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European tire Co

How good will 2010 be?

Gaetan Toulemonde
Research Analyst
(+33) 1 4495-6668
gaetan.toulemonde@db.com

Jochen Gehrke
Research Analyst
(+49) 69 910-31949
jochen.gehrke@db.com

Carola Bardelli
Research Analyst
(+39) 0286379708
carola.bardelli@db.com

How good will be 2010?

Despite a significant negative volume effect, tire Co have been very resilient in 2009 thanks to pricing discipline, raw mat tailwind (H2) and to a positive mix OE/Replct. Next year volumes should rebound strongly on a low base. Thus, coupled with leftover raw mat tailwind and with restructuring paybacks, margins should rebound strongly. Michelin should benefit the most followed by Pirelli. While Continental should benefit the least since tires represent only 30% of the group's revenues.

Sell in market should recover more strongly than Sell out markets

Sell in markets (what tire Co sell to dealers) have been significantly worse than sell out markets (what dealers are selling to end consumers) due to a significant destocking effect at every level of the value chain (fleets, dealers, tire Co). A progressive recovery of end markets should be amplified at the sell in levels. After a 13-15% volume decline in 2009, sell in markets could recover by 6-8% in 2010, or potentially even by more since they are today still 15-17% below the level reached in 2007. We estimate that 1% incremental volume should have a positive impact on Continental EBIT by approx Euro 20m (or share price +3% based on 12x), Euro 70m for Michelin (or price +7%) and Euro 12m for Pirelli (or price +5%).

Raw material tailwind

Current raw material prices are below the average price paid in 2007. And in 2008, they represented a headwind of Euro 200m for Continental tire operations, a high Euro 725m for Michelin and Euro 195m for Pirelli. Even if a portion is passed on to customers (mostly to OEMs), the net impact should still remain significantly positive for the tire companies.

Restructuring payback

Each tire Co has closed plants, transferred production from high cost to low cost countries, reduced workforce.... These cost reduction program initiatives should bring annual savings of Euro 150-200m for each of the three tire Co.s.

Consolidation of the industry

Western players are all losing global market share. Their combined market share today represents only 71% of the world tire market, versus 77% in 2005 and 83% in 2000. This is because their main markets (Europe, North America and Japan) are not growing. New comers, on the contrary, are growing fast. Asian players now enjoy a 12% world market share (versus 7% in 2005 and 4% in 2000). This situation could lead to the next round of consolidation when balance sheets will be rebuilt.

Valuation/Risk

For tire Co, we have based our TP on an average between a P/E of 12x and an EV/EBITDA of 6x. We value Continental Auto part business in line with the sector ie based on 10x P/E. And non tire Pirelli assets are based on a SoP. Main risks concern a worsening car market in 2010 and a price war initiated in the entry level tire segments, leading Co to give back to the market a larger portion of savings. We are raising our TP to Euro 35 (+40%) for Continental, Euro 67 (+10%) for Michelin and Euro 0.40 (+15%) for Pirelli (see details page 2).

Deutsche Bank AG/London

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Forecast Change

Top picks	
Michelin (MICP.PA),EUR54.00	Buy
Pirelli & C (PECI.MI),EUR0.36	Buy

Companies featured			
Michelin (MICP.PA),EUR54.00			Buy
	2008A	2009E	2010E
DB EPS (EUR)	2.50	1.02	5.09
P/E (x)	20.6	53.1	10.6
EV/EBITA (x)	15.7	17.5	9.4
Continental (CONG.DE),EUR37.18			Hold
	2008A	2009E	2010E
DB EPS (EUR)	-6.65	-2.22	0.27
P/E (x)	-	-	139.6
EV/EBITA (x)	-	73.5	21.1
Pirelli & C (PECI.MI),EUR0.36			Buy
	2008A	2009E	2010E
DB EPS (EUR)	-0.00	-0.01	0.02
P/E (x)	-	-	20.5
EV/EBITA (x)	17.2	12.3	9.1

Target price upgrade

Continental: TP raised by 40% from Euro 25 to Euro 35

Continental is a mixture between auto parts Co traded at a 10x P/E and tire Co traded at an average between 12x P/E and 6x EV/EBITDA. The group has so far done better than feared in the current crisis (limiting the negative operational gearing to below 30% which is the fixed cost base of the group) and should benefit from a potential recovery next year (with a stable European car production and +25% in North America). Thus moving from 2010 to 2011 earnings (discounted back), we raise our TP from Euro 25 to Euro 35. However, next right issue of at least Euro 1.5bn could be highly dilutive on future EPS.

Main downside risks: concern over a worsening negative volume environment., especially in Europe and higher negative operational gearing (usually 2x more negative on the downside). On the other side, upside risks concern a better volume environment and lower raw mat prices.

Michelin: TP raised by 10% from Euro 60 to Euro 67

Our new Euro 67 target price is based on 2011E PE of 12x (discounted back) and EV/EBITDA of 6x (tire companies have less volatile volumes as they are mostly involved in the less cyclical aftermarket). We believe this pricing premium to the auto part sector is justified given our expectation that the cost reduction program should allow the group to lift its OP margin and generate strong free cash flow. In the short term, falling raw material prices should help.

Key downside risk concerns: i) the execution of significant industrial reorganization (involving 30,000 people by 2012), ii) an aggressive price war initiated in the entry level segment leading Michelin to give a larger percentage of savings back to the market, and iii) currently abnormal low volumes could last longer

Pirelli: TP raised by 17% from Euro 0.34 to Euro 0.40

We remain confident that management will address the issue of the holding discount sooner or later. Therefore, instead of applying a 40% holding discount on NAV, we continue to apply a 40% discount only on the stub (i.e. what is left after spinning off Tires) – we subtract only E0.10 to NAV. For Tires, we apply the average of 6x 2011E EV/EBITDA and 12x 2011E P/E (discounted by 15% p.a.). BB Solutions and Pirelli Environment are both valued at 1x 2008E sales. We raise our target price for the following reasons:

- to reflect the increased value of Pirelli's listed assets,
- we subtract from NAV the perpetuity of Euro 10m holding costs instead of Euro 15m to reflect the re-organization announced last week
- we updated the pension funds value reported in the interim results report

We note that if we no longer applied the 40% discount to the cash that is left in the parent company (i.e. in the stub), then SOTP would be Euro 0.43. This would make sense as Chairman Mr Tronchetti declared he intends to go back paying dividends as reported by Il Sole 24 Ore and other Italian papers.

Key downside risk concerns: i) a lower volume recovery than anticipated, ii) an aggressive price war initiated in the entry level segment leading Michelin to give a larger percentage of savings back to the market.

Earnings drivers

Summary of our estimates

Figure 1: EBIT margin trend (before restructuring charges)

(% Sales)	H1 08	H2 08	2008	H1 09	H2 09e	2009e	H1 10e	H2 10e	2010e	2011e
Continental tire	10.8%	9.9%	10.3%	10.9%	13.1%	12.1%	11.2%	13.1%	12.2%	13.1%
Michelin	8.6%	2.6%	5.6%	4.0%	6.8%	5.4%	9.9%	9.1%	9.5%	10.1%
Pirelli Tyre	8.8%	3.1%	6.1%	7.6%	6.0%	6.8%	8.5%	6.9%	7.8%	8.5%

Source: Deutsche Bank

Note: operating margin for each Co is before restructuring charges. In 2009, they concern the closure of Clairoux(F) and Stöcken (D) at Continental, the closure of Opelika (USA) and the restructuring in France at Michelin and the closure of Marresa (SP) at Pirelli

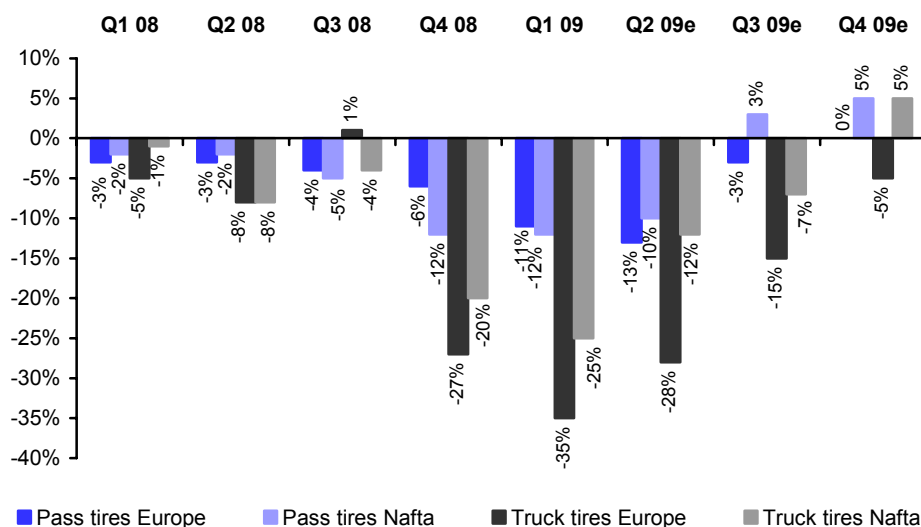
H1 09 results have been very resilient despite a very negative volume effect and a still low raw material headwind. This gives us confident that next quarters should show a sharp rebound of earnings due to:

- A recovery of volumes which have been significantly below trend during the last few quarters. On a long period, tire volumes move in a narrow band, from +4% to -4%, since 70% of the volumes go to the aftermarket, which is much less cyclical. However, over the last 9 months, volume declines were significantly worse, in the magnitude of -20%.

This volume recovery should start in North America first (20% of Continental tire sales, 31% of Michelin and 8% of Pirelli).

Truck tires have suffered the most over the last 9 months (volume dropped 2x more than in pass tires). When volumes will rebound, their magnitude should be stronger too. Michelin has the strongest exposure to truck tires, 30% of sales (45% when specialty tires are included) versus 20% at Continental and 28% at Pirelli.

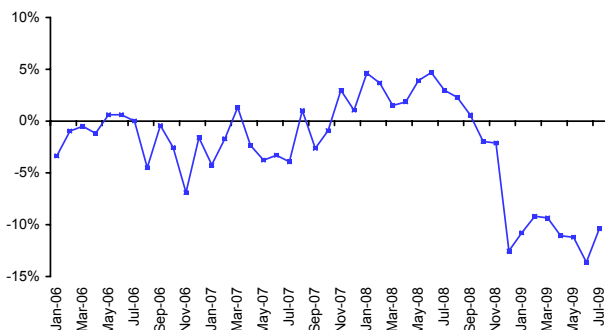
Figure 2: Volume trend in the replacement markets (Sell in)



Source: Deutsche Bank

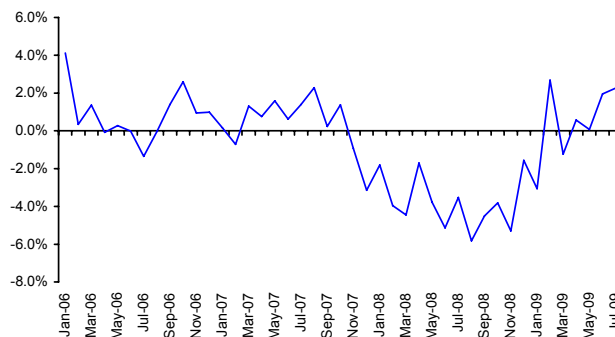
- Sell in markets have been significantly worse than sell out markets due to a significant destocking effect at every level of the value chain (fleets, dealers, tire Co). With a progressive recovery of end markets (number of miles driven by pass cars is increasing and freight indexes should recover with the rebound of western economies see Fig 3 and 4), it will amplify at the sell in level.

Figure 3: ATA tonnage index (2006-09)



Source: US Department of Transport, Deutsche Bank

Figure 4: YoY change in monthly car travel in the US



Source: American Trucking Association

After a 13-15% volume decline in 2009, sell in markets could recover by 6-8% in 2010, or even by a higher margin given that the market is still 10% below the level reached in 2007. As shown in the table below, Michelin has the strongest sensitivity to higher volumes since; i) it's a pure player, and ii) they have the highest fixed cost base (approx 40% at Michelin versus 30% for Continental and Pirelli).

Figure 5: Impact of a 1% incremental volume

	Impact on EBIT (Euro m)	Impact on EPS (Euro)	Impact on share price (based on 12x)
Continental group	Euro 20m	Euro 0.08	Euro 1 or +3%
Michelin	Euro 70m	Euro 0.33	Euro 4 or +7%
Pirelli	Euro 12m	Euro 0.0016	Euro 0.02 or +5%

Source: Deutsche Bank

- A positive raw material price effect. Current raw material prices (for ex natural rubber is currently at USD 2.1/kg for TSR20 grade), even after recent surge, are below the average price paid in 2007 (natural rubber at USD 2.3/kg) and in 2008 (natural rubber at USD 2.8/kg). In 2008, they represented a headwind of Euro 200m for Continental tire operations, a high Euro 725m for Michelin and Euro 195m for Pirelli. Even if a portion of savings this year is passed on to customers (mostly to OEMs), the net impact should remain significantly positive.
- A positive restructuring payback. Each tire Co has closed plants, transferred production from high cost to low cost countries.... These cost reduction programs initiatives should bring annual savings of Euro 150-200m for each of the three tire Co, according to our estimates.

Figure 6: Restructuring measures announced

	Restructuring 2008-09	Workforce involved
Continental	Closure of Clairoux (F), Stocken (D)	1,500
Michelin	Closure of Opelika (USA), Lille(F), Toul (F), Turin (I), Lasarte (SP)	6,000
Pirelli	Closure of Marresa (SP)	1,500

Source: Deutsche Bank

Note: 2 years ago, the tire industry has shut down 44m units of pass tires capacity in North America (15% of the North America replacement demand, 260m units). This time, the

industry is doing the same in Europe with Pirelli shutting down Marresa plant in Spain in 2009 (4.1m units), Continental shutting down Clairoux, France (8.0m units), Michelin closing so far 4 European plants (14m units). And Goodyear has announced 13-25m of capacity shutdown in high costs countries over the next 12 months (including Amiens in France). Overall, the industry is currently shutting down approx 15% of European capacity (European replacement market of 280m units). This is a very positive sign on potential pricing discipline.

- However, the positive OE/Replacement mix recorded in 2009 (replacement markets suffered much less than OE markets where replacement markets enjoy much higher pricing levels) should partly reverse in 2010 with the non recurrent destocking effect of 2009, ie we expect stronger OE than replacement markets next year (see Fig 7).

The following table is giving an idea on how volume growth will look like next year. Recovery of OE volumes could be 2x stronger than in replacement markets. And volumes in North America should be significantly stronger than in Europe

Figure 7: Volume trend OE/Replct, pass tires and truck tires

YoY (%)		2006	2007	2008	2009e	2010e	2011e
Pass tires	OE Europe	(0.5%)	+4.5%	(7.2%)	(16.0%)	0.0%	+9.0%
	Replacement Europe	+2.4%	(1.6%)	(4.0%)	(5.0%)	+5.0%	+3.0%
	OE Nafta	(2.5%)	(1.8%)	(16.5%)	(30.0%)	+30.0%	+12.0%
	Replacement Nafta	(3.7%)	+3.0%	(5.3%)	(4.0%)	+5.0%	+3.0%
Truck tires	OE Europe	+8.8%	+18.6%	(0.9%)	(50.0%)	0.0%	+30.0%
	Replacement Europe	+2.4%	+3.3%	(9.7%)	(20.0%)	+5.0%	+10.0%
	OE Nafta	+7.9%	(32.0%)	(16.5%)	(30.0%)	+37.0%	+57.0%
	Replacement Nafta	(5.4%)	(2.0%)	(8.2%)	(12.0%)	+15.0%	+10.0%

Source: Michelin, Deutsche Bank estimates

In summary, despite a significant negative volume effect (-12/-15%), tire Co earnings have been very resilient in 2009 thanks to pricing discipline, raw material tailwind (in H2 09), and to a positive mix OE/Replacement (selling prices are up to 50% higher in replacement markets). Next year, volumes should rebound strongly especially with a necessity to rebuild inventories in the whole value chain (Sell in markets should be much stronger than sell out markets). Thus, coupled with leftover raw material tailwind (H1 10) and with restructuring paybacks, margins should rebound further.

Continental (Hold)

Figure 8: Continental Tire EBIT trend

(Euro m)	H1 08	H2 08	2008	H1 09	H2 09e	2009e	H1 10e	H2 10e	2010e	2011e
Sales (Euro m)	3,221	3,283	6,504	2,594	3,286	5,880	2,850	3,480	6,330	6,860
Volume growth YoY(%)				-25%	-3%	-14%	+10%	+3%	+6%	+6%
EBIT before exceptional (Euro m)	348	324	672	284	430	714	320	455	775	900
Variation (Euro m)	(69)	(131)	(200)	(64)	+106	+42	+36	+25	+61	+125
Of which raw mat impact (Euro m)	(75)	(189)	(264)	+45	+120	+165	0	0	0	0
EBIT margin (% Sales)	10.8%	9.9%	10.3%	10.9%	13.1%	12.1%	11.2%	13.1%	12.2%	13.1%

Source: Deutsche Bank

Difference with peer groups

- Continental is significantly bigger in pass tires (80% of revenues) than in truck tires (20% of revenues), where the group is a regional player. So far this year this has been a positive since for the industry, truck tire sales have suffered significantly more than pass tires sales.
- More than 90% of tire operations are in Europe (70%) and in North America (20%). The group has very limited exposure to emerging markets.
- Continental isn't a pure tire player. Tires represent only 30% of the group's sales and more than 100% of restated EBIT. Furthermore, it's a strong cash cow machine since free CF from tires represent approx Euro 500m per annum.
- Free CF will be primary used to reduce debt (Euro 10bn at the group level). The tire division has limited financial resources to participate to the consolidation of the tire industry, unless Mgt decide to focus on their pass tire operations (selling truck tires)
- With 14% EBIT margin, their pass tire operations are among the highest in the industry

H1 2009 results, amazingly resilient, despite very poor volumes.

- Volumes were poor, -23% in pass tires, -33% in truck tires.
- Strong positive mix OE/Replacement. The group has moved the mix in North America from 60/40 OE/Replct to 25/75. Since prices in replacement markets are approx 50% higher than in OE markets, it had a positive impact on the bottom line. Overall, when the pass tire division had volume decline of 23%, the mix was positive by +7%.
- Contrary to Michelin and Pirelli, Continental enjoyed a positive raw material price effect in H1, Euro +45m. Before a positive raw mat effect, operational gearing was below 20%, when fixed costs represent approx 30% of revenues.

Outlook

- Positive raw material effect both in H2 09 (Euro +120m(e)) and a leftover Euro 50m in H1 2010. Overall, due to the positive raw material price effect, margins in H2 09 should be stronger than in H1 09 with the truck tires being at breakeven and the pass tire division generating an EBIT margin (before restructuring charges) of a high 14%.
- In 2010, payback of the restructuring measures, mostly Euro 100m from the closure of Clairoux in France and Stöcken in Germany should further improve margins. However, with a 12.2% EBIT margin, we might be close to a limit, especially for the pass tire division, 14.7%(e)

Michelin (Buy)

Figure 9: Michelin EBIT trend

(Euro m)	H1 08	H2 08	2008	H1 09	H2 09e	2009e	H1 10e	H2 10e	2010e	2011e
Sales (Euro m)	8,239	8,169	16,408	7,135	7,916	15,051	7,765	8,036	15,801	16,831
Volume growth YoY(%)	+2%	-8%	-3%	-23%	-2%	-13%	+10%	+3%	+6%	+6%
EBIT before exceptional (Euro m)	708	212	920	282	538	820	770	730	1,500	1,700
Variation (Euro m)	(153)	(572)	(725)	(424)	+326	(98)	+488	+192	+680	+200
Of which raw mat impact (Euro m)	(239)	(565)	(804)	(117)	+600	+483	+150	0	+150	0
EBIT margin (% Sales)	8.6%	2.6%	5.6%	4.0%	6.8%	5.4%	9.9%	9.1%	9.5%	10.1%

Source: Deutsche Bank

Difference with peer groups

- Michelin is equally spread between pass tires, 55%, and industrial tires, 45% (trucks, earthmovers...).
- The group is more exposed to mature markets. However, free CF, in the magnitude of Euro 800m will be partially used to finance expansion projects in Emerging markets (China, India, Latin America).
- In the past, the group had more cyclical earnings (EBIT margin between 6% and 10%) than peer group.
- The group's EBIT margin is in the average of the industry when Michelin enjoy a pricing premium (+10-15%). This tells us they have a poor cost structure. With the attrition of 30,000 people in the coming years, the group will reorganise its industrial footprint (bigger plants to get eco of scale, better equilibrium of sales/prod by continent)

H1 09 results

- H1 09 results declined the most among the peers. However, they suffered from a bigger raw mat negative impact (Euro -117m) than the peer group and from a significant destocking effect (unit sales -23%, production -32%), which could be estimated at almost Euro 200m on the OP level (based on the non absorption of fixed costs estimated at 40%).
- When adjusted from these 2 negative effects, operating income didn't decline.
- And the group reduced net debt significantly, Euro -450m thanks to free cash flow and destocking.

Outlook

- In H2 2009, Michelin will get a significant Euro 600m raw mat tailwind, will keep a positive mix effect and will benefit from the payback of the restructuring measures implemented. These positive should largely exceed a still-weak volume environment (-2%e). Overall, Operating Income should more than double in H2. Our estimates are 30% above consensus numbers.
- 2010. A recovery in volumes, +6%, especially in H1, +11% (on a very low base) coupled with the full effect of raw material price decline (especially in H1 too) will have a strong positive impact on the bottom line. This explains why we expect a sharp rebound of earnings in H1 10 (operating income of Euro +770m versus Euro +282m in H1 09). Our FY10 sales estimates (Euro 15.8bn), operating income (euro 1.5bn) and Net profit (Euro 750m) are all above consensus, respectively, Euro 15.4bn, Euro 1.1bn and Euro 550m.

Pirelli (Buy)

Figure 10: Pirelli Tyre EBIT trend

(Euro m)	H1 08	H2 08	2008	H1 09	H2 09e	2009e	H1 10e	H2 10e	2010e	2011e
Sales (Euro m)	2,166	1,934	4,100	1,916	1,888	3,804	2,012	1,922	3,934	4,229
Volume growth YoY(%)	-1%	-11%	-6%	-16%	-3%	-9%	+8%	+2%	+5%	+4%
EBIT before exceptional (Euro m)	191	60	251	147	114	260	172	133	305	361
Variation (Euro m)	(15)	(92)	(107)	(45)	+54	+9	+25	+20	+45	+56
Of which raw mat impact (Euro m)	(45)	(150)	(195)	(19)	+109	+90	+30	0	+30	0
EBIT margin (% Sales)	8.8%	3.1%	6.1%	7.6%	6.0%	6.8%	8.5%	6.9%	7.7%	8.5%

Source: Deutsche Bank

Difference with peer groups

- Pirelli has the strongest industrial footprint in emerging markets (65%). This percentage should increase in the future with the doubling of their production in Romania (+4mn units), a +20% capacity increase in Brazil (+4mn units too) when at the same time the group has shut down Marresa plant in Spain in 2009 (4.1mn units).
- The group is more exposed to consumer products, 72% of sales (pass and moto tires) than to industrial products, 28% (truck tires).
- The group is mostly present in Europe (44% of sales) and in Latin America (32%) with a limited exposure to North America (8%).
- The group has a strong presence in Latin America which is an export base (mostly to the US). Latin America represents 40% of the group's production and 32% of sales. EBIT margin is above the group's average.
- Furthermore, Pirelli has a leadership in a niche, motorcycles tires (10% of sales) which enjoy higher margins too.

H1 09 results

- Volume decline of -16%, was significantly more resilient than at Continental (-25%) or at Michelin (-23%).
- Raw material impact was marginally negative, Euro 19m, of which Euro -37m in Q1.
- 80% of the workforce reduction target for 2009 has been achieved in H1 (1,200 people).
- The group has been able to almost fully offset a 16% volume decline in H1. Before raw mat headwind and restructuring charges, EBIT declined by only 13%. This corresponds to a negative operational gearing of only 10% in H1 (when fixed costs represent approx 30% of sales).

Outlook

- Brazil will start putting duties on tires imported from China. Brazil will charge an additional \$0.75 per kilo of tires. The measures will be in place for the next five years. Automakers will be exempted from duties on 13-inch tires they buy from China for six months to avoid price increases. Since Pirelli enjoys a 30% market share in Brazil while Chinese brand only 10%, the group should get marginal incremental volumes and mostly get better pricing in Brazil. However, the net positive effect is difficult to estimate currently.

- Mgt recently confirmed their guidance to achieve a 6.5%-7.0% EBIT margin in 2009 on Euro 3.8bn of revenues, probably closer to the top end (DBe 6.8%). This underlines a 2x EBIT increase in H2 which will mostly benefit from a raw mat tailwind, Euro +109m(e) (which was highly negative in H2 08). These positive effects should more than offset a still negative volume effect (-3%).
- Restructuring payback. The group has implemented a cost reduction program involving 1,500 people and concerned mainly the shut down of Marresa in Spain and restructuring in Italy. In H2 09, the group should get approx Euro 30m of cost savings (mostly labor costs) after Euro+20m in H1. The full payback of the restructuring program should be achieved in 2010, ie Euro 50m of incremental savings.
- Raw material tailwind should be significantly higher than the Euro 40m mentioned by Mgt (or Euro 20m per quarter).

Overall, the group H2 09 results will be influenced by the followings: On the negative, a worsening of Ecotechnology EBIT (break even is now targeted by management for 2009 – see interim results report - vs. 10% margin previously). This should be offset by; i) the disposal of a 0.6% stake in T.I. in July for Euro 87m with Euro 1m capital gain, ii) a slight increase of the tyres' EBIT margin vs. previous estimates.

The reorganization of the holding company will reduce its holding costs from Euro 20m to Euro 10m by halving managers from 150 to 75. We estimate the extraordinary charge could be in the region of Euro 20m but we are inserting only a part of it in our numbers (Euro 4m) as it could be offset by capital gains in case the remaining 0.3% held in Telecom Italia was sold on the market (the price is above Euro 1.2 vs. book value of Euro 0.99).

Consolidation of the industry

Breakdown of the world tire market

Figure 11: Breakdown of the world tire market

	1991	1995	2000	2005	2008
Big 3 Global (Bridgestone, Michelin, Goodyear)	53.3%	52.4%	56.8%	52.1%	46.2%
Japanese Tire Co (Sumitomo, Yokohama, Toyo)	13.2%	12.5%	9.5%	8.1%	8.0%
European Tire Co (Continental, Pirelli)	12.7%	11.9%	10.8%	10.6%	10.1%
Korean Tire Co (Hankook, Kumho)	3.0%	3.3%	3.5%	4.2%	4.7%
Cooper Tire	1.7%	1.9%	2.6%	2.1%	2.1%
Sum Top 11	83.9%	82.0%	83.2%	77.1%	71.1%
Asian Tire Co (China, Singapore, Taiwan)	1.5%	3.3%	4.0%	7.0%	12.3%
Indian Tire Co	3.1%	2.3%	2.3%	2.3%	3.2%
Russian Tire Co	0.0%	0.6%	0.6%	2.1%	2.0%
Others	11.5%	11.8%	9.9%	11.5%	11.4%
Sum World tire market (%)	100.0%	100.0%	100.0%	100.0%	100.0%
Sum World tire market (USD m)	49,750	66,900	69,780	103,250	140,000

Source: Tire business

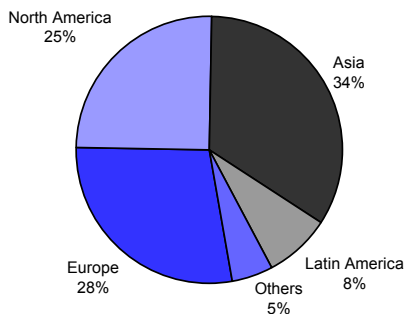
Tire Business has published early Sept. the breakdown of the world tire market. In the table above, we have grouped the different tire makers by country/continent. And it tells us the followings:

- Big 3 Global players (Michelin, Bridgestone and Goodyear) are losing global market share. Their combined market share today represents only 46% of the world tire market, versus 52% in 2005 and 57% in 2000. This is mostly attributable to a below average market share in the countries which are growing fast (China for ex).
- Among the 3 Global players, Goodyear has lost 3x more market share than Bridgestone or Michelin.
- Mid size Japanese (Sumitomo, Yokohama and Toyo) and European (Continental and Pirelli) tire Co have lost market share too at a lower degree. They are also too exposed to their mature domestic market (Japan and Europe).
- Today Europe, North America and Japan are barely growing. They represent 66% of the world tire market in terms of volume (25%, 29% and 7%, respectively) versus 70% in 2000 (29%, 31% and 9%, respectively).
- New comers, on the contrary, are growing fast. This is true for Korean, Chinese and Indian players. Below the Top 11 players, there are 12 Co with revenues in excess of USD 1bn (3 from India, 5 from China, 1 each from Russia, Taiwan, Singapore and Europe).
- We should expect further consolidation of the industry in coming years, when balance sheet will be rebuilt:
 - i) Tire companies based in mature markets need to expand in fast growing emerging markets (China, India...).
 - ii) Tire companies based in emerging market need to consolidate to get the economies of scale (R&D, purchasing...) In the top 30, there are 15 Chinese Co with revenues between Euro 0.5bn and Euro 2.0bn.
 - iii) And they need to tie up with those based in mature markets to get access to their technology to pass stricter new regulation (safety, noise, CO2...).

- Over the last 18 months, Bridgestone and Toyo Tire have build cross shareholder structures, Michelin has increased its stake in Hankook from 6% to 10%, and Apollo Tyres has acquired Vredestein NV ...

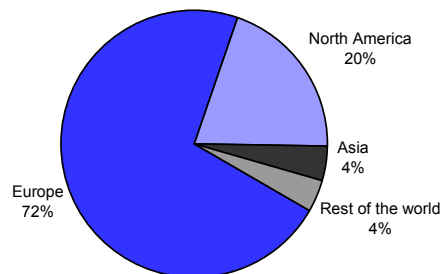
Strategy of European players

Figure 12: World market



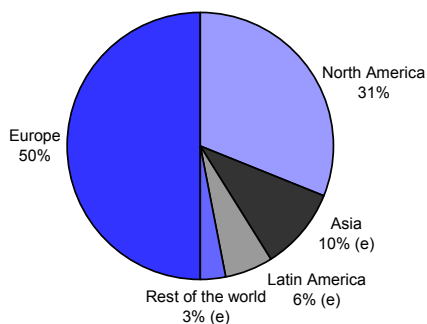
Source: Deutsche Bank

Figure 13: Continental



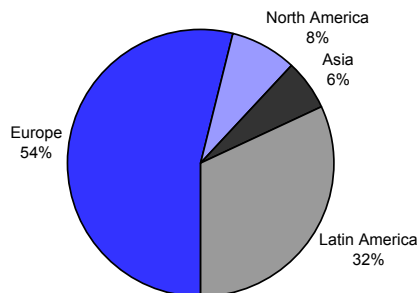
Source: Deutsche Bank

Figure 14: Michelin



Source: Deutsche Bank

Figure 15: Pirelli



Source: Deutsche Bank

Continental can't afford to make any acquisition nor any expansion project. All free CF should be used to reimburse the group's net debt (Euro 10bn). Today the tire business is generating approx Euro 500m of annual free CF. The group just announced a JV with Modi group in India (not among the top 50 world tire makers) where the Indian partner will produces 1mn truck tires for the Indian market under the Continental brand. We should see further examples of this kind in the future.

Michelin wants to accelerate its presence in emerging markets. Today, emerging market represent 30% of sales (and only 25% of production). Mgt is targeting a minimum of 40% of sales and production from emerging markets. The group is building capacity in China (a truck tire plant followed by a pass tire plant), in India (truck tire plant) and in Brazil (pass tire plant).

Pirelli has already a strong footprint in Latin America (32% of their sales which represent only 6% of the world market). And the group wants to grow in China and in Russia either through acquisition or through internal growth.

Margins & Valuation

Operating margin trend of major tire Co

Figure 16: Operating margin trend of tire Co

	Sales 09 USD m	EBIT 09 USD m	2005	2006	2007	2008	2009e	2010e	2011e
Bridgestone	29,070	830	7.8%	6.4%	6.8%	3.7%	2.9%	5.1%	6.1%
Continental (tires only)	8,820	1,070	13.2%	12.2%	13.6%	10.3%	12.1%	12.2%	13.1%
Cooper tire	2,520	152	0.9%	0.4%	4.8%	(3.6%)	6.0%	7.4%	NA
Goodyear	15,700	336	5.5%	5.3%	5.4%	3.9%	2.1%	6.5%	NA
Michelin	22,580	1,230	8.8%	8.2%	9.8%	5.6%	5.4%	9.5%	10.1%
Nokian Tire	1,240	200	16.9%	18.3%	22.8%	23.2%	16.1%	21.8%	26.1%
Pirelli Tire	5,710	390	9.1%	8.7%	8.6%	6.1%	6.8%	7.7%	8.5%
Sumitomo rubber	5,760	270	9.9%	6.6%	8.1%	3.4%	4.7%	5.8%	6.3%
Yokohama rubber	5,320	170	5.2%	4.3%	5.8%	2.5%	3.2%	4.3%	4.9%

Source: Deutsche Bank estimates. EBIT margin of Japanese Co is coming from Reuters consensus
Note: 2009 sales and EBIT are based on a Yen/USD of 90 and on a USD/Euro of 1.50

These 9 Co represent 65% of the world tire market. The table above shows the OP margin trend with 4 years of historic data and 3 years of forecasts. This table highlights the followings:

- While the industry is often perceived as cyclical, OP margins are high and are offering some resilience on the long run, probably because 70% to 80% of demand is coming from the less cyclical replacement market (with the exception in 2009). In average the spread between trough and peak OP margin has been limited to 300bp with the exception of Continental on one side (the most stable margins) and Sumitomo and Cooper on the other side
- Among the three Continents, European Co have recorded higher margins than Japanese Co (which are suffering from a strong Yen since they are net exporters from Japan) and than US Co (the most competitive market)
- There has been strong pricing discipline in the industry. This is the consequence of the reduction of significant capacity in North America (2006-07) and now in Europe (2008-09), equivalent to approx 15% of the pass tire replacement markets. Furthermore, with lower labor costs (consequence of restructuring measures) and with higher raw material prices, the industry has progressively moved from a fixed to a variable cost industry
- During the 2005-09 period, there has been 3 years of declining margin of which 2 (2006 and 2008) attributable to a surge of raw material prices which have been impossible to pass on to customers the same year. And the decline during the third year (2009) has been attributable to an abnormal sharp decline of demand, in the -15% range (4x worse than previous worse year)
- We expect a rebound of margins during the next two years thanks to i) a recovery of volumes, ii) a stabilization of raw material prices and to iii) a payback of restructuring measures (mostly for European and US Co of our universe). We thus expect OP margin to get back in 2011 to previous peak margin achieved in 2007
- Nokian Tire is by far the most profitable Co in our universe (EBIT margin above 20%) and is not representative of the industry. They represent only 1% of the world tire market and are specialized in niche products (winter tires)

Valuation tables of global tire Co

Figure 17: Valuation of global tires Co

(24 Sept)	Market Cap	P/E 09e	P/E 10e	Dividend yield 09e	Price/Book 2009e	EV/Sales 2009e	EV/Sales 2010e	EV/EBITD A 2009e	EV/EBITD A 2010e
Continental (Euro 37.2)	E6,290m	NM	NM	0.0%	1.3x	91%	84%	9.6x	7.2x
Cooper Tire (USD 17.4)	\$1,070m	10.8x	7.7x	2.5%	3.3x	57%	55%	4.6x	4.0x
Goodyear (USD 16.5)	\$3,970m	NM	9.7x	0.0%	3.9x	55%	52%	6.2x	4.3x
Nokian Tire (Euro 16.0)	E2,120m	26.4x	13.3x	1.5%	2.6x	276%	247%	11.8x	8.4%
Michelin (Euro 54.0)	E7,960m	55.3x	10.6x	1.9%	1.4x	94%	88%	8.1x	5.7x
Pirelli (Euro 0.37)	E1,980m	NM	20.5x	1.9%	0.9x	62%	60%	6.3x	5.3x

Source: Deutsche Bank

- Tire Co have traditionally high valuations when put in perspective with the Auto-Auto part sector. This is because i) their earnings are less volatile (since demand is driven by the less cyclical replacement market), ii) their margin is high, even in comparison with luxury OEMs (50% higher prices in replacement markets)
- Our target price based is on an average between 12x P/E (10x for the auto part industry in average) and 6x EV/EBITDA. In our European universe, only Michelin and Nokian Tire are pure plays. The bulk of Continental revenues are now coming from auto parts businesses (which deserve lower multiples) while Pirelli is still momentary keeping a small real Estate business (which explains higher multiples). At current price (Euro 0.65) their real estate business is worth Euro 300m (for 56%)
- Since Capex are covered by depreciation, the industry is in theory generating strong free CF, in the magnitude of Euro 500m at Continental (tire operations), Euro 700m at Michelin and Euro 150m at Pirelli

Consensus tracker

Figure 18: EPS estimates and consensus tracker

(23 Sept 09)	2009 EPS		2010 EPS		2011 EPS		Recommendation Tracker		
	DBe	Consensus	DBe	Consensus	DBe	Consensus	% Buy	% Hold	% Sell
Continental	(2.1)	(2.8)	0.5	(0.9)	2.7	3.0	15%	56%	29%
Michelin	1.0	1.1	5.1	3.8	6.2	5.4	75%	13%	12%
Pirelli	0.01	0.01	0.02	0.02	0.03	0.03	50%	36%	14%

Source: Deutsche Bank

EPS estimates

- Our estimates are broadly in line with consensus except for Michelin where our EPS estimates are approx 30% above consensus for H2 09, 2010 and 2011.
- Over the last 2 months there has been little upgrade on Continental and on Pirelli. On the contrary, Michelin 2010 EPS has been upgraded by 23%.

Recommendation tracker

- Pirelli and Michelin are clearly among the preferred stocks in the auto sector. This is especially true for Michelin which enjoys the highest Buy recommendation rate (75%).
- On the other side, Continental reco is more neutral (56% Hold) probably due to the high level of debt the group carries, uncertainties regarding the right issue (size, EPS dilution...) and due to numerous Mgt changes (Mgt team has completely changed over the last 12 months).

Appendix 1

Important Disclosures

Additional information available upon request

Disclosure checklist

Company	Ticker	Recent price*	Disclosure
Michelin	MICP.PA	54.00 (EUR) 24 Sep 09	6,14,17
Continental	CONG.DE	37.18 (EUR) 24 Sep 09	2,6,7,8,14,17
Pirelli & C	PECI.MI	0.36 (EUR) 24 Sep 09	6,7,8

*Prices are sourced from local exchanges via Reuters, Bloomberg and other vendors. Data is sourced from Deutsche Bank and subject companies.

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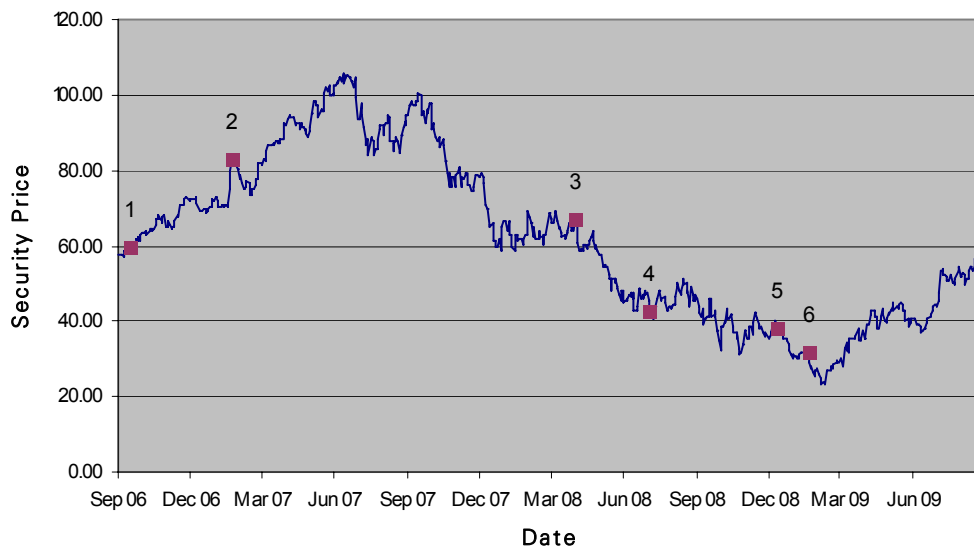
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Historical recommendations and target price: Michelin (MICP.PA)

(as of 9/24/2009)



Previous Recommendations

- Strong Buy
- Buy
- Market Perform
- Underperform
- Not Rated
- Suspended Rating

Current Recommendations

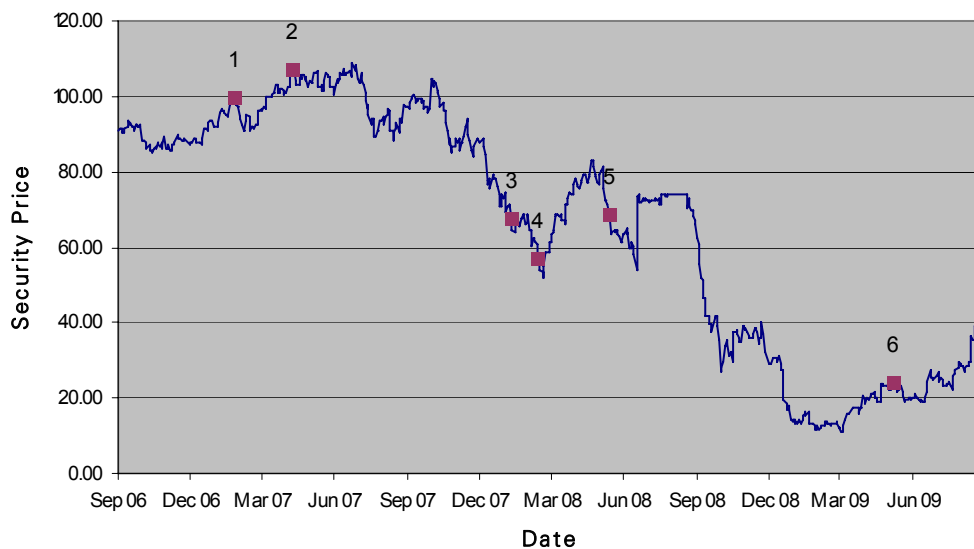
- Buy
- Hold
- Sell
- Not Rated
- Suspended Rating

*New Recommendation Structure as of September 9, 2002

1.	13/10/2006:	Buy, Target Price Change EUR78.00	4.	31/7/2008:	Buy, Target Price Change EUR75.00
2.	19/2/2007:	Buy, Target Price Change EUR107.00	5.	8/1/2009:	Buy, Target Price Change EUR70.00
3.	28/4/2008:	Buy, Target Price Change EUR92.00	6.	16/2/2009:	Buy, Target Price Change EUR60.00

Historical recommendations and target price: Continental (CONG.DE)

(as of 9/24/2009)



Previous Recommendations

- Strong Buy
- Buy
- Market Perform
- Underperform
- Not Rated
- Suspended Rating

Current Recommendations

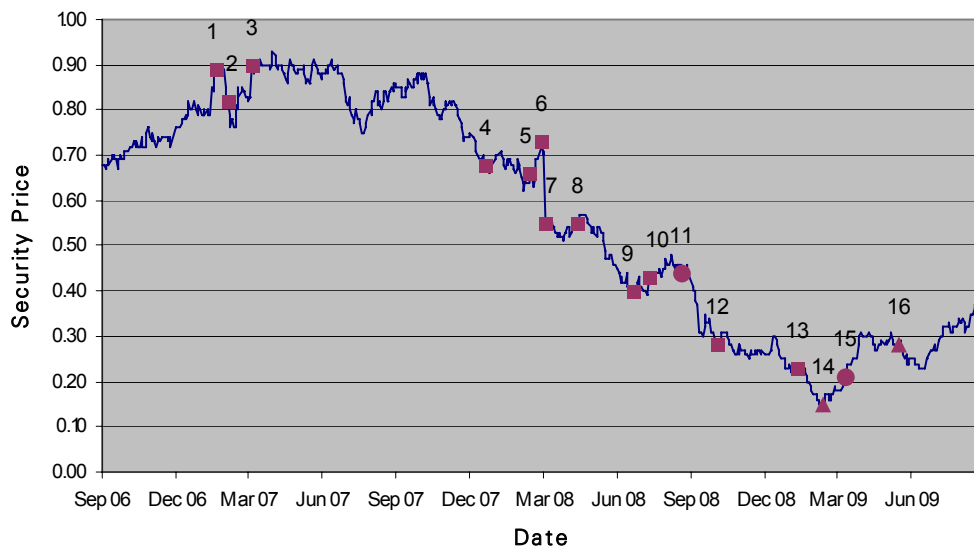
- Buy
- Hold
- Sell
- Not Rated
- Suspended Rating

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3.	6/2/2008:	Hold, Target Price Change EUR87.00	6.	4/6/2009:	Hold, Target Price Change EUR25.00

Historical recommendations and target price: Pirelli & C (PECI.MI)

(as of 9/24/2009)



Previous Recommendations

- Strong Buy
- Buy
- Market Perform
- Underperform
- Not Rated
- Suspended Rating

Current Recommendations

- Buy
- Hold
- Sell
- Not Rated
- Suspended Rating

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3.	2/4/2007:	Buy, Target Price Change EUR1.00	11.	16/9/2008:	Downgrade to Hold, Target Price Change EUR0.51
4.	16/1/2008:	Buy, Target Price Change EUR0.83	12.	30/10/2008:	Hold, Target Price Change EUR0.40
5.	12/3/2008:	Buy, Target Price Change EUR0.79	13.	5/2/2009:	Hold, Target Price Change EUR0.32
6.	26/3/2008:	Buy, Target Price Change EUR0.82	14.	11/3/2009:	Upgrade to Buy, Target Price Change EUR0.23
7.	31/3/2008:	Buy, Target Price Change EUR0.66	15.	7/4/2009:	Downgrade to Hold, EUR0.23
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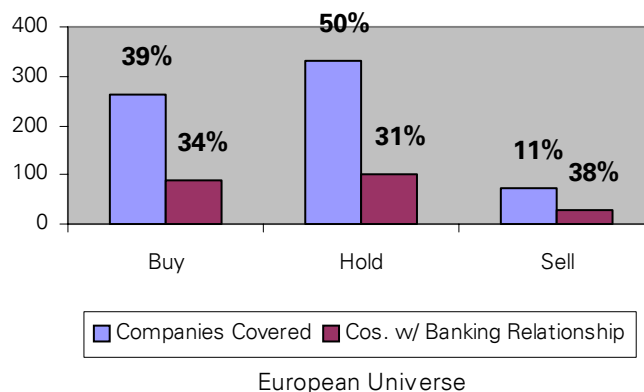
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Deutsche Bank AG/London

European locations

Deutsche Bank AG London

1 Great Winchester Street
London EC2N 2EQ

Tel: (44) 20 7545 8000

Deutsche-Bank AG,

Secursale de Paris
3, Avenue de Friedland
75008 Paris Cedex 8
France
Tel: (33) 1 44 95 64 00

Deutsche Bank AG

Equity Research
Große Gallusstraße 10-14
60272 Frankfurt am Main
Germany
Tel: (49) 69 910 00

Deutsche Bank Sim S.p.a

Via Santa Margherita 4
20123 Milan
Italy

Tel: (39) 0 24 024 1

Deutsche Bank AG

Herengracht 450
1017 CA Amsterdam
Netherlands

Tel: (31) 20 555 4911

Deutsche Securities

S.V.B, S.A.
PO de la Castellana, 42
7th Floor
28046 Madrid, Spain
Tel: (34) 91 782 8400

Deutsche Bank AG

Stureplan 4 A, Box 5781
S-114 87 Stockholm
Sweden

Tel: (46) 8 463 5500

Deutsche Bank AG

Uraniastrasse 9
PO Box 7370
8023 Zürich
Switzerland
Tel: (41) 1 224 5000

Deutsche Bank AG, Helsinki

Kaivokatu 10 A, P.O.Bvox 650
FIN-00101 Helsinki
Finland

Tel: (358) 9 25 25 25 0

Deutsche Bank AG

Hohenstaufengasse 4
1010 Vienna
Austria

Tel: (43) 1 5318 10

Deutsche Bank AG

Aurora business park
82 bld.2 Sadovnicheskaya street
Moscow, 115035
Russia
Tel: (7) 495 797-5000

Deutsche Bank AG, Warsaw

al.Armi Ludowej 26
Budynek FOCUS
00-609 Warsaw
Poland
Tel: (48) 22 579 87 00

Deutsche Bank AG, Turkey

Eski Buyukdere Cad. Tekfen Tower
No:209 Kat:17-18
TR-34394 Istanbul
Tel: (90) 212 317 01 00

Deutsche Bank AG, Greece

23A Vassilissis Sofias Avenue
6th Floor
10674 Athens, Greece
Tel: (30) 210 72 56 150

International locations

Deutsche Bank Securities Inc.

60 Wall Street
New York, NY 10005
United States of America
Tel: (1) 212 250 2500

Deutsche Bank AG London

1 Great Winchester Street
London EC2N 2EQ
United Kingdom
Tel: (44) 20 7545 8000

Deutsche Bank AG

Große Gallusstraße 10-14
60272 Frankfurt am Main
Germany
Tel: (49) 69 910 00

Deutsche Bank AG

Deutsche Bank Place
Level 16
Corner of Hunter & Phillip Streets
Sydney, NSW 2000
Australia
Tel: (61) 2 8258 1234

Deutsche Bank AG

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2 Queen's Road Central
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