Pirelli 2014 Preliminary Results

February 12, 2015

Marco Tronchetti Provera - Pirelli & C. SpA - Chairman and CEO

Good evening, Ladies and Gentlemen, and thank you for joining us at this Conference Call on 2014 Preliminary Results.

I believe that the results, which have just been approved by the Board of Directors, were satisfactory, especially when we take into account the strong macroeconomic slowdown in Latin America, where we have one third of our business. This slowdown produced a 17% decrease in the OE Car market and 23% in the OE Truck Business. Another challenge is the geopolitical and macroeconomic crisis which is affecting Russia, where in spite of the current scenario we are well on track with our turnaround plan, which I am going to discuss in detail later on.

Our results were achieved through our actions increasingly focused on the Premium segment, where we are ahead of schedule compared with our London Plan.

The addressable world Premium market is exceeding our initial expectations.

We used to think that the Premium vs. the non-Premium segment grew three times as fast. In 2014, the Premium Business grew by about 10% year on year against a non-Premium market which was only slightly positive, thereby going beyond our initial assumptions.

In this high growth market we achieved a high-teen Premium volume growth and acquired 1 percentage point of market share worldwide.

This Premium growth contributed to the overall annual 4% price/mix improvement and this is what makes us different from the rest of the Industry.

Let’s now briefly review how our results compare with our guidance which has been restated - for the purpose of comparison – to account for the deconsolidation of third party results of the Steelcord business.

2014 results were in line with our targets. These are the main highlights:

- A significant growth in the Premium segment, volumes up 17.8% as against +10% of the total market, which was higher than expected;
- Price/mix at +4.2%, confirming the distinctive positioning of Pirelli in the Industry;
- Profitability at 14%, with an EBIT margin growing year-on-year by 1 percentage point as a result of our Premium Strategy and successful execution of our Efficiency Plan;
- Strong Cash Generation, higher than expected, with a net Cash Flow on sales of 5.2% (3.8% in 2013)
- Progressive deleveraging, with a Net Debt to Ebitda ratio at 0.8x and a Net Debt below 1 billion, 1.17 billion net of the impact of Steelcord disposal in Italy, Romania, and Brazil.

Let us briefly analyze the dynamics that led to the 2014 results.

A 5.9% Revenue Organic Growth, supported by a solid Consumer Business performance (a +8.9% growth, net of exchange rates) through:

- a 5% volume increase, higher than the +3% Industry average;
- a mix improvement and a balanced approach to pricing.

On the contrary, the Industrial Business trend (-1.5% Organic Growth, -10% inclusive of exchange rates) discounts a marked slowdown in the Truck and Agro Markets in Latin America, with a 6.5% volume decrease, partly offset by price increases and mix improvements (+5% price/mix).

A 838 mln euro Ebit, with an over 50 mln euro improvement yoy, due to:

- a solid Tyre Business performance where Volume, Price Mix and Efficiencies all contributed to offset higher manufacturing costs and a negative exchange rate impact;
- improved minor business results which halved operating losses compared to 2013.

Consumer Business reaches a 15% profitability, almost 1 percentage point more compared to our London Plan, while the Industrial Business closed 2013 with a 13% stable Profitability, in spite of the market weakness in LatAm.

Net Debt of approximately 980 mln euro, after:

- 378 mln euro of investments, mainly allocated to Premium Capacity improvement in Europe, Nafta and China as well as Mix improvement;
- 160 mln euro of Dividends.

High Cash Generation in the Fourth Quarter, worth over 1 billion euro through improved Operating Results, a careful Working Capital management policy, as well as the impact from Steelcord disposal.

Our 2014 Net Debt includes the devaluation of the positive Net Financial Position of Venezuela for 57 million euro, as a consequence of the progressive adjustment in the Bolivars / Dollar exchange rate.

In the first quarter, the move from 6.3 to 10.7 resulted in a devaluation of 46 million euro in the positive Net Financial Position. Further adjustment to 12 led to an additional devaluation for 11 million euro booked in the fourth quarter.

The exchange rate loss on prior commercial debts, which reflects the above mentioned progressive FX adjustments, was booked over the course of the year in the Net Equity.

Considering the increasingly scarce availability of dollars in the market, as a cautionary measure, we booked in the fourth quarter a loss on exchange rates among financial charges for a total yearly amount of 70 million euro.

This will bear no impact on dividends.

Our value-oriented strategy in 2014 translated into solid Organic Growth in all markets and an increase in Profitability by nearly 1 percentage point overall.

Mature Markets and Asia Pacific, where Premium and Super Premium products account for a larger share of the total market or are growing the fastest, made up the bulk of growth in the year. We will discuss this trend in more detail in the next slide.

In Europe, a warmer winter meant a somewhat slower pace of Revenue Growth. Our unchanged pricing policy and focus on efficiency allowed us to protect Profitability, and hit our “mid-teen” range target.

The results in North America were in line with our targets, due to a strong mix improvement and the successful ramp-up of our Mexican plant, which now has a capacity of more than 2 million Premium Car pieces.

In Latin America, we were able to gain market share in a declining Original Equipment market and be consistent with our price/mix improvement objectives.

Asia Pacific and Middle-East Africa are confirmed to be the areas with the strongest Profitability, supported by the growth in the Premium segment, growing Car Parc and improved retail coverage.

Turning to Russia, 2014 marked the success of our turnaround plan.

Our internal levers brought about a double-digit Organic Sales Growth and mid-single digit profitability, just shy of our Ebit target due to the weakening economic outlook and shrinking Tyre markets. We recorded a market share increase which brings us in the double digits. Our mix has clearly improved as industrializations came on stream and our product portfolio became more competitive. Finally, we made a further progress in our Retail Development Plan and were able to improve Productivity and Efficiency: Russia is now one of our lowest cost production locations and we are ready to push on exports, when needed, and serve nearby markets.

Let us now focus on the performance of our Premium product range.

The investments made in developing top products alongside the best Prestige and Premium car makers, allowed us to outgrow the Premium tyre market by about 2 times in 2014, gaining share in every region.

In terms of revenues, this fast-growing segment accounts for 55% of our 2014 consumer revenues, an increase of 4 percentage points year-on-year.

Our homologation portfolio continues to grow: we added nearly 60 Prestige and Premium homologations in the fourth quarter of 2014 alone, for best-selling car models such as Jaguar XE, Land Rover Discovery Sport and Porsche Macan.

Together with these homologations, we secured a portfolio of marked tyres for the Replacement channel. These products will assure the very same driving experience for the entire life cycle of the car. This value is perceived by OEMs, our replacement customers as well as consumers, and it is visible in our very high pull-through rates.

Such trend was particularly evident in Europe, where we improved our positioning in the SuperPremium segment. This was also achieved by reducing our reliance on generalist wholesalers while growing with Premium specialized clients and high-mix distribution channels such as car dealers.

North American customers continue to show appreciation for our value proposition, in particular for our new lines of regionalized products: in 2014 alone, we brought to the market 4 new products designed with the US consumer in mind, emphasizing tyre features such as increased mileage and durability. Our strategy of providing unmatched level of service to selected Tier-1 replacement customers paid off and translated into 2-digit revenue growth in 2014.

After consistently outgrowing the global Premium market in the last year, Emerging Markets now account for 27% of this segment’s revenues, an increase of 2 percentage points year-on-year.

Especially in South America and Asia Pacific, car parcs are growing in volume and mix, creating a natural need for replacement tyres which we are able to capture due to our unique positioning in OE and pervasive distribution network. The growing popularity of SUVs and green products, together with product specialties such as Run Flat, offer us other clear growth opportunities.

We continue to increase our product portfolio in Russia, including OE marked winter tyres, like Sottozero III, a new Friction range for 2015, as well as studded products specifically designed for Russia like Ice Zero and Formula Ice.

Now, addressing 2015, we must discuss our first outlooks and then our priorities and targets:

At macroeconomic level, we expect dynamics largely in line with 2014. China and mature markets are the engines of growth, while volatility is still the major feature in both Latin America and Russia;

At market level,

- the Car Parc will reach approximately 1.1 billion cars, of which 9.3% Premium due to the fast development in New Premium Car Registrations. As a consequence, the Premium Tyre addressable market widens with an expected year-on-year 2015 growth rate of over 5x the non-Premium Business;

- in 2014, the Truck Tyre Production in emerging markets decreased significantly, while a moderate recovery is expected in 2015. The Truck Tyre Market is expected to grow by 2%, totally driven by the Replacement Business.

Competition is growing, also in the Premium arena, where competitive barriers, mainly based on technological innovation and customer service, continue to rise too.

Finally, our industry has set very clearly its value drivers. Basically all players are confirming profitability targets and cash generation, which should approximately amount to 4% of Revenues.

Let us briefly look at where growth will come from in 2015, from a macro perspective.

As in this past year, growth will mostly come from mature economies:

- In the United States, positive signs from the job market as well as a continued low interest rate environment should support economic activity and consumer confidence
- European corporations will be aided by a weaker Euro, the announced quantitative easing by the ECB and growth-oriented policies by governments

China will continue to play a strong role in world economic growth, transitioning to a new scenario of more moderate but still substantial growth rates, despite the risks looming from an excessive reliance on investments and a complex financial system.

These trends are about in line with what we envisaged in November 2013 when we announced our Industrial Plan.

We see, however, increased volatility in some rapidly developing economies, notably:

- Russia, where consensus is expecting a recessionary 2015 on the back of current oil prices expectations, and

- South America, which shows a slower growth profile with pockets of high volatility such as Venezuela and Argentina

Given these trends, as usual we take a cautious approach and make use of our long-standing experience of dealing with economic cycles in markets where we have established industrial traditions. In the remainder of the presentation, we will address the impact on our business of the expectations we currently have for South America.

The macroeconomic scenario we just reviewed translates into a 3 to 4 percent annual growth in the number of cars in use globally; this is in line with the assumptions of our London 2013 Industrial plan.

Premium Car parc growth is amazingly on the upside, supported by the trend of new registrations, with almost 9 million new vehicles on the road in 2015, corroborating our strategy in value-added product segments.

Vehicle sale data confirm APAC as the region that will drive Premium growth in 2015, while mature markets keep their relevant weight in the segment.

Growth in China will be supported by the expected leap in the replacement demand base for 2015-2016 and the increasing penetration rate of financial services (from 10% in 2010 to 40% in 2015). This will also contribute to increase the weight of APAC in Premium Car Registrations from 27 to 30% in 2015.

In this evolving scenario, mature economies will still have the lion's share in Premium vehicle sales in 2015, the weight of Europe and NAFTA moving from 65% to 62%.

Let us now review how these trends are reflected in the global tyre market.

Premium is accelerating versus our initial expectations for 2013-2015 with a growth 3 times that of the total market. As a consequence, its expected weight out of the total market is now 25% in 2015, 1 percentage point ahead of our previous assessment. After a 10% growth in 2014, we expect a 7% increase in 2015.

On a regional basis, mature markets will perform slightly better than the Emerging in the 2013-2015 period.

Europe and Nafta, combined, are a year ahead of our previous expectations in terms of Premium incidence on total volumes. Growth in 2013-2015 is at 8.3% and in 2015 38% of the total market will be Premium or 2 percentage points more than in our 2013 London Plan.

The overall trend of Emerging markets is still positive but slightly lower than our expectation (2.5% vs 5.2%). The Premium segment continues to outperform now accounts for 13% of total volumes.

Latam is expected to remain substantially stable in 2015, after a 1.5% contraction in 2014, while in Russia the car market will shrink by 7% in 2015.

APAC Premium market is still growing at the same rate as forecast in our London plan, almost 12%, reaching an overall incidence of Premium on total market of almost 16% in terms of volume.

Turning to Truck production, our current expectations are slightly behind our November 2013 assumptions.

A slower European market is mainly linked to the end of the pre-buy effect resulting from the coming into force of the emission regulation standards EURO VI in January 2014.

The 2015 outlook for Europe is positive, as it benefits from an ageing fleet which increased to a record 9 years.

The NAFTA region is performing strongly while Emerging markets missed the growth, due to a slowing down LATAM region and in particular in Brazil.

Brazil's investment support program (PSI) boosted sales of vehicles in 2010-2013, but as a counter-cyclical effect strongly reduced production and vehicle sales in 2014. A middle-single-digit growth is expected in 2015, also due to an aging vehicle parc, almost double that of Europe.

Overall, truck tyre markets (all steel only) are expected to trend in line with our November 2013 Industrial Plan, namely +2% globally in 2015 but with significant differences among regional markets.

The strength of Europe and Nafta is expected to offset the slowdown in Emerging Markets.

Europe, in particular, is expected to grow at +3.0% in the 2013-2015 period, mainly driven by the replacement market (+4.5%).

South America – which accounts for 13% of the total truck tyre market in rapidly developing economies – experienced a drop in original equipment between 2013 and 2014 (-23%) which will only be partially recovered in 2015 (+5%).

In 2015, Asia Pacific confirms an Original Equipment market at -2.4% year on year, with a Replacement market offsetting this slowdown (+2.1%).

The tyre industry as a whole is expected show a solid performance in 2015, revenue growth of 5%, improving profitability up to 13%, +0.5 percentage points year-on-year, and cash flow generation around 4% on sales, improving by the same amount.

There is a distinct industry push towards value-added products, including Premium. Barriers to entry, however, are very high, since product complexity and R&D expenditures are substantial. As an example, in years of commitment we have built the current unmatched portfolio of almost 700 marked items, which grew more than 30% year-on-year.

Being Premium also means facing a manufacturing and efficiency challenge, which we master with our patented production process and flexible plant setup.

One of our competitive advantages lies in our new Premium plants, which produce 62% of our total Premium tyres; they are all located in low cost countries and have close customer proximity.

In the current raw material environment, product focus and innovation are also functional to protecting pricing; price protection will also be enhanced through stronger retail integration, exclusive distribution agreements and increased car dealer coverage.

Capitalizing on the assets we have built in the last few years, we are approaching 2015 with a clear set of priorities in mind.

Consolidating our Prestige and Premium leadership through the OE business means:

- Keep innovating with products that meet today's technological challenges, such as our Cyber PZero which just equipped the new Ferrari FXX K hybrid. Our product roadmap for the years 2013-2017 is on track: 5 new car product lines were launched in 2014 and 9 are expected for 2015.

- Grow our homologation portfolio for those products with highest value in the replacement channel and

- Develop our technological niches – Run Flat, Self-sealing, Noise Canceling – into substantial profit pools, given their profitability which is line or above the Premium average.

As we did in 2014, we aim to continue growing our market presence in the replacement channel.

Our channel strategy will be more selective, focused on value-oriented and long-term customer relationships. For 2015, we plan to reduce our business with generalist wholesalers by a few percentage points, in favor of car dealers and specialized dealers.

Additionally, we are designing new products and sizes to grow with car models where we are not homologated; we have a sales target of about 1 million pieces for 2015, meaning an increase of our market share.

In our Medium range, we are planning a significant product renewal which includes the recently launched Cinturato All Season targeting a small but growing market niche.

In our Moto business, 2015 will see the beginning of production in the Indonesia plant we have in partnership with Astra, which will mostly supply the Asia Pacific region. In this business, we aim to reinforce our positioning as a technological leader and exploit our experience in Motorsport.

For our Industrial tyre business to thrive, more scale is needed as well as a better coverage of regional markets where we are under-represented. To this end, while we are actively seeking a partnership, we are designing a more independent organization.

At the same time, starting from our core South American market, our business model will become more "fleet-centric": it will benefit from an enriched value proposition which will include tyres, retreads and services, delivered through owned dealers, independent trade partners, retreaders and truck vehicle dealers.

Finally, we continue to push on efficiency throughout the Business and aim to at least hit the targets of our November 2013 Industrial Plan.

We are ready to put in place a contingency plan to mitigate the negative impact of any possible further deterioration of the scenario in Venezuela and Argentina, which I will elaborate on in the remainder of the presentation.

Let us now review our expectations on a regional basis, which are in line with the outlook we just described:

- Asia Pacific will show the strongest growth, with organic revenues up in the "mid-teens" and an improvement of the already high profitability. This is expected despite a slowing macroeconomic scenario.
- Nafta and Europe will show moderate top-line growth and deliver a profitability in the "mid-teen" range. In these regions, we continue to roll out our geo-marketing tools and reduce our dependence from generalist wholesalers in favor of specialists and car dealers.
- South America is expected to recover and show flat revenues in euro terms and an improvement in profitability. Brazil will be the main driver of this performance, more than offsetting the weakness of Venezuela and Argentina, which we will address in the next slide.
- Premium growth continues in Middle-East Africa, where we plan to extend our SUV portfolio to meet local demand. The region is expected to confirm its above average profitability also thanks to an improved product and service offer in the Truck business.
- The difficult scenario in Russia will have an impact on revenues in euro terms, expected to be lower than in 2014, given the ruble devaluation to 65 against the euro, as a yearly average. This effect will be mitigated by mix and price improvements, bringing organic sales to an increase in the mid-single digit range and supporting profitability.

2015 targets reflect the protracted economic crisis in Venezuela and Argentina, where in 2014 real GDP went down approximately 3.5% and 1%, respectively, with very volatile exchange rates. The Car Tyre markets is expected to shrink by 40% year on year in Venezuela (-30% in 2014) and to remain basically stable in Argentina (-7.5% in 2014).

Our presence in Venezuela and Argentina goes back a long way, over 100 years in Argentina and 25 in Venezuela, and we have learned how to cope with such volatility. Over the last few years, for example, in Venezuela, we have reduced our production capacity down to approximately 1 million car pieces, mostly for the local market.

In Venezuela, the currency scenario is moving to a new multi-tiered exchange rate regime, with:

- An official rate of 6.3 Bolivares per US Dollar used for essential goods, like food and medications;
- The SICAD1, currently at 12 Bolivares per US Dollar, a reference for the Auto&Parts Industry, considered strategic for the Country;
- The Simad, an open market platform, which will soon be launched to only manage a fraction of the dollar supply to Venezuela.

As mentioned, FX volatility in Venezuela has already had an impact on our 2014 accounts, given the move from the official rate to the SICAD1:

- 57 million euro in Cash Devaluation; and
- 70 million euro in Financial Charges, related to the exchange rate loss on prior commercial debts. This impact has been progressively booked in Net Equity and, as a cautionary measure, booked in P&L in the fourth quarter

In 2015, we expect a Bolivar to US Dollar exchange rate devaluation from 12 to 20. For the same reason of 2014 we expect:

- a devaluation of our positive Net Financial Position in Venezuela for 70 million euro, and
- a loss worth approximately 30 million euro in terms of financial charges.

These impacts are included in the 2015 Cash Generation target, worth at least 300 million euro.

Furthermore, 2015 targets include temporary measures for Venezuela, such as:

- Reduced production, with 50% capacity saturation, currently 80-70%;
- Temporary discontinuation of finished product imports.

The economic impact of these measures will be offset by efficiency-driven actions in Latin America.

In the event the scenario turns out to be worse than the assumptions made above, with a further capacity reduction down to 30% in Venezuela and sales volumes down to 10-15% in Argentina, a consolidated Ebit target risk is currently quantifiable to 30 million euro.

After a successful 2014, we expect the current year to mark yet another step forward in the path we designed through our Industrial Plan.

More in detail, we expect to grow revenues by about 400 million euro, on the back of:

- Volume growth of at least 3%, slightly above the market, and double-digit Premium growth, continuing to increase our share
- Improving price/mix to the tune of at least 4% year-on-year, mostly due to a higher proportion of Premium and value-added products in our portfolio

We also expect a negative impact from the devaluation of emerging market currencies, partially mitigated by the revaluation of the US dollar, for a total of -1% on sales.

Quality top-line growth will translate into a profitability of about 930 million euro Ebit, that is to say an increase of more than 90 million euro year on year; this is also due to our continuous commitment to improve the efficiency of our operations.

As previously detailed, we assessed a possible further deterioration of the market scenario in Venezuela and Argentina, beyond our already cautious 2015 budget, which we estimate in a risk of about 30 million euro Ebit.

In line with our Industrial Plan, investments are expected to amount to less than 400 million euro, mostly devoted to growing our Premium capacity and improving mix.

Finally, net cash flow generation before dividend payment is expected to be above 300 million euro, nearly 5% on sales, confirming the ability of our business to structurally produce cash.

I can now switch the floor to Mr. Sala.

Maurizio Sala - Pirelli & C. SpA – Head of Group Planning and Control

Briefly on our targets by business.

In 2015, the Consumer business will grow by about 300 million euro in revenues and by nearly 1 percentage point in Ebit margin. This is based on:

- Improving price/mix of at least 4%, largely due to Premium growing 10% year-on-year
- Overall volume growth of at least 3 percent and a slightly negative Forex impact.

For the Industrial business, we expect top-line growth between 7 and 7.5 percent year on year, assuming:

- A rebound in volumes, between 4.5 and 5 percent due to growth in our OE business in Europe and Asia and a positive trend in Replacement in LatAM and Europe
- Solid mix improvement, approximately +4.5 percent, and
- A -2% impact from emerging markets currency depreciation.

This will lead to a profitability of approximately 12% Ebit margin before non-recurring items, or a slight improvement against 2014 pro-forma results which exclude the Steelcord business in its entirety.

As mentioned, we are on track with our 2014-2017 Efficiency Program which should result in approximately 90 million euro efficiencies per year or more than 1% of sales.

Our Efficiency Plan is based on the following three main pillars:

- De-complexity
- Productivity improvement, and
- Scrap reduction.

These are already making Pirelli a leaner company with:

- A rationalization of products and components along the value chain
- More efficient processes
- More specialized plants

These programs are backed by a number of cross-functional teams, working on short- and medium-term objectives that have been identified and constantly tracked.

In the raw material market, the scenario we envisage is that of a slight rebound in raw material prices, starting from the second half of the year, against the current spot prices.

- The current price of natural rubber is below the break-even point for most producers, some countries are implementing buying schemes or subsidies to support farmers. Where no governmental support is available, output is decreasing.
- Brent oil is already showing signs of slight recovery and stabilization from the January lows.

- Butadiene stays volatile, due to inherent difficulties in keeping large stocks and low margins for producers.

We expect a raw material tailwind that will be eroded by the depreciation of currencies in emerging markets, where we are present with most of our production base.

Finally, on capacity, in 2015 we plan to add approximately 3 million pieces in terms of Premium Car Capacity, mainly in Mexico, China and Romania, to bring our Premium Capacity to about 40 million pieces.

Our industrial capacity will remain unchanged and our 400 million euro investments will mostly be made to improve the Mix and expand our Premium plants.

Now, briefly on the main additional assumptions behind our profitability guidance of 930 million euro Ebit for 2015.

As already mentioned, the positive contribution from volumes and price/mix will be slightly higher than in 2014, respectively at least +3% and between 4% and 4.5%; our international mix of sales will translate in a negative FX impact of about -1%.

Efficiency gains are confirmed, in line with our November 2013 Industrial Plan assumptions, to amount to about 90 million euros.

Raw materials will have a slightly supportive impact, whereas inflation and other costs will have about the same impact as they did in 2014.

Finally, the cost of debt will be lower than 6%, since the benefits from our recent capital market operations, launch of a 600 million euro bond and refinancing of our credit line, will be compensated for by higher interest rates in Russia and South America. The full benefits of our successful capital market operations will be realized in 2016, due to the expiration of our outstanding 500 million euro bond.

Tax rate is expected at 35%, anticipating our 2016 target, and a tight management of working capital will translate into a year-end operating working capital on sales of more than 5%.

This is all from me for the moment, thank you very much for your attention. I now give the floor back to Mr. Tronchetti.

Marco Tronchetti Provera - Pirelli & C. SpA - Chairman and CEO

Thank you for your attention. Now ladies and gentlemen, we may open the Q&A session.

Questions & Answers

Ashik Kurian – Goldman Sachs - Analyst

Good evening. It's Ashik from Goldman Sachs. I've got a couple of questions. First on the price mix, could you possibly give a bit of color on the split between price and mix for the price mix numbers you've reported for both consumer and industrial? And how much of the pricing, per se, maybe in the industrial business it's just the increase of prices a lot of time to offset the inflation.

Gregorio Borgo - Pirelli & C SpA - General Manager, Operations

So let's start from consumer business. The price mix will be more or less 75% mix, and 25% prices. So price will be around 1% overall.

If we talk about LATAM, LATAM and Russia for sure the two countries where we must raise the price, and we are already starting actually both in consumer and industrial business. While in the other market, I think we have a different dynamic.

If we talk about Europe, we are not in position to increase the price. But for the time being we are keeping on price thanks to the 700 homologated items we are going to have in 2015, as mentioned by Mr. Tronchetti. I think as usual, in that part of the market we can be more resilient.

On top of these, as far as Europe, as mentioned by Mr. Tronchetti, the fact that we will reduce by 5 percentage point the weight of our wholesaler will give us a better price balance in the market.

For USA, duties on the Chinese tires will help us to stabilize the price, not only in the high-end part thanks to the marked tires, but as well in the let me say, in the local range, in the all-season range that represents more or less 90% of the market.

I remind you that last year we were introducing a lot of tires. We were introducing the new P Zero AllSeason. We were introducing the Cinturato 1 Plus, the Scorpion All season, and as well an updated version of Cinturato P7 Allseason. So thanks to the new product, I think we are going to have a balanced situation there.

Ashik Kurian – Goldman Sachs - Analyst

Okay. Can I just have a clarification on the devaluation impact for 2015? Now your cash flow before the dividend of EUR300 million, does that already capture the devaluation of EUR70 million? So is the way to think about your net (inaudible) for 2015 would be plus EUR300 million, inclusive of the devaluation or would the devaluation come on top of the free cash flow?

Marco Tronchetti Provera - Pirelli & C. SpA - Chairman and CEO

Yes. The Venezuela devaluation has been taken into account in our target. So the cash flow production of more than EUR300 includes EUR70 million of devaluation in Venezuela, and financial charges of EUR30 million in our P&L.

Ashik Kurian – Goldman Sachs - Analyst

Okay. Thank you.

Philip Watkins - Citi - Analyst

Good evening, and thanks for taking my question. It refers to the higher import tariff in the US for Chinese players. Do you think is there any particular risk that some of these tires could end up in South America? And therefore they'll be sort of higher pricing pressure there.

And just if I may, on Russia, do you have a feeling for how much you may be raising prices this year? And perhaps you could also comment on how the distribution channels is advancing here. Because I know you're working with Rosneft there. But is that on track, basically? Thank you.

Marco Tronchetti Provera - Pirelli & C. SpA - Chairman and CEO

So first the import duties in US, will have as an effect, what Mr. Borgo underlined before, a stabilization of the prices in North America, with no effect on Latin America. That means that the prices will remain at a good level. The real effect in Latin America is that we'll provide more opportunity for exports from Latin America to the US thanks also to the weakening of the Real in front of the dollar.

Then going to Russia, we are exploring a price increase of 10% in Russia. We are increasing our export from 500 to more than 2.5 million tires from Russia to Europe and the countries around. And we are also protecting our position in internal markets with a wide range of products.

We see mostly negative effects on the original equipment that we can balance in an effective way with the increase in exports.

Philip Watkins - Citi - Analyst

Thank you. Just actually on the South American issue, I was wondering, not a sort of direct impact from pricing, but these Chinese tires are going to end up somewhere. It could be Europe. It could be South America. I don't know if there's a worry there's going to be a glut of these Chinese tires in the South American market.

Marco Tronchetti Provera - Pirelli & C. SpA - Chairman and CEO

What we see is that these volumes will effect only the standard business. We don't see major inputs coming to Brazil, also because of the weakness of the Real. As you know, the yen follow much more the dollar than the euro lately. And so the market of reference for these exports will not be very much in Latin America. So we don't see any major effect on Latin America.

Philip Watkins - Citi - Analyst

Yes. That's clear. Thank you.

Martino De Ambroggi - Equita SIM - Analyst

Thank you. Good evening, everybody. One more question on pricing. You mentioned plus 1% in your guidance for the current year. I suppose it includes the automatic adjustment for the contractual agreement regarding adjustment for raw material cost. So could you please elaborate a bit more on this plus 1%, taking into account there is also a negative effect of the automatic adjustment.

Gregorio Borgo - Pirelli & C SpA - General Manager, Operations

Yes. So the 1% is the average. And as we said before, it depends on the region. If we start from Russia, as mentioned by Mr. Tronchetti before, we are going to have a two-digit price increase. It's actually already happened at the beginning of February, and will be for a part of the summer season, and then we'll go ahead for all as well, the winter season, considering that Russia is a seasonal market.

And as well in LATAM, as mentioned before, we already started to increase the price in the aftermarket. We see Europe with a slight decrease, almost flat in the replacement, for sure the premium flatter. And the same is valid for North America and China. North America, we mentioned before, we stabilized the pricing through the import duty of Chinese product.

As far as original equipment, usually it depends from customer to customer. But we have a cost matrix that follow from three to six months.

Of course, in our number we were including as well the cost matrix effect on original equipment.

Martino De Ambroggi - Equita SIM - Analyst

Which can be less than 1%, a negative effect overall?

Gregorio Borgo - Pirelli & C SpA - General Manager, Operations

Yes.

Martino De Ambroggi - Equita SIM - Analyst

Okay. And the second question is on Russia. During your initial remarks, you mentioned you want to push on export, and you already gave an indication of the volumes. But going forward, first what is the percentage of production you can eventually export without any problem? And second, how cheaper is the production in Russia compared with the European one? And third, in Russia you are giving a target of EBIT margin high single digit, so higher than last year. And I was just wondering if it includes the export or there are other drivers justifying this improvement.

Marco Tronchetti Provera - Pirelli & C. SpA - Chairman and CEO

So we planned this year to export from Russia mostly to Europe, about between 2.5 million and 3 million tires. It will depend on market conditions, out of 8 million capacity we will have in 2015 in Russia. So approximately between 30% and 35% of our production.

We can-- we have the flexibility to move inside the capacity, in case the market will be better than we expect. Imagining the worst scenario, we can balance well our production in Russia, keeping it full speed at the factories with the distribution between local markets and exports.

About internal market, we reached this year a mid-single digit profitability. We target in 2015 to go close to two digits. And so we continue this trend of improvement of profitability in Russia with the local market, thanks to the product portfolio range we have now in Russia that is very competitive.

Martino De Ambroggi - Equita SIM - Analyst

And what's the price? I remember in your last presentation in Milan, you indicated that more than EUR10 per share-- generated EUR10 per tire as lower price, lower production cost.

Marco Tronchetti Provera - Pirelli & C. SpA - Chairman and CEO

If you mean advantage, yes. Yes, it is.

Martino De Ambroggi - Equita SIM - Analyst

Okay. But the improvement in the organic sales is mainly due to the export or there are other efficiencies or improvement in the commercial network?

Marco Tronchetti Provera - Pirelli & C. SpA - Chairman and CEO

It is due to efficiencies we made. And we have also--talking about competitiveness of the factories compared to the other factories, we have the effect of the devaluation of the rubles. So we combine both the devaluation and efficiencies.

Martino De Ambroggi - Equita SIM - Analyst

Okay. Just a last question on the Asian Partner, if there is any update on that issue.

Marco Tronchetti Provera - Pirelli & C. SpA - Chairman and CEO

We continue to keep the contacts we started more than a year ago. And so we go ahead, we hope that within 2015 we will be able to start the process with some of the players we are in touch with.

Martino De Ambroggi - Equita SIM - Analyst

Okay. Thank you.

Paul Hartley - BofA Merrill Lynch - Analyst

Hi. It's Paul Hartley from Bank of America here. My first question is just on currency. You've given the FX rates you're assuming for 2015, the averages across the year. What would be the impact if we just took spot rates or say the average rates sort of across January 2015 this year? That would be my first question, so the impact on sales and then the impact on the raw material guidance as well. That would be useful.

And then secondly, just on the South America part of the business, you've talked about increased efficiency savings that you're going to be seeking to offset some of the headwinds in Venezuela and Argentina. Could you please expand on these a bit in relation to what you've done in 2014, and what you expect to do in addition in 2015? Thank you.

Maurizio Sala - Pirelli & C. SpA – Head of Group Planning and Control

So we mentioned the currencies. We mentioned the currencies in the slide 21 for raw materials in which you can see that the devaluation effect in 2014 was around EUR180 million. Devaluation effect in 2015 was around EUR160 million. Within this number we have the part of devaluation of the South American and Russia currencies, which is in the region of EUR140 million.

And then we have two opposite effects. In 2014 we have the devaluation of the Turkish lira that devaluated from 2.52 to 2.90, so devaluation of 15%. And this year we are assuming in our management plan, in our budget, a slight devaluation versus the previous number. Now it is around 2.80.

And the effect is compensated in negative from the effect of the exchange rate for the purchase of raw material cost in Europe driven from the valuation of the US dollar. Because the market currency of raw material is US dollar. So same effect of Latin America's and Russian number, negative impact of Turkish in 2014, negative impact of Europe in 2015.

If we move to the impact of the exchange rate in the revenues, which was presented in the page 18, in this case we have in 2014 a negative impact of 6.6%. And in 2015, a negative impact of around 1%. We are assuming the same negative impact concerning the South American currencies. What is making the difference is the revaluation of the US dollar that we have in 2015 assumption, we put in our assumption 1.22 versus the average of 2013 and 2014 that was equal 1.33.

And this revaluation of the US dollar of 1.22 in our assumption, calculated for the 56% of the sales that we are doing outside Europe, is making the compensation, the mitigation from the negative impact of 6.6% to the negative impact of 1%.

So it means that in our results, in our EBIT margin, we have a negative impact which is around EUR15 million versus the negative impact of EUR80 million that we had in 2014.

Marco Tronchetti Provera - Pirelli & C. SpA - Chairman and CEO

Going to how we balance in the situation in Latin America, the fact is that we already consider in our figures to capital action and to have down to zero the import to Venezuela in order to rebalance the effects of the slowdown and the crisis of the country.

In our balance sheet, in our budget, we consider to go down to 50%. We have also a more cautious view that as reserve of EUR30 million in EBIT, considering a worsening of the situation,t even worse than what we have already in our plan, both in Venezuela and Argentina.

So what we consider today is to have Venezuela with an exchange rate of 20 bolivars. Today we have in our accounts 12. And in case the maximum risk, which is for Ebit to go down to 900 million euro, but it's really volatile the situation in Venezuela.

Paul Hartley - BofA Merrill Lynch - Analyst

Thank you. Could I just follow up on the FX question? I see the impact of negative 1% assumed for sales in 2015. The rates you've disclosed there, some of them are quite far from where we actually are at spot rate. So I was just wondering if you could perhaps give us an impact at spot rates, what you think the impact would be if we just kept current rates for the full year. Thank you.

Marco Tronchetti Provera - Pirelli & C. SpA - Chairman and CEO

So there are situations that can be different from what we have forecast. We could have a stronger euro compared to the dollar, and a worsening of the rubles compared to the dollar, and a worsening of the Real compared to what we have in our plan.

So we consider that we have been cautious with the target, with the average ratio between dollar and euro, and with this ratio we could also balance what we have for the Real. In our plan we have 265. It is today around 280. And in our plan we have 1.82 for the dollar-euro relation. Today we around 1.14 and 1.15.

I think that the volatility can be faced with this balance between the difference currencies.

Paul Hartley - BofA Merrill Lynch - Analyst

Okay. Thank you.

Alexander Haissl - Credit Suisse - Analyst

Yes, good evening. This is Alexander, Credit Suisse. I have two questions, most strategic on first of all the use of cash, giving your net financial debt below EUR1 billion, and cash flow generation decent, above EUR300 million. I was just wondering if you can share with us your thoughts on returning cash to shareholders. What's your thoughts here? That would be my first question.

And my second question, given the ongoing improvement on the consumer side and more difficult environment for the industrial business, maybe you give your thoughts also on how you see the industrial business positioned within Pirelli over a two to three-year horizon. Thank you very much.

Marco Tronchetti Provera - Pirelli & C. SpA - Chairman and CEO

Thank you. So cash generation, we confirm the policy that is to distribute around 40% of the net profit. Obviously the cash generation is creating an opportunity in terms of cash. And the Board hasn't taken any decision. If the trend will continue and our budget shows that the trend continue and the cash generation will continue, and so the net debt-EBITDA ratio will go down. In that scenario the Board would take the decision how to proceed, if to have higher dividends in the future, if consider also buybacks. That is in the hands of the Board, and no decision has been taken until now.

Going to the strategy on industrial business, the strategy is the one we mentioned in November 2013, the industrial plan. The industrial business is an opportunity for the group to combine this business with others. We have a good industrial footprint, but limited to Latin America, Asia, Turkey and a small production in China.

We have good technology, good product, and we consider that we can combine our business with other players that want to strengthen their position, profiting of our technology and our industrial footprint, and creating synergies with us. So the future is in a venture with a third party. And the players that could be interesting for Pirelli are in Asia. There are a few of them very valuable.

Alexander Haissl - Credit Suisse - Analyst

Excellent. Many thanks for the numbers.

Giuseppe Puglisi - Intermonte Securities SIM - Analyst

Good evening. Giuseppe from Intermonte. I have two questions. The first, what is the potential impact if you applied the Simad for the Bolivar?

And the second questions regards the oil. In slide number 21, you're assuming an oil price of $78 per barrel. Why this number? What is the underlying assumption?

And the third question, I just would like to know, to have more color about your new Cinturato all-season; why this strategic move? And will there be a cannibalization effect with the winter tire? What are the growth prospects for this kind of segment? Thank you.

Marco Tronchetti Provera - Pirelli & C. SpA - Chairman and CEO

Thank you. So Bolivar, default, unfortunately we have experienced defaults in our past life. But even recently with the Argentina in default. It has been in order to keep that production capacity there. We were successful doing this in Argentina. Looking to today's situation, we do the same in Venezuela. We stay there, reducing down to the limit we consider affordable. And that's why also we capture this sort of EUR30 million in our profit. At any term, that could go down to 900 gruoup Ebit. And in that scenario, after the default there is an opportunity for the exports.

In the past, Venezuela was a good basis to export. In the future, if there will be a default after some months, Venezuela will become a good basis for export. So that is, at least for a bad experience we had in the past, what we believe could happen.

Giuseppe Puglisi - Intermonte Securities SIM - Analyst

Excuse me. But if the new standard, the Simad standard that will be applied, there will be a farther impact on net financial position.

Marco Tronchetti Provera - Pirelli & C. SpA - Chairman and CEO

We are already including the Sicad 1 in our net financial position. And we are considering for 2015 an exchange rate of 20 bolivar to dollar. So that's what we are doing now.

I think to the all-season question. Mr. Borgo will answer. Mr. Borgo, if you could answer to more details in case you need it.

Gregorio Borgo - Pirelli & C SpA - General Manager, Operations

So let's start with all-season. I think all-season is the application of what we announced in London 15 months ago. That there are premium products as well as profitability that are not belonging technically to premium segment. The all-season is a demonstration of this, because it's a product that is granting excellent performance during 365 days here. And on top of this is the first time that someone is introducing the concept sealing side. So this means this is a tire that once it gets a puncture is able to self-repairing.

And this is showing that Pirelli has two technology for the total automobile. One is run flat technology and the other is SelfSealing technology.

As far as cannibalization of the winter, we believe that this is not going to happen, because this is the product for the people that today are used to using summer tire for all the seasons. So they have an issue because if the people are living in North area of Italy or Germany or Europe where there are legislation about the usage of the winter products during the winter season, so these people are not compliant with this legislation.

And all-season satisfies this need. On top of this, I remind that the price position is a premium one because for the same size, the price is 20% higher in the same size in the summer. And if you want to have on top of this the sealing side technology, you have to add another 10%. So I think it's going to be a product with for sure, around 15% profitability.

Marco Tronchetti Provera - Pirelli & C. SpA - Chairman and CEO

Going to the oil price, so we have the price that is basically the price of the previous four months. So the average price we will have in the four months from January to April will be average 84. We consider to a major average price for the 2015 of 78, which means that in case the oil remains as low as it is today, there is some room to have a better average. But anyhow, we have to consider what we have in hands now, what is visible. So until if we know the figure is that one, and that's why we say for us 78 is still valid.

Giuseppe Puglisi - Intermonte Securities SIM - Analyst

Thank you.

Martin Viecha - Redburn Partners - Analyst

Hi. This is Martin Viecha from Redburn. Thank you very much for taking my question. I notice that you've shared quite a bit of information on Venezuela and Argentina. And I wanted to ask about the profitability. You've mentioned that the two countries account for about 8% of revenue. But how much profit do they account for?

And the second question is how was the exchange rate of 20 bolivars per dollar established, given we know that the Sicad II is at about 50 bolivars per dollar, and the black market rates is about 200 bolivars per dollar. So I wanted to ask how confident are you that the profits you are reporting will ultimately reach your bank account in this exchange rate? Thank you.

Marco Tronchetti Provera - Pirelli & C SpA - Chairman, CEO

Talking about Venezuela and linking Venezuelan confidence is something very difficult to say. What I can say is that today, just yesterday to be precise, they confirmed the Sicad at 12. You can see that is true for the automotive industry. They consider this. They still consider valid contracts at 6.5 also. We do not consider them. We consider 20 as reasonable. And mix in the fact that we reduced down to 50% our production and sales, taking into account that we do not consider to import any product from abroad or no raw materials, we consider that the figures we give to the market are cautious. And we have also to consider a worsening compared to that scenario. That's why we consider another EUR30 million of effect on the EBIT terms.

That means that total activity in Venezuela could go down in our mind, average in the year, to 25%, which is not true for what has happened until now.

Martin Viecha - Redburn Partners - Analyst

And on the question on how much Venezuela and Argentina accounted for in profit terms in 2014?

Marco Tronchetti Provera - Pirelli & C SpA - Chairman, CEO

The average EBIT margin in Venezuela has been a bit higher than the average of the group, but just slightly. So it hasn't been the best country, I mean what was likely the profitability we had in NAFTA.

Martin Viecha - Redburn Partners - Analyst

And in Argentina?

Marco Tronchetti Provera - Pirelli & C SpA - Chairman, CEO

Argentina has been lower, has been in the low teens.

Martin Viecha - Redburn Partners - Analyst

Thank you.

Jose Asumendi - JPMorgan - Analyst

Thanks. Jose, JPMorgan. A few items, the first one on cost savings. Can you talk a bit more about that share of labor productivity and scale that's growing on a year-on-year basis? And maybe you can give us some examples of why that share is increasing.

The second point behind the input cost, another large hit 2015. Had you described the largest hit there? Third point please, on Russia, how many units did you produce in 2014, and how many did you export?

And then I've got two sort of a bit more strategic, one for Mr. Tronchetti, and one for Mr. Boiocchi. Mr. Tronchetti, so two to three years out, three years out really, I mean where do you want to take the company, cash, earnings-wise, what is your vision of the Company? And strategically, would you support import tariffs in Europe to avoid a large entry for Chinese players in the market?

And I take the third one for Mr. Boiocchi afterwards. Thank you.

Marco Tronchetti Provera - Pirelli & C SpA - Chairman, CEO

I'm sorry. I didn't understand the last part when you were talking about tariffs to Europe. I do not understand the question.

Jose Asumendi - JPMorgan - Analyst

Would you support additional restrictions or higher import tariffs for Chinese tire players in entering the European tire market?

Marco Tronchetti Provera - Pirelli & C SpA - Chairman, CEO

Starting from the last point, Europe has been at least a market that is more open. There has been in the past no restrictions like the one that they had in the United States. There is a reason why. So the United States is a huge market of standard products, much larger than let's say the one in Europe. And the driver in Europe of restriction is based on safety and quality. So the regulation is not based on duties to third parties. So we don't see restrictions coming to Europe in the next two years.

Talking about capacity in Russia, we had in 2014, around 7 million capacity, around 500,000 were the tires exported to Europe. In 2015 we will have around 8 million capacity. And we target between 2.5 million and 3 million export from Russia. The largest part will be exported to Europe.

And now I leave to answer the other question to Mr. Menassi about the efficiencies.

Giuliano Menassi - Pirelli & C SpA – Head of Manufacturing

Yes, hello. Regarding efficiency, our plan is based on three main pillars, as Maurizio Sala say before. The first one is de-complexity. Where we are talking about de-complexity, we are talking about reduction of product complexity at its component, the current bill, list of material items reduction. You're talking about allocation planning and product turnover, when you talk about technology cluster. The last one is process complexity. It means machine variability.

And further we have productivity improvements with our PMS, or Pirelli Manufacturing System. The last one is scrap reduction.

Marco Tronchetti Provera - Pirelli & C SpA - Chairman, CEO

So going to the cost inflation, the figures we see on page, slide number 23, so the cost inflation is EUR135 million. That is in line with the expected devaluation of the currencies. So the US dollar was 67%. US dollar-Argentina peso is 42%, [euro]-rubles 27%, euro-dollars 8% and plus. And US dollar compared to the Brazilian Real is 13%. So this is related just to the cost inflation related to currencies.

Jose Asumendi - JPMorgan - Analyst

Thanks. I have just one follow up for Mr. Boiocchi. I know it's late and I don't want to keep you talking for too long. But we don't have the chance to talk to you that often. If you compare the Chinese tire makers, this year they're gaining across some countries in Europe. And you look at the products. How many years do you think they are away in terms of R&D investments, in terms of product development, in terms of being competitive to the budget price?

I know for you it's not a threat. But how many years do you think they're away in terms of offering competitive products?

Maurizio Boiocchi - Pirelli & C SpA - General Manager, Technology

I believe it is not a question of money. But it is a question of people, ability and know-how. So we have, as you know, 7% focus of our turnover based on the premium. That is more or less 3% to 3.5% on the full. But we have a strong team of people with a very high level of know-how as well as a full network around the globe from university, suppliers, JDA, that means more or less doubling our strength in these aspects.

So more or less, it's very, very difficult to move on all in money.

Jose Asumendi - JPMorgan - Analyst

Understood. Thank you.

Operator

We have no further questions at this time. I'd now like to turn the conference back over to today's speakers for any additional or closing remarks.

Marco Tronchetti Provera - Pirelli & C SpA - Chairman, CEO

So thank you, ladies and gentlemen. Thank you for your attention, and I wish all of you a good evening.