

Pirelli & C. S.p.A. 1H 2020 Results Conference Call Transcript

August 5, 2020

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

Good evening Ladies and Gentlemen, and welcome to our Conference Call.

This afternoon, I shall address the outlook for the industry and the company for the second half of the year, as well as the progress of our strategic evolution.

Mr. Andrea Casaluci, our General Manager Operations, will elaborate on Pirelli's first half operating results, while Mrs. Valeria Leone, our Head of Strategic Planning & Controlling and Investor Relations, will discuss our Financial Results.

Before getting into the core of our discussion, I wish to welcome Mr. Angelos Papadimitriou, General Manager co-CEO, who has just joined our Management Team.

You already know the hardships we are all going through. The second quarter of 2020 has put our business to the test more than ever.

- We took extraordinary steps to cope with the general crisis triggered by Covid-19, never compromising on the Health and Safety of our people.
- We trusted our company to the High Value segment, which proved once again its resilience
- We kept working on our Competitiveness and Covid action programs, which are well on track, and
- We are accelerating our Transformation Program towards
 - a leaner
 - faster and more profitable company

A more volatile environment on forex and raw mat led us to review our guidance for the Full Year, while confirming all the internal levers, namely volume, price/mix, efficiencies and cost reductions. A solid cash flow generation is still expected.

Pirelli was the only tyre company to provide a full-year outlook in the middle of the Covid 19 crisis.

Despite the high volatility of the external scenario, we confirm what we foresaw in early April:

- Car production to decrease by ~-22% compared with last year
- Premium & Prestige Car Manufactures to over-perform the synergic segment by almost 10 percentage points

This, coupled with the ≥18" tyre market now expected at -13% year over year, is proving again that High Value, our main target, is more resilient.

Pirelli volume guidance is also confirmed, at ~52 million Car tyres, a reduction of -19% versus 2019 levels, with ≥18" performance expected above market trend.

High Value resilience is expected to become even more established in the second half of the year, sustained by replacement recovery in EU and APac, and O.E. rebound in the U.S.

In this context, we expect to over-perform the market, benefitting from:

- a strengthened leadership in ≥18” in China, where we expect to grow double-digit, and
- an accelerated New Product pipeline, to catch new consumer trends and SUVs growth:
 - in Europe targeting the growing All Season segment and the new High Value “Push” demand coming mostly from Synergic SUVs
 - in the U.S., leveraging on our third generation of high mileage products for SUVs
 - in China, developing new dedicated lines for the highly growing e-commerce channel

First half performance in the High Value discounted:

- our policy to support trade partners in keeping low stock levels, and
- our exposure to areas most impacted by mobility restrictions as Mr. Casaluci will better detail.

Moving to our Cost Reduction plan, progress is in line with our expectations, pursuing a flexible cost structure and limiting the effect of the production lockdown and fall in demand.

The combined gross benefits of the Competitiveness Program and Covid Actions for the Full Year are confirmed at ~€280 million (~6% of the 2019 cost base), or €140 million net of inflation and slowdown.

In particular, as per May indications:

- the Cost Competitiveness Plan will contribute for ~€160 million, or €110 million net of inflation, while
- the Covid Action plan is expected to generate a further ~€120 million, ~€30 million net of production slowdown

During 1H’20, consistent with our forecasts, gross benefits from the two plans amounted to 45% of FY target. Net of inflation and slowdown, efficiencies were equal to ~€32 million, since the slowdown was felt more in 2Q.

For 2H, we expect ~€150 million of gross efficiencies, with a major contribution from SG&A, product range optimization and footprint rationalization.

Net of inflation and slowdown benefits are expected to amount to ~€110 million.

Improving the 2020 Cost competitiveness is obviously not our only objective.

As I said in May, we are changing the way we work, to achieve three major objectives:

- a leaner company
- a faster company, and
- economic benefits

We are also integrating digital technologies across the company for a more effective execution. More specifically:

- the design effort is led by multidisciplinary teams, integrating Business and Staff, as well as People Management and Technology: the three vital ingredients for a change of mind-set
- the target working model is much more horizontal, linking all actors of the Value Chain, from Consumers owning Cars fitting High Value tyres, right through to the Suppliers
- the operating model is built around 14 Journeys, under which 80 processes are being redesigned
- these processes and workflows are run digitally on 4 integrated cloud-based platforms, like Sales Force
- artificial intelligence models are integrated in the workflows, since they help improve decision-making and act as early warning systems

— the transformation program is broken down in waves. In the first wave, we are working on applications to improve our relationships with consumers and customers and get as close to them as possible. Their needs will guide the performance of our value chain.

Progress is underway, first key milestones have been achieved, with positive feedbacks from our organization, where a new digital way of working has been adopted with enthusiasm and effectiveness.

To mention just a few examples:

- in the pilot countries where we have released our new Sales Processes, we have already reached over 90 % adoption rate from our workforce
- more than 300 products have already been developed with the support of virtualization

Our Transformation Program is a major undertaking, and will take around two years to reach a higher ground, from which further opportunities will be captured

To accelerate this undertaking, and in parallel, broaden the management team, in consideration of my future succession, my proposal to the Board, to nominate Angelos Papadimitriou as a new General Manager and Co-CEO, has been accepted

Mr. Papadimitriou has held leadership positions in important multinational companies, and has proved his skills in profitable growth, both organically and with M&A. He has formally joined Pirelli 4 days ago, on August 1st.

Our respective roles and key missions are summarized as follows:

- I will be responsible for Strategy setting, orchestrating the Plan, and Controlling Strategy Implementation
- I will also approve major Corporate Policies, Initiatives and Projects
- finally, together with Chairman Ning, I will represent Management and the Board to all our key stakeholders: the General Public, Institutions, Shareholders and Investors

The General Manager and Co-CEO will start off by focusing on the Acceleration of our wide-ranging Transformation Program, and with the achievement of its targets

The General Manager Operations focuses on day-to-day Operations, integrating all new improvements in our Line Functions (R&D, Manufacturing, Supply Chain, Sales, Marketing, and so on), in all Regions.

Let's now move to 2020 targets.

With the 1Q release, we confirmed our April guidance, being more confident in its lower range:

- revenues ~€4.3 billion
- adjusted EBIT margin ~14%, implying an absolute value of ~€590 million
- a Net cash Flow of ~€230 million

We confirm the impact of all internal levers, namely volumes, price/mix, and actions on costs.

However, we now face a more volatile external scenario on both Forex and raw materials, as Mr. Casaluci will better detail.

We now forecast:

- Revenues between -20% and -22% year over year

- an adjusted EBIT margin between 12% and 13%, implying an absolute adj. EBIT of €530 million in the mid-point of the range, €60 million less vs. the previous indication due to the above mentioned external headwinds and an increase of the other costs, this increase is related to non-cash items
- a Net Cash Flow between €190 million and €220 million, leading to a Net Debt of ~€3.3 billion; Mrs. Leone will give more colour on 2H trend

And now I leave the floor to Mr. Casaluci.

Andrea Casaluci – General Manager Operations

Thank you, Mr. Tronchetti and good evening, Ladies and Gentlemen.

Let me start with the second quarter harsh market dynamics and how Pirelli weathered the storm.

Covid-19 outbreak heavily impacted car tyre demand in 2Q with a 36% drop in volume, affecting both the Original Equipment and Replacement channels.

- in the O.E. (-47%) several production facilities around the world were kept locked, especially in April and May
- Replacement demand (-32%) also suffered from mobility restrictions that kept consumers at home for several weeks

High Value (Car $\geq 18''$ -26% in Replacement) showed again its better solidity vs. the Standard segment (-33.0%)

Overall Pirelli $\geq 18''$ performance in 2Q was aligned with the market (-35%), with different trends among channels:

- over-performance in the Original Equipment (-43% vs. -47%), still benefitting from the customer base widening in N. America and Asia Pacific, already underway since 2H'19
- slight underperformance in the Repl. channel (-29% vs. -26%):
 - to support our main distributors, we took destocking actions until April in Europe, and for the whole quarter in the U.S.
 - in the U.S., we were more affected by lockdowns, since stricter measures have been taken where the concentration of Premium and Prestige cars is high (e.g. California, Florida, and the Upper East Coast) and some consumers trading down towards lower brands, given their economical hardship
 - in general, performance in Europe was solid and very strong in Asia Pacific where we gained market share

For the Standard Car, our drop was more pronounced (-50% for 2Q) compared to the market (-36% for 2Q), due to our high exposure to LatAm, where we keep reducing less profitable lower rim diameter products, and we are gradually exiting from the less profitable mass market segments.

Looking ahead, visibility is still very low. We can confirm our market view at $\sim -19\%$ YoY for the full year. This figure does not assume, so far, a severe second wave of Covid-19, with new mobility restrictions.

In 2H'20, the market trend is expected to be $\sim -10\%$, with cautions forecasts on the recovery pace.

All regions are still expected to record a double-digit drop, apart from APac:

- China is obviously driving the market recovery, especially in High Value; the $\geq 18''$ Replacement market in the Region is expected to be already growing in 3Q
- in Europe, the market is rebounding, but there are some concerns over the upcoming Winter season because of
 - reduced new car registrations
 - low consumption of winter tyres during the lockdown
 - Trade Stocks likely to be re-aligned to the new demand scenario
- in North America, there are good signs coming from OE, but it is still very difficult to assess replacement trends due to:
very heterogeneous situations in stock levels and supply chains

- coastal areas more damaged by lockdown restrictions
 - some Consumers trading down towards lower Brands due to the economic crisis
 - a still rather high number of coronavirus cases
- in Standard Regions, LatAm and Russia & MEAI, a gradual recovery is expected; yet, the presence of scattered Covid outbreaks, coupled with the difficulties of the real economy, will extend the challenging market situation

As already said by Mr. Tronchetti, our efficiency efforts over the entire Pirelli value chain and across all regions are confirmed and in line with forecasts.

We are optimizing our cost baseline and facing the short-term impact of Covid-19 with an overall program of ~€280 million, out of which ~45%, or €126 million, already saved in 1H.

Let me give you an update on the major activities within each stream.

On Product cost, with a FY target of €60 million and 50% of the target already achieved during 1H, we are on track with expectations:

- continuing to streamline the entire product range toward a value-based portfolio [competitiveness],
- working on tyre structure simplification, weight reduction and material portfolio de-complexity [competitiveness], and
- exploiting virtual design process, reducing need for physical prototypes [Covid]

After freezing ~€20 million worth of benefits last quarter, Manufacturing initiatives are now in line with forecasts, having reached ~50% of the €60 million FY target. In this stream, we leverage on both structural and short-term actions, in particular:

- we continue to rationalize our footprint, especially in Latin America, and constantly exploit benefits from lowered waste, increased flexibility and plant digitalization [Competitiveness]
- we focus on quick efficiencies from factory flows optimization and strict control over fixed and variable costs, mainly consumables, ancillaries, indirect materials and energy consumption [Covid]

Regarding SG&A, in 1H we registered ~40% of the FY target since we expect a major contribution from belt-tightening of G&A and marketing during the second part of the year. In particular, in this stream we:

- continue applying a strict control over professional services, travel and overheads,
- deeply reviewing marketing, communication and motorsport events, supporting more digital activities,
- taking advantage of procurement re-negotiations,
- optimizing distribution flows and exploiting warehousing efficiencies from stock reduction

Finally, we confirm our efforts toward a leaner Organization that will bring us a FY cost saving of ~€50 million, out of which 50% already saved in 1H. In terms of activities, we are leveraging on:

- footprint rationalization in Latin America,
- development of our existing shared service centers in Latam and Europe,
- process reengineering, also thanks to Digital Transformation, and
- forthcoming introduction of structural remote-working

Pirelli took a number of measures to address the harsh demand scenario which led to low utilization rates in 2Q:

On the manufacturing side:

- the production slowdown has allowed a significant reduction in inventory levels in 2Q, by over 2 million pieces in Car, -15% compared to March 31, which partly anticipated the reduction expected for 3Q
- added to this decrease was the reduction in inventories of finished Motorcycle products (~0.2m pieces, -7% compared to March)
- in parallel, we increased mix rotation to provide optimal customer service level
- complexity is coming down, thanks to the already mentioned improvements in the component design modularity and range optimization activities

On the Commercial side:

- actions are balanced with the need of our partners to keep low stock levels, so as to safeguard their financial health
- strong Investments in the online business, in particular in China; this channel is growing fast and we are consolidating there our leadership in ≥18” with ambitious growth targets
- trade innovation aimed to bring new traffic to the POS of our partners, where together with them, we have successfully designed a contactless customer experience

Turning to Innovation, Covid-19 crisis is not impacting the pace of our new product pipeline.

Indeed, we are accelerating in the areas where we see opportunities and we will launch 6 new lines in the next 9÷12 months, key to boost a strong post Covid-19 recovery. The new Product pipeline will catch new consumer trends and SUVs growth.

We have just launched in the global market the new Cinturato P7 flagship product, designed for the Premium Segment with many innovative features:

- a distinctive design to optimize safety braking distance as proven by the ecolabel “A” on wet braking across the entire replacement range
- flat profile aimed for rolling resistance reduction and mileage to ultimately allow consistent CO₂ savings
- Optimized Footprint, Structure and Aerodynamics to limit Noise, allowing to reach the Perfect-Fit with Electric Cars as proven by Pirelli proprietary “Elect” Marking
- new level of performance reached in co-operation with O.E. Partners, such as BMW, Audi, Mercedes, Jaguar, Volvo, Alfa Romeo and many others, that allowed us to be leaders in homologations already at product launch

Let’s finally move to the Operational Drivers of our Guidance.

All internal levers are confirmed with:

- volumes between -18% and -20%, of which High Value at ~-14% and Standard ~-26%
- price/mix at ~+2% driven by the improvement in both channel and regional mix as already shown in 2Q
- Net Efficiencies worth €110 million and Cost Cutting Covid worth €30 million, net of slowdown

However, we now face a more volatile external scenario on both Forex and raw materials.

Forex outlook worsened in 2Q, and we now foresee that the volatility of Emerging Currencies (especially in LatAM) will continue for the rest of the year, coupled with a weaker US Dollar. We now expect Forex to impact negatively the Group revenues by -4%.

The shift of raw materials, from a €15 million of tailwind to a -€10 million headwind, is attributable to:

- higher volatility of the Oil, which is trimming down the overall commodities tailwind (from +€105 million to +€95 million), and
- the different exchange rates outlook. We remind you that 78% of our production is located in low-cost countries whose currencies are expected to devalue against the U.S. Dollar, making the raw mat bill more expensive (FX impact from -€90 million to -€105 million)

For our assumptions on Raw Mat and Forex, please refer to slides 26 and 27.

The €70 million of other costs include:

- €35 million of non-cash items: provisions on bad debt, accrued in 2Q, other provisions, and some costs related to the reduction of inventories
- €20 million related to transformation programs, and
- €15 million of lower earnings

The difference versus the May guidance is only related to the increase of non-monetary costs: €20 million more related to fixed from stock and bad debt and other provisions.

As a reminder, we confirm the usual drop-through: 42% on volumes, ~50% on price/mix, 15% on Forex. As already pointed out by Mr. Tronchetti, we are putting all the efforts needed to protect our cash generation also from an operational point of view.

I now leave the floor to Valeria for the review of the financial results.

Valeria Leone – Executive Vice President Investor Relations, Planning & Controlling and Business Velo

Thank you, Andrea and good evening, Ladies and Gentlemen. I am glad to participate in our Conference Call in my capacity as Head of Strategic Planning and Control.

In 1H, our performance showed the effectiveness of the actions taken against the Covid crisis:

- a sound price/mix, rebounded in 2Q, mainly supported by a strengthening of our positioning in China
- efficiencies and cost-cutting measures, which produced savings for €126 million, more than offsetting inflation and the impact of the slowdown
- strong inventories reduction, allowing us to bring cash absorption almost to zero in 2Q

Let's go through our financial results, starting from our top line.

We ended 1H'20 with Net Sales at ~€1.8 billion, -31.6% year over year.

As Andrea explained you previously, the global demand slowdown affected our volume trend (-29.5%), especially in the Standard segment (-35.4%) where we kept following a selective strategy.

Our High Value performance proved to be resilient with a less pronounced decrease (-24% on 18 inches), in line with the market (-23%).

Price/mix was +1.0% in 1H, and discounts a different trend between quarters:

- -1.3% in 1Q, with a negative channel mix (steeper decline for the Replacement sales), and a temporary drop in the regional mix
- in 2Q we were back to a sound +3.3%, supported by the rebound of both the channel and regional mix (recovery of sales in China), and with the continuous contribution from product mix; this trend is expected to continue in the second part of the year

Finally, Forex was negative by -3.1% in 1H, with a downward acceleration in 2Q (-4.7%) due to the increased volatility of Emerging Market currencies.

This trend is expected to continue in 2H, with pressure also on the U.S. dollar.

Moving to profitability, we used our internal levers to minimize the impact of the external scenario:

- the Cost Competitiveness program produced structural efficiencies worth 3.5% of our sales covering inflation, forex and raw mat headwind, the latter impacted by the depreciation of the main currencies of countries where the Group's production is located (e.g. LatAm, Romania and Russia)
- Covid-19 emergency cost-cutting measures basically offset the impact of the slowdown (-€71 million); as mentioned in slide 26, the slowdown was mainly felt in 2Q, reaching in 1H ~80% of its expected annual impact
- price/mix was positive (€7 million in 1H), thanks to the solid performance in 2Q
- the decline of volumes weighed -€332 million, reflecting the usual 42% drop-through
- finally, D&A and other costs, with the latter amounting to -€35 million, and mainly related to non cash-items (-€28 million), such as:
 - provisions on credits (~-€10 million) due to a more conservative stance in the current scenario
 - non-monetary costs relating to the strong stock reduction in 2Q (-€15 million)
 - other provisions

We closed the first 6 months with a Net Debt of ~€4.3 billion, almost flat vs. the 1Q.

Cash absorption in 2Q was basically zero, mainly supported by the sharp reduction of inventories: €175 million or 2.1 million car tyres and 0.2m motorbike pieces, with an increase of 285 thousand car pcs and 0.23m motorbike pieces in 1Q due to lockdown measures. In 1H'20, inventories went down by a net 1.8 million pcs in the Car and 0.4m pieces in the Motorbike.

At the end of June, inventories accounted for 21.4% of Sales, ~1 percentage point less than last year and 1Q. Inventories are expected to be further reduced in 2H by ~0.2m car pcs, reaching a 20% on normalized sales.

In 2H'20, we expect to generate a Net Cash Flow close to the 2H'19 (€963 million vs. €985 million in 2H'19) thus reaching the €199-€220 million full year target.

For 2H'20, operating cash flow is expected to be almost in line with 2H'19, supported by:

- an EBITDA basically at 2H'19 level
 - a contained CapEx
 - a more contained positive Net Working Capital (€576 vs. €765 million in 2H'19), consistent with the lower level of activities compared with 2019 (lower receivables and payables)
- Lower interest and lower taxes are almost offsetting the cash-out for restructuring.

Finally, just a few words on the comparison between the new and the previous guidance.

The mid-point of the new guidance on adj. EBIT is equal to €530 million, €60 million less vs. the €590 million indicated as a floor in May. The mid-point of the new target for Cash flow is €205 million, €25 million less versus the floor of the previous guidance (€230 million).

In terms of cash flow, the €60 million reduction in EBIT translates into just €25 million cash absorption.

- part of this is due to the additional non-cash items versus the previous guidance, amounting to €20 million, included in the «other costs», in particular higher provisions and stock accounting treatment, linked to 300k pcs additional inventory reduction vs previous guidance
- the rest comes from the higher target for year-end inventory reduction (2.3m pcs vs 2.0 previous guidance, +300k pcs), which should bring an additional benefit of at least €10 million

Finally, our Capital Structure. As of June 2020, our Gross Debt stands at €6.2 billion. When compared to 1Q, the increase is due to the drawdown occurred on April 2nd of our €800 million 5-year ESG bank line subscribed on March 31st.

Net Financial Position and liquidity Margin remain stable versus end of March at €4.3 billion and €2.2 billion, respectively, thanks to the actions taken to preserve liquidity in balance.

As quick remainder, during the first half we have managed to:

- subscribe, at very favourable terms, the previously mentioned €800 million loan which made our debut in the sustainable finance space
- extend the maturity of a €200 million bilateral financing, originally due in June 2020 and now postponed to September 2021
- exercise the sole borrower discretionary option we had on the tranche of our main bank line coming due in June 2020; €253 million are therefore now postponed to June 2021

During our 1Q result call we anticipated we had proactively approached our lenders to gain flexibility on those financial covenants which, at a certain point in future and with an extended slowdown, could

go under pressure. We can confirm that we have successfully addressed our needs for the next 18 months and have received support by all lenders.

Finally, during the first 6 months of 2020, our cost of debt went down to 2.22% from 2.83% at December 2019, mainly thanks to a lower exposure to high-yield currencies, generalized interest rate reduction and lower margin applied to our bank financial debt due to our financial performance.

Now I leave the floor back to Mr. Tronchetti.

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

Thank you Mrs. Leone, this ends our presentation, and we may open the Q&A session.

Questions & Answers

Monica Bosio – Banca IMI Analyst

I have 3 questions. The first one is on the inventories. I understood that the group reduced materially the inventories and I'm just wondering if you can give us more colour on the dealer inventories level. Do you see the dealers' inventories in a healthy position now to face the demand trend ahead? Or are there any areas where we can see some tensions in terms of dealers' inventory?

And the second question is on the expected slowdown of the Replacement in 3Q due to a likely winter season. I know it's difficult, but could you please quantify what kind of slowdown do you expect in the Replacement for the 3Q?

And the very last is on the footprint rationalization in LatAm. Do you expect any assets write-down ahead, or can you quantify the restructuring costs for 2020?

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

Thank you. I answer to the last question, and then I give the floor to Mr. Casaluci.

We already put in our account the effects of the restructuring in Brazil. So nothing is expected this year on this area. But in general, we don't see major restructuring of assets around the world. The greater part has been done last year. Mr. Casaluci?

Andrea Casaluci – General Manager Operations

Thank you Mr. Tronchetti. As far as dealer inventories is concerned, we see, let me say, mostly recovered picture in Europe on summer. So the level of stock we see in the trade in summer in Europe is in line with the needs of the market. While in winter is still too high comparing to the expected reduced demand in 4Q'20.

In China, we don't see major risk on the stock level. Overall, the situation is back to the normal environment. While in the U.S., there are different pictures: if we look at the most affected areas of the United States, as I said in the presentation, California, Florida and the Upper East Coast, the supply chain overall is not yet stabilized, and there are still risks in the stock level of the dealers, while in the rest of the U.S. is more back to a normal environment.

As far as the expectation of the winter season, as I said before, the pre-booking started in line with our expectations. So we don't expect a negative surprise in 3Q, while for the normal season, that normally start end of October. In Europe, there are some risks related to the lower car registration in 1H'20 of the year and to the high stock level in the trade. So our estimation is one-digit negative demand on winter in 4Q.

Akshat Kacker – J.P. Morgan Analyst

Three questions from my side. The first one on your full year EBIT guidance. When I look at the implication for 2H, a large part of it depends on the pickup in the cost savings, €70 million from €40 million in 1H. Could you just summarize what parts of those cost saving measures are really accelerating in 2H? And if there are any risks to achieve those cost savings? That's the first one.

The second one is on your market underperformance in the High Value Replacement market. I can understand dealer restocking and clearly trying to maintain pricing power. Can you just give us a picture,

if you have, of how market shares have to hold on a sell-out level in 1H for High Value Replacement, please?

And the third one is on raw materials. I can see that your core underlying assumptions on raw materials are more bearish than peers, especially on synthetic rubber and Brent crude oil. Can you comment on that, please? And the second element of raw material effects. Has this FX impact factored in the sharp depreciation of the dollar? Because even against emerging market currencies, like the Turkish lira and the Chinese renminbi, the U.S. dollar has depreciated. So just trying to understand what drives that weaker FX impact on raw materials then.

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

On the exchange rate, we expect the trend of devaluation in Turkey and Brazil to continue. There is a weakening also of the U.S. dollar for which we don't see any major changes. And so our forecast for the full year includes this trend.

I'll leave the floor to Mr. Casaluci to answer to the business questions. And for cost saving measures, Mrs. Leone will give you the answers.

Andrea Casaluci – General Manager Operations

Thank you. As far as the expectation on the High Value performance in 2H, considering that we have finalized our destocking process in Europe.

Akshat Kacker – J.P. Morgan Analyst

Sorry, I mean the sell-out share in 1H on High Value Replacement.

Andrea Casaluci – General Manager Operations

Yes. In 2H, we project to gain market share and we project in the High Value to over-perform the market: the drivers are enlargement of the customer base, introduction of new products, mainly in the U.S. and Europe and completed destocking phase in the trade.

Valeria Leone – Executive Vice President Investor Relations, Planning & Controlling and Business Velo

So with regard to the profitability of 2H, I'll try to give you more colour. Consider that in 2H, we will expect a stronger contribution from internal levers, first of all, lower volume decline. We should have more or less -9%÷-10% versus -29.5% in 1H. The price/mix should be ~+3% with a higher drop-through. So that means ~50% in 2H versus 26% in 1H. And what's very important is the contribution that will come from efficiencies recorded net of inflation has slowed down, that should stand more or less more than €100 million versus net effect and for sales of ~€32 million.

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

One point I just want to add: you have to take into account that 1H results in Europe were affected also by the bankruptcy of Fintyre in Germany and the following negative effects that it had in Italy. Now we

are recovering the lost volumes through our other clients. I think that this is over, so 2H shouldn't discount this effect. Thank you.

Kai Mueller – Bank of America Analyst

The first one sort of follows up a little bit with regards to the market. Obviously, a lot of people are talking about somewhat more driving that's happening in the summer, back end of the year when people travel. Have you seen some more promising trends on your sell-out from your customers that demand is coming through and the sell-out is accelerating, but you obviously are still worried about the sell-in, given where the dealer should stand right now with the inventory level? The first one.

And then what I found is quite interesting is your comments with regards to down-trading in the U.S. in terms of brands or price points. Does that mean customers are no longer purchasing, let's say, a Pirelli tyre? Or do they go for a lower cost version?

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

For the down-trading, we have to consider this as something that is not affecting Pirelli in a consistent manner. It happened only in the United States. It's something we can cope with thanks to the new lines that we are launching in the U.S. that will be much more performing in terms of mileage, and that will satisfy the demand of people asking price per kilometre. I think the answer we are giving to this down-trading can be offset by the brand and the mileage effect. Mr. Casaluci?

Andrea Casaluci – General Manager Operations

Yes. I confirm there is a recovery in the demand. And if we look at the trend of April, May and June, during 2Q, this is clearly visible in all the major High Value markets. For example, the market in June in the ≥ 18 " was basically flat in Europe and there was a -14% in North America versus the -35% of May. And was flattish, slightly positive in China already in the month of May.

Gabriel Adler – Citi Analyst

My first question is on price/mix. Your full year guidance adjusted price/mix will remain ~3% in 2H. Given the positive channel mix would have helped in 2Q and this channel mix is likely to slow in the 2H if Replacement and O.E. growth converge. What's going to offset this? That means that price/mix will stay at ~3% in 2H, similar to what was achieved in 2Q.

My second question is on the other costs that you're guiding to. Can you just give a little bit more detail, please, on what gives you confidence that this is going to be limited to €35 million additional other costs in 2H? Could you talk through your assumptions on other costs and specifically around provisions, what you're expecting in 2H?

And then my third and final question is on CapEx. Because you've reaffirmed your CapEx guidance for 2020. But could you give us a sense how much this relates to delays and how much will come back in 2021, given that we're clearly seeing overcapacity in the industry and High Value. Is it fair to assume that CapEx will remain significantly below 2019 levels in the coming years?

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

I'll answer the last question, and then I'll leave the floor for the other answers.

For CapEx, obviously, there will be an increase compared to 2020 but we don't see a reason to go back to the level of 2019 because we are introducing a number of changes that are increasing our productivity in the factory. We believe that these 3 months of lock down and smart working, helped us in finding ways to be more efficient. So an increase compared to 2020, but not at the level of 2019. That is the trend we see today. Mr. Casaluci?

Andrea Casaluci – General Manager Operations

Yes. Price/mix expected to be +3% in 2H. This +3% is basically done by -1% on price that confirms the performance of 1H, mainly related to O.E. and a +4% on mix. The +4% on mix in 2H is expected to be driven by a +1% on regional mix, because of the overweight of China in the performance of the market and in our sales. And the +3%, which is the usual product mix performance, is the combination of the High Value growth and the decrease of the Standard and the micro mix inside our product offer.

Valeria Leone – Executive Vice President Investor Relations, Planning & Controlling and Business Velo

As per the additional other costs, they are expected to reach €70 million on a FY. The additional €35 million to 1H related to €7 million on noncash items related to additional reduction of finished product stock and €30 million of cash items linked to “transformation” (€10 million more or less will be related to R&D, some activities to digital), to lower earnings from Prometeon (~€5 million) and motorsport / sponsorships due to the concentration of Formula 1 and other sport events in 2H.

The difference versus the May guidance is only related to the increase on non-monetary costs, equal to €20 million and related to: fixed from stock (€3 million), bad the debt (€10 million) and other provisions (€7 million).

Gabriel Adler – Citi Analyst

Okay. If I could just quickly follow-up on the price/mix. Is the 3% product mix you mentioned, an acceleration compared to 1H? What was the product mix contribution in 1H?

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

So the different speed compared to 1H and 2H is related to the performance of 1Q that was affected negatively by the region mix and the channel mix. As you remember, the region mix in 1Q was affected by the slowdown of China. This is affecting negatively our performance because our average selling price in China is ~20% higher than the average of our Replacement phase because of the mix, mainly. And so this was the main reason of the negative performance of 1Q that was -1.3%.

Now in 2Q, we are back to a normal performance, with the positive impact of the region mix is a +3.3%. And as I mentioned before, we do expect a stable performance from now on, a +3% in 2H.

Henning Cosman – HSBC Analyst

I understand the guidance cut as you moved through the external sector. So I just wanted to make sure on the internal sector that you're now giving yourself enough cushion for 2H, so that you don't have to cut again, and specifically on the Covid actions, you're obviously looking to generate the same amount of growth savings, again, while the net impact is much higher because the slowdown is allegedly much lower.

So if you could just remind us of the dynamic there. How do you sustain the gross savings while the negative offsetting element of slowdown comes down?

And then the second question, also maybe to take the opportunity of the FX cut again to discuss this a little bit more. If I accumulate the FX components on either just within the raw material, I think over the last 4 years, it's an accumulated number of something like €330 million. And it appears that there's also a structural component to this. And maybe we could just talk again about if it's just the volatility that makes this structurally very difficult to contain? Or is it really just the continuous depreciation of the emerging market currencies? And I perfectly understand you have the 78% in low-cost countries. But it just seems there's no real offsetting element because you sell, of course, mostly into hard currency denominated countries.

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

First of all, we suffer a lot on Latin America devaluation, let's say, deeper than expected. And that affected, obviously, the impact on our exchange rate. And the increase of costs of raw material was the second element that is affecting our cost in future. In 2H, the effect will be lower in the O.E. because in the O.E. we had the cost matrix that is creating an advantage for our customers. And for us, this was a minus. In 2H, this effect will be offset. So the big numbers will be more balanced in 2H. But I leave to Mrs. Leone the answer on details.

Valeria Leone – Executive Vice President Investor Relations, Planning & Controlling and Business Velo

So with regards the ForEx, we expect to have a negative impact on revenues for ~€200 million. And will be driven by the weakness of LatAm currencies that were worth 82% of the total effect, plus 7% will come from Russia ruble.

On EBIT adjustment, the impact of this ForEx is twofold for us. On one side, we have the negative consolidation effects from the translation of the local statutory EBIT in euro; and the second factor will emerge from raw mat purchase price in local currencies, more than offsetting the reduction of commodity prices in in dollar-euro. I remind you that the Pirelli production is located in low-cost countries for 78%, so it means in high volatile currencies, while 60% of Pirelli raw material are denominated in U.S. dollar and 35% in euro. In FY'20 is stronger than usual since the current Covid crisis as it severely impacted export volumes versus United States and Europe, thus reducing the natural currency hedge on our accounts from more competitive sourcing.

For what regards your previous demand on 2H competitiveness and Covid details. For 2H'20, we expect ~€150 million of gross efficiencies with a major contribution, as Mr. Casaluci said before during the speech, from SG&A, throughout the range of optimization and footprint rationalization. Net of inflation has slowdown benefit, we expect more or less €110 million coming from the 4 main projects included in competitiveness.

Martino de Ambroggi – Equita Sim Analyst

Two more questions on the full year guidance. If I take the midpoint of your adjusted EBIT guidance, it implies 2H is not far from last year, ~-4%, and high end would be even higher. So my question is, what is your level of confidence, low end and high end of this range, considering the remarks that you made at the beginning, saying that the visibility at market level remains low?

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

Yes. We base our expectation in 2H on a better performance on the ≥ 18 ". We expect to have something close to a -0.6% compared to last year versus a -3% of the market. In the Standard segment, we will continue the pruning of our portfolio. So the reason why we are confident on the 2H EBIT is based on this and on the mix that Mr. Casaluci elaborate before. So that's why we consider that the Replacement market, as a whole, in our segment, will be close to what was last year, considering that we expect to have FY winter volumes between -10% and -15%, due to the lower number of kilometres made by winter tyres last year. And because in Europe, there was 38% less sales of new cars in 1H, which means that for Germany and Italy mainly the winter season for new cars, is really very poor.

Martino de Ambroggi – Equita Sim Analyst

Okay. The second question on the guidance related to the Covid costs, €26 million, which are not in the guidance or below the guidance. What's the rough figure for this line for the full year?

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

Given their extraordinary nature, they are included among the non-recurring costs. That means that they are not included in the Adjusted EBIT.

Martino de Ambroggi – Equita Sim Analyst

Yes. €26 million in 1H, and what should we expect for the full year?

Valeria Leone – Executive Vice President Investor Relations, Planning & Controlling and Business Velo

For the full year, we expect ~€35 million.

Martino de Ambroggi – Equita Sim Analyst

Okay. Not a big change. The last question is still on CapEx. Because none of your competitors cut CapEx by 60% as you did immediately when the emergency started. Is there any risk of losing any opportunity in some markets or segments because of this? And I understand that your indication of higher CapEx for next year, if I assume something in the region of €300 million, is a reasonable assumption?

Andrea Casaluci – General Manager Operations

Yes, it's reasonable. It's too early to have a clear number and clear picture, but it's reasonable to go back to a more normal level of CapEx. And no, there are no risk because we have decreased everything which is related to capacity increase, and we are protecting all the necessary investment for the technology upgrade, and to assure the business continuity. So no risk so far.

Thomas Besson – Kepler Cheuvreux Analyst

I have 2 very quick questions, please. The first is on the €25 million incremental raw materials you are reporting. I was wondering why you're not trying to pass part of that to end customers, as you seem to anticipate a better mix in 2H with Replacements stronger. That's the first question.

And the second, when I look at your Slide 11, and you outperformed a lot in the O.E., you underperformed a lot in Replacement in 1H. So 2 small questions. First, are we still in the pull-through phase? Or is it just the fact that some of the models you are exposed to are working well while the Replacement market was tough? That's it.

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

First of all, the raw materials, you have to take into account that the view we have today being in August, goes up to November. So our figures, considering the input cost of the raw mat was quite certain. So there could be something happening, but it will affect only the very last part of the year. So we expect this number being consistent with what is going to happen. Mr. Casaluci?

Andrea Casaluci – General Manager Operations

Yes. We are over-performing the market in Latin America, in the ≥ 17 " segment, that is what we define premium segment in South America, because the 17" itself is still a High Value segment for these regions. And we are over-performing both in the O.E. and in the Replacement in 1H, and we do project a growth in the market share also in 2H. And this is, as you mentioned, leveraging, mainly on the pull-through rate of the O.E. that are fitting Pirelli tyres in the last 2 years.

Gianluca Bertuzzo – Intermonte Sim Analyst

I have 3 questions. The first one is, how will you describe your 1H and 2Q performance compared to your peers mainly in terms of profitability?

Second one is on 2021. I know it may be too early to comment, but do you see any structural reason preventing you in 2021 to go back to the same level of profitability of 2019? I mean if we look at some of the drivers that have led you to revise downward this year guidance, such as ForEx in low-cost countries, it seems this kind of pressure might not easily go away.

And last question, more housekeeping question is on the level of total restructuring we can assume for this year.

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

I'll start with a question you raised about 2021. It's very, very early to say. What we can see is that our Replacement market ≥ 18 " will come back to 2019 levels in 2021 [quello che dice sotto Casaluci ma solo su HV]. We don't see major risks not to recover in 2021. That is a general statement we can make unless there will be other lockdowns related to Covid that are now unexpected. But for the rest, I leave the floor to Mr. Casaluci.

Andrea Casaluci – General Manager Operations

Yes. I confirm what Mr. Tronchetti mentioned before. So the risk related to ForEx it's not something we can completely offset. It's too early to say if we will be back to the profitability of 2019 in 2021. We have still a high level of uncertainty from now until the end of the year. So it's extremely difficult to forecast 2021.

But our target segment, the High Value in 2021 is expected to be back to the normal level of 2019. While the other segments of the market, most probably will require at least another couple of years. So we do expect to be back to the normal level of the market of 2019, not before 2H'22, with the exception of the High Value. So we are confident with our business model to protect the profitability.

Jose Asumendi – J.P. Morgan Analyst

I want to follow-up on that last question and maybe ask a little bit more sort of longer-term for the coming 2 years. And coming back to the discussion we had during the IPO, product mix has always been an important opportunity for Pirelli. How do you think about product mix improvement over the coming, not 6 months, but 1-, 2-year, which could actually allow us to understand how markets can actually normalize on a 1- and 2-year view and see the value with the case.

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

What we are working on is to reduce the breakeven point. So what you see, the actions we have taken already in our 3 years plan and the additional actions taken for Covid-19 are having an impact on our cost basis that's quite consistent, 6% on the cost baseline gross impact, is something that will change the profile of risks on cost side looking forward.

On product mix and product, in general, the new ways of making the new sets of tyres in a faster shape and with better performance is related to all what has been done in the last few years. So we have invested heavily in R&D. We have invested in technology and R&D. So simulation, mathematic model, standardization inside factories. All this will provide us a number of new lines that will reduce drastically the cost. And this is an additional value that we can exploit in '21, '22 and should support our business model that I can call a High Value, low cost. In a sense that we are trying to be as effective as possible and Covid helps, in a way, to make additional action in place. That's why we feel comfortable that our performance will be much more performing in the next couple of years that one can expect today.

Andrea Balloni – Mediobanca Analyst

My first one is about interest cost. You did a good a reduction in 1H. I would like to know what are you projecting over the second part of the year. Can you expect a similar trend also in 2H?

My second question is about free cash flow. I lost your comment about the FY'20 guidance, if you can give us the main driver of reduction in guidance, I guess this is basically made on the lower profitability, but could be probably something which could be offset also by net working capital, if you can repeat it, please?

And my very last question is again about Covid-19 cost. I lost your answer to my colleague about the FY'20 amount. Just to understand, it was €26 million in 1H and I lost the amount for the full year.

Valeria Leone – Executive Vice President Investor Relations, Planning & Controlling and Business Velo

Yes. No problem at all. So with regards to the cash flow guidance, what we told before that the midpoint of your target is equal to €205 million. That means a €25 million less versus the guidance we gave in last May that was equal to €230 million. And what's the difference? In terms of cash flow, we have €60 million reduction in the adjusted EBIT that translates to €25 million cash absorption.

Part of this is due to the additional non-cash items versus the previous guidance, amounting to €20 million, included in the other cost, in particular, higher provisions and stock accounting treatment that are linked to 0.3m pieces, additional inventory reduction versus previous guidance.

The remaining one comes from the higher target for the year-end inventory reduction. We should bring an additional benefit of at least €10 million.

For what regards, the Covid costs, what we told before, that we recorded in 1H, €26 million of direct Covid costs. And our estimate for the full year is equal to €35 million, so only €8 million, €9 million in 2H.

Andrea Balloni – Mediobanca Analyst

Okay. And about interest cost in full year?

Francesco Tanzi – Executive Vice President and Chief Financial Officer

For what is concerning the interest charges, we see a stable trend. And assuming interest credit curves and spread does not change, we will probably keep our cost of funds in line with 1H.

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

So this concludes our today program. Thank you for the attendance, and have a good evening.