

Pirelli & C. S.p.A. Milan

Annual Report 2006
Sustainability Abstract

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Chairman's letter

To the shareholders,

2006 was a particularly demanding year for the Pirelli & C. Group which dealt not only with the complexity of normal business operations but had to confront important challenges on the financial front.

From the standpoint of operations, the Group continued on the path of growth begun in the last few years thanks to the good performance of all its activities, especially the Tyres and Real Estate sectors. In fact, the consolidated figures show that revenues grew by 6.5 percent to nearly Euros 5 billion, with a gross operating margin of 8.2 percent, and operating income exceeded the threshold of Euros 400 million, recording double-digit growth (+13.1 percent).

These results confirm the excellent state of the health of the Group's activities and the validity of our strategy of focusing on sectors with greater value-added and with a higher technological content.

During the course of 2006, besides, the Group further expanded its presence worldwide in the wake of a tradition that spans a century in which Pirelli is a protagonist of the competition in the major international markets. As regards industrial activities, in particular, Pirelli Tyre commenced the production of high-performance tyres in Romania, inaugurated a new truck tyre production facility in Brazil and consolidated its presence in China, where in the next few months the current truck tyre factory will be joined by a new car tyre plant. But 2006 was also the year of the internationalization of Pirelli Real Estate, a protagonist in important deals in Poland and especially in Germany where it concluded the agreement for the acquisition of DGAG, one of the foremost real estate companies in the country with its main offices in Hamburg and Kiel.

On the financial front, the first part of the year was the focus of the project for the listing of Pirelli Tyre on the stock market. The objective of this operation was the further development of the company, which its launch on the market would have been an optimal way for its intrinsic value to emerge. However, the difficult market conditions and, above all, the sharp drop in the market prices of the major operators of the sector during the final stages of the process led us to choose to withdraw the offering last June 30. But the idea of listing Pirelli Tyre on the stock market was not abandoned. At the beginning of August, in fact, we signed an agreement with a syndicate of leading financial institutions for a private placement of 38.9 percent of the company, finalized with a view to a successive Initial Public Offering.

Again on the financial side, we began a plan to dispose of non-strategic investments with the aim of focusing still further on the core businesses of the Group. With regard to Olimpia, Pirelli increased its investment in 2006, raising it from 57.66 percent to 80 percent following the purchase of the stakes held by Hopa, Banca Intesa and UniCredit at the end of pre-existing shareholders' agreements. Nevertheless, the market performance of Telecom Italia shares, below the expectations of Pirelli's management, and the reduction in the target price by analysts led to a decline in the market value of that investment. As a consequence, at the board of directors' meeting, we decided to adjust the carrying amount.

The amount of the adjustment in the consolidated financial statements was equal to Euros 2,110 million and corresponds to the value assigned to Olimpia's asset (the Telecom Italia shares) of Euros 3 per share versus the previous value of about Euros 4 per



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share. This transaction had an impact on the net result of Pirelli which, despite its good operating performance reported a loss of Euros 1,048.8 million on consolidation and will not allow the company to pay out dividends for the year 2006. The adjustment of the value of the Telecom Italia investment in Olimpia, however, had no repercussions on the soundness of the equity and financial position of our company which, at the end of 2006, reported consolidated equity of Euros 4,686.6 million and net financial debt of Euros 1,979.6 million, a figure in line with the forecasts announced to the market.

As for Olimpia, finally, the Pirelli board of directors' meeting last March 12 vested me with the power to explore all possible options, not excluding that of its total disposal, to achieve the best strategic valuation of the asset in the interests of all the stakeholders. Moving on to the individual businesses, in tyres, Pirelli Tyre recorded an increase in sales of nearly 9 percent and a growth in operating income compared to 2005, despite higher raw material costs which hurt the tyre industry throughout the world. In an economic scenario that was not favorable, the company managed to grow more than the average of the market thanks to efficiencies and, above all, to the product mix, the outgrowth of its positioning in the high range of the segments. The performance of the Consumer market (cars and motorcycle), in particular, was excellent: strong gains were recorded in both sales and operating income. Demand was particularly positive in Europe and in North America (even though the market in that area was negative), confirming Pirelli's leadership in the high-performance, ultra-high-performance and Winter segments. In the Industrial market, in spite of a general rise in demand which had a positive effect on sales, operating income is lower than in 2005 owing to the peak reached in the price of natural rubber, the main raw material cost item of the sector. As for Pirelli's international presence, the start of the new truck plant at Gravatai (Brazil) allowed the company to complete its investment program in the Industrial segment with additional production capacity and a better competitive position. In the second half of the year, moreover, the new car tyre production facility came on line at Slatina (Romania) and once fully operational will be able to manufacture each year 4.5 million high-performance tyres slated for the European market and employ about 1,000 people. The overall investment totals Euros 170 million and makes it possible to bring into being, together with the steelcord factory inaugurated in 2005, one of the most important industrial hubs of the company in the world. In real estate, Pirelli Real Estate recorded double-digit growth in the main economic indicators, in particular, in operating income including the earnings of investment holdings (+15 percent) which reached the top range in the three year 2006-2008 business plan (CAGR 10-15 percent). During 2006, the company consolidated its leadership position in Italy and, with Pirelli Pekao Real Estate in Poland and DGAG in Germany, accelerated the expansion process in Central-East Europe. Asset management reached Euros 14.5 billion (14 percent of which is outside Italy), with a growth of 12 percent compared to 2005. In March 2007, moreover, Pirelli Real Estate was awarded the management of the first private fund seeded by state-owned properties managed by the Sicily Region. The acquisition of Ingest Facility from the Fiat Group followed in the same month; this company has become the leader in the facility management sector in Italy and is now branching out to create a European pole. As for the start-ups, Pirelli Broadband Solutions reported a 15.3 percent gain in sales, linked in part to a significant contribution by second-generation photonics, and achieved breakeven at the

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operating level for the time since it was set up. After having consolidated the top position on the market in Italy, the company has commenced the internationalization process, marketing its solutions in Europe for broadband access (specifically residential gateway accesses and dual-mode telephones) and higher-margin photonics products (components and optical modules for improving the performance and the flexibility of telecommunications networks). Pirelli Ambiente, too, active in the sectors of the environment and sustainable development, reached an operating breakeven and confirmed the growth trend in sales (+12.2 percent). In 2006, moreover, the company signed the lease contract for land in the Romanian county of Gorj on which a production facility will be built for anti-particulate filters for diesel vehicles destined for the original equipment market in Europe.

The growth of the results of the start-ups is also the outcome of synergies with Pirelli Labs, the center of technological excellence of the Group. In 2006, Pirelli Labs continued its research activities on innovative materials and on optical technologies for telecommunications, sectors in which it has also sealed two new partnerships with the ENEA and the CNR Istituto sull'Inquinamento Atmosferico research centers. Besides collaborating with all the businesses of the Group, Pirelli Labs has also gone forward on the joint research projects with important national and international centers such as Politecnico di Milano University, Georgia Tech and the Alberta Research Council.

Pirelli's commitment on the front of innovation is also confirmed by the latest figures of the World Organization of Intellectual Property Organization (Wipo), according to which in 2006 our company is in the top three in Italy for international patent filings.

For 2007, the strategy of focusing on segments with higher value-added and the good performance of the core businesses allow us to forecast a further improvement in results. This path on the road to growth will thus continue thanks to the quality and the values which have always been the trademark of the Pirelli Group and its persons; orientation towards results, ability to innovate and compete on international markets, allegiance, correctness and transparency.

Loyalty to values, in fact, has always been the inspiration behind all of the Group's actions and this leads us to dedicate a section to the Sustainability Report. Now in its second edition, the report aims to be the full expression of the company culture founded on the integration of economic choices with environmental and social ones, representing an indication of priorities and, at the same time, an encouragement to work for the satisfaction of all the stakeholders.

It is to them that we wish to offer a description that is the most exact possible of the activities of the Group, also from this particular point of view. The promotion of a sustainable industrial growth is increasingly appreciated by the financial markets and the rating agencies and the whole of public opinion as an important element in the evaluation of corporations, as a premise for healthy and long-lasting growth.

On January 23, 2007, Leopoldo Pirelli, Honorary Chairmen of the company passed away. The memory full of respect and affection is not only mine and that of family and friends alike but of all those who have, as Pirellians, lived the entrepreneurial adventure of the company from the postwar period until today.

Relations with the financial community are maintained through the organisation of meetings or conference calls (over 200 in 2006) to present the company's periodic economic & financial results and the related strategies for development.

One of the methods for disseminating information that deserves special mention is Pirelli's website. From the website's home page visitors can access the investor relations area, which contains all documents distributed at meetings with the financial community, documents containing published economic and financial information about the company, and all other documents relating to the company's corporate governance system.

A further indication of the importance that Pirelli accords the market is the fact that both the Group parent company, Pirelli & C. S.p.A., and its subsidiary, Pirelli & C. Real Estate S.p.A. (also listed on the electronic trading system organised and managed by the Italian stock exchange), have prepared an innovative information tool exclusively for retail investors: the Shareholders' Manual. This document is the end product of company experience based on international best practices, and it may be downloaded from the Pirelli website.

2.3. CUSTOMERS

TYPE OF GROUP CUSTOMERS

The types of customer served by Pirelli Group differ greatly from one business area to the next.

The tyre sector serves the following categories of customer:

- » Original Equipment, which includes the leading international makers of cars, motorcycles, scooters, commercial vehicles (light, medium and heavy), buses and agricultural machinery.
- » Replacements, a group which includes around fifteen distribution channels (for car, truck and motorcycle tyres), and whose importance differs from country to country.

In the real estate sector we have:

- » Asset & Fund Management, whose customers consist of funds and property-owning companies in which Pirelli & C Real Estate generally has qualified minority shareholdings.
- » Service companies, whose customers include, in addition to third parties, funds and property-owning companies and non-performing loans managed by the Asset Management departments of Pirelli & C Real Estate.
- » The Franchising Network, made up of affiliate agencies distributed throughout Italy.

Customers of Pirelli Broadband Solutions can be divided into the following categories for the broadband access and photonics business areas:

Broadband Access (BBA) products:

- » VARs (Value Added Resellers)
- » System Integrators
- » Telecom Operators

New-generation photonics products from the photonic business area:

- » Operators/System Integrators (CWDM systems)
- » Equipment Manufacturers (components and modules)

The companies under Pirelli Ambiente have the following categories of customer:

- » Customers in the Renewable Energy sector, i.e. companies that convert urban solid waste to energy.
- » Customers in the Site Remediation sector, i.e. companies – mainly in the Group and other closely-related companies – that assess, plan and manage the demolition and decontamination of buildings and/or lands.
- » Customers of Pirelli Ambiente Eco Technology, i.e. companies that operate in public transport, goods transport, waste collection, the mining sector and in construction. Pirelli Ambiente Eco Technology also operates through partners that are licensees of its Gecam™ technology and which operate independently in Italy. In addition to receiving royalties on its licensees' sales, the company also (indirectly) performs the technical and marketing activities associated with the product.

DISTRIBUTION OF SALES BY GEOGRAPHIC AREA

| GEOGRAPHIC AREA | % on total number of customers | | % on total sales value | |
|---------------------------|--------------------------------|-----------|------------------------|-----------|
| | Year 2006 | Year 2005 | Year 2006 | Year 2005 |
| Italy | 38% | 32% | 27% | 32% |
| Rest of Europe | 38% | 36% | 33% | 36% |
| North America | 2% | 7% | 7% | 7% |
| Central and South America | 13% | 17% | 21% | 17% |
| Australia, Asia, Africa | 9% | 8% | 12% | 8% |

GROUP POLICIES

Customer orientation – a central element in the Values and Ethical Code of the Pirelli Group – presumes a constant and ongoing commitment from Pirelli in terms of:

- » Comprehension of the market context in which the Group operates
- » Consideration of the impact of the Group's actions and behaviour on the customer
- » Exploiting every opportunity in doing business in order to satisfy the customer's needs

These principles are made explicit in articles 2 and 4 of the Pirelli Ethical Code. The relevant extracts are given below.

The companies of the Group:

- » *“pursue market excellence and competitiveness, offering customers a quality of service that effectively meets their requirements;”* (from article 2, of the Ethical Code - 'Aims and Values')
- » *“the excellence of the Group's products and services is based on customer service and the readiness to meet customer needs. The aim is to offer immediate, thoroughgoing and competent responses, tailored to the needs of customers, and in keeping with the spirit of legality, courtesy and co-operation.”* (article 4, of the Ethical Code - 'Customers')