# Pirelli & C. S.p.A. - Milan

# Quarterly Report

# September 30, 2006

**PIRELLI & C. Società per Azioni**

**Registered office in Milan, Via G. Negri 10**

**Share Capital - Euros 2,791,311,344.64**

**Milan Companies Register No. 00860340157**

**Economic Administrative File (REA) No. 1055**

# PIRELLI & C. S.p.A. - MILAN

**Quarterly Report at September 30, 2006**

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**PIRELLI & C. S.p.A.**

**Board of Directors** [1]

| | |
|---|---|
| Honorary Chairman | Leopoldo Pirelli |
| Chairman [2] | Marco Tronchetti Provera |
| Deputy Chairman [2] | Alberto Pirelli |
| Deputy Chairman [2] | Carlo Alessandro Puri Negri |
| Directors: | Carlo Acutis * |
| | Carlo Angelici * o |
| | Gilberto Benetton |
| | Alberto Bombassei * |
| | Franco Bruni * o |
| | Gabriele Galateri di Genola |
| | Mario Garraffo * |
| | Dino Piero Giarda * |
| | Berardino Libonati * ^ |
| | Giulia Maria Ligresti |
| | Massimo Moratti |
| | Giovanni Perissinotto |
| | Giampiero Pesenti * ^ |
| | Aldo Roveri * ^ |
| | Carlo Secchi * o |
| | Paolo Vagnone |

* Independent director
o Member of the Internal Control and Corporate Governance Committee
^ Member of the Remuneration Committee

| | |
|---|---|
| Secretary to the Board | Anna Chiara Svelto |

**Board of Statutory Auditors** [3]

| | |
|---|---|
| Chairman | Luigi Guatri |
| Standing members | Enrico Laghi |
| | Paolo Francesco Lazzati |
| Alternate members | Franco Ghiringhelli |
| | Luigi Guerra |

**General Managers**

| | |
|---|---|
| Operations | Claudio De Conto |
| Finance and Strategic Planning | Luciano Gobbi |

**Independent Auditors** [4]

PricewaterhouseCoopers S.p.A.

1 Appointment: April 28, 2005. Expiry: shareholders' meeting called to approve the financial statements at December 31, 2007. Alberto Bombassei was co-opted by the board of directors on September 12, 2006. On November 6, 2006,.Carlo Buora tendered his resignation from the posts held in the company.

2 Office conferred by the board of directors' meeting held on April 28, 2005.

3 Appointment: April 21, 2006. Expiry: shareholders' meeting called to approve the financial statements at December 31, 2008.

4 Appointment conferred by the shareholders' meeting held on April 28, 2005.

**DIRECTORS' REPORT ON OPERATIONS**

The Group recorded growth in all major economic indicators over the corresponding period of the prior year thanks to its strategy of focusing on higher-margin businesses.
The results up to September 30, 2006 show an increase in the operating margins from the same period of last year due to the positive performance of the core businesses of the Group. Consolidated revenues of the Group rose by 9.1 percent and operating profit by 7.8 percent.

The board of directors also decided to adjust the carrying amount of the investment held by Pirelli & C. S.p.A. in Olimpia S.p.A.. This adjustment, on consolidation, is equal to Euros 2,110 million and corresponds to a transparent valuation of Olimpia's assets (that is, the Telecom Italia S.p.A. shares held by Olimpia) at Euros 3 per share as compared to the previous valuation of about Euros 4 per share.
The reduction in the recoverable amount of the investment, which occurred during the course of 2006, can be ascribed to the stock market performance of Telecom Italia stock – lower than both the European sector indexes and the expectations of Pirelli management – and the decline in the target prices by analysts.
Having established the effective existence of an impairment of the investment, the company decided, considering the importance of the investment and also taking into account the observations formulated by Consob, to use both the fair value less costs to sell and the value in use, as provided by international accounting standards, to determine the amount of the impairment loss. This was decided partly because of the absence of a consolidated practice to date, due to the recent introduction of IFRS, and owing to the variety of measurement configurations and criteria used to estimate the recoverable amount by European operators of the telecommunications sector, as well as on account of the type of asset subject to the impairment test.

The criteria used to estimate the value in use led to a range of recoverable amounts that did not differ from the results obtained from the estimate of fair value less costs to sell. The company considered it opportune to adjust the carrying amount of the investment to an amount equivalent to Euros 3 per ordinary Telecom Italia share, an amount confirmed by both the value in use and the fair value less costs to sell.
After this adjustment, the consolidated equity of Pirelli & C. at September 30, 2006 is equal to Euros 4,426.7 million, compared to a net debt of Euros 1,430.8 million at the same date. The equity of the parent, Pirelli & C. S.p.A., following the adjustment of the investment, is equal to Euros 2,936 million (including share capital of Euros 2,790 million). The adjustment of Olimpia, therefore, does not have any repercussions on the soundness of the equity and financial position of the Group.

With regard to **industrial activities**, Pirelli Tyre closed the first nine months with a double-digit growth in net sales (+10.5 percent) over the corresponding period of 2005, signaling increases in both the Consumer and Industrial business areas. At the same time, the Pirelli Broadband Solutions and Pirelli Ambiente start-ups recorded significant jumps in sales of 26 percent and 35.9 percent, respectively, over the prior year.

As for **real estate activities**, Pirelli Real Estate recorded a 11 percent increase in operating profit including earnings from investments.

Consolidated **net sales** of the Group in the nine months ending September 30, 2006 amount to Euros 3,623.1 million. This is an increase of 9.1 percent compared to the same period of 2005. Excluding the foreign exchange effect, net sales grew by 6.4 percent.
Net sales in the third quarter, in particular, posted a considerable gain (+13.1 percent) from the third quarter of 2005.

Consolidated **gross operating profit** in the nine months to September 30, 2006 is Euros 462 million (12.8 percent of net sales) up 6 percent compared to Euros 435.9 million (13.1 percent of net sales) in the first nine months of 2005. Excluding nonrecurring expenses incurred for the project to list Pirelli Tyre S.p.A. (Euros 13.5 million), consolidated gross operating profit is Euros 475.5 million (13.1 percent of net sales) with an increase of 9.1 percent compared to the first nine months of 2005.

Consolidated **operating profit** in the nine months to September 30, 2006 amounts to Euros 299.7 million, an increase of 7.8 percent over the corresponding period of 2005. The profit margin (ROS - Return on Sales) is equal to 8.3 percent. Excluding nonrecurring expenses incurred for the project to list Pirelli Tyre S.p.A. (Euros 13.5 million), consolidated operating profit is Euros 313.2 million (+12.7 percent over the same period of 2005) with a ROS of 8.6 percent (8.4 percent in the nine months to September 30, 2005).

**Earnings (losses) from investments** is a loss figure of Euros 1,469.5 million. The caption includes the aforementioned writedown of the investment in Olimpia S.p.A. (Euros 2,110 million) and is countered by the gain realized in the third quarter on the sale of a 38.9 percent stake in Pirelli Tyre (Euros 416.4 million). It also comprises the result of the companies accounted for using the equity method and dividends from other unconsolidated holdings. Olimpia S.p.A., in particular, contributed earnings of Euros 127 million compared to Euros 130 million in the first nine months of 2005.

The **net result** in the first nine months of 2006 is a **loss** of Euros 1,410.5 million. Excluding the writedown of Olimpia S.p.A. (Euros 2,110 million), the gain on the sale of a 38.9 percent stake in Pirelli Tyre (Euros 416.4 million) and nonrecurring expenses incurred on the project to list Pirelli Tyre (Euros 13.5 million), the net result would be income of Euros 296.6 million. That figure is an appreciable increase over the income of Euros 266.4 million in the first nine months of 2005 on a comparable basis, prior to the income from discontinued operations of Euros 49.8 million.

The **loss attributable to the equity holders of Pirelli & C. S.p.A.** in the first nine months of 2006 is Euros 1,472.4 million (-Euros 0.276 per share) compared to income of Euros 276 million in the first nine months of 2005 (Euros 0.057 per share).
After nonrecurring items (adjustment of Olimpia, gain on the sale of the stake in Pirelli Tyre and IPO project costs), and on a comparable basis, income attributable to the equity holders of Pirelli & C. S.p.A. is Euros 234.7 million compared to Euros 226.2 million in the corresponding period of 2005.

**Consolidated equity** at September 30, 2006 is Euros 4,426.7 million compared to Euros 5,613.8 million at December 31, 2005.

**Equity attributable to the equity holders of Pirelli & C. S.p.A.** at September 30, 2006 is Euros 3,766.3 million (Euros 0.702 per share) compared to Euros 5,204.9 million at December 31, 2005 (Euros 0.979 per share).

The **net financial position** of the Group at September 30, 2006 is a net financial debt position of Euros 1,430.8 million compared to Euros 1,574.9 million at June 30, 2006. The change during the quarter is primarily due to the difference between the outlay for the purchase of the 12.8 percent stake in Olimpia S.p.A. from Hopa S.p.A. (about Euros 498 million) and the proceeds from the private placement of 38.9 percent of Pirelli Tyre (about Euros 740 million). The net financial debt position was Euros 1,235.8 million at September 30, 2005 and Euros 1,177.4 million at December 31, 2005.
Even considering the effect of the purchase of the stake in Olimpia S.p.A. held by the banks which took place on October 4, 2006, the equity and income statement figures of the Group are far from failing to comply with existing financial covenants.

There are 28,645 **employees** of the Group at September 30, 2006. This is an increase of 1,818 compared to December 31, 2005. Such increase refers particularly to employees with temporary contracts (+798) and is mainly associated with the growth of operations in the tyres sector.

**The parent, Pirelli & C. S.p.A.**

The interim financial statements of the parent, Pirelli & C. S.p.A., prepared in accordance with IFRS, show a loss of Euros 1,712.3 million in the first nine months of 2006. This result is entirely due to the adjustment of the investment in Olimpia S.p.A. (Euros 1,827 million).

The equity of the company at September 30, 2006, after this adjustment, is equal to Euros 2,936 million (including share capital of Euros 2,790 million).

## Significant events in the third quarter

### Corporate

- On July 4, 2006, Pirelli & C. S.p.A., Edizione Finance International S.A. and Edizione Holding S.p.A. together with Hopa S.p.A. communicated that they had reached full agreement over all aspects relating to the cash settlement of the investments held in Olimpia S.p.A. and in Holinvest S.p.A. following the dissolution of the shareholders' agreements that were already in existence among the above companies.

  This agreement provided for:

  - the purchase on the part of Pirelli & C. S.p.A., Edizione Finance International S.A. and Edizione Holding S.p.A. of all the shares held by Hopa S.p.A. in Olimpia S.p.A. (equal to 16 percent of capital) for a cash settlement of Euros 622 million (of which Euros 208 million relates to the premium to which Hopa had the right on the basis of previous agreements);
  - the purchase on the part of Hopa S.p.A. of all the shares held by Olimpia S.p.A. in Holinvest S.p.A. (equal to 19.999 percent of capital) for a cash settlement of Euros 86 million.

  Holinvest S.p.A., at that date, was the owner of 492,697,862 Telecom Italia S.p.A. shares, equal to about 3.68 percent of ordinary share capital.

  On the basis of the terms of the agreement, 320,253,610 Telecom Italia S.p.A. shares held by Holinvest S.p.A. (equal to 65 percent of the total shares in its possession) are covered by a pre-emptive two-year agreement in favor of Olimpia S.p.A. which also establishes that Holinvest S.p.A. may not effect new purchases of Telecom Italia S.p.A. shares without the prior agreement of Olimpia S.p.A. during the same period.

  The purchases of the investments and the signing of the pre-emptive agreement were finalized on July 12, 2006.

Specifically, Pirelli & C. S.p.A. purchased 12.8 percent of Olimpia S.p.A. for an outlay of Euros 331 million. At the same time, it paid its share of the premium due to Hopa S.p.A. of Euros 166 million, which had already been set aside in the 2005 financial statements.

- On July 27, 2006, the board of directors of Pirelli & C. S.p.A. examined a transaction with some leading Italian and international financial institutions (Banca Intesa, Banca Leonardo Group, Capitalia, One Equity Partners – JP Morgan Group, Lehman Brothers and Mediobanca) for the sale of a minority interest in the capital of Pirelli Tyre S.p.A., for the purpose of a later IPO.
  Subsequently, on July 29, 2006, the relevant agreements were reached for the sale of 38.9 percent of the capital of Pirelli Tyre S.p.A. for consideration equal to Euros 740 million, with an equity value for the entire company of about Euros 1.9 billion, realizing a gain on the transaction of approximately Euros 416 million.
  The purchase of the minority interest in Pirelli Tyre S.p.A., finalized on August 2, 2006, was carried out by Speed S.p.A., an Italian company in which about a 19 percent stake each is held by Banca Intesa, Capitalia, One Equity Partners – JP Morgan Group, Lehman Brothers and Mediobanca and about a 4 percent stake by the Banca Leonardo Group.
  The agreements provide that the purchasing company may start and conduct, within a period of four years and six months from the closing date, an Initial Public Offering of the shares acquired.
  Pirelli has the right to repurchase the shares that were sold in the event in which, after four years and six months, the shares have not been placed in an IPO.
  The relationships between the seller and the buyer are regulated by shareholder agreements which provide, among other things, that the acquiring company may designate five out of the thirteen directors on the board of directors of Pirelli Tyre S.p.A. and appoint a member of the board of statutory auditors.

After a lock-up period of six months, and after receiving Pirelli's approval, the acquiring company or its shareholders will have the right to sell up to 49 percent of the shares originally purchased to qualified parties (leading financial institutions or mutual funds).

A commission of 3 percent of the equivalent amount of the transaction was paid to the financial institutions and an additional 1 percent will paid on an annual basis until the IPO.

- On September 28, 2006, in implementing the plan for the disposal of financial investments communicated to the market on February 14, 2006, Pirelli & C. S.p.A. announced that it had informed the participants of the Capitalia Shareholders' Agreement of its intention to sell its investment in the company (about 1.92 percent of share capital), entirely contributed to the Agreement.

  The offer, on which the participants of the Capitalia Shareholders' Agreement had pre-emption rights for consideration of about Euros 6.6993 per share, was finalized on October 26, 2006 with the sale of 49,689,476 shares for a total of approximately Euros 333 million, realizing a gain, on consolidation, of about Euros 214 million.

**Real estate activities**

- On July 28, 2006, the board of directors of Pirelli RE SGR approved the management accounts at June 30, 2006 of Tecla Fondo Uffici, Berenice Fondo Uffici and Olinda Fondo Shops, and passed resolutions on the following:
    - for Tecla Fondo Uffici, in the first half of 2006, the payment of dividends of Euros 25.14 per share with a semiannual yield of 5.4 percent and the restitution of Euros 21.73 per share, as a partial reimbursement of capital. Considering the amount reimbursed in the past, the fund has repaid 10.4 percent of subscribed capital, therefore the carrying amount of the share goes from Euros 505 to Euros 452.79 as of the date of June 30, 2006.
    - for Berenice Fondo Uffici, in the first half of 2006, the payment of dividends of Euros 17.50 per share with a semiannual yield of 3.5 percent and the restitution of Euros 2.45 per share, as a partial reimbursement of capital. The carrying amount of the share, which was Euros 505 for the subscribers during the placement stage, is Euros 502.55 as of the date of June 30, 2006.
    - for Olinda Fondo Shops, in the first half of 2006, the payment of dividends of Euros 16.94 per share with a semiannual yield of 3.5 percent and the restitution of Euros 9.78 per share, as a partial reimbursement of capital. To date, the fund has repaid 5.1 percent of subscribed capital and the carrying amount of the share, which was Euros 508 for the subscribers during the placement stage, is Euros 482.43 as of the date of June 30, 2006.

- On August 2, 2006, Pirelli RE and Calyon, the corporate investment bank of the Crédit Agricole Group, signed a binding agreement to establish a joint venture to invest in Europe in the non-performing loans segment.

  The joint venture, in which Pirelli RE will have a 33 percent interest and Calyon a 67 percent interest, is committed to acquiring 100 percent of five non-performing mortgage loan receivable portfolios held since November 2004 by the Pirelli RE/MSREF joint venture with a residual gross book value of approximately Euros 2.6 billion at December 2005. After the new strategic partnership is established, Pirelli RE will take over 53 percent of Credit Servicing (in which it already has a 47 percent stake) and 25 percent of Asset Management NPL (in which it already has a 25 percent stake) from the Morgan Stanley Real Estate Funds. The portfolio of loans purchased from Banca Popolare di Verona e Novara last June 7, 2006 will also be transferred to the non-performing loan portfolio of the joint venture. At the same time, the joint venture established in August 2004 between Pirelli RE Group (25 percent) and Morgan Stanley Real Estate Funds (75 percent) for the purpose of investments on the Italian market has been dissolved; the American investment bank will remain a strategic partner of Pirelli RE in the offices sector.

  The closing of the transaction is scheduled to take place by the end of 2006 on condition of approval by the Antitrust Authority and the trustees of the securitization transactions.

- On September 29, 2006, the unlisted closed-end fund Armilla was established for qualified investors. The new real estate fund managed by Pirelli RE SGR is made up of 14 commercial office properties that were contributed by Cloe Fondo Uffici on September 29, 2006 for a value of about Euros 225 million. The fund, which has a property portfolio of about 155,000 $m^2$, allows the Pirelli RE Group to continue to pursue the strategy of specializing its funds in various segments of the real estate market according to the risk/return profile.

**Pirelli Broadband Solutions**

- On September 27, 2006, Pirelli Broadband Solutions reached an agreement with Arasor International Limited, a Chinese company specializing in integrated solutions in the field of optics and wireless communications, to develop new optical components for telecommunications networks. Under the agreement, a new line of ITLA (Integrable Tunable Laser Assembly) opto-electronic components will be jointly developed and subsequently marketed. The components, which will be based on Pirelli's Tunable Laser, an innovative optical device using nanotechnology, through software, can rapidly change the wavelength of signals, achieving the same amount of work as more than 100 fixed conventional lasers, while guaranteeing very high spectral purity and frequency stability. These components will be used with the aim of augmenting flexibility and reducing the running costs of metropolitan telecommunications networks.

  The devices will be produced in the Arasor facility at Guangzhou, whereas the tunable lasers on which the system is based will be produced by Pirelli in Italy. To begin with, the new components will be destined for the Chinese market, in particular to the Huawei Technologies group, one of the world's key players in the field of optical solutions for telecommunications operators.

## THE GROUP

In this report on operations, in addition to the financial performance measures established by IFRS, certain non-IFRS measures originated from the latter are presented although they are not required by IFRS (“Non-GAAP Measures”).
These performance measures are presented for purposes of a better understanding of the trend of operations of the Group and should not be construed as a substitute for the information required by IFRS.
Specifically, the “Non-GAAP Measures” used are described as follows:

- **Gross operating profit**: this financial measure is used by the Group as the financial target in internal business plans and in external presentations (to analysts and investors). It represents a useful unit of measurement for the evaluation of the operating performance of the Group as a whole and for each single segment, in addition to the Operating Profit. The Gross Operating Profit is an intermediate performance measure represented by the Operating Profit from which depreciation and amortization are subtracted.
- **Earnings (losses) from investments:** earnings (losses) from investments consist of all the effects recorded in the income statement referring to investments that are not consolidated line-by-line. These include dividends, the share of the earnings (losses) of companies accounted for using the equity method, impairment losses of available-for sale financial assets and gains (losses) on the disposal of available-for-sale financial assets.

  Movements in the fair value of assets available-for-sale that are recognized directly in equity are excluded.
- **Net financial (liquidity)/debt position:** this performance measure is represented by the gross financial debt less cash and cash equivalents as well as other interest-earning financial receivables. The Notes present a table that shows the balance sheet amounts used to calculate the net financial (liquidity)/debt position.

The highlights of the consolidated financial data of the Group in the first nine months of 2006 can be summarized as follows:

(in millions of euros)

| | **3rd Quarter 2006** | 3rd Quarter 2005 | **9 months to 9/30/2006** | 9 months to 9/30/2005 | Year 2005 |
|---|---|---|---|---|---|
| . Net sales | **1.177,2** | 1.040,9 | **3.623,1** | 3.322,3 | 4.545,7 |
| . Gross operating profit | **137,8** | 129,6 | **462,0** | 435,9 | 567,6 |
| % of net sales | **11,7%** | 12,5% | **12,8%** | 13,1% | 12,5% |
| . Operating profit | **83,6** | 75,5 | **299,7** | 278,0 | 354,9 |
| % of net sales | **7,1%** | 7,3% | **8,3%** | 8,4% | 7,8% |
| . Earnings (losses) from investments | **(1.634,7)** (*) | 61,5 | **(1.469,5)** (*) | 194,9 | 267,1 |
| . Operating profit (loss) incl. earnings (losses) from investments | **(1.551,1)** | 137,0 | **(1.169,8)** | 472,9 | 622,0 |
| . Financial income (expenses) | **(18,6)** | (22,8) | **(129,3)** | (110,0) | (144,4) |
| . Income taxes | **(33,9)** | (25,4) | **(111,4)** | (96,5) | (128,5) |
| **. Income (loss) from continuing operations** | **(1.603,6)** | 88,8 | **(1.410,5)** | 266,4 | 349,1 |
| % of net sales | **n.s.** | 8,5% | **n.s.** | 8,0% | 7,7% |
| **. Income from discontinued operations** | **-** | 17,0 | **-** | 49,8 | 49,8 |
| **. Total income (loss)** | **(1.603,6)** | 105,8 | **(1.410,5)** | 316,2 | 398,9 |
| . Income (loss) attributable to the equity holders of Pirelli & C. S.p.A. | | | **(1.472,4)** | 276,0 | 327,4 |
| . Earnings per share (in euros) | | | **(0,276)** | 0,057 | 0,066 |
| . Total equity | | | **4.426,7** | 5.565,0 | 5.613,8 |
| . Equity attributable to the equity holders of Pirelli & C. S.p.A. | | | **3.766,3** | 5.187,0 | 5.204,9 |
| . Equity per share (in euros) | | | **0,702** | 0,976 | 0,979 |
| . Net financial (liquidity)/debt position | | | **1.430,8** | 1.235,8 | 1.177,4 |
| . R&D expenditures | | | **131** | 131 | 174 |
| . Employees (number at period-end) | | | **28.645** | 26.864 | 26.827 |
| . Factories | | | **24** | 24 | 24 |
| *Pirelli & C. shares outstanding* | | | | | |
| . ordinary shares (number in millions) | | | **5.233,1** | 5.180,7 | 5.180,7 |
| . savings shares (number in millions) | | | **134,8** | 134,8 | 134,8 |
| . Total shares outstanding | | | **5.367,9** | 5.315,5 | 5.315,5 |

(*) Includes the writedown of Olimpia S.p.A. for Euros 2,110 million and the gain on the sale of a 38.9 percent stake of Pirelli Tyre for Euros 416 million.

For a more meaningful understanding of the performance of the Group in its various segments of business, the following economic data and the net financial position are provided divided by business segment.

| (in millions of euros) | Tyres | Broadband | Environment | Real Estate | Other | | TOTAL |
|---|---|---|---|---|---|---|---|
| | **9 months to 9/30/2006** | | | | | | |
| . Net sales | 2.990,6 | 102,6 | 54,5 | 464,4 | 11,0 | | **3.623,1** |
| . Gross operating profit (loss) | 418,1 | (0,1) | 1,5 | 58,9 | (16,4) | | **462,0** |
| . Operating profit (loss) | 271,4 | (1,0) | 0,9 | 52,3 | (23,9) | | **299,7** |
| . Earnings (losses) from investments | 0,3 | - | - | 63,3 | (1.533,1) | (1)(2)(3) | **(1.469,5)** |
| . Operating profit (loss) incl. earnings (losses) from investments | 271,7 | (1,0) | 0,9 | 115,6 | (1.557,0) | | **(1.169,8)** |
| . Financial income (expenses) | (42,3) | (1,0) | - | (1,0) | (85,0) | | **(129,3)** |
| . Income taxes | (75,8) | (0,5) | (0,4) | (29,2) | (5,5) | | **(111,4)** |
| . Income (loss) | 153,6 | (2,5) | 0,5 | 85,4 | (1.647,5) | | **(1.410,5)** |
| . Net financial (liquidity)/debt position | 783,3 | 9,0 | (0,3) | 94,9 | 543,9 | | **1.430,8** |

| (in millions of euros) | Tyres | Broadband | Environment | Real Estate | Other | | TOTAL |
|---|---|---|---|---|---|---|---|
| | **9 months to 9/30/2005** | | | | | | |
| . Net sales | 2.706,9 | 81,4 | 40,1 | 458,8 | 35,1 | | **3.322,3** |
| . Gross operating profit (loss) | 412,4 | (5,6) | (1,2) | 48,3 | (18,0) | | **435,9** |
| . Operating profit (loss) | 271,1 | (6,0) | (2,4) | 41,9 | (26,6) | | **278,0** |
| . Earnings (losses) from investments | (0,5) | - | - | 62,6 | 132,8 | (1) | **194,9** |
| . Operating profit (loss) incl. earnings (losses) from investments | 270,6 | (6,0) | (2,4) | 104,5 | 106,2 | | **472,9** |
| . Financial income (expenses) | (29,6) | (0,7) | - | 0,8 | (80,5) | | **(110,0)** |
| . Income taxes | (75,9) | (0,2) | (0,1) | (26,4) | 6,1 | | **(96,5)** |
| . Income (loss) | 165,1 | (6,9) | (2,5) | 78,9 | 31,8 | | **266,4** |
| . Net financial (liquidity)/debt position | 384,7 | 3,1 | (1,5) | 29,4 | 820,1 | | **1.235,8** |

(1) The valuation of Olimpia S.p.A. by the equity method shows earnings of Euros 127 million (Euros 130 million in 2005).
(2) The writedown of Olimpia S.p.A. amounts to Euros 2,110 million.
(3) The gain on the sale of a 38.9 percent stake of Pirelli Tyre is Euros 416 million.

## Net sales

**Net sales in the nine months ending September 30,2006** amount to Euros 3,623.1 million, 2006, with an increase, on a comparable basis, of 6.4 percent compared to the corresponding period of the prior year. Considering also the foreign exchange effect, the increase is 9.1 percent.

A percentage breakdown of net sales on a comparable basis by business segment of the Group is as follows:

| | **9 months 2006** | **9 months 2005** |
|---|---|---|
| Pirelli Tyres | 82,5% | 81,5% |
| Pirelli Broadband Solutions | 2,8% | 2,5% |
| Pirelli & C. Ambiente | 1,5% | 1,2% |
| Pirelli & C. Real Estate | 12,8% | 13,8% |
| Other | 0,3% | 1,1% |

**Net sales in the third quarter of 2006** amount to Euros 1,177.2 million compared to Euros 1,040.9 million in the third quarter of 2005.

## Operating profit

**Operating profit in the nine months to September 30, 2006** amounts to Euros 299.7 million, representing 8.3 percent of net sales compared to Euros 278 million in the corresponding period of 2005 (8.4 percent of net sales). Excluding nonrecurring expenses incurred for the project to list Pirelli Tyre S.p.A. (Euros 13.5 million), the consolidated operating profit from ordinary operations is Euros 313.2 million (+12.7 percent compared to the same period of 2005) with a ROS of 8.6 percent compared to 8.4 percent to September 30, 2005.

A breakdown of the change in the operating profit by business segment of the Group can be summarized as follows (in millions of euros):

| | | |
|---|---|---|
| **Operating profit - 9 months 2005** | | **278,0** |
| . Pirelli Tyres | 0,3 | |
| . Pirelli Broadband Solutions | 5,0 | |
| . Pirelli & C. Ambiente | 3,3 | |
| . Pirelli & C. Real Estate | 10,4 | |
| . Other | 2,7 | |
| | | **21,7** |
| **Operating profit - 9 months 2006** | | **299,7** |

**Operating profit in the third quarter of 2006** amounts to Euros 83.6 million (7.1 percent of net sales) compared to Euros 75.5 million in the third quarter of 2005 (7.3 percent of net sales).

**Earnings (losses) from investments**

Earnings (losses) from investments in the first nine months of 2006 amounts to losses of Euros 1,469.5 million compared to earnings of Euros 194.9 million in the first nine months of 2005.

The third quarter of 2006 includes the writedown of the investment in Olimpia S.p.A. (Euros 2,110 million) offset by the gain realized on the sale of a 38.9 percent stake in Pirelli Tyre (Euros 416.4 million). This item includes the earnings of Olimpia S.p.A., valued by the equity method, for Euros 127 million (Euros 130 million in the first nine months of 2005), the results of the companies in the real estate sector valued by the equity method, which show earnings for Euros 63.3 million (Euros 62.6 million in the first nine months of 2005), and dividends received for Euros 51.4 million (Euros 20 million in the first nine months of 2005).

## Financial income (expenses)

Financial income (expenses) is a net financial expense balance of Euros 129.3 million compared to Euros 110 million in the same period of 2005.
This item includes a negative amount of Euros 50.4 million for the measurement of the derivatives on Telecom Italia S.p.A. shares that were already in the financial statements at December 31, 2005 and held by Pirelli Finance Luxembourg S.A. (Euros 38.2 million in the nine months to September 30, 2005).

## Income (loss)

The consolidated net result in the nine months to September 30, 2006 is a loss of Euros 1,410.5 million compared to income of Euros 266.4 million in the nine months to September 30, 2005, on a comparable basis, before income from discontinued operations.
In the first nine months of 2005, income, including the income from discontinued operations of Euros 49.8 million, was Euros 316.2 million.

The loss attributable to the equity holders of Pirelli & C. S.p.A. in the nine months to September 30, 2006 is Euros 1,472.4 million (-Euros 0.276 per share).

## Equity

Consolidated equity went from Euros 5,613.8 million at December 31, 2005 to Euros 4,426.7 million at September 30, 2006.

The change in equity can be summarized as follows:

| | | (in millions of euros) |
|---|---|---|
| . Translation differences | | (78) |
| . Loss for the period | | (1.411) |
| . Dividends to third parties paid by: | | (163) |
| - Pirelli & C. S.p.A. | (114) | |
| - Pirelli & C. Real Estate S.p.A. | (37) | |
| - Other Group companies | (12) | |
| . Exercise of Pirelli & C. Real Estate S.p.A. stock options | | 14 |
| . Pirelli & C Real Estate S.p.A. treasury share purchases/sales | | (14) |
| . Fair value adjustment of available-for-sale financial assets | | 65 |
| . Net actuarial gains (losses) on employee benefits | | 48 |
| . Exercise of warrants 2003/2006 | | 27 |
| . Change in Olimpia valuation | | 37 |
| . Pirelli Tyre stake purchased from minority shareholders by private placement | | 295 |
| . Other changes | | (7) |
| | | **(1.187)** |

The equity attributable to the equity holders of Pirelli & C. S.p.A. went from Euros 5,204.9 million (Euros 0.979 per share) at December 31, 2005 to Euros 3,766.3 million (Euros 0.702 per share) at September 30, 2006.

## Net financial position

The net debt position is Euros 1,430.8 million compared to Euros 1,177.4 million at December 31, 2005, with a change of Euros 253.4 million.

The change is summarized in the following table:

(in millions of euros)

| | |
|---|---|
| . Cash flows used in ordinary activities | (110,7) |
| . Exercise of warrants 2003/2006 | 27,3 |
| . Purchase of Telecom Italia shares | (201,0) |
| . Purchase of Capitalia shares | (38,2) |
| . Partial sale of F.C. Internazionale Milano S.p.A. | 13,5 |
| . Outlay to Hopa | (497,7) |
| . Net proceeds on sale of 38.9% stake in Pirelli Tyre S.pA. | 715,8 |
| . Dividends paid | (162,4) |
| **Change in net financial position** | **(253,4)** |

## R&D expenditures

R&D expenditures, equal to Euros 131 million, are in line with the first nine months of 2005 and represent 3.6 percent of net sales. Such expenditures are completely expensed to income.

## Employees

At September 30, 2006, there are 28,645 employees (including 3,900 temporary employees), compared to 26,827 at December 31, 2005. The increase in the work force principally refers to employees with temporary contracts.

**Related party disclosures**

Related party transactions, including intragroup transactions, are neither unusual nor exceptional but fall under the normal business operations of the Group companies. Such transactions, when not concluded at standard conditions or dictated by specific laws, are in any case conducted at arm's length.

The economic and balance sheet effect of transactions with related parties on the consolidated financial statements of the Pirelli & C. Group at September 30, 2006 are as follows:

Transactions with associates and joint ventures:

(in millions of euros)

| | | |
|---|---|---|
| Revenues for goods and services | 115 | These mainly refer to the supply of services to the associates and joint ventures of Pirelli & C. Real Estate S.p.A. |
| Costs for goods and services | 7 | |
| Financial income | 12 | |
| Trade receivables and other receivables | 105 | These mainly refer to receivables from the associates and joint ventures of Pirelli & C. Real Estate S.p.A. |
| Financial receivables | 363 | These refer to receivables from the associates and joint ventures of Pirelli & C. Real Estate S.p.A. |
| Trade payables and other payables | 9 | These mainly refer to payables to the associates and joint ventures of Pirelli & C. Real Estate S.p.A. |

Transactions with related parties of Pirelli through the directors (Telecom Italia, Camfin and F.C. Internazionale Milano S.p.A.):

(in millions of euros)

| | | |
|---|---|---|
| Revenues for goods and services | 187 | These refer to services rendered by Pirelli & C. S.p.A., Shared Service Center s.c.r.l. and Pirelli & C. Real Estate S.p.A. to the Telecom Italia group (Euros 182 million), services rendered by Pirelli Ambiente Tecnologie S.p.A. to the Camfin group (Euros 2 million) and services rendered to F.C. Internazionale Milano S.p.A. (Euros 3 million) |
| Costs for goods and services | 59 | These refer to telephone, computer and power services by the Telecom Italia group (Euros 23 million), the supply of natural gas by the Camfin group (Euros 29 million) and costs for the sponsorship of F.C. Internazionale Milano S.p.A. (Euros 7 million) |
| Trade receivables and other receivables | 49 | These refer to receivables for the supply of the above services (to the Telecom Italia group for Euros 47 million, the Camfin group Euros 1 million and F.C. Internazionale Milano S.p.A. Euros 2 million) |
| Trade payables and other payables | 14 | These refer to payables for the supply of the above services (to the Telecom Italia group for Euros 6 million, the Camfin group for Euros 5 million and F.C. Internazionale Milano S.p.A. for Euros 3 million) |

**Significant events subsequent to the end of the third quarter**

- On October 4, 2006, Pirelli & C. S.p.A. announced that it had finalized the purchase of the investments in Olimpia S.p.A. held by Banca Intesa S.p.A. (4.77 percent) and Unicredito Italiano S.p.A. (4.77 percent). Payment of approximately Euros 585 million was made to each bank, as envisaged by the agreements between the parties which expired on October 4, 2006 after exercise of the right of withdrawal communicated by the two banks last March. The transaction was funded by cash and by the utilization of available credit lines. The impact of the purchase on the net debt of Pirelli & C. S.p.A. is about Euros 1,040 million, since part of the payment (approximately Euros 130 million) had already been considered, in accordance with IFRS, in the debt of the company as at December 31, 2005.

- On October 9, 2006, Pirelli RE signed the binding agreement for the purchase of about 97 percent of Deutsche Grundvermögen (DGAG), one of the most important real estate companies in Germany with offices in Hamburg and Kiel, based on a valuation of 100 percent of the equity of Euro 440 million (figures at December 31, 2005). DGAG’s residential property portfolio, which in terms of area represents about 88 percent of the total, will be transferred to the joint venture between Pirelli RE (35 percent) and the real estate funds of RREEF (65 percent), the division of Deutsche Bank responsible for real estate investments. The retail and office property portfolio (about 12 percent of the total) will be transferred to the joint venture between Pirelli RE (30 percent) and the Morgan Stanley (MSREF) real estate funds (70 percent). Other assets and asset management and services activities, with about 400 employees, will remain with Pirelli RE. The Pirelli RE business model will be applied to DGAG with the aim of transforming it into a platform for real estate investments, asset management and services.

- On October 11, 2006, Pirelli Broadband Solutions, a company of the Pirelli Group active in broadband access and second-generation photonics, and Arcor (Vodafone Group), the second largest land-line operator on the German market, reached an agreement for the supply of Pirelli's new dual-mode telephones. These phones will be used by the German operator as part of the launch of a new offer for telephone services via Internet (Voice Over IP). The Pirelli dual-mode telephone is an innovative phone which supports the integration of land-line and mobile telephone services, combining the technology of cell phones with the advantages of telephony via Internet. Based on SIP protocol (Session Initiation Protocol), the new Pirelli telephone can act alternatively as a land-line telephone in Wi-Fi mode and as a cell phone. With the dual-mode telephone, the user can make calls from a cell phone using a normal SIM card or call via Internet with a DSL connection. The solution makes it possible to use mobile telephone services such as SMS, MMS, e-mail and Internet also through a broadband connection on a land-line network, with important benefits in economic terms and from the standpoint of bandwidth capacity.

- On October 18, 2006, Olimpia, Pirelli, Edizione Holding, Edizione Finance International, Mediobanca and Generali signed a shareholders' agreement in which Olimpia, Mediobanca and Generali tied up a total of 23.2 percent of Telecom Italia ordinary capital. With the signing of this agreement, the intention of the Parties is to ensure the continuity and stability of the shareholder base and the governance of the Telecom Italia group with the aim of sustaining its industrial development in a context of economic and financial equilibrium for the creation of value for all shareholders.

The three-year agreement is managed by a body, the Board, in which all the Parties are members and the Chairman is designated by Olimpia. The agreement establishes, in particular:

1. the obligation of the Parties to consult with each other on how to exercise their voting rights before each Telecom Italia shareholders' meeting, with the understanding that each Party may freely exercise the right to vote in Telecom Italia shareholders' meeting where the Board of the pact does not unanimously agree;
2. the possibility of admitting to the agreement new Parties having at least a 0.5 percent stake in Telecom Italia;
3. lock-up on the Telecom Italia shares in the agreement, except for limited operational thresholds;
4. the possibility that Olimpia sells its entire holding, subject to the right of first refusal of Mediobanca and Generali; such right of first refusal shall not apply in the case of an offer to buy the shares held by Olimpia, Mediobanca and Generali. The same mechanism is applicable in the event of a sale by Pirelli, alone or together with Edizione, to third parties, of an interest in Olimpia exceeding 50 percent; sales by Pirelli, alone or together with Edizione, up to that ceiling are not restricted;
5. the possibility that Mediobanca and Generali purchase additional shares up to a maximum of 25 percent of the Telecom Italia shares contributed in the pact by each of them;
6. the possibility that Olimpia increases its share capital by way of a contribution in kind of Telecom Italia shares by new shareholders.

- On October 26, 2006, Pirelli Tyre officially started up tyre production in Romania in the new factory at Slatina. With an investment of about Euros 170 million, the new production facility will manufacture top-of-the-range tyres for cars and SUVs and is located near the steel-cord factory inaugurated last year.

The industrial complex, steel-cord included, extends over an area of 500 thousand square meters and, at the end of the year will employee about 770 employees, 450 of whom will work in tyres. The year 2006 will close with a production of 300 thousand tyres which will rise to 2 million in 2007. When fully operational, the new factory will be able to manufacture 4.5 million high-performance tyres a year, with about a 1,000-person work force.

The Group is thus building up its presence in East Europe with an annual growth target set at more than 10 percent per year. Pirelli intends to take advantage of the Slatina area by adding a platform of logistics, computer and commercial services to the industrial activities to support its expansion in these countries.

Moreover, Pirelli also has plans for a series of initiatives to promote the training and the wellbeing of its employees and their families and the local area in general.

## Outlook for the current year

The results achieved up to September 30, 2006 confirm, for 2006, the forecasts of an improvement in the operating results across all business areas over the prior year, unless external factors of an extraordinary nature intervene which cannot be foreseen at this time. As for the bottom line, it will continue to be impacted by the adjustment made to the value of the investment in Olimpia S.p.A.. The Group expects to reach a level of net financial debt of around Euros 2 billion at the end of 2006, net of the temporary effect of the transaction concluded on October 9, 2006 by Pirelli Real Estate in Germany, which when fully completed, will have an impact of about Euros 80 million on the consolidated net financial position of the Group.

## PIRELLI TYRES

The highlights of the consolidated data of the Tyres Sector in the nine months ending September 30, 2006 can be summarized as follows:

(in millions of euros)

| | 3rd Quarter 2006 | 3rd Quarter 2005 | 9 months to 9/30/2006 | 9 months to 9/30/2005 | Year 2005 |
|---|---|---|---|---|---|
| . Net sales | **972,2** | 911,1 | **2.990,6** | 2.706,9 | 3.632,9 |
| . Gross operating profit | **125,5** | 132,8 | **418,1** | 412,4 | 518,1 |
| % of net sales | **12,9%** | 14,6% | **14,0%** | 15,2% | 14,3% |
| . Operating profit | **76,8** | 84,1 | **271,4** | 271,1 | 328,8 |
| % of net sales | **7,9%** | 9,2% | **9,1%** | 10,0% | 9,1% |
| . Financial income (expenses) | **(17,8)** | (14,4) | **(42,0)** | (30,1) | (33,4) |
| . Income taxes | **(23,7)** | (20,8) | **(75,8)** | (75,9) | (97,0) |
| . Income | **35,3** | 48,9 | **153,6** | 165,1 | 198,4 |
| % of net sales | **3,6%** | 5,4% | **5,1%** | 6,1% | 5,5% |
| . Net financial (liquidity)/debt position | | | **783,3** | 384,7 | 237,4 |
| . R&D expenditures | | | **112** | 112 | 146 |
| . Employees (number at period-end) | | | **25.396** | 23.727 | 23.673 |
| . Factories (number) | | | **24** | 24 | 24 |

**Net sales in the first nine months of 2006** amount to Euros 2,990.6 million, with an increase of 10.5 percent compared to the corresponding period of the prior year. Excluding the foreign exchange effect, net sales rose by 7.3 percent.

The change can be summarized as follows:

| | | |
|---|---|---|
| • Volumes | + | 3,9% |
| • Prices/mix | + | 3,4% |
| **Change on a comparable basis** | + | **7,3%** |
| • Foreign exchange effect | + | 3,2% |
| **Total change** | + | **10,5%** |

**Net sales in the third quarter of 2006** amount to Euros 972.2 million, with an increase over Euros 911.1 million in the third quarter of 2005.

**Operating profit in the nine months ending September 30, 2006,** excluding IPO costs (Euros 7.4 million) shows a growth of 3 percent compared to the corresponding period of the prior year. After these costs, operating profit is Euros 271.4 million, a figure in line with last year.

As a percentage of net sales, operating profit is 9.1 percent (9.3 percent pre-IPO costs), a decrease from the first nine months of 2005 (10 percent) mainly as a result of the increase in the price of raw materials.

The change can be summarized as follows (in millions of euros):

| **Operating profit - 9 months 2005** | | **271,1** |
|---|---|---|
| . Foreign exchange effect | 15,7 | |
| . Prices/mix | 8,2 | |
| . Volumes | 40,0 | |
| . Production factors per unit cost | (100,3) | |
| . Efficiencies | 21,7 | |
| . Depreciation | (0,9) | |
| . Other | 15,9 | |
| | | **0,3** |
| **Operating profit - 9 months 2006** | | **271,4** |

**Operating profit in the third quarter of 2006** is Euros 76.8 million and compares to Euros 84.1 million in the same period of 2005.

**Income in the nine months to September 30, 2006** is Euros 153.6 million (after financial expenses of Euros 42 million and income tax expenses of Euros 75.8 million) compared to income of Euros 165.1 million in the first nine months of 2005 (after financial expenses of Euros 30.1 million and income tax expenses of Euros 75.9 million).
The increase in financial expenses is strictly related to higher net debt basically due to the reorganization of the company effected during the first quarter of the year.

The **net financial position** at September 30, 2006 is a net debt position of Euros 783.3 million compared to Euros 237.4 million at December 31, 2005, after the payment of dividends to the parent Pirelli & C. S.p.A. (Euros 30 million) and after the aforementioned reorganization which caused an increase in net debt of Euros 406 million.

At September 30, 2006, there are 25,396 **employees** (including 3,729 temporary employees) compared to 23,673 employees (including 2,958 temporary employees) at December 31, 2005.

There are 24 **factories**, unchanged compared to December 31, 2005.

**Consumer Market**

Cumulative figures to the end of September show an increase in both net sales (+9 percent) and results (+14 percent) compared to the prior year, with net sales totaling Euros 2,072 million and operating profit amounting to Euros 193.9 million.
Net sales in the third quarter of 2006 stand at Euros 669 million, with an increase of 6 percent compared to the same period of 2005, thanks to higher volumes and a considerable improvement in the price/mix.
Operating profit from ordinary operations also shows a positive increase from the prior year (+5 percent) to Euros 53.2 million, equal to 8 percent of net sales. The gain is due to the positive contribution of sales variables and efficiencies which globally more than compensated the higher costs of raw materials.
In the **Auto** segment, demand was again positive in Europe, especially in the segments in which Pirelli Tyre is the traditional leader, that is, High Performance and Ultra High Performance tyres. Gains were also recorded in the Winter segment, where Pirelli continues to make inroads in the most sports-related applications with the Car range (Sottozero, Snowsport and Snowcontrol) and SUV range (Scorpion ICE and Snow), thanks partly to the success of the tests conducted by Automobile Clubs and the most prominent German, Austrian and Swiss magazines.
In original equipment, Pirelli continues its collaboration with major carmakers and obtained positive results in terms of new homologations on models at the top of their respective product lines. As for sports events, in the quarter, victories were taken in the Drivers and Team categories in the FIA GT 1 and GT 2 Championships.
The South American market exhibited a generally stable demand whereas in North America demand was negative. The latter market continues to be the focus of selective growth by Pirelli Tyre, backed by new products such as the SUV Scorpion ATR tyre. Finally, mention is made of the positive reception by the market of the innovative K- Pressure Optic system which actively monitors tyre pressure.
Profitability continues to improve in the **Motorcycle** segment due to the growth of volumes and mix.

In original equipment both Pirelli and Metzeler obtained various new homologations on the most popular models of the motorcycle industry.

Besides the results gained in the SBK World Championship, victories were won in the World Motocross MX1 Championship (for the 46th time since its inception) and in the Enduro Championship in all three classes, in addition to national championships.

## Industrial Market

Cumulative industrial sales to the end of September totaling Euros 919 million grew by 13 percent over the previous year; a decline was reported in operating profit which amounts to Euros 84.9 million. Market demand during the quarter was generally positive in Europe, Turkey and Egypt while a contraction featured in South America. The introduction of the Pirelli product continues on the Chinese market.

**Steel Cord** volumes again grew in the third quarter**.** The third quarter closed with net sales of Euros 303 million; this is an 8 percent gain over the corresponding period of 2005. The operating profit from ordinary operations is Euros 24.5 million, down from the third quarter of 2005 due to the peak reached in the cost of natural rubber, the main raw material in Industrial tyres.

ROS is 8.1 percent.

## Outlook for the current year

Pirelli Tyre expects a continued improvement in the operating results compared to the prior year.

## PIRELLI BROADBAND SOLUTIONS

The highlights of the data of Pirelli Broadband Solutions in the first nine months 2006 can be summarized as follows:

(in millions of euros)

| | **3rd Quarter 2006** | 3rd Quarter 2005 | **9 months to 9/30/2006** | 9 months to 9/30/2005 | Year 2005 |
|---|---|---|---|---|---|
| . Net sales | **29,9** | 17,5 | **102,6** | 81,4 | 112,2 |
| . Gross operating profit (loss) | **-** | (3,3) | **(0,1)** | (5,6) | (6,3) |
| % of net sales | **n.s.** | n.s. | **n.s.** | n.s. | n.s. |
| . Operating loss | **(0,4)** | (3,4) | **(1,0)** | (6,0) | (7,0) |
| % of net sales | **n.s.** | n.s. | **n.s.** | n.s. | n.s. |
| . Financial income (expenses) | **1,3** | - | **(1,0)** | (0,7) | (0,7) |
| . Income taxes | **(0,1)** | 0,1 | **(0,5)** | (0,2) | (0,4) |
| . Income (loss) | **0,8** | (3,3) | **(2,5)** | (6,9) | (8,1) |
| % of net sales | **n.s.** | n.s. | **n.s.** | n.s. | n.s. |
| . Net financial (liquidity)/debt position | | | **9,0** | 3,1 | 7,2 |
| . Employees (number at period-end) | | | **156** | 119 | 122 |

**Net sales in the nine months ending September 30, 2006** amount to Euros 102.6 million, with an increase of 26 percent over Euros 81.4 million in the corresponding period of 2005.
Sales principally consist of products for broadband access.
**Net sales in the third quarter of 2006** are almost double those of the third quarter of 2005.

The **gross operating result in the nine months ending September 30, 2006** reached a breakeven and represents an improvement over the gross operating loss of Euros 5.6 million in the first nine months of 2005.

The **operating result in the first nine months of 2006** shows a profit for broadband access activities but was nevertheless hurt by the start-up of second-generation products which reported an overall operating loss of Euros 1 million. This is an

improvement over the operating loss of Euros 6 million in the corresponding period of 2005.
The **operating result in the third quarter of 2006** is a loss of Euros 0.4 million. This is an appreciable improvement over the corresponding period of 2005.

The **loss in the nine months ending September 30, 2006** is Euros 2.5 million compared to a loss of Euros 6.9 million in the first nine months of 2005.
The **third quarter of 2006** shows income of Euros 0.8 million compared to a loss of Euros 3.3 million in the corresponding period of 2005.

The **net financial position** is a net debt position of Euros 9 million, an increase from December 31, 2005.

At September 30, 2006, there are 156 **employees,** an increase of 34 people compared to December 2005.

**Broadband Access**

Development activities in the first half of the year 2006 focused on four product lines: access gateways, Set-top Boxes, PMP and Extenders. Recently a new product line was introduced, namely Terminals, with the Dual-Mode Phone standard setter, a telephone which integrates GSM/GPRS and Wi-Fi 802.11b/g technology.
With regard to residential access gateways, development of the ADSL2+ platform was completed, resulting in the products Agv3 (Telecom Italia) and HAG v02 (Fastweb).
New products developed include AG2+ and AGW2+, which constitute the new Telecom Italia line based on ADSL2+ technology, with an external case owned by the customer.
Development of gateways projects with the aim of completing the product portfolio is in the final stages: Discus Multiplay (ADSL2+, 4 Ethernet, Wi-Fi 11g, USB2.0h,

2FXS + FXO, 1 USB1.1d, smart card reader), Modem combo (ADSL2+, 1 Ethernet, 1 USB1.1d), Wireless router (ADSL2+, 4 Ethernet, 1 USB1.1d), Router (ADSL2+, 4 Ethernet, 1 USB1.1d). The whole portfolio is based on Broadcom technology (the current market leader) and incorporates an embedded SW solution which can be used on all the products, which will allow remote management using TR-069 protocol.

In addition, a strategic collaboration agreement has been signed with the French company OneAccess. Thanks to the agreement, Pirelli Broadband Solutions has the exclusive rights in Italy for a comprehensive portfolio of routers and IAD for the small business market, which is in direct competition with the products of Cisco, the market leader.

In order to increase the competitiveness of the SW solutions used in the access gateways line, a licensing agreement has been signed for the technology of SW Jungo, a market leader in the sector, which, in addition to supplying PBS with a complete and exhaustive stack, including applications for small businesses, makes it possible to transfer all the applications developments implemented by PBS to various xDSL chipset technologies. This option guarantees the continuity of the services offered on several platforms and thus augments the competitiveness of PBS' proposals to the market.

The Set-top Box project continued with the development of an H.264 single chipset product which integrates Alcatel OMP 2.1 middleware, requested by Telecom Italia.

The first version of the product developed implements the IP-TV function, with the decoding of Conditional Access by means of a smart card, and includes a DVB-T tuner for decoding digital Free-To-Air signals.

The product has now received EC certification and has been awarded both Dolby and HDMI certification.

The second version being developed also includes the support of a hard disk for PVR functions.

The integration phase of Microsoft MS-TV2 middleware in the United States will start at the beginning of November.

The PMP project was reorganized in order to keep up with new developments in the market.

The product, still based on the JMS bus architecture, will incorporate core functions in the roadmap (group management, back-up and restore smart card), will manage the products of Pirelli or third parties by means of plug-ins on the bus and will implement suitable customized features according to the requirements of individual customers.
With regard to the range of Extenders, the qualification of the Power Lines (PLC) adapter based on Home-Plug 85Mb/s and DS2 200Mb/s technology was completed and the products were launched on the market.
The testing phase of MIMO technology began for video-over-wireless distribution applications by developing some prototypes based on Ralink, Airgo and Metalink solutions.
As far as the dual-mode telephone based on SIP technology is concerned, it has been confirmed that the solution will be priced within a low-competition residential price-range. The excellence of this solution from a technological and industrial standpoint has made it possible to acquire three customers within a short space of time: the German operator Arcor, the French operator Free and the English provider Mobiboo, which supplies the British supermarket chain Tesco.

**New Photonics Products**

Development activities continued in the three main areas of the photonics sector (innovative optical components, optical modules and optical transport systems).
With regard to optical systems, the market success of the optical Coarse WDM system known as City8™, continued. Work has begun to install the system for two new customers, thus extending its application to the Spanish market.
Overall, more than 1,034 junctions have been installed. For this product, development work is continuing with the aim of also supporting 10 Gbit/s signals and DWDM. This will result in a platform known as Light WDM which will be able to combine the versatility and low costs typical of the CWDM systems with the typical services of a DWDM system of a higher level.

The applications, which, for the moment, mainly involve the support of new services (such as IPTV) or the extension of already-existing metropolitan broadband networks, will be extended to higher levels of the network so that it also covers metro-regional access sectors.
In the field of optical components, the qualification of the Tunable Laser for application in transmission systems for metropolitan optical and transport networks was successfully completed. Our main customers continue to test samples of the product. While Europe's top optical communications event (ECOC 2006) was being staged, it was announced that a supply agreement had been signed with one of the world's leaders.
In the field of optical modules, the supply of Radio-over-Fiber modules continued under the existing supply agreement with Alcatel.
Finally, the in-house development of the line of innovative opto-electronics modules (MSA and XFP format) and based on optical devices using nanotechnology (such as the Tunable Laser and the Optical Dispersion Compensator), begun in December 2005, continues. The new product lines were announced during the ECOC 2006 fair, and were enthusiastically received by potential customers. Samples of the modules are already being demonstrated at the premises of our main customers.

## **Outlook for the current year**

During the current year, there is expected to be marked growth both in the access market and in the market of photonics based on optical devices using nanotechnology, leading to a considerable improvement in the operating result.

## PIRELLI & C. REAL ESTATE

During the first nine months of 2006, confirming the trend of higher results, income attributable to the equity holders of the company reached Euros 84.0 million versus Euros 78.0 million in the first nine months of 2005, an increase of 8 percent.

### Economic review

In reading the income statement presented below, it should be noted that the aggregate revenues and the operating profit including earnings from investments, because of the type of business conducted by the Group, are the most important indicators and express, respectively, the business volumes managed and the trend in results. It should be pointed out that in the third quarter of 2006, there was a slowdown in activities due to legal uncertainties surrounding the final approval of the law for the conversion of Legislative Decree 223/06 as a result of which the tax system for properties was changed. The new tax system is fully applicable starting from October 1, 2006 when the reduction in the transfer tax from 4 percent to 2 percent came into effect, among other things, for financial real estate agents (funds and leasing companies).

| (in millions of euros) | **9 months to 9/30/2006** | **9 months to 9/30/2005** |
|---|---|---|
| Total aggregate revenues | 2.223,3 | 2.381,1 |
| **Share of aggregate revenues** | **915,1** | **920,1** |
| Consolidated revenues | 464,4 | 458,8 |
| **Operating profit including earnings from investments (*)** | **115,6** | **104,5** |
| **Income attributable to the equity holders of the company** | **84,0** | **78,0** |

(*) Operating profit including earnings from investments comprises the operating profit (Euros 52.3 million in the first nine months of 2006) in addition to the share of earnings of companies accounted for by the equity method (Euros 59.5 million in the first nine months of 2006) and income from real estate investment funds (Euros 3.8 million in the first nine months of 2006). That amount also includes Euros 3.8 million for the fair value adjustment of investment property (IAS 40), up to June 2006.

**Aggregate revenues** amount to Euros 2,223.3 million against Euros 2,381.1 million in the first nine months of 2005.

The **share of aggregate revenues** amounts to Euros 915.1 million and is basically in line with Euros 920.1 million in the first nine months of 2005.

**Consolidated revenues** amount to Euros 464.4 million compared to Euros 458.8 million in the nine months ending September 30, 2005.

**Operating profit including earnings from investments** is Euros 115.6 million, with an increase of 11 percent compared to Euros 104.5 million in the first nine months of 2005. This is in line with announcements to the market.

**Income attributable to the equity holders of the company** is Euros 84.0 million, compared to Euros 78 million in the first nine months of 2005, with a growth of 8 percent.

## Balance sheet and financial review

| (in millions of euros) | 9/30/2006 | 12/31/2005 |
|---|---|---|
| **Fixed assets** | **597,5** | **410,7** |
| *. including investments in funds and investment companies (*)* | *447,9* | *303,3* |
| **Net working capital** | **110,0** | **215,9** |
| **Net invested capital** | **707,5** | **626,6** |
| **Equity** | **552,9** | **552,1** |
| *. of which attributable to the equity holders of the company* | *542,4* | *535,4* |
| **Provisions and contributions** | **59,7** | **44,0** |
| **Net financial (liquidity)/debt position** | **94,9** | **30,5** |
| *. of which shareholder loans* | *(420,0)* | *(262,0)* |
| **Total net invested capital financed** | **707,5** | **626,6** |
| **Net financial (liquidity)/debt position before shareholder loans** | **514,9** | **292,5** |
| **Gearing ratio (**)** | **0,93** | **0,53** |
| **Net financial (liquidity)/debt position before shareholder loans net of non-performing loan transactions not yet converted to the current business model** | **429,1** | **292,5** |
| **Gearing ratio (**)** | **0,78** | **0,53** |

(*) This item includes investments in associates and joint ventures, investments in real estate investment funds and junior notes.

(**) The gearing ratio corresponds to the ratio of the net financial (liquidity)/debt position before shareholder loans to equity.

**Equity attributable** to the equity holders of the company at September 30, 2006 is Euros 542.4 million compared to Euros 535.4 million at December 31, 2005, with an increase of Euros 7.0 million. The change is basically due to an increase in the income for the period (+Euros 84 million) and a decrease generated by the payment of dividends (-Euros 77.3 million).

The **net financial position** shows a net debt position of Euros 94.9 million compared to Euros 30.5 million at December 31, 2005 (Euros 29.4 million at September 30, 2005).

The **adjusted net financial position** (expressed before shareholder loans made to minority-owned companies) is a net debt position of Euros 514.9 million, compared to Euros 292.5 million at December 31, 2005 (Euros 257.8 million at September 30, 2005); the gearing ratio is 0.93 compared to 0.53 at December 31, 2005.
Considering a comparison with amounts at the end of 2005 on a comparable basis, which calls for the most recent purchases of non-performing loans (BNL and BPVN portfolios) to be converted to the usual business model, the adjusted net financial position would amount to Euros 429.1 million and the gearing ratio would be 0.78, completely in line with the target in the 2006-2008 three-year plan.

**Fixed assets** total Euros 597.5 million at September 30, 2006 from Euros 410.7 million at the end of December 2005, with an increase of Euros 186.8 million. The change is due to an increase in the value of the investments in associates and joint ventures for an amount of Euros 144.5 million and the purchase of securities from the securitization of the non-performing loans of the former Banco di Sicilia; the remaining amount is largely related to the investments made in Pirelli Pekao RE for a 75 percent stake and in Pirelli RE SGR for the remaining 12.7 percent interest.

**Net working capital** at September 30, 2006 is equal to Euros 110.0 million compared to Euros 215.9 million at the end of 2005. The reduction of

Euros 105.9 million is mainly due to the combined effect of the increase in inventories, mainly as a result of the acquisitions made in Poland, a significant reduction in trade receivables and an increase in other payables following the purchase of non-performing loans from Banco di Sicilia.

**Outlook for the current year**

Forecasts for the last quarter of 2006 are for double-digit growth in the operating profit including earnings from investments and meeting the full-year targets in the 2006-2008 three-year plan (CAGR 10-15 percent).

## PIRELLI & C. AMBIENTE

The highlights of the consolidated data of Pirelli & C. Ambiente in the first nine months of 2006 can be summarized as follows:

(in millions of euros)

| | **3rd Quarter 2006** | 3rd Quarter 2005 | **9 months to 9/30/2006** | 9 months to 9/30/2005 | Year 2005 |
|---|---|---|---|---|---|
| . Net sales | 15,2 | 11,3 | **54,5** | 40,1 | 61,5 |
| . Gross operating profit (loss) | (0,4) | (0,2) | **1,5** | (1,2) | (2,0) |
| % of net sales | **n.s.** | n.s. | **n.s.** | n.s. | n.s. |
| . Operating profit (loss) | (0,6) | (0,6) | **0,9** | (2,4) | (3,6) |
| % of net sales | **n.s.** | n.s. | **n.s.** | n.s. | n.s. |
| . Income taxes | - | (0,1) | **(0,4)** | (0,1) | 0,2 |
| . Income (loss) | (0,6) | (0,7) | **0,5** | (2,5) | (3,4) |
| % of net sales | **n.s.** | n.s. | **n.s.** | n.s. | n.s. |
| . Net financial (liquidity)/debt position | | | **(0,3)** | (1,5) | 0,8 |
| . Employees (number at period-end) | | | **49** | 41 | 43 |

**Net sales in the nine months ending September 30, 2006** amount to Euros 54.5 million, with an increase of about 36 percent compared to Euros 40.1 million in the same period of 2005.

**Net sales in the third quarter of 2006** also show an improvement over the third quarter of 2005.

**Income in the nine months ending September 30, 2006** is Euros 0.5 million against a loss of Euros 2.5 million in the first nine months of 2005.

**Pirelli & C. Ambiente Renewable Energy S.p.A.**

The company reported income of Euros 1.3 million in the first nine months of 2006 compared to a loss of Euros 1.6 million in the corresponding period of 2005 and a loss of Euros 2.5 million in the year ended December 31, 2005.

The income in the first nine months of 2006 benefited considerably from the agreement which provides for the granting of licenses, patents, know-how and assistance to the UK and North Ireland start-up by Pirelli & C. Ambiente Renewable Energy S.p.A. (PARE) to ReEnergy Group Plc. Last January, the agreed amount on the granting of licenses, patents and know-how was received for Pounds sterling 1.8 million, equal to Euros 2.7 million (net of the 8 percent withholding tax equal to Euros 0.2 million). Furthermore, since January, Pirelli & C. Ambiente Renewable Energy also supplies assistance to the start-up based on a four-year service contract against payment of a "fixed amount". The services supplied in the first nine months of 2006 total to Euros 0.3 million.

In addition, if the RDF-P (Refuse Derived Fuel-Pirelli) market in the U.K. becomes stronger, the agreements provide for the possibility of forming a joint venture with ReEnergy Group Plc to build up the business. This transaction has made it possible to export the business model of the company abroad and to evaluate whether to propose it at an international level.

In the first nine months of 2006, PARE continued to promote negotiations with the aim of starting new projects in the field of renewable energy sources through the production of a quality fuel (RDF-P) derived from solid urban waste for the subsequent start of renewable energy development through the replacement of primary fossil fuels in existing systems. The activities for producing the quality fuel (RDF-P) were profitably conducted through the associate I.D.E.A. Granda S.Cons.r.l..

**Pirelli & C. Ambiente Eco Technology S.p.A.**

The operating result of the company in the first nine months of 2006 is a loss of Euros 0.25 million. This is a decisive improvement over the corresponding period of the prior year when the company reported a loss of Euros 1.0 million.
The above result was the consequence of a return of the emulsions division to a profit position, which largely made it possible to absorb the costs incurred for developing diesel post-treatment filtering systems and the costs for maintaining the structure.
With regard to emulsions, there was a decrease of approximately 13% in volumes of Gecam sold in Italy, compared to the same period of 2005. This was offset by the good performance of per unit margins and controls over costs. Furthermore, the marked increase in volumes sold in France, which more than doubled compared to the same period of the prior year, enabled the French subsidiary Gecam France to basically achieve a breakeven.
With regard to the diesel post-treatment filtering systems, during the period, the company reported sales of approximately Euros 0.8 million. This is largely on the supply contract with ATM Milano (a total of approximately Euros 1.2 million in sales generated between 2005 and 2006).
Long-awaited clarifications with regard to uncertainties about standards relating to the homologation of vehicles fitted with filtering systems and the measures announced by the Regional Authorities of Central and Northern Italy have confirmed expectations of rapid growth in the “retrofit” sector.
Construction work at the Arese production facility, scheduled for start-up in the first few months of 2007, is going according to plan.

**Pirelli & C. Ambiente Site Remediation S.p.A.**

The company reported a loss of Euros 0.08 million in the first nine months of 2006 against basically a breakeven in the same period of 2005 and an income of Euros 0.05 million in the year ended December 31, 2005.

The activities conducted involve the full-scale management of environmental problems, principally in the companies of the Group and related companies, with particular reference to Environmental Due Diligence, evaluation, planning and management of activities such as demolition and land reclamation conducted by specialist companies which are authorized to conduct such work.

The most significant contracts completed or still in progress during the first nine months of 2006 include the clean-up of the former Cartiere Burgo paper factory, the start and completion of land remediation at the former industrial site of Sesto S. Giovanni, completion of activities begun in prior year to reclaim the former site of Pirelli Cables & Systems in the Milan Bicocca area and inquiries to assess the environmental situation of the former ENI site at Portogruaro.

**Outlook for the current year**

Pirelli Ambiente expects to report an improved result over the prior year.

## PROFORMA DATA

**Proforma consolidated economic and financial data assuming the line-by-line consolidation of Olimpia S.p.A.**

Proforma consolidated data at September 30, 2006 of Pirelli & C. S.p.A. is presented below, assuming the consolidation line-by-line of Olimpia S.p.A..

| *(in millions of euros)* | Interim consolidated financial statements 9/30/2006 Pirelli & C. S.p.A. (1) | Proforma adjustments: Elimination of Olimpia S.p.A. result attributable to Pirelli & C S.p.A. | Proforma adjustments: Olimpia S.p.A. line-by-line consolidation | Proforma adjustments: Olimpia S.p.A. consolidation entries | Proforma adjustments: Total proforma adjustments | Proforma interim consolidated financial statements 9/30/2006 Pirelli & C S.p.A. (2) |
|---|---|---|---|---|---|---|
| **Condensed income statement** | | | | | | |
| Net sales | 3.623 | - | - | - | - | 3.623 |
| Operating profit | 300 | - | (1) | - | (1) | 299 |
| Financial income (expenses)/valuation adjustments to financial assets | (1.599) | 1.983 | (2.443) | - | (460) | (2.058) |
| Income taxes | (111) | - | - | - | - | (111) |
| Income (loss) | (1.410) | 1.983 | (2.444) | - | (461) | (1.870) |
| Income (loss) attributable to the equity holders of Pirelli & C. S.p.A. | (1.472) | 1.983 | (1.983) | - | - | (1.472) |
| **Reclassified balance sheet** | | | | | | |
| Equity | 4.427 | 1.983 | 4.497 | (5.518) | 962 | 5.389 |
| - of which equity attributable to the equity holders of Pirelli & C. S.p.A. | 3.766 | 1.983 | 3.294 | (5.277) | - | 3.766 |
| Net financial (liquidity)/debt position | 1.431 | - | 3.179 | - | 3.179 | 4.610 |

(1) Pirelli & C. S.p.A. interim consolidated financial statements (investment in Olimpia S.p.A. accounted for by the equity method with Olimpia accounting for Telecom Italia by the equity method).
(2) Proforma data (line-by-line consolidation of Olimpia S.p.A.).

The proforma consolidated economic and financial data has been prepared using:

- the interim financial statements of Olimpia S.p.A. at September 30, 2006, adjusted to conform with IFRS, wherein the investment in Telecom Italia S.p.A. is accounted for by the equity method (using interim financial statements prepared in accordance with IFRS);
- the interim consolidated financial statements of Pirelli & C. S.p.A. at September 30, 2006 (prepared in accordance with IFRS) wherein Olimpia S.p.A. is accounted for, in turn, by the equity method.

The principal proforma adjustments included in the above table are as follows:

- in the column "Elimination of Olimpia S.p.A. result attributable to Pirelli & C. S.p.A.": elimination of the income statement and balance sheet effects of valuing Olimpia S.p.A. by the equity method in the Pirelli & C. S.p.A. interim consolidated financial statements at September 30, 2006;

- in the column "Olimpia S.p.A. line-by-line consolidation": inclusion of the assets, liabilities, costs and revenues resulting from the interim financial statements at September 30, 2006 of Olimpia S.p.A., prepared in accordance with IFRS consistent with the Pirelli Group, attributing the share of net equity and the results of operations to the minority interest. It should be pointed out that the forward purchase of 124,129,937 Telecom Italia S.p.A. ordinary shares, concluded by Olimpia S.p.A. in 2001, was accounted for at original cost as an increase in the investment in Telecom Italia S.p.A. with a contra-entry to the relative payable account;

- in the column "Olimpia S.p.A. consolidation entries", the carrying amount of the Olimpia investment in the Pirelli interim financial statements was eliminated against the underlying share of the accounting net equity.

  For purposes of this representation, the difference between the carrying amount of the Olimpia S.p.A. investment in the Pirelli interim consolidated financial statements and the underlying share of net equity (Euros 660 million for Pirelli's share equal to 73.2 percent and Euros 901 million for the entire amount) was directly deducted from equity (with a contra-entry to the carrying amount of the Telecom Italia S.p.A. investment).

A comparison of equity and net debt between the consolidated financial statements of Pirelli & C. S.p.A. and the proforma consolidated financial data of Pirelli & C. S.p.A. at December 31, 2005 and at September 30, 2006 is presented below, assuming:

- the line-by-line consolidation of Olimpia S.p.A.;

- the line-by-line consolidation of both Olimpia S.p.A. and the Telecom Italia group.

| *(in millions of euros)* | Equity | | Net debt | | Net debt/Equity | | Equity attributable to the equity holders of Pirelli & C. | |
|---|---|---|---|---|---|---|---|---|
| | 9/30/2006 | 12/31/2005 | 9/30/2006 | 12/31/2005 | 9/30/2006 | 12/31/2005 | 9/30/2006 | 12/31/2005 |
| Pirelli & C. S.p.A. Group: interim consolidated data | 4.427 | 5.614 | 1.431 | 1.177 | 0,32 | 0,21 | 3.766 | 5.205 |
| Pirelli & C. S.p.A. Group: interim proforma consolidated data with Olimpia S.p.A. consolidated line-by-line | 5.389 | 8.393 | 4.610 | 4.667 | 0,86 | 0,56 | 3.766 | 5.205 |
| Pirelli & C. S.p.A. Group: interim proforma consolidated data with Olimpia S.p.A. and the Telecom Italia group consolidated line-by-line | 28.550 | 32.029 | 44.114 | 44.525 | 1,55 | 1,39 | 3.766 | 5.205 |

The Board of Directors

Milan, November 7, 2006

# INTERIM CONSOLIDATED FINANCIAL STATEMENTS
# AND
# NOTES

# INTERIM CONSOLIDATED FINANCIAL STATEMENTS

(in millions of euros)

| Income statement data | **3rd Quarter 2006** | 3rd Quarter 2005 | **9 months to 9/30/2006** | 9 months to 9/30/2005 | Year 2005 |
|---|---|---|---|---|---|
| **. Net sales** | **1.177,2** | **1.040,9** | **3.623,1** | **3.322,3** | **4.545,7** |
| . Other revenues | 97,5 | 132,6 | 234,7 | 270,5 | 283,6 |
| **. Production value** | **1.274,7** | **1.173,5** | **3.857,8** | **3.592,8** | **4.829,3** |
| . Cost of sales | (887,1) | (794,5) | (2.605,0) | (2.400,6) | (3.231,8) |
| . Labor costs | (249,8) | (249,2) | (790,8) | (756,2) | (1.029,9) |
| . Depreciation and amortization | (54,2) | (54,3) | (162,3) | (158,0) | (212,7) |
| **. Operating profit** | **83,6** | **75,5** | **299,7** | **278,0** | **354,9** |
| . Earnings (losses) from investments | (1.634,7) | 61,5 | (1.469,5) | 194,9 | 267,1 |
| . Financial income (expenses) | (18,6) | (22,8) | (129,3) | (110,0) | (144,4) |
| **. Income (loss) before income taxes** | **(1.569,7)** | **114,2** | **(1.299,1)** | **362,9** | **477,6** |
| . Income taxes | (33,9) | (25,4) | (111,4) | (96,5) | (128,5) |
| **. Income (loss) from continuing operations** | **(1.603,6)** | **88,8** | **(1.410,5)** | **266,4** | **349,1** |

(in millions of euros)

| Balance sheet data | **30/09/2006** | 30/09/2005 | 31/12/2005 |
|---|---|---|---|
| . Property, plant and equipment | 6.378,0 | 7.518,9 | 7.629,1 |
| . Net working capital | 199,2 | 21,1 | (53,2) |
| **. Net invested capital** | **6.577,2** | 7.540,0 | 7.575,9 |
| . Equity | 4.426,7 | 5.565,4 | 5.613,8 |
| . Provisions | 719,7 | 738,8 | 784,7 |
| . Net financial (liquidity)/debt position | 1.430,8 | 1.235,8 | 1.177,4 |
| **. Net invested capital financed** | **6.577,2** | 7.540,0 | 7.575,9 |

## NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

### Form and Content

The consolidated quarterly report is prepared in accordance with art. 82 of Consob Resolution No. 14990 of April 14, 2005 which amends and supplements the regulation of issuers.

The content and form are consistent with the minimum requirements indicated in attachment 3D "Content of quarterly reports" of Consob Regulation No. 11971 of May 14, 1999, as amended and supplemented.

The accounting policies and principles used in the preparation of this Quarterly Report are consistent with those used in the preparation of the financial statements at December 31, 2005, to which reference should be made for additional information.

The recognition and measurement of accounting amounts are based upon International Accounting Standards (IAS) and International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board (IASB) and the relevant interpretations of the International Financial Reporting Interpretations Committee (IFRIC), formally endorsed by the European Commission and in force at the time of the approval of this report.

## Measurement of the investment in Telecom Italia held through Olimpia

### Impairment test

IAS 36, Impairment of Assets, specifies that whenever there is any indication of the impairment of an asset, the recoverable amount of the asset should be re-estimated without waiting for the balance sheet date. Since, during the course of the first nine months of 2006, there were indications of a deterioration in certain market parameters used in the measurement techniques adopted for the purpose of estimating the fair value less costs to sell (fair value less costs to sell was used for the impairment test made by the company at December 31, 2005), the company has re-estimated the recoverable amount of the investment in Telecom Italia held through Olimpia.

The principal indications of a reduction in the recoverable amount during the course of 2006 can be ascribed to the following:

a) the stock market price of Telecom Italia shares which recorded a relative negative performance against the European sector indexes and (especially) with respect to the expectations of Pirelli management;

b) the target prices of the analysts who follow Telecom Italia stock, which recorded a higher decline than the reduction in the stock market price.

All the measurement techniques adopted for purposes of the impairment test at December 31, 2005, making widespread use of market input, produced a reduction in the recoverable amounts (expressed as fair value less costs to sell) compared to the previous estimates made at December 31, 2005. In particular, moreover, the criteria based on option pricing models indicated the higher degree of sensitivity to the new market input, expressing fair value estimates that were consistently below the carrying amount in the financial statements.

Having established the effective existence of an impairment of the investment, the company decided, considering the importance of the investment and also taking into account the observations formulated by Consob, to use both the fair value less costs to sell and the value in use, as provided by international financial reporting standards, to determine the amount of the impairment loss. This was also decided partly because of the absence of a consolidated practice a year after the introduction of international financial reporting standards and owing to the variety of measurement configurations and criteria to estimate the recoverable amount used by European operators in the telecommunications sector which have adopted international financial reporting standards. Moreover, in estimating the value in use, since neither one or the other is more important nor is there a consolidated practice relating to either of the two measurement techniques provided by IAS 28.33, the company decided to use both estimation criteria in order to ensure a result consistent with a variety of calculation methods and measurement techniques.

These refer to:

a) a criterion (the so-called asset side) which considers the operating flows of the associate and the consideration received on the final disposal of the investment;

b) a criterion (the so-called equity side) which considers the flows of expected dividends and the disposal of the investment.

In order to estimate the value in use all of the factors which market participants would have considered have been taken into account. They refer, in particular, to:

a) flows of results (operating) and dividends as well as the discount and capitalization rates used by the analysts (aligned with the consensus) who follow Telecom Italia stock;
b) multiples of comparable transactions, for the estimate of the final amount under the asset side criterion;
c) premiums paid in transactions involving listed companies operating in the telecommunications sector in both Europe and the United States (the country where the sector concentration process first began) to estimate the consideration on the disposal of the shares under the equity side criterion.

The two criteria for estimating the value in use resulted in recoverable amounts that did not differ from the results obtained from the estimate of fair value less costs to sell. The company considered it opportune to adjust the carrying amount of the investment to an amount equivalent to Euros 3 per Telecom Italia ordinary share, an amount confirmed by both the value in use and the fair value less costs to sell.

**Net sales**

Net sales in the nine months to September 30, 2006 amount to Euros 3,623.1 million compared to Euros 3,322.3 million at September 30, 2005.

The increase from the corresponding period of 2005 can be analyzed as follows:

| | | |
|---|---|---|
| • Volumes | + | 3,1% |
| • Prices/Mix | + | 3,3% |
| **Change on a comparable basis** | **+** | **6,4%** |
| • Foreign exchange effect | + | 2,7% |
| **Total change** | **+** | **9,1%** |

The breakdown of net sales by geographical area of destination is the following:

(in millions of euros)

| | **9 months 2006** | | **9 months 2005** | |
|---|---|---|---|---|
| **Geographical area** | | | | |
| Europe: | | | | |
| . Italy | 1.320 | 36,45% | 939 | 28,28% |
| . Other European countries | 1.154 | 31,86% | 1.233 | 37,10% |
| North America | 171 | 4,71% | 213 | 6,41% |
| Central and South America | 649 | 17,92% | 668 | 20,12% |
| Oceania, Africa and Asia | 328 | 9,06% | 269 | 8,10% |
| | **3.623** | **100%** | **3.322** | **100%** |

**Labor costs**

Labor costs in the nine months to September 30, 2006 amount to Euros 790.8 million (21.8 percent of net sales) compared to Euros 756.2 million in the first nine months of 2005 (22.8 percent of net sales).

## Operating profit

The operating profit is Euros 299.7 million (8.3 percent of net sales), with an improvement over the Euros 278 million in the corresponding period of 2005.

## Net financial position

The net debt position is Euros 1,430.8 million compared to Euros 1,177.4 million at December 31, 2005 and Euros 1,574.9 million at June 30, 2006.

(in millions of euros)

| Net financial position | 30/09/2006 | 12/31/2005 |
|---|---|---|
| . Current borrowings from banks and other financial companies | 1.544 | 556 |
| . Current financial accrued liabilities and deferred income | 82 | 62 |
| . Cash and cash equivalents | (709) | (300) |
| . Securities held for trading | (123) | (180) |
| . Current financial receivables | (42) | (27) |
| . Current financial accrued income and prepaid expenses | (9) | (12) |
| **Short-term net financial position** | **743** | **99** |
| . Non-current borrowings from banks and other financial companies | 1.319 | 1.551 |
| . Non-current financial receivables | (626) | (468) |
| . Non-current financial accrued income and prepaid expenses | (5) | (5) |
| **Medium/long-term net financial position** | **688** | **1.078** |
| **Total net financial position** | **1.431** | **1.177** |

At September 30, 2006, bonds issued to third parties, for a total of Euros 1,150 million, are as follows:

- Euros 500,000 thousand issued by the subsidiary Pirelli Finance (Luxembourg) S.A. on April 4, 2002, maturing April 4, 2007, with a 6.5 percent fixed interest rate;
- Euros 500,000 thousand issued by Pirelli & C. S.p.A. on October 21, 1998, repayable in a one-time payment on October 21, 2008, with a 4.875 percent rate;
- Euros 150,000 thousand issued by Pirelli & C. S.p.A. on October 7, 1999, maturing April 7, 2009, with a 5.125 percent rate.

These bonds do not contain either financial covenants or clauses which could cause the early repayment of the bonds due to events other than the insolvency of the group.

As for other financial borrowings, even considering the effect of the purchase of the stake in Olimpia S.p.A. held by the banks which took place on October 4, 2006, the equity and income statement figures of the Group are far from failing to comply with existing financial covenants.