

Pirelli's Investment in Telecom Italia (2001 to 2007)

1. COMPANY MANAGEMENT, INVESTMENTS AND STRATEGIES

Summer 2001: Pirelli enters Telecom Italia via Olimpia

In the Summer of 2001, the Pirelli group, together with the Benetton family and two Italian banks (Intesa and Unicredito), acquired through the company Olimpia a 27% stake in Olivetti for a total of about 7.2 billion euros.

Olivetti was the controlling shareholder of Telecom Italia, with a stake of about 55% of the ordinary share capital. The purchase price (4.175 euros per Olivetti share) corresponded to an Enterprise Value of Telecom Italia 8.15 times the Ebitda forecast for year end, in line with the multiples of companies in the sector. The value attributed to the Olivetti shares, corresponding to a see-through premium of 48% on Telecom Italia shares (as confirmed by analyst reports and by fairness opinions by Lazard and Merrill Lynch), was linked to the controlling stake held by Olivetti in Telecom Italia.

In September 2001, following the terrorist attack in the US, with the stock market crisis (in particular in the telecoms sector), multiples in the sector fell to about 6.8.

The situation at Telecom Italia before the change of management

When the management team led by Marco Tronchetti Provera took over, the Olivetti-Telecom Group had net debt of 43 billion euros (on 30 September 2001) and a three-level corporate structure composed of Olivetti, Telecom Italia and TIM.

New management: "balance sheet cleanup"

Consequently, starting from the last quarter of 2001, the new management of the company began a "balance sheet cleanup" writing down some overvalued assets by about 3.4 billion euros. Overall, between 2001 and 2004, Telecom Italia wrote down assets for about 11.8 billion euros.

Reducing the debt

From the acquisition of the Olivetti-Telecom stake by Olimpia to the end of 2004, the Olivetti-Telecom group's net debt improved significantly, falling from about 43 billion euros (on 30 September 2001) to 29.5 billion euros (on 31 December 2004), partly thanks to the sale of non-strategic assets for 11.3 billion euros.

Following the Telecom-Tim merger, the company's debt amounted to 46.7 billion euros, which at the end of December 2006 had been reduced to 37.3 billion euros, a level in any case lower than that of September 2001. At the end of 2006, the ratio between net debt and EBITDA at Telecom Italia was below 3 (it stood at about 2.9) and essentially in line with that of Telefonica (2.8). The debt target for 2007 indicated during Pirelli management was 33.5 billion euros.

In recent years, in addition, Telecom Italia worked on consolidating its debt, which at the end of 2006 was 70% fixed rate. On this subject, on 18 February 2008 the current CEO of Telecom Italia, Franco Bernabè, said "excellent work has been done on (debt) consolidation, making us feel at ease even in the difficult conditions that have characterized the markets in recent months."

Sale of non-core assets and international development

From the end of 2001 Telecom Italia began to sell non-strategic international holdings, mainly minority stakes and holdings that did not allow the company to have a say in management, in Europe and Latin America, to focus on its international presence in mobile communications in Brazil and in broadband in Europe.

Under Pirelli management, in addition, there were writedowns of international assets for about 6 billion euros. That was because many of the holdings abroad, purchased between 1999 and 2001 for a total of 8.5 billion euros, were paid for at prices common during the stock market bubble.

Brazil: strong customer growth in mobile (from 5.3 million in 2002 to 25.4 million in 2006)

TIM Brasil grew from 5.3 million customers in 2002 to 25.4 million at the end of 2006 (up 26% compared with 2005), with market share of 25.4%. The company is currently market leader as GSM operator with 23.1 million lines at the end of 2006. At the end of 2006, TIM Brasil generated revenue of 3.96 billion euros, nearly four times the 1.03 billion euros of 2002.

Growth of broadband in Italy and in Europe

In its Italian broadband businesses, Telecom Italia grew from 390,000 lines in 2001 to 6.7 million lines at the end of 2006. As for its "European Broadband Project", Telecom Italia grew from 160,000 customers in December 2003 in the Netherlands, France and Germany, to 1.9 million customers at the end of 2006. Revenues from European assets stood at 915 million euros at the end of 2006.

International activities 2001-2006: customer, revenues and margin growth

In terms of revenues, the international activities of Telecom Italia grew from 3,681 million euros in 2001 (11.9% of the total) to 5,072 million euros in 2006 (16.2% of the total).

EBITDA of international activities rose from 932 million euros (6.8% of the total) to 1,114 million euros (8.7% of the total). Under Pirelli management, a call option on Telecom Argentina was negotiated which, if exercised (late 2008), will allow the Telecom Italia Group to raise the weight of its international businesses on total revenues to 31% in 2009, and on total Ebitda to 24%.

Non-Italian mobile lines of the Group increased from 30.7 million in 2001 (56% of the total) to 36.4 million at the end of 2006 (53% of the total), with more than 18% growth. In the same period, broadband customers in Europe grew from 0 to 1.9 million (about 22% of the company's total broadband customers).

2001-2005: more than 17% of revenue earmarked for investments

From September 2001 to the end of 2006, Telecom Italia invested more than 20 billion euros, 70% of which in innovation. An analysis of the data of the main European operators (former monopolies) between 2001 and 2005, shows that Telecom Italia was the operator that dedicated the largest share of revenue (more than 17%) to investments, thanks to its high profitability (EBITDA margin, or the incidence of the gross operating margin on revenues, amounting to 41.1% at the end of 2006).

Thanks to these investments, the network of Telecom Italia, as emphasized in a November 2004 report by Morgan Stanley, was one of the most advanced in Europe in terms of technology and efficiency. In terms of productivity, Telecom Italia was the European telecoms operator with the highest revenue per employee in 2005 (345,000 euros).

Simplifying corporate structure, industrial synergies

Between 2003 and 2005, through the Olivetti-Telecom Italia and TIM-Telecom Italia mergers, the chain of control was shortened.

Those transactions, in which Olimpia invested in order not to dilute its stake, were conceived mainly with the aim of allowing the Telecom Italia Group to obtain significant benefits of a financial and industrial nature: bringing closer together debt and cashflow, and greater integration between fixed and mobile platforms in order to create Europe's first "quadruple play" platform (fixed, mobile, Internet, IPTV).

This latter was a goal shared by large international groups such as Microsoft, Google and Yahoo.

The plan for shortening the chain of control of Telecom Italia put into action by Marco Tronchetti Provera allowed for returning to the market, net of dividends, the amount of 22 billion euros (repurchase of minority stakes in Olivetti and TIM respectively for 8 and 14 billion euros).

Corporate governance: Telecom Italia and domestic and international best practices

Under Pirelli management, Telecom Italia set up a system of corporate governance in line with international best practices.

This was a continuous journey, which had as an important step the adoption of a majority of independent board members starting from the Board of Directors which took office in 2004.

Among its systems of governance, starting from 2004 the company adopted a highly modern practice regarding transactions with interested third parties on the basis of which independent directors of Telecom Italia, on every occasion, investigate and verify further with respect to evaluations done by the Board of Directors, which is called to approve all such transactions.

These activities are done through the internal audit and corporate governance committee (composed only of independent directors) or external consultants identified by the same independent board members. This mode of operating was adopted during the TIM-Telecom merger for evaluation of the share swap ratio, and later re-proposed at the time of restructuring of the Internet division.

Finally, in the case of the most significant transactions with related parties (such as real estate sales to companies Pirelli RE owns minority stakes in), the Board of Directors conferred a mandate to the internal audit and corporate governance committee for evaluating procedures to follow in order to guarantee correctness of the process.

2. GROWTH STRATEGIES AND THE FAILED NEGOTIATIONS WITH MURDOCH, TELEFONICA AND AT&T

Summer 2006: the regulatory framework and the "media&broadband" plan

Between Spring and Summer of 2006, the regulatory framework shifted for Telecom and TIM, requiring a more dynamic approach to allow longer-term value creation. The first real industrial result of the Telecom-TIM merger was the launch of "Unico", the first fixed-mobile convergent telephone, scheduled for July 2006.

Telecom Italia had forecast sales of 1 million pieces by the end of 2008. The commercial launch of Unico never happened, however, due to the suspension decided in June by the Council of the Italian telecoms authority, which as an alternative allowed experimental use of 30,000 handsets for a period of six months. Previously the Authority had also suspended other particularly innovative ADSL (fast Internet) offers.

All this despite the fact that in July, in the Authority's annual report, it recognized that *"in telecommunications... Italy has been indicated in Europe as a country of excellence in the promotion of services with innovative technology content. The European Commission, in its latest report on the state of electronic telecommunications in Europe, emphasizes the leading role of Italy in mobile telephony and unbundling.... In broadband we were among the last. Today Italy, though starting from a backward position, is growing at an incremental rate (187% in two years) significantly higher than that of the Europe of 15."*

Faced with this regulatory framework, and in the light of the need to focus the Telecom Italia Group more closely on the business of broadband and media services in Italy and the rest of Europe, the management asked the Board on 11 September 2006 to approve a reorganization plan that called for separation of fixed, mobile and network access businesses.

The new plan essentially had two objectives: to increase focus and effectiveness of commercial offers, in particular in broadband and content; 1) to lessen anomalous regulatory, political and competitors' pressure on the network, separating access; 2) to demonstrate to Murdoch that the Group could not be conditioned by politics in its strategic decisions and that, if necessary, the Group could have freed up resources for an acceleration of investments of broad technological and industrial significance.

Strategies: talks with NewsCorp and Telefonica

From the point of view of favoring development of the company in the content distribution business through broadband, in Spring 2006 Telecom Italia began negotiations with Rupert Murdoch's News Corporation.

The aim of the talks was to reach an agreement that would have allowed Telecom Italia to transmit over its broadband network the content produced by NewsCorp Group companies.

Contacts between the two companies were interrupted in September (on 20 September Corriere della Sera reported Murdoch's considerations with Wall Street analysts, partly with reference to the Telecom matter: "Too much politics, I must find partners for Sky Italia").

The agreement with Murdoch could have been extended to another large telecommunications group to aggregate more than 300 million customers with, becoming the only large media and telecommunications group able to compete with Microsoft, Google and Yahoo.

Halfway through that same month, Marco Tronchetti Provera resigned as chairman of Telecom Italia. In the following months, on the back of consolidated contacts Telecom Italia had with Telefonica, Marco Tronchetti Provera, as chairman of Pirelli, started negotiations with the same Telefonica for the Spanish company to enter Olimpia with a minority stake. In parallel, Telecom Italia began an analysis of industrial synergies with Telefonica.

The aim was to consolidate an industrial partnership between the two groups, with a potential for cost-cutting synergies and further international development. The talks, announced on 11 February 2007, were accompanied by a strong political and media debate on the subject of the "Italian-ness" of Telecom Italia, even though Pirelli had ensured that a majority stake in Olimpia would remain in Italian hands.

On 1 March 2007, during a conference call with analysts, Telefonica Chairman Cesar Alierta announced suspension of the talks since "the circumstances make it difficult (for us) to proceed". A few weeks later, the lead independent director of Telecom Italia, Guido Ferrarini, on behalf of the independent directors, wrote a letter to Chairman Guido Rossi to complain of a lack of transparency by the management regarding the strategic plan for the company and, in particular, the talks with Telefonica.

Pirelli's decision to fully exit Olimpia: talks with AT&T and America Movil

Following the failure of talks with Telefonica, in consideration of the stalled situation, on 12 March 2007 the Board of Directors of Pirelli & C. SpA gave a mandate to the Chairman, Marco Tronchetti Provera, to explore all possible options with regard to Olimpia, not excluding sale of the stake, in order to bring out the best value from the asset in the interest of all shareholders.

On 1 April, Pirelli and Sintonia (Benetton) communicated to the market that they had begun negotiations with important international operators of the caliber of AT&T and America Movil for sale of 66% of Olimpia. The news provoked various negative reactions, despite friendly

statements by the management of the American companies and the existing right of first refusal held by Mediobanca and Generali.

Some politicians called for Telecom's licenses to be revoked (even though there is no license), while others called for nationalization of the network. Thus, two weeks after the start of talks, AT&T decided to withdraw its offer "due to possible regulatory difficulties".

The American ambassador in Rome, Ronald Spogli, criticized the state intervention in the economy that characterizes Italy, compromising American investments to the advantage of other European countries such as Germany, France and Spain. Only the offer of America Movil remained.

28 April 2007: agreement with Telco partners

After the failure of the talks with AT&T and America Movil, an Italian pool of investors, strengthened by a partnership with an international operator, intervened. On 28 April 2007, in fact, Pirelli and Sintonia reached an agreement with a group of major Italian financial investors (Intesa, Mediobanca, Generali and Sintonia) and Telefonica for sale of 100% of Olimpia.

Telefonica thus reappeared as a significant investor in the new shareholding structure of Telecom Italia (with a see-through value stake of about 10%), this time without provoking any political opposition. The agreement, signed on 4 May, was closed on 25 October 2007.

3. OLIMPIA AND PIRELLI INVESTMENTS IN TELECOM ITALIA AND THE FALSE MYTH ABOUT DIVIDENDS

Commentators have frequently held that Pirelli and Olimpia "squeezed" Telecom Italia through dividends to pay their own debts, sacrificing investments to modernize the company. But a review of the numbers shows that Olimpia and its shareholders (in particular Pirelli and Benetton) made significant investments in Telecom Italia with their own resources. In addition, thanks to the structural simplification put forward under Pirelli management, minority shareholders received about 22 billion euros in addition to dividends.

Pirelli and Olimpia investments in the Olivetti-Telecom transaction and the 22 billion euros returned to the market

The acquisition of the stake in Olivetti-Telecom was financed with a mix of liquidity and debt. The initial capital of shareholders amounted to about 5.2 billion euros. A few months after the Olivetti-Telecom purchase, Olimpia held a capital increase and a bond issue in Olivetti, contributing about 1 billion euros with own resources (the total capital increase was for about 4 billion euros, half in shares and half in convertible instruments).

The goal was to strengthen the financial structure of Olivetti. Investments continued in the 2003-2005 period, when Marco Tronchetti Provera decided to start shortening the chain above Telecom Italia. With two capital increases for a total of 2.8 billion euros, Olimpia contributed in a determining way to the Olivetti-Telecom and Telecom-TIM mergers. Hopa entered Olimpia in 2003 with a contribution of 961 million euros.

As is known, the Olivetti-Telecom and Telecom-TIM mergers allowed for simplification of the shareholding structure of Telecom Italia, bringing cashflow closer to debt, improving financial management, and favoring convergence of fixed and mobile platforms. But there was also a financial benefit for all shareholders, to whom 22 billion euros were "returned", from the purchase of Olivetti minority shares (8 billion euros) and TIM minority shares (14 billion euros).

The total investment of Olimpia shareholders amounted to about 9 billion euros, 6.5 billion euros of which were invested by the Pirelli Group. In detail, Pirelli invested: 3,120 million euros to subscribe to initial capital of Olimpia (2001), 388 million euros to subscribe the capital

increase of Olimpia in support of the Olivetti-Telecom merger (2003), 1,344 million euros to subscribe the capital increase of Olimpia in support of the Telecom-TIM merger (2005), 497 million euros for the repurchase of the Hope stake in Olimpia (2006) and 1,170 million euros for the repurchase of the Banca Intesa and Unicredito stakes in Olimpia (2006).

Throughout the entire period of indirect investment in Olimpia, Pirelli never received a dividend from Olimpia.

Olimpia and the dividend policy of Telecom Italia

Regarding the subject of dividends, it is important to recall that Olimpia, which held 12.4% of the total corporate capital of Telecom Italia (made up of ordinary and savings shares), benefited in a marginal way compared with all the other shareholders.

The dividend policy of Telecom Italia during Pirelli management, as announced many times by management, was not conceived in order to favor the interest of a single shareholder. On the contrary, like its peers in the telecommunications industry (such as Deutsche Telekom, which in 2006 had the highest payout ratio among European carriers) Telecom Italia responded to the wishes of the market, which considered the dividend one of the major attractions in an industry which in recent years had been particularly penalized by stock market trading.

Olimpia, over the years, progressively improved its ordinary accounting management, which became positive starting from 2004. Olimpia's financial equilibrium did not depend on Telecom Italia maintaining a high payout. Starting from 2006, in fact, Olimpia could have obtained a positive result from ordinary business even with a 50% cut in Telecom Italia's payout. And starting from the same year, theoretically, Olimpia would have been able to go without any Telecom Italia dividend for about five years (until 2010) without violating the covenants on its credit lines. The company's equity situation was such that its gearing was never higher than 1. In the theoretical case that Telecom Italia stopped distributing dividends starting from 2006, that ceiling would have been surpassed only in 2009.

Table 1: Olimpia and Telecom Italia dividends

in millions of euros

	Ord+extrd result	Net interest	dividends	writedowns	Net result	net financial position	Net result before writedowns	Net result before writedowns div 50%
2001	(0.9)	(30.5)			(31.4)	3,509.0	(31.4)	(31.4)
2002	(4.3)	(173.0)		(68.4)	(245.7)	3,675.8	(177.3)	(177.3)
2003	(11.5)	(174.7)		(143.4)	(329.6)	3,277.8	(186.2)	(186.2)
2004	(2.0)	(164.8)	182.4		15.6	3,251.1	15.6	(75.6)
2005	(1.0)	(168.0)	263.1	(1,191.0)	(1,096.9)	3,164.3	94.1	(37.5)
2006	(1.4)	(140.9)	337.0	(3,131.4)	(2,936.7)	2,870.7	194.7	26.2
2007 (to 25/10)	(0.9)	(102.1)	337.0		234.0	2,696.8	234.0	65.5

Debt covenants foresaw:

for €2.4 bn line	NFP not greater than € 4 bn
for € 0.6 bn line	NFP not greater than € 6 bn
for €0.3 bn line	NFP not greater than € 6 bn

Value of TI at which Olimpia given as guarantee for all TI shares was about 1.3

Table 2: hypothesis of net debt and equity from 2006, without Telecom Italia dividend (interest basis 2006+5%)

	Ord+extrd result	Net interest	net financial position	Net equity	gearing
2006	(1.4)	(140.9)	3,207.7	3,969.0	0.81
2007	(1.4)	(147.9)	3,357.0	3,819.7	0.88
2008	(1.4)	(155.3)	3,513.8	3,662.9	0.96
2009	(1.4)	(163.1)	3,678.3	3,498.4	1.05
2010	(1.4)	(171.3)	3,851.0	3,325.7	1.16
2011	(1.4)	(179.8)	4,032.2	3,144.5	1.28
2012	(1.4)	(188.8)	4,222.4	2,954.3	1.43

Olimpia debt: from 3.6 billion in 2002 to 2.87 in 2006

The net financial position of the Company decreased, over the years, from about 3.6 billion euros in 2002 to about 2.87 billion euros at the end of 2006. At the time it was sold, the company had debt of less than 2.7 billion euros and medium term credit lines that were unutilized for about 400 million euros. The maturity of the debt was between 2010 and 2012; about 70% of the debt was covered at fixed rate (average cost about 4.5%).