# Pirelli & C. S.p.A. FY / 4Q 2018 results conference call transcript

*February 14, 2019*

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

Good evening Ladies and Gentlemen, thank you for joining our Conference Call today

We will first comment 2018 Full Year preliminary results, and give you the outlook for 2019.
We remind you that the final results will be published on February 26th.

In the first two years of our 2017-2020 Plan:
- we delivered our High Value Strategy, despite a tougher 2H 2018, where the Car industry faced several headwinds, especially in 4Q, with unpredicted demand shortfalls, and Car makers halting production plans
- we achieved lower volumes in the Standard business, with a significant reduction in 2018, bringing our Standard volumes below the IPO plan trajectory

The choice of speeding up our disengagement in the Standard business, along with the changes versus the external IPO assumptions require to work on a new Long-Term Plan that will be presented in 4Q 2019.

The new Plan will include:
- a broader Restructuring Plan in the Standard Business
- an Operating Business Model, with a higher level of integration, capturing the benefits resulting from our current digital transformation
- our solutions for the changing Car industry, as it moves towards electric and connected vehicles

Let's start from 2018 achievements.

Pirelli closed the year with a solid operating performance that confirms the soundness and resilience of our business model.

We strengthened our positioning in the High Value segment, now accounting for ~64% of total revenues and 83% of EBIT

The strong price mix improvement is confirmed to be Top in the Industry: +6.8% for the Full Year and +8.1% in the last quarter vs. +1.5% peers average in both FY and 4Q.

In 2018, we posted a sound profitability improvement in line with the target, with an EBIT Margin increase of 2 percentage points YoY, driven by our internal levers - namely price/mix, efficiency and cost-cutting program - that more than offset external headwinds and the strong decrease of Standard volume.

Finally, 2018 Net Financial Position includes €140 million consisting of advances on investments in China, in our new JV, and the slowdown/restructuring in Brazil to be recouped by 2020 when we will be able to start exploiting the cash impact of patent box benefits.

Consequently, the Net Financial Position / Adjusted EBITDA before start-up costs reached 2.49 times, 2.35 times the 2018 target. Later on, Mr. Sala will give you more colour on the cash flow dynamics.

Let’s focus on High Value.
Our market expectations proved to be right and Pirelli results are fully in line with our IPO trajectory.

More specifically, in 2018:
- Pirelli increased its ≥18” market share, with a peak in the Asia Pacific Region
- indeed, Pirelli volumes grew by 14%, of which 16% in Replacement

In the pinnacle Prestige segment, our Original Equipment market share is now well above 50%, with an impressive gain of more than 5 points over the last year.
Within Premium Car Makers, we are well established in the upper end of their offer, where we are clear leaders.

Our marked ≥18” products portfolio grew in 2018 by ~20%, reaching in Europe >950 products available, 2 times the average of our top 2 competitors.

Our pull-through effect – the capability to capture the natural replacement demand deriving from our homologation efforts - grew to 83%, 2 points more than 2017.

Most of our High Value volumes are highly technological Marked tyres a segment where competition will continue to be limited to very few Players.

All this factored in, Pirelli has achieved a distinctively competitive position both in the OE and in the Replacement that allow us value and pricing safeguard.

Instead, in the Standard business, market trends proved to be different than our IPO assumptions.

In particular in 2018, LatAm experienced a severe market contraction, particularly intense in the 2nd half (Replacement -13%, O.E. -5%) and even more in the last quarter (Replacement –15%, O.E. –10%).

Competition is increasing globally as well.

Therefore, Pirelli further accelerated its planned disengagement from the Standard, where we recorded volumes -14%, compared to a -12% target, with our Full Year volumes -20% in LatAm.

Our strategic choice was to privilege value:
- trimming less profitable lower rim sizes
- phasing out marginal local second brands, and
- increasing prices in Emerging markets to offset Forex volatility

In 2018, our global Standard capacity was cut by 4 million pieces, in line with the IPO, yet less than our Standard volume reduction which was particularly severe later in the year.
Comparing our Standard footprint with an optimal global allocation, we see today a surplus of 3 million pieces Standard capacity

To limit the negative impact on 2018 profitability from lower sales in Standard, we promptly deployed a crash cost-cutting program worth €50 million - of which €20 million in Brazil – in the second half of the year, working on marketing and advertising budgets, purchasing negotiation, plant overheads and labour cost.

To deal with the structural gap between Standard Capacity and Volumes, a global Restructuring Plan on Standard will be implemented within the next 18-24 months, preserving social balance and employment. I will comment about it in a couple of slides.

Let's now move to 2019 scenario.

Our current assumptions for 2019 are different from what we envisaged in the IPO Plan.

We see a global GDP growth at 2.9%, lower than the +3.2% of 2018, with a slowdown across regions, in a scenario dominated by trade and geopolitical issues.

Comparing to our IPO plan, in 2019 we assume:
- lower growth in Brazil (+1.8% vs. +3.7% at IPO)
- more contained development in Europe with a GDP growing +1.4% vs. +1.6% at IPO
- still positive outlook for the U.S. and China, +2.5% and +6.3% respectively, without fully factoring-in the looming uncertainties, already showing some early signs of slower consumption

In 2019, Forex is expected to have a marginal impact on our sales compared to the -6% of 2018. We are far away from the IPO scenario, where we assumed an almost flat forex impact.

Raw materials costs have increased less than predicted at IPO (+7.3% on average in 2017-2018 vs. +14.8% on average in IPO plan). Yet in 2019, we still expect an increase of ~6% mainly related to butadiene and oil prices, where high volatility is still lingering.

Despite the uncertain Macro-economic scenario, the High Value market is expected to continue its positive growth clearly outperforming Standard demand, with:
- the ≥18" market still solidly growing at +8%, while
- Standard market is expected to be flattish

The issues of the car market are going to spill into early 2019, resulting into a different pace of tire market growth among channels:
- in the Replacement, we expect the ≥18" to grow double digit, ~10%, with all the Regions performing well
- in the Original Equipment, the ≥18" market is expected to grow +5%
    - the 1H will still be weak, considering a flattish Europe
    - in 2H we expect a recovery, also supported by the weak comparison with the 2018 base

So, our strategic priority market will grow strongly and we are targeting, as we did in the last years, market share gains:
- in the O.E. business, we can count, on reinforced leadership in premium and Prestige, and new supply contracts in the Premium range of top Asian and U.S. car makers, coming to the delivery phase over the course of the year
- in the Replacement, capturing the growing pull-through demand sustained by homologations in the last few years

The Standard business we will continue streamlining our exposure, reducing volumes by almost 10%, mainly in LatAm, Europe and Middle East and Africa.
Our global Standard capacity will be reduced by 2.5 million pieces reaching 27.5 million pieces.
In 2019, we will have over 4 million pieces of Standard capacity in surplus, if compared with an optimal global allocation

In this scenario, a new cost-cutting program is underway, targeting ~€50 million savings working on Outsourcing rationalization, Commercial and G&A Costs, Travelling and other Expenses.

Concurrently, the above-mentioned Restructuring Plan will start being implemented.

The majority of economic efforts of this Restructuring Plan has already been taken into account in our 2018 results and 2019 guidance.

- in 2018, we have set apart provisions for the majority of restructuring costs
- in 2019, our Capex guidance already includes investments required for plant reconfiguration
- cash-out for restructuring are spread over the next few years
- P&L and cash impacts covered by Patent Box benefits

In 2019, we will benefit from the impact of our three key programs:

- first of all, as we offer increasing variety to our Prestige and Premium OE customers, we are containing the complexity costs by working on component commonality and product modularity, as well as plant debottlenecking to achieve flexibility
- our integrated business model is being transformed, with a more inter-functional / horizontal organization, made more efficient by digital applications. After having invested in enablers such as Digital Talent, Data infrastructure and Cloud Architecture, this year we will deploy a new Sales & Marketing Model in Europe, our key High Value Region, in parallel, we will release our new manufacturing Scheduling and Execution System
- our third program aims to work on long-term cost optimization. In 2019 we will capitalize our organization simplification, such as reducing the number of Regions from 6 to 5 by creating the new Macro area of EMEA and Aggregating Nordics with Russia. Mr. Casaluci will further explain the updated Regional organization later. Further benefits will be achieved from marketing and supplier base optimization

The impact of these 3 key Programs will contribute to 70 million in efficiencies, 1.3% on sales for 2019.

Our targets for 2019 are:

- a revenue growth between 4 and 6% sustained by the strengthening in High Value and price/mix improvement
- we aim to continue outperforming the market with a High Value volume growth of 11% reaching a 67% weight on total revenues and 85% of the EBIT
- we will continue to reduce our exposure to the Standard business with a volume reduction of 9% / 10%
- price/mix is expected to improve by 5% / 5.5%, driven by the shift to high-end products, the micro mix improvement within each single segment as well as price increase in emerging markets
- adjusted EBIT margin is expected to improve to ~19% through the soundness of our internal levers (volume, price/mix, efficiencies and cost cutting) that will more than offset the raw materials and forex headwinds as well as the higher inflation; in particular,

- we confirm the usual drop through of top line drivers and a positive gap between efficiencies and inflation
- raw mat headwind is expected to be ~-€100 million, 70% driven by forex volatility, please refer to slide 26 for our assumptions
- the above mentioned €50 million cost-cutting measures
- start-up costs equal to €40 million (€47.7 million in 2018) support the digital transformation of the Company, the on-going development of Cyber solutions and the kick-off of manufacturing operations of the new Joint Venture in China
- we expect to reduce our leverage reaching a ratio of Net Financial Position to Adjusted EBITDA before start-up costs, ~2.1 times with a cash flow generation before dividends and extraordinary operations of ~€400 million, mainly driven by the operating performance and the working capital optimization
- CapEx will amount ~€430 million mainly to sustain our High Value capacity increase and promote mix and quality improvement in our plants.

The different external scenario, the acceleration in Standard reduction requiring a global rationalization of our Standard capacity, and the strengthening of our transformation programs for a stronger High Value development need an update of our IPO plan.

In any case, we are confident that all our actions and rationalisation steps will keep us in line with the IPO deleverage target of a Net Debt over EBITDA ratio below 2 times by 2020.

We are working at a new long-term plan with a 2019-2022 time horizon which will be presented in the 4Q 2019. It will address the following issues:

- Standard reduction to sustainable level
- global capacity and footprint, taking also the Chinese JV fully into account
- review LatAm’s strategic role
- reap the full benefits on a transformed High Value Business Model

Now I leave the floor to Mr. Casaluci for the Regional review of 2018 results and 2019 strategy.

## Andrea Casaluci – General Manager Operations

Thank you, Mr. Tronchetti and good evening, Ladies and Gentlemen.
Let's go through the results by Regions and our strategy for 2019, starting from High Value Regions which contribute 80% to our Group Sales and 93% to High Value Revenues.

In Europe, in 2018 we kept on strengthening our positioning in the High Value segment.
In the Replacement channel, our better performance versus the market was driven by the pull-through effect, the growing demand for our Specialties and a more pervasive presence in the car dealer channel.
In the Original Equipment, we experienced changes in seasonality with sales concentrating earlier in the year and a 2H impacted by the new WLTP emissions test on $CO_2$, mitigated by our exposure to the Prestige and Premium Car makers.
The Standard trend was negative (organic sales -8.9%), with:

- an accelerated reduction of the less profitable products
- a reduction of second brands and lower rim sizes, in favour of wider rims

Profitability in the "High-Teens" range improving by more than 1 percentage point compared to 2017, backed by the mix improvement and efficiencies.

In NAFTA, we kept improving High Value Sales, in particular in the Replacement channel, with a market share improvement supported by the success of our Specialties ≥18" and our Regional All-Season products.
Profitability in the "Twenties" range, improving year over year over 1 percentage point, as a result of the mix improvement and the progressive strengthening of the U.S. Dollar.

APac is confirmed as our Region with the highest growth rate and profitability. The 21% organic growth in High Value Sales was the result of:

- a strong performance in the O.E. channel, with new homologations with European and local brands
- a better positioning in the Replacement channel, supported by a strong pull-through effect and a wider distribution network, with >4,500 points of sale, mainly concentrated in China

The Standard business experienced a -8% organic reduction, with lower sales of the products ≤17", in a general context of weaker market demand for the segment.
We recorded an EBIT margin in the "Twenties", recording a significant improvement against 2017.

Moving to 2019, to further accelerate execution, we reshaped our regional organization by:

- creating the new Macro area of EMEA, including Europe and Middle East and Africa. This will help us accelerating the execution of the high value business model also in markets like GCC, an area where High value demand is now very relevant
- and by aggregating Nordics with Russia, in order to optimize:
  - synergies in operation, given markets proximity and,
  - product development, since winter tyre demand is very similar

Now, our organization counts 5 regions, instead of 6.

In High Value Regions, we are progressing along the IPO strategic guidelines.

In EMEA, we will continue to leverage on the O.E. / pull-through virtuous cycle, further rationalising the Standard business and costs.

In North America, in the Replacement, our ambition is to increase our presence in Tier 1 distributors, and grow our share of wallet. We are strengthening our All-Season business leveraging our product portfolio.
Finally, we will differentiate the O.E. portfolio by expanding our collaboration with key partners in the High Value and with new Electric Vehicles players.

In Asia Pacific, the new JV in China will allow us to increase our High Value capacity to better seize market opportunities in China and in the other APac countries. In O.E. we will enter into the delivery phase in premium Asian car makers and in the replacement we will continue to leverage on the expansion of the retailers network and we plan new product launches.

Standard Regions account for 20% of our Sales and just 7% of our High Value revenues.

Our performance in Latin America is affected by the weakness of the market and our choice to protect our value:

- by reducing our exposure to the less profitable products and to lower rim sizes, and
- by increasing prices in Argentina and lately in Brazil in response to forex devaluation

These actions led to a strong price/mix improvement (+12% in 2018), especially in the 4Q(+24%).
Profitability trend discounts:

- the above-mentioned volume reduction
- the impact of the high inflation accounting in Argentina, from the 3Q
- the increasing cost of raw materials

These negative impacts were partially compensated for by the better price/mix and the cost-cutting actions (worth ~€20 million) to respond to the challenging external context.

In MEAI we reduced our Standard volumes in the less profitable segments, in a weak market context.
Profitability was impacted by exchange rates volatility, especially in Turkey.

Finally, in Russia & CIS, our focus on the most profitable segments and a strong market, allowed us to grow both sales and profitability, with an adjusted EBIT margin aligned to the Group's.

2019, we do not expect a significant market recovery in Latin America. Our priorities are to better manage our inventories, to cut cost and to optimize our production footprint, strengthening the position of industrial Hub to support the High Value growth in North America.

Finally, we will strengthen High Value in Russia and Nordics

- by seizing new opportunities with Premium OEMs in the region, and
- by widening our product portfolio for winter with the launch of the new Ice Zero 2, a studded product for extreme temperatures

We will continue to leverage on our Voronezh plant as a source of High Value export to Europe.

Now I leave the floor to Mr. Sala for a more detailed review of 2018 results.

<u>Maurizio Sala – Executive Vice President and Chief Planning & Control Officer</u>

Thank you, Mr. Casaluci and good evening, ladies and gentlemen.

2018 closed with €5.2 billion revenues, with an organic growth of almost 4%.
Volumes reflect a different trend between High Value and Standard.

High Value volumes recorded a strong growth, +11.0% across the 12 months, with market share improvements in all the main Regions.
During the 4Q, High Value volumes improved by +7.2%, supported by the very strong Replacement figures, partly dented by the reduction in the Original Equipment as already explained.

Opposite trend for the Standard business, where we reduced volumes by -14.0% throughout the year and by -22.6% just in the 4Q.
Price/mix grew by +6.8% in 2018, supported by

- the increasing weight of High Value
- the improving mix within High Value and Standard tyres, and
- the price increase in Emerging Markets to compensate for the volatility of exchange rates

Forex was negative by -5.9% in the Full Year and -3.4% in the 4Q, mainly due to the volatility of Emerging Markets currencies.

Finally, IFRS 15 negatively impacted Group Net Sales by -0.7%.

The quality of our top line drivers translated into a profitability improvement in 2018, with an acceleration of the trend in the 4Q. Adjusted EBIT reached €955 million over the full-year 2018, with a margin at 18.4% and a record high of 20.0% in the 4Q, 2.2 percentage points more than the 4Q 2017.

The profitability improvement in 2018 was driven by our internal levers, namely:

- price/mix (+€239 million), which more than compensated for raw materials (-€52 million) and forex headwind (-€43 million), and the drop of volumes (-€68 million)
- efficiencies (+€70 million) more than offsetting rising inflation costs (-€48 million)
- the cost-cutting actions (€50 million), taken in the second half of 2018, balanced the reduction of Standard volumes and increasing D&A and other costs related to the development of High Value.

All the elements and drivers determining the Net Income will be published with the final figures on February 26. Next we talk about the Net Financial Position.

We closed 2018 with a Net Debt of €3,180 million, that includes ~€140 million between advanced financial investments in the new JV in China (~€65 million) and the temporary negative effect from the slowdown / restructuring in Brazil. Said impacts will be recovered by 2020.

The ratio of Net Financial Position to Adjusted EBITDA before start-up costs was 2.49x (2.7x in 2017, 2.35x the 2018 target) reflecting the extraordinary build-up of inventories, mainly Standard products and the temporary revision of the payment terms from some dealers in Brazil (for which the company has already taken actions) besides the advanced financial investment in China already described.

In particular: the net cash flow generation was equal to:

- €858 million in the last quarter of the year, due to the usual seasonality of working capital, and including the JV financial investment in China
- almost €40 million for the full year.

The net cash flow from operations in 2018 was positive for €383 million.

CapEx was equal to €463 million and related to High Value and the constant improvement of the mix & quality in all factories.

The change in working capital and other items (-€388 million absorption in 2018) reflects:

- the realignment of factoring to historical levels compared to those of 2017 (the negative effect in 2018 compensating for the positive effect in 2017 reaching a stabilized level at the end of 2018)
- the increase of inventories (21.7% of sales at the end of 2018, mainly linked to Standard) following the great slowdown in sales in LatAm. The company has launched a plan to normalize this phenomenon and realign inventories during 2019 to a level below 20% of revenues
- the temporary revision of the payment terms for some dealers in Brazil, given the difficult macro-economic context, which will return to the norm over the course of 2019;
- the usual refinancing of Pension Funds deficit

Net cash flow was positive €38.4 million. It includes, among others, the interest and tax payments, cash-out for restructuring and for financial transactions.

Moving to 2019, actions to bring cash flow up to €400 million are based on

- Operating performance improvement
- A tight control of working capital that will benefit versus the strong absorption of 2018 from the normalizing factoring level, and the recovery actions on stock and payment terms mostly in Brazil that started already in the 1Q.
- Lower Investments (€430 million vs €463 million in 2018) benefitting from the advanced financial investment in China and the capacity available from the Standard Conversion, and
- including a lower positive financial effect vs previous year from financial transactions

Now I leave the floor back to Mr. Tronchetti.

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

Before the Q&A session, I would like to talk about our performance and achievements in Sustainability, consistently with the ongoing 2017-2020 Sustainability Plan.

In 2018, meaningful improvements were indeed achieved in terms of environmental, social and economic performance and we are well line to reach 2020 targets.

Worth mentioning for this year:
- the release of the implementation manual of our policy on sustainable natural rubber, which benefitted from a multi-stakeholder consultation
- the ISO 37001 certification of Pirelli Anti-corruption management system and the adoption of the Tax Control Framework and the admission to the Cooperative Compliance Regime

Last, we have been acknowledged World Leader in Sustainability in the Auto Components sector of the Dow Jones Sustainability Index (with a score of 81, versus a Sector median of 32) in addition to other rating indexes listed hereafter.

We may now open the Q&A Session.

## Questions & Answers

### Martino De Ambroggi – Equita Sim Analyst

Thank you, good evening, everybody. The first question is on the pricing environment, because some of your competitors mentioned to perceive pressuring Europe in the High Value segment. Someone else denied it. So what do you perceive about the pricing pressure in Europe and also in other regions?

### Andrea Casaluci – General Manager Operations

Yes, good evening. I would like to start from North America where the demand is performing quite good and all the Tier 1 players announced the price increase in 4Q 2018 and we are now in the phase of the capitalization of the price improvement. So, the all-in-all scenario is slightly positive, while China and Europe where the demand is less brilliant all-in-all we do see a price environment, which is flat. But in the High Value segment, let's consider that we are more protected because the majority of our sales are focused on the high-end mix, where there are fewer competitors and we are supported by our OE, Original Equipment presence, where on average we have two or three players maximum. So, in our in our market, there is high protection also in Europe and in China.

### Martino De Ambroggi – Equita Sim Analyst

Okay. So, not worried about it. Okay. The second question is on the price mix because in 2018 the drop-through was 69% and can we take it as a similar assumption for the current year?

### Andrea Casaluci – General Manager Operations

Yes. We can have the same trend. As you know, we are protected by the growth of our marked tyres market. So, every year, the new homologations we are getting in marked tyres providing us a strong support in the growth of our mix.

### Martino De Ambroggi – Equita Sim Analyst

Okay. And the last question on the net debt guidance. If I look at what you have for this year and next year, okay, we don't know exactly what would be the dividend policy going forward, but the debt will remain in the €2.9 billion, €3 billion range. What is really changing in 2019, we understood the temporary effect in LatAm, the change in payment terms that will return to our normal situation in 2019. But could you elaborate a bit more on what is really temporary and what will continue to affect the performance?

### Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

Yes. First of all, the dividend policy is already stated is 40% of the net result. So the target and the cash flow and target – financial targets they includes – that include dividends in 2019 paid on balance sheet 2018. The improvement in our cash flow and the extraordinary effect of 2018 will be partially offset already in the first quarter and that that is related to the stock in Brazil and to delayed payments. And this – I think in the first quarter we will see the result of in our improvement in cash flow. For the financial investment in the JV worth €65 million, we made in advance this investment in China that would be offset in 2020 by the cash impact of the Patent Box. So we see 2019 back to normal, we will have lower investments in both 2019 and 2020 and so we will deliver the cash flow in line with the IPO plan.

## Martino De Ambroggi – Equita Sim Analyst

Okay. Very last on the start-up costs; if I remember correctly at the IPO, they were quantified in €90 million or €100 million to be finalized in a couple of years' time. It seems to be a longer life for the start-up costs?

## Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

On start-up costs, we have digital where we are investing in line with what was planned. The difference you see is in 2019, 2020 will be zero. In 2018 start-up costs were €48 million, €40 million instead of €20 million in 2019. This is mainly due to digital, with our programs delivering some results in terms of efficiencies already in 2019.

## Martino De Ambroggi – Equita Sim Analyst

And for Cyber that would be the first sales this year in Original Equipment?

## Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

Cyber is improving technologically quite fast, but we are already in platform for 2021. As you know the process of homologation and the introduction of new technologies requiring between three to four years, we are well in advance of our plan for the evolution technologically of the Cyber Tyre and with three carmakers, we are in project – the first will be delivered in 2021.

## Monica Bosio – Banca IMI Intesa Sanpaolo Analyst

Good evening and thanks for taking my questions. The first one is on the guidance for the High Value over the full year. You are still expecting a double-digit growth, but I can imagine that first part of the year would be weaker than the second part. The last quarter ended with a growth in High Value in the region of 7.6%. Can we project a similar growth also for the first part of 2019 or it could be even lower? And is there any country where the growth of the High Value would be a little bit at risk? And secondly over the first part of the year, can you give us an indication of the balance between Original Equipment and the aftermarket? That's for the first question. The second question is about the delta between the adjusted EBIT and the reported EBIT. There is a significant delta between the two items. And I think that it is due to the restructuring actions that you have put in place and that we'll have an effect on that 2019. But I can imagine that also in 2019, there will be some restructuring costs. Can you give us an indication about this and the very last is maybe too early to ask but basically the company has accelerated a lot in the reduction of the Standard to High and these as an impact, a positive impact on the price/mix merely mix. Going forward, my feeling is that a comparison base will be tougher in terms of improvement and mix. Can you confirm this and can you share with us some idea of the sustainable price mix for the company on the longer-term. Thank you very much.

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

I start from the last question and I hope to remind the first questions, many interesting questions. First of all; price/mix, the more – the Standard we go out, the more there will be growth in the top line. I mean a decrease in the top line is related to the Standard reduction. Top line increase will be supported by the high value products, products having EBIT margin close to 25% will provide these double digit growth and for us it's important to have these growth of profitability coming continuously.
So that is not a question of reducing the mix, is a question to continue to increase the profitability in real terms. So I don't see any problem if you'll have a lower mix in the future. But if we grow to double digit on the high value and the growth of the EBIT in real terms. The figure to be always kept under control is the growth of the high value.
On High Value we expect a double digit growth in the Replacement channel. In the Original Equipment will have a slowdown in the first part of the year and in the second part of the year we see the recovery but the recovery that is not related only to the market which should rebound but is related to contracts that we already have in hands that are starting with new moulders that would be supplied start in the second half both in Asia and in the United States. So it is consistent with these expectations.
And other questions I forgot?

Monica Bosio – Banca IMI Intesa Sanpaolo Analyst

Maybe that the growth of the High Value overall in the 1Q and 2Q if you can give us an indication and the restructuring charges for 2019.

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

EBIT margin take into account all the other costs with a start-up will be in the range of 19%. This is the number. So including obviously the start-up costs.

Monica Bosio – Banca IMI Intesa Sanpaolo Analyst

Yes and what about the reported EBIT?

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

The one that includes PPA, purchasing price allocation, which is not cash.

Monica Bosio – Banca IMI Intesa Sanpaolo Analyst

Ok. And just the very last. What is the growth for High Value in 1Q and 2Q, just a rough indication?

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer
I have mentioned before, we expect a growth double digit in the Replacement market.

Monica Bosio – Banca IMI Intesa Sanpaolo Analyst

Ok, thank you.

## Renato Gargiulo – Fidentiis Analyst

Good evening. Well, some of my questions have been already answered. I have one question left... still on pricing: some of your competitors have been talking about a slowdown for Winter tyres in the last part of the fourth quarter, I'm wondering what have you seen, what have you experienced in terms of pricing for the European market?
And, more in general question, on the U.S., almost all of your competitors have announced price increases, can you give us some indications about the price increase? You have been talking about up to 6%. Do you see also, going forward, some more room to increase prices and to reduce the gap versus other competitors?
Then, if I may ask, in 4Q, on the non-recurring items, you reported between adjusted EBIT and EBIT a quite significant increase of more than €110 million, can you give us some more details about the items making this number?
And then my final question on free cash flow, so if I well understood you are saying that all the factors impacting on the cash flow, this year, 2018, should be a reversal in 2019. How confident you are about going back to more normal levels of inventories and payment terms in Brazil given that you are not expecting the market to recover significantly this year? Thank you.

## Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

I'll start with the last question and then I leave to Mr. Casaluci and Mr. Sala for the other questions. So, for Brazil, we had a delay in payments, that are already being recuperated. They are under control and we don't see any issue. We are already cashing in now, so the recovery is coming, and the stock reduction is ongoing. So, during the first quarter you will see some adjustment that will be in favour of a better cash flow.
Talking about the American market, taking into account the price increase, well related to a different situation on raw materials, so the important thing is that profitability remains at the level that we expect. Now I leave the floor to Mr. Sala, who will explain you the EBIT adjusted, the €110 million you mentioned. Please Mr. Sala.

## Maurizio Sala – Executive Vice President and Chief Planning & Control Officer

Thank you. As you may remember, when we announced the obtainment of the patent box equal to €54 million, we announced immediately that we wanted to use this future cash inflow to sustain the activity to accelerate the growth in High Value reducing the presence in the Standard. So, practically, this was the main item that we charged in the last part of the year, because out of the €110 million, the restructuring charge for the full year were €67 million, out of which the most important part was charged in the last quarter for actions that we already took at the end of 2018 and we will continue to take in 2019 and 2020. €80 million were related to one-off, for a value of €15 million linked to the increase of pension liability following U.K. core sentences, and following this sentence in U.K. all pension fund minimum level were revised upward, but taking the cash that we are putting in our pension fund, you will see in the release of the final balance sheet, that the deficit of our pension fund was dramatically reduced vs. the previous year. Then the remaining part was related mostly to the revision of certain commercial agreements and royalties, out of which €9 million related to the revision of royalties with Aeolus in which we revised the contract but with a reduced cost for the future.

## Andrea Casaluci – General Manager Operations

As far as Winter price environment, we have to say that the sell-in season in Winter in Europe is basically finished, now we focus only on the sell-out. January was a good month in terms of sell-out because of the weather conditions and this facilitated the destocking phase of dealers and reduced the pressure on the price environment. While if you move to summer products, as I said before, in Europe we see a stable price environment. So, in High Value considering our segment there is no strong pressure, but rather windows to increase prices in this moment in Europe, so it's a stable price environment.

## Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

On the sustainability of the free cash flow in 2019, considering the €400 million we mentioned versus 2018, let's consider by what is sustained? By the EBITDA which is €100 million, considering the consensus, an increase of €100 million. The normalisation of working capital in the range of €270 million. Inventories going down below 20% on sales, at the end of 2018 they were 21.7%. Factoring that will stabilize back to the normal level of 2018. The recovery of payment terms in Brazil, as I mentioned before. That's why the 200 million difference between 2017 and 2018 and the recovery of payment terms in Brazil. So this is the reason why we consider the free cash in our plan as solid and consistent.

## Renato Gargiulo – Fidentiis Analyst

Ok, perfect, thank you very much.

## Jose Asumendi – J.P. Morgan Analyst

Thank you, José, J.P. Morgan. A couple of quick items, please. Can you talk a little bit about your current CapEx for 2019 and 2018? Second, can you talk about the operations in China, the JV ones and the non-JV? Can you talk a bit more about where you stand, the products you're bringing out, and the profitability, where you see these operations maybe into 2019? And the third element is: can you just give some comments on the replacement tyre market non-Standard? Are you seeing any weakness at the moment in Europe, specifically? Or you continue to see a strength going on, and also can you put that into contrast with the high-value segment? Thank you.

## Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

Starting from the last question in segment High Value we see a strong replacement market, as I was mentioning before, that continues, double digit. We see a weaker Original Equipment, but in our plan we put a 5% growth which will be stronger in the second half, and weaker in the first half. On CAPEX we have this year 430 million versus 460 million in 2018, and the joint venture which we will not consolidate in 2019. We expect a production of 1 million pieces High Value, we consider the consolidation to happen after 2021.

## Jose Asumendi – J.P. Morgan Analyst

And any comments on Standard Replacement, are you seeing any signs of weakness there?

## Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

Standard business is weak as we mentioned before, but Mister Casaluci, you can elaborate on this? At a global level.

## Andrea Casaluci – General Manager Operations

Yes, we still have opportunities to reduce the Standard business in Europe, accounting for ~30% of our sales. What we are doing is to continue the approach we had in the last two years, so we continue the reduction of the second brands and low rim size, where the competition is more and more related to tier 2 and 3 player, and the profitability is lower and lower. So we stay out from this arena, and we have opportunities to reduce Standard in Europe, as well as, of course, in South America.

## Henning Cosman – HSBC analyst

Yes, thank you. If you don't mind, please, could we go once more and slowly, if we can, over the reconciliation of the €400 million in free cash flow. I understood you are suggesting ~€100 million from higher EBIT, €270 from net working capital. I think that some amount related to recovery of payment terms, €33 million from different CapEx, I think you also mentioned lower net financial result, just so we can sort of tick this off, if you would just go over it one more time.

## Maurizio Sala – Executive Vice President and Chief Planning & Control Officer

Okay. I will recap what was already explained by Mr Tronchetti saying that if you take the 2018 cash-flow, that was "poor", considering not ordinary effects we had in this number, that was equal to €40 million, we have to add what is the current consensus of the adjusted EBITDA that is +€100 million, then in term of working capital, as in 2017 we had a positive effect coming from the higher factoring, in 2018 we re-put the factory in the normal condition, so practically we had a negative effect in the working capital by €200 million. And, for what concern the impact of the stocks and receivables in Brazil, we had a negative effect of €80 million. So, if you sum €40 million, €100 million and €280 million of working capital, you are arriving already to a value that is €420 million of cash flow.
Then you have to add also the difference of investments; in 2018 we invested €463 million, our target for 2019 is €430 million, so we have also lower investments, because we begin to use the financial investment that we did in China. For instance, €65 million, that impacted negatively in the cash flow of 2018, we'll begin to benefit of it because we will reduce the investment in China vs. the IPO plan in 2019, and with this you arrive to €450-€460 million having also space for lower positive cash flow coming from financial activities, because we will not have any more the inflow of Mediobanca stake sale. At the same time we will not have any more the cash-flow impact for the financial JV in China. So, €400 million, doing the final recap: €40 million 2018 not ordinary effects, +€100 million EBITDA, +€280 million of working capital, +€30 million of investment, -€50 million of financial activity you arrive to the €400 million!
And it is important to consider that the 40 million of 2018 were impacted by €280 million of working capital, not ordinary, that we are going to recover in 2019.

## Henning Cosman – HSBC analyst

Very helpful. Thank you. And then can I ask about the sustainability of the savings and the net efficiencies in the EBIT bridge? Can you confirm that we will see another €50 million of savings and another €20 million of net deficiencies in 2019. Is that correct understanding?

## Maurizio Sala – Executive Vice President and Chief Planning & Control Officer

As you mentioned, for 2018 we had €70 million of efficiencies vs. €48 million of inflation. In 2019 we are targeting further €70 million of efficiencies vs. €60 million of inflation, because we are experiencing an increase of operating costs, in particular for what concerns inflated energy and logistic costs. For what concerns reduction of cost, after the €50 million of costs we have already reduced in 2018, I can confirm that we are operating for further €50 million reduction that we will add to the initial €50 million.

## Henning Cosman – HSBC analyst

That's very clear, thank you and final question from me. As far as the non-recurring result goes, PPA and restructuring, can you give us an indication for this line item in combination with the whole bucket of 2019?So really, what I'm asking is the reconciliation between adjusted EBIT and reported EBIT?

## Maurizio Sala – Executive Vice President and Chief Planning & Control Officer

For what concern 2019, PPA will continue with the same number of 2018. So, €114.6 million, exactly the same, because is a depreciation of the purchase price allocation coming from the PPA activity from the OPA. For what concerns non-recurrent, restructuring costs, we are targeting ~€50 million in 2019.

## Henning Cosman – HSBC analyst

For the entire bucket of non-recurrent PPA and restructuring only ~€170 million or so, yes?

## Maurizio Sala – Executive Vice President and Chief Planning & Control Officer

Yes, ~€165 million.

## Henning Cosman – HSBC analyst

Thank you so much.

## Andrea Balloni – Mediobanca Analyst

Hi, good afternoon, thanks for taking my question. Actually you have answered most of my question. Just to recap about the net working capital trend in 2018, just to be clear, you have stated that the lower level of factoring had an impact of €200 million, is this correct?

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

Yes.

Andrea Balloni – Mediobanca Analyst

While inventory and delayed payment in Brazil were ~€80 million negative impact correct?

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

Right.

Andrea Balloni – Mediobanca Analyst

Okay. And just to be clear, I would expect in 2019 a reversal trend only in the case of inventory and delayed payment in Brazil, so of net positive impact to be expected in 2019 should be only €80 million, isn't it?

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

Correct.

Andrea Balloni – Mediobanca Analyst

Ok, thank you.

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

Thank you ladies and gentlemen for your attention. Have a good evening.
Ladies and Gentlemen, this will conclude today's call. Thank you for your attendance.