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

May 13, 2020

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

Good evening Ladies and Gentlemen, and welcome to our 1Q results Conference Call.

I will give you an overview of what we expect for the 2020 and our compass to navigate the current crisis. Mr. Casaluci will comment market trend and Pirelli performance and actions, while the financial results will be illustrated by Mr. Sala.
Last time we met, we were in Milan, for the presentation of our Industrial Plan, just before the outbreak of the Covid-19 pandemic.

We are witnessing an extraordinary emergency, an unprecedented health crisis that is causing a deterioration of the global economy and a deep change of the scenario which was at the basis of our 2020-2022 Industrial Plan, that was recalled as a consequence.
The experience built up in China, where the virus first emerged, allowed us to promptly react to the new global context and rapidly define a very detailed action plan to protect the Company profitability and cash flow. This plan was announced on April, 3rd.

So far, we are the only player in the Industry with a clear outlook and guidance that we are confirming today.
For the Full Year 2020, we foresee a 20% drop in tyre demand, with High Value proving again to be more resilient than Standard, which is the foundation of our strategy.

Against this backdrop, our safety measures are giving the first results. We are fully on track with two sets of programs:
- the Cost Competitiveness action plans, and
- the Covid Countermeasures launched in the 1Q

Finally, even if second half 2020 will show market improvements, and China is recovering fast also thanks to massive subsidies and incentives, it will take time to fully recover 2019 levels. For this reason, we are already working on a more radical transformation, so as to make Pirelli a lighter and faster player.

So let's start from the outlook for 2020.
This slide shows how deep the crisis has reached, compared with the scenario we considered for our Plan:
- 18 million less cars produced
- 319 million less tyres in the market
- ~19% lower Pirelli volumes

A serious crisis which is going to bring about structural changes in the industry.
Coming to the 2020 scenario, the outlook we gave you on April, 3rd, has been confirmed by recent data and industry commentaries:
- -22% drop in car production, confirmed by the latest figures from Global Insight

- such fall is mainly driven by Europe and North America, less pronounced in the Prestige segment, with few order cancellations, and where Covid-19 is considered more of a suppliers shock
- -20% the total car tyre market, now a consensual scenario, with a very challenging quarter in 2Q and optimism for the second half, driven by China recovery and better Europe trend
- in this scenario, High Value is confirming its resilience versus the Standard segment, with a less pronounced decline (-15% in High Value vs. -21% in Standard)
- high-teens volume decline for Pirelli, mitigated by its exposure to High Value; as Mr. Casaluci will illustrate, the expectation are for a tough 2Q, in line with the market, and a better trend for the second half of the year, where the replacement demand improving

In this tough market environment, cost flexibility is crucial.
At the Investor Day, in February, we presented the Cost Competiveness program aiming at optimizing variable and fixed costs, and producing gross benefits for €180 million, or €110 million net of inflation for 2020.

We are in line with our expectations, except for some projects in the Manufacturing area – affected by the slowdown in production due to the Covid emergency – where we had to freeze ~€20 million in efficiencies.
The benefits expected for the year are now €160 million, or 3.6% of 2019 cost base. However, the €110 million of benefits net of inflation are confirmed being the impact of the inflation now estimated at -€50 million compared with -€70 million of the previous indication.

To limit the effect of the production lockdown and fall in demand, Pirelli also launched a second cost containment plan (Covid Actions), announced on April 3rd, 2020. This plan, equal to a total of €120 million for the year, includes short-term actions Mr. Casaluci will talk about. These savings will offset the cost of production slowdown, estimated at ~€90 million in 2020.

Overall, the combined benefits of the two plans amount to ~€280 million (~6% of the 2019 cost base), or €140 million net of inflation and slowdown (~3% of the 2019 cost base).

In 1Q 2020, the net benefits of the two plans amounted to a total of €33 million (€64 million gross, or ~25% of FY target); in details:
- ~€16 million from the Competitiveness Plan, in line with the Plan's forecast for 1Q (benefits of ~€31 million gross of inflation equal to -€15 million)
- ~€17 million from the Covid Actions (~€33 million before the impact of the slowdown of -€16 million)

We expect markets to start recovering in 2H 2020, with China leading the way and benefitting from government's aids to the Auto Industry.
Should Europe and the U.S. be able to count on government support, their markets could also recover as quickly.
However, if no aids are given, markets will take 2 years to go back to 2019 level.

With this perspective, Pirelli is using this time to transform into a leaner and faster moving company, also leveraging on the lesson learnt during lockdown.

In order to be leaner, we are:
- pruning products more than expected in February Industrial Plan
- moving our processes to digital ,backed by more automation and data insight
- simplifying the organization architecture
- changing our way of working with savings in office space, energy, and travel

- “mothballing” capacity
- creating Regional Service Centers

Whilst to be faster, we are:
- connecting directly to Consumers and to Customers, pushing collaborative forecasting and replenishment. All these actions will reduce stock
- reducing plant throughput time
- reducing product time to market with virtualization and simulation

All the benefits of this transformation will be captured in our New 2021-2023 Plan.

Let’s now move to the guidance we gave in April:
- revenues between €4.3 and €4.4 billion
- adjusted EBIT margin between ~14% and ~15%
- investments of ~€130 million (57% less than in the February guidance) consistent with the new market scenario and capacity utilization level and the postponement of some projects.
- Net Financial Position confirmed at ~-€3.3 billion with net cash generation of ~€230÷€260 million

We confirm this guidance but being realistic, as 2Q is expected to be the worst of the year, we feel more confident with the low range of our targets. The next two or three months will be crucial to understand, based on the health crisis evolution, what the consumption recovery trend can be.

We remind you that our balance sheet is solid and further strengthened by recent refinancing operations, as Mr. Sala will detail later on, with a liquidity margin worth €2.1 billion, covering for debt in the next 3 years.

Before concluding, I would like to give you a very brief update on the on-going negotiations between Camfin and Longmarch that started early April.

Camfin is expected to finalize soon the partnership anticipated on April 1st last.

Longmarch is owned by the Chinese family Niu, having industrial relationships with Pirelli since 2005 when the Group's first factory in China was established through the creation of a joint venture that contributed to the development of Pirelli’s factories in the county of Shandong.

The partnership between Camfin and Longmarch, through a newly incorporated entity whose governance will be held by Camfin itself, is aimed at developing private equity investments.

Longmarch also holds, through a Repurchase agreement, a potential participation with the right to repurchase ~7.68% of Pirelli, increasing from the 5.19% announced on April 1st.

The agreement currently under negotiation would provide for prior consultations between Camfin and Longmarch before the shareholders’ meetings of Pirelli and the right for Camfin to provide voting instructions for such meetings.

In this context, Camfin confirms the solidity of the long-term partnership launched in 2015 with ChemChina and the stability over time of the current governance structure which aims to preserve Pirelli's entrepreneurial culture.

And now I leave the floor to Mr. Casaluci..

Andrea Casaluci – General Manager Operations

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

Let's start focusing on market dynamics and Pirelli performance.
Covid-19 emergency heavily impacted car tyre demand in 1Q with a 20% drop in volume affecting both the O.E. and Replacement channels.

- on the O.E. side (-22.7%), the decline mirrored the car production trend (-23.8% Synergic, -17.7% Premium), while
- an unprecedented downturn in Replacement demand (-19.3%) occurred due to mobility restrictions

The fall in the demand was more pronounced in the Standard segment (-22.0%), while the High Value was more resilient (-11.6%).

Pirelli performance in the High Value Segment has been characterized by:

- outperformance of the market in the O.E. (-9.5% vs. -16.0%) thanks to the widening of the customer base in N. America and Asia Pacific, already underway since the 2nd half of 2019
- underperformance in the Repl. Channel (-18.1% vs. -8.2%) caused by:
    - the significant exposure to ≥18" within the Chinese market, in which Repl. has been ~-50% YoY in 1Q; It is worth mentioning that April data are signalling a general recovery of the market
    - the choice to support our main distributors in Europe and North America in keeping low stock levels, in order to be best prepared for a quick recovery

In the Standard segment, Pirelli performance (-22%) was pretty much in line with the market, and our focus has been maintained over the reduction of the exposure to less profitable sizes.

Let's have a look now to the expected market evolution throughout the year.

Outlook for the full-year is confirmed with a tyre demand ~-20% YoY:

- for 2Q we now project a more severe downturn, with tyre market at ~-40%, particularly negative in the O.E., where OEMs are slowly ramping up production after lockdowns
- assuming no second waves of Covid-19 spread and the success of Government restrictions' loosening, partial recovery is expected to bring 2H demand to single-digit decrease. As mentioned by Mr. Tronchetti, the next couple of months will be crucial to understand the consumption trend

The outlook differs Region by Region:

- in APac, China has brought down 1Q market figures, but is clearly recovering in 2Q, where we are cautiously optimistic after getting good signs in April; other countries in the Region, such as Japan, Singapore or Malaysia are still facing instead lockdowns restrictions
- in Europe, now activities have restarted, but the productivity both in O.E. and store traffic in Replacement are still far from normal level
- in North America, some O.E. factories are currently not running and 2Q market trend is expected to be very tough; the recovery of consumer demand is expected to lag Europe, as the social impact will probably be more severe

In Standard Regions:

- In LatAm, 2Q is expected to be severely hit, but Repl. demand should catch up quicker, while O.E. will remain depressed throughout the year

- in Russia, lockdowns impacting 2Q demand are coupled with the economy difficulties with low oil prices and currency devaluation

As already said by Mr. Tronchetti, in this tough market environment we are further optimizing our cost baseline with a gross efficiency plan of ~€280 million in 2020. This program is the combination of:
- the "Competitiveness plan" announced in February, which is now worth €160 million, and
- a second "Cost containment plan" of ~€120 million, to limit the effect of the production lockdown and fall in demand

The two projects are working on the same streams and in most cases the latter represents an enhancement of Cost Competitiveness Actions.
Let me now give you an update on each stream.

On Product cost, which is now equal to ~€60 million, we are performing in line with expectations:
- continuing to streamline the entire product range toward a value based portfolio
- working on tyre structure simplification and weight reduction, and
- accelerating the virtual design process and material portfolio de-complexity to face the impact of slowdown (Covid actions)

Some projects in the Manufacturing area were affected by the slowdown in production due to the Covid emergency. We had to freeze ~€20 million in Competitiveness efficiencies but, in response to production slowdown, we are:
- further focusing on flexibility and factory flow optimization (Covid actions), and
- activating additional short term actions on fixed costs and, especially, on variable costs, mainly consumables, auxiliaries, indirect materials and energy consumption (Covid actions equal to €40 million of which 60% variable costs)

The manufacturing stream is now worth €60 million.

On SG&A, which accounts for 40% of 2020 efficiency, we are deeply reviewing marketing, communication and motorsport activities as a consequence of the lockdown at worldwide level, supporting more digital activities.
To protect margins, we also increased the target reduction of discretionary costs, through a further belt-tightening of professional services, travel and overheads.
Moreover, leveraging on procurement re-negotiations and stock reduction, we continue working on optimizing distribution flows and reducing warehousing costs. The SG&A stream is now worth €110 million.

Finally, we are working toward a leaner Organization that will bring a cost saving of ~€50 million. We are:
- completing the footprint rationalization in Latin America,
- developing our existing shared service centers in that region and Europe, and
- working on a more pervasive "pay for performance" system, more closely linked to functional objectives, improving the effectiveness of the schemes

During this period of emergency we have also let people work from home to protect their safety first. Smart-working has proven to be very effective in terms of results and now we are trying to implement it in a more structural way with benefits already visible in the near future.

Covid slowdown is forcing the tyre industry to deal with rising un-absorbed fixed costs given the lowered utilization rates. In this context we are putting all the effort needed to contain production slowdown costs:
- we are adhering to Governments Social Safety Nets in Europe and South America since March, a key support to our employees
- we keep reducing the complexity in our plants operations to maximize efficiency and enhance our quality
- in 2Q, we will face very low utilization rate: as a countermeasure, we will increase mix rotation to provide optimal customer service level
- we are speeding up re-allocations of the Standard sizes range to low-cost footprint Regions
- to keep stock levels aligned to the evolving production requirements, the purchase of raw materials has started to slow down already in mid-February, also thanks to an enhanced MRP system
- finally, we took lockdown restrictions as a chance to step up our Smart Manufacturing Digital Training for the workforce and further integrate data platforms

In order to face the current market scenario, we have defined several commercial actions to mitigate the negative impact of the downturn and be prepared for the market rebound:
- we balanced our commercial actions with the need to lower our distribution partner stock, to ensure rapid orders inflow when consumers will be back in stores and to keep under control any potential financial risk with trade
- we keep investing in the Chinese market, which has already started to regain traction, with positive feedbacks from April figures; online business is growing at a fast pace and we are exploiting this trend, forecasting in 2020 almost 10 times the volumes done in 2018 through this channel; our exposure to China will support the next quarters results
- we've been very active in Trade channels, accelerating new customer acquisition in Europe, but also in the USA, and expanding franchising and affiliations to cope with the new scenario in distribution
- we keep on broadening our geographical exposure in O.E. towards N. America and Asia Pacific

Finally, as for new products, we have just launched the new Cinturato P7 flagship High Performance product in China, but also in Europe, together with a new offering of 18" Self-Sealing sizes. Between 3Q and 4Q we plan to anticipate the launch of new regional lines in N. America and Europe, thanks to the improvements in our development simulation tools.

Let's finally move to the Operational Drivers of our guidance.

For what regards revenue drivers:
- we foresee High Value volumes ~-14% YoY
- for Standard, we forecast a more severe decline: ~-26%, keeping pruning the exposure to the less profitable products
- the combined trend of High Value and Standard will bring Group volumes between -18% and -20%
- price/mix improvement is expected at ~+2% driven by the improvement of both channel and regional mix already from 2Q
- Forex at ~-2%

Moving to profitability, we expect Pirelli adjusted EBIT margin to be in the range of ~14% ÷ ~15%
- we confirm the following drop-through: 42% on volumes, ~50% on price/mix and ~15% on Forex
- our competitiveness plan is expected to deliver ~€110 million benefits, net of inflation
- in addition to that, to compensate for the slowdown deriving from the Covid-19 emergency, we implemented additional cost actions, which should bring extra net savings for ~€30 million

As already pointed out by Mr Tronchetti, we feel more confident with the low range of our targets. The next few months will be important to understand what the recovery trend in consumption will look like.

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 ended 1Q 2020 with Net Sales in excess of €1 billion, -20% from the same period of 2019.

This trend was mainly impacted by the drop of volumes by -17% at Group level, reflecting the general slowdown of demand.

High Value volumes recorded a -14%, and the same did the Car ≥18" volumes, where Pirelli performance varied in the O.E. and Replacement channels as Mr. Casaluci already explained.

Standard volumes decreased by -20% in 1Q'20, in line with the market. In this segment, we kept reducing our exposure to less profitable rim sizes.

Price/mix recorded -1.3%. Pricing was in line with previous quarters:
- the O.E. business was a bit more negative, discounting the indexation to raw material prices in the O.E. contracts
- the Replacement was a touch less negative; we still see some price competition, but the sector has shown a price discipline, especially in High Value, a segment well protected by technology, content and brand

Mix basically flat in 1Q affected by
- temporary negative regional mix, particularly due to the drop in sales in China, characterized by an average selling price higher than Pirelli average; April data are encouraging, with general recovery of sales. Regional mix is expected to rebound in 2Q thanks to the demand recovery in China and a lower contribution from South America e Russia
- negative channel mix: with a more marked drop in Replacement sales compared with O.E.; this trend is rebalancing in the course of 2Q
- positive product mix, but with a lower contribution vs. previous quarters, considering the more contained performance of High Value vs. Standard

And finally, negative FX of -1.5%, affected by the weakness of currencies of Emerging markets.

The efficiency and cost-cutting actions in connection with the Covid-19 emergency contributed to contain the impact of the tough external scenario (weakness in market demand and pressure on prices, increase in the cost of production factors,).
In more details:
- the Cost Competitiveness program generated structural efficiencies of €31 million (2.9% of revenues) by offsetting the inflation of cost of production factors (-€15 million), the temporary negativity of the price/mix (-€15 million), and the exchange rate impact (-€1 million). These efficiencies mainly concerned the cost of the product (optimization of specifications, and

rationalization of components), organization (re-engineering of processes), and SG&A costs (strict control of overheads)

- the cost reduction plan linked to the Covid-19 emergency, equal to €33 million for 1Q, offset the impact of the slowdown (-€16 million), and the higher cost of raw materials (-€3 million); cost reduction measures were carried out with regard to discretionary costs (SG&A), the review of marketing and communication activities, the renegotiation of contracts with suppliers, the prioritization of R&D investments, and efficiencies for the distribution channel
- the impact of volumes, in the end, was negative (-€95 million), while the item "amortization, depreciation and other costs" was positive to the amount of €4 million

We ended 1Q'20 with a Net Debt of ~€4.3 billion.
In 1Q'20, Net Cash Flow was -€754 million, in line with the trend of 1Q'19, where lower investments (CapEx and financial investments), together with an improved financial management, mitigated the impact of the operational performance.
More in details, the Cash Flow from operations was negative for -€697 million and reflects:

- CapEx for €57 million, with investments mainly directed to the High Value business, continued improvement of the mix and quality in all factories
- higher rights of use IFRS 16 for €23 million, deriving from the application of the new IFRS 16 principle and relating to the new leasing contracts entered during 2020
- the usual seasonality of the working capital with a negative cash absorption of -€861 million, slightly higher than in 1Q'19 and discounting the increase in stocks, raw materials and finished products, caused by the production slowdown and following closure of plants due to Covid-19 emergency; the Company has also taken actions leading to the normalization of stocks levels in the course of the year

As of March 2020, our Gross Debt of €5.6 billion lands to a Net Financial Position of €4.3 billion thanks to €1.3 billion in Financial Assets.

Our liquidity margin at €2.1 billion is very sound and covers forthcoming maturities into 1Q 2023, thanks to the possibility of extending our bank debt expiring in 2022. In the first months of the year our actions were indeed aimed at maintaining an adequate level of cash. I remind you that in March we:

- subscribed, at very favourable terms, a €800 million loan with a maturity of 5 years; this financing also represents our debut in the sustainable finance space, as it is linked to the Group's ESG and Circular Economy targets
- extended the maturity of a €200 million bilateral financing, originally due in June 2020 and now postponed to September 2021

More recently, in April, we have also exercised the sole borrower discretionary option we had on the tranche of our main bank line coming due in June 2020. €259 million are therefore now postponed to June 2021.

It is also positive from the cash level perspective that we are easily renewing our local short term lines. In the current environment we have also considered prudent to proactively approach our lenders and gain flexibility on those financial covenants which, at a certain point in future and with a prolonged slowdown, might go under pressure. The process will be closed in the next days.

Finally let me spot the positive trend of our cost of debt which benefit from a lower exposure to high yield countries and now stands at 2.54% vs 2.83% at year end.

Before ending my presentation, I want to thank you all in advance. After over 10 years as Chief Planning and Controlling Officer, I am going to take on new responsibilities within Pirelli. I am pleased to pass the baton to Mrs. Leone, wishing her the best of success.

Now I leave the floor back to Mr. Tronchetti.

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

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

Questions & Answers

Kai Mueller – Bank of America Merrill Lynch Analyst

I hope you're all well given the current times. The first one is really on your tyre demand. You mentioned obviously on your Slide 10, when you look at your outlook, that you actually expect Replacement demand to pick up slower than O.E. What is really the driver there? And that's, I think, especially in terms of some commentary, what we've heard from your peers, that have seen really Replacement demand in China, in particular, but also in Europe, picking up quite strongly with people switching from Winter tyres into Summer tyres. Maybe as the first one. And as a second point, just trying to understand, on your replacements demand forecast versus achievement in 1Q versus the market, what we can see on Slide 9 is you've done much better on O.E., but you underperformed the market in the High Value space in Replacement. What has been the driver there? Is it the distribution mix? Or is there anything you can add to that?

Andrea Casaluci – General Manager Operations

So starting from the expectation of the Replacement demand. First of all, this is a period of uncertainty, but we have one sure effect which is coming from the recovery on China, occurred in April. The first signs are positive. We don't have final figures of the market, but we can say that we see low single-digit decrease in the entire market and a positive trend on the ≥18”, which is performing better than last year in Replacement. So it goes without saying that the reaction of China is positive and strong, but we do expect the same trend, with a delay of 1 month, 1.5 months also occurring in Europe. Individual mobility will increase after the Covid-19, and this will support the consumption of tyres. On the other hand, cars has been stopped for 2/2.5 months, and tyres were not utilized. So the 2 effects we expect will be compensated. But all in all, the recovery that we show on Slide 10 of our presentation is forecasting a recovery in 2Q of the Replacement.
Second question, what occurred in distributions? As I said before, in 1Q, we decided to reduce our stock position in the trade, mainly in Europe and North America because in a volatile context as this one, we do prefer to stay on the safe side, and we want to support our partners in distributions. In Europe, there is also a change in the go-to-market and in the state of distribution, mainly in Germany and in Italy, as you know. And we are redesigning our go-to market, enlarging our presence in the retail channel and relaunching our franchising program.

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

So one more comment. So in 1Q, we destocked. The sell-in was lower than the sell-out. Sell-out was in line with the expectation. We reduced sell-in, just to reduce the stock. We anticipate also the slowdown in our factory, taking into account the experience we had in China. Thank you.

Kai Mueller – Bank of America Merrill Lynch Analyst

That's very clear. And maybe just one follow-up on your price mix and it was slightly negative. Obviously, you see that still at +2% for the year. If you think about the cadence throughout the year, is it really a turnaround already in 2Q? Or do you think it's coming towards the back end of the year? Because obviously, with those volumes, people would be more concerned about pricing down more and it's not such a big mix benefit.

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

So before leaving the floor to Mr. Casaluci. I had to say that price, -1%, is in line with previous quarters. Mix, flattish, -0.3% due to temporary effects ofnegative China and regional mix. So we had obviously lower sales in China, where we have the highest mix within our markets. And there was also channel mix that affected us related to the O.E. that over-performed the Replacement. If we look to 2Q, we see a rebound in price/mix, driven by the regional mix supported by China. Price will continue the trend of -1%, consistent with the full year guidance. But Mr. Casaluci, please.

Andrea Casaluci – General Manager Operations

Thank you, Mr. Tronchetti. Nothing to add. Just saying that the first result of April is already showing the expected rebound, supported by the positive regional mix. Just to give you a number, the weight of sales in China in 1Q has been half of the average we normally have.
And the average selling price in China is ~20% higher than the average of our global average price. That's the reason why we have been affected negatively by the region mix. And the recovery is expected and already visible starting from 2Q.

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

One last comment. So we see a recovery in the second half, because we see what is happening in China and the resilience of the ≥18″,. So we expect 2H confirming the trend and the resilience of the High Value compared to the rest of the market.

Monica Bosio – Banca IMI Analyst

The first one is once again on China. According to other premium players, China might end the year with a -10%, -12% downside in car production. And expectation for the next year could be in the region of +3%, +4%. I know that it is too early to say this. But just a view, if you are going to share this view. And what is your feeling on the speed of the recovery for the rest of the market? Do you expect NAFTA will recover faster and stronger than Europe? Just some flavour on this.
And the second question is on the benefits from the cost savings plan. In 1Q, the benefits were €31 million. Do you expect the same amount in 2Q or maybe a much higher amount of cost savings, both from the competitiveness and the Covid action? And as for the price/mix, +2% for FY'20, in the initial plan, the price/mix was expected at +3%. Just to check, is that due only to the pricing, not to the mix? Is it correct?

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

Starting from China. In the country, we see the market recovering well. Considering the 2 months of shutdown, what the market is expecting is in line with what we expect. What we see is the resilience of the Premium segment, which obviously is our reference segment. About the other countries, it really depends on the actions that will be taken by governments to support the industry. For sure, the resilience of the High Value segment is supportive to our results. But we have to see which will be the tools that will be given to the Automotive Industry by mainly the U.S. and Europe.
On cost savings, we have a quite distributed gross savings. You saw that we were able to deliver €64 million gross in 1Q. We expect to have also in 2Q a gross effect that will be, on global, another 28%/30%.

Net will be less in 2Q because the slowdown will affect much more. So the real bad quarter is obviously the 2Q in terms of net costs. And we expect to have the other 50% at a gross level in 2H, which it should be 60% considering that the impact of the slowdown will not be as much as in 2Q. So we have control on the cost side.
Going to price/mix. Yes, you are right. Mr. Casaluci can elaborate on it.

Andrea Casaluci – General Manager Operations

Thank you, Mr. Tronchetti. Yes, you are right. We are moving from a +3% to a +2% in our guidance. This is driven by two effects. First is a slightly mix and second is price on the O.E. due to the cost metrics logic because the reduction of the raw material cost is affecting through the cost metrics mechanism, the price in the O.E., while the price environment in the Replacement we see for the time being is of global discipline of the Industry, mainly in the High Value segment. So we don't see changes for the time being in the price environment in all the High Value markets. Thank you.

Martino de Ambroggi – Equita Sim Analyst

Yes. Sorry to bother you on the price/mix once again. But just very roughly, could you split a bit more the mix effect because you mentioned several different variables? O.E., aftermarket, different products, High Value, Standard, different regions. Just to have a sort of classification of what were the most important and the less important components in 1Q. And just to double check if what I understood is that China, isolating China would be, by far, the most important element in 1Q and should drive the recovery starting from 2Q.

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

So in general, we see that China is recovering,. And the last data showing that the Replacement is performing better than last year in the month of April. This is what we see happening in China. Also, the O.E., is moving fast because of the incentives that we mentioned.
I think that Mr. Casaluci can elaborate more in detail about the 1Q mix effects.

Andrea Casaluci – General Manager Operations

Thank you. So try to simplify. The performance was -1.3%. As Mr. Tronchetti mentioned, price impact was ~-1% and mix, flattish.
Now we go inside the mix. We have 2 major effects. The positive effects coming from the product mix, which is the usual performance of ~+2% due to the positive product mix, reduction of Standard, increase of value in the total weight and micro mix. Then we have a -2% leading to the neutral total effect, which is coming from the regional mix that Mr. Tronchetti mentioned before.
Why? Because the weight of China on our sales in 1Q was half of the normal, and we sell at an average price in China that is ~20% higher than the average of the other markets, because of the mix. Second negative effect is the channel mix. Again, the weight of the O.E. on our sales in 1Q was 3 percentage point higher than the average. And this is because the slowdown started from the Replacement, while the effect on the O.E. arrived later. These 2 negative effects, regional mix and channel mix, will rebound with a positive impact in 2Q because we see that the restart of sales starting from Replacement, with the pace of recovery higher than the O.E., and China started sales with positive signs already coming from April results.

Martino de Ambroggi – Equita Sim Analyst

The second question is on the free cash flow, specifically on the net working capital. So just what you see right now in the market, in your dealer network, considering that in the past you suffered sometimes some cash absorption just to change the payment terms for some regions for your dealers?

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

We are adopting a very cautious view for receivables and for payables.
We are guiding with a net cash flow that is, if we take the floor, €230 million net versus €220 million that was forecasted before in 19 of February. That was related to €400 million gross of dividend, -€180 million of dividend.
The advantage that we are having are coming from the fact that we are not paying dividend by €180 million. We have lower investment for €170 million. We have lower taxes with the lower results for €70 million. And this is more than compensating the EBITDA that, if you take the floor, is -€330 million. And finally, also the worsening of the working capital in the region of €80 million. But this worsening is coming from 2 temporary effects. The fact that the reduction of investments is not generating a full impact of positive cash in 2020 because one part, the last quarter, will be paid in 2021, and finally, also, the cancellation of short-term incentive will generate lower payables. So these are temporary effects. For your concern the other elements of working capital, we're working on reducing the stocks with a stronger action that will already generate reductions starting from 2Q. So not major elements negative on working capital.

Martino de Ambroggi – Equita Sim Analyst

Okay. A very last question for Mr. Tronchetti. If someone do suggest to you a merger with Brembo, what would be your reaction?

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

It's a very interesting question. I think this is time to work hard on costs and be very careful. Mergers, I don't think now are in the agenda. Anyhow, I'm always ready to analyse any proposal. I always, in my life, done the same way. So nothing have to be refused before analysing, but nothing is on the agenda and nothing is on my desk.

Gabriel Adler – Citi Analyst

Gabriel Adler from Citi. My first one is on CapEx. And the CapEx cuts of ~70% this year is quite significant. I know that you're already carrying to CapEx a lot when you announced at CMD that it was coming down, but it's still quite a large decline compared to peers. So could you give us some more details on way of finding these additional CapEx savings from? That's the first question. My second is on dealer inventory because you mentioned that you were destocking in 1Q. Can you just confirm whether dealer inventories are now at a normal level at your dealerships in Europe and North America? And my last question is on cost savings. Could you explain please in a little bit more detail where the additional €20 million of lower inflation costs coming from in order to offset the €20 million of manufacturing costs that you now don't expect to achieve this year?

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

Thank you. So first, on CapEx. Obviously, with the slowdown, we have been able to drastically reduce capex starting mostly in March and going on in the following months. And so we continue to make investments in technology upgrade.
Let's say that the largest part of the investment will be in technology upgrade. And then business continuity, obviously, is lower considering the freeze of production. And capacity, obviously, is an investment that we have been able to cancel. So we reacted quite fast, thanks to China which was helpful in that scenario because we could foresee the damages that COVID could have given to the other markets, and so I think we have reacted quite fast.
Mr. Casaluci, if you want to answer to the other question, please.

Andrea Casaluci – General Manager Operations

Yes. Thank you. As far as the stock is concerned, the stock level is more or less in line with 1 year ago. It means that despite a reduction of demand without precedent, we were able to slow down the production in order to maintain the same level of stock of last year.
Our plan for the coming 2 quarters is to reduce the total level of stock, and the first important step has been done during the month of April of ~14% in value.
As far as North America is concerned, it is the region where we have to reduce them all because it was not optimized as we would like in this moment. But within the end of 2Q, we will be in the target position we want to reach, and this will be part of the global plan of reduction of stock.

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

For what concerns, the third question, on inflation. We guided at the beginning of the year with an inflation of -€70 million. Now we are guiding with an inflation of -€50 million. This is composed by 3 major elements: labour cost, energy, and transport and logistic costs.
Consider the current oil scenario, the current oil scenario is not impacting positively, only in raw material costs, but also in energy, in transport costs, international transport and local cost. And in term of labour cost, we acted with negotiation by reducing what was our initial assumption of increase of inflation. So practically, this is impacting positively versus the initial assumption by €20 million. It's improving, for this reason, the production cost.

Gabriel Adler – Citi Analyst

Could I just follow-up on the inventory question? I was more referring to inventory levels in the dealer network. And any comment on the dealer network inventories would be helpful.

Andrea Casaluci – General Manager Operations

Sorry, the question is related to the trade stock level. Okay. I answered on our stock position. So trade stock level. In Europe, after 1Q, the stocking is now at the normal level for the season. While in North America, in the trade, the stock position is still higher than our target. And so we plan to reduce the stock position also in the trade during 2Q.

Thomas Besson – Kepler Cheuvreux Analyst

I have a few questions as well. Can I please start with a simple one? Can you remind us how much China accounts for your ≥18" business, please, in OEM replacement?

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

China accounts for 12% of our sales.

Thomas Besson – Kepler Cheuvreux Analyst

Another question on the volumes, please. You had a bigger volume decline than most of your competitors. Mission accomplished. But your drop-through on volumes was only 42%, while it was, for instance, 45% last year. Can you explain how you managed to reduce the drop-through despite the increase in volumes, which normally tends to increase drop-through?

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

We guided for a 42% of drop for your concern on volumes. ~50% for your concern on price/mix, ~15% for Forex. The drop-through on volumes, 42%, is in line versus last year.

Thomas Besson – Kepler Cheuvreux Analyst

Okay. Can you comment on industry pricing in March and April? And what you assume for the rest of the year in the ≥18" business, knowing that everybody in the industry now has excess capacity? Do you expect the industry pricing to remain as disciplined as possible? Or do you anticipate that pricing will become more complex?

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

No. I have to say that we see a price resilience. We don't see any price erosion in the industry. I think there was an erosion last year, and now we see that the price discipline doesn't have signs of weakening.

Thomas Besson – Kepler Cheuvreux Analyst

Okay. Last question, please. In 1Q, you explained that geographic mix and the willingness to cut inventories explain your underperformance in Replacement in ≥18". Can you confirm that you are now happy with inventories? And that 2Q, 3Q, we should see clearly ≥18" in Replacement perform at least as well as the market, please?

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

No. In sell-in, as we mentioned before, we destock, and so the sell-out was in line with our market share, but we reduce the sell-in just to reduce the stock in the market. Now we see a situation that we remain flattish looking forward. At the end of the year, we will have a total effect of destocking. We target ~€2 million in destocking by year-end.

Jose Asumendi – J.P. Morgan Analyst

I was just wondering if you could give more details behind the Covid Actions on Slide #11, especially a little bit more around manufacturing and SG&A. And the timing of those gross benefits, what do you think we will see the bigger benefit coming? Is it between 2Q and 4Q? Which quarter roughly do you think we will have the biggest benefits? That's the first thing. And second, I know you commented on CapEx and you've cut the guidance for the full year. How far can you bring CapEx down in 2Q? That's the second question.

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

On CapEx, in 2Q, we should have half of what we had in 1Q. So considering the €130 million for the FY, we expect ~€27 million, ~€28 million of CapEx in 2Q.
And Mr. Casaluci, for the other questions.

Andrea Casaluci – General Manager Operations

Yes. The net impact, that benefit of the 2 actions on cost competitiveness and Covid is expected to be 60% in 2H and 40% in 1H as net impact. Why is less? Because the negative impact of the slowdown is affecting mainly 2Q.

Gianluca Bertuzzo – Intermonte Analyst

Just a quick question is on the guidance. During the opening remarks, you said that you are more confident on the low end of the guidance. I wanted just a confirmation. If this means that you're looking for revenues of €4.3 billion and an adjusted EBIT margin of ~14%. This is just my only question for today.

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

Yes, we confirm the low end. That is around the figures that you are considering as realistic. We consider realistic to stay in the low end of the range.

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

So thank for attending this, let's say, unusual meeting.