Special Report: Pirelli IPO

Introduction

On 28-Sep-17, the Italian newspaper 'Il Sole 24Ore' has reported the news that Pirelli will tap the market at €6.5 per share, settling at the bottom of the updated price range (€6.5 - €6.7) and implying a market cap of €6.5b. The price set is significant for two reasons: it is at the bottom of the valuation range, after the initial suggestion of pricing between €6.3 and €8.3 per share and implies a new market cap diminished of approximately €1bn compared to the one previous to the delisting.

Having clear in mind this snapshot of the pricing metrics, we believe some further attention is due to the disclosure performed by Pirelli, following the closure of the books. As per the final global offering results the IPO will be implemented according to the following terms:

- Demanded shares: 824,268,217
- IPO price: €6.5ps
- Allotted shares: 400,000,000 of which 350,000,000 from a secondary offering and 50,000,000 from the over-allotment (Greenshoe) option
- Out of all the shares offered, 365,000,000 have been offered to Institutional investors and 35,000,000 have been offered to retail investors

As foreseeable, Institutional demand was 2.1 times the offered shares (including Greenshoe) and foreign interest was significantly stronger than domestic one.

IPO strategic rationale (page 47/62 of 'Nota di Sintesi')

The most straightforward goal of the IPO is, by definition, to have shares floating and open up to new markets and investors and, as such, also Pirelli is pursuing this goal.

Other than this, Pirelli management also believes the IPO will allow the company to gain visibility in the international arena and to ensure higher transparency and accountability. As a side note on this last benefit, it is important to stress that these consequences are at times referred to as 'indirect costs' of an IPO among academia; nonetheless, the benefit counterbalancing this cost is higher safety for investors and availability of more information on the market, an element which could facilitate more fair valuations.

As the IPO is only relying on existing shares (over-allotment provided by the controlling shareholders) it is a secondary offering and Pirelli will not benefit from any cash injection. Again, according to academia, IPO is not only a way to foster growth and build up on cash (for primary offering only) but also a good path to provide liquidity to an otherwise illiquid asset and allow for the exit (total or partial) of some shareholders; as this is the case, a secondary offer will allow to exit and liquidate a part of the stake.

Worth noting is that, as the IPO is completely consisting of a secondary offering, existing shareholders will not suffer from any dilutive effect (other than the reduction in the stake arising from the sale of a portion of it).

Product Overview (page 6/62 of 'Nota di Sintesi')

Pirelli (or 'the Company') is a global tire producer which has lately been refocusing on the high added value segment in the tire market; more specifically, Pirelli is mainly focusing on the production of high performance tires, a segment with an highly technology and innovation focused value chain. A key strength of the business model is that, not only is the product a high-performance one, but also consumers have a perception of an outstanding quality, which allows Pirelli to command premium pricing.

Below the main operating segments as reported by the Company:

New premium: this segment consists of high-shrink tires (at least 18 inches) mainly addressing car buyers in the prestige and premium segments

Prestige: with the prestige segment, Pirelli partners with automakers to manufacture tailored tires. The final product is an ad-hoc one for a given auto line but, generally, the targeted segment is still the prestige one

Specialties and Super Specialties: highly technology-driven tires for multiple car segments, addressing specific needs (e.g. runflat, a tire with self-sustaining sides so to allow safe driving even with a flat tire) or customization needs (e.g. color edition tires; interestingly, color edition tires are more easily perceived as an high value product by the final customer, which implies premium pricing and higher margins). Usually, Specialties and Super Specialties tiers are suited for 18 inches-shrink tires or above.

Pirelli operates also in other segments, other than the ones previously reported:

Standard tires: car tires addressing the broader public, usually addressing needs of some carmakers. These tires belong to the following categories: PZero, Cinturato, Winter and Scoprion. Each of these lines allows for the servicing of 'Specialties' and 'Super Specialties' tires at the need of the customer

Moto tires: besides the automobile market, Pirelli is also active in the motorcycle segment and its tires are well suited, with features changing accordingly, for multiple needs: all motorcycles, scooters, off-road tires, customer cruises and high-speed tires (for speed up to 210 km/h; in the jargon, for a speed coefficient equal or above H). Worth noting is that Pirelli operates in the motorcycle segment with two brands: Pirelli and Metzeler; according to the management of the Company this solution allows for stronger value creation and a broader pool of customers.

Pirelli offers 'leisure tires', well suited for on-road and off-road activities, and 'urban mobility' and 'commuting' tires for a more standardized use in light of a less demanding need for perfomance. The products for these segments are the following: Pirelli Diablo, Pirelli Scorpion, Metzeler Roadtree and Metzeler Marathon

Business overview (page 9/62 of 'Nota di Sintesi')

The key pillars of the operating model of the Company can be summarized as follows:

- Strategic positioning in a market showing profit margins and undergoing a significant growth phase; the attractiveness of this markets is further enriched by the resilience of the overall industry
- Pirelli is currently a leader in the most value-added markets, where it is possible to command higher premiums and price mark-ups
- Strong brand equity in the tires segment, nonetheless able to attract consumers beyond the limits of this market
- Well-established commercial partnerships with prestige and premium automakers
- Proven ability to continuously grow and innovate
- Production and distribution stance focused on high added-value segments
- Experienced management
- Cash flow potential

In terms of geographical markets and relative market share, Pirelli is currently the leading company in the prestige tire market with 36% global market share. In the new premium segment, Pirelli is among the top players of the industry and a leader in Europe, China and Brazil with 18%, 19% and 16% market share respectively.

A key market is the USA and the broader NAFTA area where indeed Pirelli holds a relevant role: in the US, Pirelli is among the top 4 new premium tires producers, with a market share of 9%. In North America Pirelli is strengthening its position, increasing its market share by 25% (first equipping and replacement parts).

Pirelli believes that, from the standpoint of the overall global tires market, it is gaining significant competitive advantages mainly from the offering of tires in the specialties and super specialties segments, where other players cannot attain its role and awareness among customers, which ultimately drives higher mark-ups and added-value.

On the side, for what concerns the market for motorcycle tires, Pirelli believes to hold the leadership in Europe, LATAM and APAC with 33%, 13% and 20% market share respectively; Pirelli also covers 14% of the motorcycle tires replacement market in NAFTA. The motorcycle market is a source of revenues for Pirelli also in terms of radial tires with a 34% share of the total market.

Shareholding Structure – look through (page 11/62 of 'Nota di Sintesi')

Total equity: €10,224,318.72 divided in 32,870,380 ordinary shares (of which 21,365,770 class A and 11,504,610 class B; identical from the economic standpoint but with some differences in terms of governance rights).

As of the date of the summary note, the shareholding structure is composed as follows:

- ChemChina: 65%
- Camfin: 22.40%
- LTI: 12.60%

These three companies hold an equity stake in Pirelli, at first, through a HoldCo named 'Marco Polo'.

As per art. 93 of 'Testo Unico della Finanza', Pirelli is therefore controlled by ChemChina (indirectly). The latter is incorporated under corporate Chines law and was initially established in the context of the re-organization of entities controlled by the PRC Ministry of Chemical Industry; as of today, the company is still subject to the influence of the Chinese government.

ChemChina acquired the stake in Pirelli in 2015 (completion of the acquisition in the late of the year), according to the following terms:

- ChemChina has agreed to acquire the 26.2% stake held by Camfin in Pirelli at €15ps
- The purchase agreement has actually been signed by 'China Narional Tire & Rubber Group' (CNRC), a subsidiary fully owned by ChemChina
- Upon completion of the transaction, a consortium led by ChemChina and Camfin has tendered the remaining shares of Pirelli; the consortium has also launched a PTO on the saving shares, subject to a take up of at least 30%

The offer represented a 1.5% discount to the price one day before the announcement, yet a 28% premium over the average price for the 6 months ending 20-Mar-15 (transaction announced on 23-Mar-15). Likely, the deal has been rumored before the official disclosure and to have a better assessment of the premium over the unaffected price it is advisable to consider the 6 months average reference price. The implied equity value for Pirelli was €7.4bn and the key pillar of the post-merger plan for ChemChina was to delist and restructure Pirelli.

Following the IPO, the pro-forma shareholding structure will be the following:

- Marco Polo: 65%
- Free Float / Market: 35%

If the Greenshoe is fully exercised, the shareholding will be:

- Marco Polo: 60%
- Free Float / Market: 40%

Business plan (page 19/62 of 'Nota di Sintesi')

€m & %	2016	2020
Revenues	4,976	7,024
o/w high added-value	*55.0%*	*63%*
EBITDA margin adj.	21.7%	23.0%
EBIT margin adj.	17.0%	18.5%
o/w high added-value	*81.0%*	*85.0%*
Capex as a % of sales	6.8%	7.0%
Leverage	4.6x	2.0x

Notes:

- *Implied revenues 2016 – 2020 CAGR of 9%; Pirelli has instead reported this level as the lower bound (i.e. 2016 – 2020 ≥ 9%)*
- *Leverage as a multiple of EBITDA*

The financial data for the business plan have been backed by an analysis by PwC and have subsequently confirmed on 31-Jul-17; consistently with stressed with reference to the markets Pirelli is operating in, high added-value segments do play a major role (as shown by the margin effect on revenues and EBIT) and will increase their relevance going forward.

Key financials (page 27/90 of 'Nota Informativa' & IPO prospectus)

The Information Memorandum comes in handy as it provides a quick overview on the main balance sheet aggregates which have also affected the IPO pricing. The key elements are described below:

- Net Working Capital (NWC): Pirelli believes the current level of working capital is adequate to sustain short-term financial needs. In our belief, this piece of information is a satisfactory proof of the fact that Pirelli believes its NWC intensity may remain substantially stable going forward.
- Net Financial Position / Net Debt: Pirelli is currently holding on to approximately €4.3b of financial debt, mainly comprehensive of long-term financing*. According to our view, this is an expected condition as the business is likely to require an investment cycle targeting longer maturities and is mature and resilient enough to allow borrowing on the longer tail of the curve. If any concern shall be risen, going forward tapering and the refinancing wall may impact the capital structure of Pirelli and, almost surely, imply a higher cost of debt.

(*) the vast majority of longer term financial debt is in the form of unsecured debt and consists of bank debt.

A more in depth analysis of the key financials of Pirelli can be performed after a quick analysis of the IPO prospectus. All the reported metrics have been pro-formed for the carve-out of industrial business. Below the updated financials for the Company:

€m	2014	2015	2016	CAGR
Revenues	4,480	4,785	4,976	5.4%
EBITDA	890	1,021	1,082	10.3%
% margin	19.9%	21.3%	21.7%	
EBIT	654	769	844	13.6%
% margin	14.6%	16.1%	17.0%	
Net Income	204	(360)	151	(14.0)%
% margin	4.6%	(7.5)%	3.0%	
Net Debt	1,093	1,284	5,045	114.8%
Leverage	1.2x	1.3x	4.7x	

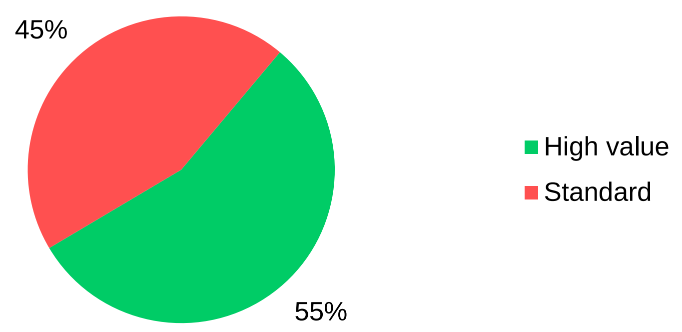
Given these metrics and the insights on the business plan previously reported and as disclosed in the summary note, it is possible to draw the following comparisons:

- Revenues growth has been pretty modest from 2014 to 2016 whilst for the BP period the management is forecasting stronger growth, at an yearly rate almost twice the historical one
- Looking at both EBITDA and EBIT margins it is possible to understand that the management is somewhat bullish on the performance of the Company, yet realistic as Pirelli has showed steady improvements over the past years and the targets set (23.0% and 15.8% for the EBITDA margin and EBIT margin respectively) are reasonable and imply a similar growth path
- Leverage has peaked in 2016 and, according to the business plan, it is foreseen to reach levels which ensure ease on the Company financial structure; beyond the reduction in the multiple, the effort will be significant even with a growing EBITDA (leverage has to fall by more than 50% whilst EBITDA will improve slightly, on top of faster growing sales)

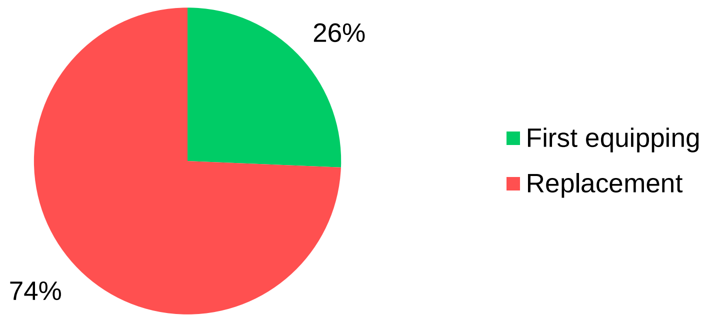
As reported in the prospectus, net income is the portion of income accruing to the controlling shareholders after having taken into consideration the preferred dividend to be paid to minorities.

As Pirelli is a complex mechanism, operating in multiple segments and geographies, it is useful to also have a look at the revenues breakdown according to this two dimensions:

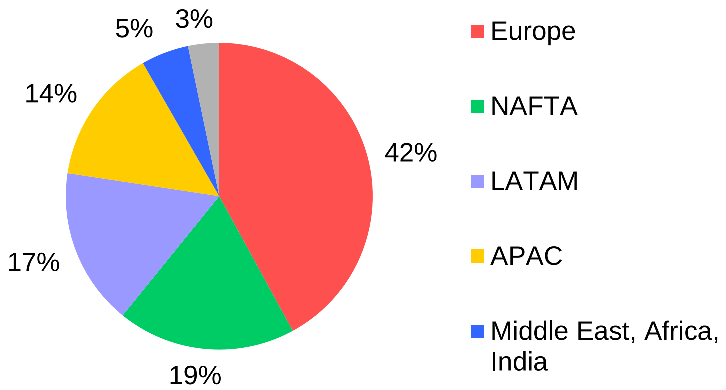
By Segment (I)	
High value	2,755
Standard	2,222
Total	**4,976**



By Segment (II)	
First equipping	1,277
Replacement	3,699
Total	**4,976**



By Geography	
Europe	2,093
NAFTA	935
LATAM	824
APAC	713
Middle East, Africa, India	249
Russia & CIS	163
Total	**4,976**



IPO syndicate (page 15/90 of 'Nota Informativa')

Joint Bookrunners	Banca IMI S.p.A., BNP Paribas, Goldman Sachs International, HSBC Bank plc, J.P. Morgan, Mediobanca – Banca di Credito Finanziario S.p.A., Merril Lynch International, Morgan Stanley & Co. International plc and UniCredit Bank AG, succursale di Milano
Joint Global Coordinators	Banca IMI, J.P. Morgan and Morgan Stanley

In September'17, Pirelli announced its half yearly figures. The revenues had totaled $3.19bn, registering a 10.6% year-on-year growth. The adjusted earnings was $650.9m, which 3.1% higher than the same for the previous period. Volumes only saw a 1.3% increase, which constituted an increase by 13.2% in "high value" products and a 4.7% drop in volumes of standard products. The company also came out with its strategic plans wherein, it clearly mentioned that it wanted to be a pure consumer tire company focusing on high value products. The high value products comprise of four categories: Prestige (developed in partnership with automobile manufacturers like Ferrari, Bentley, Bugatti and Rolls Royce), New Premium (tires with diameter of more than 18 inches), Speciality tires (runflats and color editions) and Premium Moto (high-end motorcycle tires).

Gearing up for the IPO, the company reorganized into consumer activities - passenger, light truck and motorcycle tires. The commercial/industrial businesses were spun off into a new company, Prometeon Tyre Group S.R.L. It comprises the truck, bus, agriculture and OTR tire businesses.

The company also decided to expand the board of directors to 15 members from 14 members. The shareholders agreed to expand the board of directors to 15 members, adding one additional independent director, to be appointed at the first shareholders' meeting of Pirelli to be held after the IPO. This change will ensure that independent directors will make up the majority of the board of directors. This move is in line with the decision made during Pirelli's shareholder's meeting held on 31st August 2017, which was that the corporate governance will be inspired by the best international practices. A few more moves were made to protect the shareholders, such as the continued presence of the group's headquarters and executive offices in Italy and maintenance of control over technical know-how.

However, some questions have been raised on the growth targets that the group aims to achieve and also who would be taking over from the long-term boss Marco Tronchetti Provera. Even the though the market for tires with a diameter of more than 18 is growing three times faster than the standard variety, the group's target to achieve average sales grow at least 9% over the next three years is ambitious considering the revenues expanded by 5.4% a year between 2014 and 2016. Also, the now CEO, approaching 70, has agreed to step down in 2020.

Pirelli, the "Prada of tyres", will be among the biggest IPOs in Europe this year with an expected enterprise value of about €6.5bn. ChemChina, a state-backed chemical company, is selling up to 40 per cent of its stake in Pirelli, which it bought two years ago. It agreed that it would relist the company "in a few years".

Final allocation

Regarding the book building process, in the context of the Global Offer for 824,268,217 shares, 400,000,000 shares have been assigned to 33,329 applicants for a price of €6.50 per share. This number comprises 350,000,000 shares from a secondary offering and 50,000,000 from over-allotment.

Of these, 365,000,000 shares have been allocated to institutional investors and 35,000,000 to the remaining public.

Qualified investors in Italy and Institutional investors abroad requested 775,321,217 shares, for an amount that represents 2.4x the maximum amount of shares dedicated to Institutional Investors (90% of the Global offer of shares) and 2.1x the amount including other ordinary shares subject to the overallotment option.

The total 243 applicants can be split in the following way:

- 42,235,714 shares requested by 48 qualified investors in Italy
- 733,085,503 shares requested by 195 foreign Institutional investors

The 365,000,000 shares dedicated to Institutional investors have been allocated to 205 applicants in the following way:

- 27,862,846 shares allocated to 40 qualified investors in Italy
- 337,137,154 shares allocated to 165 Institutional investors abroad

In the context of the public offer, the public requested 48,947,000 shares, for an amount 1.4x the minimum dedicated amount (10% of the Global Offer).

The total 33,124 applicants can be split in the following way:

- 29,422,000 shares requested by 30,465 general investors for the Minimum Order Quantity
- 19,525,000 shares requested by 2,659 general investors for the Increased Minimum Order Quantity

The 35,000,000 shares dedicated to the public have been allocated to 33,124 applicants in the following way:

- 15,475,000 shares allocated to 30,465 general investors for the Minimum Order Quantity
- 19,525,000 shares allocated to 2,659 general investors for the Increased Minimum Order Quantity

The overall demand from investors of 824,268,217 shares represents 2.35x the maximum amount provided for by the Global Offer and 2.1x if we include the amount of shares issued through the Green shoe option. This represents a great success for Pirelli's IPO, allowing the firm to match its financial and strategic goals.

No share has been allocated to any of the Book runners nor the members of the syndicate.

Market Reaction

As the market opened on the 4th of October, Pirelli shares dropped to 6.30€ ps. In the afternoon, the stock slowly recovered most of its value, closing at 6.47€. Volumes were high in the early trading. Throughout the whole morning, the order book was characterized by a lot of pressure on the selling side, whereas at the closing about 75% of volumes were on the buy side. Overall, the FTSE MIB, which during the day went as low as 22,438, closed at 22,456, losing 1.44%.