

Pirelli & C. S.p.A. 1Q 2022 results conference call transcript

May 10th, 2022

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

Good evening, Ladies and Gentlemen.

The first three months of 2022 were characterised by a growing volatility of the macro scenario, exacerbated by the recent geopolitical tensions and the new lockdown in China.

Despite this volatility, Pirelli closed 1Q with a clear improvement of its results year-on-year, which rank among the best in the Industry.

For 2022, we expect a positive scenario, however characterised by a slowdown in economic growth.

- the war in Ukraine and the sanctions imposed on Russia pushed energy and raw material prices up
- the new COVID outbreaks in China are an additional element of uncertainty, with an impact on economic activity and consumption

As a result, the expectations on Car Tyre demand are more cautious, especially for the Standard segment. On the other hand, High Value confirms its resilience, with a growth rate 7 times higher than that of $\leq 17''$, despite the prices hikes to offset the increase in input costs.

In this scenario, Pirelli responded promptly, by acting on all its levers to mitigate the impact of growing headwinds.

We are implementing further actions to improve profitability, with an adj. EBIT margin cautiously expected at 15%, in consideration of the impact of the war in Ukraine and demand slowdown in China.

Deleverage target is confirmed, with a Net Cash Flow generation expected to be €450 million.

Finally just a few words on our commitment to fight climate change.

Having reached the greenhouse gas reduction target set for our plants in 2025 already in 2021, we asked to Science Based Targets Initiative, the international body that defines and promotes best practices in this area, to validate new upgraded targets in line with the 1.5°C scenario, versus the previous target scenario "well below 2°C", and we obtained SBTi validation.

The 2025 targets are:

- reduction of absolute greenhouse gas emissions of 42% compared with 2015 (-25% the previous target)
- 9% reduction of those from raw materials purchased compared with 2018 (confirmed)

Since March we have put in place a set of measures to mitigate the impact of lockdown in China and of the Ukraine war.

Before reviewing Pirelli performance in the first three months of the year, I would like to spend a few words on our operations in Russia and on the measures taken by Pirelli.

I remind you that in 2021 Russia accounted for 3% of Sales and 11% of the Group's Car capacity, mainly Standard and half of which for export.

Pirelli is against war and we are supporting the Ukrainian people with a donation of €500,000 and raising funds among our employees ending on May 13th.

Pirelli operates in full compliance of the international sanctions, which are banning the imports of finished products from Russia to Europe and the export from Europe to Russia of some raw materials (chemical polymers), from 2H.

In this context:

- We identified alternative supplies, both for exports from the country (with the gradual activation of supply from Turkey and Romania) and imports of raw materials (mainly Russian suppliers)
- We diversified our logistics, to ensure continuity in the supply of finished products and raw materials
- local production will be addressed to the domestic market
- to guarantee financial support for our operations, we opened a new credit facility with a local bank

Looking at Pirelli financial results: Pirelli closes 1Q 2022 with a solid economic and financial performance:

- the Top Line growth (+22.2% YoY) was supported by the price/mix and by the strengthening of High Value, now accounting for 74% of the Group's revenues
- improved profitability, with a 15.0% adjusted EBIT margin, supported by internal levers
- Net Income was €110 million, 2.6 times that of 1Q'21
- Net Cash absorption (-€673 million) in line with the levels of 1Q'21, reflecting the business seasonality; the Net Financial Position stands therefore at €3.58 billion

I now leave the floor to Mr. Casaluci.

Andrea Casaluci – General Manager Operations

Thank you, Mr. Tronchetti, and good evening everybody. Let us analyze both the market dynamics and Pirelli's performance.

In the first 3 months of 2022, the Global Car tyre demand increased by +1%, with a very different trend by channel and segment.

O.E. market (-5% YoY) discounted the impact of supply shortages (and in particular semiconductors); more in details:

- Standard saw a -7% decrease YoY, also affected by the stop of production in Russia from main OEMs
 - High Value was flat, as OEMs keep prioritizing high-end models in a volatile scenario
- Pirelli reduced the exposure to O.E. Standard and in general to less profitable products, focusing on ≥19" and EVs.

Replacement demand has been solid (+3% YoY), almost close to pre-COVID levels, supported by the recovery in mobility:

- ≥ 18 " grew +14% YoY, as demand for high-end products remains sound, despite the increase in prices
- ≤ 17 " saw a minor improvement YoY

Pirelli outperformed the Repl. market in both segments by over 2 points. The solid performance across main Regions was driven by our pull-through High Value volumes and new product launches.

The results of 1Q 2022 reflect the implementation of the "Key Programs" of the Industrial Plan.

In the Commercial Program:

Consistently with our strategy,

- We strengthened our positioning in the Car segment ≥ 18 " and outperformed the market
- We increased our exposure to O.E. ≥ 19 " (now reaching 75% of O.E. in the Car ≥ 18 " segment, +3pp YoY) and EVs
- We reduced our exposure to the Standard segment, which accounted for 40% of Car volumes in 1Q

In the Innovation Program

- We collected ~90 technical homologations, 27% of the yearly target, especially in the ≥ 19 " (~90%) and Specialties (~30%)
- We introduced 2 new lines dedicated to the SUV segment, in particular for Electric and Hybrid Vehicles

In the Competitiveness Program: Phase 2 of the efficiencies plan continues, having reached 20% of the yearly target, in line with the seasonality of our programs.

In the Operations Program: plant saturation increased further to over 90%. In addition, Cycling production started in the Bollate plant in Italy.

Our volume results in 1Q are consistent with the strong focus of the Commercial Program on the top of the range and the selectivity in the O.E.

In Car ≥ 18 ", a +8% growth was recorded, driven by the most technological and highest range products, namely:

- the rim sizes ≥ 19 " contribute 81% of the growth observed in the Car ≥ 18 "
- the Specialties account for over 65% of the volume increase in the ≥ 18 " segment in 1Q, mainly due to EV products, which account for 48% of the volume increase in the ≥ 18 " segment

The Replacement ≥ 18 " is the driver of this growth:

- both in the «Pull» volumes, especially Europe and North America and EV products
- and in the «Push» volumes, where the new lines dedicated to this channel show very good results in the three High Value Regions

On the other hand, in the Original Equipment ≥ 18 ", the growing selectivity of O.E. projects led to volumes almost in line with the previous year, with a higher incidence of EV products.

Pirelli Innovation Program proceeded in 1Q 2022 with the renewal of the Scorpion range, a product dedicated to Sport Utility Vehicles (SUVs) and expanded to meet the specific requirements for the different seasons.

The renewed Scorpion line combines low consumption and a high mileage with excellent braking performance, also thanks to the new reinforced tread certified with the prestigious TÜV SÜD «performance mark».

The Scorpion family is particularly addressed to «green» vehicles which amount to ~50% of the homologation target. This trend started with the previous generation of tyres and continues with these new products.

Let's see some more details of the new Scorpion range, built to the latest Pirelli technologies that provide further efficiency and sustainability improvements, with:

- excellent grip in dry and wet conditions, consistently with Pirelli DNA, and low rolling resistance; results are certified by the European A-B labels
- exceptionally quiet, with up to 3 decibel less noise than in the previous generation
- much attention was devoted to the wear rate to achieve a higher mileage and therefore decrease tyre waste disposal, as well as to lower particle emissions, now down 25% compared with the previous generation

Pirelli innovation stands out especially in the EV segment. The rich EV portfolio includes as many as ~250 homologations with the most innovative and well-known brands in the world.

This positioning is unique in the Industry, as evidenced by the wide portfolio of EV marked products, where Pirelli offering is ~2.5 times wider than its competitors' average.

This success was also consolidated by the prizes recently received, like “that of best technological innovation of 2021”, awarded to Pirelli Elect by the Spanish Tyre and Auto Parts Industry.

The EV segment is confirmed as the one with the fastest growth with Pirelli aiming at:

- almost doubling its sales in this segment, and
- reaching already in 2022, that is to say three years in advance, its market share target for top-of-the-range EVs, equal to ~1.5 times that for Premium and Prestige Internal Combustion Engine

In 1Q, the Competitiveness Program has achieved €29 million of efficiencies, in line with expectations and equal to ~20% of the yearly target, which is confirmed to be €150 million.

Looking closely at 1Q performance by the single projects:

- in the Product cost project, which accounts for ~32% of efficiencies, the adoption of a modular and value-driven approach is proceeding,
- in the Manufacturing project (~24% of the quarterly efficiencies), we continued increasing plant flexibility, digitisation and sustainability,
- in the SG&A project (~24% of the quarterly targets), we achieved efficiencies by using different levers, like redesigning our distribution networks, optimising warehouse use and renegotiating with our suppliers
- finally, in the Organization project (~19% of the quarterly efficiencies), we went on digitising processes and upskilling our colleagues

I now give the floor to Mr. Bocchio.

Fabio Bocchio – Senior Vice President Strategic Planning & Controlling

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

Let us review the Top Line dynamics of 1Q:

- volumes decreased slightly (-1.4% at Group level); they discounted a different trend between the High Value and Standard segments, both in the Car and the Moto businesses:
 - High Value volumes are improving (+5.8% from 1Q'21) especially supported by the market share gain in Car Replacement $\geq 18"$, with a +16% volume growth, showing an improvement compared with 4Q'21, despite the price hikes
 - Standard volumes are going down -9.7%, under the impact of a greater selectivity in Car O.E., the Russia-Ukraine crisis and Gravatai closure (Standard Moto plant in Brazil) in 3Q'21
- the price/mix reached a record level (+20.4%), due to:
 - Price increases, especially in the Replacement channel in all major countries, to compensate for the increasing inflation rate of raw materials and costs (e.g., energy / transportation)
 - Mix improvement in all its components: Product (migration from Standard to High Value), Channel (better trend of Replacement vs. O.E.) and Region (sales increase in Europe and N. America)

Also positive the impact of Forex (€40 million, or 3.2%), reflecting the revaluation of the major currencies against the euro.

In 1Q 2022, the adjusted EBIT was €229 million, posting a 35% year-on-year growth, with a 15.0% margin, compared with the 13.6% of 1Q 2021.

Internal levers, price/mix and efficiencies, more than offset the negative external scenario (raw materials and inflation). In particular, the trend reflects:

- the positive impact of the price/mix (+€206 million), which more than compensated for raw material cost increase (-€120 million, including the related exchange rate impact), input cost inflation (-€53 million) and volume decrease (-€7 million)
- the contribution from Phase 2 of the Competitiveness Program, which generated structural efficiencies of €29 million, accounting for 20% of the yearly target, in line with projects seasonality
- the positive effect of Forex (€6 million)
- the flat balance between the reduction of other costs (€4.3 million) and the increase of amortizations (-€4.8 million)

Let us look at the Net Income dynamics for the quarter.

Net Income strongly increased YoY. The trend takes into account:

- the already mentioned improvement in the operating performance
- lower restructuring and non-recurring costs

Net Financial Charges for the first 3 months of 2022 are quite in line with previous' year quarter, despite the general progressive increase in interest rates, which we will discuss in a couple of slides.

The €25 million increase in tax charges relates to the higher operating results we just discussed, as tax rate is stable at ~27%.

Net Income adjusted, i.e. excluding all the one-offs and non-recurring items, is positive for €136 million at the end of March.

The Net Cash Flow in the first three months was -€673 million, in line with the business seasonality and the value in the same period of 2021. This result benefits from:

- the above mentioned improvement of the operating performance
- lower investments, also due to a different timing in the project implementation in 2022, and mainly attributable to a geographic reallocation of investments themselves, as a consequence of the changed external scenario
- the usual seasonality of the working capital, which experienced a greater absorption than in 1Q'21, due to:
 - an inventory increase, mainly attributable to raw material stock, aimed at mitigating supply chain risks in an extremely volatile macroeconomic context
 - a greater absorption related to trade payables, attributable to both the spot measures taken in the quarter to tactically guarantee some raw materials supplies to the Group, and the dynamics of investment-related payables, which in 1Q'21 benefitted from the low level of investments made in 4Q'20

Pirelli's Gross Debt as of March 31st amounts to ~€5 billion, whereas its Net Financial Position, excluding €1.4 billion of financial assets, is ~€3.6 billion.

Among the most relevant actions in 1Q, Pirelli:

- obtained an Investment Grade rating (BBB- with stable outlook) from two of the most important international agencies, Standard & Poors and Fitch, and
- opened a new banking line in pool, committed, from €1.6 billion in 5 years, parametrised to the Group's sustainability objectives; this new line does not have any financial covenant due to the public rating obtained

The Group's debt profile is now well balanced, with back-loaded deadlines. The Group's liquidity margin, of ~€2 billion, allows therefore to cover debt deadlines until February 2024.

The liquidity margin, the deadline profile and the rating obtained, will allow the Group to deal with markets, even if volatile, in the best conditions.

Finally, the cost of debt as of March 31st is equal to 2.47%, with a 9 basis points increase due to the general increase in interest rates, especially in Brazil and Russia.

And now I leave the floor back to Mr. Tronchetti.

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

Thank you, Mr Bocchio.

We are now going to review how we changed our assumptions on 2022 in the light of the recent events.

The outlook for 2022 remains positive, although definitely slowing down compared with the estimates made early this year.

The war in Ukraine and the sanctions imposed on Russia pushed energy and raw material prices up, exacerbating the inflationary tensions already recorded from the start of the year.

COVID outbreaks in China are a further element of uncertainty, with an impact on the local economic activity and global supply chains still under pressure.

Global GDP is now expected to grow by +3.2% in a context still characterised by a high volatility. The outlook of growth in the major European economies appears weakened, as these depend on Russia to meet their energy needs.

The outlook for the U.S. economy is also more conservative. In the U.S., various increases of interest rates are expected during the year, to fight the inflation rate which reached its peak since 1995.

Talking about inflation, in 2022 we expect an even more marked increase in the price of the major production factors, however offset by price/mix and efficiencies.

The increasing raw materials headwind is mainly driven by higher oil prices, whose quotations, after reaching a peak of \$127 per barrel in early March, are expected to go down to an average price of \$104 per barrel in FY'22. As for raw materials, I remind you that Pirelli entered price indexation clauses with OEMs for over 72% of the production of O.E.

Actions on prices and efficiencies are speeding up to cope with the growing energy cost. Namely:

- the reduction of consumption and the acceleration on renewable sources in our plants
- the implementation of hedging contracts to protect against too strong price fluctuations

As for shipping, large ports remain jammed, with strong impacts on long sea routes. Pirelli appears to be less exposed than many other players thanks to its local-for-local production which is close to 85%, with the exception of the North American market served by our plants in Mexico and Europe.

Let's now move to the outlook for the tyre market:

- the Supply Chain issues, exacerbated by the war in Ukraine, and
- slowdown of demand in China

led us to adjust our expectations for the Car Tyre market in 2022.

We foresee a slight market growth: +0.5% YoY against the +3% of the previous guidance, where:

- O.E. remains flat year-on-year (+6% our previous guidance), in line with Car production, and
- Replacement grows a little: +1% (against the +2% of February) discounting the demand slowdown in China.

Car $\geq 18''$ is confirmed as the most resilient segment with the highest growth, ~7 times that of the Standard (~4x the overperformance expected in February).

For O.E. $\geq 18''$, we estimate a +7% growth, slightly lower than in the previous forecasts (+9%) due to the strong decline of demand in Europe in 1Q (-15%) caused by the chip shortage, which is going to be almost recovered in 2H.

For Replacement, the growth trend is basically confirmed for the $\geq 18''$ segment in spite of price increases. China's demand slowdown caused by the lockdown measures will be compensated for by a better trend of sales in other Regions, especially in North America.

We prefer to keep cautious about China (-6% total Car in FY'22; -3% in Car $\geq 18''$) after the strong decline recorded in the market in March (Repl. -23%) which will continue in 2Q. This situation is expected to improve in the second half of the year. Demand will recover in the period, driven by O.E. and high-end products. In this context, Pirelli confirms its leadership in High Value, with a market share gain in Replacement supported by product innovation and the consolidation across our major distribution partners.

The evolution of the macro scenario and market led us to adjust our Full Year 2022 targets:

- Revenues between $\sim\text{€}5.9$ and $\sim\text{€}6.0$ billion, growing from +10% to +12% YoY, driven:
 - mainly by price increases in an inflationary scenario, and a further improvement of the mix
 - by Volumes, growing between +0.5% and +1.5%, consistently with our strategy to strengthen Car Replacement $\geq 18''$, greater selectivity in O.E. and lower exposure to Standard
 - Exchange rates are going to be stable: we cautiously assume a greater volatility of the currencies of emerging countries in the second half of the year
- Profitability (adj. EBIT margin) is expected to be $\sim 15\%$, which cautiously considers the impact of the war in Ukraine and demand slowdown in China.

We confirm the solidity of our internal levers, with the price/mix and efficiencies capable of more than offsetting the impact of raw materials and inflation headwinds.

More specifically, the difference between the current guidance mid-point ($\text{€}880$ million) and that of the previous guidance ($\text{€}917$ million) is attributable to:

- on the one side, the Russia-Ukraine crisis. We confirm the sensitivity indicated in February (adj. EBIT at $\text{€}890$ million) with an impact on adj. EBIT of $\sim\text{€}27$ million for the lower plant saturation, also due to the ban on import from Russia to Europe from 2H, higher transportation costs, different allocation mix and supplier diversification;
 - on the other, demand slowdown in China is partially offset by the better trend in North and South America
- We are putting in place new actions to compensate those headwinds (Russia-Ukraine conflict, China slowdown), working on internal levers - mainly prices - in markets where demand is more solid (Europe and N. America), but also cost rationalization
 - CapEx at $\sim\text{€}390$ million is confirmed: the suspended investments in Russia are going to be diverted to other low cost plants, mainly Romania and Mexico
 - Net Cash generation before dividends at $\sim\text{€}450$ million, in line with the guidance of February, where the lower operating performance is offset by lower taxes and a slight improvement of the working capital.
 - the deleverage target is confirmed, with Net Debt on adj. EBITDA $\leq 2x$

This ends our presentation. We may open the Q&A session.

Questions & Answers

Giulio Pescatore – BNP Paribas Exane Analyst

The first one on the guidance you define the 15% margin target as cautious in your earlier remarks. And you said you pointed to China, for example, is one of the things which are cautious on, but I was just wondering if you can outline what other cautious assumptions are you currently incorporating in this target?

And then the second question is more on the pricing/mix side. Can you maybe help us understand how much of the 1Q price/mix was price, and how much was mix? How much are you currently assuming for price and mix at the full year stage? If you can give us an indication of that. And can you remind us of what is the drop-through of mix of that pricing?

And then a last one on Russia. Well, I understand that you have responsibility towards your employees in the market, but have you consider potentially selling the assets? I mean it's shutting it down wouldn't be fair for your employees in the region.

Have you considered spinning it off or selling these assets? Thank you.

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

We consider that should recover in the second half of the year. So we expect the situation of the lockdown continue until end of June. That is what we cautiously believe and obviously we have to see which will be the development before mid-May where these restrictions should be revised.

The second element is obviously the strength of demand that until now is good, and stocks in the trade are still lower than where they were in 2019. So the situation is still good both in US, Europe, and also obviously, in China. That is the general situation why we are cautious.

We experienced that in our segment, the price increase went well until now, so we expect it to continue. But obviously, it depends on the global demand.

On Russia we continue what we've already announced. So slowing down and reducing down to zero the export to Europe, remaining as we did in other countries, we did it in in Venezuela in very bad times, just to continue to pay wages and salaries and social protection to our workers and employees. On price/mix, I leave the floor to Mr. Casaluci.

Andrea Casaluci – General Manager Operations

Try to give a bit more colour on the price/mix. The performance of the first quarter was at +20.4%, out of which more or less half is related to pure price effect. On the full-year basis, we project today from 10% to 11%, out of which most will be price (roughly 80%). So we expect to move from a +10% of the 1Q into a +8% of the full year.

Here was probably the results of consciousness that is part of our numbers. In 2021 we started with the price increase process from May, June on, so the comparison versus last year on the price will be less favourable. Nevertheless, if the demand will remain as sound as it is today, especially in Europe and North America, we see opportunities to improve these performance even more.

As far as the mix is concerned, we had very good performance in 1Q, also driven by the channel mix, so the slowdown of the O.E., while we do expect a recovery during 2H, because of the recovery of the supply, mainly on Semi-conductor.

This is the reason why you see a lower performance in terms of mix in the second part of the year versus the first quarter. Thank you.

Giulio Pescatore – BNP Paribas Exane Analyst

Just to follow up on mix, what is the normal drop-through of mix on the EBIT?

Andrea Casaluci – General Manager Operations

65% the average mix drop through.

Gabriel Adler – Citi Analyst

I'd like to start with price/mix again.

Could you maybe help us understand how you will manage the business as and when raw material prices begin to soften? So do you think that you could maintain price at high levels if raw mats. begin to come down?

My second question is on the High Value / Standard mix. How much further you think you can push the High Value with your current production capacity?

Lastly, I just wanted to come back to Russia. I know you had a question already, but I think it's important to have some clarity on the longer-term plan. Are there any circumstances where you would fully withdraw from Russia? Or is this just another option that you're considering the environment?

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

Starting with the second question. On Russia obviously nobody knows what is going to happen. What we consider is to stay only in the local market. We have no problem on our assets because all the lines are in rubles. So it is isolated the self-sustaining and that is what we are targeting looking forward. So nothing more than this. Please Mr Casaluci.

Andrea Casaluci – General Manager Operations

So I confirm the reason in this moment in the market, the very high level of price discipline. The stock level in the trade is still below the normal level in Europe and North America, so we don't see major issues for the foreseeable future in applying the price increase in the replacement channel related to the installation of the input cost. While in the O.E., we have 72% of the business, which is related to the cost matrix approach. So when the price increase, it comes automatically with the inflation of the input costs.

As far as the expectation of growth in the High Value, yes we confirm, this is the most resilient segment. And every time we've faced the crisis or a volatility in the external environment, we saw the higher resilience of the High Value. This is also demonstrated by the decision of the carmakers to always protect the high value segment in an environment of shortages of parts, so we are very positive on the future demand of the High Value.

Monica Bosio – Intesa San Paolo Analyst

The first one is just to check. In the first quarter, the Group more than covered the raw material cost and inflation in other inputs. Do you expect these could happen in each of the remaining quarters? Or there will be a quarter more challenging on side way, what the group maybe will not be able to cover?

And the second is on China. Can you elaborate a bit more on the expected growth of the Group in High Value in China? Because I have seen that the market is still down at -3% for tyres $\geq 18''$ and I was just wondering if you can elaborate a little bit more and give us the highlight on the market share gains that you expect to get both in China and elsewhere.

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

Thank you. First, on price mix looking forward and obviously inflation cost, we see that the demand is still positive, even in the coming months, so we have visibility for the second quarter and the beginning of the third. And we see stocks remaining at a level that is below what we saw in the previous years and that's why we are positive and we believe we can continue the same trend for the coming quarters.

On the other question I leave the floor to Mr Casaluci.

Andrea Casaluci – General Manager Operations

As far as the Chinese market, you are right. First, the first quarter was pretty good with a $\geq 18''$ market demand positive at 3.3%, and Pirelli overperforming the market, mainly in the Replacement.

We do expect a negative second quarter fully affected by these slowdown, and this slowdown is affecting the mobility in all the Tier 1 cities involved by the restriction, so we do expect that this will affect the $\geq 18''$ as well, of course. Our expectation for the total tyre market in China in the second quarter is, let me say, it's difficult to have a clear understanding of all the impacts, but today we estimate market down 20%, more or less affecting both channels, replacement and O.E., in the same way.

While if we move to the market outlook of the full year, all in all, we still maintain a positive outlook for the second half of the year with a ≥ 18 " demand at +3% to +4%, with replacement over-performing the O.E.

Pirelli is targeting to over-perform the market in both channels. O.E. because of the enlargement of the customer base mainly driven by EV producers like Tesla that is growing very fast in China or NIO the newcomers, local producers and over-performing the replacement, at least of a couple of percentage point, thanks to the pull-through effect and the large element of our retail network.

Martino De Ambroggi – Equita SIM Analyst

The first question is on Russia. I don't know if you can elaborate a bit more on how you plan to substitute the Russian capacity with the Turkish or the Romanian plant, whether it means maybe the risk of lower profitability because of transportation cost, the production cost and so on, and what the output capacity utilization nowadays in the alternative plans that we are planning to use?

The second question is probably connected to the answer to the first question, because Mr. Bocchio during your remarks, you talked about CapEx with a different geographic reallocation. They were very low in 1Q. So trying to understand where this geographic reallocation is acting.

And frankly I thought the €390 million for the full year could have been lowered for this year because what is surprisingly me, the third question, is the €450 million free cash flow, knowing that lower profitability, higher working capital because the cost on average are growing every day, and you are confirming CapEx, so, just to understand, how do you elaborate these moving parts?

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

Thank you for the question. First I answer your last question. The priority is the cash flow production, so working capital, investments, everything will be done in line with this target. The €390 million capex can remain or can also be reduced in case there would be a slowdown somewhere. We have a flexibility that accounts for 1/3 of these investments. And so, we don't see now any reason to reduce it, but we are ready to do it to preserve our cash flow.

On Russia, it's obvious that there is a cost in these months to move capacity out of Russia and to create capacity in other countries, mostly in Romania and Turkey, which means investment, that's one of the reason why we foresee €390 million remain as they are forecasted to be. There is also some investments in Mexico to improve capacity where we have good opportunities in the United States. So this is the picture we see today, but keeping in mind that cash flow is the most important driver to stick to.

On Russia, internal market remains good for the local sales, so we have factories working now in normal condition and we have a very low cost in Russia. So even if there is a slowdown, we don't see major impacts coming from this slowdown. There is obviously a reduction, a temporary reduction of profitability on standard because of the cost that you mentioned, but we are quite confident that we are back soon with the double-digit we have as a target.

Andrea Casaluci – General Manager Operations

Just to reinforce with few numbers, today the export from Russia, more or less 50% of the production, it goes in Europe for 3.5 million tyres, half million is going to other countries not affected by the ban of the export. The volumes to Europe will be recovered with a higher level of production in Europe in the low-cost countries like Turkey or Romania and reducing the export from Europe to Asia-Pacific and to North America, taking advantage of the free capacity we have in China today for Asia-Pacific and setting new investment of capacity increase in North America. And this is the reason why for the time being we confirm the €390 million capex target.

Martino De Ambroggi – Equita SIM Analyst

Thank you. If I may, just a very quick follow-up on price/mix. Could you provide the split between the price mix in High Value and Standard?

Andrea Casaluci – General Manager Operations

Yes, more or less is 17%, 18% on the High Value and 22% on the Standard.

Akshat Kacker– J.P. Morgan Analyst

Two questions from me please. The first one just on cost inflation, you mentioned that raw material, energy and other inflation elements was 11% on sales headwind in 1Q. How do you expect this to evolve in the coming quarters or the full-year please?

And the second one is on M&A, if I can ask that the key winter tire competitor of yours is facing operational difficulties in the current situation. Do you think this could be an opportunity for you to look at the asset or is this off the table for you?

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

The second question, we don't have evidence that there are transaction on assets of competitors now. So we don't have anything in mind, and we don't see anything on the table. I'll leave the floor to Mr. Casaluci for the other question.

Andrea Casaluci – General Manager Operations

Yes. Now the impact of the inflation on the input cost is more or less balanced. And that's the reason why you see the full compensation on the price with the price/mix of all the inflation in input cost, keeping this from 8% to 10% of price increase along the year.

We don't see for the foreseeable future major impact. We consider the actual input costs are more or less stabilize. Clearly we monitor on a daily basis the market trends in the future, and we will react as soon as possible with hedging always price increase into the market.

Philipp Konig – Goldman Sachs Analyst

My first question is just following up on raw materials and inflation. I think on the full year call, you mentioned that you were expecting around 7% of sales as a headwind for this year. I'd be curious sort of what your latest estimate will be at this points?

My second question is on your plant in Mexico. You were mentioning that you're expanding your capacity that to serve North America. Can you provide us with a number of how many more units you're expecting capacity for this year?

And then my last question is just on raw material sourcing. You had mentioned that obviously there also costs associated with moving raw materials that use to source from Russia to other regions. Can you just provide us with an update? Have you already resourced from Russia or when you're expecting to buy the raw materials that you used to buy from the region? When do you think that is completed? And where will you buy them from?

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

Starting with the last question, raw materials and Russia. We already a move to a different, let's say, raw material. We are substituting some derivatives of butadiene, with treated natural rubber obtaining the same result, plus we are buying Mostly Japan, some of the products and we don't need to go back to Russia - we have only few raw materials from Russia. We don't have carbon black and they are already substituted by other sources in line with the quality.

On Mexico we don't have any growth this year. We are investing for next year and we are serving today the market from Mexico and Brazil. We have need of more capacity for the internal market in Brazil, and it's more convenient to have a Mexican source for US and that's why we are planning to invest this year for next year.

I leave the floor to Mr Casaluci for the other questions.

Andrea Casaluci – General Manager Operations

The other question was related to the impact of the inflations on net sales as far as understood. we consider the 12% on 2021 net sales, 12% of all the inflation impact, including raw material, logistics, energy and labor, all together.

Thomas Besson – Kepler Cheuvreux Analyst

First on price/mix, we've seen the industry re-raising prices at the amazing pace. I think it's with that your or others have reached higher levels of price/mix than in 2011, 2012. And you have continued to

raise prices in 2Q. So the question is, do you expect price/mix to go even higher in 2Q or have we seen the peak already?

Question two, could you please give us the book value of your Russian operations? Maybe a more abrupt way of asking the questions, if at one point distribution becomes untenable, what would eventually be the potential write-down?

And the third question still on Russia. Could you explain how you managed to source natural rubber in Russia and how you handle transportation logistics and so on? Because from what we hear from other players, nobody else seems to be operating normally in Russia, even for the local market or at least if people operate normally now, it's going to be over as of July 6.

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

We have created a task force that has been taking care of transportation and we are having obstacles obviously, but we are replacing quite easily the source Russia, because these are Standard products what we used to sell from Russia. So we have some capacity. We are adding some capacity, as I was saying before, mainly to in Romania and Turkey.

We have problems, as everybody has, that's why we also mentioned that we have, for the time being, Standard profitability that is in the high digit- close to 10% but not reaching temporary the double-digit. And with a sources we are setting that are also local sources. We go back soon to that profitability. But this is something that in few months will be solved. The Internal market we are serving in a normal way. There are no restrictions until we are independent in raw materials because we buy most of raw materials in Russia for Russia. So for the time being is not a major reason. I think this is mostly because it is Standard what we have to replace.

You mentioned the price/mix, we see the same trend we had in the first quarter if the demand remains as it is. So in our segment - in the High Value segment, the demand we see for the next 3, 4 months continue to be strong enough to guarantee a policy of price, that is fine. The mix is also related to replacement that is stronger than O.E. and that trends we continue for some months. So we don't see major changes coming up.

Thomas Besson – Kepler Cheuvreux Analyst

Sorry, maybe I missed it, did you mentioned the book value of your Russian operation or you're not disclosing that?

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

I think I've said enough. So the position in Russia is set for the local market. It takes few months to set it properly. We handle these problems in other countries. I mentioned before, Venezuela, it happened in Argentina many years ago. We stay there until there is a market, and we have employees in regions that are poor regions and we work in internal market. It takes some months to stabilize the situation. But the local market was a little part of our easily sold part of our business and we can grow a bit, and

there is nothing hidden just as I was saying, is a situation of crisis as we had in other countries and we are handling.

Edoardo Spina – HSBC Analyst

My question is on China, you have very strong operations there and I was wondering if you can give us an update about the current state of production and also logistics. If you have any problems or if you see of disruptions to come?

And finally, on the sales level, I assume miles driven are pretty low in many regions in China. Do you see any improvements at the moment and what do you assume for the second half in your guidance?

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

So what we expect until now is that by mid-May some decision will be taken to open up. So we really don't know what is going to happen. What we know is that the economy in China is suffering because of it and it's much more important in our business.

I think that this problem will be handled in a way that the situation of lockdown will improve and we know that the demand is there, but it's only the people are locked down. So the problem is in the hands of politicians but is not Pirelli problem. This is the Chinese problem, which involves obviously the global economy. And hopefully, as they say in a few weeks, the situation should be eased. But we don't have any information more than what we read in the newspaper.

Andrea Casaluci – General Manager Operations

Yes I can only confirm that the operations in China are running. Our factories are in Shandong and in Henan province, not affected by the restriction for the time being. We have a slowdown in the 2Q of course, of production related to this slowdown of the local demand.

As far as supply base is concerned. We have suppliers that are providing goods for the local factories, while we have a backup plan to be fully independent from China in the other factories in terms of supply. So that's the picture for is a bit of dissolved in the harbours, you are right, but this is affecting as Mr. Tronchetti was saying the global environment, we are managing it.

Gianluca Bertuzzo - Intermonte SIM Analyst

I know maybe it is hard to tell, but how do you expect the you and the industry will behave in the case of raw material prices will go down or this is unlikely as you don't expect raw material to come down?

Second question is on competition, I would like to better understand because you cited that the surge in shipping cost is keeping away some competitors. Can you elaborate a bit on that?

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

So as far as shipping cost is concerned, what Mr. Casaluci was underlying is that we have our production that is 85% local for local. In China, it's even more than this. And we don't have export from China to other region if not Asia and that's why we are less involved in the problems of logistics. And all the other regions are local for local now. Russia is becoming under 100% local for local; Europe is local for local and some to the United States. So the only exception is that one.

On our raw materials. But if they go down to normal. That's fine. So it happened in the past and can happen in the future. And when we have an inflationary environment, what we do is always to set the prices to protect obviously from the inflation and when the cycle changes or specific situation changes, we will do as in the past, whatever is related to keep the same shape of growth of our company the same business model. Nothing can be predicted 100%, but we know that we have the flexibility to cope of the different situations.

Michael Shawn Jacks – Bank of America Analyst

Two questions, the first one is just going back on volumes. I know there are a lot of moving parts here, but the impact of Russia lower global light vehicle production. China lockdowns on their own, I would imagine account for around a 4% negative volume impact for the year, which in light of your new volume estimate being only 1% lower suggests that your expectations in the High Value replacement segments in North America and Europe are well ahead of what your initial plan was. So would you say then that the new volume guide is more on the optimistic side of the spectrum?

And in the second question is, again, this is going back on price/mix. Unless this drops off quite significantly in 2Q already, the full year guide doesn't seem to be factoring much in for 2H despite the fact that you've announced another price increase of up to around 10% in North America effective in June. Does this mean perhaps that you expect a negative mix impact in 2H?

Andrea Casaluci – General Manager Operations

Yes. As far as volume is concerned, the first question we have already included in our guidance the hypothesis of slowdown of the demand in China, at least for the entire second quarter, and some prudence for the third quarter, but is not forecastable the trend of demand in China.

All the other regions are much more stable and we feel confident with this number. Price/mix, you are right, we announced yesterday further price list increase in United States up to 10% and this is part of the opportunity that we have in our price/mix and is part of what we mentioned is the consciousness. Again we have, we see opportunities on the price mix. We see major risk not predictable in the demand of China. These are the two major aspects.

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

Thank you. So ladies and gentlemen, this will conclude today's program. Thank you for your attendance, and have a good evening.