TELEFONOS DE MEXICO S A DE C V
Form 20-F
June 28, 2004
Table of Contents

As filed with the Securities and Exchange Commission on June 28, 2004.

SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

FORM 20-F

ANNUAL REPORT PURSUANT TO SECTION 13

OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 2003

Commission File Number: 1-10749

Teléfonos de México, S.A. de C.V.

(Exact name of registrant as specified in its charter)

Telephones of Mexico

(Translation of registrant s name into English)

United Mexican States

(Jurisdiction of incorporation or organization)

Parque Vía 190, Colonia Cuauhtémoc, 06599 México, D.F., México

(Address of principal executive offices)

SECURITIES REGISTERED PURSUANT TO SECTION 12(b) OF THE ACT:

Title of each class	Name of each exchange on which registered
American Depositary Shares, each representing 20 Series L Shares, without par value (L Share ADSs)	New York Stock Exchange
Series L Shares, without par value (L Shares)	New York Stock Exchange (for listing purposes only)

SECURITIES REGISTERED PURSUANT TO SECTION 12(g) OF THE ACT:

American Depositary Shares, each representing 20

Series A Shares, without par value (A Share ADSs)

Series A Shares, without par value (A Shares)

SECURITIES FOR WHICH THERE IS A REPORTING OBLIGATION PURSUANT TO SECTION 15(d) OF THE ACT: None

The number of outstanding shares of each class of capital or common stock as of December 31, 2003 was:

4,136 million	AA Shares
265 million	A Shares
7,708 million	L Shares

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days.

Yes x No ¨

Indicate by check mark which financial statement item the registrant has elected to follow.

Item 17 ¨ Item 18 x

TABLE OF CONTENTS

Table of Contents

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

SELECTED FINANCIAL DATA

The selected consolidated financial data set forth below have been derived from our audited consolidated financial statements for each of the five years in the period ended December 31, 2003, which have been reported on by Mancera, S.C., a member of Ernst & Young Global, independent public accountants. The selected consolidated financial data should be read in conjunction with, and are qualified in their entirety by reference to, our consolidated financial statements and notes thereto included elsewhere in this Annual Report.

Our consolidated financial statements have been prepared in accordance with generally accepted accounting principles in Mexico, or Mexican GAAP, which differ in certain respects from generally accepted accounting principles in the United States, or U.S. GAAP. Note 18 to our audited consolidated financial statements provides a description of the principal differences between Mexican GAAP and U.S. GAAP, as they relate to us; a reconciliation to U.S. GAAP of operating income, net income and total stockholders equity; and a condensed statement of cash flows under U.S. GAAP.

Pursuant to Mexican GAAP, in the consolidated financial statements and the selected consolidated financial data set forth below:

- nonmonetary assets (excluding plant, property and equipment of non-Mexican origin) and stockholders equity are restated for inflation based on the Mexican National Consumer Price Index;
- plant, property and equipment of non-Mexican origin are restated based on the rate of inflation in the country of origin and converted into Mexican pesos using the prevailing exchange rate at the balance sheet date;

gains and losses in purchasing power from holding monetary assets and liabilities are recognized in income; and

all financial statements are restated in constant pesos as of December 31, 2003.

We have not reversed the effect of inflation accounting under Mexican GAAP in the reconciliation to U.S. GAAP of our net income and stockholders equity, except with respect to the methodology for restatement of plant, property and equipment of non-Mexican origin. See Note 18 to the consolidated financial statements.

Table of Contents

	Year ended December 31,				
	2003	**2002**	**2001**	**2000**	**1999**
	(in millions of constant pesos as of December 31, 2003, except per share data)				
Income Statement Data:					
Mexican GAAP:					
Operating revenues	P. 116,848	P. 117,241	P. 121,864	P. 117,113	P. 106,478
Operating costs and expenses	77,309	76,079	75,053	71,556	63,909
Operating income	39,539	41,162	46,811	45,557	42,569
Income from continuing operations	22,450	20,347	25,822	28,683	26,063
Income from discontinued operations[1]				1,691	5,351
Net income	22,450	20,347	25,822	30,374	31,414
Income per share from continuing operations Basic[2]	1.803	1.567	1.907	1.955	1.727
Income per share from continuing operations Diluted[2]	1.754	1.539	1.789	1.850	1.686
Net income per share Basic[2]	1.803	1.567	1.907	2.070	2.082
Net income per share Diluted[2]	1.754	1.539	1.789	1.960	2.035
Dividends paid per share[2][3]	0.605	0.545	0.490	0.445	0.388
Weighted average number of shares outstanding (millions)[5]					
Basic	12,454	12,986	13,541	14,669	15,092
Diluted	13,101	13,677	14,221	15,345	15,326
U.S. GAAP:					
Operating revenues	P. 116,848	P. 117,241	P. 121,864	P. 117,113	P. 106,478
Operating costs and expenses	81,611	81,704	83,201	78,360	71,093
Operating income	35,237	35,537	38,663	38,753	35,385
Income from continuing operations	21,707	18,467	22,229	26,547	24,830
Income from discontinued operations[1]				1,431	4,476
Net income	21,707	18,467	22,229	27,978	29,306
Income per share from continuing operations Basic[2]	1.743	1.422	1.642	1.809	1.645
Income per share from continuing operations Diluted[2]	1.697	1.401	1.537	1.710	1.605
Net income per share Basic[2]	1.743	1.422	1.642	1.907	1.942
Net income per share Diluted[2]	1.697	1.401	1.537	1.804	1.898
Dividends paid per share[2][3]	0.605	0.545	0.490	0.445	0.388

(see footnotes on following page)

Table of Contents

	December 31,				
	2003	**2002**	**2001**	**2000**	**1999**
	(in millions of constant pesos as of December 31, 2003)				
Balance Sheet Data					
Mexican GAAP:					
Plant, property and equipment, net	P. 121,062	P. 127,406	P. 125,616	P. 122,016	P. 122,446
Total assets of continuing operations	185,762	175,510	172,456	180,015	170,778
Total assets of discontinued operations[1]					76,559
Total assets	185,762	175,510	172,456	180,015	247,337
Short-term debt and current portion of long-term debt	20,262	11,500	19,220	50,621	30,479
Long-term debt	48,416	57,266	57,431	34,763	30,631
Total stockholders equity[4]	79,649	63,598	55,791	56,741	152,901
Capital stock[4]	27,691	28,792	29,422	30,818	64,743
Number of outstanding shares (millions)[5]					
Series AA	4,136	4,136	4,307	3,266	4,326
Series A	265	289	313	339	369
Series L	7,708	8,352	8,545	10,405	10,254
U.S. GAAP:					
Plant, property and equipment, net	P. 126,753	P. 138,652	P. 148,614	P. 141,321	P. 143,733
Total assets of continuing operations	193,351	188,162	196,892	201,531	194,637
Total assets of discontinued operations[1]					77,337
Total assets	193,351	188,162	196,892	201,531	271,974
Short-term debt and current portion of long-term debt	20,262	11,500	19,220	50,621	30,479
Long-term debt	48,416	57,266	57,431	34,763	30,631
Total stockholders equity[4]	73,384	60,101	58,142	55,579	141,445
Capital stock[4]	27,691	28,792	29,422	30,818	64,743

(1) In 1999 and 2000, the businesses we spun off to América Móvil, S.A. de C.V., or América Móvil, in September 2000 are presented as discontinued operations. See *Item 4. Information on the Company Telmex History*.

(2) We have not presented net income or dividends on a per ADS basis. Each L Share ADS represents twenty L Shares, and each A Share ADS represents twenty A Shares.

(3) Nominal amounts. For information on dividends paid per share translated into U.S. dollars, see *Item 8. Financial Dividends.*

(4) The decrease in 2000 was due to the spin-off of América Móvil.

(5) All amounts have been adjusted to reflect a two-for-one stock split approved in February 2000.

Table of Contents

EXCHANGE RATES

Mexico has a free market for foreign exchange, and the Mexican government allows the peso to float freely against the U.S. dollar. After a volatile 1997 and 1998, the Mexican peso remained relatively stable through 1999, 2000 and most of 2001. In 2002, the peso declined significantly and continued to decline through 2003. The peso depreciated slightly in 2004 to date. There can be no assurance that the Mexican government will maintain its current policies with regard to the peso or that the peso will not further depreciate or appreciate significantly in the future.

The following table sets forth, for the periods indicated, the high, low, average and period-end noon buying rate in New York City for cable transfers in pesos published by the Federal Reserve Bank of New York, expressed in pesos per U.S. dollar. The rates have not been restated in constant currency units.

Period	High	Low	Average(1)	Period End
1999	P. 9.24	P. 10.60	P. 9.56	P. 9.48
2000	9.18	10.09	9.47	9.62
2001	8.95	9.97	9.33	9.16
2002	9.00	10.43	9.66	10.43
2003	10.11	11.41	10.79	11.24
2003:				
December	11.17	11.41	11.25	11.24
2004:				
January	10.81	11.10	10.92	11.01
February	10.91	11.25	11.03	11.06
March	10.92	11.23	11.02	11.18
April	11.16	11.43	11.27	11.40
May	11.38	11.64	11.52	11.41

(1) In the case of annual periods, average of month-end rates.

On June 23, 2004, the noon buying rate was P.11.35 to U.S.$1.00.

We will pay any cash dividends in pesos, and exchange rate fluctuations will affect the U.S. dollar amounts received by holders of ADSs on conversion by the depositary of cash dividends on the shares represented by such ADSs. Fluctuations in the exchange rate between the peso and the U.S. dollar have affected the U.S. dollar equivalent of the peso price of our shares on the Mexican Stock Exchange (*Bolsa Mexicana de Valores S.A. de C.V.*) and, as a result, have also affected the market price of the ADSs.

Table of Contents

RISK FACTORS

Risks Relating to Our Business Generally

Increasing Competition Could Adversely Affect Our Revenues and Profitability

Our results of operations have been affected by the opening of the Mexican market for long distance services to competition beginning in August 1996 and the availability of interconnection to our network beginning January 1, 1997. Competing carriers have won a share of the long distance market, and prices have fallen steadily as real rates have fallen and customer discounts have increased. The effects of increased competition have been particularly severe in international long distance service, where our revenues declined from 1996 through 1998, and again in 2000 through 2003. We believe that a factor in the decline in our international traffic volume has been an unauthorized practice referred to as illegal bypass, which occurs when an incoming international call is routed into Mexico through private circuits or other channels and then handled as a local or domestic long distance call. We estimate that illegal bypass represented a loss of revenues of approximately P.2,530 million in 2003. The practice is difficult to prevent and is likely to arise whenever there is a price advantage to be gained by competing carriers.

Competition in local service, principally from wireless service providers, has been developing since 1999. In December 2003, there were approximately 30.0 million cellular lines in service, compared with approximately 16.3 million fixed lines in service (15.7 million of which are part of our network). At present, 18 fixed-line local operators have been granted licenses, primarily in Mexico City, Guadalajara, Monterrey, Puebla and other large cities.

The effects of increased competition on our business are highly uncertain and will depend on a variety of factors, including Mexican economic conditions; regulatory developments, such as the lowering of interconnection fees; the behavior of our customers and competitors; and the effectiveness of measures we take.

Dominant Carrier Regulations and Other Regulatory Developments Could Hurt Our Business by Limiting Our Ability to Pursue Competitive and Profitable Strategies

Our business is subject to extensive regulation, and it can be adversely affected by changes in law, regulation or regulatory policy. The Mexican Competition Commission has determined that we are a dominant provider of certain telecommunications services, and Mexican law provides for the regulatory authorities to impose additional regulations on a dominant provider. In September 2000, the Mexican Federal Telecommunications Commission (*Comisión Federal de Telecomunicaciones,* or Cofetel) adopted regulations that apply specifically to us as a dominant carrier. In 2001, a Mexican federal court held that the determination that we are a dominant carrier was procedurally defective, but the Mexican Competition Commission promptly addressed the defect and issued a second resolution with the same findings. We, in turn, challenged the constitutional validity of the Mexican Competition Commission s second resolution. In May 2002, a Mexican federal court nullified several resolutions issued by the Mexican Competition Commission and Cofetel, including the September 2000 Cofetel resolution adopting the dominant carrier regulations. In April 2004, a Mexican federal court upheld our constitutional challenge of the Mexican Competition Commission s second dominant carrier resolution and declared the resolution invalid. We cannot predict whether the Mexican Competition Commission or Cofetel will issue new resolutions or regulations that are substantially similar to the prior dominant carrier provisions. We believe that if dominant carrier regulations are eventually implemented, the new rules and the related regulatory procedures will reduce our flexibility to adopt competitive tariff policies.

5

Table of Contents

In October 2001, the Mexican Congress announced the beginning of a process to reform the Federal Telecommunications Law (*Ley Federal de Telecomunicaciones*). We cannot predict whether or when such reform may be implemented and, if implemented, its effect on our business.

World Trade Organization Dispute Settlement Between the United States and Mexico Will Result in Changes in Regulation That May Affect Our Business

In August 2000, the United States initiated a World Trade Organization (WTO) dispute settlement against Mexico regarding alleged illegal barriers to competition in the Mexican telecommunications market. The United States claimed that Mexico had not complied with its WTO commitments, alleging in particular that (i) Mexico had not ensured that we provide international termination to U.S. telecommunications carriers at cost-based and reasonable rates, (ii) Mexico had failed to ensure that U.S. companies could route their calls into and out of Mexico over leased lines and (iii) Mexico s rules authorizing the Mexican carrier with the largest market share to negotiate rates on behalf of all Mexican carriers are anticompetitive. In April 2004, the WTO panel announced its decision, which was in substantial part adverse to Mexico. In June 2004, the United States and Mexico announced that they had mutually agreed to resolve the dispute. Under their agreement, Mexico will eliminate its uniform settlement rate system, its proportional return system and its requirement that the Mexican carrier with the greatest share of outgoing traffic to a particular country negotiate the settlement rate on behalf of all Mexican carriers for that country. Mexico also agreed to introduce new regulations authorizing the resale of international long-distance, public, switched telecommunications services. In addition, the United States recognized that Mexico will continue to restrict international simple resale, or the use of leased lines to carry cross-border calls. We expect that the required changes in regulation will likely affect our business and competition in the future, although we cannot predict yet the impact on the results of our operations and revenues.

Shifting Usage Patterns Could Adversely Affect Our Revenues

Our fixed-line network services face increasing competition due to shifting usage patterns resulting from the adoption of popular new technologies, including wireless devices for voice and other communications, and the subsequent substitution of these technologies for fixed-line phones. For example, we estimate that an increasing proportion of calls that previously would have been made over our fixed network are now being made on wireless telephones outside our network. There can be no assurance that this process will not adversely affect our traffic volume and our results of operations.

We have invested in countries in which we have limited experience, and we may be unsuccessful in addressing the new challenges and risks they present

We have invested in a growing number of telecommunications businesses outside our historical core activity of providing fixed-line telecommunications services in Mexico, and we plan to continue to do so in the rest of Latin America. These investments have been made in some countries in which we have little experience and may involve risks to which we have not previously been exposed. Some of the investments are in countries that may present different or greater risks than Mexico, such as Argentina, Brazil, Chile, Colombia and Peru. We cannot assure you that these investments will be successful.

Table of Contents

We Have Agreed to Buy MCI s Interest in Embratel, But There Are Conditions to Be Met Before We Can Complete the Purchase

In March 2004, we entered into an agreement with MCI, Inc., or MCI (successor by merger to WorldCom, Inc.), and certain of its subsidiaries to purchase their entire indirect interest in Embratel Participações S.A., or Embratel, a leading Brazilian telecommunications provider of long distance and data services. This agreement is subject to conditions precedent, including the receipt of required regulatory approvals in Brazil and other customary conditions precedent. Under certain circumstances, if the agreement is terminated without our having received required regulatory approvals, MCI would be entitled to retain up to U.S.$50 million in deposits made by us. We cannot assure you that these approvals will be obtained or that the transaction will close as contemplated.

Risks Relating to Our Controlling Shareholder and Capital Structure

We Are Controlled by One Shareholder

A majority of the voting shares of our company (70.5% as of June 16, 2004) is owned by Carso Global Telecom, S.A. de C.V., or Carso Global Telecom, which is controlled by Carlos Slim Helú and members of his immediate family. Carso Global Telecom has the effective power to designate a majority of the members of our Board of Directors and to determine the outcome of other actions requiring a vote of the shareholders, except in very limited cases that require a vote of the holders of L Shares.

The Protections Afforded to Minority Shareholders in Mexico Are Different from Those in the United States

Under Mexican law, the protections afforded to minority shareholders are different from those in the United States. In particular, the law concerning fiduciary duties of directors is not well developed, there is no procedure for class actions or shareholder derivative actions and there are different procedural requirements for bringing shareholder lawsuits. As a result, in practice it may be more difficult for minority shareholders of Telmex to enforce their rights against us or our directors or controlling shareholder than it would be for shareholders of a U.S. company.

We Engage in Transactions with Affiliates That May Create the Potential for Conflicts of Interest

We engage in transactions with certain subsidiaries of Grupo Carso, S.A. de C.V., or Grupo Carso, and Grupo Financiero Inbursa, S.A. de C.V., or Grupo Financiero Inbursa, both of which are under common control with Carso Global Telecom. Transactions with subsidiaries of Grupo Carso include the purchase of network construction services and materials, and transactions with Grupo Financiero Inbursa include banking services and insurance. We also have ongoing operational relationships with América Móvil, which is controlled by América Telecom, S.A. de C.V., or América Telecom. América Telecom, like Carso Global Telecom, Grupo Carso and Grupo Financiero Inbursa, is controlled by Carlos Slim Helú and members of his immediate family.

We also make investments jointly with our affiliates, sell our investments to our affiliates and buy investments from affiliates. Recent investment transactions with our affiliates include our investment in the equity securities of MCI (of which we hold approximately 8.1% of the outstanding shares of common stock and others who may be deemed to be under common control with us hold approximately 5.7% of the outstanding shares of common stock), our acquisition of América Móvil s stake in Techtel-LMDS Comunicaciones Interactivas, S.A. and an investment in Telvista, Inc.

Table of Contents

Our transactions with affiliates may create the potential for conflicts of interest.

Holders of L Shares and L Share ADSs Have Limited Voting Rights

Our bylaws provide that holders of L Shares are not permitted to vote except on such limited matters as the transformation or merger of Telmex or the cancellation of registration of the L Shares with the Mexican National Banking and Securities Commission or any stock exchange on which they are listed. If you hold L Shares or L Share ADSs, you will not be able to vote on most matters, including the declaration of dividends, that are subject to a shareholder vote in accordance with our bylaws.

Holders of ADSs Are Not Entitled to Attend Shareholders Meetings, and They May Only Vote Through the Depositary

Under Mexican law, a shareholder is required to deposit its shares with a Mexican custodian in order to attend a shareholders meeting. A holder of ADSs will not be able to meet this requirement, and accordingly is not entitled to attend shareholders meetings. A holder of ADSs is entitled to instruct the depositary as to how to vote the shares represented by ADSs, in accordance with procedures provided for in the deposit agreements, but a holder of ADSs will not be able to vote its shares directly at a shareholders meeting or to appoint a proxy to do so.

You May Not Be Entitled to Participate in Future Preemptive Rights Offerings

Under Mexican law, if we issue new shares for cash as part of a capital increase, we generally must grant our shareholders the right to purchase a sufficient number of shares to maintain their existing ownership percentage in Telmex. Right