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Price
EUR0.36

Target
EUR0.31

Previous
Reduce

Reduce

Outlook improving for tyres

The outlook for tyres has improved further, while for other business it has stabilised. We lift tyres' valuation and reduce NAV discount. Current prices already factor in an improved scenario. Reduce rating confirmed, target price raised from EUR0.22 to EUR0.31.

Italy Automobiles & parts

Pirelli & C.

COMPANY UPDATE

25 September 2009

Reuters PECI.MI
Bloomberg PC IM
Index DJ Stoxx 600

In brief

- > Tyre unit's valuation increased by 32% to EUR1.256bn
- > Stable outlook for other business
- > Target price raised from EUR0.22 to EUR0.31

Latest financials

Market cap (EURbn)	2.0
Free float	53%
Shares outstanding (m)	5,368
Daily trade volume ('000)	41,728
YTD abs. performance	38%
52-week high (EUR)	0.42
52-week low (EUR)	0.15
Enterprise value (EURm)	2,127
Net debt (EURm)	853

(EUR)	2008	2009E	2010E
Sales	4,660.2	4,212.2	4,312.7
EBITDA	354.0	377.7	491.2
EBIT	-125.3	160.5	292.0
Pretax profit	-380.3	45.7	221.3
Net profit (adj)	-387.9	-14.3	126.3
EPS (adj)	-0.07	0.00	0.02
DPS	0.02	0.00	0.00
PE	-6.6	-136.2	15.4
EV/sales	0.5	0.5	0.5
EV/EBITDA	7.2	5.6	4.3
EV/EBIT	na	13.3	7.3
Net div. yield	3.3%	0.0%	0.0%

Financial year end: 31 December

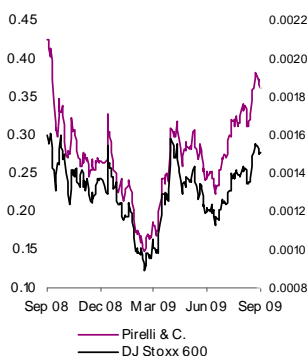
In detail

Tyre unit's valuation increased to EUR1.256bn

We are upping our valuation for the tyre unit from EUR0.95bn to EUR1.256bn and are fine-tuning 2009 tyre sales from minus 6.5% YOY to minus 7.2% YOY while we increase 2010 by 1.5% YOY. We increase our 2009E EBIT after equity participations from EUR218m to EUR261m (after EUR25m in restructuring costs) thanks to cost efficiency, and increase our 2010E EBIT from EUR256m to EUR319m. We assume an EBIT margin of 7.3% in 2009 and 8.3% in 2010 before restructuring costs and 6.7% in 2009 and 8.0% in 2010 post restructuring costs. We now believe the industrial plan's margin targets of 6.5-7% in 2009 and 8-8.5% in 2011 are feasible. On the back of our estimates and assuming 2009E debt of EUR1.35bn for the division, we set our valuation for the tyre unit at EUR1.256bn (long-term growth of 0.5% and WACC of 6.9%), implying 8.2x 2010E EV/EBIT and 9.7x 2010E PE. We believe our valuation fairly factors in the cyclical nature of the business and the implied risks of the turnaround (delay in completing the projected investments and/or higher-than-expected restructuring costs).

Stable outlook for other business

The main asset after tyres is Pirelli RE. After the share capital increase and the management reshuffle, we believe Pirelli RE's outlook is now rather stable with some EUR15m potential risks to our valuation, related to the completion of some asset disposal transactions by year-end. We perceive a major risk on RCS Media Group, where current valuation looks quite stretched, although the impact on Pirelli's NAV is negligible.



Investment conclusion

Target price upped from EUR0.22 to EUR0.31

The main change in our NAV valuation relates to our tyre valuation. After our 2009-10 increase in estimates we have lifted tyres' equity value from EUR0.95bn to EUR1.256bn.

The outlook for the division has improved at a much faster pace than we were expecting. Raw materials trends are favourable, major restructuring costs have been borne and there is no particular pressure on final tyre prices. We now recognise that tyres' EBIT margin is set to match industrial plan guidance at 8% (before restructuring costs) already in 2009, whereas we had been sceptical about this. There is no doubt the division is being turned around and we have accordingly revised our 2009-10 estimates and lifted our valuation.

On Pirelli RE, our view remains basically unchanged: after the share capital increase there is less urgency to dispose of non-core assets and therefore less likelihood of property sales being finalised at a significant discount to market value.

Based on these considerations, we further reduce our NAV discount from 40% to 25%, in line with historical levels. We still believe Pirelli's highly cyclical portfolio (exposed to tyres, real estate, telecoms and publishing) deserves a consistent NAV discount. We therefore rule out any further reduction in NAV discount, also keeping in mind that the Pirelli RE turnaround entails risks which are difficult to estimate or quantify for now.

As for the cash position at holding level, we are factoring the EUR482m of credits for Pirelli RE at 40% as the estimated recovery time is between two and six years and relies on the potential asset disposal of Pirelli RE.

After our NAV revision) Pirelli & C. is trading at around a 12% discount to our EUR0.42 NAV (previously at EUR0.37), far below historical levels (around 25-30%).

Applying a 25% discount to our EUR0.42 per share NAV, we increase our target price from EUR0.22 to EUR0.31 per ordinary share and from EUR0.24 and to EUR0.33 per saving share.

At current prices, we see no upside on the stock, and believe the tyres' turnaround is fully priced in. Despite the vigorous rally and the improved outlook, we continue to believe that diversified and cyclical holdings are unappealing. We confirm our mild negative stance and Reduce rating.

Table 1: Change in 2009 and 2010 estimates

(EURm)	FY 2009E			FY 2010E		
	Old	New	Change	Old	New	Change
Sales	4,230.0	4,212.2	-0.4%	4,314.7	4,312.7	0.0%
<i>o/w tyres</i>	3,834.6	3,804.4	-0.8%	3,884.4	3,859.8	-0.6%
EBITDA	326.6	377.7	15.6%	443.5	491.2	10.8%
<i>o/w tyres</i>	397.8	449.5	13.0%	441.1	492.8	11.7%
EBITDA margin	7.7%	9.0%		10.3%	11.4%	
<i>o/w tyres</i>	10.4%	11.8%		11.4%	12.8%	
EBIT after equity part.	135.8	118.2	-12.9%	233.6	282.0	20.7%
<i>o/w tyres</i>	218.0	261.3	19.9%	256.8	319.1	24.2%
EBIT margin	3.2%	2.8%		5.4%	6.5%	
<i>o/w tyres</i>	5.7%	6.9%		6.6%	8.3%	
Net profit	-2.2	-47.2	nm	65.9	107.9	63.7%

Source: Kepler Capital Markets

Table 2: NAV valuation

(EURm)	N. shares (m)	Pirelli's direct stake	N° of shares held (m)	Valuation method	Book value	Price	Pirelli stake	Per share	% of NAV
Listed assets									
Pirelli Real Estate	841.2	58.0%	487.8	Market value	243.9	0.6	314.6	0.06	14.1%
Intek Spa (ord)	341.6	2.4%	8.3	Market value	4.9	0.3	2.6	0.00	0.1%
RCS Mediagroup	780.4	4.9%	37.8	Market value	112.8	1.3	50.4	0.01	2.3%
Mediobanca	819.1	1.8%	15.0	Market value	211.0	9.8	147.5	0.03	6.6%
Telecom Italia SpA	13,380.8	0.29%	39.2	Market value	49.7	1.2	48.6	0.01	2.2%
Total listed assets					622.3		563.7	0.11	25.3%
Unlisted assets									
Tyres		100.0%		DCF	248.0		1,256.4	0.23	56.3%
Broadband Access		100.0%		DCF	28.5		82.8	0.02	3.7%
Eco Technology		51.0%		Book value	1.5		20.0	0.00	0.9%
Others (including Oclaro)							50.0	0.01	2.2%
Total unlisted assets					278.0		1,409.2	0.26	63.2%
Pension and corporate costs							(160.0)	(0.03)	-7.2%
Net cash + treasury stocks	8.4						416.8	0.08	18.7%
Net asset value					900.3		2,279.7	0.42	100.0%
Pirelli ord.	5,233.1					0.37	1,944.1		
Pirelli sav.	134.8					0.39	52.6		
Total number of shares	5,367.9						1,996.7		
Current premium/(discount) to NAV							-12.4%		
Fair premium/(discount) to NAV							-25.0%		
Fair NAV							1,709.8		
Fair NAV per ord. share							0.31		
Fair NAV per sav. share							0.33		

Source: Kepler Capital Markets

Key financials

Company profile

Pirelli is a conglomerate whose main focus is on tyres production (4.5% market share worldwide). It is also exposed to the production of components for broadband access and real estate businesses.

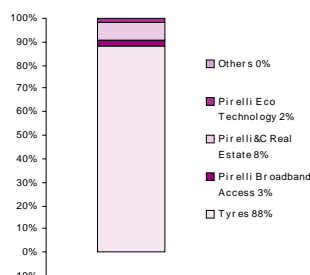
Top shareholders		Events calendar	
Camfin	25.6%	BoD approves Q3 09	05/11/2009
Allianz	4.4%		
Assicurazioni Generali	5.3%		
Premafin	4.3%		
Mediobanca	4.0%		

Income statement, 31 December (EURm)	2008	2009E	2010E	2011E
Sales	4,660.2	4,212.2	4,312.7	4,418.4
EBITDA adjusted	354.0	377.7	491.2	563.9
EBITA adjusted	-125.3	160.5	292.0	370.1
EBIT adjusted	-125.3	160.5	292.0	370.1
Net financial	-80.0	-72.5	-60.7	-54.3
Non recurring items	0.0	0.0	0.0	0.0
Associates	-175.0	-42.3	-10.0	-4.0
PBT	-380.3	45.7	221.3	311.9
Income tax	-72.6	-85.0	-105.0	-104.0
Tax rate (%)	-35.4%	96.6%	45.4%	32.9%
Others	63.4	0.0	0.0	0.0
Minorities	65.0	25.0	10.0	11.0
Reported net earnings	-324.5	-14.3	126.3	218.9
Adjustments	-63.4	0.0	0.0	0.0
Adj. net earnings (group)	-387.9	-14.3	126.3	218.9

Cash-flow statement (EURm)	2008	2009E	2010E	2011E
Net earnings	-389.5	-39.3	116.3	207.9
D&A	420.2	264.6	212.5	15.5
Change in TWC	-111.7	268.9	-24.0	-18.4
Other changes & non-cash	0.0	0.0	0.0	0.0
Operating cash flow	-81.0	494.2	304.7	205.0
Capex	-770.5	-206.2	-211.0	-215.8
Free cash-flow	-851.5	287.9	93.7	-10.8
Disposals	0.0	112.6	0.0	0.0
Financial investments	0.0	115.9	0.0	0.0
Investing cash flow	-770.5	22.3	-211.0	-215.8
Change in equity	-579.2	0.0	0.0	0.0
Change in debt	-383.7	-175.5	-94.2	-80.7
Dividends	-167.9	0.0	-5.5	0.0
Others	268.0	-341.0	6.0	91.4
Financing cash flow	-862.8	-516.4	-93.7	10.8
Change in cash & equivalents	-1,714.3	0.0	0.0	0.0
Change in net debt	1,330.7	-175.5	-94.2	-80.7

Ratios	2008	2009E	2010E	2011E
Sales growth (%)	-10.5%	-9.6%	2.4%	2.4%
EBITDA growth (%)	-39.1%	6.7%	30.1%	14.8%
EBIT growth (%)	-134.4%	-228.1%	81.9%	26.8%
Net earnings growth (%)	ns	ns	ns	73.4%
Gross margin (%)	0.0%	0.0%	0.0%	0.0%
EBITDA margin (%)	7.6%	9.0%	11.4%	12.8%
EBIT margin (%)	-2.7%	3.8%	6.8%	8.4%
Net earnings margin (%)	-8.3%	-0.3%	2.9%	5.0%
Net debt/equity (%)	43.3%	36.6%	30.9%	27.7%
Net debt/EBITDA (%)	290.6%	225.9%	154.5%	120.3%
ROE (%)	-15.1%	-0.7%	5.8%	9.8%
ROCE (%)	-3.1%	3.8%	6.9%	8.7%
Equity/total assets (%)	37.1%	36.9%	38.7%	38.4%
TWC/sales (%)	12.9%	11.6%	11.8%	11.9%
Operating CF/sales (%)	-1.7%	11.7%	7.1%	4.6%
Capex/sales (%)	16.5%	4.9%	4.9%	4.9%
FCF/sales (%)	-18.3%	6.8%	2.2%	-0.2%
Capex/D&A (%)	160.8%	95.0%	105.9%	111.4%
Dividend pay out (%)	na	0.0%	0.0%	0.0%

Sales split - Divisional



Balance sheet, 31 December (EURm)	2008	2009E	2010E	2011E
Cash and equivalents	515.6	515.6	515.6	515.6
Account receivables	788.0	758.2	776.3	795.3
Other current assets	1,352.7	1,429.0	1,440.5	1,461.9
Current assets	2,656.3	2,702.8	2,732.4	2,772.8
Goodwill	0.0	0.0	0.0	0.0
Other intangible assets	1,128.3	1,092.5	1,057.8	1,024.2
Property, plant & equipment	1,598.2	1,619.3	1,647.7	1,679.4
Financial assets	1,021.2	905.3	905.3	905.3
Fixed assets	3,747.7	3,617.1	3,610.8	3,608.9
Short-term debt	756.0	580.5	486.3	405.6
Accounts payable	1,108.6	1,035.3	1,031.8	1,040.7
Other current liabilities	869.1	1,029.3	1,016.0	1,114.6
Current liabilities	2,733.7	2,645.2	2,534.1	2,560.9
Long-term debt	788.2	788.2	788.2	788.2
Pension provisions	366.5	379.1	388.1	397.7
Other long-term liabilities	141.2	176.0	180.2	184.6
Long-term liabilities	1,295.9	1,343.3	1,356.6	1,370.5
Shareholders' equity	2,171.8	2,132.5	2,243.3	2,241.2
Minority interest	202.6	198.9	209.2	209.0
Total shareholders' equity	2,374.4	2,331.4	2,452.5	2,450.2
Net debt	1,028.6	853.1	758.9	678.2
Trade working capital	600.5	489.8	508.8	525.5
Capital employed	4,113.6	4,249.4	4,229.0	4,234.1
Total assets	6,404.0	6,319.9	6,343.2	6,381.7

Per share (EUR)	2008	2009E	2010E	2011E
EPS adjusted	-0.07	0.00	0.02	0.04
EPS reported	-0.06	0.00	0.02	0.04
CFPS	-0.02	0.09	0.06	0.04
BVPS	0.40	0.40	0.42	0.42
DPS	0.02	0.00	0.00	0.00
Year-end nb of shares(m)	5,233.1	5,233.1	5,233.1	5,233.1
Av. diluted nb of shares(m)	5,367.9	5,367.9	5,367.9	5,367.9

Valuation	2008	2009E	2010E	2011E
P/E	na	na	15.4	8.9
P/BV	1.2	0.9	0.9	0.9
P/CF	na	3.9	6.4	9.5
Dividend yield	3.3%	0.0%	0.0%	0.0%
FCF yield	-24.8%	11.1%	-1.2%	0.7%
EV/sales	0.5	0.5	0.5	0.5
EV/EBITDA	7.2	5.6	4.3	3.6
EV/EBITA	na	13.3	7.3	5.6
EV/EBIT	na	13.3	7.3	5.6
EV/capital employed	0.6	0.5	0.5	0.5

Disclosures

Disclosure checklist - Potential conflict of interests

Stock	ISIN	Disclosure (see below)	Currency	Price
Allianz SE	DE0008404005	nothing to disclose	EUR	81.11
Assicurazioni Generali SpA	IT0000062072	nothing to disclose	EUR	17.82
Camfin	IT0000070810	nothing to disclose	EUR	0.36
Intek SPA	IT0000076791	nothing to disclose	EUR	0.31
Mediobanca SpA	IT0000062957	nothing to disclose	EUR	9.89
Pirelli & C Real Estate	IT0003270615	nothing to disclose	EUR	0.64
Pirelli Co	IT0000072725	nothing to disclose	EUR	0.37
Premafin Finanziaria	IT0001475109	nothing to disclose	EUR	1.06
RCS Media Group	IT0003039010	nothing to disclose	EUR	1.36
Telecom Italia Spa	IT0003497168	nothing to disclose	EUR	1.22

Source: Factset closing prices of 24/09/2009

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Kepler Capital Markets' current rating for Pirelli & C. is Reduce and was issued on 29 September 2008. The preceding rating was hold.

We have disclosed the recommendation to the issuer before its dissemination and the recommendation has not been amended following this disclosure.

Rating ratio Kepler Capital Markets Q2 2009

Rating breakdown	A	B
Buy	48.3%	0.0%
Hold	10.7%	0.0%
Reduce	37.8%	0.0%
Not Rated/Under Review/Accept Offer	3.2%	0.0%
Total	100.0%	0.0%

Source: Kepler Capital Markets

A: % of all research recommendations

B: % of issuers to which Investment Banking Services are supplied

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