

## Equities

15 November 2011 | 16 pages

# Pirelli (PECI.MI)

## Reducing Volume Sensitivity

- Volume sensitivity** – By focusing on Mix improvement as the driver of margin enhancement, theoretically the sensitivity to volume declines should be reduced. Indeed, we believe that if volumes were to fall by 10%, more than the 6% decline experienced in 2009, EBIT margins could stay above 9%. There are risks to this assumption most notably if Mix improvement, particularly in Europe, does not proceed at the pace Pirelli has outlined given Tyres are significantly more expensive than in 08/09.
- Ambitious guidance** – A year ago Pirelli targeted a 10.5-11.5% EBIT margin in 2013; it now expects to beat this in 2011 (11-12% target) and by 2014 sees a 15-16% margin. There will be a tendency, we believe, for the market to apply the forecasts that Pirelli has provided in emerging consensus. We are enthusiasts of the stock and raise our forecasts but we think that merely applying Pirelli's forecasts may prove too bullish given the scale of ambition and macro worries.
- Upgrading forecasts** - We are upgrading our earnings forecasts seeing an EBIT margin of 11.1 % in 2012 v 10.2% previously, for 2013 we see a 11.9% EBIT margin v 10.8%. Given the broad macro risks, we are applying modestly lower price/mix improvement estimates than Pirelli does in its Industrial plan (e.g. 6% in 2012 v 8% guidance) and lower volume growth (-1% in 2012 v 2% guidance).
- Uncertainties** – Beyond volumes, we also remain cautious on the capacity to sustain margins in LatAM at the mid-teens level despite Pirelli remaining a predominantly Standard Tyre player here and with Goodyear, its main competitor, reporting a significant drop in margins in 2011 on cost inflation and the pricing impact of new entrants.
- Target price upgrade** – Nevertheless, despite some caution we think Pirelli delivered an impressive message and we upgrade our target price to €8.5 from €8. This target price is based on 5.5x EV/EBITDA a c.10% premium to peers.

- Company Update
- Target Price Change
- Estimate Change

<b>Buy</b>	<b>1</b>
Price (14 Nov 11)	€7.01
Target price	€8.50
	<i>from €8.00</i>
Expected share price return	21.3%
Expected dividend yield	3.7%
<b>Expected total return</b>	<b>25.1%</b>
Market Cap	€3,394M
	US\$4,668M

### Price Performance (RIC: PECI.MI, BB: PC IM)



### Pirelli (EUR)

Year to 31 Dec	2009A	2010A	2011E	2012E	2013E
Sales (€M)	4,067.0	4,848.0	5,760.1	6,385.9	6,828.3
Net Income (€M)	-75.1	261.4	326.9	397.3	451.9
Diluted EPS (€)	-0.15	0.54	0.67	0.82	0.93
Diluted EPS (Old) (€)	-0.15	0.54	0.67	0.72	0.85
PE (x)	-45.5	13.1	10.4	8.6	7.6
EV/EBITDA (x)	4.2	4.7	5.1	4.8	4.1
DPS (€)	0.16	0.17	0.23	0.28	0.34
Net Div Yield (%)	2.3	2.4	3.3	4.0	4.9

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See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

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Fiscal year end 31-Dec	2009	2010	2011E	2012E	2013E
<b>Valuation Ratios</b>					
P/E adjusted (x)	nm	13.1	10.4	8.6	7.6
EV/EBITDA adjusted (x)	4.2	4.7	5.1	4.8	4.1
P/BV (x)	1.6	1.7	1.5	1.4	1.2
Dividend yield (%)	2.3	2.4	3.3	4.0	4.9
<b>Per Share Data (€)</b>					
EPS adjusted	-0.15	0.54	0.67	0.82	0.93
EPS reported	-0.21	0.50	0.65	0.79	0.90
BVPS	4.46	4.09	4.56	5.12	5.74
DPS	0.16	0.17	0.23	0.28	0.34
<b>Profit &amp; Loss (€M)</b>					
Net sales	4,067	4,848	5,760	6,386	6,828
Operating expenses	-3,762	-4,415	-5,161	-5,660	-5,999
<b>EBIT</b>	<b>305</b>	<b>433</b>	<b>599</b>	<b>726</b>	<b>830</b>
Net interest expense	-70	-66	-90	-100	-110
Non-operating/exceptionals	-67	-2	-10	-10	-10
<b>Pre-tax profit</b>	<b>168</b>	<b>366</b>	<b>499</b>	<b>616</b>	<b>710</b>
Tax	-90	-137	-185	-222	-255
Extraord./Min.Int./Pref.div.	-179	18	0	-10	-15
<b>Reported net income</b>	<b>-101</b>	<b>246</b>	<b>314</b>	<b>384</b>	<b>439</b>
Adjusted earnings	-75	261	327	397	452
Adjusted EBITDA	521	658	845	996	1,126
<b>Growth Rates (%)</b>					
Sales	-12.7	19.2	18.8	10.9	6.9
EBIT adjusted	63.1	42.0	38.3	21.3	14.2
EBITDA adjusted	29.0	26.3	28.4	17.9	13.0
EPS adjusted	78.0	448.1	25.1	21.5	13.8
<b>Cash Flow (€M)</b>					
<b>Operating cash flow</b>	<b>405</b>	<b>848</b>	<b>351</b>	<b>454</b>	<b>716</b>
Depreciation/amortization	216	225	246	270	296
Net working capital	212	95	-209	-210	-34
<b>Investing cash flow</b>	<b>31</b>	<b>-452</b>	<b>-550</b>	<b>-767</b>	<b>-500</b>
Capital expenditure	-186	-415	-500	-550	-500
Acquisitions/disposals	202	-36	-50	-217	0
<b>Financing cash flow</b>	<b>-174</b>	<b>-568</b>	<b>-82</b>	<b>-112</b>	<b>-136</b>
Borrowings	-102	-422	0	0	0
Dividends paid	-2	-85	-82	-112	-136
<b>Change in cash</b>	<b>257</b>	<b>-164</b>	<b>-280</b>	<b>-425</b>	<b>80</b>
<b>Balance Sheet (€M)</b>					
<b>Total assets</b>	<b>6,727</b>	<b>5,619</b>	<b>6,438</b>	<b>6,713</b>	<b>7,139</b>
Cash & cash equivalent	793	455	679	261	347
Accounts receivable	1,001	912	1,092	1,207	1,289
Net fixed assets	1,727	1,977	2,226	2,501	2,698
<b>Total liabilities</b>	<b>4,233</b>	<b>3,591</b>	<b>4,177</b>	<b>4,169</b>	<b>4,278</b>
Accounts payable	1,730	1,720	1,806	1,799	1,908
Total Debt	1,795	1,142	1,642	1,642	1,642
<b>Shareholders' funds</b>	<b>2,495</b>	<b>2,028</b>	<b>2,261</b>	<b>2,543</b>	<b>2,861</b>
<b>Profitability/Solvency Ratios (%)</b>					
EBITDA margin adjusted	12.8	13.6	14.7	15.6	16.5
ROE adjusted	-3.5	12.6	15.5	16.8	17.1
ROIC adjusted	7.7	10.9	14.1	14.8	15.2
Net debt to equity	40.2	33.9	42.6	54.3	45.3
Total debt to capital	41.8	36.0	42.1	39.2	36.5

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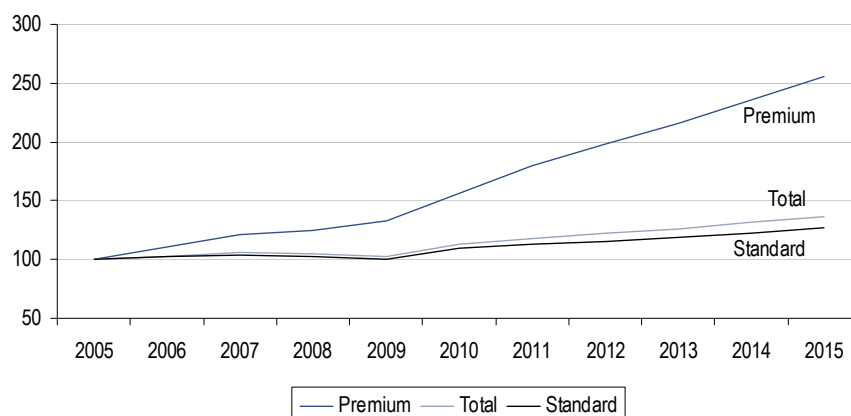


## Reduced Volume Sensitivity

Pirelli has set very ambitious targets on which it will be judged

Pirelli has set itself a very high benchmark upon which it will be judged in the years to come. And it has a good track-record in achieving its aims – in November 2010 it set itself a target EBIT margin of 8.5-9.5% for FY11E, yet in 2011 it is likely to secure a 10% EBIT margin. We do believe that Pirelli is setting the right path by focusing on upgrading capacity, which reduces margin sensitivity to volume declines. We also upgrade our forecasts though not to the same level as Pirelli's targets retaining some caution on volumes, LatAm margins and indeed Premium Tyre growth. Premium Tyre sales did continue to rise in 2008/2009 despite the credit crisis which led to a decline in standard Tyres (see Figures 1 & 2). With the growth in the premium car parc, and regulatory changes favouring Green and Winter Tyres we anticipate premium sales should also continue to grow in another European recession too.

Figure 1. Relative performance of Global Premium & Standard Tyre markets, 2005A-2015E



Source: Citi Investment Research and Analysis, Company data

Figure 2. Relative performance of Global Premium & Standard Tyre markets, 2005A-2015E

### YoY Trend

	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Premium	+11.1%	+9.2%	+2.9%	+6.8%	+16.8%	+15.8%	+9.6%	+9.5%	+9.1%	+8.7%
Standard	+1.7%	+2.7%	-1.2%	-3.0%	+8.9%	+3.3%	+2.4%	+2.8%	+3.4%	+3.6%
Total	+2.4%	+3.3%	-0.8%	-2.1%	+9.7%	+4.7%	+3.3%	+3.7%	+4.2%	+4.3%

Source: Citi Investment Research and Analysis, Company data

Premium Tyre sales are likely to grow though the raw material influenced rise in prices since the 08/09 credit crisis provides a note of caution

Nevertheless, prices for premium Tyres are also higher than they were during the 08/09 financial crisis following a raft of price rises primarily influenced by higher raw material costs. Hence, we can't merely assume that there is no risk of a stalling in demand should macro conditions weaken even if Premium consumers are likely to be less impacted by austerity measures than consumers of standard Tyres. The introduction of labeling in Europe at the end of 2012 may also help the premium Tyre business with recent testing from the European Tyre & Rubber Manufacturers' Association suggesting that 10% of tyres sold in Europe will not meet the minimum standards outlined in the new rules. The potential for these participants to be forced out of the market should increase market share for mainstream players. Nevertheless, it may be that the primary beneficiaries are Tier 2 players rather than the high end Tyre makers. This suggests that of the three European Tyre companies we cover, Pirelli, Conti and Michelin, that Michelin may indeed benefit most given its broader depth of brands some of which are geared more to Tier 2 consumers.

Figure 3. Tyre price rises announced by major Tyre players 2009-2011 %

		Bridgestone	Michelin	Goodyear	Continental	Pirelli
FY 11	12					☆up to 7%
	11	up to 8%	☆avg 4%	☆up to 10%	☆up to 8.5%	
	10	☆8-9% ⊖5%	☆avg 6.5%	☆up to 5%		
	9	av 10%	5-10%	up to 8%		
	8					
	7	⊖-12% ☆av 11%	☆avg 12%		☆up to 11%	☆up to 5%
	6	8.0%				☆6-9% ⊖-12%
	5	av 7% (4-6)	☆up to 8.5%	☆up to 8%		
	4	up to 8%	☆up to 7%	up to 15%	☆up to 10%	☆5%
	3	av 7%		☆up to 6%		⊖-7%
	2	up to 12%				
	1	⊖av 6%			☆P: up to 6.5% T: up to 8%	
FY 10	12		☆av 8%			☆up to 7%
	11	☆up to 8%				
	10	⊖-6%		☆up to 6%		⊖4%
	9		⊖%			⊖up to 6%
	8					
	7	☆up to 6%				☆4%
	6	☆up to 6%	☆up to 6%	☆up to 6%	☆up to 7%	
	5		☆up to 7%	up to 8%	av 5.5%	
	4	⊖-5%			up to 8%	
	3					
	2				☆up to 8%	
	1	☆up to 5%			up to 5%	☆up to 4.5%
FY 09	12			☆up to 6%		
	11					
	Passenger		Truck& Bus		Both	

Source: Citi Investment Research and Analysis, Company data

We also assume lower volume growth than that implicit in Pirelli's forecasts specifically seeing volumes down modestly in 2012. Though Pirelli has more than delivered on its Price/mix targets it has been less successful at predicting volumes – it now sees 2011 volumes up 3%, half the >6% estimates of the beginning of the year. This is not a criticism as unlike Mix improvement this is much less controllable. Even if volumes were to decline by 10% in 2012, which seems unlikely, we believe that Pirelli would still be able to generate 9% EBIT margins.

Figure 4. 2012E Pirelli group EBIT forecasts, sensitivity to various Volume and price/mix scenarios, €mn unless stated

Volume sensitivity	2012	Price/Mix sensitivity	2012
Base case Volumes -1% EBIT	706	Base case Price/Mix 6% EBIT	706
Base case Volumes -1% EBIT margin	11.1%	Base case Price/Mix 6% EBIT margin	11.1%
Volumes -5% EBIT	638	Price/Mix 4% EBIT	627
Volumes -5% EBIT margin	10.40%	Price/Mix 4% EBIT margin	10%
Volumes -10% EBIT	553	Price/Mix 3% EBIT	604
Volumes -10% EBIT margin	9.40%	Price/Mix 3% EBIT margin	9.7%

Source: Citi Investment Research and Analysis

In the table below we highlight our estimate of the main revenue and EBIT drivers of the Tyre business within the group.

Figure 5. Tyre EBIT (pre-exceptional) main revenue and EBIT drivers, €mn unless stated

	2010	2011	2012	2013
<b>Group Net Sales Growth %</b>				
FX	3.3%	-2.0%		
Volumes	7.3%	3.0%	-1.0%	3.0%
Mix		9.0%	4.0%	4.0%
Price		9.00%	2.0%	0.0%
Price/mix	8.9%	18.0%	6.0%	4.0%
Perimeter	0.0%	0.0%	6.0%	0.0%
Growth	19.5%	19.0%	11.0%	7.0%
<b>Group Net Sales Growth €m</b>		<b>19.0%</b>	<b>5.0%</b>	<b>7.0%</b>
FX	132	(95)	0	0
Volumes	291	144	(57)	189
Price/mix	355	859	341	252
Perimeter	0	0	341	0
<b>Growth</b>	<b>779</b>	<b>907</b>	<b>625</b>	<b>441</b>
<b>Net sales</b>	<b>4,772</b>	<b>5,680</b>	<b>6,306</b>	<b>6,748</b>
Operating expenses	-4,296	-5,031	-5,560	-5,904
EBIT (pre-exceptional)	476	649	746	845
<b>EBIT Margin</b>	<b>10.0%</b>	<b>11.4%</b>	<b>11.8%</b>	<b>12.5%</b>
	131			
Margin Expansion	130	173	97	98
- Mix		215	91	101
- Price		429	114	0
Price/Mix	332	644	204	101
Raw Material / Energy Prices	-317.8	-560	75	0
Volumes	101	57	-17	47
FX	3	-13	-140	0
Fixed costs/other (production cuts etc, depreciation)	-38	-36	-145	-120
Efficiencies	50.1	80	120	70
<b>Margin Expansion</b>	<b>2.7%</b>	<b>3.0%</b>	<b>1.5%</b>	<b>1.5%</b>

Source: Citi Investment Research and Analysis, Company data

Figure 6. Pirelli's Industrial plan targets, €bn unless stated

	2011E	2012E	2014E
Total Revenues	<5.8	~6.7	~7.7
		YoY	CAGR 11-14
Growth Rate		16%	10%
o/w Russia JV		6%	2%
o/w volumes	~+3%	2%	3%
o/w premium	23%	20%	17%
ow price mix	~+18%	8%	5%
EBIT DA*%	~14%	15% - 16%	19%-20%
EBIT **%	~10%	11% - 12%	~15% - ~16%
o/w Russia		mid single digit	14% - 15%

Source: Citi Investment Research and Analysis, Company Data, \* After continuous restructuring

The decline in Goodyear's profitability in Latin America provides another note of caution

### Latin America is probably the biggest uncertainty

We also feel there is considerable uncertainty on the development in Latin America which was 50% of EBIT for the group in 2010. Standard Tyres in Latin America are much more profitable than elsewhere. Although there is limited data on margins in the LatAm region from peers apart from Goodyear, the higher profitability in this region is clearly evident in the consolidated EBIT margins of Tyre players. Pirelli itself, in 9M 2011 results, described its LatAm business as generating mid double digit margins with NAFTA on low single digit and its more premium-focused European business just moving into double digit margins from mid-single digit in the first nine months of 2010.

Figure 7. Pirelli and peer group EBIT margins, 2007A-2010A

	2007	2008	2009	2010
<b>Europe</b>				
Pirelli	8.6%	6.1%	8.7%	8.9%
Continental Tire	13.1%	10.6%	12.7%	14.6%
Michelin	9.8%	5.6%	5.8%	9.5%
Nokian	22.8%	23.2%	12.8%	20.8%
<b>US</b>				
Cooper Tire	4.8%	-3.6%	7.3%	6.9%
Goodyear	5.4%	3.9%	1.4%	4.0%
<b>Japan</b>				
Bridgestone	7.4%	4.1%	2.9%	5.8%
Sumitomo	8.0%	4.2%	5.5%	7.9%
Yokohoma Rubber	4.2%	6.0%	2.5%	4.6%

Source: Citi Investment Research and Analysis, Company data

**Goodyear margins have fallen dramatically in LatAm this year**

LatAm margins may well be sustainable especially with Latin American GDP likely to outgrow developed markets in the years ahead. However, Goodyear, Pirelli's main competitor in this market has seen margins decline from 15-17% to nearer 10% in Q311 on cost inflation and the pricing impact of newer and cheaper imports mainly from China in H111. Pirelli seems to have avoided margin dilution through pricing and the roll-out of new products. Also, with the weakening of the Brazilian Real recently the pricing advantage of imports is weakening. But this Goodyear data does highlight a less predictable market than Pirelli suggests. And there will be new capacity launched in the market of c. 15mn Tyres coming from Michelin, Goodyear and Continental that may also increase pricing pressure.

**Figure 8. Goodyear EBIT margin progression, 2007-Q311 %**

Period	2007	2008	2009	2010	Q111	Q211	Q311
EBIT margin	19.20%	17.60%	16.60%	15.30%	11.50%	8.40%	9.50%

Source: Citi Investment Research and Analysis, Company data

## Valuation

Our new target price of €8.5 applies a 5.5x EV/EBITDA multiple on 2012E which is roughly at a 10% premium to the level we apply to Michelin as we feel Pirelli is reducing its sensitivity to volumes and is likely to generate EBIT margins of c. 1% higher than peers in 2012. We are tempered in our enthusiasm though by it trading on P/E terms at a higher multiple than peers as can be seen in Figure 8.

**Figure 9. Pirelli, Conti, Michelin, 2012 EBIT margins and 2012 valuation multiples**

	Pirelli	Conti	Michelin
EBIT margin %	11.1%	10.3%	9.8%
EV/EBITDA	4.8x	4.3x	4.2x
P/E	8.9x	6.4x	6.4x

Source: Citi Investment Research and Analysis

**Figure 10. Pirelli Valuation multiples at market price**

**VALUATION MULTIPLES AT MARKET PRICE**

	2006	2007	2008	2009	2010	2011E	2012E	2013E
EV/Sales	141%	80%	96%	56%	66%	77%	76%	70%
EV/EBITDA	11.1x	8.3x	11.0x	4.3x	4.8x	5.2x	4.8x	4.2x
EV/EBIT	17.0x	13.2x	23.9x	7.4x	7.4x	7.4x	6.7x	5.8x
P/E	(3.2)	25.7x	(13.6)	31.2x	65.1x	10.8x	8.9x	7.8x
FCF Yield	6.2%	6.7%	-8.3%	22.9%	8.7%	-4.1%	-2.6%	6.3%
Price/Sales	77%	70%	52%	37%	51%	61%	55%	52%
Price/Book	1.0x	1.4x	1.1x	0.7x	1.2x	1.6x	1.4x	1.3x
Dividend yield	0.0%	2.0%	0.0%	5.1%	3.3%	3.2%	3.9%	4.7%
EV/CE	0.86x	1.26x	0.95x	0.54x	0.93x	1.12x	1.04x	0.98x
ROCE/WACC	0.66x	1.48x	0.38x	1.31x	2.03x	2.44x	2.50x	2.72x

Source: Citi Investment Research and Analysis

Figure 11. Pirelli Financial Summary, 2007A-2013E, €mn unless stated

<b>Profit &amp; Loss</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>	<b>2010</b>	<b>2011E</b>	<b>2012E</b>	<b>2013E</b>
<b>Net Sales</b>	<b>6076</b>	<b>4660</b>	<b>4067</b>	<b>4848</b>	<b>5760</b>	<b>6386</b>	<b>6828</b>
Operating expenses	-5,709	-4,473	-3,762	-4,415	-5,161	-5,660	-5,999
<b>Clean EBIT (pre-exceptional)</b>	<b>367</b>	<b>187</b>	<b>305</b>	<b>433</b>	<b>599</b>	<b>726</b>	<b>830</b>
<b>Clean EBIT Margin, %</b>	<b>6.0%</b>	<b>4.0%</b>	<b>7.5%</b>	<b>8.9%</b>	<b>10.4%</b>	<b>11.4%</b>	<b>12.1%</b>
Other non-recurring items	-3	-144	-55	-25	-20	-20	-20
<b>Reported EBIT</b>	<b>364</b>	<b>43</b>	<b>250</b>	<b>408</b>	<b>579</b>	<b>706</b>	<b>810</b>
<b>Reported EBIT Margin, %</b>	<b>6.0%</b>	<b>0.9%</b>	<b>6.1%</b>	<b>8.4%</b>	<b>10.1%</b>	<b>11.1%</b>	<b>11.9%</b>
Net Interest	-82	-80	-70	-66	-90	-100	-110
Other	97	-366	-12	23	10	10	10
<b>PBT</b>	<b>379</b>	<b>-403</b>	<b>168</b>	<b>366</b>	<b>499</b>	<b>616</b>	<b>710</b>
Tax	-123	-73	-90	-137	-185	-222	-255
<b>Reported Net Income (incl discontinued items)</b>	<b>256</b>	<b>-476</b>	<b>78</b>	<b>228</b>	<b>314</b>	<b>394</b>	<b>454</b>
<b>Reported EPS</b>	<b>0.34</b>	<b>-0.71</b>	<b>0.05</b>	<b>0.05</b>	<b>0.65</b>	<b>0.79</b>	<b>0.90</b>
DPS	0.18	0.00	0.16	0.17	0.23	0.28	0.34
<b>Pre-Exceptional:</b>							
EBIT	367	187	305	433	599	726	830
Clean EBIT Margin, %	6.0%	4.0%	7.5%	8.9%	10.4%	11.4%	12.1%
<b>EPS</b>	<b>0.34</b>	<b>-0.37</b>	<b>0.10</b>	<b>0.08</b>	<b>0.67</b>	<b>0.82</b>	<b>0.93</b>
EPS (excl. goodwill)	0.34	-0.37	0.10	0.08	0.67	0.82	0.93
<b>Balance Sheet</b>							
Current Assets	4390	2459	2473	2059	2578	2362	2592
Fixed Assets	4563	4474	4254	3560	3859	4351	4548
<b>Total Assets</b>	<b>8953</b>	<b>6933</b>	<b>6727</b>	<b>5619</b>	<b>6438</b>	<b>6713</b>	<b>7139</b>
Current Liabilities	3663	2577	2019	1968	2554	2546	2655
Long-term Liabilities	1487	1982	2214	1623	1623	1623	1623
<b>Net Assets</b>	<b>3804</b>	<b>2374</b>	<b>2495</b>	<b>2028</b>	<b>2261</b>	<b>2543</b>	<b>2861</b>
Minority Interests	824	203	320	37	37	47	62
<b>Shareholders' Funds</b>	<b>2980</b>	<b>2172</b>	<b>2175</b>	<b>1991</b>	<b>2224</b>	<b>2496</b>	<b>2799</b>
Net Working Capital	-689	208	-50	-116	93	303	337
<b>Net Cash (Debt)</b>	<b>302</b>	<b>-1028</b>	<b>-529</b>	<b>-456</b>	<b>-731</b>	<b>-1150</b>	<b>-1063</b>
Gearing (Net Debt / Equity)	-10%	47%	24%	23%	33%	46%	38%
Gearing (post pension PBO)	-22%	30%	4%	-1%	11%	27%	21%
Net Debt/Ebitda	-0.52x	2.53x	1.01x	0.69x	0.86x	1.15x	0.94x
<b>Cash Flows</b>							
Gross cash flow	475	-257	297	457	578	683	770
Change in net working capital	80	333	235	171	-221	-223	-47
<b>Cash Flow from Operations</b>	<b>554</b>	<b>76</b>	<b>532</b>	<b>628</b>	<b>356</b>	<b>460</b>	<b>723</b>
Capex	-287	-311	-223	-433	-500	-550	-500
Net Disposals (Acquisitions)	2655	-505	249	-17	-50	-217	0
<b>Cash Flow from Investing</b>	<b>2368</b>	<b>-816</b>	<b>25</b>	<b>-450</b>	<b>-550</b>	<b>-767</b>	<b>-500</b>
Dividends paid	-74	-168	-2	-85	-82	-112	-136
Equity issued (redeemed)	-46.8	13.4	0.0	4.8	0.0	0.0	0.0
Debt issued (redeemed)	-1041	-929	-172	-488	0	0	0
<b>Cash Flow from Financing</b>	<b>-1162</b>	<b>-1084</b>	<b>-174</b>	<b>-568</b>	<b>-82</b>	<b>-112</b>	<b>-136</b>
Other Changes	3	-28	-2	5	0	0	0
Increase in Cash	1763	-1852	381	-384	-275	-419	87

Source: Citi Investment Research and Analysis, Company data

## Pirelli

### Company description

Pirelli is a leading tyre manufacturer generating revenues of €4.85bn in 2010. The company remains the dominant Latin American player in both passenger car tyres and truck tyres. Pirelli's strategy is focused on being a premium player in the passenger car tyre business and an emerging markets player in truck tyres. The free float is only 47% with investment holding company Camfin the largest shareholder.

### Investment strategy

Our Buy rating reflects our view of growing demand for premium tyres globally and its capacity to grow margins through a de-emphasis of standard Tyre production. We expect Pirelli to enjoy the strongest Mix improvement in the sector over the medium term reducing sensitivity to volume declines. Raw materials are also likely to prove a tailwind in 2012 with the decline in natural rubber.

### Valuation

Our 8.50 Euro target price is based on 2012E EV/EBITDA of 5.5x, c.10% higher than the multiple we apply to Michelin which generates similar margins currently but which has a lower prospect for margin enhancement in the 2011-2013 period than Pirelli, in our view. We choose only a modest uplift to the multiples we apply to peers' target prices in terms of EV/EBITDA with Pirelli currently trading on a P/E basis 15-20% higher than peers. Pirelli historical multiples are only of limited use given the 2010 spin-off of its real-estate business and the 2010 reverse stock split.

### Risks

The key risks to achieving our target price are: renewed softness in replacement markets and lack of progress in improving Truck sales; materially higher raw material prices that cannot be passed on through price rises; and poorer mix. Conversely, stronger-than-anticipated control of working capital and lower debt, falling raw material prices, more rapid progress in reducing labour costs, and a faster-than-anticipated increase in mature market margins could see the share price rise above our target.

## Continental AG

(CONG.DE; €54.76; 1)

### Valuation

Our target price of €69 represents EV/EBITDA of 5x on 12E, a roughly 15% discount to its historical average to reflect growing macro uncertainties. Near-term P/E metrics have become less useful with the temporarily high tax rate, which should normalise in 2012E - a year when our TP implies a P/E of c.8x and we forecast an adjusted EBIT margin of 10.3%.

## Risks

The shares would most likely underperform our target price in a scenario where industry conditions deteriorated more than envisioned or if there was difficulty securing favourable debt refinancing terms or failure to remain in compliance with debt covenants. Conversely, the most likely scenario in which the stock would perform more strongly than we foresee would be further strong evidence of industry outperformance.

## Michelin

(MICP.PA; €48.88; 1)

## Valuation

We believe that Michelin should be able to return to its average historical valuation levels, given an increasingly positive medium term volume growth outlook spurred by emerging market demand and higher Truck Tyres; tighter regulation should also improve mix and boost market share. Our €65 target price is based on 2012E EV/EBITDA of 5.1x, roughly a 15% discount to its average attainment for 2000-08. The discount reflects ongoing (though moderating) uncertainties about the development of raw material prices and Michelin's capacity to continue to pass these onto customers but more importantly growing macro uncertainties.

## Risks

The key risks to achieving our target price are: renewed softness in replacement markets and lack of progress in improving Truck sales; materially higher raw material prices that cannot be passed on through price rises; and poorer mix. Conversely, stronger-than-anticipated control of working capital and lower debt, falling raw material prices, more rapid progress in reducing labour costs, and a faster-than-anticipated increase in EM margins could see the share price overshoot our target.

# Appendix A-1

## Analyst Certification

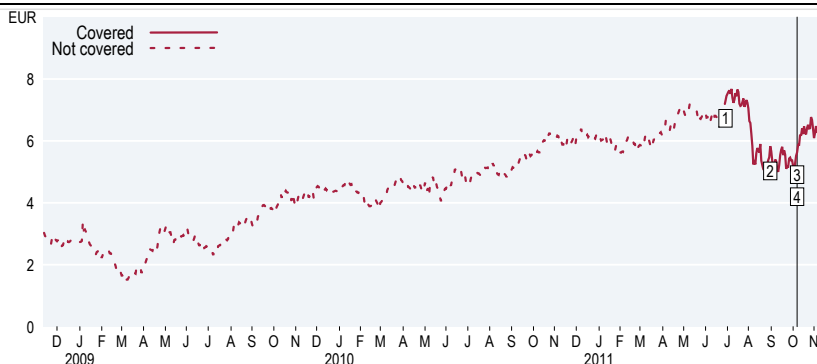
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### Pirelli (PECI.MI)

#### Ratings and Target Price History Fundamental Research

Analyst: Philip Watkins  
Covered since June 30 2011



	Date	Rating	Target Price	Closing Price
1	29-Jun-11	1M	*9.00	7.29
2	31-Aug-11	1M	*8.00	5.83

	Date	Rating	Target Price	Closing Price
3	7-Oct-11	Stock rating system changed		
4	7-Oct-11	*1	8.00	5.63

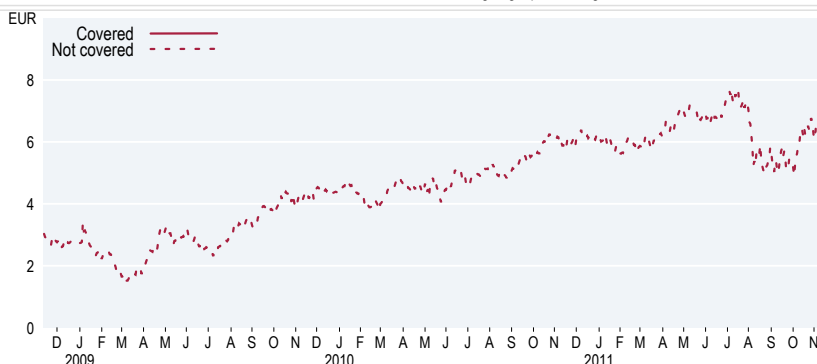
\* Indicates change

Rating/target price changes above reflect Eastern Standard Time

### Pirelli (PECI.MI)

#### Ratings and Target Price History Best Ideas Research Relative Call (3 Month)

Analyst: Philip Watkins  
Covered since June 30 2011



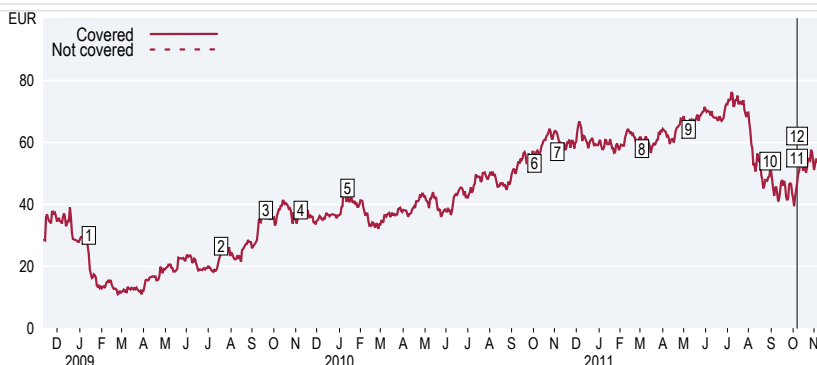
\* Indicates change

Rating/target price changes above reflect Eastern Standard Time

### Continental AG (CONG.DE)

#### Ratings and Target Price History Fundamental Research

Analyst: Philip Watkins  
Covered since November 13 2009



	Date	Rating	Target Price	Closing Price
1	14-Jan-09	3M	*25.14	23.80
2	20-Jul-09	*2M	*29.01	26.54
3	21-Sep-09	2M	*38.68	35.21
4	8-Nov-09	*1H	*43.52	35.39

	Date	Rating	Target Price	Closing Price
5	13-Jan-10	*1M	*53.00	42.20
6	3-Oct-10	1M	*68.00	56.97
7	4-Nov-10	1M	*73.00	62.61
8	3-Mar-11	1M	*83.00	59.90

	Date	Rating	Target Price	Closing Price
9	8-May-11	1M	*86.00	66.26
10	31-Aug-11	1M	*69.00	51.37
11	7-Oct-11	Stock rating system changed		
12	7-Oct-11	*1	69.00	46.91

\* Indicates change

Rating/target price changes above reflect Eastern Standard Time

### Continental AG (CONG.DE)

#### Ratings and Target Price History

#### Best Ideas Research

#### Relative Call (3 Month)

Analyst: Philip Watkins

Covered since November 13 2009



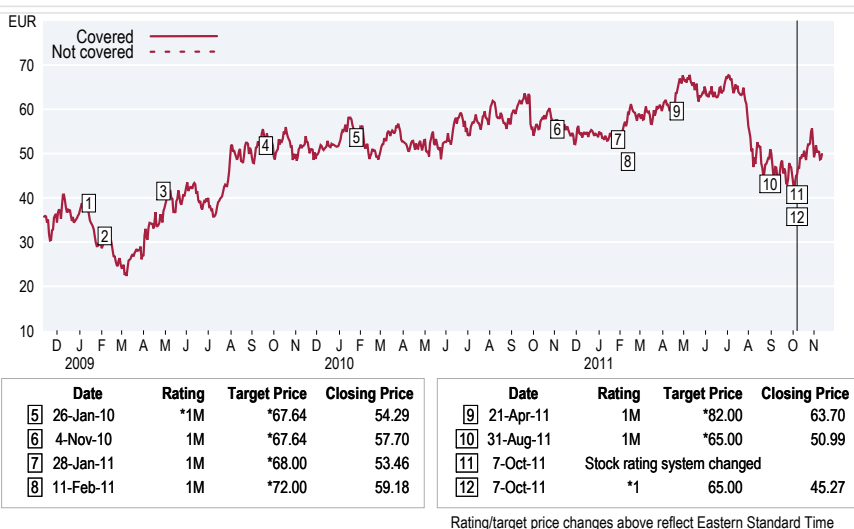
### Michelin (MICP.PA)

#### Ratings and Target Price History

#### Fundamental Research

Analyst: Philip Watkins

Covered since September 22 2009



### Michelin (MICP.PA)

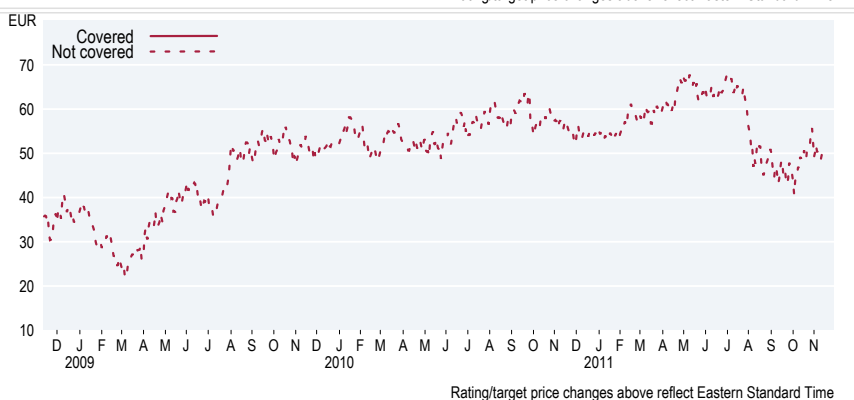
#### Ratings and Target Price History

#### Best Ideas Research

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Analyst: Philip Watkins

Covered since September 22 2009



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