

## Pirelli Real Estate

Returning to its roots: Upgrade to Neutral

*Pirelli RE has underperformed EPRA Europe by 47% ytd and has plummeted 93% from its peak in April 2006. In our view, Pirelli RE remains a risky play, given its high leverage in vehicles (80% LTV), loss making activities and complicated business model/structure, while major shareholder Pirelli & C (tyre company) could potentially dispose its stake at some stage next year. However, most risks seem priced in and some initial signs of improvement are visible. We maintain our PT of €0.60 and upgrade the stock to Neutral.*

- **(1). Upside of 9% to our PT**, based on our EVM-based Dec'10 price target of €0.60ps. The stock trades at a 15% discount to our 2009E company NAV estimate of €0.65 (goodwill and high street portfolio excluded) and a 49% discount to the Sep-09 NAV of €1.08.
- **(2). Risks weighted to the upside**, as we estimate a bear case NAV of €0.42 ps (24% downside) and bull case NAV of €0.91 (65% upside).
- **(3). Increased focus on services should improve recurring EBIT**, as Pirelli RE is going back to its old core business of services in Italy, and aims to increase its AuM in Italy to €10-11bn by 2011 from €7.5bn currently. We welcome the move back to its core strength (and abandoning its failed German strategy) and expect positive recurring EBIT of €1.2m (including holding costs) in 2010 from -€2.5m in 2009.
- **(4). Holding company degenerated**, as Pirelli RE has a positive net debt position of €43.5m and unused credit lines of >€350m on our estimates. The average loan-to-value of 80% (of stakes) in vehicles is high, but is non-recourse to the holding (except for €46.5m of debt).
- **(5). Potential partnership with Italian fund manager Fimit** (c. €4bn in AuM), could provide support to the share price, while the company targets another €350m disposals before year-end.
- **(6). Cost savings from restructuring**, as Pirelli RE has revised upwards its 2009 cost savings target to c. €65m from €50m previously, which we believe should result in a recurring profit in 2011 or an earlier upside surprise in earnings in our view.

### Pirelli & C. Real Estate SpA (PCRE.MI;PRS IM)

FYE Dec	2008A	2009E (New)	2009E (Old)	2010E (New)	2010E (Old)	2011E
Adj. EPS FY (€)	(0.05) <sup>1</sup>	(0.02)	(0.04)	(0.01)	(0.01)	0.00
Adjusted NAV ps FY (€)	1.2	0.7	0.7	0.7	0.7	0.8
EBITDA adjusted FY (€ mn)	-60	-27	-38	-8	-11	9
Headline EPS FY (€)	(0.23)	(0.38)	(0.06)	0.06	(0.03)	0.11
DPS FY (€)	0.00	0.00	0.00	0.00	0.00	0.00
LTV (Loan-to-value) FY	67.0%	84.2%	84.2%	82.5%	82.5%	80.9%
NAV premium (discount) FY	(55.1%)	(15.4%)	(15.4%)	(25.1%)	(25.1%)	(34.5%)
Adjusted NAV ps growth FY		(46.9%)	(46.9%)	13.0%	13.0%	14.3%

<sup>1</sup>-Parent

Source: Company data, Bloomberg, J.P. Morgan estimates.

## ▲ Neutral

Previous: Underweight

PCRE.MI, PRS IM

Price: €0.54

Price Target: €0.60

### Property

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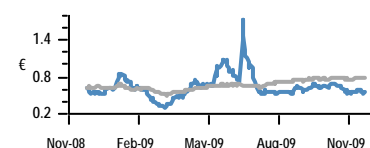
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### Price Performance



	YTD	1m	3m	12m
Abs	-10.1%	-11.4%	-2.0%	-13.6%
Rel	-34.6%	-12.9%	-7.8%	-38.4%

### Company Data

Price (€)	0.54
Date Of Price	24 Nov 09
Price Target (€)	0.60
Price Target End Date	31 Dec 10
52-week Range (€)	1.89 - 0.28
Mkt Cap (€bn)	0.5
Shares O/S (mn)	836

See page 15 for analyst certification and important disclosures, including non-US analyst disclosures.

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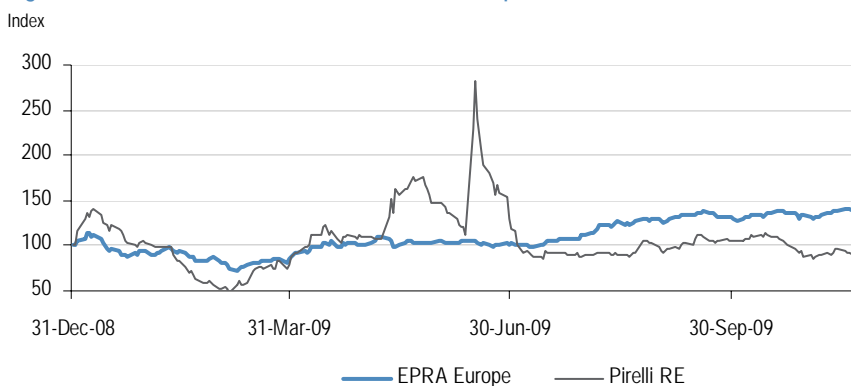
## Upgrade to Neutral

### Pirelli RE has fallen 84% since end 2007

**47% underperformance year-to-date**

Pirelli Real Estate has generated a total return of -10% year-to-date, underperforming EPRA Europe by 47%. The stock has returned -84% since the end of 2007 versus -30% for the EPRA Europe, while it has plummeted 93% from its peak on 21 April 2006. The stock experienced a temporary spike in its price after its capital raising in June/July '09, primarily due to technical factors relating to the right issue.

Figure 1: Total return index: Pirelli RE vs. EPRA Europe

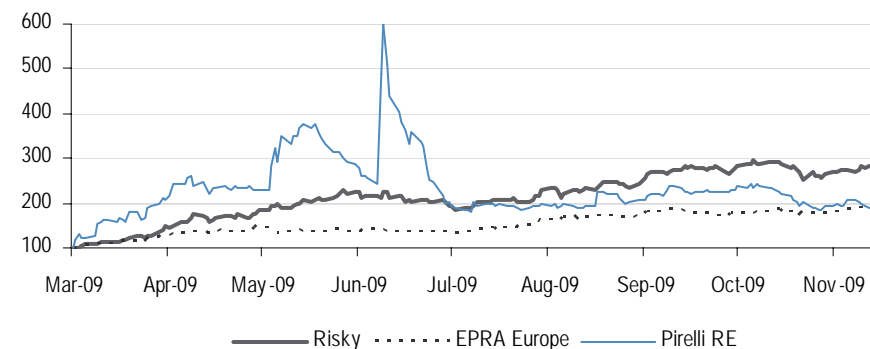


Source: Bloomberg

**Pirelli RE has missed the beta rally**

Since the stock hit its low in the beginning of March, it has performed in the line with the EPRA Europe and gained 92%. However, we consider Pirelli RE a high beta stock within the property sector (beta of around 1.2) and compared to an index of high beta stocks it has missed the rally, as the share price underperformed the 'risky stocks' by 80% since March.

Figure 2: Pirelli RE vs. Index of high beta stocks and EPRA Europe since March low



Source: Datastream

**The stock trades at a 15% discount to our forecast 2009 NAV.**

## 9% upside to TP

Pirelli RE has revised upwards its 2009 cost savings target to c. €65m from €50m previously (at the third quarter results), which we believe should result in a small recurring (adjusted) profit in 2011 or an earlier earnings surprise in our view. We expect fund distributions to start picking up only by 2011/2012. The stock currently trades at a 15% discount to our forecast 2009 NAV.

Table 1: Key estimates ps and premium to company NAV

	2008A	2009E	2010E	2011E
EPS (IFRS)	-0.23	-0.38	0.06	0.11
Adj EPS	-0.05	-0.02	-0.01	0
Company NAV	1.22	0.65	0.73	0.84
Premium to NAV	-55%	-15%	-25%	-35%

Source: J.P. Morgan estimates.

**We upgrade Pirelli RE from Underweight to Neutral**

We expect a further negative revaluation of 5% for the real estate holding in the second half of 2009, after which we expect capital growth to improve gradually. Based on the current 9% upside to our target price, we upgrade Pirelli RE from Underweight to Neutral.

Table 2: Output European Valuation Model

	Price	NNAV t+1	Premium	Operating return	Indirect return	Total return	WACC	Spread	Assigned value t+1	Upside	Target price	Upside to target price
Pirelli RE	0.55	0.66	-16.3%	4.9%	2.6%	7.5%	7.8%	-0.4%	0.60	8.5%	0.60	9.1%

Source: J.P. Morgan estimates, price based on COB November 23

## Risks weighted to the upside

**Bear case company NAV of €0.42**

Based on our stress test of Pirelli RE's intrinsic value, we estimate a bear case company NAV of €0.42, which would imply 23.6% downside from current share price level.

The company NAV (based on real estate market value) is €1.08 per share as per our estimate as of Sep'09. In our worst case scenario, i) we do not assign any value to the goodwill on the balance sheet, which was c. €151.9m as at Sep'09 and is primarily related to German acquisitions (and a part to the Italian services business); ii) we also don't assign any value to equity in German real estate exposure, given a very high LTV of c. 93.5% (including loans from Pirelli RE to vehicles); and iii) equity in developments and the residential small office house office portfolio (SOHO), is also excluded.

Table 3: Stress testing (bear case)

(as of Sep'09)	Book value (€m)	Market value (€m)	Book value ps	Market value ps
Real estate NAV	510.57	712.84	0.61	0.85
Invested capital in services and NPL	188.33	188.33	0.23	0.23
<b>Company NAV at market value</b>	<b>698.90</b>	<b>901.16</b>	<b>0.84</b>	<b>1.08</b>
Shareholder loans	490.90	490.90		
NIC including shareholder loans	1189.80	1392.06		
<b>Adjustments</b>				
Goodwill		-151.86		-0.18
German equity		-141.99		-0.17
SOHO Italy		-114.93		-0.14
Developments Germany		-22.28		-0.03
Developments Italy		-93.15		-0.11
Developments Poland		-23.71		-0.03
<b>Bear case scenario (company NAV per share)</b>				<b>0.42</b>

Source: J.P. Morgan estimates

**Bull case NAV of €0.91 implies 65% upside**

In our bull case scenario, we make following adjustments to the September NAV: i) Goodwill: around half of it is related to the services business, which we keep intact, while subtracting the rest from the given NAV; ii) we take out the equity in German developments business, as the company looks to exit Germany, and the leverage is high; iii) we also subtract the equity of c. €38m in the Karstadt portfolio (let to Arcandor). We do not include any (future) valuation gains. We arrive at a bull case NAV of €0.91, which would imply 65% upside from current share price.

Table 4: Stress testing (bull case)

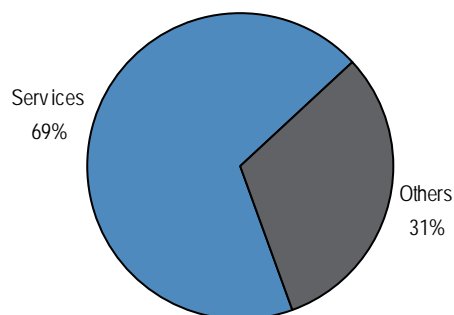
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Shareholder loans	490.90	490.90		
NIC including shareholder loans	1189.80	1392.06		
<b>Adjustments</b>				
Goodwill		-75.93		-0.09
Developments Germany		-22.28		-0.03
Arcandor		-38.00		-0.05
<b>Bull Case Scenario</b>				<b>0.91</b>

Source: J.P. Morgan estimates

**Principal activities – Increased focus on services**

Pirelli RE is active in three principal businesses: (1) Property investment, (2) Management activities and specialized services, and (3) Non performing loans (NPL) business. Based on the 9m2009 results, management activities (services) amounted to 69% of total revenue.

Figure 3: 9m consolidated revenue distribution – Services dominates



Source: Company reports

**Distributions have declined sharply**

**(1) Investment**

Pirelli RE typically makes investments in the real estate sector together with specialized financial partners by creating real estate funds or investment vehicle companies. It holds minority interests, generally between 20% and 40%, in these vehicles (as of June' 09, the average equity interest was c.25%). The company receives distributions from these funds in proportion to its stakes. The distributions have declined sharply in the past two years and we pencil in no distributions over 2009 and 2010.

## (2) Management activities

Management activities are related to: (A) fund and asset management, and (B) specialised real estate services. Specialised services can be further broken down into Agency, Property management and Facility & project management.

*A) Fund and asset management.* This business generates revenues through fees as per the services provided and excess returns generated by funds (success fees). The company does not expect to receive any success fees over its three-year plan to 2011. In the 9m 2009, Fund & AM revenues totaled €44m, accounting for c. 32% of total service revenues. Pirelli RE SGR is the fund manager in Italy, with an AuM of c. €5.6bn. The company recently sold a 5% stake in the SGR to Intesa Sanpaolo for €10m, with another 5% expected to be sold by the year end.

*B) Specialized real estate services.* Pirelli RE also provides – both for initiatives in which it invests and for third-party customers - specialized real estate (mainly agency) services, property management and, with regard to the German and Polish markets, facility management and project management services. In 2007 and 2008, specialized property services generated revenues of €121.6m and €115.3m respectively. In 9m 2009, it generated total revenues of €78.4m, accounting for 57% of the total revenues.

### Specialised services accounted for 57% of total revenues

*i) Agency* involves advice on sales and purchases, valuations, leases and operational marketing. It generates revenue through fees proportionate to the value of the asset (or to the rent paid in case of lettings). In the 9m 2009, Agency revenues totaled €18.5m, accounting for c. 13% of total service revenues.

*ii) Property management* comprises primarily of the coordination of lease agreement management, due diligence services, sales support and the management of real estate databases relating to a whole portfolio or individual real estate properties. Pirelli RE charges a commission on the rents charged. In the 9m 2009, property management revenues totaled €47.6m, accounting for c. 35% of total service revenues.

*iii) Facility and project management.* Facility management involves planning, supply and control of all services aimed at tenants, in order to improve the quality of the real estate properties rented. The project management element consists of organising the process of building new real estate complexes starting from urban promotion, through to planning and coordinating the initiative, obtaining the necessary building occupation permits and delivering the complexes to the final user. In the 9m 2009, Facility revenues totaled €12.3m, accounting for c. 9% of total service revenues.

## (3) NPL business

Pirelli RE started its Non Performing Loans (NPL) business in 2002, and as a part of this business it has minority interests in loan portfolios and provides administrative management and debt collection services for a fee. Of the total AuM of €16.8bn as of Jun'09, Pirelli's NPL under management amount to €1.7bn, in which it has an average c. 33% stake. In 9m 2009, this business generated consolidated revenues of €2.1m, accounting for c.9% of the total services revenues. The company is looking to cut its exposure to this sector, and does not plan to acquire any more NPL portfolios.

### Pirelli RE looking to cut exposure to NPL

*NPL Investment.* Pirelli RE subscribes to financial instruments (primarily junior notes) issued by securitisation companies. The gain on this investment is the difference between the amount recovered through collections and the price paid to purchase them, plus the costs related to credit recovery, and financial charges.

*Management activities.* The management of NPL portfolios is carried out by Pirelli RE Credit Servicing, which is 80% owned by Pirelli RE with the remaining 20% held by DGAD International (which is controlled by Calyon). It manages and monitors in-court and out-of-court actions with regard to the loans, their valuation, and the management of the flow of data and information. As of June'09, the company managed a €1.7bn NPL portfolio.

### Company divisions

Pirelli RE has organized its business into two primary divisions based on geographical exposure: Italy and 'Germany-Poland'. Business units operate within these General Management divisions, specializing in different product types (residential, tertiary and development).

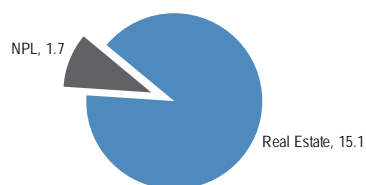
### Portfolio - €15.1bn AuM

Pirelli RE manages a €5.1bn real estate portfolio (apart from €1.7bn in NPL), of which it has stakes in funds/vehicles managing c. €4.7bn (rest managed for third parties), with a pro rata ownership of c. €3.9bn.

### Pro rata real estate ownership of c. €3.9bn

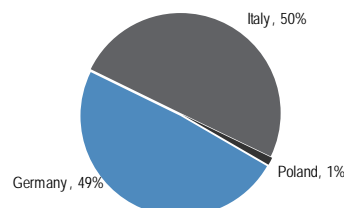
As of June'09, Italy accounted for 50% of the AuM, while Germany was 49%, with Poland making up the rest 1%. In Italy, most of the assets are located in Milan and Rome (c. 80%). The major tenants in its Italian portfolio include ENI, Telecom Italia, Enel and TNT. In Germany, the company doesn't have any office exposure and prime focus is on retail, largest tenant being Arcandor.

Figure 4: Market value of AuM: €16.8bn (June'09)



Source: Company reports

Figure 5: Real estate AuM geographical breakdown



Source: Company reports

### Portfolio valued at a passing yield of 6.6%

**Rents and yields.** Pirelli RE's portfolio is valued at a passing yield of 6.6% at June'09 (no revaluation in 3Q). The pro quota income portfolio totals €2.87bn (out of the total portfolio of €3.9bn), and generates annualized passing rent of €182.5m as of June'09. Additionally, the company has pro-rata developments totaling c. €607m and a residential small office house office portfolio (small assets acquired as part of large portfolios, and company intends to sell) totalling €456.7m.

*Small office house office portfolio.* This portfolio totals €456.7m and comprises small assets (value between €200,000 and €800,000) in Italy, and generates a 1.7% gross yield. The portfolio has a “very high” vacancy rate, and the company plans to sell the entire portfolio by 2011. The company has already sold €45m of this portfolio in the first nine months of the year.

*Developments.* Pirelli RE has €607m development portfolio (pro rata) and c.90% of the Italian development portfolio (€456.7m) is located in Milan and Rome. The Italian development portfolio can be broken up in 30% residential, 28% offices and 42% retail, but there are currently no projects ongoing. As we do not have a lot of details on this portfolio, we penalize its future returns in our valuation models.

Table 5: Pirelli pro rata portfolio details

	Pirelli stake	Passing Rent (Sep'09)	Passing Yield (Sep'09)	Passing Yield (Jun'09)	Vacancy (Sep'09)	Book Value (Sep'09)	Book Value (Jun'09)	Market Value (Jun'09)	NFP* Jun'09	Net Debt Jun'09	LTV Jun'09 (NFP based)
<b>Commercial Core Italy</b>											
Tecla Fondo Uffici	45.0%	17,770	5.5%	5.6%	9.7%	322,643	326,376	326,376	233,452	233,452	71.5%
Fondo Cloe	18.6%	4,664	5.9%	6.9%	13.7%	79,105	72,582	93,149	42,185	42,185	45.3%
Fondo Retail & Entertainment	31.6%	6,923	4.6%	4.9%	13.1%	150,399	150,680	156,720	134,532	113,771	85.8%
<b>Commercial Yielding Italy</b>											
Fliprs	22.0%	4,666	8.2%	8.2%	0.0%	56,944	57,048	66,726	55,566	50,408	83.3%
Tiglio 1	12.9%	1,802	6.8%	6.9%	37.8%	26,447	26,038	28,268	15,959	15,959	56.5%
Raissa	35.0%	8,158	6.7%	6.8%	0.0%	121,327	123,140	125,934	67,940	57,554	53.9%
Olinda Fondo Shop	1.8%	4,545	6.7%	6.6%	3.1%	68,307	68,307	75,401	34,681	34,681	46.0%
Dolcetto Tre s.r.l	33.0%	470.6	10.4%	10.4%	0.0%	4,513	4,513	6,659	3,027	3,027	45.5%
Progetto Perugia	100.0%	1,618	4.9%	4.8%	1.7%	32,995	33,138	33,700			0.0%
Armillia	2.3%	386.2	7.5%	7.5%	0.0%	5,174	5,174	5,490	3,028	3,028	55.2%
Spazio Industriale Fondo (Portafoglio)	22.0%	9,074	7.2%	7.2%	2.0%	125,346	129,428	134,494	69,278	69,278	51.5%
Fo. Hospitality & Leisure	35.0%	3,154	8.3%	8.3%	0.0%	38,135	38,028	40,117	35,226	27,687	87.8%
Italia Turismo	16.3%	1,631	5.2%	5.2%	0.0%	31,130	31,352	32,174	16,272	16,272	50.6%
<b>TOTAL Italy</b>		<b>64,861</b>	<b>6.1%</b>	<b>6.2%</b>	<b>5.8%</b>	<b>1,062,465</b>	<b>1,065,804</b>	<b>1,125,208</b>	<b>711,146</b>	<b>667,301</b>	<b>63.2%</b>
<b>Commercial Core Germany</b>											
Mistral	35.0%	0	0.0%	6.3%	0.0%	0	51,666	54,951	39,121	24,762	71.2%
Highstreet	12.1%	13,212	6.2%	6.2%	0.0%	214,665	214,342	214,565	214,765	190,051	100.1%
<b>Commercial Germany</b>											
Highstreet	12.1%	19,619	7.1%	7.1%	1.0%	275,985	275,607	276,286	276,688	244,848	100.1%
Mistral	35.0%	3,806	5.5%	3.6%	10.8%	69,726	52,462	53,194	44,191	29,855	83.1%
<b>Residential Yielding Germany</b>											
DGAG	40.0%	27,316	7.4%	7.5%	3.6%	370,402	373,798	391,695	337,307	280,284	86.1%
BIB (Baubecon)	40.0%	40,670	6.5%	6.6%	7.1%	622,836	622,952	626,079	613,835	535,524	98.0%
Small Deal	49.9%	8,048	6.5%	7.3%	9.1%	123,749	122,753	128,184	105,643	88,603	82.4%
<b>TOTAL Germany</b>		<b>112,671</b>	<b>6.7%</b>	<b>6.8%</b>	<b>4.9%</b>	<b>1,677,364</b>	<b>1,713,579</b>	<b>1,744,953</b>	<b>1,631,549</b>	<b>1,393,928</b>	<b>93.5%</b>
<b>INCOME PORTFOLIO</b>		<b>177,532</b>	<b>6.6%</b>	<b>6.6%</b>	<b>5.2%</b>	<b>2,739,829</b>	<b>2,779,383</b>	<b>2,870,161</b>	<b>2,342,695</b>	<b>2,061,229</b>	<b>81.6%</b>
<b>Residential Small Office House</b>											
Office ITA		6,388				348,002	356,642	414,423	294,010	242,384	70.9%
Development ITA		600.3				436,871	428,885	456,670	368,967	297,137	80.8%
Development Germany		3,592				66,614	70,313	81,154	59,106	59,106	72.8%
Development Poland		123.2				58,203	54,058	69,136	48,968	25,017	70.8%
OTHER PORTFOLIO		10,703				909,689	909,897	1,021,382	771,051	623,644	75.5%
<b>GRAND TOTAL</b>		<b>188,235</b>				<b>3,649,518</b>	<b>3,689,280</b>	<b>3,891,543</b>	<b>3,113,746</b>	<b>2,684,873</b>	<b>80.0%</b>

\*NFP: Net Financial Position, Source: Company reports,

**Stakes.** Pirelli RE has an average stake of c. 25% in the funds/vehicles and on average is the largest shareholder. Primary investors in the funds/vehicles apart from Pirelli RE include: Morgan Stanley, RREEF, pension funds and retail investors among others.

**Lease length.** Within the Italian portfolio, the average lease term for Pirelli RE's core assets was an estimated 5.5 years at Jun'09, while that for the yielding assets was 7.5 years. In Germany, the lease length for commercial assets was 12 years as of June'09.

**Vacancy 5.2%.** On a pro rata basis the vacancy rate of the income portfolio is relatively modest at 5.2% as of Sep'09, down from 5.3% at Jun'09. On a 100% basis the portfolio vacancy is 4.9%. The income portfolio vacancy doesn't take into account small office house office portfolio, where we believe the vacancy rate is "very high", looking at the low passing yield of only 1.7%

**Arcandor accounts for c. 17% of portfolio rents (100% basis)**

**Tenants- Arcandor the largest.** Its key tenants are Arcandor, Telecom Italia, La Rinascente, the Region of Sicily, Conforama Italia, Valtur, Prada, Fintecna, Enel, Eni, Vodafone and Editoriale L'Espresso. Arcandor is its largest tenant accounting for c. 17% of its portfolio rents. Note, that Arcandor went into administration earlier this year.

#### Details on the NAV

In the below table we explain the evolution from real estate NAV to the company NAV. We adjust the September book value of assets for the unrealised gains (c. €202m) at June (no revaluation in 3Q) to arrive at NAV at market value. From this figure we subtract the mark to market financial liabilities of €12m, to arrive at the real estate NNNNAV of €0.85 ps. Adding the invested capital per share in services and NPL business gives us the company NAV of €1.08ps.

Table 6: Evolution from real estate NAV to company NAV

As of Sep'09	€m	per share
Real estate NAV at book value	622.57	0.74
Real estate NAV at market value	824.84	0.99
Mark to market of financial instruments	-112	-0.13
Real estate NNNNAV	712.84	0.85
Invested capital in services and NPL business at book value	188.33	0.23
<b>Company NAV</b>	<b>901.16</b>	<b>1.08</b>

Source: Company reports, J.P. Morgan estimates

#### Shareholder loans

These are loans from Pirelli RE to the SPV/vehicles in which it has participated, rather than being loans to Pirelli RE from the parent Pirelli & C, as could generally be misunderstood. These loans totaled c. €491m as of June'09. Pirelli RE modified the way it calculates the NAV in its 1H09 results, and added the shareholder loan to the real estate NAV. We believe it is more prudent to adjust them against the holding company net debt, instead of adding to the NAV. We have followed this adjustment while formulating our forecasts.

## German real estate LTV at 93.5%

### Capital Structure - Real estate LTV at 80%

*Real estate LTV* in vehicles/funds is a high c. 80% (including Pirelli RE loans to funds), 63.2% (including Pirelli RE loans to funds) in the Italian portfolio and 93.5% (including Pirelli RE loans to vehicles) in Germany. On a holding company basis (excluding off balance sheet debt in fund/vehicles) Pirelli RE's gearing (d/e) was 0.65x, down from 2.35x at Dec'08, primarily due to the €400m rights issue earlier in the year. Adjusting the €447m net debt for the loans from Pirelli RE to funds and vehicles, the company has a net cash position of €43.5m as of Sep'09.

*Debt expiries.* Pirelli RE has a real estate pro-quota debt of c.€2.6bn as of Sep'09, of this, €130m is due this year, followed by €250m in 2010 and €760m in 2011. *Cross defaults.* The off balance sheet bank debt on funds/vehicles has recourse guarantees (to Pirelli RE) on only €46.5m worth of debt, which is fairly small given the overall pro-quota debt in the vehicles (real estate: €2.6bn).

*On a holding company basis* (excluding off balance sheet debt in fund/vehicles), Pirelli RE has a gross debt of c. €490m, of which its parent company, Pirelli & C. (which has a c. 58% stake in Pirelli RE) is owed €103m. Earlier in the year, Pirelli RE obtained a committed credit line of €320m, which matures in 2012, increasing the overall loan duration of the committed facilities to 26 months (as of Sep'09). 83% of the holding company debt is fixed. We estimate that the company has currently unused credit lines in excess of €350m.

#### €400m equity raising

Pirelli RE completed a €400m equity raising in July'09, as part of a highly needed deleveraging. The net proceeds from the issue were €395.5m and c. 58% of the issue was subscribed the parent Pirelli & C. As a part of the subscription, Pirelli & C. cancelled a portion of its debt to Pirelli RE.

### Management/Shareholder structure

Pirelli RE underwent a management change earlier in the year, and is now lead by Giulio Malfatto (MD Pirelli RE), who has 25 years of experience in real estate and real estate fund management. Over 1996-2003, he worked as the MD of Specialized Services, and later founded Zero SGR with an AuM of €1bn. He recently sold it to private investors to avoid any potential conflict of interests with his current position.

Claudio De Conto is the MD (Finance) of Pirelli RE and was appointed in Dec'08. He has worked for over 20 years in Pirelli Group, having worked in Finance, Administration, Control and Planning. He is also the General Manager and COO of Pirelli & C.

**Management strategy.** Pirelli RE announced a shift in strategy earlier this year, with an increased focus on its services business, so as to increase its recurring revenues. The shift assumes more importance in a scenario where the distributions from funds have a taken a hit. Previously, the company had shifted to a strategy of increased importance to investments over 2006-2008. Pirelli RE has recently announced a potential partnership with Italian fund manager Fimit (c. €4bn in AuM), which could provide support to the share price in our view. In addition, the company targets another €350m of disposals before year-end.

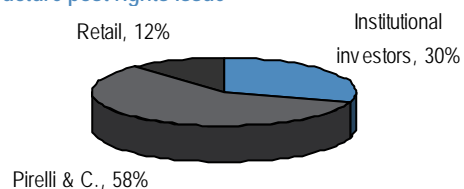
### Top management compensation

Pirelli RE has not yet finalized an incentive scheme since the new management has taken charge earlier this year. It will be finalized and presented for shareholder approval at the annual general meeting in April 2010.

### Shareholder structure

Post the €400m rights issue, the parent Pirelli & C owns a 58% stake in Pirelli RE. Pirelli & C has publicly indicated that it aims to focus on its core activities in the future, which may indicate, in our view, that its stake in Pirelli R.E may be put up for sale at some point (potentially early next year and could coincide with Pirelli RE's likely deal with Fimit).

Figure 6: Shareholder structure post rights issue



Source: Company website

### Major issues/risks

Pirelli RE is not yet out of the woods in our view and we believe investors should therefore remain alert on how management tackles the outstanding issues:

*Covenant breaches.* Many of the funds Pirelli RE manages/owns stakes in reported breaches of covenants earlier in the year. Such loans in breach totaled €55.6m at a fund level before the capital raising in July and currently stands at around €100m on an overall fund level.

*Increase in equity injections in vehicles.* Pirelli RE has already invested €47.4m in its funds/vehicles, and further requirements could arise given the high level of gearing in its funds. We estimate that another €35m of equity injections may be required by Pirelli RE for the LTV in the German vehicles to decrease from 93.5% at June to c.80%, but believe it is more likely that the amount will remain limited to €100m.

*Efforts to Increase focus on Italy.* Pirelli RE intends to increase its AuM in Italy to c. €10-€11bn by 2011 from c. €7.5bn now, while maintaining the overall AuM at the current levels. While we see understand the high LTV in the German funds, and relatively lower asset management fees in Germany, we believe that it would be difficult for the company to achieve such a big shift (Germany AuM: €7.19bn) by 2011. However, a deal with Fimit could potentially speed up the process.

*Highstreet.* Pirelli RE holds a 12.1% stake in the highstreet portfolio, in which Arcandor is the sole tenant. The portfolio accounts for c.17% of rents at a fund level. Arcandor went into administration earlier this year, and failed to pay rents during June'09, although payments have been made in the subsequent months. The portfolio comprises 164 retail real estate assets across Germany, valued at c. €4bn at June'09. Pirelli RE has c. €38m in equity in the vehicle, and we exclude it from our model (PT impact: c. -€0.045ps). Recent press reports indicated that Arcandor has agreed lower rents with the consortium owing the portfolio, although the extent of decline has not

been disclosed. The company has clarified that the rent reduction is “limited”, which is compensated by an extension of the contract from 2021 to 2027. We do not expect this development to have much impact on the fund management revenues, as the fees in Germany are already fairly low (<0.5%)

*Issues with Baubecon (BIB).* The Baubecon portfolio, valued at €1.56bn at June’09 (Pirelli RE’s stake: c.€625m), is currently facing issues with interest payments to its banks, and the disagreement is regarding the high rate of interest charged. The company maintains that the tenants are doing fine in the portfolio. We note that the fund has a high LTV of 98% (including loans from Pirelli RE), implying that it is currently having troubles in terms of meeting its debt obligations, and a potential equity injection may be required. The company is in preliminary discussions with banks for alternative solutions.

*Cash flows.* Pirelli RE is currently seeing a very low level of distributions from its funds/vehicles, implying that its real estate stakes are not producing any recurring income, a situation that is unlikely to change in the near future. The company will have to cover all expenses plus any interest costs from recurring services revenues. We expect fund distributions to start picking up only by 2011/2012.

*Losses from other businesses.* The company also has stakes in other businesses that are currently seeing losses, including two retail chains in Italy. These are partly responsible for the -€9.7m (in nine months to Sep’09) loss from capital participation in vehicles.

*Possible sale of Pirelli RE by the parent.* The parent company Pirelli & C. may contemplate a sale of the real estate business, given its desire to concentrate on its core tyre business. We believe any such development could be a potential overhang on the stock.

*Lack of transparency.* We believe that Pirelli RE has one of the lowest transparency levels in the sector, apart from having a complicated corporate structure.

## Valuation Methodology and Risks

### Pirelli Real Estate (*Neutral; Price Target €0.60*)

#### **Valuation Methodology**

Our Dec-10 target price of €0.6 for Pirelli RE is based on our European Valuation Model. We forecast a 5 year average total return on capital employed of 7.5% versus a WACC of 7.8%, which indicates that Pirelli RE should trade at a discount to its 12m forward NNAV of €0.66.

#### **Risks to Our View**

Upside risks to our target price and rating include successful dealing with covenant breaches, positive property revaluations, disposals at better than expected prices and better than expected economic growth. Downside risks include significant writedowns on the property portfolio, limited transactions in the investment market, tenant failures and stronger than expected interest rates increases.

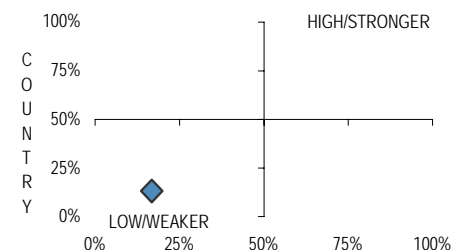
All Data As Of 24-Nov-09

## Q-Snapshot: Pirelli & C. Real Estate S.p.A.

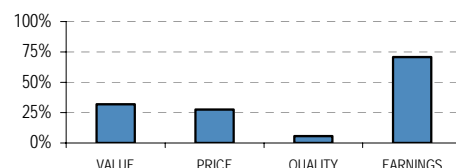
Quant Return Drivers (a Score >50% indicates company ranks 'above average')

Score 0% (worst) to 100% (best)	vs Country	vs Industry	Raw Value
<b>Value</b>			
P/E Vs Market (12mth fwd EPS)	1%	4%	6.8x
P/E Vs Sector (12mth fwd EPS)	1%	5%	5.7x
EPS Growth (forecast)	95%	93%	50.0%
<b>Value Score</b>	<b>19%</b>	32%	
<b>Price Momentum</b>			
12 Month Price Momentum	6%	4%	-17.2%
1 Month Price Reversion	91%	94%	-19.0%
<b>Momentum Score</b>	<b>23%</b>	28%	
<b>Quality</b>			
Return On Equity (forecast)	0%	3%	-20.2%
Earnings Risk (Variation in Consensus)	9%	9%	0.90
<b>Quality Score</b>	<b>2%</b>	6%	
<b>Earnings &amp; Sentiment</b>			
Earnings Momentum 3mth (risk adjusted)	18%	10%	-83.3
1 Mth Change in Avg Recom.	99%	99%	0.85
Net Revisions FY2 EPS	23%	18%	-50%
<b>Earnings &amp; Sentiment Score</b>	<b>78%</b>	71%	
<b>COMPOSITE Q-SCORE* (0% To 100%)</b>	<b>13%</b>	17%	

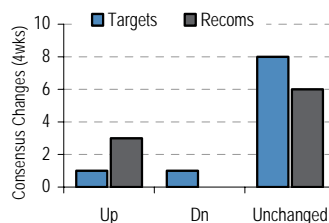
J.P. Morgan Composite Q-Score



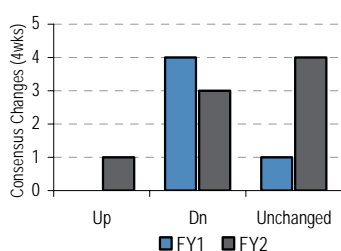
INDUSTRY  
Quant Return Drivers Summary (vs Industry)



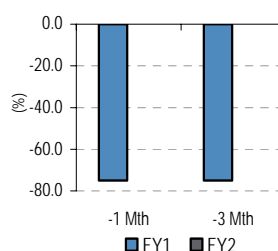
Targets & Recommendations\*\*



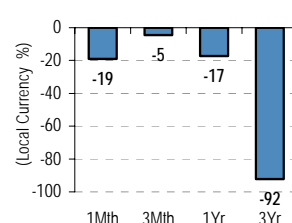
EPS Revisions\*\*



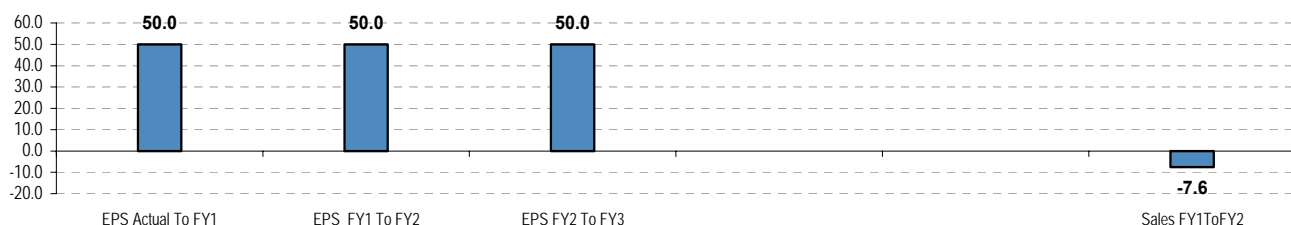
EPS Momentum (%)



Historical Total Return (%)



Consensus Growth Outlook (%)



Closest in Industry by Size (Consensus. ADV = average daily value traded in US\$m over the last 3 mths)

Code	Name	Country	USD MCAP	ADV	PE FY1	Q-Score*
PEPR-NL	ProLogis European Properties	Luxembourg	1,346	2.49	7.9	89%
VASTN-NL	Vastned Retail N.V.	Netherlands	1,230	4.47	11.5	34%
IVG-DE	IVG Immobilien AG	Germany	1,137	8.05	-5.6	23%
CWI-AT	conwert Immobilien Invest AG	Austria	1,015	3.04	30.1	13%
BYG-GB	Big Yellow Group PLC	United Kingdom	798	2.60	30.4	12%
RLIA-ES	Realia Business S.A.	Spain	748	0.47	-11.2	3%
<b>PRS-IT</b>	<b>Pirelli &amp; C. Real Estate S.p.A.</b>	<b>Italy</b>	<b>663</b>	<b>11.73</b>	<b>-5.1</b>	<b>17%</b>
IGD-IT	IGD-Immobiliare Grande Distribuzione S.p.A.	Italy	661	1.04	24.5	24%
AOX-DE	alstria office REIT-AG	Germany	649	0.93	25.0	37%
VNOI-NL	Vastned Offices/Industrial N.V.	Netherlands	342	1.39	7.9	43%
P1Z-DE	PATRIZIA Immobilien AG	Germany	275	0.26	-55.5	89%

Source: Factset, Thomson and J.P. Morgan Quantitative Research. For an explanation of the Q-Snapshot, please visit <http://jpmorgan.hk.acrobat.com/gsnapshot/>  
Q-Snapshots are a product of J.P. Morgan's Global Quantitative Analysis team and provide quantitative metrics summarized in an overall company 'Q-Score.'  
Q-Snapshots are based on consensus data and should not be considered as having a direct relationship with the J.P. Morgan analysts' recommendation.  
\* The Composite Q-Score is calculated by weighting and combining the 10 Quant return drivers shown. The higher the Q-Score the higher the one month expected return. On a 14 Year back-test the stocks with the highest Q-Scores have been shown (on average) to significantly outperform those stocks with the lowest Q-Scores in this universe. \*\* The number of up, down and unchanged target prices, recommendations or EPS forecasts that make up consensus.

## Pirelli Real Estate: Summary of Financials

Profit and Loss Statement					Per share data				
€ in millions, year end Dec	FY08	FY09E	FY10E	FY11E	€, year end Dec	FY08	FY09E	FY10E	FY11E
Sales	365	270	273	274	Headline EPS	(0.23)	(0.38)	0.06	0.11
EBITDA	(60)	(27)	(8)	9	% change Y/Y	-	62.7%	(115.3%)	96.9%
Depreciation	-	-	-	-	Adjusted EPS	(0.05)	(0.02)	(0.01)	(0.00)
<b>EBIT</b>	<b>(60)</b>	<b>(27)</b>	<b>(8)</b>	<b>9</b>	% change Y/Y	-	-	-	-
Net interest	(26)	(14)	(6)	(6)	CF/share	0.00	0.35	-0.01	0.01
Pre-tax profit	-266	-317	49	95	% change Y/Y	-	147779.3%	-101.4%	-396.3%
Tax	2	(5)	1	2	Real Estate NAV	1.22	0.65	0.73	0.84
<b>Net Profit</b>	<b>(195)</b>	<b>(317)</b>	<b>49</b>	<b>95</b>	% change Y/Y	-	(46.9%)	13.0%	14.3%

Balance Sheet					Cashflow Items				
€ in millions, year end Dec	FY08	FY09E	FY10E	FY11E	€ in millions, year end Dec	FY08	FY09E	FY10E	FY11E
<b>Total current assets</b>	<b>430</b>	<b>338</b>	<b>341</b>	<b>342</b>	EBIT incl. net income from investments	(60)	(27)	(8)	9
PP&E / Intangible Assets	23	23	23	23	Operating Cash Flow	(74)	(98)	(4)	12
Participations / Others	786	592	667	744	Operating Cash Flow per share	-0.1	-0.1	-0.0	0.0
Non curr. assets	1,619	1,265	1,340	1,417	Dividends paid	0	0	0	0
<b>Total assets</b>	<b>2,050</b>	<b>1,602</b>	<b>1,681</b>	<b>1,758</b>	Net Cash Flow	0	(98)	(4)	12
<b>Total current liabilities</b>	<b>354</b>	<b>287</b>	<b>289</b>	<b>289</b>					
Debt	915	619	623	611					
<b>Total liabilities</b>	<b>1,421</b>	<b>1,059</b>	<b>1,067</b>	<b>1,056</b>					
Ordinary S/H Funds	628	544	614	702					
Shareholder Loans	-	-	-	-					
<b>Total equity</b>	<b>628</b>	<b>544</b>	<b>614</b>	<b>702</b>					

Source: Company reports and J.P. Morgan estimates.

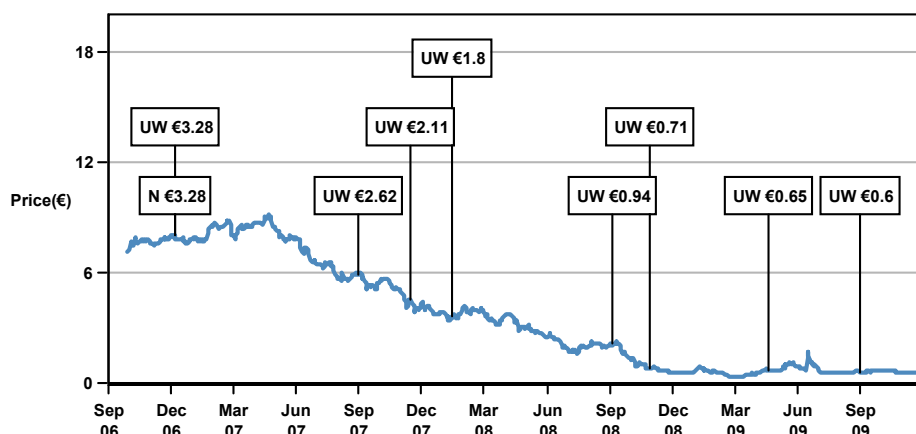
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Pirelli Real Estate (PCRE.MI) Price Chart



Date	Rating	Share Price (€)	Price Target (€)
06-Dec-06	N	8.02	3.28
07-Dec-06	UW	7.98	3.28
31-Aug-07	UW	5.91	2.62
15-Nov-07	UW	4.48	2.11
14-Jan-08	UW	3.65	1.80
03-Sep-08	UW	2.11	0.94
30-Oct-08	UW	0.80	0.71
20-Apr-09	UW	0.65	0.65
01-Sep-09	UW	0.61	0.60

Source: Bloomberg and J.P. Morgan; price data adjusted for stock splits and dividends.  
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JPM Global Equity Research Coverage	39%	46%	15%
IB clients*	56%	57%	42%
JPMSI Equity Research Coverage	38%	51%	10%
IB clients*	76%	72%	56%

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