

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.

2.4. SUPPLIERS

GROUP POLICIES

Pirelli Group maintains a sustainable approach to its suppliers. In this regard the Pirelli policy on Health, Safety, Environment and Social Responsibility expressly states the company's commitment *"to establish and actively maintain the procedures to evaluate and select contractors and subcontractors based on their commitment in the field of social and environmental responsibility."*

CSR has been integrated in both the General Conditions for Purchase of Goods and Services, applied by the company to its suppliers, and the phases of Vendor Approval and Vendor Rating, as described in more detail below.

The purchasing processes are described in the Purchasing Manual. This document sets out guidelines and procedures that are aimed at ensuring both transparency in internal processes and honesty in business dealings, and also integrity and contractual impartiality in relations between the company and its suppliers.

The purchasing processes have been reinforced by the development of new technologies (e.g. electronic auctions) that by their nature help enforce the measures for contractual transparency put in place by Pirelli.

For the most important suppliers, the purchasing policies allow for long-term contracts, partnership contracts and, in some cases, shared growth strategies.

NEW GENERAL CONDITIONS FOR PURCHASE OF GOODS AND SERVICES

In 2006 Pirelli drew up its new General Conditions for Purchase of Goods and Services, which were to be introduced to all orders/tender contracts stipulated by the Group. This contract includes some clauses that specifically refer to Pirelli's Ethical Code and Policy for Health, Safety, Environment and Social Responsibility. The stipulation of a supply contract involves the supplier's signing of these clauses, which commit the supplier to adopting behaviours at their company that adheres to the content of the aforementioned ethical code and CSR policy. Pirelli also has the right to carry out audits to verify this adherence.

The new conditions are already applied to the Group's Italian suppliers and they will be extended to all foreign suppliers by the first months of 2007.

DISTRIBUTION OF PURCHASES BY GEOGRAPHIC AREA

The table below shows the geographical distribution of purchases, distinguishing between OECD and non-OECD countries. The table also gives the percentage weight of purchases made in each area over the total value of all purchases made.

DISTRIBUTION OF PURCHASES BY GEOGRAPHIC AREA				
		% on total number of suppliers	% ov total purchases value	
GEOGRAPHIC AREA		Year 2006	Year 2006	Year 2005
OECD countries	EUROPE	73.0%	63%	67%
	NORTH AMERICA	4.0%	6%	9%
	OTHERS (1)	0.2%	2%	2%
Non-OECD	LATIN AMERICA	19.2%	15%	11%
	ASIA	1.6%	12%	10%
	AFRICA	1.8%	2%	1%

(1) Australia, New Zealand, Japan and Korea

Over 80% of all purchases made by the entire Group are made up of goods and services purchased by the tyre sector.

For this reason, for the 2006 sustainability report we decided to focus on Pirelli Tyre's relationships with its suppliers.

FOCUS ON PIRELLI TYRE

The table below shows the distribution by type of goods and services purchased by Pirelli Tyre in 2005-2006. The table also gives the percentage weight of purchases made in each area over the number of suppliers and over the total value of all purchases made.

DISTRIBUTION BY TYPE OF GOODS AND SERVICES PURCHASED BY TYRE SECTOR				
TYPE	% of number of suppliers		% of total value of purchases	
	Year 2006	Year 2005	Year 2006	Year 2005
Raw materials	7%	8%	56%	37%
Consumables	5%	5%	4%	4%
Services	80%	78%	32%	30%
Plant and equipment	8%	9%	8%	29%

DIALOGUE AND INTERACTION BETWEEN PIRELLI TYRE AND ITS SUPPLIERS

Raw materials suppliers

Relations with suppliers are defined and enforced by specific company processes.

There are two fundamental underlying phases to supplier management:

- 1) Supplier approval (more commonly known as *Vendor Approval*)
- 2) Supplier monitoring (more commonly known as *Vendor Rating*)

The homologation process

The process of approving new suppliers of materials already in use or of new materials is governed by the MP 063 Quality Standard, "Approval of materials for purchase and their vendors". This interdepartmental process of approval follows definite and specific rules, and it concludes with the addition of the approved material/vendor to the Vendor List. The Vendor List is the company's list of approved suppliers for each individual product.

The vendor rating process

The goal of the Vendor Rating process is to evaluate suppliers according to the following criteria:

- » Quality of the product supplied or service provided
- » Quality of commercial relations
- » Technical/scientific cooperation
- » Performance in terms of safety in the workplace, environmental responsibility and corporate social responsibility

In 2007 the Pirelli CSR policies will be integrated into the Vendor Approval phase.

The process owner* of this interdepartmental activity is the Sector Purchasing Department, which circulates the Vendor Ratings to the suppliers every year.

The Vendor Rating is periodically reviewed and commented on by the Purchasing Department. This process involves meetings organised with the suppliers, the aim of which is to identify any corrective action that may be regarded as necessary for improving results.

The procedures described above are followed by the entire Sector and are supported by a special website available on line via the Purchasing Portal. This website provides centralised support for surveys, feedback and the definition of support actions. This provides both an assurance of process uniformity and a guarantee of transparency, apart from being an excellent knowledge sharing tool.

MEASURES AND PROCESSES ADOPTED BY PIRELLI TYRE IN 2006

The processes of dialogue and interaction with suppliers are the object of continual process improvement, both in qualitative terms and in terms of tools. Several measures and processes were adopted by Pirelli Tyre in 2006 to improve the purchasing process, both internally and in terms of supplier relations:

- » Training courses have been developed on buyer professionalism (EIMP) and buyer-supplier relations
- » A Purchasing Portal has been set up as a tool for communications and ongoing training. All company standards and procedures (Purchasing Manual, Ethical Code) are available on the site, as well as the Vendor List and Vendor Ratings
- » The main purchasing processes have been automated and linked to the company SAP platform. These processes include raw materials requirements planning (MRP project) and the entire process governing requirements and supply of natural rubber, from the individual units to the purchasing centre in Singapore (PTE S'pore project)
- » The order/delivery/invoice flow with suppliers have been automated by means of WEB or HUB platforms (the RNC project), via EDI documents and document scanning

The above measures started in 2006 and their completion is projected for 2007 at all Pirelli Tyre facilities worldwide.