS (state VAT) Agreement No.39/CAT Administrative Ruling 06 (b)	288,520	307,832
PIS and COFINS	148,092	210,950
Other	53,957	28,440
Total	2,791,388	3,510,025
Current	2,052,423	2,495,066
Non-current	738,965	1,014,959

(a) Refers to credits arising from additions to property, plant and equipment, subject to offsetting in 48 months.

(b) Refers to the request for reimbursement of VAT paid for invoices that were later canceled.

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## 8.2 Deferred taxes

The Company and its subsidiaries calculate deferred income and social contribution tax assets considering the existence of taxable profit for the past five financial years and expected future taxable profit generation, which were based on a technical feasibility study approved by the Board of Directors.

The main deferred income and social contribution tax components are stated as follows:

	2012	2011
<b>Deferred Assets</b>		
Tax loss carry-forwards – Income tax and social contribution (a)	21,290	348,576
Merged tax credit (b)	9,461	46,962
Provisions for tax, labor and civil claims	1,104,065	950,988
Post-retirement benefit plans	133,371	104,856
Allowance for doubtful accounts	169,434	178,433
Provision for demobilization, losses and disposal of assets	210,107	137,829
Employee Profit sharing	62,218	82,564
Accelerated depreciation	421,768	433,512
Allowance for reduction of inventory to recoverable value	13,951	17,542
Provision for loyalty program	28,168	23,399
Derivatives	42,922	69,387
Trade accounts payable and other provisions	290,199	354,916
Income tax and social contribution on other temporary differences	136,170	110,664
	2,643,124	2,859,628
<b>Deferred liabilities</b>		
Merged tax credits (b)	(269,514 )	(207,668 )
Technological innovation Law	(416,700 )	(333,156 )
Foreign Exchange variation	(3,383 )	(14,742 )
Customer portfolio	(546,383 )	(630,896 )
Trademarks and patents	(508,178 )	(536,808 )
Licenses	(399,878 )	(79,976 )
Effect of goodwill generated upon Vivo Part. merger	(344,927 )	(258,695 )
Effect of goodwill generated on the acquisition of Vivo Part.	(266,870 )	(53,374 )
Income tax and Social contribution on other temporary differences	(74,344 )	(104,389 )
	(2,830,177)	(2,219,704)
Total non-current asset (liability), net	(187,053 )	639,924

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Deferred taxes were set up on the assumption of future realization as follows:

a) Income and social contribution tax losses: represent the amount recorded by the Company (2012) and its subsidiaries (2011), which, according to tax legislation in Brazil can be offset by up to 30% of the tax bases computed for the following years with no expiration date. The subsidiaries, TData and TSTV, did not record the potential deferred income and social contribution tax credits which would be generated for the use of income and social contribution tax losses amounting to R\$301,081 at December 31, 2012 (R\$241,361 at December 31, 2011), considering uncertainties, at this moment, as to the ability of these subsidiaries to generate future taxable profits sufficient to ensure realization of these deferred taxes.

Tax credits of the Company and its subsidiaries arising from income and social contribution tax losses at December 31, 2012 and 2011 recognized and not recognized are as follows:

	Income Tax	Social Contribution	Total
Tax-loss carry-forward and negative basis at 12/31/2012	930,409	997,434	1,927,843
Tax credit (25% + 9%)	232,602	89,769	322,371
Recognized tax credit	12,066	9,224	21,290
Unrecognized tax credit	220,536	80,545	301,081

	Income Tax	Social Contribution	Total
Tax-loss carry-forward and negative basis at 12/31/2011	1,745,928	1,705,050	3,450,978
Tax credit (25% + 9%)	436,482	153,455	589,937
Recognized tax credit	259,011	89,565	348,576
Unrecognized tax credit	177,471	63,890	241,361

b) Merged tax credit: Represented by tax benefits arising from corporate restructuring of goodwill for expected future profitability, whose tax use follows the limit set forth in tax legislation.

c) Income and social contribution on temporary differences: realized upon payment of the provisions, the actual loss for reduction in recoverable value of accounts receivable or the realization of inventories, as well as the reversal of other provisions.

Changes in deferred income and social contribution tax assets and liabilities are as follows:

Deferred Tax Assets	December 31, 2011	Additions	Write-offs/ realization	December 31, 2012
Tax losses	348,576	154,657	(481,943)	21,290
Other deferred assets	2,511,052	376,070	(265,288)	(2,621,834 )
Total	2,859,628	530,727	(747,231)	2,643,124

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Deferred Tax Assets	December 31, 2010	Additions	Write-offs/ realization	Business Combination	December 31, 2011
Tax losses	2,325	-	(393,067)	739,318	348,576
Other deferred assets	1,011,687	252,826	(108,222)	1,354,761	2,511,052
<b>Total</b>	<b>1,014,012</b>	<b>252,826</b>	<b>(501,289)</b>	<b>2,094,079</b>	<b>2,859,628</b>

Deferred Tax Liabilities	December 31, 2011	Additions	Write-offs	Business Combination	December 31, 2012
Deferred liabilities	(2,219,704 )	(755,397)	144,924	-	(2,830,177 )
<b>Total</b>	<b>(2,219,704 )</b>	<b>(755,397)</b>	<b>144,924</b>	<b>-</b>	<b>(2,830,177 )</b>

Deferred Tax Liabilities	December 31, 2010	Additions	Write-offs	Business Combination	December 31, 2011
Deferred liabilities	(510,333 )	(274,332)	176,794	(1,611,833)	(2,219,704 )
<b>Total</b>	<b>(510,333 )</b>	<b>(274,332)</b>	<b>176,794</b>	<b>(1,611,833)</b>	<b>(2,219,704 )</b>

At December 31, 2012, the Company projects deferred tax (liabilities) assets to be realized as follows:

Year	
2013	810,532
2014	264,867
2015	142,010
2016	(17,122 )
2017	(19,784 )
From 2018	(1,367,556)
<b>Total</b>	<b>(187,053 )</b>

These recoverable amounts are based on projections that may suffer changes in the future.

#### 9. Escrow deposits and Frozen assets

The Company and its subsidiaries have escrow deposits and frozen assets related to civil, labor and tax claims, as follows:

##### a) Breakdown

	2012	2011
Labor	933,866	789,705
Tax	2,182,719	1,938,470
Civil	866,668	715,285
	3,983,253	3,443,460
Frozen assets (*)	52,846	47,651

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Total	4,036,099	3,491,111
Current	126,625	116,421
Non-current	3,909,474	3,374,690

(\* ) At December 31, 2011, the amount of R\$25,554 consolidated, was reclassified under “Investments in guarantee”.

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	b) Changes				
	Labor	Tax	Civil	Freeze of assets by court order	Total
Balances at December 31, 2010	555,322	546,387	528,887	45,070	1,675,666
Inflows	139,123	92,412	141,146	83,222	455,903
Write-offs/reversals	(42,796 )	(5,605 )	(76,361 )	(99,991 )	(224,753 )
Business combination	54,939	1,146,771	77,336	58,113	1,337,159
TVA consolidation	2,488	24,128	6,542	1,743	34,901
Monetary restatement	39,847	133,211	39,177	-	212,235
Transfers	40,782	1,166	(1,442 )	(40,506 )	-
Balances at December 31, 2011	789,705	1,938,470	715,285	47,651	3,491,111
Inflows	193,650	131,495	205,779	55,659	586,583
Write-offs/reversals	(93,583 )	(17,681 )	(77,468 )	(71,268 )	(260,000 )
Monetary restatement	42,714	134,776	40,915	-	218,405
Transfers	1,380	(4,341 )	(17,843 )	20,804	-
Balances at December 31, 2012	933,866	2,182,719	866,668	52,846	4,036,099
Current	37,113	15,939	47,502	26,071	126,625
Noncurrent	896,753	2,166,780	819,166	26,775	3,909,474

At December 31, 2012, the Company and its subsidiaries had several tax-related escrow deposits, amounting to R\$2,182,719 (R\$1,938,470 at December 31, 2011) consolidated. In Note 20, we present further details on the matters giving rise to these deposits.

A brief description of the main consolidated tax-related escrow deposits is as follows:

- Social contribution tax on gross revenue for social integration Program (PIS) and social contribution tax on gross revenue for social security financing (COFINS)

Vivo is party to legal claims involving (i) a claim arising from tax credits resulting from overpayments not

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recognized by tax authorities; (ii) tax debt arising from underpayment due to differences in ancillary statements (Federal Tax Debt and Credit Return – DCTF); and (iii) disputes referring to changes in rates and increase in tax bases introduced by Law No. 9718/98.

At December 31, 2012, consolidated escrow deposits amounted to R\$62,924 (R\$68,532 at December 31, 2011).

•Social Contribution Tax for Intervention in the Economic Order (CIDE)

The Company and its subsidiaries are involved in legal and administrative disputes for the exemption of CIDE levied on offshore remittances of funds arising from agreements for the transfer of technology, brand and software licensing etc.

At December 31, 2012, escrow deposits amounted to R\$136,211 (R\$123,228 at December 31, 2011) consolidated.

•Telecommunications Inspection Fund (FISTEL)

ANATEL collects the Installation Inspection Fee (TFI) on extension of licenses granted and on radio base stations, mobile stations and radio links.

Such collection results from the ANATEL's understanding that said extension would be a triggering event of TFI and that mobile stations, even if owned by third parties, are also subject to TFI. As the Company and its subsidiaries understand such collection is not applicable, they have challenged the matter in court.

At December 31, 2012, consolidated and individual escrow deposits amounted to R\$818,502 (R\$767,530 at December 31, 2011).

•Withholding income tax (IRRF)

The Company and its subsidiaries were involved in disputes related to: (i) exemption of IRRF payment on offshore remittances for out-coming traffic (land-line operators); (ii) exemption of IRRF payment on interest on shareholder's equity recognized (mobile operators); (iii) IRRF levied on rent and royalties, salaries and fixed-income short-term investments.

At December 31, 2012, escrow deposits amounted to R\$58,367 (R\$61,469 at December 31, 2011) consolidated.

•Corporate income tax (IRPJ)

The Company and its subsidiaries were involved in disputes related to: (a) debts stemming from offsetting of IRPJ overpayments not recognized by the Brazilian IRS; and (b) requirement of IRPJ estimates and lack of payment – debts in the integrated system of economic and tax information (SIEF).

At December 31, 2012, escrow deposits amounted to R\$25,422 (R\$23,866 at December 31, 2011) consolidated.

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•Contribution to Empresa Brasil de Comunicação (EBC)

Sinditelebrasil (The Telephony and Mobile and Personal Services Union) filed an injunction challenging the Contribution to Foster Public Radio Broadcasting payable to EBC, established by Law No. 11652/2008. The Company and its subsidiaries, as union members made escrow deposits referring to that contribution.

At December 31, 2012, escrow deposits amounted to R\$370,026 (R\$254,328 at December 31, 2011) consolidated.

•Social Security, Work Accident Insurance (SAT) and Funds to Third Parties (INSS)

The Company filed an injunction in order to nullify the entry stemming from collection of (i) SAT and third party funds on payment of “Damages for Suspension of Benefits” due to the suspension of collective bargaining agreements of 1996/1997 and 1998/1999, (ii) and differential rate of SAT (1% to 3% of insurance accident).

At December 31, 2012, consolidated and individual escrow deposits amounted to R\$91,915 (R\$88,532 at December 31, 2011).

•Unemployment Compensation Fund (FGTS)

The Company filed an injunction in order to represent its right not to pay surtax of 0.5% and 10% for FGTS introduced by Supplementary Law No. 110/2001 levied on deposits made by employers (the proceedings did not result in any reduction of FGTS deposits made by the Company on behalf of its employees).

At December 31, 2012, consolidated and individual escrow deposits amounted to R\$66,386 (R\$62,154 at December 31, 2011).

•Tax on Net Income (ILL)

The Company filed an injunction in order to represent its right to offset amounts unduly paid for ILL purposes against future IRPJ payments.

At December 31, 2012, consolidated and individual escrow deposits amounted to R\$49,355 (R\$46,770 at December 31, 2011).

•Universal Telecommunication Services Fund (FUST)

The Company and its subsidiaries filed an injunction in order to represent their right: (a) not to include expenses with interconnection (ITX) and Industrial Use of Dedicated Line (EILD) in FUST tax base for landline phone carriers and (b) not to include revenues from ITX and EILD in FUST tax base for mobile phone carriers, according to Abridgment No. 7, of December 15, 2005, as it does not comply with the provisions contained in sole paragraph of article 6 of Law No. 9998, of August 17, 2000.

At December 31, 2012, escrow deposits amounted to R\$341.403 (R\$299,545 at December 31, 2011) consolidated.

•Provisional Contribution Tax on Financial Transactions (CPMF)

Due to the merger of PTelecom Brasil S.A. into Vivo Part., (later merged into the Company), the escrow deposit balance related to the injunction filed by PTelecom Brasil S.A. was absorbed, so as to reject the requirement for

CPMF on pro forma and simultaneous foreign exchange agreements, as required by the Central Bank of Brazil to translate foreign loans into investment.

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At December 31, 2012, the Company and consolidated balance of escrow deposits amounted to R\$20,899 (R\$20,220 at December 31, 2011).

•State Value-Added Tax (ICMS)

The Company and its subsidiaries were involved in disputes related to: unpaid ICMS; (ii) non levy of ICMS on non-sanctioned communication; (iii) demand for late payment penalty, on the spot fine; (iv) ICMS supposedly levied on access, adherence, approval, availability and use of services as well as those relating to supplementary services and additional facilities; (v) credit rights from acquisition of assets intended for property, plant and equipment and electric energy (vi) activation cards for pre-paid services.

At December 31, 2012, escrow deposits amounted to R\$34,235 (R\$29,974 at December 31, 2011) consolidated.

•Other taxes, charges and contributions

The Company and its subsidiaries were involved in disputes related to:

(i) Service Tax (ISS) on non-core services; (ii) Municipal Real Estate Tax (IPTU) not subject to exemption; (iii) municipal inspection, operation and publicity charges; (iv) different SAT rate (1% to 3% - Work Accident Insurance); (v) land use fee; (vi) social security contributions related to supposed failure to withhold 11% on several invoices, bills and receipts or service providers engaged for workforce assignment; (vii) Public Price for Numbering Resource Management (PPNUM) by ANATEL.

At December 31, 2012, escrow deposits amounted to R\$107,074 (R\$92.322 at December 31, 2011) consolidated.

10.	Prepaid expenses	2012	2011
	Advertising and publicity	173,688	171,566
	Rents	31,207	24,126
	Insurance	10,705	10,289
	Software maintenance	7,872	14,503
	Financial charges	3,247	3,426
	Taxes, charges and contributions	1,654	974
	Other assets	19,964	30,172
	Total current	248,337	255,056
	Advertising and publicity	130	835
	Rents	20,000	19,618
	Insurance	3,545	1,695
	Financial charges	3,905	5,317
	Other assets	3,816	4,673
	Total non-current	31,396	32,138

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11.	Other assets	2012	2011
	Advances to employees and suppliers	97,152	73,646
	Related parties receivables	38,033	40,285
	Subsidy on handset sales	53,756	53,408
	Suppliers receivables (a)	479,283	217,255
	Other assets	37,900	39,218
	Total current	706,124	423,812
	Receivables from Barramar S.A. (b)	47,797	52,248
	Amounts linked to National Treasury	-	13,819
	Pension plan surplus	48,048	31,210
	Related party receivables	20,118	20,214
	Other assets	24,142	30,802
	Total non-current	140,105	148,293

(a) Amounts consolidated at December 31, 2012 include R\$362,774 related to the disposal of non-strategic transmission towers, property of Vivo, with guaranteed payment made by the owner.

(b) Refers to receivables from Barramar S.A., recorded in Company AIX de Participações, net of allowance for losses.



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12.	Investments			
	2011	Other Comprehensive Income	Write-off of residual value	2012
Other investments (*) (a)	37,835	(5,568 )	(8,584 )	23,683
Zon Multimédia – direct interest (c)	6,737	(33 )	(6,704 )	-
Zon Multimédia – indirect interest (c)	2,380	(500 )	(1,880 )	-
Other investments	28,718	(5,035 )	-	23,683
Total consolidated investments	37,835	(5,568 )	(8,584 )	23,683

- (a) Other investments are measured at fair value.  
(b) Consolidated from January 1, 2011 as mentioned in Note 2.2.  
(c) On May 8, 2012 the Company sold its equity interest in ZON (Note 2.2)

	2010	Additions	Result of Equity Method	Other Comprehensive Income	Consolidation of TVA	2011
<b>I n v e s t m e n t s i n</b> subsidiaries	57,990	3,920	1,992	-	(63,902 )	-
GTR Participações e Empreendimentos S.A. (b)	2,055	-	18	-	(2,073 )	-
L e m o n t r e e Participações S.A. (b)	17,047	3,920	(1,286 )	-	(19,681 )	-
Comercial Cabo TV São Paulo S.A. (b)	32,392	-	3,125	-	(35,517 )	-
TVA Sul Paraná S.A. (b)	6,496	-	135	-	(6,631 )	-
<b>Other investments (*)</b> (a)	42,847	-	-	(5,012 )	-	37,835
Zon Multimédia – direct interest	9,036	-	-	(2,299 )	-	6,737
Zon Multimédia – indirect interest	3,190	-	-	(810 )	-	2,380
Other investments	30,621	-	-	(1,903 )	-	28,718
<b>Total consolidated investments</b>	100,837	3,920	1,992	(5,012 )	(63,902 )	37,835

(\*) Other investments are measured at fair value.

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## Proportionally consolidated subsidiaries

The Company holds 50% equity interest in companies Aliança Atlântica Holding B.V., Companhia AIX de Participações and Companhia ACT de Participações, which are proportionally consolidated. The nature of this operation is detailed in Note 1.c.

The proportion corresponding to the Company of the assets, liabilities, revenues and expenses of the proportionally consolidated companies for the years ended December 31, 2012, December 31, 2011 and December 31, 2010, is as follows:

	2012			2011		
	Cia ACT	Cia AIX	Aliança Atlântica	Cia ACT	Cia AIX	Aliança Atlântica
Current assets	5	6,707	58,161	4	3,501	49,655
Noncurrent assets	-	60,012	-	-	65,461	2,378
Current liabilities	-	1,640	1,151	1	2,338	10
Noncurrent liabilities	-	2,896	-	-	1,849	-
Shareholders' Equity	5	62,183	57,010	3	64,775	52,023

	2012			2011			2010		
	Cia ACT	Cia AIX	Aliança Atlântica	Cia ACT	Cia AIX	Aliança Atlântica	Cia ACT	Cia AIX	Aliança Atlântica
Revenues	35	25,353	2,920	25	27,491	1,139	27	31,254	13,200
Expenses	(33 )	(25,628)	(2,059)	(28 )	(24,240)	(82 )	(24 )	(21,985)	(99 )
Net income for the year	2	(275 )	861	(3 )	3,251	1,057	3	9,269	13,101

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## 13. Property, plant and equipment, net

## 13.a) Breakdown

At December 31, 2012:

2012	Cost	Accumulated depreciation	Net book value
Switching equipment	15,533,267	(13,282,873)	2,250,394
Transmission means and equipment	30,747,089	(23,674,159)	7,072,930
Terminal equipment and modems	9,887,957	(8,319,054 )	1,568,903
Infrastructure	13,303,406	(9,041,716 )	4,261,690
TV materials and equipment	1,054,592	(861,018 )	193,574
Other	3,669,465	(2,863,451 )	806,014
Valuation allowance	(19,073 )	-	(19,073 )
Fixed assets in progress	1,476,419	-	1,476,419
Total	75,653,122	(58,042,271)	17,610,851

At December 31, 2011:

2011	Cost	Accumulated depreciation	Net book value
Switching equipment	15,084,380	(13,133,295)	1,951,085
Transmission means and equipment	30,051,932	(23,289,097)	6,762,835
Terminal equipment and modems	8,830,900	(7,283,847 )	1,547,053
Infrastructure	13,124,946	(8,504,974 )	4,619,972
TV materials and equipment	907,865	(728,696 )	179,169
Other	3,546,825	(2,758,443 )	788,382
Valuation allowance	(23,435 )	-	(23,435 )
Fixed assets in progress	1,328,859	-	1,328,859
Total	72,852,272	(55,698,352)	17,153,920

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## 13.b) Changes

	Net book value as of 12/31/2011	Additions	Write-offs, net (a)	Transfers, net (c)	Business combination	Net book value as of 12/31/2012
Switching equipment	1,951,085	59,238	(14,103 )	706,758	(452,584 )	2,250,394
Transmission equipment	6,762,835	396,498	27,960	995,829	(1,110,192 )	7,072,930
Terminal equipment and modems	1,547,053	1,084,260	(4,261 )	(14,488 )	(1,043,661 )	1,568,903
Infrastructure (a)	4,619,972	42,599	(180,142 )	474,162	(694,901 )	4,261,690
TV equipment and materials	179,169	121,817	(8 )	21,789	(129,193 )	193,574
Other	788,382	216,483	(3,177 )	50,040	(245,714 )	806,014
Provision for losses (b)	(23,435 )	(1,965 )	6,327	-	-	(19,073 )
Property, plant and equipment in progress	1,328,859	2,419,269	(15,184 )	(2,256,525)	-	1,476,419
Total	17,153,920	4,338,199	(182,588 )	(22,435 )	3,676,245 )	17,610,851

	Net book value as of 12/31/2010	Additions	Write-offs, net	Transfers, net	Depreciation (d)	Business combination	TVA merger	Net book value as of 12/31/2011
Switching equipment	1,234,081	60,166	(5,087 )	390,972	(346,804 )	617,757	-	1,951,085
Transmission equipment	3,709,166	377,411	(49,123 )	1,106,119	(847,229 )	2,441,209	25,282	6,762,835
Terminal equipment and modems	1,274,037	991,417	(4,819 )	1,081	(1,002,764 )	258,714	29,387	1,547,053
Infrastructure	2,811,505	228,124	(61,059 )	492,876	(703,375 )	1,851,056	845	4,619,972
TV equipment and materials	187,343	125,865	-	(53,488 )	(109,607 )	-	29,056	179,169
Other	218,469	160,948	(4,879 )	48,747	(193,108 )	556,973	1,232	788,382
Provision for losses (b)	(41,373 )	-	8,985	8,953	-	-	-	(23,435 )
Property, plant and equipment in progress	807,469	2,068,327	(12,609 )	(2,009,147)	-	472,649	2,170	1,328,859
Total	10,200,697	4,012,258	(128,591)	(13,887 )	(3,202,887)	6,198,358	87,972	17,153,920

(a) Net write-off balances include the amount of R\$138,812 for disposal of non-strategic towers and rooftops owned by Vivo.

(b) The Company and its subsidiaries recognized a provision for potential obsolescence of materials used in PP&E maintenance, based on levels of historical use and expected future use.

(c) Remaining balances in transfers presented in the table above of R\$18,774 refer to residual values of tower and rooftops pending transfer of ownership and risk when sold, which will be recognized as net write-off upon recognition of the corresponding revenues.

(d) The addition from depreciation costs and expenses are stated under "Depreciation and amortization" under Notes 25, 26 and 27, pending transfer of title.

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## 13.c) Depreciation rates

For years ended December 31, 2012 and 2011, PP&E items were depreciated under the straight line method at the following annual rates:

Switching equipment	10 to 33.33
Transmission means and equipment	5 to 14.29
Terminal equipment and modems	10 to 66.67
Infrastructure	4 to 66.67
T V material and equipment	8 to 20
Other PP&E	10 to 20

## 13.d) Property, plant and equipment as collateral

On December 31, 2012, the Company and its subsidiaries had fixed assets pledged as collateral in legal proceedings consolidated amount of R\$235,847 (R\$70,317 at 31 December 2011).

## 13.e) Capitalization of borrowing costs

On December 31, 2012 and 2011, the Company and subsidiaries did not capitalize borrowing costs due to non-qualifying assets.

## 14. Intangible assets, net

## 14.a) Breakdown

	2012	2011
Goodwill	10,225,280	10,225,280
Other intangibles assets	19,784,009	19,828,404
Total	30,009,289	30,053,684

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The movements in goodwill as of December 31, 2012 and 2011 is as follows:

Goodwill	2010	Business Combination	2011	2012
Ajato Telecomunicações Ltda.	149	-	149	149
Goodwill Spanish and Figueira (merged in TDBH) (a)	212,058	-	212,058	212,058
Santo Genovese Participações Ltda. (b)	71,892	-	71,892	71,892
Telefônica Televisão Participações S.A. (c)	780,693	-	780,693	780,693
Vivo Participações S.A. (d)	-	7,169,577	7,169,577	7,169,577
Telemig Celular S.A. (e)	-	133,896	133,896	133,896
Telemig Celular Participações S.A. (e)	-	1,485,172	1,485,172	1,485,172
Global Telecom S.A. (e)	-	204,762	204,762	204,762
Tele Centro Oeste Celular Participações S. A. (e)	-	150,930	150,930	150,930
Ceterp Celular S. A. (e)	-	16,151	16,151	16,151
Total	1,064,792	9,160,488	10,225,280	10,225,280

(a) Goodwill from partial spin-off of the company Figueira, which was reversed to the Company upon merger with Telefônica Data Brasil Holding S.A in 2006.

(b) Goodwill generated upon acquisition of equity control over Santo Genovese Participações Ltda occurred in 2004.

(c) Goodwill generated upon acquisition of TTP (formerly Navytrees) merged in 2008. This is grounded on a future profitability study.

(d) Goodwill generated upon acquisition of Vivo Part. in April 2011.

(e) Goodwill arising from Vivo Part., reversed to the Company upon merger in 2011.

The balance of other intangible assets was composed on December 31, 2012 and 2011, as follows:

At December 31, 2012:

	Cost	Accumulated Depreciation	Net book value
Software	9,516,578	(7,625,745 )	1,890,833
Customer Portfolio	2,114,561	(507,552 )	1,607,009
Trademarks and patents	1,643,511	(148,870 )	1,494,641
Licenses	16,987,547	(2,275,703 )	14,711,844
Other	719,431	(690,791 )	28,640
Software in progress	51,042	-	51,042
Total	31,032,670	(11,248,661 )	19,784,009

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At December 31, 2011:

	Cost	Accumulated Depreciation	Net book value
Software	8,744,914	(6,883,758 )	1,861,156
Customer Portfolio	2,114,561	(251,730 )	1,862,831
Trademarks and patents	1,643,511	(64,665 )	1,578,846
Licenses	15,937,373	(1,577,392 )	14,359,981
Goodwill	38,800	(31,116 )	7,684
Other	683,021	(658,554 )	24,467
Software in progress	133,439	-	133,439
Total	29,295,619	(9,467,215 )	19,828,404

## 14.b) Changes

	Net book value as of 12/31/2011	Additions	Disposals, net	Transfers, net (a)	Depreciation (b)	Net book value as of 12/31/2012
Software	1,861,156	486,278	(18 )	313,630	(770,213 )	1,890,833
Customer Portfolio	1,862,831	-	-	-	(255,822 )	1,607,009
Trademarks and patents	1,578,846	-	-	-	(84,205 )	1,494,641
Licenses	14,359,981	1,050,200	-	-	(698,337 )	14,711,844
Goodwill	7,684	-	-	(7,684 )	-	-
Other	24,467	12,510	-	-	(8,337 )	28,640
Software in progress	133,439	227,572	-	(309,969 )	-	51,042
Total	19,828,404	1,776,560	(18 )	(4,023 )	(1,816,914 )	19,784,009

	Net book value as of 12/31/2010	Additions	Disposals, net	Transfers, net (a)	Depreciation (b)	Business Consolidation Combination of TVA	Net book value as of 12/31/2011
Software	638,975	380,942	(64 )	161,984	(632,725 )	1,312,044	1,861,156
Customer Portfolio	14,512	-	-	-	(193,681 )	2,042,000	1,862,831
Trademarks and patents	-	-	-	-	(63,154 )	1,642,000	1,578,846
License	-	811,754	-	-	(483,743 )	14,031,970	14,359,981
Goodwill	-	2,976	-	-	(1,962 )	6,670	7,684
Other	12,195	10,436	(314 )	(1,263 )	(7,842 )	1,487	24,467
Software in progress	-	183,179	-	(146,834)	-	97,094	133,439
Total	665,682	1,389,287	(378 )	13,887	(1,383,107 )	19,133,265	19,828,404



- (a) Remaining balances in transfers stated in the table above R\$7,684, refers to the transfer to Vivo's prepaid expenses and R\$3,662 to property, plant and equipment.
- (b) The addition of depreciation costs and expenses are stated under "Depreciation and amortization" under Notes 25, 26 and 27.

14.c) Amortization rates

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For years ended December 31, 2012 and 2011, Intangible assets were amortized under the straight line method at the following annual rates:

Software use licenses	20 to 33.33
Customer portfolio	9 to 15
Trademarks and patents	5
Licenses	3.6 to 20
Other intangible assets	10 to 20

## 15. Payroll and related accruals

	2012	2011
Salaries and fees	38,640	40,651
Payroll charges	204,778	223,359
Employee profit sharing	172,937	214,983
Other indemnities	-	16,631
Total	416,355	495,624

## 16. Trade accounts payable

	2012	2011
Various suppliers	5,205,511	5,348,202
Amounts payable to other operators	151,809	146,437
Interconnection/networking	532,057	513,646
Technical support	-	29,030
Total	5,889,377	6,037,315

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17.	Taxes payable	
	2012	2011
Direct taxes		
Income tax and social contribution (a)	243,542	129,610
Indirect taxes	2,026,687	1,995,452
ICMS (state VAT) (b)	1,534,750	1,585,884
PIS and COFINS (taxes on revenue)	362,998	319,981
Fust and Funtel	34,853	38,306
Others	94,086	51,281
Total	2,270,229	2,125,062
Current	1,781,480	1,691,991
Non-current	488,749	433,071

(a) Income and social contribution taxes payable are stated net of payments based on estimates.

(b) The portion of non-current liabilities, including the amount of R\$437,295 December 31, 2012 (R\$380,271 at December 31, 2011) which refers to ICMS - Programa Paraná Mais Emprego, resulting from an agreement with the Paraná State Government, involving the deferral of ICMS payment. This agreement establishes that ICMS shall be paid on the 49th month subsequent to that in which ICMS is computed. This amount is restated based on the Annual Restatement Factor (FCA) variation.

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## 18. Loans, Financing and Debentures

## 18.1 Loans and Financing

	Currency	Annual interest rate	Maturity	2012 (a)	2011 (a)
Financing – BNDES	URTJLP (b)	TJLP+3.73%	5/15/15	938,063	1,327,147
Financing – BNDES	URTJLP (b)	TJLP+1.73%	5/15/15	50,770	71,821
Financing – BNDES	BRL	5.50%	1/15/21	1,957	1,912
Loan – Mediocrédito	US\$	1.75%	2/2/14	9,310	14,027
Loan – working capital	BRL	108.90% CDI		-	91,570
Loan – Resolution No. 4131	US\$	4.10%	10/25/13	326,263	282,205
		TJLP+0% to			
Financing – BNDES	URTJLP (b)	4.30%	7/15/19	1,916,737	1,659,858
Financing – BNDES	UMBND (c)	ECM(d)+2.38%p.a	7/15/19	455,296	194,276
Financing – BNDES	R\$	4.50% to 5.50%	10/15/20	146,365	135,471
Loans – BEI	US\$	4.18% to 4.47%	3/2/15	795,601	707,975
Financing – BNB	R\$	10.00%	10/30/16	338,610	438,279
BBVA commission	-	0.43%	2/28/15	241	221
Financing – BNDES	URTJLP (b)	TJLP+5.0%	1/15/15	2,071	-
Financing – BNDES	URTJLP (b)	TJLP+5.70%	4/15/16	2,312	2,071
Financing – BNDES	URTJLP (b)	TJLP+9.00%	4/15/16	1,901	2,341
Financing - BNDES PSI	R\$	5.50% and 8.70%	4/15/16	25,471	17,628
Financing - Leasing	R\$	14.70%	11/9/13	356	726
Total				5,011,324	4,947,528
Current				1,255,323	988,413
Noncurrent				3,756,001	3,959,115

(a) Amounts stated at fair value, where applicable.

(b) Long-term Interest Reference Unit (URTJLP) used by the Brazilian Development Bank (BNDES) as the contractual currency in financing agreements.

(c) Currency unit based on a currency basket (UMBND) used by BNDES as a contractual currency in financing agreements based on funds raised in foreign currency.

(d) ECM is the rate published quarterly by BNDES and refers to charges of currency basket.

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Brazilian Development Bank (BNDES)

- In October 2007, a credit facility was approved for the Company to finance investment in products and services that are produced domestically. All of these funds have been withdrawn and investment thereof has been proven and accepted by BNDES.
- In August 2007, Vivo took out a credit facility with BNDES in the amount of R\$1,530,459. Funds were released for the purpose of financing investment projects for implementation and expansion of the wireless capacity all over Brazil. Credits were released gradually and, as of December 31, 2011, no more funds were available for withdrawal. The agreement is effective for seven years. Principal will be repaid in 60 consecutive monthly installments as from September 15, 2009, after a two-year grace period.

On October 14, 2011, a credit facility totaling R\$3,031,110 credit facility was taken out from BNDES. These funds will be used in investments of expansion and improvement of the current network, implementation of the infrastructure required for new technologies, from 2011 to 2013, and construction of a data center in the city of Tamboré (São Paulo State) and social projects.

The agreement has a term of eight years, with its grace period ending July 15, 2014, until when only interest will be paid, on a quarterly basis. After this period, interest and amortization of principal shall be repaid within 60 consecutive monthly installments.

As the interest rates applied to two of the five sub-credit lines of this financing are lower than those prevailing in the market (TJLP and TJLP + 1.48%), this operation qualifies under the scope of IAS 20/CPC 7. Accordingly, using the effective interest rate defined in IAS 39/CPC 38, was made a comparison between (i) total amount of debt calculated based on rates defined in contract, and (ii) total amount of debt calculated based on rates used in the market (fair value). The government grant from BNDES, adjusted to present value and deferred in accordance with the useful life of the financed asset item, resulted in balance amounting to R\$18,322 at December 31, 2012 (R\$21,418 at December 31, 2011).

At December 31, 2012, the amount of R\$1,802,113 (R\$1,004,177 at December 31, 2011) had been released.

- On January 2010, a financing line with the BNDES in the amount up to R\$319,927 through its Investment Maintenance Program (BNDES PSI). The funds borrowed are used to improve the network capacity through acquisition of domestic equipment previously registered with BNDES (subject to Finame), and released as that investment is evidenced. Until December 31, 2012, the amount of R\$184,489 was released and the remaining balance of R\$135,438 was canceled.

As the interest rates applied this financing are lower than those prevailing in the market (4.5% to 5.5% p.a. fixed), this operation qualifies under the scope of IAS 20/CPC 7. Accordingly, using the effective interest rate defined in IAS 39/CPC 38, was made a comparison between (i) total amount of debt calculated based on fixed rates in contract, and (ii) total amount of debt calculated based on rates used in the market (fair value). The government grant from BNDES, adjusted to present value and deferred in accordance with the useful life of the financed asset item, resulted in balance amounting to R\$23,876 at December 31, 2012 (R\$29,007 at December 31, 2011).

With the merger process, Vivo became liable for the financing agreements which belonged to former Vivo Part. whose balance amounted to R\$26,825 at December 31, 2012 (R\$24,848 at December 31, 2011).



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- In November 2010 and March 2011, credit facilities for Comercial Cabo TV São Paulo were approved amounting to R\$40,163. At December 31, 2012, R\$41,950 (R\$24,237 at December, 2011) had been released. This transaction also falls under the scope of IAS 20/CPC 7 due to the fact that interest rate is lower than the market rate (5.5% p.a prefixed), and the subvention granted by BNDES, adjusted to present value, resulted in the amount of R\$2,404 at December 31, 2012 (R\$2,401 at December 31, 2011).
- In December 2010, BNDES, through its Investment Maintenance Program (BNDES PSI), approved a financing line in amount of R\$5,417 for the Company. At December 31, 2012, the balance amounted to R\$1,946 (R\$1,912 as of December 31, 2011). This transaction also falls into the scope of IAS 20/CPC 7 because the interest rate is lower than the market rate (5.5% p.a prefixed), and the subvention granted by BNDES, adjusted to present value, resulted in the amount of R\$331 at December 31, 2012 (R\$376 at December 31, 2011).

Médiocrédito

Loan taken out in 1993 between Telecomunicações Brasileiras S.A. (Telebrás) and Instituto Centrale per il Credito a Médio Termine (Mediocrédito Centrale) amounting to US\$45,546, is paid semiannual and matures in 2014. This loan was taken in order to build rural telephony via satellite in the state of Mato Grosso. There is a derivative contracted to hedge the exchange rate currency risks related to such debt and, given it is assessed as an effective hedge, the hedge accounting methodology has been adopted. Therefore, at December 31, 2012, the risk against which the Company was hedged by this instrument was recognized in the balance sheet at its fair value as of the balance sheet date.

Banco Europeu de Investimentos - BEI

Vivo signed an agreement with BEI for a credit facility in the amount of €250 million (equivalent to U\$365 million). Funds were released in two installments, the first of which on December 19, 2007, and the second on February 28, 2008. The agreement will be effective for seven years, with principal amount repayment in two installments, on December 19, 2014 and March 2, 2015. Interest on this financing is paid semiannually according to the date of credit release. This financing is hedged with a swap agreement that converts the currency risk into a percentage of CDI variation.

Banco do Nordeste – BNB

- On January 29, 2007, a credit facility from BNB was taken out amounting to R\$247,240. Funds borrowed were used to expand coverage and increase mobile network capacity in the Northeastern region of Brazil. This agreement will be effective for ten years, with principal amount repaid in 96 installments, after a two-year grace period.
- On October 30, 2008, a credit facility from BNB amounting to R\$389,000 was taken out. Funds borrowed were used to expand coverage and increase mobile network capacity in the Northeastern region of Brazil. This agreement will be effective for ten years, with principal amount repaid in 96 installments, after a two-year grace period.

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## 18.2 Debentures

	Currency	Annual interest rate	Maturity	2012	2011
Debentures (2nd issuance) – Series 2	R\$	106.00% of CDI 108.00% to		-	346,470
Debentures (4th issuance) – Series 1 and 2	R\$	112.00% of CDI	10/15/14	744,678	756,617
Debentures (4th issuance) – Series 3	R\$	IPCA+7.00%	10/15/14	96,249	87,390
Debentures (1st issuance) – Telemig	R\$	IPCA+0.50%	07/05/21	72,137	67,935
Debentures (3th issuance)	R\$	100.00% of CDI + 0.75	09/10/17	2,044,674	-
Issuance costs	R\$			(1,833)	(1,981)
Total				2,955,905	1,256,431
Current				702,215	468,624
Non-current				2,253,690	787,807

Funds raised by Vivo Part.

## 2nd Issue

In connection with the First Securities Distribution Program amounting to R\$2 billion announced on August 20, 2004, Vivo Part. issued debentures related to the 2nd issue, amounting to R\$1 billion, on May 01, 2005, with ten-year term, starting from the issuance date, i.e., May 01, 2005.

Debentures were issued in two series: R\$200 million in the first and R\$800 million in the second with maturity expected to end on May 4, 2015. The first series was redeemed in advance, on January 31, 2011, and the second series yield interest semiannually at a rate of 106% (second series) of accumulated daily average rates of interbank deposits index (DI) calculated and disclosed by CETIP S.A. (Clearing House for the Custody and Financial Settlement of Securities).

On July 29, 2011, the General Debenture holder Meeting decided to approve transfer of 2nd Public Distribution debentures issued by Vivo Part. to Telefônica Brasil with no changes to terms and conditions, and the correspondent amendment of the indenture in order to reflect change in issuer's ownership.

## 1st series

At January 31, 2011, the complete and early redemption of the 1st series of the second issue of Vivo Participações totaling 20,000 registered non-convertible debentures, with a par value of R\$10 (ten thousand reais) totaling R\$200 million, the characteristics of which were approved in the Company's Board of Directors' meeting held on April 25, 2005 and May 13, 2005 with first rescheduling on March 30, 2009.

The redemption was carried out at the debenture unit par value on the issue date, plus: the remuneration due up to the redeemed debenture payment date and (ii) the bonus percentage calculated on the nominal unit value (bonus) equivalent to R\$4.41 (four reais and forty-one cents) per debenture in accordance with that provided under clause 4.13 of the private subscription instrument for the second issue of non-convertible debentures.





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### 2nd series

At the meetings held on April 25, 2005 and May 13, 2005 the Board of Directors approved the characteristics of the Company's second series – second issue debentures were approved.

Vivo Part. 2nd series debentures of the 2nd issue were rescheduled on May 3, 2010, according to the conditions approved in Board of Directors' meeting held on May 29, 2010. Total rescheduled amount was R\$340,230 and Vivo Part. redeemed and cancelled debentures of dissenting debenture holders amounting to R\$459,770. The new interest accrual period is 24 months from May 1, 2010, during which interest accrual conditions established herein shall remain unchanged. During this second interest accrual period (until May 1, 2012), Vivo Part. debentures shall yield interest at the rate of 106% of average rate of one-day interbank deposit (DI), calculated according to the formula stated in clause 4.9 of the "2nd Issue Indenture."

On April 13, 2012, the Board of Directors approved early redemption of debentures of the 2nd issue 2nd series. This redemption took place on May 2, 2012, totaling 21,936 debentures amounting R\$219,360, under the following terms and conditions: debentures were redeemed and canceled, redemption was performed at unit nominal value plus remuneration owed through payment date, and no premium was paid, as redemption date coincided with the rescheduling due date. The remaining outstanding debentures were repurchased on April 9 and 10, 2012, amounting to 539 and 11,548 respectively, for R\$120,870, considering the Option Acquisition Clause of the Indenture and later cancelled.

### 4th issue

On September 4, 2009, the Board of Directors of Vivo Part. approved the 4th public issue by Vivo Part. of simple, registered debentures nonconvertible into unprivileged Company issue shares, with a ten-year interest accrual period.

Total issue amounted to R\$810 million, basic offering of which corresponded to R\$600 million, plus R\$210 million due to full exercise of the additional debentures option.

The total of 810,000 (eight hundred ten thousand) debentures were issued in three series: 98,000 debentures in the 1st series, 640,000 in the second series and 72,000 in the third series. The number of debentures allocated to each series was jointly decided in an agreement between Vivo Part. and the leading coordinator of the offer after completion of the book building procedure.

Remuneration of the 1st series is 108% of CDI, of the 2nd series is 112% of CDI, and a coupon of 7% p.a. for the 3rd series on face value restated based on Brazil's Extended Consumer Price Index (IPCA) variation. These debentures accrue interest payable on a semiannual basis in the 1st and 2nd series and annual basis in the 3rd series.

The proceeds raised from the issue of the offering were used for full payment of the debt relating to the 6th issue of commercial promissory notes of Vivo Part. and to support its working capital.

Transaction costs in connection with this issue, amounting to R\$840 at December 31, 2012 (R\$1,981 at December 31, 2011), were allocated to a liabilities reducing account as deferred cost and are recorded as financial expenses, pursuant to the contractual terms of this issue. The effective rate this issue, considering transaction costs, is 112.13% of CDI.

The General Debenture-holder Meeting held on July 29, 2011 (first call), decided to approve transfer of 4th Public Distribution debentures issued by Vivo Part. to Telefônica Brasil with no changes to terms and conditions, and the correspondent amendment of the indenture in order to reflect change in issuer's ownership.

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On July 24, 2012, the Company's Board of Directors approved the proposal to reschedule the 1st series of 4th issue, amounting to R\$98 million at 106% CDI.

On October 15, 2012, the Company renegotiated the 1st series of the 4th debenture issuance under the conditions approved by the Board of Directors in a meeting held on July 24, 2012. Total value renegotiated was R\$93,150 and the Company redeemed debentures held by dissenting debenture holders amounting to R\$4,850, and kept them in treasury for later cancellation.

Rescheduling of the 2nd and 3rd series is provided for as follows: 2nd series on October 15, 2013, and 3rd series on October 15, 2014.

At December 31, 2012 the total balance was R\$840,927.

Fund raised by Telemig Celular S.A.(Telemig, company merged into Vivo Part. as of June 1, 2010)

1st issue

Abiding by the SMP Service Agreement, in compliance with Public Selection No. 001/07, the state of Minas Gerais, through the State Department for Economic Development, has undertaken to subscribe debentures issued by Telemig (company merged as of June 1, 2010), within the scope of the "Minas Comunica" Program, using proceeds from the Fund for Universal Access to Telecommunications Services (Fundo de Universalização do Acesso a Serviços de Telecomunicações) – FUNDOMIC. Under the terms of this program, Telemig would make SMP services available to 134 locations in the areas registered under No. 34, No. 35 and No. 38.

Also according to the program, 5,550 simple, registered, book-entry debentures nonconvertible into unprivileged shares, book-entry type debentures would be issued, without stock certificates being issued, in up to five series.

In consideration for the certification by the State Department of Economic Development of the service to be provided to 15 locations, 621 debentures were issued in the 1st series of the 1st issue, amounting to R\$6,210 in December 2007. In March 2008, for the service in 42 locations, 1,739 debentures were issued in the 2nd series of the 1st issue, amounting to R\$17,390. At December 31, 2008, for the service in 77 locations, 3,190 debentures were issued in the 3rd series of the 1st issue, amounting to R\$31,900, thus completing the program for providing services to 134 locations inside the state of Minas Gerais.

At December 31, 2012 the total balance was R\$72,137.

Fund raised by the Company

3rd issue

On July 24, 2012, the Company's Board of Directors approved a proposal to raise funds from local financial market through issue of simple debentures nonconvertible into Company shares, amounting up to R\$2 billion, with a maximum seven-year term and firm underwriting.

On September 10, 2012, total of 200,000 (two hundred thousand) simple, registered, book-entry debentures nonconvertible into unprivileged Company issue shares were issued in a single series, with unit face value of R\$10,000.00 (ten thousand reais), totaling R\$2 billion, under the terms of CVM Rule No. 476, of January 16, 2009, with public distribution and limited placement efforts.

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Remuneration is 100% of CDI, plus spread of 0.75% p.a., based on 252 working days. These debentures yield interest with semiannual payments, with interest accrual period of five years, maturing on September 10, 2017. Unit face value of each debenture will be fully repaid in a lump sum, on the maturity date.

Debentures will not be subject to rescheduling.

Funds obtained through this limited offering were allocated to: (i) direct investment in 4th generation (4G) wireless phone services, specifically to settle the authorization price obtained by Vivo in the 4G auction; and (ii) sustaining liquidity and extension of other debts already incurred by the Company.

Transaction costs in connection with this issue, amounting to R\$993 at December 31, 2012 were allocated to a liabilities reducing account as deferred cost and are recorded as financial expenses, pursuant to the contractual terms of this issue.

At December 31, 2012 the total balance was R\$2,044,674.

## 18.3 Payment Schedule

The maturities of the long-term portion of loans, financing and debentures as of December 31, 2012, are as follows:

Year	
2014	1,300,124
2015	1,159,235
2016	439,277
2017	2,389,703
From 2018	721,352
Total	6,009,691

## 18.4 Restrictive Clauses

The Company and Vivo have loans and financing taken out from BNDES, the balance of which at December 31, 2012, was R\$3,360,866 (R\$3,253,102 at December 31, 2011). In accordance with the agreements, there are financial and economic indexes that should be considered on a semiannual and annual basis. On the same date, all economic and financial indices for the agreements in effect were met.

4th issue debentures, net of issue costs, at December 31, 2012 amounted to R\$840,927 (R\$842,026 as of December 31, 2011) and have economic and financial indices that should be calculated on a quarterly basis. At this same date, all economic and financial indexes for the agreements were met.

Telemig's agreement (company merged into Vivo Part. as of June 1, 2010) with the State Department of Economic Development referring to debentures – amounting to R\$72,137 at December 31, 2012 (R\$67,935 at December 31, 2011) – includes covenants as for in-court and out-of-court reorganization, liquidation, spin-off, insolvency, voluntary bankruptcy or bankruptcy, lack of payment, non-compliance with non-fiduciary commitments and compliance with certain financial indexes. On the same date, all these covenants were met.

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## 18.5 Guarantees

At December 31, 2012, guarantees were given for part of loans and financing of the Company and Vivo, as follows:

Banks	Amount of loan/financing	Guarantees
Brazilian Development Bank (BNDES)	R\$1,916,737 (URTJLP)	· Contract (2007) R\$514,355: Guarantee in receivables referring to 15% of the higher of debt balance or 4 (four) times the highest installment.
	R\$445,296 (UMBND)	· Contract (PSI) R\$146,365: Disposal of financed asset items.
	R\$146,365 (PSI - Vivo)	· Contract (2011) R\$1,857,678: Guarantee in receivables referring to 15% of the higher of debt balance or 4 (four) times the highest installment. · Telefônica Brasil is the intervening guarantor
European Bank of Investment – BEI	R\$795,601	· Commercial risk guaranteed by Banco BBVA Spain. · Bank guarantee provided by Banco Bradesco S.A. amounting to approximately 100% of the financing obtained.
BNB	R\$338,610	· Establishing a liquid fund comprising short-term investments at amounts equivalent to 3 (three) repayment installments by reference to the average post-grace period installment. Telefônica Brasil is the intervening guarantor.



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## 19. Dividends and interest on shareholders' equity payable

Below, we present balances of the dividends and interest on shareholders' equity payable:

## a) Breakdown of payables:

	2012	2011
Telefónica International	-	156,589
SP Telecomunicações Participações	-	126,283
Telefónica	-	129,489
Compañía de Telecomunicaciones de Chile	-	310
Minority shareholders	467,831	560,315
Total	467,831	972,986

## b) Changes in payables:

	2012	2011
Opening Balance	972,986	450,897
Supplementary dividends	1,953,029	1,694,099
Business combination	-	2,074,065
Interim dividends and interest on shareholder's equity	1,122,522	2,249,400
Expiry of dividends and interest on shareholder's equity	(89,692 )	(107,874 )
Payment of dividends and interest on shareholder's equity	(3,493,997)	(5,387,601)
Other changes	2,983	-
Ending balance	467,831	972,986

Interest on shareholder's equity and dividends not yet claimed by shareholders expire in three years from the date payment commences. Should dividends and interest on shareholder's equity expire, these amounts are recorded against equity and then distributed.

For the cash flow statement, interest on shareholder's equity and dividends paid to shareholders are classified as the Financing Activities.

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20.	Provisions		
	a)	Breakdown	
		2012	2011
Provisions for judicial and administrative proceedings			
Labor		717,247	526,210
Tax		1,953,043	1,606,735
Civil and regulatory		795,294	664,703
Subtotal		3,465,584	2,797,648
Provision for post-retirement benefit plans (a)		392,269	308,893
Contingent liabilities (b)		264,520	256,044
Provision for demobilization (c)		221,316	200,813
Total		4,343,689	3,563,398
Current		496,790	416,313
Non-current		3,846,899	3,147,085

(a)Refers to actuarial provisions for post-retirement benefits, recorded by the Company and subsidiaries (Note 35).

(b)Arising from PPA generated in acquisition of the controlling interest of Vivo Part. in 2011 (Note 4).

(c)Refers to costs to be incurred to return the sites (locations for installation of base radio and administrative real estate of the Company and subsidiaries) to their respective owners in the same conditions as they were at the time of execution of the initial lease agreement.

The Company, as an entity and also as successor to the merged companies, and its subsidiaries are a party in labor, tax and civil claims filed in different courts. The management of the Company and its subsidiaries, based on the opinion of its legal counsel, recognized provisions for those cases in which an unfavorable outcome is considered probable.

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Nature	b) Changes						Total
	Labor	Tax	Civil and Regulatory	Provision for post-retirement benefit plans	Contingent liabilities	Provision for demobilization	
Balances as of 12/31/2010	366,391	310,649	446,159	219,000	-	16,712	1,358,911
Additions	112,300	66,569	172,518	72,565	-	12,760	436,712
Payments	(26,696 )	(11,143 )	(117,734 )	-	-	-	(155,573 )
Reversal	(32,088 )	(6,760 )	(57,144 )	(3,259 )	(31,084 )	(66,512 )	(196,847 )
Monetary restatement	11,918	110,618	48,347	-	-	5,581	176,464
Business combination	93,739	1,136,802	162,266	20,587	283,000	232,272	1,928,666
TVA consolidation	646	-	10,291	-	4,128	-	15,065
Balances as of 12/31/2011	526,210	1,606,735	664,703	308,893	256,044	200,813	3,563,398
Additions	238,830	231,977	244,595	84,281	766	21,484	821,933
Payments	(37,946 )	(1,665 )	(109,356 )	-	-	-	(148,967 )
Reversal	(28,383 )	(7,979 )	(67,843 )	(905 )	-	(7,853 )	(112,963 )
Monetary restatement	18,536	123,975	63,195	-	7,710	6,872	220,288
Balances as of 12/31/2012	717,247	1,953,043	795,294	392,269	264,520	221,316	4,343,689
Current	80,091	20,833	395,866	-	-	-	496,790
Non-current	637,156	1,932,210	399,428	392,269	264,520	221,316	3,846,899

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## 20.1 Labor contingencies and provisions

Risk	Amount Involved	
	2012	2011
Probable	717,247	526,210
Possible	274,156	404,262

Provisions and labor contingencies involve labor claims filed by former's employees and employees at outsourced companies (the later alleging joint or subsidiary liability) claiming for, among other issues, overtime, salary equalization, post-retirement salary supplements, job hazard premium, additional for unhealthy work conditions and claims related to outsourced services.

The Company is also defendant in labor claims filed by retired former employees regarding the Medical Care Plan for Retired Employees (PAMA), which require, among other issues, the annulment of the change occurred in such plan. The claims await decision by the Regional Labor Court of São Paulo. Based on the opinion of its legal advisors and the current jurisdictional benefits, management considers this claim as a possible risk. No amount has been assigned for these claims, since in the case of loss, estimating the corresponding amount payable by the Company is not practicable at this time.

Additionally, the Company is party to public civil actions filed by the Department of Labor, in respect to the decision to restrain the Company from continuing to hire outsourced companies to carry out the Company's main activities. No amounts were assigned to the possible likelihood of an unfavorable outcome related to these public civil actions in the table above, since in these phases, in the event of loss, it is not possible to estimate the monetary loss for Company's.

## 20.2 Tax contingencies and provisions

Risk	Amount Involved	
	2012	2011
Probable	1,953,043	1,606,735
Possible	13,738,155	11,679,158

## Tax provisions

## Federal taxes

At December 31, 2012, the Company was party to administrative and judicial proceedings relating to: (i) additional contributions to the FGTS (Unemployment Compensation Fund) on deposits made by employees ( the issue does not result in the reduction of part of FGTS deposits made by the Company on behalf of its employees); (ii) claims resulting from the non-ratification of compensation and refund requests, formulated by the Company;(iii) social contributions relating to a supposed failure to pay 11% on the value of invoices, billing and receipts from service providers hired for the transfer of labor; (iv) CIDE levied on the remittance of funds abroad relating to technical services, administrative assistance and to services of similar nature, as well as royalties; (v) fixed: non-inclusion of interconnection and EILD expenses in the FUST base and Wireless carriers: non-inclusion of revenues from interconnection in the FUST tax base; (vi) contribution to Empresa Brasileira de Comunicação, created by Law No. 11,652/08; (vii) TFI/TFF on mobile stations; (viii) IRRF on Interest on shareholder's equity; (ix) Public Price for Numbering Resources Management (PPNUM) by ANATEL instituted by Resolution No. 451/06; (x)

IRPJ/PIS/COFINS resulting from the non-ratification of the companies' offset and refund requests; (xi) Social Investment Fund (Finsocial) offset amounts; (xii) failure to pay withholding social

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contribution levied on services rendered, remuneration, salaries and other salary bases; (xiii) COFINS – Requirement resulting from non-inclusion of financial income into the tax base; (xiv) additional charges to the PIS and COFINS tax base, as well as additional charges to COFINS required by Law No. 9,718/98; and (xv) Tax on Net Income (ILL). On December 31, 2012, total provisions amounted to R\$1,860,803 (R\$1,530,789 at December 31, 2011) consolidated.

### State taxes

On December 2012, the Company and its subsidiaries were party to administrative and judicial proceedings in progress referring to (i) ICMS tax credits on electric power and tax credits without documentation (ii) ICMS not levied on telecommunication services; (iii) disallowance of ICMS tax incentives for cultural projects; (iv) ICMS on TV subscription; and (v) environmental administrative fine. At December 31, 2012, total provisions amounted to R\$67,426 (R\$63,625 at December 31, 2011) consolidated.

### Municipal taxes

On December 31, 2012, the Company and its subsidiaries were party to tax claims at a municipal level, both in the administrative and judicial sphere which, based on the opinion of its legal advisors, are classified as a probable loss. At December 31, 2012, total provisions amounted to R\$16,648 (R\$4,531 at December 31, 2011) consolidated.

These proceedings relate to: (i) IPTU, (ii) ISS levied on chattel lease services and secondary and complementary activities, and (iii) Surveillance, Control and Inspection Fee (TVCF).

### Other provisions

At December 31, 2012, the Company and its subsidiaries recorded other provisions, relating to legal claims, both in the administrative and in the judicial level, related to ISS on effective provision of services of lease, sublease, right of way or use right, whether shared or not, of railway, highway, telegraph poles, cables, ducts and conducting wires of any kind. At December 31, 2012, the consolidated provisioned amounts totaled R\$8,166 (R\$7,790 at December 31, 2011).

### Possible tax contingencies

#### Federal taxes

At December 31, 2012, the Company and its subsidiaries were a party to various administrative and judicial proceedings in the federal sphere, which are waiting to be tried at various court levels. At December 31, 2012, the total amount was R\$3,146,736 (R\$3,185,747 at December 31, 2011) consolidated.

Key proceedings refer to: (i) Non-compliance manifestations due to the ratification of compensation requests made by the Company; (ii) fine for distribution of dividends even in view of the alleged existence of outstanding debts payable to the federal government; (iii) social security contribution (INSS) on compensation payment for salary devaluation arising from losses caused by “Plano Verão” (Summer Plan) and “Plano Bresser” (Bresser Plan), SAT (Work Accident Insurance), Social Security and payables to third parties (INCRA and SEBRAE), supply of meals to employees, 11% retention

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(labor assignment); (iv) IRRF on the funds remittance abroad related to technical services and to administrative support and similar services, as well as royalties; (v) PIS levied on roaming; (vi) CPMF levied on operations resulting from the technical cooperation agreement with the National Treasury Department (STN) (offsetting through the Integrated System of Federal Government Financial Administration - SIAFI) and on foreign-exchange contracts required by the Brazilian Central Bank; (vii) IRPJ and CSLL related to deductions on revenues from reversal of provisions; (viii) Income tax and social contribution – disallowance of costs and miscellaneous expenses not substantiated; (ix) deductions of COFINS from loss in swap transactions; (x) PIS / COFINS accrual basis versus cash basis; (xi) IRPJ payable in connection with allocation of excess funds to Northeast Investment Fund (FINOR), Amazon Region Investment Fund (FINAM) or Economic Recovery Fund of the State of Espírito Santo (FUNRES); (xii) IRPJ on derivative operations; (xiii) IRPJ and CSLL – disallowance of expenses related to the goodwill paid in the acquisition of Celular CRT S.A., goodwill arising from the privatization process and Vivo’s corporate restructuring; and (xiv) contribution to the Brazilian company of communication, created by Law No. 11.652/08.

According to Management and its legal advisors’ opinion, the chances of losses in these processes are possible.

State taxes

On December 31, 2012, the Company and its subsidiaries were a party to various administrative and judicial proceedings related to ICMS, at the state level, which are ongoing in various court levels. At December 31, 2012, the total amount was R\$5,870,365 (R\$4,172,479 at December 31, 2011) consolidated.

Key proceedings refer to: (i) provision of facility, utility and convenience services and rental of the “Speedy” service modem; (ii) international calls (DDI); (iii) undue credit related to the acquisition of items intended to property, plant and equipment; (iv) lack of proportionate credit reversal referring to the acquisition of property, plant and equipment items; (v) amounts unduly appropriated as ICMS tax credits; (vi) service provided outside São Paulo state with ICMS paid to São Paulo State; (vii) co-billing, (viii) tax substitution with a fictitious tax base (tax guideline); (ix) use of credits related to acquisition of electric power; (x) secondary activities, value added and supplementary services (Agreement 69/98); (xi) tax credits related to opposition/challenges referring to telecommunications services not provided or mistakenly charged (Agreement 39/01); (xii) shipment of goods with prices lower than acquisition prices (unconditional discounts); (xiii) deferred charge of ICMS - Interconnection (DETRAF – Traffic and Service Provision Document); (xiv) credits derived from tax benefits granted by other states; (xv) disallowance of tax incentives related to cultural projects; (xvi) transfers of assets among business units owned by the Company; (xvii) communications service tax credits used in provision of services of the same nature; (xviii) card donation for prepaid service activation; (xix) reversal of credit from return and free lease in connection with assignment of networks (used by the Company itself and exemption from public bodies); (xx) DETRAF fine, (xxi) ICMS on own consumption; (xxii) ICMS on exemption of public bodies; (xxiii) issue of invoices with negative ICMS amounts; and (xxiv) restructuring of ledger without prior authorization by the Treasury.

According to Management and its legal advisors’ opinion, the chances of losses in these processes are possible.

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### Municipal taxes

At December 31, 2012, the Company and its subsidiaries were party to various administrative and judicial proceedings at the municipal level, which are ongoing various court levels. At December 31, 2012, the total amount was R\$544,323 (R\$471,876 at December 31, 2011) consolidated.

Key proceedings refer to: (i) ISS – secondary activities, value added and supplementary services; (ii) withholding ISS; (iii) IPTU; (iv) Land Use Fee; (v) municipal fees; (vi) tariff for Use of Mobile Network (TUM), infrastructure lease; (vii) advertising services; (viii) services provided by third parties; (ix) business management consulting services provided by Telefonica Internacional (TISA); (x) ISS tax levied on caller ID services and on cell phone activation

According to Management and its legal advisors' opinion, the chances of losses in these processes are possible.

### ANATEL

#### Universal Telecommunication Services Fund (FUST)

Writs of Mandamus filed separately by the fixed and mobile operators to recognize the right to: Fixed: Failure to include interconnection and EILD expenses in the FUST base and Mobile: Failure to include interconnection revenue in the FUST base, pursuant to Abridgement No. 7, of December 15, 2005, since it disagrees with the provisions of the sole paragraph, article 6, of Law No. 9,998/00, which are waiting to be tried in the court of appeals.

A number of delinquency notices referring to debit entry issued by ANATEL in the administrative level to set up the tax credit related to interconnection, EILD and other revenues that are not earned from the provision of telecommunications services.

At December 31, 2012, the total amount was R\$1,970,800 (R\$1,719,531 at December 31, 2011) consolidated.

According to Management and its legal advisors' opinion, the chances of losses in these processes are possible.

#### Telecommunications Technology Development Fund (FUNTTEL)

At December 31, 2012, the Company and its subsidiaries were parties to administrative and judicial proceedings which are waiting to be tried at the lower administrative court and the court of appeals. At December 31, 2012, the total amount was R\$614,314 (R\$622,606 at December 31, 2011) consolidated.

Such proceedings concern the collection of contributions to FUNTTEL on other revenues (not related to telecom services), as well as on income and expenses transferred to other operators (interconnection).

According to Management and its legal advisors' opinion, the chances of losses in these processes are possible.

#### Telecommunications Inspection Fund (FISTEL)

Due extension of the effective license period to use telephone switches in connection with use of STFC (landline phone carriers) and extension of the right to use radiofrequency in connection with wireless service (wireless carriers), ANATEL charges the Installation Inspection Fee (TFI).





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This collection is based on ANATEL's understanding that such extension would represent a taxable event for TFI. The Company and its subsidiaries understand that such collection is unjustified, and separately challenged the aforesaid fee in court. At December 31, 2012, total amount was R\$1,589,479 (R\$1,504,365 at December 31, 2011) consolidated, without the respective deposit in full.

According to Management and its legal advisors' opinion, the chances of losses in these processes are possible.

Public Price for Numbering Resource Management (PPNUM) by ANATEL.

Vivo, along with other wireless carriers in Brazil, are challenging in court the tariff charged by ANATEL for use by such carriers of the numbering resources managed by the agency. When charged by ANATEL, Vivo made an escrow deposit referring to the amounts payable. On April 23, 2009, the carriers received a favorable sentence and the lawsuit is currently waiting to be tried at the court of appeals. At December 31, 2012, total amount was R\$2,138 (R\$1,977 at December 31, 2011).

According to Management and its legal advisors' opinion, the chances of losses in these processes are possible.

## 20.3 Provisions, civil and regulatory contingencies

Risk	Amount Involved	
	2012	2011
Probable	795,294	664,703
Possible	2,656,850	1,978,973

## Provisions for civil contingencies

- a) The Company is party in proceedings that involve right to receive supplementary amounts from shares calculated in relation to the network expansion plan after 1996 (supplement of shares proceedings). These proceedings involve various phases: 1st level; Court of Justice and Supreme Court of Justice. Considering the degree of risk involved R\$31,260 was provisioned (R\$26,182 at December 31, 2011)
- b) The Company and its subsidiaries are parties to proceedings of a civil nature, in the administrative and judicial spheres the object of which are rights relating to the provision of services. This proceedings are filed by individual consumers, civil associations representing consumer rights, PROCON, as well as the State and Federal Public Prosecutor's Offices. Similarly, the companies are defendants or plaintiffs in other proceedings the subject of which relate to matters other than those under the normal course of business. At December 31, 2012, provisions amounted to R\$377,649 (R\$315,169 at December 31, 2011) for consolidated.
- c) The Company is also involved in various lawsuits filed by individual consumers, with similar characteristics, which individually are not considered to be material, based on provision analysis, the historical average of losses in similar proceedings. At December 31, 2012, provisions amounted to R\$78,711 (R\$81,539 at December 31, 2011).

## Provision for regulatory contingencies

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At December 31, 2012, the Company and its subsidiaries were parties in administrative proceedings against ANATEL, which were filed based on alleged noncompliance with obligations set forth in industry regulations, as well as in legal claims discussing sanctions by ANATEL at the administrative level. The chance of losses in these processes are probable and at December 31, 2012 provisions amounting to R\$307,674 (R\$241,813 at December 31, 2011) consolidated were set up.

Civil contingencies

- a) Community Telephone Plan – PCT: Refers to a Public Civil Action to which the Company is a party and which is related to the PCT, a plan that allows purchasers of telephone line expansion plans who did not receive shares for their financial investment to claim indemnity rights, in the municipality of Mogi das Cruzes. The total amount is approximately R\$236,236 (R\$197,863 at December 31, 2011). This proceeding was assessed as a possible loss by legal counsel. The São Paulo State Court of Justice (TJSP) has reversed the decision and deemed the claim groundless. The carriers association of Mogi das Cruzes (plaintiff) filed a special appeal to reverse that decision, which is currently awaiting a decision.
- b) Class actions filed by SISTEL Members Association in the State of São Paulo, whereby SISTEL members in São Paulo State question the changes made in the health care plan for retired employees (PAMA), and that former conditions are restored. The claim is still in the evidentiary stage, and no decision was issued in any court level. The likelihood of loss in this proceeding was deemed as possible by legal counsel. The amount is not measurable and the claims are uncertain due to their unenforceability, since it would be necessary to restore the plan to its previous conditions.
- c) Public civil actions filed by (i) ASTEL - SISTEL Members Association in São Paulo State and (ii) FENAPAS - National Federation of Associations of Retirees, Pensioners and Pension Funds Members of the Telecommunications Industry, both against SISTEL. The Company and other carriers seek annulment of PBS pension plan spin-off, claiming “the dismantling of SISTEL Foundation supplementary pension system”, which originated several specific PBS-mirrors plans, and respective allocation of resources deriving from technical surplus and tax contingencies at the time of the spin-off. The chance of losses in this proceeding was deemed as possible by legal counsel. The amount is not measurable and the claims are uncertain due to their unenforceability, since it would be necessary to restore SISTEL’s spun-off fund related to carriers of the former Telebrás System.
- d) The Public Prosecutor’s Office of the State of São Paulo began a class action claiming moral and property damages suffered by all consumers of telecommunications services from 2004 to 2009 due to the bad quality of services and failures of the communications system. The Public Prosecutor’s Office suggested that the indemnification to be paid should be R\$1 billion. The decision handed down on April 20, 2010 imposes the payment of indemnification for damages caused to all consumers who have filed a suit for such damages.

Conversely, in the event that the number of claiming consumers is not in line with the gravity of damages, after the lapsing of one year, the judge determined that the amount of R\$60 million should be deposited in the Special Expenses Fund to Recover Natural Rights Damages (Fundo Especial de Despesa de Reparação de Interesses Difusos Lesados). It is not possible to estimate the number of consumers who will individually file suits nor the amounts claimed thereby. The parties filed an appeal on the merits of the case. The judgment effects are in abeyance. No amount has been assigned to the possible likelihood of an unfavorable outcome in connection with this action, since in the case of loss, estimating the corresponding amount payable by the Company is not practicable at this time. Likewise, establishing a provision for contingency equivalent to the amount sought is not possible.



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- e)The Company and its subsidiaries are involved in other civil claims, at several levels, related to service rendering. Such claims have been filed by individual consumers, civil associations representing consumer rights or by the Bureau of Consumer Protection (PROCON), as well as by the Federal and State Public Ministry. They are also involved in other claims of several types related to the normal course of business. Total contingency amounts to R\$1,236,312 (consolidated) R\$920,509 at December 31, 2011, whose likelihood of an unfavorable outcome has been assessed by their legal advisors as possible.
- f)The Company and its subsidiaries have received fines regarding the noncompliance with SAC Decree. We currently have various actions (administrative and judicial proceedings), whose likelihood of an unfavorable outcome has been assessed by legal advisors as possible, of R\$19,314 consolidated.
- g)Intellectual Property: Lune Projetos Especiais Telecomunicação Comércio e Ind. Ltda (Lune), a Brazilian company, proposed the lawsuit on November 20, 2001 against 23 wireless carriers claiming to own the patent for caller ID and the trademark “Bina”. The purpose of that lawsuit it to interrupt provision of such service by carriers and to seek indemnification equivalent to the amount paid by consumers for using the service.

An unfavorable sentence was passed determining that Vivo should refrain from selling mobile phones with Caller ID service (Bina), subject to a daily fine of R\$10,000 in case of noncompliance. Furthermore, according to the sentence passed, Vivo must pay indemnification for royalties to be calculated in settlement. Motions for Clarification were opposed by all parties and Lune’s motions for clarification were accepted since an injunctive relief in this stage of the proceedings was deemed applicable. Bill of review appeal in view of the current decision which granted a stay of execution suspending unfavorable decision until final judgment of the review. Bill of review for appeal at sentence phase pending decision. The likelihood of an unfavorable outcome has been assessed by legal advisors as possible. There is no way to determine the extent of potential liabilities with respect to this claim.

- h)Validity of prepaid plan: Vivo and other wireless carriers are defendants in several lawsuits filed by the Public Prosecutor’s Office and consumer associations to challenge imposition of a period to use prepaid minutes. The plaintiffs allege that the prepaid minutes should not expire after a specific period. Conflicting decisions were handed down by courts on the matter. Although we believe that our criteria for the period determination comply with ANATEL standards, the likelihood of an unfavorable outcome has been assessed by legal advisors as possible, except for collective actions against Telemig, for which the probability of an unfavorable outcome in relation to this claim is deemed remote, also based on the opinion of our legal advisors.

Regulatory contingencies

- a)The Company and its subsidiaries are parties to administrative proceedings filed by ANATEL alleging noncompliance with the obligations set forth in industry regulations, as well as legal claims which discuss the sanctions applied by ANATEL at the administrative level, rating the chance of loss as possible amounting to R\$1,164,988 at December 31, 2012 and R\$860,601 at December 31, 2011.
- b)Administrative proceedings discussing payment of 2% charge on revenue from interconnection services due to the extension of right of use of SMP-related radiofrequencies: Under clause 1.7 of the Authorization Terms that grant right of use of SMP-related radiofrequencies, the extension of right of use of such frequencies entails payment every two years, during the extension period (15 years), of a 2% charge calculated on net revenue from the basic and alternative service plans of the service company, determined in the year before that of payment.

However, ANATEL determined that the 2% charge should be calculated on revenue from service

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plans and also on revenue from interconnection services, which is not provided for by clause 1.7 of the referred to Authorization Terms.

Considering, based on the provisions of the Authorization Terms, that revenue from interconnection services should not be included in the calculation of the 2% charge for radiofrequency use right extension, Vivo filed administrative proceedings challenging these charges, based on ANATEL's position.

According to its legal advisors, the chances of losses in these processes are deemed as possible.

c)Administrative Proceeding No. 08012.008501/2007-91: It is a proceeding filed at the level of the Brazilian System for Competition Defense (SBDC) by Global Village Telecom Ltda (GVT), Intelig Telecomunicações Ltda (Intelig), Transit do Brasil Ltda. and Easytone Telecomunicações Ltda. on August 6, 2007 against Claro S.A. (Claro). (Claro), Tim Brasil Serviços e Telecomunicações S.A. (TIM), TNL SCS S.A. for supposed trust and price squeeze practices, with the objective of increasing VUM tariff, thus increasing the costs of competitors Due to the proceeding filed on August 21, 2008, the Department for Economic Right (SDE) started an administrative proceeding against the defendants in order to evaluate whether the practices adopted would fit into (i) items I, III and IV, article 20 and items V, article 21 and (ii) items I, III and IV, article 20 and items I and V, all of Law No. 8,884/94, to wit trust and price squeeze.

On March 25, 2010, SDE issued a technical note whereby: (i) it dismissed the accusation of trust against all the defendants, recommending filing of such accusation, (ii) suggested excluding Oi from the group of defendants in the investigation of price squeeze for considering that its economic group would be responsible for paying VUM and for lack of evidence of recurrent practices of prices below VUM; (iii) recommended condemning Vivo, TIM and Claro, based on article 20, items I, III and IV, and article 21, item V, all of Law No. 8,884/94, for the increase in costs of competitors (price squeeze).

The proceeding is pending judgment by the Administrative Council for Economic Defense (CADE).

The Company's legal advisors consider that Administrative Proceeding No. 08012.008501/2007-91 involves possible unfavorable outcome, therefore no related provision has been set up. If CADE hands down a sentence against defendants solely for price squeeze, the fine estimated for this case may range from 0.1% to 0.5% of Vivo's gross income for 2006. However, in the remote case that CADE accepts the hypothesis of trust, initially dismissed by SDE, fines may range from 10% to 15% of Vivo's gross income for 2006.

It is worth highlighting that Law No. 12,529/12 became effective on May 29, 2012 and there is no former case for which CADE has handed down a decision based on the new criteria. This estimate is based on a proportional calculation that took into consideration former court decisions and the criteria set forth by Law No. 8,884/94.

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## 20.4 Guarantees

At December 31, 2012, the Company and its subsidiaries granted guarantees for tax, civil and labor proceedings, as follows:

	Property and equipment	Escrow deposits	Letter bond
Civil, labor and tax	235,847	4,036,099	1,887,699
Total	235,847	4,036,099	1,887,699

In addition to the guarantees presented above, at December 31, 2012, the Company and its subsidiaries had amounts under short-term investment frozen by the courts (except the applications related to loans), amounting to R\$49,728 (R\$69,298 at December 31, 2011).

## 21. Deferred revenues

## a) Breakdown

	2012	2011
Activation revenue (a)	57,581	67,672
Payphone cards	9,948	15,783
Services and goods (b)	558,165	583,751
Government grants (d)	8,294	8,322
Customer loyalty program (e)	82,848	68,821
Other	17,737	16,919
Total current	734,573	761,268

Activation revenue (a)	31,786	30,792
Services and goods (b)	38,742	48,095
Disposal of property, plant and equipment (c)	171,174	-
Equipment donations (f)	16,235	22,638
Government grants (d)	36,639	44,880
Other	8,786	9,861
Total non-current	303,362	156,266



- a) Refers to the deferral of fee revenue (fixed) recognized in income over the estimated period of duration of the customer plan.
- b) Refers to the balances of agreements of prepaid services revenue and multi-element operations, which are recognized in income to the extent that services are provided to customers.
- c) Refers to net balance of the residual value from disposal of non-strategic towers and rooftops owned by Vivo, to be transferred to income upon compliance of conditions for recognition in books.
- d) Refers to government grant deriving from funds raised with BNDES in a specific credit line (PSI Program), used in the acquisition of domestic equipment and registered at BNDES (Finame) and applied in projects to expand the network capacity, which have been amortized by the useful lives of equipment.

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e) Refers to the fidelity points program that Vivo maintains, which allows customers to accumulate points when paying their bills referring to use of services offered. The balance represents the Company's estimate for exchange of points, by customers, for goods and/or services in the future.

f) Refers to the balances of network equipment donations from suppliers, which are amortized by the useful lives of the referred to equipment.

## b) Changes

Balances as of 12/31/2010	141,739
Additions	12,139,462
Write-offs	(12,017,250)
Business combination	653,583
Balances as of 12/31/2011	917,534
Additions	20,763,225
Write-offs	(20,642,824)
Balances as of 12/31/2012	1,037,935
Current	734,573
Non-current	303,362

## 22. Other Liabilities

## a) Breakdown

	2012	2011
Consignments on behalf of third parties	139,154	252,807
Amounts to be refunded to subscribers	45,618	59,265
Lease (a)	14,799	11,669
Liabilities with related parties	50,147	66,476
Charges payable – concession arrangement	106,877	44,296
Other payables	22,859	32,101
Total current	379,454	466,614
Lease (a)	18,460	9,398
Liabilities with related parties	7,201	4,976
Personnel, social charges and social benefits	13,224	15,160
Intercompany loan, debt assumption and installment payment	-	21,587
Charges payable – concession arrangement	87,564	-
Other payables	17,730	17,137

Total noncurrent	144,179	68,258
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- (a) The Company has finance lease agreements for use of IT equipment and transmission towers.

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## b) Lease

	2012	2011
Lease future gross payments	51,025	23,920
Unrealized financial expense	(17,766)	(2,853 )
Present value of minimum payments due	33,259	21,067
Current	14,799	11,669
Noncurrent	18,460	9,398

The consolidated schedule lease maturities are as follows:

Year	Gross investment	Present value
Maturing within one year	16,367	14,799
Maturing more than one year but within five years	34,658	18,460
Total	51,025	33,259

There are no unguaranteed residual values resulting in benefits to the Lessor or contingent payments recognized as revenue for the year.

## c) Commitments and guarantees (rentals)

The Company leases equipment and facilities, and Vivo is Lessor of several stores, administrative buildings and sites where the radio-base stations (ERB) are located through several operating agreements maturing on different dates with payment made on a monthly basis. At December 31, 2012, the total amount equivalent to the full contractual period was R\$9,906,827 for consolidated.

The aging list of commitments referring to rentals, stores and sites under non-cancellable contracts is as follows:

Year	Value
Up to one year	1,230,640
One to five years	5,216,076
More than five years	3,460,111
Total	9,906,827

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## 23. Shareholders' equity

## a)Capital

Paid-in capital as of December 31, 2012 and 2011 amounts to R\$37,798,110. Subscribed and paid-in capital is represented by shares without par value, as follows:

	2012	2011
<b>Total Capital in shares</b>		
Common shares	381,587,111	381,587,111
Preferred shares	744,014,819	744,014,819
<b>Total</b>	<b>1,125,601,930</b>	<b>1,125,601,930</b>
<b>Treasury shares</b>		
Common shares	(251,440 )	(239,740 )
Preferred shares	(2,081,246 )	(1,477,546 )
<b>Total</b>	<b>(2,332,686 )</b>	<b>(1,717,286 )</b>
<b>Outstanding shares</b>		
Common shares	381,335,671	381,347,371
Preferred shares	741,933,573	742,537,273
<b>Total</b>	<b>1,123,269,244</b>	<b>1,123,884,644</b>
<b>Book value per outstanding share in R\$</b>	<b>39.78</b>	<b>38.55</b>

According to its bylaws, the Company is authorized to increase its capital up to the limit of 1,350,000,000 (one billion three hundred and fifty million) shares, common or preferred. The capital increase and consequent issue of new shares are to be approved by the Board of Directors, subject to the authorized capital limit. However, the Brazilian Corporation Law – Law No. 6.404/76, article 166, IV – establishes that capital may be increased through a Special Shareholders' Meeting resolution held to decide about charter amendment, if statutory share capital limit has been reached.

Capital increases do not necessarily have to observe the proportion between the numbers of shares for each type. However, the number of preferred shares, nonvoting or with restricted voting, must not exceed 2/3 of the total shares issued.

Preferred shares do not have voting rights, but have priority in the reimbursement of capital, without premium, and are entitled to dividends 10% higher than those paid on common shares, as per article 7 of the Company's bylaws and clause II, paragraph 1, article 17, of Law No. 6404/76.

In April 2011, there was a capital increase of R\$31,222,630 resulting from merger of 100% of shares of Vivo Part. into the Company, approved at the shareholders' meeting of April 27, 2011 (see Note 3) corresponding to 619,364,658 (six hundred and nineteen million, three hundred and sixty-four thousand and six hundred and fifty-eight) shares of which 212,767,241 (two hundred and twelve million, seven hundred and sixty-seven thousand, two hundred and forty-one) are common shares and 406,597,417 (four hundred and six million, five hundred and ninety-seven thousand, four hundred and seventeen) are preferred shares.

b) Bonus Paid on Acquisition of Interest from Non-Controlling Shareholders

In accordance the with accounting practices previously adopted in Brazil to the adoption of the IFRS/CPC, goodwill was recorded when shares were acquired at a higher value than their book value, generated by the difference between the book value of shares acquired and the transaction's fair value. With the adoption of

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IAS 27R/CPC 35 and 36, the effects of all acquisition of shares from non-controlling shareholders are recorded under equity when there is no change in the shareholding. Consequently, these transactions no longer generate goodwill or income, and the goodwill previously generated from acquisition from non-controlling shareholders, including expenses inherent to these transactions, were adjusted based on the Company's equity. The acquisition of shares from non-controlling shareholders of Lemontree and GTR (described in Note 2.2) totaled R\$40,519, recorded in "premium on acquisition on non-controlling interest". The balance of this account at December 31, 2012 was R\$70,448 (R\$29,929 at December 31, 2011).

## c)Capital reserves

## Special Goodwill Reserve

This represents the tax benefit generated by the incorporation of Telefônica Data do Brasil Ltda. which will be capitalized annually in favor of the controlling shareholders to the extent the tax credits are realized under the terms of CVM Ruling No. 319/99. The balance of this account at December 31, 2012 and 2011, was R\$63,074.

## Other capital reserves

Due to the merger of the holdings: TBS Celular Participações Ltda, Portelcom Participações S.A. and PTelecom Brasil S.A. into Vivo Part, which was recorded in the Company after merger of Vivo Part. This reserve (R\$47,723) may be used as future capital increase by the Company. The balance of this account at December 31, 2012 and 2011 was R\$2,735,930.

## Treasury Shares

These represent the Company's treasury shares arising from: incorporation of TDBH (in 2006); ii) incorporation of Vivo Part. shares (in 2011); and iii) repurchase of common and preferred shares which, up to December 31, 2012, totaled R\$94,385, the average acquisition cost is R\$44.74 for common shares and R\$48.82 for preferred shares, which correspond to 40,700 common shares and 1,896,000 preferred shares. The balance of this account at December 31, 2012 was R\$112,107 (R\$79,339 at December 31, 2011).

On November 5, 2012, the Company informed its shareholders and the market that the members of the Company's Board of Directors approved the acquisition of common and preferred shares issued by the Company, without capital reduction, for subsequent cancellation, disposal or maintenance in treasury for the purpose of increasing shareholder value. The repurchase will be made through the use of part of the existing capital reserve as of October 31, 2012, except for the reserves referred in Article 7 subsection (a) to (d) of CVM Ruling No. 10/80. This repurchase will begin from the deliberation date of the Board of Directors, remaining in force until November 4, 2013, the acquisitions being carried out in BM&FBOVESPA at market prices and is responsibility of Management to decide the moment and number of shares to be acquired, whether in a single operation, whether in a series of operations, as well as to define the parameters for carrying out the repurchase, within legal limits, until a maximum of 2,894,534 common shares and 24,257,777 preferred shares.

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## d)Income Reserve

## Legal reserve

The legal reserve is set up by allocation of 5% of the net profit for the year, up to the limit of 20% of the paid-up capital stock. Legal reserve may only be used to increase capital or to offset accumulated losses. The balance of this account at December 31, 2012 was R\$1,100,000 (R\$877,322 at December 31, 2011).

## e)Interim Dividends

On April 11, 2012, the Ordinary General Shareholders' Meeting approved the allocation of the proposed additional dividends balance for the year totaling R\$1,953,029 at December 31, 2011, provided in the proposal for allocation of income to holders of common and preferred shares recorded by the Company up to April 11, 2012

As from May 2, 2012, the first portion, amounting to R\$1,075,550, began to be paid and the remaining balance amounting to R\$877,479, began to be paid on December 12, 2012.

On November 5, 2012, the Board of Directors approved a declaration of interim dividends amounting to R\$1,122,522 based on income in the quarterly balance at June 30, 2012 to holders of ordinary and preferred shares that were recorded in the Company register on November 23, 2012. The payment of these interim dividends shall begin on December 12, 2012.

The dividends are calculated in accordance with the Company's bylaws and under the provisions of Brazil's Corporation Law. The calculation of dividends and interest on shareholder's equity for 2012 and 2011 is as follows:

Minimum mandatory dividends calculated based on adjusted net income	2012	2011
Net Income for the year	4,453,573	4,355,318
Appropriation to legal reserve	(222,678 )	(217,766 )
Adjusted net income for the year	4,230,895	4,137,552
Minimum mandatory dividends - 25% of adjusted net income	1,057,724	1,034,388
Dividends and interest on shareholders' equity distributed:		
Interest on Shareholders' Equity (Gross)	-	1,867,000
Interim Dividends	1,122,522	382,400
Profit available for distribution	3,108,373	1,888,152
(+) Interest on Shareholders' Equity / Prescribed Dividends	89,692	107,874
(-) Actuarial (Gains) / losses recognized and effect of the limitation of the surplus plan assets, net of tax	(49,296 )	(42,997 )
Additional proposed dividend	3,148,769	1,953,029



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Amounts in R\$ per share (a)	2012	
	Common	Preferred
Interim dividends declared in November 2012	0.937417	1.031158
	0.937417	1.031158

Amounts in R\$ per share (a)	2011	
	Common	Preferred
Interim dividends declared in March 2011	3.139752	3.453727
Interim dividends declared in September 2011	0.319058	0.350964
Interest on shareholders' equity - net of withholding tax	0.886505	0.975156
Interest on shareholders' equity - net of withholding tax	0.437720	0.481492
	4.783035	5.261339

Amounts in R\$ per share (a)	2011	
	Gross amount	Net amount
Interest on shareholder's equity – common shares	1.557913	1.324226
Interest on shareholder's equity – preferred shares	1.713705	1.456649
	3.271.618	2.780.875

(a) Do not include the amount of proposed dividends.

The manner proposed by management for the payment of dividends to be decided was:

For 2011: On April 11, 2012, the Ordinary General Shareholders' Meeting approved the allocation of the balance of unallocated income for the year ended December 31, 2011 amounting to R\$1,888,152, plus dividends and interest on shareholder's equity for 2011, amounting to R\$107,874 less other comprehensive income, amounting to R\$(42,997), totaling R\$1,953,029, provided in the proposal for allocation of income to holders of common and preferred shares recorded by the company up to April 11, 2012.

For 2012: The remaining balance of unallocated net income for the year ended December 31, 2012 amounting to R\$3,108,373, plus dividends and interest on shareholder's equity for 2012, amounting to R\$89,692 less other comprehensive income and other changes in amounting to R\$(49,296), totaling R\$3,148,769, were classified as additional proposed dividends under equity in accordance with management's proposal for the allocation of income for the year which shall be submitted to approval at the Ordinary General Shareholders' Meeting.

	Reais	Common	Preferred (1)
2012 - Total proposed for deliberation – per share	3,148,769	2.629533	2.892487
2011 - Total proposed for deliberation – per share	1,953,029	1.630092	1.793102

1 10% higher than that attributed to each ordinary share in accordance with article 7 of Company by-laws.



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## f)Dividends and Interest on Shareholders' Equity

As proposed by Management, in 2011 interest on shareholders' equity were credited to shareholders in accordance with Article 9 of Law No. 9,249/95, net of withholding income tax, as follows:

	2011
Gross interest on shareholders' equity	1,867,000
Common shares	594,113
Preferred shares	1,272,887
Withholding income tax	(280,050 )
Interest on shareholders' equity, net of withholding tax	1,586,950

Tax-exempt shareholders receive interest on shareholders' equity in full, not subject to withholding tax.

## g)Prescribed Dividends

Dividends prescribe in three years, as from the initial payment date, the dividends and interest on shareholders' equity not claimed by shareholders in accordance with Article 287, clause II, item a. of Law No. 6,404 dated December 15, 1976.

24.	Net operating revenue		
	2012	2011	2010
Telephony services	26,555,103	24,254,154	15,366,014
Network usage	4,453,340	3,785,017	523,787
Data Transmission and value added services	14,389,812	10,929,344	5,028,441
Cable TV services	805,319	865,376	587,374
Other services (a)	1,282,632	1,104,095	166,464
Sale of goods and equipment	2,792,611	2,135,165	936,970
Gross operating revenue	50,278,817	43,073,151	22,609,050
ICMS	(10,048,616)	(8,800,749 )	(4,702,669 )
PIS and COFINS	(2,056,553 )	(1,780,503 )	(864,994 )
ISS	(44,054 )	(45,576 )	(39,441 )
Deductions	(4,198,172 )	(3,317,583 )	(1,203,695 )
Net operating revenue	33,931,422	29,128,740	15,798,251

(a) Vivo's contracted amounts of swap and infrastructure, within the concept of agent and principal (CPC 30 and IAS 18), are not being disclosed as costs and revenues for the years ended December 31, 2012 and 2011 were R\$44,758 and R\$23,980, respectively (Note 25).

There is no single customer contributing more than 10% of gross operating income for the years ended December 31, 2012 and 2011.

All amounts in net income are included in income and social contribution tax bases.



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## 25. Costs of goods and services

	2012	2011	2010
Depreciation and amortization	(4,132,456 )	(3,582,633 )	(1,687,449 )
Personnel	(459,707 )	(380,067 )	(257,385 )
Interconnection	(4,012,065 )	(4,537,124 )	(4,176,714 )
Third-party services	(3,288,842 )	(2,817,324 )	(1,841,072 )
Rental / insurance / condominium and means of connection (a) (b)	(968,774 )	(910,503 )	(364,303 )
Taxes, fees and contributions	(1,615,537 )	(1,279,426 )	(240,346 )
Charges payable – concession arrangement (Note 1.b.1)	(194,442 )	(142,252 )	(102,568 )
Other	(90,749 )	(106,055 )	(19,318 )
Total of service costs	(14,762,572)	(13,755,384)	(8,689,155)
Costs of goods	(1,801,892 )	(1,284,279 )	(155,650 )
Total	(16,564,464)	(15,039,663)	(8,844,805)

(a) The amount of Vivo's infrastructure swap contracts, falling into the agent and principal concept (CPC 30 and IAS 18), which are not being disclosed as costs and revenue for years ended December 31, 2012 and 2011, were R\$44,758 and R\$23,980, respectively (Note 24).

(b) In the first half of 2012, the Company reversed the provision with the Highway Department (DER), referring to right-of-way in highways, amounting to R\$244,462, due to the expectation of a remote disbursement related to this topic.

## 26. Selling expenses

	2012	2011	2010
Depreciation and amortization	(927,874 )	(684,891 )	(123,043 )
Personnel	(1,321,397)	(1,049,978)	(443,386 )
Third-party services	(4,416,402)	(3,541,958)	(1,730,908)
Allowance for doubtful accounts (note 6)	(654,273 )	(506,581 )	(386,340 )
Rental / insurance / condominium	(119,300 )	(79,239 )	(9,434 )
Publicity and advertising	(867,364 )	(735,622 )	(224,796 )
Donation and sponsorships	(253,756 )	(251,597 )	-
Others	(133,330 )	(98,345 )	(46,725 )
Total	(8,693,696)	(6,948,211)	(2,964,632)

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27.	General and administrative expenses			
		2012	2011	2010
	Depreciation and amortization	(432,829 )	(318,470 )	(103,002)
	Personnel	(623,341 )	(556,058 )	(287,866)
	Third-party services	(832,493 )	(693,260 )	(300,101)
	Rental / insurance / condominium and other expenses	(259,813 )	(217,870 )	(47,877 )
	Total	(2,148,476)	(1,785,658)	(738,846)

28.	Other operating income (expenses), net			
		2012	2011	2010
	Fines and expenses recovered	380,553	366,124	195,066
	Donation and sponsorships	(6,679 )	(8,612 )	(19,117 )
	Provision for civil, labor and tax contingencies, net	(770,646 )	(367,554 )	(116,996)
	Profit on disposal of assets (a)	1,100,934	513,891	230,335
	Administrative technical services	25,878	32,652	36,537
	Other expenses	(45,537 )	(94,343 )	(100,497)
	Total	687,503	442,158	312,479
	Other operating income	1,871,678	1,229,862	796,285
	Other operating expenses	(1,184,175)	(787,704 )	(483,806)
	Total	687,503	442,158	312,479

(a) During fiscal year 2012, Vivo sold a total of 4,404 transmission non-strategic towers and rooftops (1,358 towers in 2011) for different buyers for a total of R\$1,462,916 (R\$476,038 in 2011). After the transaction of sale of assets, Vivo leased back part of the towers and rooftops sold to continue transmitting data which is necessary for mobile services.

Each transaction of sale and leaseback was considered a sale and leaseback transaction as set out in IAS 17. The leaseback of each of the assets disposed (towers and rooftops individual) was analyzed by management and classified as operating or finance lease, considering the qualitative and quantitative requirements set out in IAS 17.

The risks and benefits of such assets were transferred to the buyers during the year 2012, except for assets classified as finance leasing and towers and rooftops which the transfer of risks and rewards depend on physical inspections and accepted their technical buyer. For such items, a total of R\$178,759 (R\$171,174 net of residual values) has been recognized as deferred revenue (note 21). For other assets, was recognized an amount of R\$1,185,101 (R\$1,046,289 net of residual values) as other operating income due to the sale of assets.

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## 29. Financial expenses, net

	2012	2011	2010
Financial income	1,281,554	1,103,359	344,354
Income from short-term investments	313,437	337,179	181,717
Gains on derivative transactions	345,412	251,758	18,567
Interest receivable	187,449	131,521	33,834
Monetary/foreign exchange variations gains	345,698	267,665	86,950
Other financial income	89,558	115,236	23,286
Financial expenses	(1,572,369)	(1,243,051)	(465,092)
Interest payable	(690,979 )	(484,663 )	(355,971)
Losses on derivative transactions	(230,216 )	(140,725 )	(20,746 )
Monetary/foreign exchange variation losses	(409,907 )	(308,966 )	(14,499 )
PIS/Cofins on received interest on shareholder's equity	(42,273 )	(18,500 )	-
Others financial expenses	(198,994 )	(290,197 )	(73,876 )
Net	(290,815 )	(139,692 )	(120,738)

## 30. Income and social contribution taxes

The Company and its subsidiaries monthly recognize income and social contribution taxes, on an accrual basis, and pay the taxes on an estimated basis, in accordance with the trial balance for suspension or reduction. The installment of income taxes up to financial statements month are recorded under assets or liabilities, as the case may be.

## Reconciliation of tax expenses at standard rate

Reconciliation of the reported tax charges and the amounts calculated by applying the nominal tax rate of 34% (income tax of 25% and social contribution tax of 9%) at December of 2012, 2011 and 2010 is shown in the table below:

	2012	2011	2010
Income before taxes	6,921,474	5,657,674	3,444,598
Income and social contribution taxes			
Income and social contribution taxes expenses – at 34% rate	(2,353,301)	(1,923,609)	(1,171,163)
Permanent differences			
Equity pick-up, net of effects on interest on shareholders' equity received	-	-	982
Interest on shareholders' equity expenses	-	634,780	201,280
Prescribed dividends	(30,495 )	(5,613 )	(7,483 )
Non-deductible expenses, gifts, incentives and dividends received	(68,052 )	(47,576 )	(24,532 )
Other additions (exclusions)	(17,445 )	46,543	-
Total general (IRPJ + CSLL)	(2,469,293)	(1,295,475)	(1,045,762)
Effective Rate	36 %	23 %	30 %
Current income and social contribution taxes	(1,628,669)	(928,132 )	(926,868 )
Deferred income and social contribution taxes	(840,824 )	(367,343 )	(118,894 )

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For the years ended December 31, 2012 and 2011, the total amount of changes in deferred assets and liabilities consolidated is R\$826,977 and R\$346,001 respectively, net of other changes.

The breakdown of assets and liabilities for deferred income and social contribution taxes on temporary expenses is presented in Note 8.2.

## 31. Earnings per share

Basic and diluted earnings per share were calculated by dividing income attributed to the Company's shareholders by the weighted average of the number of outstanding common and preferred shares for the year. No transactions were carried out that could have potential shares issued through the date of issuance of the consolidated financial statements; therefore, there are no adjustments of diluting effects inherent to the potential issue of shares.

The table below shows, the calculation of earnings per share as of December 31, 2012, 2011 and 2010:

	2012	2011	2010
Net income attributable to the shareholders:	4,453,573	4,355,318	2,398,836
Common shares	1,418,011	1,381,068	749,615
Preferred shares	3,035,562	2,974,250	1,649,221
Numbers of shares:	1,123,463	928,005	505,841
Weighted average common shares outstanding during the year	381,338	313,748	168,609
Weighted average preferred shares outstanding during the year	742,125	614,257	337,232
Basic and diluted earnings per share:			
Common shares	3.72	4.40	4.45
Preferred shares	4.09	4.84	4.89

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## 32. Transactions with related parties

## 32.a) Terms and conditions of transactions with related parties:

Company	Nature of transaction	Balance Sheets - Current assets					
		2012			2011		
		Current assets		Noncurrent assets	Current assets		Noncurrent assets
		Trade accounts receivable, net	Other assets	Other assets	Trade accounts receivable, net	Other assets	Other assets
Controller							
SP							
Telecomunicações Participações Ltda.	o)	1	19	545	-	4	-
Telefónica Internacional S.A.	o)	-	149	17,393	-	221	17,022
Telefónica S. A.	o)	-	54	137	-	482	1,591
		1	222	18,075	-	707	18,613
Other companies of the group							
Atento Brasil S. A.	a) / b)	-	-	-	13,350	1,370	-
T.Usa	m)	1,925	-	-	913	-	-
Telefonica da Argentina S. A.	n)	2,462	-	-	2,452	-	-
Telefónica de España S. A.	n)	2,476	-	-	5,320	-	-
Telefónica Del Peru	d) / n)	1,764	3,216	236	1,750	8,913	-
Telefónica Engenharia de Segurança do Brasil Ltda.	a) / g) / o)	556	1,915	293	484	1,552	287
Telefônica International Wholesale Services Brasil Ltda.	a) / g) / o)	641	218	22	1,683	448	22
Telefônica International Wholesale Services Espanha	m)	7,072	-	-	6,057	-	-
Telefónica Mviles España S.A.	n)	3,239	-	-	5,424	-	-
Telefônica Serviços Empresariais do Brasil Ltda.	a) / b) / g) / o)	1,770	15,605	1,009	1,068	15,622	932
Telefônica Transportes e Logística Ltda.	a) / b) / g) / o)	206	102	7	16	147	-
Terra Networks Brasil S. A.	a) / g) / o)	3,286	6,054	13	3,729	5,776	16
Others	a) / d) / g) / n)	15,624	10,701	463	15,654	5,750	344
		41,021	37,811	2,043	57,900	39,478	1,601
Total		41,022	38,033	20,118	57,900	40,285	20,214

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Company	Nature of transaction	Balance Sheets - Current Liabilities					
		2012			2011		
		Liabilities Trade accounts payable	Other liabilities	Noncurrent liabilities Other liabilities	Liabilities Trade accounts payable	Other liabilities	Noncurrent liabilities Other liabilities
Controller							
SP							
Telecomunicações Participações Ltda.	o)	2,685	4,028	4,689	-	-	-
Telefónica Internacional S.A.	o)	601	1,086	-	24,878	20,389	-
Telefónica S. A.	p)	3,168	35,162	-	4,394	38,346	-
		6,454	40,276	4,689	29,272	58,735	-
Other companies of the group							
Atento Brasil S. A.	c)	-	-	-	182,654	4,038	338
T.Usa	i)	1,051	6,680	106	-	42	97
Telefonica da Argentina S. A.	n)	1,577	-	-	1,260	-	-
Telefónica de España S. A.	n)	2,158	-	-	3,997	-	-
Telefónica Del Peru	n)	49	-	-	61	-	700
Telefónica Engenharia de Segurança do Brasil Ltda.	f)	3,828	-	8	5,704	43	210
Telefônica International Wholesale Services Brasil Ltda.	i)	68,552	-	305	29,080	-	505
Telefônica International Wholesale Services Espanha	i)	869	2,342	-	716	2,686	-
Telefónica Moviles España S.A.	n)	4,196	-	-	5,984	-	-
Telefônica Serviços Empresariais do Brasil Ltda.	j) / o)	17,783	36	1,521	10,553	162	2,976
Telefônica Transportes e Logística Ltda.	k)	32,648	272	165	36,341	269	144
Terra Networks Brasil S. A.	l)	1,366	19	291	1,081	19	-
Others	e) / h) / n)	15,096	522	116	24,365	482	6
		149,173	9,871	2,512	301,796	7,741	4,976
Total		155,627	50,147	7,201	331,068	66,476	4,976

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Company Controller	Nature of transaction	Income Statements - Revenues and Incomes			
		2012		2011	
		Revenues	Expenses	Revenues	Expenses
<b>SP</b>					
Telecomunicações Participações Ltda.	o)	-	(12,639)	4	(357,805)
Telefónica Internacional S.A.	o)	43,211	-	1	(603,066)
Telefónica S. A.	o) / p)	3,691	(142,791)	-	(578,363)
		46,902	(155,430)	5	(1,539,234)
<b>Other companies of the group</b>					
Atento Brasil S. A.	a) / b) / c)	50,580	(979,672)	51,148	(1,041,829)
T.Usa	m) / i)	3,318	(7,832)	2,431	(105)
Telefónica da Argentina S. A.	n)	3,563	(2,354)	3,254	(2,140)
Telefónica de España S. A.	n)	4,585	(3,736)	6,266	(5,643)
Telefónica Del Peru	d) / n)	3,844	-	3,788	-
Telefônica Engenharia de Segurança do Brasil Ltda.	a) / f) / g) / o)	2,374	(7,077)	1,133	(5,454)
Telefônica International Wholesale Services Brasil Ltda.	a) / g) / i) / o)	8,725	(120,876)	5,741	(88,642)
Telefônica International Wholesale Services Espanha	i) / m)	20,476	(13,917)	11,918	(14,625)
Telefónica Moviles España S.A.	n)	-	(4,841)	9,190	(7,985)
Telefônica Serviços Empresariais do Brasil Ltda.	a) / b) / g) / j) / o)	6,125	(97,665)	6,553	(94,644)
Telefônica Transportes e Logística Ltda.	a) / b) / g) / k) / o)	1,078	(86,710)	67	(80,887)
Terra Networks Brasil S. A.	a) / g) / l) / o)	7,317	(4,448)	8,461	(5,604)
Others	a) / d) / e) / g) / h) / n)	5,027	(3,172)	8,445	(30,678)
		117,012	(1,332,300)	118,395	(1,378,236)
<b>Total</b>		<b>163,914</b>	<b>(1,487,730)</b>	<b>118,400</b>	<b>(2,917,470)</b>

- a) Fixed and mobile telephony services: Fixed and mobile telecommunication services provided to Telefônica group.
- b) Rental of buildings and sale of call center assets. Rental of Company buildings where the call center infrastructure is installed and sale of fixed assets used in call center operations to Atento Brasil, Telefônica Serviços Empresariais do Brasil and Telefônica Transportes e Logística;
- c) Supporting services to teleservice, collection, back-office and sales promoters centers: Provided by Atento Brasil;

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- d) Expenses incurred: These are transferred to the Company by Media Networks Latin and Telefónica Del Peru;
  - e) Digital TV services: provided by Media Networks Latin;
- f) Rental and maintenance of safety equipment: provided by Telefônica Engenharia e Segurança do Brasil;
- g) Corporate services: these are transferred by the cost effectively incurred for these services;
- h) System development and maintenance services: provided by Telefônica Global Technology;
- i) Infrastructure for international transmission to various data circuits and connection services: provided by Telefônica International Wholesale Brasil; Telefônica International Wholesale Services; and Telefônica USA;
- j) Administrative management services: financial, equity, accounting and human resources services provided by Telefonica Serviços Empresariais do Brasil;
- k) Logistic operation services, messenger and carrier: these are provided by Telefônica Transportes e Logística;
  - l) Provider of voice portal content: these services are provided by Terra Networks Brasil;
- m) Data communication and integrated solutions: provided for Telefônica International Wholesale Services and Telefônica Usa;
- n) Long distance call and international roaming services: provided by companies from Telefônica group;
- o) Reimbursement of expenses: come from consulting fees, expenses for salaries and other expenses paid by the Company to be reimbursed by the companies of Telefônica Group, and
  - p) Brand Fee: assignment of use rights paid to Telefônica brand.

32.b) Management compensation

The amount paid (consolidated) by the Company to the Board of Directors and Statutory Directors for the year ended December 31, 2012 is approximately R\$21,586 (R\$27,476 in December 2011). Of this amount R\$16,856 (R\$21,225 in December 2011) correspond to salaries, benefits and social charges, and R\$4,730 (R\$6,251 in December 2011) to variable compensation.

These amounts were recorded as labor cost, according to function groups in Cost of Services, and Marketing Expenses General and administrative expenses (notes 25, 26 and 27).

For the years ended December 31, 2012 and 2011, our Directors and Managing Officers were not granted any security, pension or similar benefits.

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## 33. Insurance

The Company and its subsidiaries' policies as well as those of the Telefónica Group includes insurance coverage for all assets and liabilities of high risk and significant values, in accordance with the management's judgment and follows Telefónica S.A.'s corporate program guidelines. The risk assumptions adopted, given their nature, are not included in the audit scope of the financial statements and, accordingly, they were not audited by our independent auditors.

The main assets, liabilities or interests covered by insurance and their respective amounts are as follows:

Type	Insurance Coverage
Operational risks (with loss of profits)	R\$ 1,095,420
Optional civil responsibility - general	R\$ 40,293
ANATEL guarantee insurance	R\$ 24,644

## 34. Stock options

In 2012 and 2011, the Company's parent company, Telefônica S.A., maintained different share-based compensation plans, which were also offered to managing officers and employees from its subsidiaries, including Telefônica Brasil and its subsidiaries.

The options' fair value is estimated at concession date, based on the options binomial pricing model, which considers the terms and conditions for concession of these instruments.

The Company reimburses to Telefônica S.A. the fair value of the benefit delivered to managing officers and employees at concession date.

The key plans available at the end of years 2012 and 2011 are detailed below:

## a) Plan of rights on Telefônica S.A. shares: Performance Share Plan (PSP)

The General Shareholders' Meeting of Telefônica S.A. held on June 21, 2006, approved a long-term incentive plan for executives of Telefônica S.A. and its subsidiaries, which consists in the delivering to the selected participants, after the necessary requirements determined in this plan are met, a certain number of Telefônica S.A. shares, as variable compensation.

The plan's initially estimated total term is seven years. The plan is divided into five three-year cycles, each of them starting at July 1 (initial date) and ending at June 30 of the third year following the initial date (end date). At the beginning of every cycle, the number of shares delivered to plan beneficiaries will be determined based on the objectives accomplished by them. Shares will be delivered after every cycle's end date, as the case may be. These cycles are independent from one another, and the first one begins at July 1, 2006 (with delivery of shares at July 1, 2009), and the fifth cycle begins at July 1, 2010 (with delivery of shares as from July 1, 2013, as the case may be).

Conditions for the granting of shares are:

--

The permanence in the company for each cycle three-year term, subject to certain special conditions in relation to write-offs.

--The concrete number of shares to be delivered at the end of each cycle will depend on the success level and maximum number of shares attributed to each executive. The level of success is based on the comparison of the shareholder compensation evolution, considering quotation and dividends (Total

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Shareholder Return, TSR) of Telefônica shares in relation to the TSR corresponding to a set of companies from the telecommunication segment, constituting the Comparison Group. A maximum number of shares are attributed to every employee registered in the plan, and the concrete number of shares to be delivered at the end of the cycle is obtained by the multiplication of this maximum number by the success level reached at this date. This will be 100% if the evolution of Telefônica TSR is equal or above the third quarter of the Comparison Group, and 30% if this evolution is equal to the average. If the evolution is maintained between both values, a linear interpolation will be made, and if it is below the average, nothing is delivered.

At June 30, 2011 and 2012, the third and fourth cycle of this incentive plan had matured and the following maximum number of shares were attributed to executives of Telefônica Brasil and its subsidiaries:

Cycle	N° of Shares	Unit Value in Euros	Date of Completion
3rd cycle July 1, 2008	186,186	8.39	June 30, 2011
4rd cycle July 1, 2009	169,323	8.41	June 30, 2012

After the maturity of the third and fourth plan cycles in July 2011 and 2012, 186,186 and zero shares, respectively, were delivered to all executives of Telefônica Brasil and its subsidiaries which were included in these cycles. In the fourth cycle, no shares were delivered because the minimum determined in TSR program was not reached.

The maximum number of shares attributed in the outstanding cycle as of December 31, 2012 is as follows:

Cycle	N° of Shares	Unit Value in Euros	Date of Completion
5th cycle July 1, 2010	170,219	9.08	June 30, 2013

b) "Performance & Investment Plan" or "PIP"

The General Shareholders' Meeting of Telefónica, S.A. held on May 18, 2011 approved a long-term plan, whose objective is to praise commitment, outstanding performance and the high potential of its Global Officers by granting them Telefónica S.A. shares.

The participants do not need to pay for their initial attributed shares and may increase the number of shares they may receive at the end of the plan if they elect to make a joint investment in their PIP. The co-investment requires that the participant acquires and maintain up to the end of the cycle the equivalent to 25% of initial shares granted by Telefónica S.A. Over the participant's co-investment, Telefónica S.A. will increase the initial shares by 25%.

Total plan's initially estimated term previewed is three years. The cycle started at July 1, 2011, and will end at June 30, 2014. The number of shares is informed at the beginning of the cycle and after 3 years from the share granting date, these will be transferred to the participants if the goals are achieved.

Conditions for the granting of shares are:

- Maintenance of an active employment relationship with Telefônica Group at the cycle consolidation date;

-



Achievement, by Telefônica, of results representing the compliance of the objectives determined for the plan: The success level is based on the comparison of the shareholders' compensation, obtained through TSR, in relation to the performance of the TSR of Comparison Group companies predefined.

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- All shares will be delivered if the TSR of Telefônica S.A. exceeds the TSR of companies representing 75% of the stock market capitalization of the Comparison Group.
- 30% of shares will be delivered if the TSR of Telefônica S.A. is at the same level or above the TSR of companies representing 50% of the stock market capitalization of the Comparison Group.
- Determined by linear interpolation if the TSR of Telefônica S.A. is between 50% and 75% of the stock market capitalization of amounts of the Comparison Group.
- No shares will be delivered if the TSR of Telefônica S.A. is below the TSR of companies representing 50% of the stock market capitalization of the Comparison Group.

The maximum number of shares attributed in the two outstanding cycles as of December 31, 2012 is as follows:

Cycle	N° of Shares	Unit Value in Euros	Date of Completion
1st cycle July 1 2011	208,269	8.28	June 30, 2014
2st cycle July 1 2012	345,026	8.28	June 30, 2015

c)Global Telefônica S.A. share-based plan: Global Employee Share Plan” or “GESP”.

The General Shareholders’ Meeting of Telefónica, S.A. held on May 18, 2011, approved a share incentive purchase plan for all the employees of the Telefónica Group around the whole world, including employees of Telefônica Brasil and its subsidiaries. Under this plan, participants are offered the possibility of acquiring Telefónica, S.A. shares, with this company assuming the obligation of giving commits to participants a certain number of its shares, whenever certain requisites are met, free of charge.

The plan’s estimated total term is two years. Employees subscribed to the Plan were able to purchase Telefónica S.A. shares through monthly payments of up to 100 euros (or equivalent amount in local currency), up to a maximum of 1,200 euros over a period of twelve months (acquisition period). The delivery of shares will occur, as applicable, after the vesting period, as from December 1, 2014, and the conditions to be met are as follows:

- The beneficiary must continue to work for the Company throughout the two years of effectiveness of the plan (vesting period), subject to certain special conditions relating to departures from the Company.
- The actual number of shares to be granted at the end of the vesting period will depend on the number of shares purchased and maintained by the employees. As such, the employees participating in the Plan who remain in the Group and, who maintained the purchased shares for an additional period of other twelve months after the purchase period, will be entitled to receive one share free-of-charge for each share which they acquired and maintained at the end of the vesting period.

The vesting period began in November 2012 and, at December 31, 2012, the number of employees of Telefônica Brasil and its subsidiaries participating in the Plan totals 935.

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Telefônica Brasil and its subsidiaries registered the following expenses with personnel referring to the share-based compensation plans for years ended December 31, 2012, 2011 and 2010:

Plans	2012	2011	2010
PSP	3,994	10,101	9,516
PIP	3,000	4,509	-
GESP	3,435	2,298	840
Total	10,429	16,908	10,356

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## 35. Post-retirement benefit plans

The following table describes the plans sponsored by the Company with their respective benefits.

Plan	Type (1)	Entity	Sponsor
PBS-A	BD	Sistel	Telefônica Brasil and Vivo in conjunction with the other telecommunication companies resulting from the breakup of Telebras.
PAMA/PCE	Health care plan	Sistel	Telefônica Brasil and Vivo in conjunction with the other telecommunication companies resulting from the breakup of Telebras.
CTB	BD	Telefônica Brasil	Telefônica Brasil
PBS	BD/Hybrid	VisãoPrev	Telefônica Brasil and Vivo
PREV	Hybrid	VisãoPrev (2)	Vivo S.A.
VISÃO	CD/Hybrid	VisãoPrev	A. Telecom, Telefônica Data, Telefônica Brasil, Vivo and VisãoPrev Companhia de Previdência Complementar

(1)BD = Defined Benefit Plan;

CD = Defined Contribution Plan;

Hybrid = Benefit plan providing both benefits structured as define benefits and defined contributions.

(2)Except CELPREV plan, managed by Sistel.

The Company and its subsidiaries, together with other companies from the former Sistema Telebrás, sponsor private pension and healthcare plans to retired professionals, as follows: i) PBS-A; ii) PAMA; iii) CTB ; iv) PBS-Telefônica, PBS-Telesp Celular, PBS-TCO, PBS Tele Sudeste Celular and PBS Tele Leste Celular; v) TCP Prev, TCO Prev and CelPrev; and vi) Plano de Benefícios Visão Telefônica and Visão Celular – Celular CRT, Telerj Celular, Telest Celular, Telebahia Celular e Telergipe Celular.

The Company and its subsidiaries sponsor, individually, a defined benefit retirement plan (PBS plan), administered by Visão Prev. The Company and its subsidiaries also participate in a multi-sponsored pension (PBS-A) and healthcare (PAMA) plan to the Company's retired employees and their dependents (administered by Fundação Sistel, with a fund already set up and supported by contribution from participants), with shared costs. Contributions to PBS plans are determined based on actuarial analyses prepared by independent actuarial in accordance with the effective standards in Brazil. The costing determination regime is capitalization, and the contribution due by the sponsoring party is fixed at a discount percentage applied to the payroll of participant employees, as follows:

Plan	%
PBS Telesp	6.82
PBS Telesp Celular	7.16
PBS Tele Sudeste Celular	6.64

PBS Telemig	
Celular	6.11
PAMA	1.5

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For other employees of the Company and its subsidiaries, there is an individual defined contribution plan, named Visão Benefit Plan, and both are administered by Visão Prev Companhia de Previdência Complementar. These plans depend on contributions from participants (employees) and sponsors, which are credited in the participants' individual bank accounts. The Company and its subsidiaries are responsible for all administrative and maintenance expenses of these plans, including the risk of death and disability of plan participants. Contributions made by the Company and its subsidiaries to these plans are equal to participant contributions, ranging from 2% to 9% of their monthly salaries, and from 0% to 8% the monthly salary of Vivo Prev participants (pension plan maintained by subsidiary Vivo S.A.), according to the percentage elected by plan participants.

Additionally, the Company complements the pension plan of certain employees of former Companhia Telefônica Brasileira (CTB).

Vivo also sponsors CelPrev. CelPrev participants can make three types of contributions, as follows: (a) basic regular contribution: variable percentage, from 0% to 2% of plan participants' monthly salary; (b) additional regular contribution: variable percentage, from 0% to 6% of plan participant's monthly salary exceeding 10 Plan Standard Reference Units; and (c) voluntary contribution: percentage freely elected by plan participants and applied over their plan participation monthly salary. Sponsor can make four types of contribution, as follows: (a) basic regular contribution: equal to the participant's basic regular contribution, not including the contribution for sickness allowance and administrative expenses; (b) additional regular contribution: equal to the additional regular contribution, less administrative expenses; (c) occasional contribution: made voluntarily and whose frequency is determined by the sponsor; and (d) special contribution: contribution allocated exclusively to the sponsor's employees who do not belong to PBS and started participating within 90 days from CelPrev initial date.

The actuarial valuation of the plans was made in December 2012 and 2011, based on the participants record as of August 31 and July 31, 2012 for plans managed by VisãoPrev and Sistel, respectively, both planned for December 31, 2012 and based on the participants record as of August 31 and September 30, 2011 for plans managed by VisãoPrev and Sistel, respectively, both planned for December 31, 2011, adopted by the unit credit method and actuarial gains and losses generated at every year are immediately recognized in equity (under other comprehensive income).

Plan assets are allocated at December 31, 2012 and 2011, respectively, and for multi-sponsored plans (PAMA and PBS-A), the apportionment of plan assets was made based on the company's actuarial liabilities in relation to the plan's total actuarial liabilities.

Actuarial liabilities referring to the plans mentioned above are recorded under "Provisions" (Note 20).

Consolidated actuarial liabilities as of December 31, 2012 and 2011 were as follows:

Plan	2012	2011
CTB	50,652	34,615
PAMA	341,617	273,373
PBS	-	905
Total	392,269	308,893

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## Reconciliation of assets and liabilities

	PBS-A (i)	CTB	PAMA (i)	2012 PBS	Visão	PREV	Total
Total actuarial liabilities	1,376,229	50,652	437,241	229,119	34,666	53,559	2,181,466
Fair value of assets	2,136,722	-	95,624	342,323	61,189	106,150	2,742,008
Liabilities (assets), net	(760,493 )	50,652	341,617	(113,204 )	(26,523 )	(52,591 )	(560,542 )
Assets limitation	760,493	-	-	112,246	8,685	23,339	904,763
Noncurrent assets	-	-	-	(958 )	(17,838 )	(29,252 )	(48,048 )
Noncurrent liabilities	-	50,652	341,617	-	-	-	392,269

	PBS-A (i)	CTB	PAMA (i)	2011 PBS	Visão	PREV	Total
Total actuarial liabilities	1,214,453	34,615	366,660	242,227	33,986	46,251	1,938,192
Fair value of assets	1,882,195	-	93,287	294,602	108,793	73,689	2,452,566
Liabilities (assets), net	(667,742 )	34,615	273,373	(52,375 )	(74,807 )	(27,438 )	(514,374 )
Assets limitation	667,742	-	-	53,195	44,375	26,745	792,057
Noncurrent assets	-	-	-	(85 )	(30,432 )	(693 )	(31,210 )
Noncurrent liabilities	-	34,615	273,373	905	-	-	308,893

i) Refers to the company's and its subsidiaries' proportional interest in PAMA and PBS-A multi-sponsored plan assets and liabilities.

b) Total expenses recognized in the income statement

	CTB	PAMA	PBS	2012 Visão	PREV	Total
Current service cost	-	165	853	4,601	3,872	9,491
Interest cost	3,164	35,026	22,780	3,085	4,260	68,315
Expected return on plan assets	-	(10,847 )	(35,944 )	(13,392 )	(9,001 )	(69,184 )
	3,164	24,344	(12,311 )	(5,706 )	(869 )	8,622
	2011 CTB	PAMA	PBS	Visão	PREV	Total
Current service cost	-	252	821	3,971	2,482	7,526
Interest cost	1,978	29,173	17,838	3,062	3,487	55,538
	-	(8,163 )	(25,654 )	(6,940 )	(5,795 )	(46,552 )

Expected return on plan assets	1,978	21,262	(6,995 )	93	174	16,512
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	CTB	PAMA	2010 PBS	Visão	Total
Current service cost	-	159	78	3,663	3,900
Interest cost	2,148	23,038	8,803	2,865	36,854
Expected return on plan assets	-	(6,489 )	(11,334 )	(11,970 )	(29,793 )
	2,148	16,708	(2,453 )	(5,442 )	10,961

## c) Amounts recognized in other comprehensive income

	2012 CTB	PAMA	PBS	Visão	PREV	Total
Actuarial (gains) losses	17,216	43,940	(48,381 )	57,611	(20,559 )	49,827
Limitation effect	-	-	59,051	(35,690 )	(3,406 )	19,955
Total cost recognized in other comprehensive income	17,216	43,940	10,670	21,921	(23,965 )	69,782

	2011 CTB	PAMA	PBS	Visão	PREV	Total
Actuarial (gains) losses	15,398	36,581	22,643	30,628	(6,552 )	98,698
Limitation effect	-	-	(12,231 )	(28,903 )	7,612	(33,522 )
Total cost recognized in other comprehensive income	15,398	36,581	10,412	1,725	1,060	65,176

	CTB	PAMA	2010 PBS	Visão	Total
Actuarial (gains) losses	(1,809 )	13,069	(7 )	(1,138 )	10,115
Limitation effect	-	-	2,472	47,998	50,470
Total cost recognized in other comprehensive income	(1,809 )	13,069	2,465	46,860	60,585

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## d) Changes in net actuarial (assets) liabilities

	PBS-A	CTB	PAMA	PBS	Visão	PREV	Total
Plan liabilities (Assets) as of 01/01/2011	-	20,818	198,182	-	(27,171 )	-	191,829
Business Combination	(17,809 )	-	17,431	(50,294 )	(11,048 )	(19,961 )	(81,681 )
Expenses in 2011	(92,030 )	1,978	21,262	(6,995 )	93	174	(75,518 )
Contributions of the companies to plans in 2011	-	(3,579 )	(83 )	(294 )	(5,016 )	(1,100 )	(10,072 )
Amounts recognized in other comprehensive income	109,839	15,398	36,581	58,403	12,710	20,194	253,125
Liabilities (Assets) as of 12/31/2011	-	34,615	273,373	820	(30,432 )	(693 )	277,683
Expenses in 2012	(129,671)	3,164	24,344	(12,311)	(5,706 )	(869 )	(121,049)
Contributions of the companies to plans in 2012	-	(4,343 )	(40 )	(136 )	(3,621 )	(3,725 )	(11,865 )
Amounts recognized in other comprehensive income	129,671	17,216	43,940	10,669	21,921	(23,965 )	199,452
Liabilities (Assets) as of 12/31/2012	-	50,652	341,617	(958 )	(17,838 )	(29,252 )	344,221
Actuarial asset recognized in the balance sheet	-	-	-	(958 )	(17,838 )	(29,252 )	(48,048 )
Actuarial liability recognized in the balance sheet	-	50,652	341,617	-	-	-	392,269

## e) Changes in actuarial liabilities

	PBS-A	CTB	PAMA	PBS	Visão	PREV	Total
Actuarial liabilities as of January 1, 2011	1,138,330	20,818	272,140	94,177	31,915	-	1,557,380
Business Combination	35,091	-	23,936	117,481	161	49,656	226,325
Cost of current service	-	-	251	821	3,970	2,482	7,524
Interest on actuarial liabilities	114,725	1,978	29,173	17,838	3,062	3,487	170,263
Benefits paid in the year	(97,917 )	(3,579 )	(13,390 )	(13,385 )	(5,900 )	(1,113 )	(135,284 )
Contributions of participants in the year	-	-	-	345	-	-	345

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Actuarial (gains) losses in the year	24,224	15,398	54,550	24,950	778	(8,261 )	111,639
Actuarial liabilities as of December 31, 2011	1,214,453	34,615	366,660	242,227	33,986	46,251	1,938,192
Cost of current service	-	-	165	853	4,601	3,872	9,491
Interest on actuarial liabilities	113,362	3,164	35,026	22,780	3,085	4,260	181,677
Benefits paid in the year	(101,793 )	(4,343 )	(14,821 )	(13,323 )	(1,322 )	(1,606 )	(137,208 )
Contributions of participants in the year		-	-	270	180	113	563
Actuarial (gains) losses in the year	150,207	17,216	50,211	(23,688 )	(5,864 )	669	188,751
Actuarial liabilities as of December 31, 2012	1,376,229	50,652	437,241	229,119	34,666	53,559	2,181,466

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## f) Changes in plan assets

	PBS-A	CTB	PAMA	PBS	Visão	PREV	Total
Fair value of plan assets as of January 1, 2011	1,717,746	-	73,959	111,612	121,378	-	2,024,695
Business Combination	52,900	-	6,505	167,775	11,209	69,617	308,006
Benefits paid in the year	(97,917 )	(3,579 )	(13,390)	(13,385 )	(5,900 )	(1,113 )	(135,284 )
Total contributions in the year	-	3,579	81	640	5,017	1,099	10,416
Expected return on plan assets in the year	206,757	-	8,163	25,654	6,940	5,795	253,309
Gains / (losses) on assets	2,709	-	17,969	2,306	(29,851 )	(1,709 )	(8,576 )
Fair value of plan assets as of December 31, 2011	1,882,195	-	93,287	294,602	108,793	73,689	2,452,566
Benefits paid in the year	(101,793 )	-	(14,821)	(13,323 )	(1,322 )	(1,606 )	(132,865 )
Total contributions in the year	-	-	39	406	3,801	3,840	8,086
Expected return on plan assets in the year	243,033	-	10,847	35,944	13,392	9,001	312,217
Gains / (losses) on assets	113,287	-	6,272	24,694	(63,475 )	21,226	102,004
Fair value of plan assets as of December 31, 2012	2,136,722	-	95,624	342,323	61,189	106,150	2,742,008

## g) Expenses estimated for 2013

	CTB	PAMA	PBS	Visão	PREV	Total
Cost of current service	-	139	643	4,147	4,270	9,199
Net interest on net actuarial assets/liabilities	4,127	30,811	(101 )	(1,721 )	(2,703 )	30,413
Total expenses (reversions) for 2013	4,127	30,950	542	2,426	1,567	39,612

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## h) Actuarial assumptions

2012	Expected return rate on plan assets	Future salary growth rate	Medical care cost growth rate	Annual nominal index of private pension benefit restatement	Medical service eligibility age	Retirement age	Rate used to present value discount of the actuarial liabilities
PBS	8.7% to 8.91%	6.18%	N/A	4.5%	N/A	Eligibility for regular retirement	8.7% to 8.91%
Visão	8.32% to 8.84%	6.18%	N/A	4.5%	N/A	Eligibility for regular retirement	8.32% to 8.84%
PREV	8.5% to 9.05%	6.18%	N/A	4.5%	N/A	Eligibility for regular retirement	8.5% to 9.05%
CTB	8.57%	6.18%	N/A	4.5%	N/A	Eligibility for regular retirement	8.57%
PAMA	9.02%	N/A	7.64%	N/A	5% upon reaching 52 years old and 10 years participating; 3% for each subsequent year; 100% in eligibility for regular retirement	N/A	9.02%
PBS-A	8.67%	N/A	N/A	4.5%	N/A	N/A	8.67%

Note: These are all nominal rates, except for the rate of increase upon use of medical services.

In addition to the above-mentioned assumptions, other assumptions common to all plans were adopted, as follows:

- Inflation rate: 4.5%;
- Capacity factor for salaries and benefits: 98%;

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- Turnover: 0.15 (years of service +1), zero from age 50;
- Disability entry table: Mercer Disability;
- Actuarial Table: AT2000 segregated by sex; and
- Disability mortality table: IAPB-57.

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2011	Expected return rate on plan assets	Future salary growth rate	Medical care cost growth rate	Annual nominal index of private pension benefit restatement	Medical service eligibility age	Retirement age	Rate used to present value discount of the actuarial liabilities
PBS	11.60%	PBS: 6.54%	N/A	4.5%	N/A	Eligibility for regular retirement	9.73%
Visão	11.60%	Visão: 7.20%	N/A	4.5%	N/A	Eligibility for regular retirement	9.73%
PBS Telemig	12.08%	N/A	N/A	4.5%	N/A	Eligibility for regular retirement	9.73%
Celprev /PREV	Celprev: 11.10%  PREV: 11.60%	Celprev: 7.19%  PREV: 7.20%	N/A	4.5%	N/A	Eligibility for regular retirement	9.73%
CTB	N/A	N/A	N/A	4.5%	N/A	Eligibility for regular retirement	9.73%
PAMA	11.07%	N/A	7.64%	N/A	5% upon reaching 52 years old and 10 years participating; 3% for each subsequent year; 100% in eligibility for regular retirement	N/A	9.73%
PBS-A	12.08%	N/A	N/A	4.5%	N/A	N/A	9.73%

Note: These are all nominal rates, except for the rate of increase upon use of medical services.

In addition to the above-mentioned assumptions, other assumptions common to all plans were adopted, as follows:

- Inflation rate: 4.5%;

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- Capacity factor for salaries and benefits: 98%;
- Turnover: 0.15 (years of service +1), zero from age 50;
- Disability entry table: Mercer Disability;
- Actuarial Table: AT2000 segregated by sex; and
- Disability mortality table: IAPB-57.

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## i) Expected long-term investment return

	2012	2011
Percentage of allocation of plan assets		
Capital instruments	11.52%	5.87%
Debt instruments	88.30%	92.87%
Other	0.18%	1.26%
Total	100.00%	100.00%
Expected return from plan assets		
Capital instruments	8.5% to 11.4%	16.36%
Debt instruments	8.5% to 9.06%	12.46%
Other	8.5% to 10.57%	11.67%

Expected long-term investment return rates related to the plans assessed were selected by the Company, being determined based on expected long-term profitability, considering long-term projections provided by Tendências Consultoria and ANBIMA data, among others, as follows:

- Variable income assets: historic risk premium estimated by the actuarial advisor;
- Prefixed securities: weighted average rate based on National Treasury Bills (LTN) available and National Treasury Notes – F Series (NTN-F) market portfolio;
- Assets linked to inflation: weighted average rate based on NTN-B and NTN-C portfolio available in the market;
- Foreign exchange securities: average SELIC rate weighted by the foreign exchange variation rate projected for the following 10 years;
  - Fixed income assets: average internal nominal interest rate variation, projected for the following 10 years;
    - Loans to participants: the higher rate between CDI and the plan actuarial goal is considered;
    - Properties: the plan actuarial goal used was that of its administrator.

## j) History of assets and obligations observed

	2012	2011	2010	2009	2008
Present value of liabilities	805,236	723,739	419,050	386,722	337,480
Fair value of assets	605,286	570,371	309,949	289,239	253,695
Deficit (surplus) of plans	199,950	153,368	112,101	97,483	83,785
Experience adjustment on liabilities	38,543	87,413	5,397	30,043	39,929
Experience adjustment on assets	(11,283 )	(11,284 )	(1,352 )	(19,826 )	(8,598 )

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## k) Schedule of benefits to be paid in next years

	2013	2014	2015	2016	2017	2018 thereof
Defined pension plan	143,430	149,216	155,112	161,678	168,029	7,577,033

## l) Significant considerations on PAMA Plan

The effect of a one percent increase and the effect of one percent decrease in medical cost trend rates are as follows:

	2012	2011
Effect on projected medical expense trend rates		
For an increase of 1% in projected medical expense trend rates		
(i) Total effect on costs of current services and interest on liabilities	6,431	5,639
(i) Total effect on the present value of liabilities	70,393	57,677
For a decrease of 1% in projected medical expense trend rates		
(i) Total effect on costs of current services and interest on liabilities	(5,278 )	(4,653 )
(i) Total effect on the present value of liabilities	(57,867 )	(47,581 )

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## 36. Financial instruments

The Company and its subsidiaries assessed their financial assets and liabilities in relation to market values, based on information available and appropriate valuation techniques. However, both interpreting market data and selecting valuation techniques require considerable judgment and reasonable estimates to calculate the most appropriate realizable value. As such, the estimates presented do not necessarily indicate the amounts which may be realized in the current market. The use of different market hypothesis and/or methodologies may have a significant effect on the estimated realizable values.

Breakdown of financial assets and liabilities at December 31, 2012 and 2011 is as follows:

At December 31, 2012:

	Fair value		Amortized cost			Total Book Value	Total Fair Value
	Hedge	Available for sale	Loans and receivables	Level 1 Market price	Level 2 Estimated based on other market data		
<b>Financial assets</b>							
<b>Current assets</b>							
Cash and cash equivalents (Note 5)	-	-	7,196,079	-	-	7,196,079	7,196,079
Derivative transactions (Note 36)	41,109	-	-	-	41,109	41,109	41,109
<b>Noncurrent assets</b>							
Interests in other companies (Note 36)	-	23,683	-	23,683	-	23,683	23,683
Derivative transactions (Note 36)	286,278	-	-	-	286,278	286,278	286,278
<b>Total financial assets</b>	<b>327,387</b>	<b>23,683</b>	<b>7,196,079</b>	<b>23,683</b>	<b>327,387</b>	<b>7,547,149</b>	<b>7,547,149</b>
<b>Financial liabilities</b>							
<b>Current liabilities</b>							
Loans and financing (note 18)		365,192	890,131	-	365,192	1,255,323	1,456,466

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Debentures (Note 18)	6,013	696,202	-	6,013	702,215	811,919
Derivative transactions (Note 36)	470	-	29,116	29,586	29,586	29,586
<b>Noncurrent liabilities</b>						
Loans and financing (note 18)	1,009,673	2,746,328	-	1,009,673	3,756,001	3,581,630
Debentures (Note 18)	90,235	2,163,455	-	90,235	2,253,690	2,158,008
Derivative transactions (Note 36)	-	-	26,545	26,545	26,545	26,545
<b>Total financial liabilities</b>	<b>1,471,583</b>	<b>6,496,116</b>	<b>55,661</b>	<b>1,527,244</b>	<b>8,023,360</b>	<b>8,064,154</b>

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At December 31, 2011:

	Measured at fair value through profit or loss	Fair value		Amortized cost			Level 2 Estimated based on other market data	Total Book Value	Total Fair Value
		Hedge	Available for sale	Loans and receivables	Investments held to maturity	Level 1 Market price			
Financial assets									
Current assets									
Cash and cash equivalents (note 5)	-	-	-	2,940,342	-	-	-	2,940,342	2,940,342
Derivative transactions (Note 36)	730	1,110	-	-	-	-	1,840	1,840	1,840
Noncurrent assets									
Interests in other companies (Note 36)	-	-	37,696	-	-	37,696	-	37,696	37,696
Derivative transactions (Note 36)	-	225,935	-	-	-	-	225,935	225,935	225,935
Amounts linked to the National Treasury Securities (note 10)	-	-	-	-	13,819	-	-	13,819	13,819
<b>Total financial assets</b>	<b>730</b>	<b>227,045</b>	<b>37,696</b>	<b>2,940,342</b>	<b>13,819</b>	<b>37,696</b>	<b>227,775</b>	<b>3,219,632</b>	<b>3,219,632</b>

	Measured at fair value through profit or loss	Amortized cost	Hedge	Level 2 Estimated based on other market data	Total Book Value	Total Fair Value
Current liabilities						
Loans and financing (note 18)	34,802	953,611	-	34,802	988,413	1,220,811
Debentures (Note 18)	5,537	463,087	-	5,537	468,624	521,057

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Derivative transactions (Note 36)	1,327	-	49,835	51,162	51,162	51,162
Noncurrent liabilities						
Loans and financing (note 18)	969,977	2,989,138	-	969,977	3,959,115	3,586,462
Debentures (Note 18)	81,853	705,954	-	81,853	787,807	722,453
Derivative transactions (Note 36)	-	-	78,369	78,369	78,369	78,369
Total financial liabilities	1,093,496	5,111,790	128,204	1,221,700	6,333,490	6,180,314

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## Equity interests

The Company has direct and indirect equity interests, arising from the privatization process. Such investments, measured at market value, consider the latest quotation available at December 31, 2012 and 2011.

At December 31, 2012 and 2011, the breakdown of equity interest, at market value, is as follows:

	2012	2011
Zon Multimédia (a)	-	9,117
Other investments	23,683	28,718
Total	23,683	37,835

(a) On May 8, 2012, the Company disposed of 1,618,652 common shares, representing 0.52% of capital (voting shares) of Multimédia - Serviços de Telecomunicações e Multimédia, SGPS, S.A.

## Fair value hierarchy

The Company and its subsidiaries use the following hierarchy in order to calculate and disclosure the fair value of financial instruments through the valuation technique:

Level 1: Quoted prices (without adjustments) on the active markets for identical assets and liabilities;

Level 2: Other techniques to which all data with material effect on the fair value recorded are directly or indirectly observable;

Level 3: Techniques using data with relevant effect on the fair value recorded which are not based on data that can be observed on the market.

At December 31, 2012, there were neither transfers between fair value measurements “level 1” and “level 2” nor transfers between fair value measurements “level 3” and “level 2”. The Company and its subsidiaries have no financial instruments with fair value measurement level 3.

## Capital management

The purpose of the Company and its subsidiaries’ Capital management is to ensure that a solid credit rating is sustained before the institutions, as well as an optimum capital relationship, in order to support the Company’s businesses and maximize the value to its shareholders.

The Company and its subsidiaries manage their capital structure by making adjustments and fitting into current economy conditions. For this purpose, the Company and its subsidiaries may pay dividends, raise new loans, issue promissory notes and contract derivative operations. For the year ended December 31, 2012, there were no changes in objectives, policies or capital structure processes.

The Company and its subsidiaries include in its net debt structure: loans, financing, derivative operations, less cash and cash equivalents.

## Risk management policy

The Company and its subsidiaries are exposed to various market risks as a result of their business activities, debts incurred to finance their business and financial instruments related to their indebtedness.

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The main market risk factors that affect the Company and its subsidiaries' business are as follows:

a) Exchange rate risk

There is the risk arising from the possibility of the Company incur losses due to fluctuations in exchange rates, which increase expenses derived from its loans taken out in foreign currency.

At December 31, 2012, 19.9% (R\$19.3% at December 31, 2011) of the financial debt were denominated in foreign currency. The Company and its subsidiaries engaged derivative transactions (FX hedge) with financial institutions to hedge themselves against exchange variation arising from their entire financial indebtedness in foreign currency (R\$1,586,711 at December 31, 2012 and R\$1,198,483 at December 31, 2011). Therefore, the entire indebtedness on those dates was covered by long positions of FX hedging transactions with swap to CDI.

Also, there is the exchange risk associated with non-financial assets and liabilities denominated in foreign currency, which may generate a lower value receivable or a higher value payable, according to the exchange variation of the period.

From May 2010, hedging transactions were engaged to minimize the risk associated with exchange variation to non-financial assets and liabilities in foreign currency. This balance is daily changed due to the business dynamics; however, the Company intends to hedge the net balance of these rights and obligations (US\$16,130 and €4,140 payable at December 31, 2012, and US\$13,917 and €17,818 payable at December 31, 2011) to minimize its exchange risks.

b) Interest rate and inflation risk

This risk arises from the possibility of the Company and its subsidiaries incur losses in the event of an unfavorable change in domestic interest rates, which may adversely affects financial expenses derived from the debentures portion by reference to the CDI and short positions in derivatives (exchange rate hedge and IPCA) contracted at floating interest rates (CDI).

The debt with BNDES is indexed at the TJLP, fixed on a quarterly basis by the Brazilian Monetary Council and which was maintained at 6.0% p.a. from July 2009 to June 2012. From July to December 2012, the TJLP was 5.5% p.a. and from January 2013 it was reduced to 5.0% p.a.

The inflation rate risk derives from debentures of Telemig (company merged by Vivo Part. on June 1, 2010), indexed at IPCA, which may adversely affect financial expenses in the event of an unfavorable change in this index.

In order to reduce the exposure to the domestic variable interest rate (CDI), the Company and its subsidiaries invest the excess of cash and cash equivalents, amounting to R\$7,101,625 (R\$2,862,938 at December 31 2011), largely in short-term investments (Bank Deposit Certificates - CDB) based on the CDI variation. The book values of these financial instruments approximate their market values, as they are redeemable in the short term.

c) Liquidity risk

Liquidity risk refers to any circumstance in which the Company and its subsidiaries do not have sufficient funds to settle their commitments due to different currencies and realization/liquidity terms of their rights and obligations.

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The Company and its subsidiaries organized the maturities of non-derivative financial instruments, as stated in Note 18, as well as their respective derivatives, as stated in the payment schedule disclosed on that Note, so as to not affect its liquidity.

The Company and its subsidiaries' liquidity and cash flow is monitored on a daily basis by management in order to ensure that the generation of operating cash and early fund raising, where necessary, are sufficient to maintain their schedule of commitments, not generating liquidity risks.

d) Credit risk

This risk arises from the possibility that the Company and its subsidiary may incur losses from difficulty in receiving amounts billed to their customers as well as from sales of devices and pre activated prepaid cards for the network of distributors.

The credit risk from trade accounts receivable is diversified and minimized by a strict control of the customer's base. The Company and its subsidiaries constantly monitor the level of accounts receivable from post-paid services and limits the risk of undue accounts by cutting the access to the telephone line whether the bill is past due. As to mobile telephony, the customer's base is predominantly of prepaid lines, which require the recharge in advance and, therefore, does not represent credit risk. There are exceptions to the telephony services which must be kept for national security or defense reasons.

The credit risk on the sale of devices and pre activated prepaid cards is managed by a conservative policy in the credit concession, by means of modern management methods, which involves the application of credit scoring techniques, analysis of financial statements and information as well as consultation to commercial databases, in addition to requests for guarantees.

At December 31, 2012 and 2011, customer's portfolio of the Company and its subsidiaries did not present record of subscribers whose receivables were, individually, higher than 1% of the total service accounts receivable.

The Company and its subsidiaries are also subject to credit risk arising from their short-term investments, surety letters received as guarantee for certain transactions and amounts receivable from derivative transactions. The Company and its subsidiaries control the credit limit granted to each counterparty and diversify this exposure among top-tier financial institutions, according to the financial counterparty credit policy in force.

Derivatives and Risk Management Policy

All engagements of derivative financial instruments in the Company and its subsidiaries are intended for exchange rate risk hedge arising from assets and liabilities denominated in foreign currency and hedge against inflation variation risk of the debenture indexed at IPCA with shorter terms. As such, any changes in risk factors generate an opposite effect on the matching entry proposed to hedge. Therefore, there are no derivative financial instruments for speculative purposes and the possible exchange risks are hedged.

The Company and its subsidiaries keep internal controls over their derivative instruments which, on management's opinion, are appropriate to control risks related to each performance strategy in the market. Results the Company obtained through its derivative financial instruments indicate that management has been managing risks appropriately.

The Company and its subsidiaries calculate the effectiveness of derivatives contracted to cover their financial liabilities at beginning of transaction and on continuous bases (on a quarterly basis). At December 31, 2012,

derivatives contracted present effectiveness in relation to the debts covered by them. As long as these derivative contracts are qualified as hedge accounting, the risk covered also may be adjusted at fair value according to hedge accounting rules.

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The Company and its subsidiaries entered into swap agreements in foreign currency at various exchange rates to cover their assets and liabilities in foreign currency.

At December 31, 2012, the Company and its subsidiaries had no embedded derivative contracts.

Fair value of derivative financial instruments

The valuation method used to calculate market value of financial liabilities (when applicable) and derivative instruments was the discounted cash flows method, considering expected settlement or realization of liabilities and assets at market rates in force as at the balance sheet date.

The fair values are calculated by projecting the future flows from operations, using BM&FBovespa curves and discounting these flows to present value using market DI rates for swaps, disclosed by BM&FBovespa.

Market value of currency derivatives was obtained through market exchange rates in force at the balance sheet date, and rates projected by the market were obtained from Currency Coupon curves. The straight-line method (360 calendar days) was used to calculate coupon for positions rated in foreign currency, and an exponential method (252 business days) was used to calculate coupon for positions pegged to CDI.

Derivative financial instruments consolidated below are registered with the CETIP, all classified as swaps, and not requiring margin deposits.

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Description	Index	Amount receivable (payable)		Notional Value		Accumulated balance Fair value	
		2012	2011	2012	2011	2012	2011
Swap Contracts							
Receivable							
Foreign currency (a)		1,329,065	1,106,438	1,672,895	1,248,514	253,189	212,262
Citibank	USD	181,230	187,845	216,270	199,872	39,617	32,219
Votorantim	USD	7,744	13,434	9,311	14,028	-	-
Banco do Brasil	USD	258,900	258,900	326,263	282,205	32,931	19,629
Bradesco	USD	415,464	196,728	519,481	231,391	85,043	43,137
Itaú	USD	22,520	6,324	22,239	6,371	-	57
JP Morgan	USD	443,207	443,207	579,331	514,647	142,065	117,220
Foreign currency (b)		11,773	44,098	11,772	43,059	-	-
Bradesco	EUR	2,613	13,828	2,613	13,773	-	-
Itaú	EUR	9,160	30,270	9,159	29,286	-	-
Foreign currency (c)	LIBOR US\$	179,533	179,533	238,422	213,062	52,112	-
		179,533	179,533	238,422	213,062	52,112	-
Inflation rates		72,000	72,000	96,249	87,390	22,086	15,513
Itaú	IPCA	72,000	72,000	96,249	87,390	22,086	15,513
Floating rate (c)		-	4,644	-	4,638	-	-
Bradesco	CDI	-	896	-	899	-	-
Itaú	CDI	-	3,748	-	3,739	-	-

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Description	Index	Notional Value		Fair value		Accumulated balance Amount receivable (payable)		
		2012	2011	2012	2011	2012	2011	
<b>Liabilities</b>								
<b>Floating rate</b>								
(a)		(1,412,838)	(1,222,536)	(1,059,243)	(1,280,672)	(55,545 )	(125,435 )	
Citibank	CDI	(181,230 )	(187,845 )	(180,418 )	(186,324 )	(3,765 )	(18,672 )	
Votorantim	CDI	(7,744 )	(13,434 )	(21,336 )	(34,139 )	(12,025 )	(20,111 )	
<b>Banco do</b>								
Brasil	CDI	(258,900 )	(258,900 )	(287,686 )	(262,576 )	-	-	
Bradesco	CDI	(418,077 )	(210,556 )	(463,910 )	(230,901 )	(26,273 )	(28,874 )	
Itaú	CDI	(103,680 )	(108,594 )	(105,893 )	(112,680 )	(333 )	(1,153 )	
JP Morgan	CDI	(443,207 )	(443,207 )	-	(454,052 )	(13,149 )	(56,625 )	
<b>Foreign</b>								
<b>currency (b)</b>								
	LIBOR							
	US\$	(179,533 )	(179,533 )	(238,422 )	(213,062 )	(586 )	-	
Bradesco		(179,533 )	(179,533 )	(238,422 )	(213,062 )	(586 )	-	
<b>Floating rate</b>								
(b)		(72,000 )	(72,000 )	-	(75,926 )	-	(4,049 )	
Itaú	IPCA	(72,000 )	(72,000 )	-	(75,926 )	-	(4,049 )	
<b>Foreign</b>								
<b>currency (c)</b>								
		-	(4,644 )	-	(4,685 )	-	(47 )	
Bradesco	USD	-	(896 )	-	(937 )	-	(38 )	
Itaú	USD	-	(3,748 )	-	(3,748 )	-	(9 )	
						Receivable	327,387	227,775
						Payable	(56,131)	(129,531)
						Amount receivable	271,256	98,244

a) Foreign currency Swaps (Dollar) x CDI (R\$1,643,413) swap transactions were contracted with varied maturities until 2019, in order to hedge against exchange variation risk of the loan operation in US dollars (book value of the financial debt of R\$1,586,470).

b) Foreign currency swaps (Euro and Dollar) and (CDI x EUR) (R\$41,254 - swap transactions contracted with maturities until March 1, 2013, in order to hedge against exchange variation risks of net payables in Euro and in Dollar (book value of R\$32,962 in Dollar and R\$11,163 in Euro).

c) Swap IPCA x CDI percentage (R\$96,249) - swap transactions contracted with annual maturities until 2014, in order to hedge the flow identical to that of debentures (4th issue - 3rd series) indexed at IPCA (market balance of R\$96,249).

The distribution of the maturities of swap contracts at December 31, 2012 is as follows:

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Swap contracts	Maturity				Amount payable/ receivable at 12/31/2012
	2013	2014	2015	2016 thereafter	
Foreign Currency x CDI	10,902	19,395	147,851	71,022	249,170
VOTORANTIM	(8,292 )	(3,733 )	-	-	(12,025 )
BRADESCO	(10,300 )	(8,325 )	5,787	71,022	58,184
JP MORGAN	(6,234 )	(6,914 )	142,064	-	128,916
BANCO DO BRASIL	38,576	-	-	-	38,576
CITIBANK	(2,515 )	38,367	-	-	35,852
ITAÚ	(333 )	-	-	-	(333 )
IPCA x CDI	621	21,465	-	-	22,086
ITAÚ	621	21,465	-	-	22,086
Total	11,523	40,860	147,851	71,022	271,256

For the purpose of preparing the financial statements, the Company and its subsidiaries adopted the hedge accounting methodology for their foreign currency swaps versus CDI, and IPCA versus CDI intended for covering the financial debt. According to this methodology, both derivative and covered risk are valued at their fair value.

At December 31, 2012 and 2011, derivative transactions generated consolidated positive results of R\$115,196 and R\$111,033, respectively, as described in Note 29.

At December 31, 2012, the consolidated balance of R\$327,387 is recorded under assets and R\$56,131 recorded under liabilities to recognize the derivative position at that date.

## Sensitivity analysis to the Company's risk variables

CVM Deliberation 604/09 requires listed companies to disclose, in addition to the provisions of Technical Pronouncement CPC No. 40 - Financial Instruments: Disclosure (equivalent to IFRS 7), set forth that listed companies must disclose a sensitivity analysis chart for each type of market risk considered significant by management, originated from financial instruments, to which the company is exposed at each year end, including all transactions with derivative financial instruments.

The ineffectiveness the periods ending on December 31, 2012 and 2011 was R\$2,188 and R\$1,263, respectively.

In compliance with the foregoing, each transaction with derivative financial instruments was assessed, taking into consideration a probable realization scenario and two scenarios that may generate adverse results to the Company.

In the probable scenario the assumption considered was to keep, on the maturity dates of each transaction, what the market has been showing through BM&FBovespa market curves (currency and interest). Thus, in the probable scenario, there is no impact on the fair value of derivative financial instruments already presented above. For scenarios II and III, pursuant to the CVM Rule, a deterioration of 25% and 50%, respectively, was considered in the risk variables.

As the Company and Vivo has only derivative instruments to hedge their assets and liabilities in foreign

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currency, the changes in scenarios are followed by the respective hedged items, thus indicating that the effects are virtually null. For these transactions, the Company disclosed the hedged item and derivative financial instrument balance in separated lines of the sensitivity analysis chart, in order to inform the net exposure of the Company and on consolidated, in the three aforementioned scenarios, as follows:

## Sensitivity analysis - net exposure

Transaction	Risk	Probable	25% Decrease	50% Decrease
Hedge (receivable)	Derivatives (Risk of USD devaluation)	1,131,174	1,422,210	1,716,672
Debt in USD	Debts (Risk of USD appreciation)	(1,131,414)	(1,422,510)	(1,717,033)
	Net exposure	(240)	(300)	(361)
Hedge (receivable)	Derivatives (Risk of EUR devaluation)	11,772	13,927	16,717
Accounts payable in EUR	Accounts payable in EUR (Risk of EUR appreciation)	(12,317)	(15,396)	(18,475)
	Net exposure	(545)	(1,469)	(1,758)
Hedge (receivable)	Derivatives (Risk of USD devaluation)	29,482	38,251	45,921
Accounts payable in USD	Debts (Risk of USD appreciation)	(34,904)	(43,630)	(52,356)
	Net exposure	(5,422)	(5,379)	(6,435)
Hedge (receivable)	Derivatives (Risk of IPCA devaluation)	96,249	91,755	92,200
Debt in IPCA	Debts (Risk of IPCA appreciation)	(96,249)	(91,755)	(92,200)
	Net exposure	-	-	-
Hedge (receivable)	Derivatives (Risk of USD devaluation)	480,151	653,045	799,457
Debt in UMBNDES	Debts (Risk of UMBNDES appreciation)	(477,105)	(647,908)	(793,157)
	Net exposure	3,046	5,137	6,300
Hedge (CDI - receivable)	Derivatives (Risk of CDI appreciation)	(1,553,915)	(1,552,622)	(1,606,484)
	Net exposure	(1,553,915)	(1,552,622)	(1,606,484)
Total net exposure in each scenario		(1,557,076)	(1,554,633)	(1,608,738)
Net effect on the variation of current fair value		-	2,443	(51,662)

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## Assumptions for analysis of sensitivity

Risk variable	Probable	25% Decrease	50% Decrease
USD	2.0435	2.5544	3.0653
EUR	2.6962	3.3702	4.0443
IPCA	5.84 %	7.30 %	8.76 %
CDI	6.90 %	8.63 %	10.35 %

To determine the net exposure of the sensibility analysis, all derivatives were considered at market value and only (hedged elements) classified under the accounting method were also considered at fair value.

The fair value shown in the table above is based on the status of the portfolio as of December 31, 2012, not reflecting an estimated realization in view of the market dynamics, always monitored by the Company. The use of different assumptions may significantly impact estimates.

## 37. Subsequent events

On January 10, 2013, the allocation of interim dividends was approved by the Board of Directors, amounting to R\$1,650,000, based on existing profits in the quarterly balance sheet as at September 30, 2012, to common and preferred shareholders who were registered in the Company's books at the end of the day January 21, 2013. The payment of these interim dividends began on February 18, 2013.