Pirelli

Equity Note

Rating: Buy

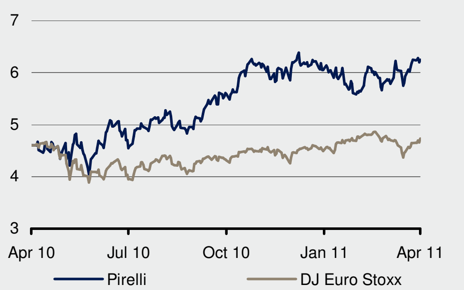
Cruising along cheerily to a Samba beat

Stock Market Data	**01.04.2011**
Sector	Consumer Discretionary
Industry Group	Automobiles & Components
Price (EUR)	6.25
52 week high	6.39
52 week low	4.05
Market cap (EURm)	3'021
Shares out (m)	475.7
Free float (%)	69
S&P / Outlook	n.a. / n.a
Moody's / Outlook	n.a. / n.a
ISIN	IT0004623051
Bloomberg	PC IM Equity

Performance

%	1m	3m	12m
Perf. Abs.	6.4	3.2	35.6
Rel. to DJ Euro Stoxx	6.7	-2.0	32.9

Share Price Performance (EUR)



Source: Datastream

Contact
Dr. Philipp Gamper
Equity Analyst
+41 44 213 94 97
philipp.gamper@sarasin.ch

- **Once a conglomerate, now a focused premium tyre manufacturer**
- **Business picked up in 2010 and will gain more speed in 2011**
- **Particularly good competitive position in the fast-growing Brazilian market**
- **Well balanced geographic spread of production sites worldwide**
- **Greenpower concepts and Formula 1 strengthen the company's reputation**
- **Risks: Rubber prices and economic slowdown in the high-growth markets**
- **Attractive valuation and clear business strategy will take the share price higher**

Once a conglomerate, now a focused premium tyre manufacturer

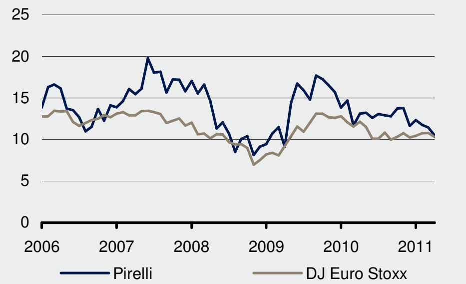
The rubber manufacturing factory that was established by Giovanni Battista Pirelli in 1872 marked the starting point of today's Pirelli corporation. It produced insulated telegraph cables, underwater telegraph cables and bicycle tyres. Production of car tyres began very early in 1901. Years later in 1998 Pirelli temporarily became the largest manufacturer of electricity and telecommunications cables in Europe when it bought the cable producing activities of Siemens based in Neustadt, Germany as well as several other production facilities in the UK. In 2005 Pirelli sold its cable manufacturing operations to Goldman Sachs, which reorganized the business and then listed it on the Milan stock exchange under the name Prysmian in 2007. A number of other divestments were also made and by the end of 2010 Pirelli had become a pure play tyre manufacturer.

Pirelli can now be described as the tyre manufacturer with the greatest focus on the premium segment. It has an outstanding market position, especially for racing tyres and extra-wide tyres. Pirelli is a particularly popular brand with premium and super-premium car manufacturers such as BMW, Mercedes-Benz, Porsche, Audi, Ferrari, Aston-Martin and Range Rover. Having captured a 4.5% share of the global market for tires, Pirelli qualifies as a successful niche player. It leads Sumitomo (Dunlop brand), which has a 3.2% share of the world market, and Yokohama (2.9%) and trails Continental (5.9%). Michelin, the world's number one tyre manufacturer with a market share of 17.1%, is more active in the replacement tyre market, where it offers premium comfort tyres, truck tyres and specialized tyres. Bridgestone/Firestone is a broadly diversified company with a market share of 16.9%, strong in the specialized tyres business, while Goodyear claims a world market share of 14.9% and has an especially strong presence in the USA.

A total of 1.2 billion tyres were sold worldwide in 2010. This number is likely to rise to about 1.4 billion tyres in 2012 and momentum should remain strong. One source of growth in the tyre market is the upward trend in the annual number of cars produced. In 2000 57 million cars rolled off assembly lines worldwide; in 2010 69 million. According to Global Insight, this number will exceed 105 million vehicles in 2017. Another source of growth is the resulting increase in the number of cars on

Valuation Metrics	2009A	2010E	2011E
P/E	n.m.	14.5	11.0
EV/FCF	11.9	132.5	n.m.
P/B	1.2	1.5	1.3
Net debt/equity	0.2	0.3	0.3
ROE (%)	0.9	9.5	12.8
P/Cash EPS	12.5	16.0	6.9
Div. yield (%)	0.0	2.6	3.0
CF/share	1.2	0.8	1.0
Net assets/share	5.3	4.3	4.6

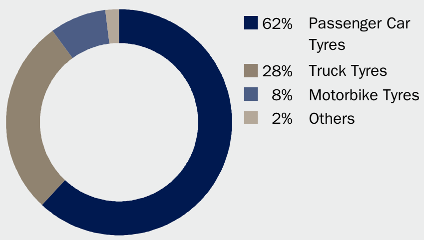
P/E Comparison (12m forward)



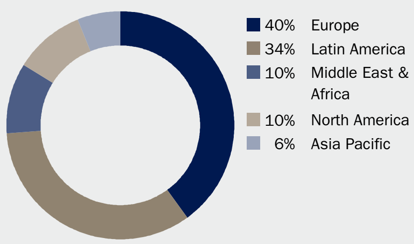
Key Figures	2009A	2010E	2011E
Sales (EURm)	4'462	4'927	5'567
EBITDA (EURm)	429	618	736
EBITDA margin (%)	9.6	12.5	13.2
EBIT (EURm)	217	395	497
EBIT margin (%)	4.9	8.0	8.9
Net income (EURm)	23	207	278
EPS (EUR)	0.04	0.43	0.57
EPS growth (%)	n.m.	975.0	32.6

Source: Datastream

Sales by segment (2010)



Sales by region (2010)



Source: Pirelli

the street. A total of 936 million vehicles were registered worldwide in 2010; this is forecast to rise to 1.15 billion by 2017, which is good news for the higher-margin replacement tyres business.

Business picked up in 2010 and will gain more speed in 2011

Pirelli's 2010 sales amounted to EUR 4.85bn, an increase of 19% over the previous year. Its operating margin (EBIT margin) rose 230 basis points to 8.4% and the company generated a high operating cash flow of EUR 107m despite having invested a net EUR 439m in its business. Pirelli also has a strong balance sheet with gearing (ratio of net financial debt to equity) at only 0.22.

In view of currently low tyre inventories, the strong inflow of new orders, both for summer and winter tyres, the good pricing discipline displayed by tyre manufacturers, the 2011 financial year has begun on a promising note. The passenger car tyre market should grow by 5% with proportionately faster growth of about 14% in the premium tyre segment, which translates into particularly rosy market opportunities for Pirelli. A recovery in demand for trucks should lead to an estimated 8% increase in truck tyre volumes.

Against this backdrop Pirelli is guiding for a 14% increase in sales with a positive impact from pricing and the product mix. Its EBIT margin is expected to widen to about 9.5%, which seems to be on the conservative side in view of the current situation.

Particularly good competitive position in the fast-growing Brazilian market

Pirelli generates 34% of its sales in Latin America and has thus established a particularly strong position in this promising high-growth region. The company's undisputed number one position in the huge fast-growing Brazilian market, where it boasts a market share of more than 30%, deserves special mention. Pirelli also has a strong presence in Argentina.

Its European business, which accounts for 40% of total sales, acts as a counterbalance. Pirelli clearly benefits from strong demand for luxury cars.

Pirelli was the first Western manufacturer of premium tyres to open a manufacturing plant in China, giving it a promising position in this rapidly growing premium market early on. The company announced a joint venture in Russia in 2010 that will serve as a platform for introducing the Pirelli brand to another large, high-growth market. A new factory in Mexico that will begin making premium car tyres in 2Q12 is under construction and Pirelli is aiming to increase its presence in the large US market, where its market share is currently a low 2%.

Well balanced geographic spread of production sites worldwide

Pirelli has displayed a methodical approach in establishing a balanced geographic distribution of production sites worldwide. It currently operates 19 factories in 11 countries. In addition to its locations in Italy, Germany, Great Britain and the USA, there are production facilities in Brazil, Argentina, Venezuela, Turkey, Romania and China. Its production capacity in China will be significantly increased during the current year when a second factory is opened and its first factory in Mexico will be inaugurated in 2012. Only high performance products with tangible value added are produced in the high-cost countries while demand for all other products is met by its factories in low-cost countries. About 80% of its total investment budget of more than EUR 500m for 2011 will be spent in the fast-growing countries. This investment will increase its annual production capacity from 62 million tyres to nearly 70 million.

Greenpower concepts and Formula 1 strengthen the company's reputation

The 01-Series is a new line of tyres for trucks that was launched in 2009. It offers top quality and high performance with reduced rolling resistance, resulting in a longer useful life. Pirelli also claims a pole position in the green space with its Cinturato product family. No environmentally harmful materials are used or emitted to produce these tyres or during their subsequent road use.

Pirelli will profile itself as the exclusive partner of the highly prestigious Formula 1 racing circuit, having signed an exclusive three-year contract for the period from 2011 to 2013 under which it will equip all F1 teams with six different sets of tyres. This will increase awareness of the Pirelli brand and enhance its brand value, and should stimulate sales of its ultra-high performance tyres in the P Zero product family.

Risks: Rubber prices and economic slowdown in the high-growth markets

Natural rubber accounted for about 33% of Pirelli's total raw material costs in 2010; the share of synthetic rubber rose to 24%. The remaining raw material costs consist of chemicals, textiles, carbon black and steel cords. Measured against top-line sales for 2010, raw material costs were equivalent to 39% of total sales and costs for natural rubber 13%. In view of fact that the tyre industry has been displaying good pricing discipline and that Pirelli is so firmly anchored in the premium segment, the negative effect rising rubber prices will have on its financial performance has been overestimated.

An economic slowdown in the fast growing markets would have an impact on Pirelli's operating performance, but this would probably not be as severe as for some of its competitors because of Pirelli's good geographical production spread, attractive cost structure and highly focused product positioning.

Attractive valuation and clear business strategy will take the share price higher

Pirelli, one of the world's largest tyre manufacturers, has profiled itself as a company with a straightforward business strategy and a sharp focus on the premium segment. The company has a very promising position in several fast growing markets and a strong brand. The shares are attractively valued at current prices and the discount to peers as measured by P/E 11E and EV/EBITDA 11E is not justifiable. Moreover, consensus expectations are not demanding so there could be some positive surprises further down the road.

We rate Pirelli shares a Buy.

Update: 4 April 2011

Company profile

Pirelli is the worldwide fifth largest tyre maker by sales and is one of the leaders in the high-end segments with strong technological content. The company has 20 factories throughout the world on four continents, and operates in more than 160 countries. Founded in 1872, Pirelli is listed on the Milan stock exchange since 1922. Pirelli holds an exceptionally strong market position as #1 in the large and fast growing Brazilian market and holds as well a promising footprint in Russia and China. Pirelli is the exclusive supplier of the Formula 1 for the three-year term 2011 to 2013. In 2010, Pirelli generated sales of EUR 4.85bn and an EBIT of EUR 408m with a headcount of almost 29,000 people.

SWOT Analysis

Strengths

- Brand recognition and technological innovation
- High presence in selected emerging markets, especially in Brazil
- Sound financial balance sheet

Weaknesses

- High cycality of the original equipment manufacturer (OEM) tyre market
- Large gap on the global market share between Michelin and Bridgestone with 17% each and Pirelli with 5%
- No relevant business portion in especially high margin special tyres as for instance for mining and construction equipment of airplanes

Opportunities

- Increasing local production in low-cost countries
- Penetration of new markets as for instance Russia
- Formula 1 offers high promotion and reputation benefit

Threats

- Rising raw material prices (natural rubber prices)
- Slower than expected recovery in replacement market
- Economic slowdown, especially in the emerging markets

Valuation / Peer Group Comparison

Data as of 01.04.2011	P/E			EV/EBITDA		EV/EBIT		EV/Sales		P/B	Div. Yield (%)	
	2009A	2010E	2011E	2010E	2011E	2010E	2011E	2010E	2011E	2010E	2009A	2010E
Michelin	87.6	10.4	9.5	4.9	4.9	8.0	7.7	0.7	0.7	1.4	1.6	2.4
Bridgestone	n.m.	13.6	14.3	5.0	5.3	10.4	10.6	0.6	0.6	1.1	0.9	1.2
Goodyear	n.m.	39.0	27.2	4.4	5.6	8.6	9.3	0.3	0.4	3.9	0.0	0.0
Continental	n.m.	13.5	9.8	5.7	4.9	9.9	8.0	0.8	0.7	2.4	0.0	0.0
Yokohama	11.6	10.4	11.5	5.2	5.6	10.4	12.7	0.6	0.5	0.8	2.5	2.5
Nokian Renkaat	62.9	24.3	17.2	13.2	10.3	17.3	12.7	3.6	2.9	4.5	1.3	1.6
Average	**54.0**	**18.5**	**14.9**	**6.4**	**6.1**	**10.8**	**10.2**	**1.1**	**1.0**	**2.4**	**1.1**	**1.3**
Pirelli	**n.m.**	**14.5**	**11.0**	**6.2**	**5.1**	**9.8**	**7.5**	**0.8**	**0.7**	**1.5**	**0.0**	**2.6**

Disclosure
None.

Important notice
This publication, issued by Bank Sarasin & Co. Ltd ("BSC") is based on publicly available information, information sources and data ("the information") whose reliability is beyond question. Nonetheless, BSC accepts no responsibility, either express or implied, for errors or incompleteness of the information provided. Possible errors in this information do not constitute grounds for liability, either directly or indirectly. In particular, neither BSC nor its shareholders or employees are responsible for the accuracy or continuing accuracy of the opinions, appraisals, conclusions, plans or details of companies, their investment strategies, the economic environment, the market, competitive or regulatory environment, etc. Although BSC has taken due care in preparing this presentation, it cannot be excluded that it is incomplete or contains errors. Even if this publication has been issued in the context of an existing contractual relationship, BSC's liability is restricted to gross negligence or wilful misconduct. Furthermore, BSC accepts no liability for minor errors of fact. In any case, the liability of BSC is limited to typical expectable damages, and liability for any indirect damages is expressly excluded.

This publication does not constitute an offer, solicitation or invitation to tender an offer for the purchase or sale of investments or other specific products. BSC may at any time be a buyer or seller of the securities covered in this publication or may act as a principal or mandate holder or may provide investment advisory or investment banking services to the issuer of said securities or to a company closely affiliated to the issuer through economic or financial links. BSC employees may also hold office in one of the companies examined in this publication. Although measures are taken to avoid or disclose conflicts of interest, BSC cannot guarantee that such conflicts of interest will not occur. Therefore BSC accepts no liability for damages arising from such conflicts of interest. The opinions and views stated in it are those of Sarasin at the time it went to press, and may change at any time without prior warning.

Insofar as factual information and the opinions of third parties (interpretations and estimates) are presented, the relevant sources are indicated. Our own value judgments (projections and forecasts) which reflect the outcome of work undertaken by BSC's Research department are not expressly marked or indicated. The substantive principles and benchmarks underlying our own value judgments are set down in our research methodology principles. In producing the research, the following valuation principles and methods were applied: The analysts' investment decisions are based on an analysis of the business model of the company concerned, the market in which the company is active, and general market characteristics (Porter analysis: barriers to market entry, bargaining power of suppliers, bargaining power of customers, threat of substitute products, level of competition). The analysts compare their results with current market expectations and the corresponding data for the company's peer group. Different valuation models are used depending on the industry. Among the most important of these are the price/earnings (P/E) ratio, price-to-book (P/B) ratio, enterprise value-to-sales (EV/sales), enterprise value to earnings before interest, tax, depreciation and amortisation (EV/EBITDA), enterprise value to earnings before interest and tax (EV/EBIT) and dividend yield (ratio of dividend to current share price). We do not set any share price targets for companies covered by our Equity Research. The present financial analysis has been prepared in compliance with the «Directives on the independence of financial research» published by the Swiss Bankers Association in January 2008. The present financial analyses/research results have not been made available to the issuer before their disclosure or publication.

Discrepancies may emerge in respect of our own financial research from the twelve months preceding publication, relating to the same financial instruments or issuers.

BSC is regulated by the Swiss Financial Market Supervisory Authority (FINMA).

Ratings Equity Research
The rating system used by Equity Research has three levels: "Buy", "Neutral" and "Reduce". "Buy" rated companies are expected to outperform the benchmark by at least 5% in the subsequent 12 month period, while "Reduce" rated companies are expected to under perform the benchmark by at least 5%. "Neutral" rated companies are expected to perform within a range of +/-5% in the subsequent 12 month period versus the benchmark. These figures are pure reference values and should in no way be understood as a binding statement concerning the effective development of a company, which may in certain cases be very different. The respective benchmarks are the SMI or SPI for Swiss companies, Dow Jones EuroStoxx for European companies, S&P 500 for US companies and MSCI World for all other companies. No price targets are set for any companies covered by Equity Research. Companies rated as a "Buy" are added to the respective regional Buy list of Switzerland, Europe, USA or the list of Large Global Players. The Top Recommendation is generated from these regional Buy Lists. It comprises the best ideas out of each region and factors in the regional and sector strategy of Bank Sarasin.

Pirelli

Bank Sarasin & Co. Ltd
Sarasin Research
Löwenstrasse 11
P.O. Box
CH-8022 Zürich
Switzerland
T: +41 (0)44 213 94 76
F: +41 (0) 44 213 92 66
research@sarasin.ch