Risks and uncertainties

The current macroeconomic picture features a series of uncertainties that are mainly associated with the volatility of financial markets, the trend of interest rates, the cost of raw materials, the unemployment rate and the growing difficulties in gaining access to credit. This scenario requires the adoption of rigorous business models that make it possible to mitigate the uncertainties generated by the limited predictability of future events that are influenced by outside factors that often cannot be controlled.

Confronted with the state of the market, the Group initiated an important review of its strategies and the preparation of a decisive action plan to ensure maximum efficiency and competitiveness. The main strategic lines, the actions adopted and the correlated financial resources available to implement them were announced at the presentation of the 2009-2011 Industrial Plan to the financial community.

RISKS ASSOCIATED WITH THE BUSINESSES IN WHICH THE GROUP OPERATES

As far as the **Tyre sector** is concerned, profitability in the new Industrial Plan is based on the current scenario in the Tyre sector and the automobile market. A difficult year is again predicted in 2009 in terms of sales volumes, especially tyre sales in the Original Equipment channel, which has been seriously affected by the fall in the sales of new cars since the second half of 2008. The same scenario is forecast for tyre sales in the Industrial segment which is directly affected by the slowdown of the whole economy and, consequently, by the reduced need to transport goods.
The Consumer Replacements market should again report lower rates of contraction in 2009, because of lower sales in the Original Equipment channel, the gradual destocking process on the part of dealers (with the prospects of a good winter season in 2009), but also the fall in the price of diesel and, an associated return, on the part of private car owners, to driving longer distances, thus increasing tyre consumption. An even more negative market than the current scenario could further influence results in the short term, but the efficiencies resulting from restructuring measures, the positive channel mix and the focus on "green" products (the Cinturato P7 and the Snowcontrol II) in the Consumer segment and in the core markets of the Industrial segment, along with the decline in the costs of raw materials should favor a structural upturn in profitability.

As far as the **Real Estate sector** is concerned, the profitability in the new Industrial Plan takes into account the macroeconomic scenario of the real estate market. With particular reference to the Italian real estate market, in 2008, there was a gradual fall of the main indicators: the number of transactions made and the average time required to complete renting, selling and relative loan operations.
Operators on the real estate market predict a difficult year in 2009, with a recovery beginning in the second half of 2010, partly

prompted by political economic decisions taken by governments and central banks.
However, to counterbalance the above, there are some structural, economic and financial aspects of the Italian real estate market which, unlike other European countries, may favor the recovery of the market:

1. as a result of the low growth rate of available new properties in recent years, Italy has not seen the excessive supply that there has been in other countries such as Spain and England;
2. the low level of indebtedness of Italian families compared to other countries, which makes our credit system more solid, should help to sustain the propensity to consume and, hence, sustain rents for commercial operators;
3. the substantial reduction in the cost of money at the end of 2008, with the return of the Euribor to the levels of 2002, will help to sustain the financial costs of real estate investment operations;
4. investment in real estate is perceived as defensive and less risky by nature, especially in periods of financial crisis.

Given this scenario, therefore, prices and values may continue to be very volatile until the market recovers its stability.
This scenario has led management to consider the potential of every single initiative and review the structure of operating costs, comparing it to what was achieved in 2008, in order to calculate the efficiency that can reasonably be achieved during the period of the plan.

FINANCIAL RISKS

As reported in the notes to the consolidated financial statements, the Group is exposed to risks of a financial nature associated mainly with the trend of exchange rates, access to financial resources on the market, the fluctuation of interest rates and the possibility of its customers meeting its obligations with the Group.

Financial risk management is an integral part of the management of the Group's operations and is carried out centrally using guidelines defined by the general management function. Such guidelines define the categories of risk and specify the procedures to be followed and the operating limits for each type of transaction and/or instrument.

Foreign exchange risk

The diverse geographical distribution of the Group's manufacturing and commercial operations generate an exposure to foreign exchange risk. Such risk is managed by the Group Treasury function which coordinates with the corresponding sector functions and gathers information on the positions subject to exchange rate and currency risk and manages the net position for every currency according to established guidelines and preset limits.

This is accomplished by negotiating derivative hedging contracts, generally forward contracts aimed at minimizing the effects generated by this type of risk.

Liquidity risk

The main instruments used by the Group to manage the risk of insufficient financial resources available to meet financial and commercial obligations according to pre-established terms and maturities are constituted by one-year and three-year financial plans and treasury plans that would enable the Group to fully and correctly recognize and measure incoming and outgoing monetary flows. Variances between the plans and the actual figures are the subject of constant analysis.
A prudent management of the above liquidity risk relies on maintaining an adequate level of available liquidity and/or short-term securities that can be readily converted into cash, the availability of funding through a sufficient amount of committed credit facilities and/or the ability to close out market positions. Due to the dynamic nature of the businesses in which it operates, the Group aims to maintain flexibility in funding by keeping committed credit lines available
The Group has put into place a centralized system for the management of collection and payment flows that follows the different local currency and tax laws. The negotiation and management of banking relations is conducted centrally so that short-term and medium-term financial requirements are assured of coverage at the lowest cost possible. Even the funding of medium/long-term resources on the capital market is optimized by using centralized management.
The availability of unused committed credit lines, together with the liquidity in the financial statements at December 31, 2008, means that the Group will not have the need to refinance for the next two years.

Interest rate risk

The Group's policy is to tend to maintain a correct balance between fixed-rate and floating-rate debt.
The Group manages the risk of an increase in floating-rate debt by indirect compensation with floating-rate financial receivables and, on a net basis, using derivative contracts, generally interest rate swaps and interest rate collars, with the aim of protecting itself against an excessive rise in interest rates while maintaining the correct mix as described above.

Price risk associated with financial assets

The Group is exposed to price risk to the extent of the volatility of financial assets such as listed and unlisted equity shares and bonds, listed real estate investment funds and unlisted closed-end real estate investment funds.

Credit risk

The Group's exposure to credit risk is represented by potential losses due to the non-fulfillment of obligations undertaken by commercial and financial counterparts.
In order to limit this risk, with commercial counterparts, the Group has put into place procedures to assess the potential and financial creditworthiness of the customer in order to monitor flows of estimated proceeds and in order to take recovery actions.
The aim of these procedures is to establish the customer credit limits which, if exceeded, will activate the rule causing supplies to be blocked.
In some cases, the client is asked to provide guarantees; these will mainly be bank guarantees provided by high-credit standing banks or personal guarantees. Mortgages are requested less frequently.
Another tool used to manage commercial credit risk are insurance policies taken out to avert the risk of non-payment through a meticulous selection of the customer portfolio made together with the insurance company, which undertakes to guarantee compensation in the case of insolvency.
As for financial counterparts, for the management of temporary excess resources or for the negotiation of derivatives, the Group only uses high-credit worthy counterparts.
The Group does not have significant concentrations of credit risk.

RISKS CONNECTED WITH HUMAN RESOURCES

The Group is exposed to the risk of the loss of key resources which could have a negative impact on future results. To meet these risks, the Group adopts an incentive policy which is periodically reviewed also in relation to the general macroeconomic context.
Moreover, the effectiveness of any restructuring measures which involve a reduction in the workforce might be limited by legal or union restrictions in the various countries in which the Group operates.

COUNTRY RISK

The Group operates in countries such as Venezuela, Argentina, Brazil, Turkey, China and Egypt, where the political and general economic situation and tax system could prove to be unstable in the future.

RISKS CONNECTED WITH ENVIRONMENT

The activities and products of the Pirelli Group, a multinational group which operates throughout the world, are subject to a number of environmental regulations associated with characteristics that are specific to the different countries.
Such regulations nevertheless share the tendency to evolve in an increasingly restrictive manner, also by virtue of the growing commitment of the international community for environmental

sustainability. A gradual introduction of harsher regulations to safeguard the various environmental aspects can therefore be expected and which could impact corporations (water use, atmospheric emissions, waste generation, ground impact, impact of products on the environment of life, etc.) as a result of which the Pirelli Group expects it will have to continue to invest and/or sustain costs which could be significant.

Outlook for the current year

In a macroeconomic scenario which continues to display critical elements and uncertainties, the Pirelli Group has already begun and will continue to implement the actions necessary to increase its competitive positioning and improve its efficiency.

For 2009, as announced when the 2009-2011 Industrial Plan was presented on February 11, 2009, Pirelli expects to report revenues amounting to about Euros 4.3 billion.

The ratio of the operating profit to sales (ROS) is forecast at 4.5 percent-5 percent. The net financial position at year-end is predicted to be an approximate negative Euros 1 billion, which will basically be in line with the level at year-end 2008.