

Europe Italy  
Autos Tires

Deutsche Bank



24 November 2011

# Pirelli & C

Reuters: **PECI.MI** Bloomberg: **PC IM** Exchange: **MIL** Ticker: **PECI**

## A mix-driven story

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### A story driven by mix, not by volume

Mgt has released a 3-year strategic plan. Thanks to mix improvement towards 20%+ EBIT margin premium tires, mgt is guiding for a 2x EBIT increase by 2014. We do not need to be that ambitious to justify our Buy stance, especially in the current recessionary environment. Over the next 3 years we expect a 74% EBIT increase which would correspond to a 2014 EPS of Euro 1.15. Based on a 37% payout ratio, it corresponds to a dividend of Euro 0.43 (yield of 6.5%). Reinstatement rating at Buy; reinstate target price at Euro 9.0.

### A three-year plan driven by a strong mix effect

By 2014, mgt wants to increase revenues by 33% to Euro 7.7bn and to increase EBIT margin to 15-16% (from 10% in 2011). This corresponds to a 2x EBIT increase. The EBIT increase is NOT to come from volume (only +3% p.a) but from a significant mix improvement (more premium tires which generate an EBIT margin of 20%+) and at a lesser extent from efficiency gains. Furthermore, raw material prices and Russia are expected to play a minor role in the EBIT improvement.

### We do not need to be that bullish to justify a Buy rating

We are more conservative than mgt. This is not because mgt targets are excessively optimistic (volume effect of only +3% p.a). But in current recessionary environment we want to be more cautious in our assumptions. Our new estimates, even below mgt target, still correspond to 74% EBIT growth over the next 3 years. Our 2014 estimate is based on revenues of Euro 7.4bn (4% below mgt's guidance) and on an EBIT margin of 13.7% in 2014 or Euro 1.0bn (or approx 15% lower than mgt's target).

### Short-term outlook: 2012 should be a good year

Revenues should reach Euro 6.3bn, +11% YoY (6% below mgt), partly attributable to the full consolidation of the Russian JV. And EBIT should increase by a high +20% to Euro 700m (10% below mgt), driven by the price and mix effect (premium segment). As for the rest of the industry we expect 0% volume. Moreover, we have factored into our estimates a positive raw material effect of only Euro 50m.

### Valuation/Risk

Our TP of Euro 9.0 is based on a 2012e P/E of 12x and EV/EBITDA of 6x. We believe the pricing premium to the auto parts sector is justified given the strong earnings growth we expect, +25% pa by 2013. Key risks are: i) a further surge of raw material price increases (mostly natural rubber) or ii) an aggressive price war initiated at the entry-level segment, leading Pirelli to give back to customers a high percentage of savings, limiting margin improvement. (See page 18 for details.)

#### Forecasts and ratios

Year End Dec 31	2009A	2010A	2011E	2012E	2013E
DB EPS (EUR)	0.00	0.04	<b>1.36</b>	0.79	1.00
P/E (DB EPS) (x)	72.3	64.6	<b>4.6</b>	7.9	6.3
DPS (EUR)	0.00	0.16	<b>0.22</b>	0.30	0.36
Yield (%)	0.0	5.8	<b>3.5</b>	4.8	5.7

Source: Deutsche Bank estimates, company data

### Forecast Change

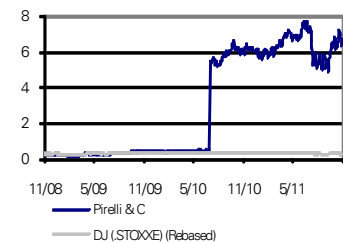
#### Buy

Price at 23 Nov 2011 (EUR)	<b>6.30</b>
Price Target (EUR)	<b>9.00</b>
52-week range (EUR)	<b>7.68 - 4.91</b>

#### Key changes

Target Price	8.00 to 9.00	↑	<b>12.5%</b>
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#### Price/price relative

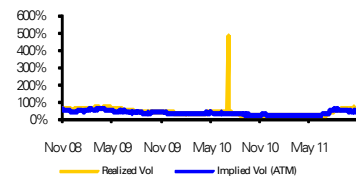


Performance (%)	1m	3m	12m
Absolute	-1.9	24.9	6.9
DJ (.STOXXE)	-10.5	-5.6	-23.2

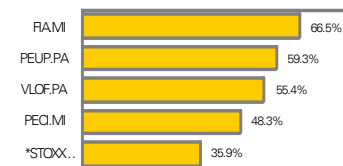
#### Stock & option liquidity data

Market cap (EUR)(m)	3,126.9
Shares outstanding (m)	488
Free float (%)	51
Option volume (und. shrs., 1M avg.)	176,761

#### Implied & Realized Volatility (3M)



#### Implied Volatility (3M, ATM) vs. Peers



\*Weighted-avg. of index components  
Data as of 23-Nov-11

Deutsche Bank AG/London

All prices are those current at the end of the previous trading session unless otherwise indicated. Prices are sourced from local exchanges via Reuters, Bloomberg and other vendors. Data is sourced from Deutsche Bank and subject companies. Deutsche Bank does and seeks to do business with companies covered in its research reports. Thus, investors should be aware that the firm may have a conflict of interest that could affect the objectivity of this report. Investors should consider this report as only a single factor in making their investment decision. DISCLOSURES AND ANALYST CERTIFICATIONS ARE LOCATED IN APPENDIX 1. MICA(P) 146/04/2011.

Model updated: 24 November 2011

**Running the numbers****Europe****Italy****Tires****Pirelli & C**

Reuters: PECL.MI

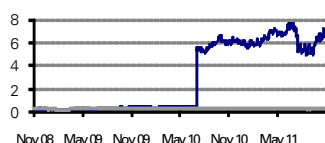
Bloomberg: PC IM

**Buy**

Price (23 Nov 11)	EUR 6.30
Target price	EUR 9.00
52-week Range	EUR 4.91 - 7.68
Market Cap (m)	EURm 3,127 USDm 4,175

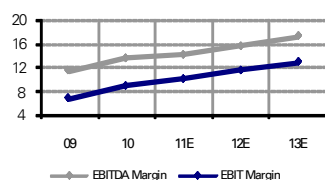
**Company Profile**

The Pirelli Group has a long industrial tradition and a position of leadership in all sectors in which it is active. With 135 years of experience, Pirelli is a multinational, deeply rooted in all countries in which it operates. The group has focused its activities on a selected number of high profit margin businesses, with segmentation towards high-range products. In the tyres business, which represents the group's core business, Pirelli is the leader in the top market segment in terms of technologies, improved earnings and quality of management, and it is the world's fifth-largest tyre manufacturer in term of sales value.

**Price Performance**

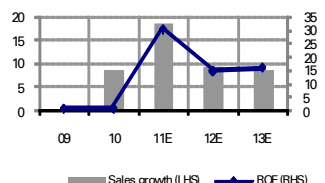
Nov 08 May 09 Nov 09 May 10 Nov 10 May 11

— Pirelli &amp; C — DJ (STOXXE) (Rebased)

**Margin Trends**

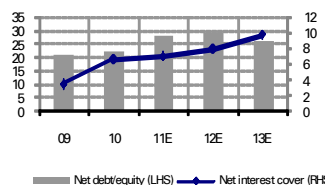
09 10 11E 12E 13E

— EBITDA Margin — EBIT Margin

**Growth & Profitability**

09 10 11E 12E 13E

— Sales growth (LHS) — ROE (RHS)

**Solvency**

09 10 11E 12E 13E

— Net debt/equity (LHS) — Net interest cover (RHS)

Fiscal year end 31-Dec	2009	2010	2011E	2012E	2013E
<b>Financial Summary</b>					
DB EPS (EUR)	0.00	0.04	1.36	0.79	1.00
Reported EPS (EUR)	0.00	0.04	1.36	0.79	1.00
DPS (EUR)	0.00	0.17	0.22	0.30	0.36
BVPS (EUR)	0.4	4.0	4.7	5.6	6.6
Weighted average shares (m)	5,459	562	500	494	488
Average market cap (EURm)	1,645	1,584	3,127	3,099	3,072
Enterprise value (EURm)	2,346	2,040	3,879	3,987	3,999
<b>Valuation Metrics</b>					
P/E (DB) (x)	72.3	64.6	4.6	7.9	6.3
P/E (Reported) (x)	72.3	64.6	4.6	7.9	6.3
P/BV (x)	1.04	1.52	1.33	1.13	0.95
FCF Yield (%)	21.1	13.2	nm	9.7	5.0
Dividend Yield (%)	0.0	5.8	3.5	4.8	5.7
EV/Sales (x)	0.5	0.4	0.7	0.6	0.6
EV/EBITDA (x)	4.6	3.1	4.8	4.1	3.4
EV/EBIT (x)	7.9	4.7	6.7	5.5	4.5

**Income Statement (EURm)**

<b>Sales revenue</b>	<b>4,462</b>	<b>4,848</b>	<b>5,740</b>	<b>6,280</b>	<b>6,830</b>
<b>Gross profit</b>	<b>508</b>	<b>654</b>	<b>810</b>	<b>982</b>	<b>1,174</b>
<b>EBITDA</b>	<b>508</b>	<b>654</b>	<b>810</b>	<b>982</b>	<b>1,174</b>
Depreciation	211	222	230	262	294
Amortisation	0	0	0	0	0
<b>EBIT</b>	<b>297</b>	<b>433</b>	<b>580</b>	<b>720</b>	<b>880</b>
Net interest income/(expense)	-85	-66	-83	-90	-90
Associates/affiliates	-57	23	0	0	0
Exceptionals/extraordinaries	-80	-25	-15	-20	-20
Other pre-tax income/(expense)	0	0	0	0	0
<b>Profit before tax</b>	<b>75</b>	<b>365</b>	<b>483</b>	<b>610</b>	<b>770</b>
Income tax expense	98	137	-179	220	276
Minorities	-45	-17	-4	8	16
Other post-tax income/(expense)	0	-224	0	0	0
<b>Net profit</b>	<b>23</b>	<b>21</b>	<b>666</b>	<b>382</b>	<b>478</b>
DB adjustments (including dilution)	0	0	0	0	0
<b>DB Net profit</b>	<b>23</b>	<b>21</b>	<b>666</b>	<b>382</b>	<b>478</b>

**Cash Flow (EURm)**

<b>Cash flow from operations</b>	<b>539</b>	<b>628</b>	<b>390</b>	<b>715</b>	<b>693</b>
Net Capex	-193	-418	-520	-414	-540
<b>Free cash flow</b>	<b>346</b>	<b>210</b>	<b>-130</b>	<b>301</b>	<b>153</b>
Equity raised/(bought back)	167	0	0	0	0
Dividends paid	-2	-85	-84	-107	-146
Net inc/(dec) in borrowings	-175	-422	214	0	0
Other investing/financing cash flows	46	-95	-71	0	0
<b>Net cash flow</b>	<b>382</b>	<b>-392</b>	<b>-70</b>	<b>193</b>	<b>6</b>
Change in working capital	162	69	-222	43	-115

**Balance Sheet (EURm)**

Cash and other liquid assets	1,295	455	679	742	793
Tangible fixed assets	1,727	1,977	2,312	2,515	2,741
Goodwill/intangible assets	1,047	849	1,048	1,048	1,048
Associates/investments	848	373	814	1,014	1,014
Other assets	1,809	1,965	1,862	2,272	2,460
<b>Total assets</b>	<b>6,727</b>	<b>5,618</b>	<b>6,716</b>	<b>7,591</b>	<b>8,056</b>
Interest bearing debt	1,824	910	1,431	1,630	1,720
Other liabilities	2,409	2,681	2,610	2,927	2,791
<b>Total liabilities</b>	<b>4,233</b>	<b>3,591</b>	<b>4,041</b>	<b>4,557</b>	<b>4,510</b>
Shareholders' equity	2,175	1,991	2,369	2,729	3,236
Minorities	320	37	305	305	310
<b>Total shareholders' equity</b>	<b>2,495</b>	<b>2,028</b>	<b>2,675</b>	<b>3,034</b>	<b>3,546</b>
Net debt	529	456	752	888	927

**Key Company Metrics**

Sales growth (%)	nm	8.7	18.4	9.4	8.8
DB EPS growth (%)	na	953.1	3,010.2	-41.9	26.8
EBITDA Margin (%)	11.4	13.5	14.1	15.6	17.2
EBIT Margin (%)	6.7	8.9	10.1	11.5	12.9
Payout ratio (%)	0.0	432.9	16.5	38.8	36.8
ROE (%)	1.0	1.0	30.5	15.0	16.0
Capex/sales (%)	5.5	9.1	9.3	8.6	7.9
Capex/depreciation (x)	1.2	2.0	2.3	2.1	1.8
Net debt/equity (%)	21.2	22.5	28.1	29.3	26.1
Net interest cover (x)	3.5	6.6	7.0	8.0	9.8

Source: Company data, Deutsche Bank estimates

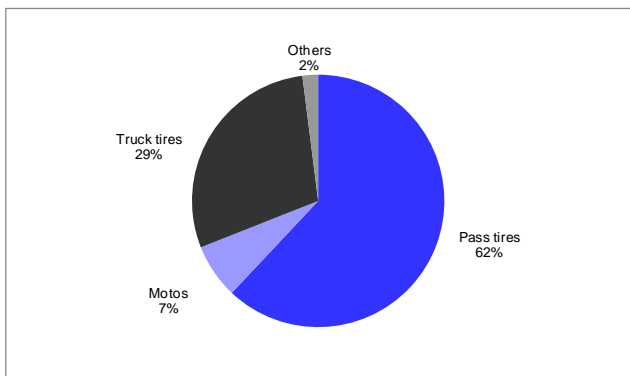
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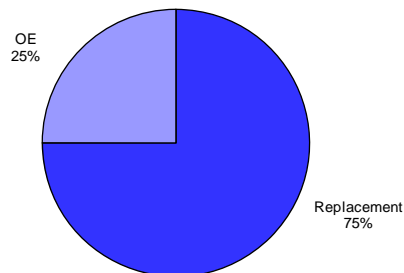
# Pirelli in one page

**Figure 1: Breakdown of sales (2011e)**



Source: Deutsche Bank

**Figure 2: Breakdown of sales by channel (2011e)**

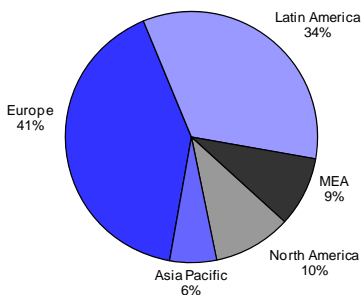


Source: Deutsche Bank

Fig 1: Since most of the revenues growth will concern the pass tire, they should represent 66% of total sales in 2014 (versus 62% today)

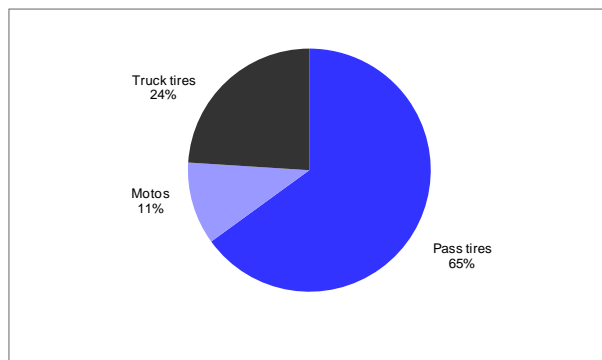
Fig 2: Since Russian sales will be exclusively in the RT markets, the ratio OE/RT of 25/75 will progressively move to 21/79

**Figure 3: Breakdown of sales by region (2011e)**



Source: Deutsche Bank

**Figure 4: Breakdown of EBIT (2011e)**

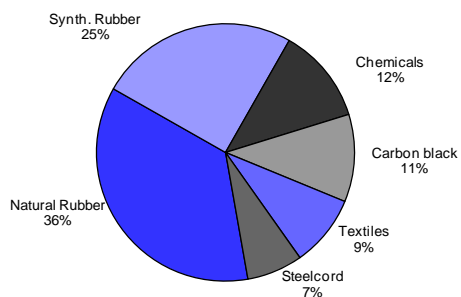


Source: Deutsche Bank

Fig 4: Since the margin improvement is mostly coming from the mix in the pass tire division, pass tire should represent 73% of EBIT in 2014 (versus 65% today).

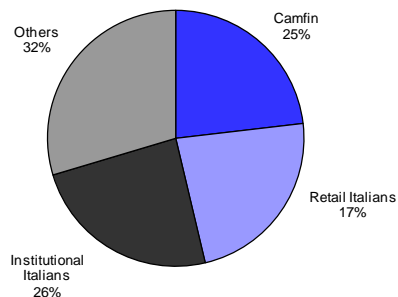
Fig 5: Raw mat should represent 43% of sales of which 36% from natural rubber. Our 2012 EBIT estimates include a small raw mat tailwind of Euro 50m

**Figure 5: Breakdown of raw mat (2011e)**



Source: Deutsche Bank

**Figure 6: Shareholders**



Source: Deutsche Bank

# Summary of our estimates

## Summary of our estimates

**Figure 7: Summary of our estimates**

(Euro m)	2010	2011e	2012e	2013e	2014e
Revenues	4,850	5,740	6,280	6,830	7,400
EBIT	408	580	700	860	1,010
% Sales (%)	8.4%	10.1%	11.1%	12.6%	13.7%
Net profit	22	308	382	478	571
EPS	0.04	0.63	0.78	0.98	1.15
Dividend	0.165	0.22	0.30	0.36	0.43
Net Debt	456	890	930	827	770

Source: Deutsche Bank, Company data

- **2011.** Mgt is guiding for revenues slightly below Euro 5.8bn and an EBIT margin of around 10% or Euro 580m, in line with our estimates.

Our FY revenue estimate of Euro 5,740m (+18%) points to +20% in Q4. This growth rate should be mostly driven by the price & mix effect (+19%e). And our FY EBIT estimate of Euro 580m (+42%) assumes Euro 119m in Q4 (+5%). This small increase in EBIT should be due to raw material headwinds, higher than during previous quarters, as shown in the table below.

**Figure 8: Price & Mix and raw mat effects on EBIT**

(Euro m)	2010	Q1 11	Q2 11	Q3 11	Q4 11e	2011e
Price & Mix effect	+332	+128	+154	+177	+142	+602
Raw material	(270)	(82)	(130)	(135)	(163)	(510)
Net impact	+62	+46	+24	+42	(21)	+92

Source: Deutsche Bank, company data

- **2012 Outlook.** Revenues should reach Euro 6.3bn, +11% YoY. This strong growth should be partly attributable to the full consolidation of the Russian JV (Euro 300m of revenues). Thus, like for like the forecast growth rate is closer to +5%, of which volumes +0% (in line with the sector) and price & mix +5%. The price & mix effect is exclusively attributable to the growth of the premium segment. In our estimates, we have factored in a net positive raw material effect of Euro 50m.

Our estimates are 6% (revenues) and 10% (EBIT) below mgt targets (revenues of Euro 6.7bn and EBIT of between Euro 740 and 800m).

- **2013 & 2014.** Volume should recover. We have estimated a conservative +3% (below the industry trend). And this growth should mostly come from the premium segment where EBIT margin exceeds 20%. This explains why EBIT margin should continue to mechanically increase strongly, +20% per annum.

Our 2014 estimates are 4% (revenues) and 15% (EBIT) below mgt target (revenues of Euro 7.7bn and EBIT of between Euro 1,160 and 1,230m).

# Industrial plan

## Summary of the industrial plan

Pirelli has recently released its three- year (2011-14) plan, which consists of increasing revenues by 33% (to Euro 7.7bn) and the EBIT margin by 500bp from an estimated 10% in 2011 to 15/16% in 2014.

- This is not a volume story. We expect volumes to grow by only +2% per annum.
- The EBIT margin increase should mostly come from the mix effect (more premium tires) and at a lesser extent from efficiency gains.
- All the capacity expansion should concern premium tires, which are all to be produced in low-cost countries (Romania, Russia, China, Mexico). This is a double effect on margin
- The recent raw material price decline is playing a minor role in the EBIT improvement. If natural rubber price stays at current level, there should be a positive impact in Q2 12 earnings.
- Russia too should play a limited role in the EBIT improvement (see specific section on Russia page 13). This is reassuring since Russia is a difficult and complex country. The group has to reorganize production, restructure the Kirov plant and improve the mix...
- Since Russia will produce tires only for the replacement market (RT), the group will reduce its exposure to the less profitable Original Equipment market (OE). The OE/RT ratio should move from 25/75 currently to 21/79.
- Targeting a 15/16% EBIT margin doesn't seem out of reach (even if the speed is ambitious) since other European tire companies are already achieving a 15% EBIT margin – for example Continental (14%) and Nokian (28% exclusively in replacement markets).
- We are more conservative than mgt in our earnings estimates. This is not because mgt targets are excessively optimistic (volume effect of only +3% p.a). But in the current recessionary environment, we want to be more cautious in our assumptions. Our new estimates, even below mgt targets, still correspond to 74% EBIT growth for the next three years. Our 2014 estimate is based on revenues of Euro 7.4bn (4% below mgt's guidance) and on an EBIT margin of 13.7% in 2014 or Euro 1.0bn (or approx Euro 180m lower than mgt's target).

## Breakdown of sales by division

<b>Figure 9: Breakdown of sales</b>						
<b>(Euro m)</b>	<b>2010</b>	<b>2011e</b>	<b>2012e</b>	<b>2013e</b>	<b>2014e</b>	<b>CAGR 2011-14</b>
Pass tires	2,940	3,560	4,010	4,450	4,900	+11%
Moto tires	360	420	480	520	570	+11%
Truck tires	1,470	1,680	1,710	1,780	1,850	+4%
Others	80	80	80	80	80	
<b>Sum</b>	<b>4,850</b>	<b>5,740</b>	<b>6,280</b>	<b>6,830</b>	<b>7,400</b>	<b>+9%</b>
	<b>YoY (%)</b>	<b>+18%</b>	<b>+9%</b>	<b>+9%</b>	<b>+8%</b>	

Source: Deutsche Bank, company data

Our main assumptions on revenues growth:

- **Pass tires.** When excluding Russia, revenues should increase by 8% per annum of which a 3% volume growth (and 0% in 2012e) and a +5% price & mix effect. Both the volume and the price & mix effects are driven by the premium segment (see specific

section page 11). We are slightly more conservative than mgt on 2012 volume (we expect zero volume growth whereas mgt expects +2%)

- **Moto tires.** Mgt expects revenues to grow by 11% per annum (volumes +8%, price&Mix +3%). In the table above, we use mgt estimates.
- **Truck tires.** Mgt is expecting to grow revenues by +4% p.a between 2011 and 2014, of which volumes +2% and price & mix of +2%. We are more conservative than mgt for 2012 (0% volume growth).
- **Overall, our revenues estimates are 5% below mgt target for each year of the 2012-14 plan.**

## Breakdown of EBIT by division

<b>Figure 10: Breakdown of EBIT by division</b>						
<b>(Euro m)</b>	<b>2010</b>	<b>2011e</b>	<b>2012e</b>	<b>2013e</b>	<b>2014e</b>	<b>CAGR 2011-14</b>
Pass tires	260	410	490	630	770	+23%
Moto tires	60	70	80	90	100	+13%
Truck tires	135	150	175	185	190	+8%
Others	(47)	(50)	(45)	(45)	(50)	
<b>Sum</b>	<b>408</b>	<b>580</b>	<b>700</b>	<b>860</b>	<b>1,010</b>	
<b>% Sales (%)</b>	<b>8.4%</b>	<b>10.1%</b>	<b>11.1%</b>	<b>12.6%</b>	<b>13.7%</b>	

Source: Deutsche Bank, company data

Note: EBIT above is after restructuring charges of Euro 20m per annum

Our main assumptions on EBIT growth are:

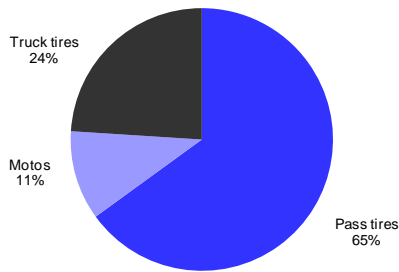
- **Pass tires.** The mix improvement (more premium tires) should be the main earnings driver. The division should benefit too from efficiency gains such as a better productivity of the plants (volume effect) and transportation, logistic, import duty tariffs cost savings...

Mgt is targeting a 17/18% EBIT margin in 2014 (versus 12% in 2010). We are more conservative with an EBIT margin of 15.7%.

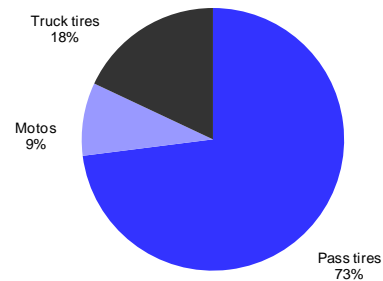
- **Moto tires.** Mgt expects to slightly increase the EBIT margin from the current high level (17%). In the table above, we use mgt estimates. Despite the high margins, it's a small contributor to the group's results (12% of the group's EBIT in 2011e).
- **Truck tires.** We believe that modest revenues growth of +4% p.a. should have a limited impact on EBIT. However, the improvement of the mix (more radial tires at the detriment of bias) and mostly the recent drop in the natural rubber price could provide a boost next year on division results (there is, on a relative basis, 2.5x more natural rubber in a truck tire than in a pass tire).

Mgt expects the EBIT margin to increase by 200 to 300bp by 2014 (from 9.0% in 2011d to 11/12% in 2014). We are more conservative than mgt with a 10% EBIT margin in 2014e.

- **EBIT walk-down between 2011 and 2014:**
  - This is not a volume growth story. Volume should grow by only +2% per annum (and 0% in 2012).
  - The main earnings driver should be from the pass tire division, mostly from a mix effect. As shown in the following pie charts, the contribution of pass tires to the group EBIT should increase from 65% in 2010 to 73% in 2014.

**Figure 11: Breakdown of EBIT in 2010**

Source: Deutsche Bank, company data

**Figure 12: Breakdown of EBIT in 2014e**

Source: Deutsche Bank

- The efficiency gains should be significant, at Euro 250m. They should reflect better efficiency of the plants (volume effect), raw material savings (lower weight of tires, substitution of natural rubber to synthetic rubber), transportation, logistic, import duty tariffs cost savings (Mexico to serve the US).

The building of a plant in Mexico can illustrate these efficiency gains. Wages in Mexico are 35% lower than in Brazil, transportation costs are reduced and import duty tariffs will drop (25% from China and 4% from Brazil). As a consequence, EBIT in Nafta should increase from Euro 20m to Euro 100m.

- These efficiency gains should offset Euro 150m of inflation costs (or Euro 50m per annum) and higher depreciation, Euro 100m (or Euro +30m per annum).
- Since the group is now booking only Euro 20m of restructuring charges per annum, the payback should be equally limited.
- **Overall, our EBIT estimate for 2012 (Euro 700m) is 10% below mgt guidance (between Euro 740-800m). And for 2014, our EBIT estimate (Euro 1,010m) is 15% below mgt target (Euro 1,150-1,240m).**

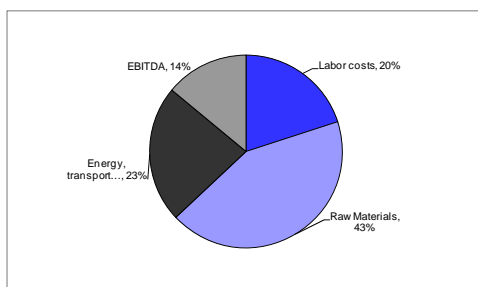
- **Our 2012 estimates are based on the following assumptions:**

- A zero volume effect, in line with what we expect for competitors (mgt targets +2%). In case of a worsening environment (especially in truck tires), the group has some flexibility since overtime (5%) and temporary workers (11%) represent 16% of the total workforce (labor costs represent 20% of sales).
- A natural rubber price of USD 4.0/kg (-13% YoY) and synthetic rubber of USD 3.2/kg (stable YoY). The gross tailwind should reach Euro 110m and Euro 65m net (assuming 40% pass through on all OE and some RT fleet contracts). Most of the tailwind should happen in Q2 12. This assumption could be perceived as conservative today since the natural rubber price is at USD 3.3/kg
- Lastly, the full effect of 2011 price increase should be equivalent to +2% or a tailwind on EBIT of Euro120m.

### Raw material potential tailwind

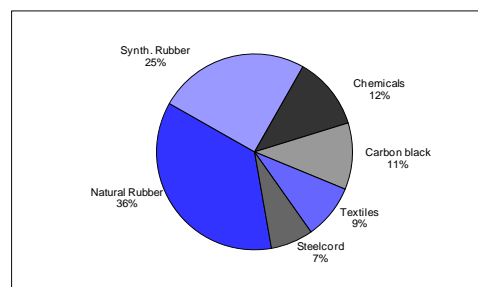
- In 2011 raw material cost should increase by 30% to Euro 2,450m (or 43% of sales versus 39% in 2010). Most of the increase should come from natural and synthetic rubber.
- However, the likely headwind of Euro 510m is lower than feared six months ago (Euro 590m) thanks to the recent decline in the natural rubber price. The variation of natural rubber price shows faster in Pirelli's P&L (lag of 3 months) than in Continental's (4 months) and Michelin's (5-6 months).
- In 2011, Pirelli bought approx 260k tons of natural rubber at an average price of USD 4.6/kg.

**Figure 13: Breakdown of costs (2011e)**



Source: Deutsche Bank

**Figure 14: Breakdown of raw mat (2011e)**



Source: Deutsche Bank

- The natural rubber price has recently dropped significantly to USD 3.3/kg.
- During the next two years, world natural rubber production should increase by +6% per annum, as a consequence of the number of latex trees planted seven years ago. And since 70% of natural rubber production goes into tires, tire demand is a key driver of the natural rubber price. In the coming years:
  - Either the natural rubber price stays low, indicating weak tire demand (especially in truck tires, which use 2.5x more natural rubber than passenger tires). In that case the negative volume effect for Pirelli should be more than offset by the raw material tailwind.
  - Or natural rubber price will rebound from current level, indicating a more favorable tire demand environment.

### Capex program

The world passenger tire market is a market of 1,300mn units, of which 70% in mature markets (mostly Europe and North America) and 30% in emerging markets. By the end of the decade, the world passenger tire market should reach 1,800mn units (CAGR of +4.3%), of which +2% p.a. in mature markets and +8% p.a. in emerging markets.

**Figure 15: Passenger tire world market trend (OE+RT)**

(million units)	2005	2010	2015e	2020e	CAGR 2010-20
Mature markets	830	840	930	1,020	+2.0%
Emerging markets	270	360	570	780	+8.0%
<b>Sum</b>	<b>1,100</b>	<b>1,200</b>	<b>1,500</b>	<b>1,800</b>	<b>+4.3%</b>
Of which mature markets	77%	70%	62%	57%	

Source: Michelin

With 60m pass tire produced in 2011, Pirelli has 4.5% world market share. To maintain this market share, the group needs to increase capacity by 10m units by 2015 (and by a further 14m unit by 2020). This is exactly what the group is doing, i.e. increasing capacity just to maintain its market share in a market that is expected to grow by 4.3% per annum.

As shown in the table below, the group is increasing capacity by 12.5m units by 2015. This is consistent with mgt goal to raise production by 14m units (from 60m in 2011 to 74m in 2015). With the exception of Romania (which production is exported to Europe), all other capacity expansions (Latam, Mexico, China, Russia) are for local markets.

Furthermore:

- The group plans to increase by 12% its truck tire production to 6.8m units, mostly through the building of a greenfield site in Argentina (investment of Euro 230m for phase 1).
- And Pirelli will open its first plant in Indonesia though a JV with Astra Otoparts (60/40) to produce motorcycle tires. Production is to begin in 2013, to reach full capacity in 2016, when the JV is expected to produce 7m motorcycle tires per annum. Investment is expected to reach Euro 66m.

**Figure 16: Expansion projects**

Country	Capacity (m units)	Investment (€ m)	Period	Comments
Mexico	5.0mn	€ 160m	2012-14	Mexico will produce tires for North America, which were previously imported from China and Europe (40%) and from Brazil (50%)  This will free up capacity in Brazil and in China for local markets
Romania	3.0mn	€ 160m	2011-13	Production will increase from 7.0mn to 10.0mn. Production is mostly exported to Europe
Russia	2.0mn	NS	2012-14	Production will increase from 8.5mn to 10.5mn. And the Kirov plant will be upgraded. 90% of the production will be for local market  Pirelli will spend Euro 200m to refurbish the Kirov plant
China	2.5mn	NA	2011	Production will double to 5.0m. Since exports to Nafta will be replaced by local production, most of the Chinese plant production will serve local market  Potentially the plant will be expanded to 8 to 10m units
Brazil			2012-14	The building of a greenfield site in Mexico will free up 4m of capacity in Brazil to participate to the growth of the Brazilian market  Pirelli has a 25% market share in a market which should increase by 20% by 2015 to 98mn units (source Pirelli)
<b>Sum pass tires</b>	<b>12.5mn</b>	<b>€ 700m(e)</b>		
Argentina	0.7mn	€ 230m	2012-14	This Greenfield will start with a production of 0.7mn truck tires (with 700 employees) for an investment of USD 300m. A second phase (additional investment of USD 200m) will bring production to 1.4mn units
<b>Grand total</b>		<b>€ 930m</b>		

Source: Deutsche Bank, company data

The pass tire market in South America is a market of 81m units in 2011 and should reach 98m in 2015 (source Pirelli) or +20%. When looking at the expansion projects of Sumitomo (+5m), Continental (+4m), Michelin (+5m in phase 1) and Pirelli (4m of additional capacity for the domestic market), capacity is to increase by a high 18m units, equivalent to the growth of the market. Therefore, as long as imports from China and Korea stay unchanged in absolute terms (they have collectively a 30% market share), there shouldn't be any significant imbalance between demand and supply. This is important for Pirelli since Latam generates a high 14%e EBIT margin (significantly above the group's average).

The table below summarizes the capacity increases at Pirelli planned over the next four years. The group is significantly expanding its pass tire capacity, marginalizing truck tires.

**Figure 17: Capacity expansion**

(m units)	2010	2011	2012e	2013e	2014e	2015e
Pass tires without Russia	56	60	64	68	71	74
Pass tires Russia			8.5	10.5	10.5	10.5
Truck tires	5.8	6.0	6.1	6.2	6.4	6.8

Source: Deutsche Bank, company data

## Cash Flow

### ■ 2011-14 plan

**Capex.** Mgt intends to invest Euro 2.1bn or Euro 500m per annum. This corresponds to the expansion projects (Euro 930m) and to the refurbishment of the Russian plant (Euro 200m). Depreciation should cover 50% of capex.

**WCR.** Pirelli tends to be much better in managing working capital than its competitors. Based on a CAGR 10% revenues growth, WCR should increase by less than Euro 100m per annum. The sharp increase in 2011 is attributable to natural rubber price surge.

**Dividend.** Since mgt intends to pay a dividend equal to a 40% payout ratio, this corresponds to a cumulative dividend of Euro 510m.

**Net Debt.** Therefore, net debt should remain unchanged at around Euro 800m.

**Figure 18: Cash Flow**

(Euro m)	2010	2011e	2012e	2013e	2014e
EBIT before restructuring charges	433	580	720	880	(1,030)
Depreciation	221	238	262	294	326
Investments	(439)	(531)	(540)	(540)	(440)
Change in WCR & other	93	(196)	(100)	(100)	(100)
<b>= Operating Cash Flow</b>	<b>308</b>	<b>90</b>	<b>342</b>	<b>534</b>	<b>816</b>
Financial charges, income tax	(201)	(261)	(310)	(366)	(425)
<b>= Net operating Cash Flow</b>	<b>107</b>	<b>(171)</b>	<b>32</b>	<b>168</b>	<b>391</b>
'- Dividends	(85)	(84)	(107)	(146)	(176)
'- others (restructuring charges, financial investments)	52	(42)	(60)	(60)	(60)
<b>= Net Cash Flow</b>	<b>73</b>	<b>(296)</b>	<b>(136)</b>	<b>(39)</b>	<b>155</b>

Source: Deutsche Bank, company data

# Premium tires

## Introduction

The world pass tire market is a market of 1,300m units, of which 160m (or 12%) are in the premium segment. With 60m units, of which 20m in the premium segment, Pirelli has 4.6% world market share (60/1300), of which 12.5% in the premium segment (20/160).

Advantages of the premium segment:

- Strongest growth. Mgt estimates the growth rate of the premium segment at +10% per annum, or 2x the growth rate of the industry (+4.5%). And during last crisis (2008), premium volumes resisted better (they increased by +3%).
- The RT/OE rate (Replacement/Original Equipment) is higher in premium (75/25) than in the industry (70/30) because premium car drivers drive more and therefore need to replace their tires more often. And selling price in RT markets are 50% higher.
- Premium tires provide better visibility since:
  - The loyalty rate OE/RT is 2x higher in the premium tire segment (60%) than in standard tires (30%).
  - The number of tires selected by OEMs is significantly lower.
- Average selling price of a premium tire (Euro 88 at Pirelli) is 2x higher than for a standard tire (Euro 44 at Pirelli) with an over-proportional EBIT margin.

Today Pirelli sells 20m premium tires (or 30% of production), mostly in Europe. All winter tires produced by Pirelli, 5m units (or 8% of the Western European winter tire market), are premium tires.

While the group expects to maintain its global market share at 4.6% in 2014, it is more ambitious in the premium segment since mgt is targeting 35m units in 2014 (DBe 32m units), or 15% of the premium segment (versus 12% today). This anticipated market share increase mostly reflects the strategy in Russia.

The group is clearly benefitting from the Formula 1 high tech image and from its advertising payback.

## Summary of our estimates

**Figure 19: Breakdown of sales of the pass tire division**

(Euro m)	2010	2011e	2012e	2013e	2014e	CAGR2011-14
Premium tires volumes (m)	16	20	22	27	32	+17%
Premium tires revenues	1,380	1,760	1,940	2,380	2,830	
Non premium volumes (m)	40	40	47	47	47	+5%
Non premium revenues (Euro m)	1,560	1,760	2,070	2,070	2,070	
<b>Sum volumes (m)</b>	<b>56</b>	<b>60</b>	<b>69</b>	<b>75</b>	<b>79</b>	<b>+10%</b>
<b>Sum Revenues (Euro m)</b>	<b>2,940</b>	<b>3,560</b>	<b>4,010</b>	<b>4,450</b>	<b>4,900</b>	
<b>o/w % from Premium</b>	<b>47%</b>	<b>50%</b>	<b>48%</b>	<b>53%</b>	<b>58%</b>	

Source: Deutsche Bank, company data

Notes:

The volume increase of winter tires in 2011e (+80%) explains 50% of premium volumes increase (from 16m to 20m units)

The volume increase in 2012e, +15%e, is entirely attributable to the consolidation of the Russian JV. At comparable structure we expect stable volumes

Main assumptions of our revenues estimate:

- Stripping out Russia (10mn units, of which 4mn premium in 2014e), all the volume increase over the next three years will only concern premium tires. Thus premium tires volumes should increase by 60% over the next three years to represent 40% of total volume.
- The average selling price of a premium tire is estimated at Euro 88 versus Euro 44 for a non premium tire.
- We have assumed a stable selling price during the next three years.

**Figure 20: Breakdown of EBIT of the pass tire division**

(Euro m)	2010	2011e	2012e	2013e	2014e	CAGR2011-14
Premium tires	180	330	390	500	620	+27%
<i>EBIT margin (% Sales)</i>	13%	19%	20%	21%	22%	
Non Premium	80	80	100	130	150	+20%
<b>Sum EBIT</b>	<b>260</b>	<b>410</b>	<b>490</b>	<b>630</b>	<b>770</b>	<b>+26%</b>
<b>o/w % from Premium</b>	<b>69%</b>	<b>80%</b>	<b>80%</b>	<b>79%</b>	<b>81%</b>	

Source: Deutsche Bank, company data

Main assumptions of our EBIT estimate:

- Today, premium tires generate an EBIT of Euro 16.5 per tire, or a high 19% EBIT margin. Non-premium tires generate an EBIT of a low Euro 2 per tire, or an EBIT margin of 5%.
- We estimate a small increase in the profitability of premium tires of Euro 1 per annum, giving an EBIT margin of 22% in 2014e (or Euro 19.5 per tire), slightly lower than mgt target of 25%.
  - Start up costs should be limited to Mexico, the only greenfield site.
  - All this new capacity is coming from low-labor-cost countries (China, Romania, Russia, Mexico).
  - This capacity increase will bring efficiency gains. They reflect better efficiency of the plants (volume effect), transportation, logistic, import duty tariffs cost savings...
 

North America best illustrates these efficiencies gains. Today 6% of Nafta sales are locally produced, the rest being imported mostly from Brazil (4% import duty tariffs) and from China (25% import duty tariffs). With the building of a greenfield site in Mexico, the group will increase local production to 53% of sales, save these import duty tariffs, transportation costs, and labor costs (wages are 35% lower in Mexico than in Brazil) and avoid currency risk. This mostly explains why mgt expects the operating margin in North America to increase from a low 3% estimated for in 2011 to 15% in 2014, or a Euro 80m improvement.
- And we have estimated the non-premium profit contribution per tire to stay unchanged.

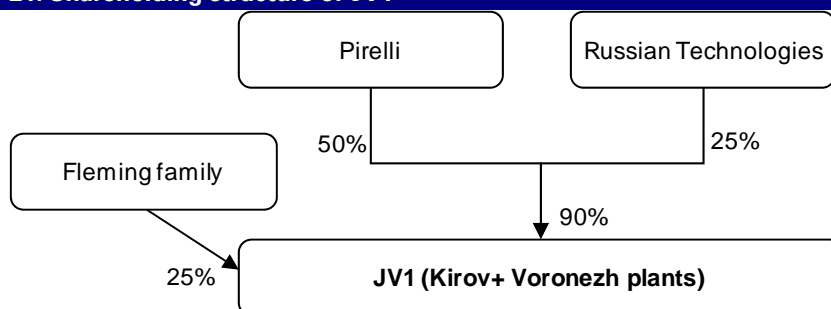
# Russia

## Joint venture in Russia

**JV1:** Pirelli owns 50% of JV1 (with Russian Technology owning 25% and other partners the remaining 25%). JV1 is taking on the pass tires production assets from Sibur Holding. Pirelli is to buy these assets for Euro 55m and is committed to investing Euro 200m in 2012/13. There are two plants, Kirov (6.5 m units of capacity making B and C tires) and Voronezh (2m of capacity, which should double to 4.0m). Pirelli will manage these assets from the start. The JV1 will be 100% consolidated by Pirelli in 2012 and should produce 8.5mn units next year, production that should be expanded to 10.5mn units in 2014. All production concerns exclusively the Replacement (RT) pass tire market.

Pirelli has a three-year option to buy the Fleming family's 25% stake.

**Figure 21: Shareholding structure of JV1**



Source: Deutsche Bank, company data

## Replacement (RT) market in Russia (pass tires)

The Russian RT market is a market of 35mn units (equivalent to 3.5% of the world RT market) worth Euro 1.6bn. In the coming years, the most expensive A segment (average selling price of Euro 76) is expected to grow the fastest and could double in five years from 7.3m units in 2010 to 13.8m units in 2015 (source Pirelli).

**Figure 22: Russian RT market**

(m units)	Selling price	2009	2010	2011e	2012e	2013e	2014e	2015e
Segment A	Euro 76	6.7	7.3	9.8	10.5	11.5	12.6	13.8
Segment B	Euro 57	4.0	6.2	8.4	8.4	9.6	10.6	11.7
Segment C	Euro 25	14.1	15.8	16.8	16.1	16.0	16.1	16.3
Sum	Euro 45	24.7	29.3	35.0	35.0	37.1	39.3	41.7

Source: Pirelli

## Contribution of Russia

Today Russia is a highly profitable market for a domestic player, which:

- Is exempt from high import duty tariffs (20%)
- Benefits from low labor costs (monthly wage in Russia of Euro 550)
- Is exempt from income taxes

When the domestic player is specialized on the most profitable A segment, operating margins could significantly exceed 20%.

This explains why Nokian Tyre is generating a high EBIT margin of 27%. Furthermore, the Nokian plant is extremely productive since the 11m pass tires are produced by a workforce of 1,040 people. The Kirov plant is significantly less productive: a workforce of 4,700 people for production of 7.0mn tires.

JV 1 should produce 8.5mn tires in 2012 for revenues of approx Euro 300m (equivalent to an average selling price of Euro 35/tire, mostly B and C segment tires).

Pirelli plans to invest Euro 200m in the coming years to upgrade the production towards more expensive A segment tires. The group is targeting the production of 10.5mn units in 2014, of which 50/60% in A segment and 40/50% in B segment. The mix improvement explains the bulk of the revenues growth and should significantly increase the operating margin. Mgt is targeting an OP margin in 2014 of 14/15%.

In Russia, the group is exclusively targeting the replacement market. As a consequence, the current OE/RT ratio of the group (25/75) should reduce the weight of the OE market towards an OE/RT ratio of 21/79.

**Figure 23: Contribution of Russia**

(€ m)	2012e	2013e	2014e	2015e
Revenues (€ m)	€ 300m	€ 340m	€ 550m	€ 630m
Number of tire produced (m units)	8.5m	8.5m	10.5m	10.5m
Average selling price (€)	€ 35	€ 40	€ 52	€ 60
EBIT (€ m)	€ 15m	€ 25m	€ 80m	€ 100m
EBIT margin (%)	5%	7%	15%	16%

Source: Deutsche Bank

## Expansion projects in Russia

A+B segments have a market size of 18mn units and should reach 25mn in 2015. Today Nokian is the leader with approx 25% market share. However, the expansion projects of Nokian, Continental and Pirelli will absorb most of the domestic market growth.

- Continental is building a greenfield plant of 4.0mn units of capacity (for an investment of Euro 220m and a workforce of 400 people). Production is slated start in Q4 13 and will be both for the OE and RT markets. Capacity could eventually be extended to 8.0mn units.
- Nokian produced 8mn units in 2010 in Russia exclusively for the RT market. Approx 50% of the production serves the domestic market and 50% is exported. The plant is currently producing 11mn units. A second plant should bring 5-6mn additional capacity by 2014 (for an investment of Euro 250m)

# Pirelli versus peer group

## Volume growth

As the table below shows, Pirelli has lost market share over the last two years (2010 and 2011). Its volume increase (+7% in 2010 and a further +3%e in 2011) is lower than the market's (+16% in 2010, +7%e in 2011). This is particularly true for the truck tire division (Pirelli volumes increased by 8% over the last two years (+9% in 2010, -1%e in 2011) versus +30% for the industry (+20% in 2010, +10%e in 2011). This is mainly because Pirelli lacks capacity.

**Figure 24: Volume growth YoY**

YoY growth (%)	2008	H1 09	H2 09	2009	H1 10	H2 10	2010	H1 11	H2 11e	2011e
Continental	0%	-26%	0%	-15%	+27%	+6%	+17%	+8%	+7%	+7%
Goodyear	-9%	-18%	0%	-10%	+12%	+5%	+8%	+3%	0%	+2%
Michelin	-3%	-23%	-5%	-15%	+15%	+11%	+13%	+13%	+3%	+8%
Pirelli	-6%	-15%	+7%	-6%	+12%	+3%	+7%	+4%	+2%	+3%
<b>Industry (DBe)</b>	<b>-2%</b>	<b>-18%</b>	<b>-2%</b>	<b>-10%</b>	<b>+22%</b>	<b>+11%</b>	<b>+16%</b>	<b>+9%</b>	<b>+5%</b>	<b>+7%</b>

Source: Deutsche Bank, company data

## Price & mix effect

Although Pirelli had lower volume growth than competitors, it succeeded in achieving a stronger price & mix effect. This is the consequence of a more selective strategy towards higher-added-value, premium products. In 2011, the stronger price & mix effect than the peer group (50% higher see below) is entirely attributable to the mix effect. And we estimate that approx 30% of the mix effect on revenues fall on EBIT.

**Figure 25: Price & Mix effect on revenues growth**

(YoY %)	H1 09	H2 09	2009	H1 10	H2 10	2010	H1 11	H2 11e	2011e
Continental	+7%	-4%	+4%	+4%	+15%	+10%	+13%	+13%	+13%
Michelin	+7%	+2%	+4%	-1%	+5%	+2%	+10%	+12%	+11%
Pirelli	+6%	+2%	+4%	+6%	+12%	+9%	+16%	+19%	+18%

Source: Deutsche Bank, company data

## Price & mix effect on EBIT net of raw material headwind

As shown in the table below, all tires companies in our universe have been able to fully offset a significant raw material headwind thanks to a strong pricing discipline. Over the last six months, Continental has increased the gross raw mat headwind for 2011 from Euro 600m to Euro 770m, Michelin has left it unchanged at Euro 1,800m and Pirelli has reduced it from Euro 580m to Euro 510m. This is because the speed of the impact of raw material prices fluctuations in the P&L differs from one company to another. Raw material prices fluctuations have a quicker impact on the Pirelli P&L than on the Michelin P&L, for example.

**Figure 26: Price & Mix effect on EBIT net of raw mat headwind**

(Euro m)	H1 09	H2 09	2009	H1 10	H2 10	2010	H1 11	H2 11e	2011e
Continental	250(e)	275(e)	525(e)	30(e)	60(e)	90(e)	(140)	130	(10)
Michelin	491	624	1,115	(39)	(227)	(266)	2	146	148
Pirelli	58	134	193	24	38	62	70	65	130

Source: Deutsche Bank, company data

## Capacity increase

The world pass tire market is a market of 1,300m units, of which 60% in mature markets (mostly Europe and North America) and 40% in emerging markets. By the end of the decade, the world pass tire market should reach 1,800m units (CAGR of +4.3%), of which +1.8% p.a. in mature markets and +7.7% p.a. in emerging markets. This underlines a volume increase of 500m tires in a nine years or +55m per annum

The four European companies we cover have collectively 27% market share of the world pass tire market (346m/1,300m). Since the market is expected to grow by 55m units per annum, our European universe needs to increase capacity by 15m units per annum, or by 60m by 2015. The table below shows that our universe plans to increase volume in line with the growth rate of the market.

**Figure 27: Capacity increase from European tire Co**

		Current capacity	Add capacity	Investments	Comments
Continental	Pass tires	125m	+20m	Euro 960m	Continental is increasing capacity by 16% by 2015 with a potential 8m units (x2 capacity in Russia and in South Carolina) 40% of the capacity increase is in North America and 60% in emerging markets: Brazil (x2 capacity to 9m units), China (green-field of 4m units), Russia (green-field of 4m units) Production increase of 0.3m in Brazil and building of a 1.3m units in India
	Truck tires	7.0m	+1.6m	NA	
Nokian	Pass tires	11mn	+6m	€ 250m	Production of a new plant has started with annual capacity of 3.0m in 2012 with 2 lines. 2 more lines will be installed in 2013-14
Michelin	Pass tires	150m(e)	+23mn	€ 1,000m	Building of a green field in China (10m units), in Brazil (5m units in phase 1 which should double in phase 2), expansion in Thailand (+1.5m units) Acquisition of 40% of Double Coin Warrior for € 75m (green-field of 15m units or 6m for Michelin) Building of a green field in China (1.8m units), in India (1.2m units including Earthmovers) with a phase 2 expected, expansion in Brazil
	Truck tires	22m (e)	+3.7m	€ 1,150m	
Pirelli	Pass tires	60m	+13m	€ 700m	Green-field in Mexico (5m units), expansion in Romania (+3m units), doubling capacity in China (to 5m units) And acquisition of the assets of Sibur Holding (8m units which should increase to 10m) Production of a green field site. In first phase, i.e by 2014, the production will reach 0.7m truck tires (for an investment of USD 300m). Later the plant should have a capacity of 1.4m units (for an incremental investment of USD 200m)
	Truck tires	5.8m	+0.7m	€ 230m	
<b>Sum</b>	<b>Pass tires</b>	<b>346m</b>	<b>+62m</b>	<b>€ 2,900m</b>	
	<b>Truck tires</b>	<b>34.8m</b>	<b>+6.0m</b>		

Source: Deutsche Bank, company data

## Capex

The world tire market is growing at a rate of +5%, driven by the emerging markets. This means that the passenger and truck tire markets are growing at a rate of +55m and +7m units per annum. Since a typical pass tire plant has a capacity of 10m units and a truck tire plant 1.5m units, the industry needs to build five pass and truck tire plants per annum.

Since investments have been limited during the last decade, all tire companies have recently announced significant expansion projects to follow the growth of the market. Between 2010 and 2012, non-weighted average capex should increase from 5.5% of sales to 7.4%.

**Figure 28: Capex/Sales in the industry**

(%)	2008	2009	2010	2011e	2012e	2013e
<b>European Tire Co</b>						
Continental Rubber	5.3%	4.0%	4.2%	5.8%	6.4%	6.0%
Michelin	7.9%	4.8%	6.4%	8.8%	9.0%	9.0%
Nokian Tire	13.9%	9.8%	5.0%	9.5%	11.5%	10.5%
<b>Pirelli</b>	<b>6.4%</b>	<b>5.0%</b>	<b>6.8%</b>	<b>9.2%</b>	<b>8.6%</b>	<b>7.9%</b>
<b>US Tire Co</b>						
Cooper Tire	4.5%	2.8%	3.6%	4.1%	4.1%	NA
Goodyear	5.4%	4.6%	5.0%	5.2%	5.0%	NA
<b>Korean Tire Co</b>						
Hankook	8.1%	5.9%	8.2%	3.9%	7.5%	7.1%
<b>Japanese Tire co</b>						
Bridgestone	8.2%	7.2%	6.4%	7.4%	7.7%	7.6%
Sumitomo	9.6%	6.5%	5.9%	6.1%	7.3%	7.3%
Yokohama Rubber	7.5%	5.4%	3.9%	5.3%	7.2%	6.1%
<b>Non weighted average</b>	<b>7.7%</b>	<b>5.6%</b>	<b>5.5%</b>	<b>6.6%</b>	<b>7.4%</b>	<b>NA</b>

Source: Deutsche Bank, company data

## Operating margin trend

- While the industry is often perceived as cyclical, OP margins are high, with only 350bp of spread between peak and trough, and should offer some resilience in the long run because 70% to 80% of demand comes from the less cyclical replacement market. Furthermore, the industry has reduced capacity in North America (by 20%) and in Europe (by 10-12%) to preserve prices and margins.
- The raw material price surge in 2010-H1 11 has tested the oligopoly with success. With stable operating margins in 2011, the industry has been able to fully offset the raw mat prices surge.
- We expect in average 100bp higher EBIT margin in 2012. Even if volumes are challenging, this should be more than offset with the recent drop in raw material prices. And raw material represent a high 35/40% of sales

**Figure 29: Operating margin trend**

(%)	2008	2009	2010	2011e	2012e	2013e
<b>European Tire Co</b>						
Continental Rubber	10.3%	13.8%	15.4%	14.3%	15.1%	14.6%
Michelin	5.6%	5.8%	9.5%	9.3%	8.6%	9.4%
Nokian Tire	23.2%	12.8%	20.8%	26.8%	25.9%	24.2%
<b>Pirelli Tyre</b>	<b>6.1%</b>	<b>8.7%</b>	<b>8.4%</b>	<b>10.1%</b>	<b>11.1%</b>	<b>12.6%</b>
<b>US Tire Co</b>						
Cooper Tire	(3.6%)	7.3%	6.9%	4.0%	5.3%	NE
Goodyear	3.9%	1.4%	4.0%	5.3%	5.6%	6.1%
<b>Korean Tire Co</b>						
Hankook	9.7%	12.0%	11.5%	10.7%	10.6%	10.9%
<b>Japanese Tire co</b>						
Bridgestone	4.1%	2.9%	5.8%	7.1%	10.4%	10.6%
Sumitomo	4.2%	5.5%	7.9%	6.8%	8.7%	9.4%
Yokohama Rubber	4.2%	5.5%	7.9%	5.0%	6.5%	7.0%
<b>Non weighted average</b>	<b>6.8%</b>	<b>7.6%</b>	<b>9.9%</b>	<b>10.0%</b>	<b>10.9%</b>	<b>NA</b>

Source: Deutsche Bank, company data

## Valuation table of tire companies

**Figure13: European OEMs and suppliers – Valuation table (as of 21 Nov 2011)**

	Price	Reco	TP	Div yield	EV/EBITDA		P/E		EV/Sales		Abs perf		
				2011E	2011E	2012E	2011E	2012E	2011E	2012E	-1m	-3m	YTD
<b>Europe</b>													
Continental	52.3	Buy	80	0.0%	4.3	4.0	6.7	6.5	62%	58%	+1%	+9%	-12%
Michelin	45.3	Buy	75	4.2%	4.6	4.7	6.5	7.2	64%	63%	-8%	-3%	-16%
Nokian Tyre	24.7	Buy	42	3.4%	7.0	6.0	10.7	9.3	224%	187%	-3%	+1%	-10%
<b>Pirelli</b>	<b>6.5</b>	<b>Buy</b>	<b>9.0</b>	<b>3.4%</b>	<b>5.6</b>	<b>4.6</b>	<b>10.3</b>	<b>8.2</b>	<b>79%</b>	<b>73%</b>	<b>+9%</b>	<b>+30%</b>	<b>+12%</b>
<b>USA</b>													
Cooper Tire	13.3	Buy	18.0	3.3%	4.1	3.4	10.5	7.4	33%	31%	+3%	+25%	-43%
Goodyear	13.0	Buy	21.5	0.0%	4.5	4.3	6.6	6.5	43%	41%	+9%	+19%	+10%
<b>Korea</b>													
Hankook Tire	44,250	Buy	50,000	0.6%	7.7	6.6	14.3	11.5	123%	113%	0%	+18%	+39%
Nexen Tire	21,650	Hold	9,600	0.2%	12.7	10.2	20.4	16.9	178%	162%	+6%	+28%	+158%
<b>Japan</b>													
Bridgestone	1,730	Buy	2,900	1.3%	4.3	3.0	10.2	6.7	55%	50%	-1%	+5%	+10%
Yokohama Rubber	412	Hold	500	1.7%	6.3	3.9	10.5	6.9	58%	47%	-7%	-1%	-2%
Sumitomo Rubber	900	Buy	1,500	2.0%	5.6	4.5	10.9	6.9	67%	63%	-6%	-1%	+6%

Source: Deutsche Bank

## Valuation and risks

**Valuation:** Our TP is based on an average of two parameters: 2012e P/E of 12x and EV/EBITDA of 6x, both representing a c.20% premium to the auto parts sector. We believe this premium is justified given the strong earnings growth we expect, +25% pa by 2013.

**Risks:** Key risks are: i) a further surge in raw material price increases (Pirelli is mostly exposed to natural rubber) or ii) an aggressive price war initiated at the entry-level segment, leading Pirelli to give back to customers a high percentage of savings, limiting margin improvement.

# Appendix 1

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Additional information available upon request

Disclosure checklist			
Company	Ticker	Recent price*	Disclosure
Pirelli & C	PECI.MI	6.30 (EUR) 23 Nov 11	7,14

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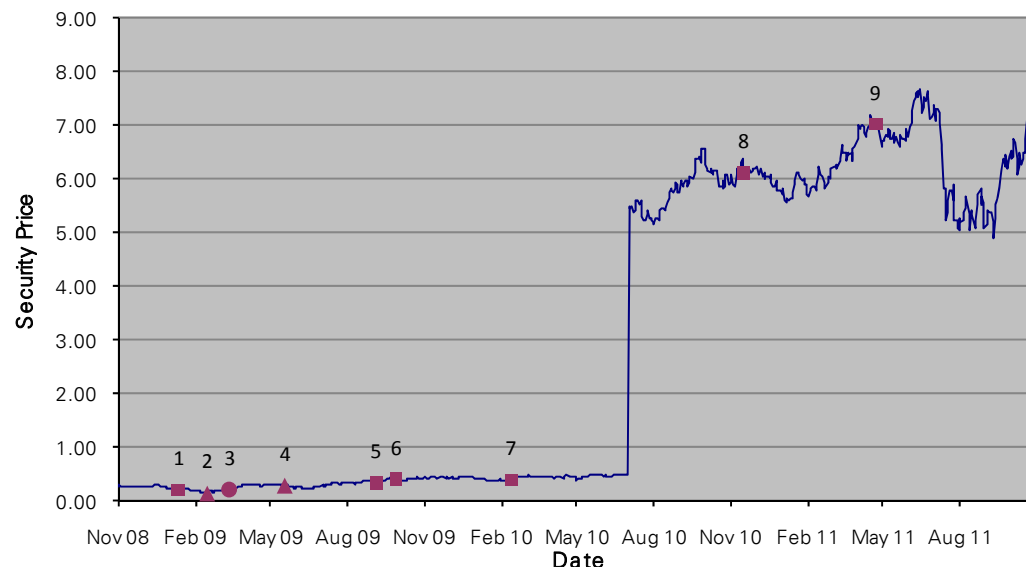
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**Historical recommendations and target price: Pirelli & C (PECI.MI)**

(as of 11/23/2011)



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.	5/2/2009:	Hold, Target Price Change EUR0.32	6.	22/10/2009:	Buy, Target Price Change EUR0.47
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3.	7/4/2009:	Downgrade to Hold, EUR0.23	8.	10/12/2010:	Buy, Target Price Change EUR7.60
4.	12/6/2009:	Upgrade to Buy, Target Price Change EUR0.34	9.	16/5/2011:	Buy, Target Price Change EUR8.00
5.	28/9/2009:	Buy, Target Price Change EUR0.40			

**Equity rating key** **Equity rating dispersion and banking relationships**

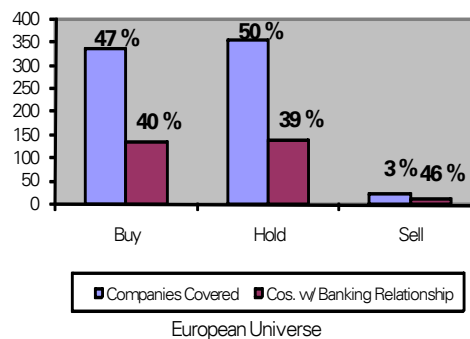
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