Pirelli & C. S.p.A. 1Q 2019 results conference call transcript

May 14, 2019

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

Good evening Ladies and Gentlemen, Thank you for joining us today.

Let me start with a few comments on our Industry.

Whereas Premium Car manufacturers face a difficult 2019, grappling with:
- shift towards electric
- tariff uncertainties, and
- Brexit-induced volatility

our High Value Business Model confirms its resilience in a market environment where we assume a more cautious view for 2019 compared to the beginning of this year.

As to the ≥18”:
- our view on the O.E. trend is almost halved (+2% ÷ +3%) compared to our previous expectations (~+5%), and also taking into due consideration the April dynamics. During the second half, Europe is supposed to be recovering due to launches of new car models and the growth in China should also be revamped by new Governments’ incentives.
- in the Replacement business, we confirm a double digit growth, with almost homogeneous rates in the High Value regions.
- we should over-perform in this segment due to both the new OEMs contracts to be enforced during the coming Summer as well as the gradual improvement of our pull-through impact on Replacement.

The Standard segment will show a negative trend.
We estimate a full year at a -1%, also due to a rather weak trend in O.E. which confirms our decision to accelerate the exit from this segment and trigger productive rationalisation projects to maximise efficiency and competitiveness.
In this challenging environment, by moving cautiously:
- we are protecting prices and continuously improve mix, reaching in 1Q a +7.7% price/mix, more than three times higher than our Peers;
- we anticipated cost-cutting measures and worked hard on efficiencies to fully offset the raw materials headwind and inflation on input costs.

We were the only Tier 1 player to keep profitability stable year over year as well as improving our Net Operating Cash Flow which is the actual outcome of our business model.
We are already working on the next 3 year plan, to be presented next November, which is addressing:
- our right-sizing in the Standard market, that will make us smaller, yet more structurally sustainable;
- a major operational improvement thanks to a leaner, digitally enabled, integrated operating model, more capable of reaping the major benefits of variety, without the complexity costs;
- continuous innovation in product and services offering, capable of capturing future shifts in mobility consumption.

Let us now make a short comment on Pirelli’s key performance in 1Q 2019.

We strengthened our positioning in the High Value segment, now accounting for ~68% of total revenues, with a market share increase across regions.

We recorded, once again, an outstanding price/mix improvement: +7.7%, and driven by the solid performance in the Replacement channel – due to the pull-through effect – and by the on-going product mix improvement.

We were able to protect our profitability using our internal levers - namely price/mix, efficiency and our cost-cutting program - to offset external headwinds and the Standard volume decrease.

A better financial management drove to a Net Income increase of 10%.

Finally, we closed the 1st quarter, with a Net Financial Position of €3.9 billion, or €4.4 billion including the IFRS 16 impact.

In a couple of slides, Mr. Sala will show you how the net cash flow before extraordinary operations improved YoY, with a lower cash absorption than in 1Q 2018. This is also resulting from a better working capital management.

The more prolonged weakness in Original Equipment demand, as well as in the Standard business, led us to trim our guidance on the top line, now expected to grow between 3% and 4%.

We confirm the soundness of our business model, where the exposure to High Value is expected to reach 67% of our Revenues and 85% of our profitability for the Full Year 2019.
This will result into an Adjusted EBIT margin ≥19%, improving year over year.

We confirm our target leverage of 2.1x times Net Debt over Adjusted EBITDA without start-up costs, implying a net cash flow generation before extraordinary operations and dividends of ~€400 million.

As a consequence of the new market scenario, we revised our CapEx estimates to €400 million or 7.5% of revenues.

I now hand over to Mr. Casaluci, our General Manager Operations, who will review our first quarter results and expand on our full year market expectations and the operational drivers underpinning our guidance.

Andrea Casaluci – General Manager Operations

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

The 1st quarter 2019 closed with €1.3 billion revenues, recording an organic growth of 1.2%.

Our performance was driven by the increased exposure to High Value and the on-going price/mix improvement, which together offset the Standard volume decline and the forex impact.

High Value volumes recorded a +4.5% growth, discounting a weak Car O.E. demand and the slowdown in the Premium Moto business:
- we consolidated our leadership in the Car ≥18", by increasing our market share across regions: we grew globally by 6.7% versus a market at +5.2%;
- the performance was more pronounced in the Replacement Channel, where we keep on growing at a double digit rate: +12%, 2 percentage points more than the market;
- in the O.E. business, we mitigated the market weakness by leveraging on a rich and well diversified homologation portfolio, and we posted a +0.4% growth in the ≥18" versus a market declining by 1%, mainly in EMEA and in Asia Pacific.

In the Standard business, we reduced volumes by 16.6%. This trend was impacted by:
- the decrease in demand for Standard products in all markets, and
- by Pirelli's continued reduction of the exposure to less profitable products.

The strong price/mix improvement (more than 3 times the Tier 1 peers average) was the result of the implementation of Pirelli's value strategy, supported by:
- higher Replacement sales, pushing the channel mix;
- migration from Standard to High Value, as well as the mix improvement within each single segment, and
- price increases in emerging countries and North America, to offset the exchange rates volatility and raw materials costs.

Forex was negative by -0.9%, mainly due to the volatility of Emerging Markets currencies, partially mitigated by the revaluation of the U.S. Dollar.

Moving to profitability, we recorded a 16.7% Adjusted EBIT margin, stable year over year.

I wish to point out that the first quarter discounts:
- the highest raw material impact of the year (one third of the Full Year headwind), and
- the strongest volume drop, while in the next quarters, we should experience a progressive recovery of the Original Equipment market and a lower reduction in the Standard business.

As already mentioned, in this quarter, internal levers countered the decline in Standard volumes and a negative external scenario.

In more detail:
- the improvement in the price/mix covered the raw mat and forex headwind, and the drop of volumes;
- our key efficiency programs are generating savings of 1.2% of sales, countering rising inflation costs;
- cost-cutting actions, mainly in South America, are compensating for the increasing D&A and other costs.

As already announced in February, Pirelli has adopted a new organizational structure, with 5 regions instead of 6, with the aim of accelerating the implementation of the business model. Two new macro regions were regrouped:

- EMEA - Europe, Middle East and Africa – including the Gulf countries that are markets with an increasing exposure to High Value;
- Russia and Nordics, grouping markets that are very similar, with the objective of creating production and commercial synergies, particularly for Winter products.

Let's start from EMEA. The region closed the first quarter with an organic change in revenues of -1.6%, impacted by the fall in car production and the slowdown of the Motorcycle market. In this context, we consolidated our market share in Car ≥18", both

- in the Original Equipment, through our diversified homologations portfolio, and
- in the Replacement channel, thanks to the pull-through effect.

In the Standard segment, reduction of exposure to the less profitable products continued.
Profitability ranged in the mid-teens, slightly lower than in the first quarter of 2018, due to the impact of the previously mentioned slowdown in the Original Equipment channel.

In North America, we kept improving High Value Sales, in particular in the Replacement channel, where we recorded a market share improvement supported by the success of our Specialties ≥18", and our regional All-Season products.
Profitability was in the "Twenties" range, improving year on year by over 2 percentage points, as a result of the mix improvement, efficiencies actions on costs and the progressive strengthening of the U.S. Dollar.

Asia Pacific still shows the highest adjusted EBIT margin among our regions. The 6% organic growth in High Value Sales was mainly due to the Replacement channel, supported by the pull-through effect and an ever wider distribution network with over 4,500 points of sale.
Organic sales of Standard tyres are down 1.5%, with a fall in sales of ≤17" rim diameters in a weak market environment for this segment.

On Russia and Nordics recorded an organic growth of +5%, supported by:

- a strategic focus on the most profitable segments, with High Value organic growth of +37% vs. Standard organic reduction of -5%, and
- an O.E. market recovery.

Profitability significantly improved: a double-digit EBIT margin adjusted in 1Q 2019, compared to mid-single-digit level for the same period of 2018.

Our South American performance is affected by the weakness of the market (Car tyre market -7% in the quarter) and our choice to protect value. On price/mix we saw a marked improvement (+20% vs. 1Q 2018), backed by:

- price increases implemented in Brazil and in Argentina as of the fourth quarter;
- a continuing focus on mix, with the progressive reduction in sales of less profitable Standard segment products.

Profitability (high single-digit) slightly improved in the first quarter 2019, due to continued efforts on costs efficiencies and mix improvement.
Organic sales of Standard tyres are down 1.0%, with a fall in sales of ≤17“ diameters in a weak market environment for this segment.

In February 2019, we announced a mid-term Global Restructuring Plan to reduce the structural gap between Standard Capacity and Production.
We are starting to implement this plan in Brazil, reducing our Standard capacity by 3 million tyres in both the car and moto segments by 2021 and streamlining our production footprint from 3 to 2 plants.
On Moto, this will gradually be achieved through the transfer of our High Value production from Gravatai to Campinas plant, while the standard moto capacity will be shut down.
This will allow us to:

- better exploit the more resilient High Value market which shows a stronger growth rate than the Standard, while
- serve closer our Premium OEMs and exploit logistics efficiencies.

At the same time, our plant in Campinas, will gradually cut its Car Standard Capacity, partially reconverted into Car High Value, increasing plant saturation.

As a result, our Brazilian production footprint will be optimized, with a stronger focus on High Value and a specific mission for the 2 plants:

- Campinas, producing Car and Moto, serving South America, while
- Feira de Santana, 100% Car, supplying both the domestic and North American markets.

We maintain our commitment to the Country confirming the expected €120 million investments in 2019-2021:

- the 2019 part of these investments is already included in our targets;
- the remaining part related to 2020 -2021 will be included in the new Plan.

Regarding the impact of this rationalization, we would like to underline that:

- Pirelli has the willingness of finding an agreement with the Unions and will take all possible actions to mitigate the social impact at the Gravataí plant, which today employs ~900 people;
- the cost of the restructuring operation is already accounted in 2018 and 2019 and covered by Patent box benefits;
- the efficiencies stemming from the restructuring operation will start in 2022; our global restructuring plan will be illustrated with the new Business Plan in November this year.

Let’s now move to the market outlook for 2019.

Based on recent trends, we are keeping a more prudent stance in Original Equipment.
For the Car ≥18”, we now project a growth between +2% and +3% from the +5% estimated initially.
The milder outlook reflects a lower demand in Europe and APac for the full year, while a positive outlook is confirmed for the North American market.

We expect that the recent weakness of the market in Europe and in APac will continue in the second quarter.
For the second half of the year, trends should improve but at a lower rate than our initial expectations:
- Europe should regain momentum supported by new models coming into market;
- China could benefit from government stimulus - currently under discussion.

Overall, second half of the year will have an easier comparison with last year figures
In Replacement, we confirm the soundness of the Demand driven by Car Parc moving towards higher rims. Replacement is expected to grow double digit, ~10% within all High Value Regions – accounting for 95% of ≥18" Global Demand.

Having discussed the market scenario, let's now talk about what we expect for Pirelli.

For the High Value, we foresee a growth of over 9% in volumes, outperforming the market in both channels:
- in the O.E., we will leverage our homologations and new supply contracts in North America and Asia Pacific becoming effective in the second half of the year;
- in Replacement we will benefit from the pull-through effect.

For the Standard, in a weaker market context, we are further reducing our exposure to the less profitable products, bringing our Full Year volumes down by 11%.

All in all, total volumes are expected to decrease by ~1% versus our prior guidance of flat / +1%.
We confirm a price/mix improvement ranging from 5% to 5.5%, still driven by the migration to High-Value, the micro mix improvement within each single segment as well as price increases, mostly in emerging markets.
Forex expectations remain unchanged.

We forecast an adjusted EBIT margin ≥19%, supported by the effectiveness of our internal levers which will contrast the external headwinds. In particular:
- we confirm the usual drop through of top line drivers, volume at ~40%, price/mix at ~65%, Forex at ~15%;
- Efficiencies are expected to exceed inflation by €10 million;
- the implementation of the cost-cutting measures will allow us to save €50 million in 2019.

The impact of lower volume sales will be mitigated by a more contained raw material headwind, now expected to be ~-€85 million, 76% of which relates to forex. As shown in slide 21, the major driver of our revision has been Butadiene.

I now leave the floor to Mr. Sala.

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

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

We closed the first quarter with a Net income of €101 million, or 7.7% of sales.

The year over year improvement was driven by a positive contribution from financial income and charges, mainly driven by lower hedging costs and FX losses versus 1Q 2018 while cost of debt is substantially flat year over year, already discounting in 1Q 2018 the net impact of one-off transactions like the repricing of the main bank loan worth €3 billion and the exercise of the make-whole option to early redeem our bond originally due in 2019.

It is worth to underline that the financial income and expenses in 1Q of 2019 include the impact of the introduction of the IFRS 16 accounting principle on leases, which determined an increase of financial charges by €7 million.

On Net Income, let me remind you, the positive one-off effect related to the Brazilian fiscal credits which will be accounted in the second quarter of the year for an amount of ~€107 million, broken down as:
- positive impact on the reported Operating Result (EBIT) of ~€80 million;
- positive impact on Financial Income of ~€82 million;
- negative fiscal impact of ~-€55 million.

We ended the first quarter with a Net Debt of €3.9 billion, excluding the impact of the IFRS 16.

As usual, the Net Cash Flow trend of the period is affected by the business seasonality, also in conjunction with the Summer sell-in season, whose receivables are collected in the second quarter.

This year, the net cash flow before extraordinary operations and equity transactions amounted to -€700 million, €162 million less than last year. This improvement is attributable to:
- the operating Cash Flow, with €124 million less in terms of cash absorption, and
- the remaining €38 million linked to lower financial expenses, non-recurring and restructuring charges, and forex impact.

Focusing on working capital dynamics, we benefitted:
- from the continuing improvement of payment conditions with suppliers, and
- the start of recovery actions on receivables and inventories.

More specifically:
- on trade receivables, we are realigning the payment terms with the main dealers in Brazil, which had temporarily been extended to the end of 2018, due to difficult market conditions;
- on inventories, we reduced stock on volumes by 2%:
    - with an 11% decline in Standard products, in line with the recovery plan announced earlier on this year;
    - with a 5% increase on High Value products to guarantee a better service level to final customer.

The stock mix improvement and Forex impact brought about a slight increase of the value of the stocks.

For the FY 2019, we confirm our commitment to generate a net cash flow before extraordinary operations and dividends of €400 million. This result will be achieved through:

- the operating performance improvement;
- a tight control of the working capital, normalized and no longer subject to swings as previously; over the year, we are taking actions on stock to reduce the incidence on sales of ~20%, based on the new revenues guidance, vs. almost 22% in 2018;
- lower Investments (€400 million vs. €430 million, previously indicated, and €463 million in 2018).

According to the usual seasonality of the business, the higher cash flow generation will be recorded in the last quarter of the year.

Pirelli's Gross Debt amounted to €5.6 billion at the end of March 2019, with an average life of 2.8 years, as more than 60% of it is now due beyond 2022. These figures include IFRS 16 impact.

During 1Q 2019, Pirelli took advantage of the better conditions granted by the bank market versus the bond market and refinanced part of 2020 bank debt through a new loan for an amount of €600 million, thus contributing to extend the maturity profile without impairing the overall cost of debt.

In addition to that, we wish to highlight the option of extending our main committed bank lines, worth ~€3 billion, for up to 2 years. These lines, as showed in the slide 16, are expiring in 2020 and 2022. They can be extended, at our sole discretion, and at current economic terms, until 2022 and 2024 respectively.

The cost of debt on an annual basis (last twelve months) stands at 3.06%, from the nominal 2.95% of December 2018, 3.37% excluding the accounting effect of re-pricing, whose impact of ~€30 million is being amortized during the life of the facilities.

Now I leave the floor back to Mr. Tronchetti.

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

This ends our presentation.

We may open the Q&A session.

Questions & Answers

Thomas Besson – Kepler Cheuvreux Analyst

Thank you very much. I have two quick questions. Firstly, can you give us a breakdown of what you call High Value between the new premium and what's not the New Premium, because basically the High Value of volume growth decelerated to 4.5%, but we see clearly that the new Premium remain steady dynamic. Can you help us understanding all that shapes in terms of proportion within High Value please, of what we can model for the future?

Andrea Casaluci – General Manager Operations

Yes, so in the High Value segment we have basically two categories of products, the ≥18” Car products, which is what is called usually the Super Premium, and out of these there are only ≥18” products, including special technologies like the Run-Flat tyres, the Seal-Inside tyres, so extended mobility solutions, and the Moto tyres, basically linked to the Radial technology.
So, we have, for the time being, two different behaviours: the ≥18” segment is growing at a fast speed, we mentioned a market at +5.2% in the first quarter while Pirelli performance was +6.7%, while the ≥18” product that are part of the High Value, so for example, as I mentioned before, extend the mobility solution, 17” or 16” are growing at lower speed. Because there is a switch from the 16” and 17” up to the 18”. So we have two different speed and behaviour. In the first quarter 2018, particularly the Moto business was performing, in terms of market, below the expectations, mainly in North America and in Asia Pacific.

Thomas Besson – Kepler Cheuvreux Analyst

Sorry, I was not clear. My question was: what is the breakdown between Super Premium or new Premium and the rest, please, within High Value, in terms of percentage of revenues.

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

We are now splitting for you the numbers, one second. Go ahead with questions, and so we'll give you later.

Thomas Besson – Kepler Cheuvreux Analyst

My second question is about CapEx. I am projecting protecting €430 million CapEx, and you are talking of ~€400 million. Can you explain what has changed please?

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

In our plan we had an increase in volume that partially is covered by more efficiency we are making in our plants, partially is also due to the lower demand we expect, so we have reduced the investment because of it.

Thomas Besson – Kepler Cheuvreux Analyst

OK. Very clear. Last one please. Your depreciation jumped year on year from €70 to €97 million. Can you explain what is the impact of IFRS 16 and what is the impact of previous CapEx or why did it jump so much and what should we expect of the year on year change for the full year, please.

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

Before answering to this question, I have the answer to your previous question: 91% is the percentage of ≥18” Car volumes, and 9% is the rest.

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

For what concern the depreciation, the reduction of the investment of €30 million will impact in term of depreciation, with a reduction only for €2 million, €3 million.
For what concerns the global amount of depreciation we don't see major variances versus what is the normal growth that we had in the recent years, that is the region of €20-€25 million per year.

Thomas Besson – Kepler Cheuvreux Analyst

Can you explain the €27 million jump in 1Q, please?

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

This is coming from the impact of the IFRS 16. We estimate for 2019, an impact on EBITDA of ~€90 million, that is mostly compensated from an impact of grow in term of depreciation, due to the use of right of the leases. On financial charges, the new principle will impact by ~€24 million. On net financial position, we saw already in the first quarter €474 million impact, and we expect for the full year ~€480 million. So this is coming from the impact of the IFRS 16, and is not coming from the normal trend of the business.

Thomas Besson – Kepler Cheuvreux Analyst

Very clear, thank you very much to all of you.

Martino De Ambroggi – Equita Sim Analyst

Yes, thank you, good evening everybody. The first question is on the price/mix drop through, because in 1Q it was 62%, which is lower of the 65%, 67%, because I remember in the previous call you mentioned it could had been similar for the full year 2018, so could you elaborate on what's the reason of a lower drop through in spite of a stronger price/mix which, maybe a big portion comes from price effect.

Andrea Casaluci – General Manager Operations

Yes, this has been affected by a higher component on the price, mainly linked to the emerging markets, where we increased the price following the Forex impact and following the exit strategy from the Standard.

Martino De Ambroggi – Equita Sim Analyst

OK but for the rest of the year, do you confirm what I remember 67% or is part of the revision to be taken into account?

Andrea Casaluci – General Manager Operations

No, we confirm ~65%.

Martino De Ambroggi – Equita Sim Analyst

OK, so it's 65%, thank you.
And the second question is on the net working capital. In the first quarter we saw a small recovery, so how this recovery progressing because last year I remember you had €180 million of negative considered temporary effect, €100 million of higher inventories and €80 million deferred payment given to the dealers, so what's the expectation for the full year in terms of networking capital recovery and if it's in line with your plan the 1Q, because I remember in the previous call you mentioned 1Q would have already shown a significant recovery in this trend.

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

As you mentioned, last year we had an increase of working capital and that was in the region of €388 million, that we have a target to recover this year. €200 million were related to the normalization of the factoring in 2018, and the rest related both to the increase of the payment terms versus the dealers in Brazil and the level of stock. The payment terms versus the dealers in Brazil are currently under reduction. If we look at the stocks, we are continuously taking action: in the first quarter, we reduced the level of stock in volume by 2%, but in particular by 11% on the Standard. The reduction of the stock on the Standard will continue during the year and during the following quarter.

Martino De Ambroggi – Equita Sim Analyst

So basically you confirm everything you forecast one quarter ago more or less?

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

Yes.

Martino De Ambroggi – Equita Sim Analyst

OK. And the last question is on the guidance at adjusted EBIT level, trying to summarize the slightly lower sales in the EBITDA margin, probably in excess of 19%. My question is if you are confident to achieve the same adjusted EBIT in absolute value or a light reduction is inevitable, just to try to summarize the change in sales and adjusted EBIT margin.

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

The answer is yes.

Martino De Ambroggi – Equita Sim Analyst

Okay. So, in absolute value no changes. OK, thank you.

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

Yes, right.

Monica Bosio – Banca IMI Intesa Sanpaolo Analyst

Yes, good evening everyone and thanks for taking my questions. Thanks for giving us the expected growth of new Premium both for Original Equipment and aftermarket. This is a consolidated guidance, I was wondering if you can give us some indication for the new Premium segment by the year-end in the Original Equipment and in after market in Europe, EMEA and in Asia. What is your expectation? I can imagine that this could be lower than the consolidated guidance. The second question, if you can give us an indication of the current aftermarket pull-through and what would you expect by year end and very last is more a general question: until the High Value, new premium plus specialties, continue to keep a high single digit growth rate in the range of +9% everything should be fine. I was just wondering if you have a level in mind in term of growth rate in case of slowdown that could be an issue in terms of profitability? I know that it's more general, but just a flavour would be useful.

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

So, I start answering the last question and then in detail Mr Casaluci will provide you the answers. So, we see a Replacement market in which the double digit growth continues, the pull-through effect continue to be in the range of 80% and so that is making us more and more efficient in the market and so we don't see problems in volumes in the Replacement market. In the Original Equipment we have already contracts for the second half of the year both in U.S. and Asia Pacific, with new clients of new models, whereby we feel comfortable that the all in all volumes on lower growth, our position is strengthened by contracts already in our hands, so that's why also in Europe there are some new models, but, anyhow, considering the weakness of the market, we don't count on the market recovery in the second half, but we count more on what we consider the new clients we have in our portfolio. So that's why we confirm the profitability and the targets we have set.
Mr. Casaluci, please.

Andrea Casaluci – General Manager Operations

Thank you, Mr. Tronchetti. So, starting from the market environment, as we said we reduced our guidance on the Original Equipment market in the super premium segment, from a 5% growth down to a 2%, 3% growth. This is mainly due to a first quarter reduction in car production, basically in Asia-Pacific and in Europe. But we are confident that mainly starting from the third quarter the market will recover, both in Asia-Pacific, mainly in China, and in Europe. This is due, first, to a comparison with the last year where we had a reduction of the market in Europe because of the change on seasonality linked to the WLTP effect and in China because of the slowdown of the car registration that started mainly to have effect in the fourth quarter. So, we are confident into a market with two different speed, basically flat in the first half and with the growth of 5%, 6% in the second half. All-in-all we forecasted 2%, 3% growth on the Super Premium segment. While the Replacement the growth is stable and solid on a double digit, ~10%, more or less in all the three High Value regions and we don't see volatility or changes in this pace of growth, so we forecast 10% stable growth in all the High Value regions.

Monica Bosio – Banca IMI Intesa Sanpaolo Analyst

And for each quarter, so there should not be very significant change in the growth rate of the Replacement, in the different quarters.

Andrea Casaluci – General Manager Operations

Yes, stable. We see a stable growth of the quarters.
While moving to the pull-though effect, today our pull-through is, on average, 83%, and the more we go into the high-end and the higher the pull-through rate is, of course, for example in the Prestige is today higher than the 90% in the pull-through rate and this is the focus to continuously to improve year after year of 2, 3 point the pull-through rate in the Replacement market.

Monica Bosio – Banca IMI Intesa Sanpaolo Analyst

Ok, very useful, thank you very much. Thank you.

Kai Mueller – Bank of America Merrill Lynch Analyst

Thank you very much for your time.
The first one is on volumes: you've obviously now downgraded your standard volume guidance again and have been cutting more aggressively than I think we've all been anticipated when we basically think two years back. What has really changed, is it really that the market is becoming so unattractive? Can you give us a little bit of colour of how unprofitable those volumes are that you're taking out? Because obviously it's not supporting a top line anymore and, as you said, your earnings are coming still in the same level, it's the first question. Then the second question: some of your competitors have mentioned that especially in Europe and also in other regions where O.E. production was weaker, some of this O.E. tyres have been finding their way into the Replacement market, is that something you will participate in as well? And can you give us a bit of colour to what extent that might actually support your margins currently in terms of the split between Replacement margins that you generate there versus the O.E. business? And then, lastly, can you just remind us again the drivers of the 1Q weak cash flow and the quarter seasonality? What exactly are those drivers again, basically all of your cash flow generated in the fourth quarter, can you just give us a bit of colour again on your payment terms and your cyclicality on that cash flow profile? Just so we get a better understanding of that.

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

Yes, in the first quarter Mr. Sala was very clear in comparing quarter to quarter, also mentioning the extraordinary items, the plus that was made in 2018 thanks to the sale of Mediobanca shares, so he gave you the breakdown showing that the operation they were, in terms of cash flow, performing better in the first quarter 2019 compared to the first quarter 2018.

Kai Mueller – Bank of America Merrill Lynch Analyst

Yeah, and on the profitability, I completely see your point in terms of the margin progression which is, you know, compared to your peers absolutely impressive, what I just wanted to understand is the volumes you are taking out on the Standard volumes how profitable are those or are they not profitable at all at the moment and that's why you have taken this decision.

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

We are reducing standards double digit this year, in the first quarter. We did it also last year, because of a market in which if you look to the figures there is a reduction of the standard volumes over 3% in the market, in the global market. We see this phenomenon going on and also there is pressure on volumes coming from Asia, that's why we decided years ago to reduce our position in standard, and we are accelerating this reduction and we are also improving our efficiencies in order to cut the fixed cost and be able to deliver the profitability we are delivering, decreasing the business that is much less profitable than the High Value or the ≥18”. So, it's a strategy that we have set years ago and we are accelerating now, I think we did it properly because we increased the speed of reduction of Standard last year and the figures of the market are showing that our decision was right because the market is becoming weaker and weaker in the Standard business.

Kai Mueller – Bank of America Merrill Lynch Analyst

Absolutely, thank you very much.

Sascha Gommel – Credit Suisse Analyst

Good evening, thank you for taking my questions. The first one would actually be on your payables, across the sector you have among the highest level of payable days, so I was just wondering if you can explain a little bit why is this the case, and also maybe give a little bit of a regional split where your payment terms are so long or where they're longer compared to other regions. My second question would be on your restructuring projects in 2019, I was wondering how much in total for the Group you're anticipating for 2019 and how much of that will be Brazil. And, yeah, those would be my two questions.

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

So, in terms of payables, we, historically, as you mentioned, are in the best position versus the peers and if you consider the situation of the last 5 years we remain in the region, in particular during the year at 25%÷27%, reaching at the end of the year also 30%. This is coming from a strong attention that we have in our purchasing department, in which each buyer is incentivized to increase and to work on payment terms versus the previous year. And so, we considered that for what concern raw material, for what concern investment, for what concern also the spare parts we are in a good position to continue to try to improve this element in order to be efficient in the working capital management, but is not only in the Payables that we are as the best in the working capital management, because also in terms of Receivables we are, in terms weight on sales, ~12% and this is also coming from the same culture that we have internal in our company, which all the managers are incentivized mostly on the financial parameters, they have before to respect the financial parameter and then to do business and in terms of stocks last year we had this increase in terms of working capital that currently we are addressing in order to reduce in particular for what concern the growth in terms of stock of standard, the volume of stocks we already reduce in the first quarter by 11% we want to continue to reduce in the following part of the year, but for sure in terms of working capital we continue to have, historically, a working capital at the end of year that is in the region of 5% versus the sales, and this is our must in term of management of the company.

Sascha Gommel – Credit Suisse Analyst

Ok. Can I briefly follow up on the cash flow question: can you explain to me why you have such a huge seasonality in the first quarter versus the year-end level? Is there an explanation why there is this big swing in 1Q versus 4Q?

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

We have different seasonality aspects, the first one is on the level of the receivable because in the region in which there are seasonal markets, like you know, Europe and Russia, in the first quarter normally we are selling, we begin to sell the summer tyres that are collected mostly in the second quarter, then we are preparing the stock for the winter season, that is starting in terms of selling activities and these finally collecting in the last quarter of the year. So, also this case there is a growth working capital in the first quarter and a strong reduction in the last quarter of the year. For what concern payables there is also in this case a seasonality that is coming from different elements, one of the elements is coming also from the investments that are mostly concentrated, let me say, at the end of the year when the factory are closed also for the year-end period the investment of maintenance, the investment coming from the closure of the factory and the payment are done in the first part of the year. These are the major elements that we have in terms of seasonality.

Sascha Gommel – Credit Suisse Analyst

All right, thank you very much. And the restructuring question, please.

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

No, for what concerns restructuring costs, our guidance for the full year remains the same, €50 million; the most part of it is dedicated to the action that we announce yesterday for the restructuring activity in South America, in Brazil.

Sascha Gommel – Credit Suisse Analyst

Perfect, very clear. Thank you.

Henning Cosman – HSBC analyst

Hi, good evening. First question is on Europe, please. One of your competitors Nokian have said that relatively tough pricing environment, in Europe specifically, that maybe this was large tyres I was interested to hear you comment on that, if you can confirm that. And also we've seen a very untypically weak Replacement market in Europe, specifically in Germany. I believe Michelin has said 1Q was -10% in Replacement in Germany, very unusual. If you could please also comment on that, if you can confirm that, that you've seen that, also if you can already see a reversal of that trend in April and May and what are you expecting there. That's my first question, please.

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

I think we have a different business model compared to Nokian. As you know, our Replacement market is mainly related to the pull-through effect of the ≥18" we have in the Original Equipment, which is a market where the price discipline is quite effective, Nokian is only in the Replacement market, without Original Equipment, so I think we cannot compare their pros and cons with ours.

Henning Cosman – HSBC analyst

And just on the level of the Replacement market in Germany you would say the same thing applies, because yours is more related to the pull-through?

Andrea Casaluci – General Manager Operations

Yes, Casaluci speaking, the tough environment in the German market is mainly due to a delay in the sell-out of the summer tyres because of the weather condition. We don't see a structural issue on the German market, nevertheless if we focus on the ≥18", the market is growing double digit also in Germany.

Henning Cosman – HSBC analyst

The next question is on the savings level, please. You are guiding again for the savings in Brazil and I believe, I don't know if it's too early to say or if you want to comment ahead of your new financial plan already, but I'd be curious to just conceptually understand if you are expecting more savings, again, of a similar magnitude in Brazil next year as you will be continuing to reduce your Standard exposure. Is that the right way to think about it? Or will that stop in 2019?

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

Savings in Brazil are going on and the outcome of the action of restructuring will be in the next years, it's something we are not seeing this year, what we'll see this year is an improvement in the mix in Brazil and efficiencies will come from 2022, from the restructuring of Gravatai and Campinas. But the real effect we have in Brazil is efficiencies internally and an increase, a strong increase, in the High Value, still a small portion of the market, but profitable.

Henning Cosman – HSBC analyst

So we are still expecting a positive impact in the EBIT bridge in 2020 over 2019, correct?

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

Yes.

Henning Cosman – HSBC analyst

OK, great and then my last question is also on cash flow for the year and working capital, maybe another way to ask it is your target level of net working capital of sales by year end: you're thinking of a target level of ~20%, is that a good way to model it as to how you think about it?

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

No, the weight of net working capital on sales remains, historically, in the region of 5%. What we have in our plan, for what concerns this year, is not to have anymore the impact of €200 million that we had last year for the normalisation of the factoring and the impact coming from €80 million of growth from the stock growth and from the receivable in South America. So, practically our assumption for the year of the working capital is to grow in the region of €40 million, €50 million. Remaining in any case below 5% on sales, for what concern the year and this will be the most important improvement to help us to reach, starting from the €40 million of net cash flow of last year, the target of €400 million, because we have this important improvement in the working capital management, then we will have an improvement of CapEx versus last year, €400 million versus €460 million and then we will have an improvement in financial charges and this can help us also to compensate the lower impact coming from the financial activities. So our €400 million of cash flow is coming from the improvement of EBITDA, the improvement of the working capital and lower CapEx. So, the real elements of cash flow of a company.

Henning Cosman – HSBC analyst

Sorry, I think I've said this wrong, I meant 20% inventories of sales, not working capital as a whole.

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

Ah, sorry. Sorry! Yes, our target is to move down from almost 22% of last year in terms of weight of stock on sales to ~20%.

Henning Cosman – HSBC analyst

Okay, great, thank you. It was my mistake, I said it wrong. Thank you very much.

Gaetan Toulemonde – Deutsche Bank Analyst

Good evening, only one small question on my side. When I look at your revenues, two businesses, Standard and High Value tyres, if we project ourselves by the next five years, you're going to do what, 90% High Value? What is the limit, because you might need a certain level of Standard tyre just to cover the fixed cost base. That's where I am a little bit lost, what is the limit by next 3 to 5 years?

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

What you mean saying what is the limit? So, we have...

Gaetan Toulemonde – Deutsche Bank Analyst

Ok, I'll phrase it a little bit differently. When I look at your breakdown of revenues today, or this year, 67% High Value compared to 64% last year and is growing at the rate of 5 percentage point per annum. Is there a limit or you see yourself in five years' time 100% High Value, zero Standard tyre. What is the limit of a minimum volume of Standard tyre you might need because it helps to cover the fix cost base. I hope that my question is clear.

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

That's very clear, sorry. We continue the trend, I don't see for the next five years going down to 0, some Standard, and there is some Standard that is in a range of profitability, that is around the double digits so we don't see this as an issue. We will continue to grow, definitely, in ≥18", and above and decrease the Standard. In volumes, as you know, now we have a bit more than 50% that is coming from the High Value and, looking from what I see, this number continue to grow, but I will not imagine, for the next five years, to go down to zero. We still have a lot in America, Russia, which some of this will remain. And as we have been showing in the last couple of years we are able to balance the fix cost reduction and increase in profitability, so our action to cut Standard goes always in line with a reduction on fix cost, and that is what is happening in Brazil and is what is happening in all the regions.

Gaetan Toulemonde – Deutsche Bank Analyst

Ok. A small detailed additional question: the breakdown of your High Value tyres volume between O.E. and Replacement is approximately 50-50?

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

More or less.

Gaetan Toulemonde – Deutsche Bank Analyst

Ok. Super. Thank you very much.

Deeya D'Souza – Morgan Stanley Analyst

Hi, good evening, I just have one question for you all. So your guidance, I just wanted to get a bit more clarity, because I know you've alluded to this in the previous questions. But the guidance for revenues obviously has come down and the EBIT is maintained slightly up, I just wondered, with efficiency guidance confirmed, price/mix guidance confirmed, volumes taken down a bit, what is the kind of driver, if the margin guidance has been maintained, like what are the levers that you have here? Because say that the market doesn't improve that much by 3Q, I just would like get an idea of what are the levers that you can call here just to meet the guidance?

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

As you can see in the slide number 13, we have split our results comparing the guidance given in February with the guidance we are giving today. Volumes were expected to grow between 1% and zero, now we expect volumes to go down and with a reduction of 1%. We see a High Value volumes growth over +9%, the previous guidance was in the range of +11%. Standard volumes, we see a decrease between ~-11%, the previous guidance was between -9% and -10%; price/mix, we confirmed the price/mix we gave as a guidance in February, between +5% and +5.5%; Forex, we confirmed the negative effect between -0.5% and -1%. Efficiency, we confirm €70 million of efficiencies, input cost we confirm a negative impact of €60 million, cost cutting we confirm €50 million of cost cutting, raw material impact we reduce this from -€100 million to -€85 million. This is, I think, the split you wanted to have. Is that's all?

Deeya D'Souza – Morgan Stanley Analyst

I just wondered how you are meeting the guidance on margins, given that your volumes and your net sales guidance is slightly lower, I just wanted to know what is the driver of the margin guidance being confirmed. This, like, on lower operating leverage or whatever you would like.

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

≥19% is the EBIT margin. In absolute value, aligned, so the number will remain aligned to consensus and what we have reduced is the top line, but this is balanced by the raw material headwind that is below the one we gave before. We go down from -€100 million raw material headwind to -€85 million raw material headwind. I think this is the number that balance the figures, in order to understand better why we confirm the profitability ≥19%.

Gianluca Bertuzzo – Intermonte Sim Analyst

Good evening to everybody and thank you for taking my question, I have just one. Recently, we have seen that two of your major competitors are become more interested in the High Value market, given the very attractive margin and growth rates of this segment. They have also said that they plan to increase capacity for this segment mainly in Europe, that is your most important region. How do you see the market reacting once this additional capacity will be available? Thank you.

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

I think that we already gave last time, but the announced increase in volumes are in line with the expected growth of the market and what is protecting our position is the effort and the success we have in getting the homologation in the Original Equipment and so the business model we have set, with this 80% and more of pull-through effect, gives us comfort looking forward and the fact that we continue to lead the homologations in the segment of ≥18" gives us a portfolio even for the following years that is granting a double digit growth in the Replacement market due to this effect. So we don't see any change coming from any announcement of our competitors.

Gianluca Bertuzzo – Intermonte Sim Analyst

Thank you.

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

Thank you. So, thank you to all of you for attending our conference call and I hope to see some of you tomorrow in our AGM. Have a good evening.