

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

August 4th, 2022

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

Good evening, ladies and gentlemen,

The first six months of the year were characterized by a growing volatility of the macroeconomic scenario, worsened by the China lockdown measures, the Russia-Ukraine conflict, and the rising inflation rate.

Despite these headwinds, Pirelli closed the first half with a clear year-on-year improvement and ranks among the best in the industry, confirming the effectiveness of our business model, as highlighted by:

- strengthening in the Car 18 inches and above, thanks to our solid partnerships with Premium and Prestige car makers, as well as the New Energy Vehicles makers, the solid pull-through and product innovation;
- Our price/mix, among the best in the industry
- Growing profitability, supported by internal levers, namely price/mix and efficiencies
- An improvement in the operating cash flow, deriving from our careful inventory management, with particular regard to finished products. Once again, this is the result of the sound partnerships with our clients and our flexible manufacturing structure.

The effectiveness of our business model and the response speed to the different headwinds - as we are going to see in the case of the gas emergency in Europe - make us confident we can cope with an increasingly challenging scenario.

Before we discuss our first half results, I wish to give you an update on the situation in China and Russia, and on the gas emergency in Europe.

In China, the situation is progressively improving thanks to the resumption of the production activity and the Government incentives to support the industry and consumption through subsidies and tax cuts, while the uncertainty related to new lockdowns remains.

In the tyre sector, June data show:

- a significant rebound in Original Equipment demand, supported by the recovery in car production and Government incentives for the purchase of new vehicles
- a progressive recovery in replacement demand, which is still below 2021 level

In this context:

- we are gradually increasing plants saturation rate to respond to the strong recovery of OE demand in the second half, due to Government incentives, focusing on EVs.
- on Replacement, where we maintain a cautious approach
- we are promoting the destocking of the distribution chain and will lever on prices to offset the increase in raw materials and inflation.

In Russia, EU sanctions effective since July 10th provide the export ban of tyres produced in Russia to the EU, and the import ban of selected raw materials and technical equipment from EU to Russia.

Pirelli confirms its presence in Russia, in full compliance with international sanctions:

- we activated alternative supplies, for both exports from the country (Turkey and Romania) and imports of raw materials (mainly local suppliers)
- we diversified our logistics to ensure the ongoing supply of finished products and raw materials. We directed production to the domestic market focusing on the most profitable products / segments, increasing prices to offset the increase in raw materials and transportation costs, and maintaining a cautious approach through a continuous monitoring of inventories and taking measures to protect trade receivables

Finally, the gas emergency in Europe, with Germany and Italy being the countries most at risk: Germany imports over 50% of gas from Russia, while Italy has significantly reduced its procurement of Russian gas from 40% in 2021 to 15% in 2022 thanks to the diversification of its sources.

To respond to this risk, Pirelli immediately established a cross-functional Committee and defined a "Contingency Plan" aimed at ensuring the continuity of production activities.

This plan provides:

- The use of alternatives to natural gas (Diesel Oil, GPL, etc.) by converting, where necessary, thermal energy production plants and ensuring the supply of such alternative fuels
- The acceleration of projects to cut energy consumption
- The containment of risks related to suppliers:
 - in the short term, by verifying their exposure to risk and an increase in inventories of products and semi-finished goods if needed and included in our numbers, and
 - in the medium term, by supporting suppliers in developing mitigation plans in the case of more disruptive scenarios.

As was the case during the Covid emergency and the Russian-Ukrainian crisis, we will leverage the flexibility of our production and logistics structure to ensure a suitable level of service to our customers. The actions taken make us confident that we will not have any major impacts on business continuity in the coming winter.

As we are going to see, our first half results are confirmed to be among the best in the industry, with:

- a 25% growth in the Top Line supported by the price/mix
- an improved profitability with the adjusted Ebit margin at 15.1%
- a net result of €233 million, up by 77% year-on-year
- an improved net cash absorption compared to the first half of 2021, and a cash generation in the second quarter at €209 million

In the first half of the year, we continued our commitment to Sustainability.

Let us start from safety. In line with our "Towards zero accident at work" vision, we promoted activities of continuous improvement in every plant and the development of our global «Excellence in Safety» Project.

As for the environment, we made quick progress towards decarbonization. Last June, we formalized our Net Zero Commitment with the Science Based Target initiative (SBTi), the international body that defines best decarbonization practices

Last May, SBTi also validated our new objectives for the reduction of greenhouse gas emissions by 2025, after reaching our previous targets four years in advance. Our new goals require actions consistent with the objective of containing the global average temperature increase within +1.5°C, in addition to the reduction of emissions from the raw material supply chain.

Important results were achieved as part of our Eco & Safety product roadmap, with the launch of new products, such as the new Scorpion Summer, with the highest level of performance in terms of labelling for rolling resistance, wet grip and noise.

Research and Development on innovative materials is benefitting from virtual processes using artificial intelligence, through which we achieved significant results:

- Material development time has been reduced by 30%
- Material prototypes have gone down by 20%

Relevant results were also obtained in the reduction of tyre wear rate, with improvements up to 33% for the new product lines compared with the previous ranges.

Finally, we increased the weight of ESG objectives in the variable remuneration of managers, placing the focus on:

- Gender balance, promoting a higher presence of women in the Company
- Revenues deriving from Eco & Safety performance products
- Reduction of absolute CO2 emissions, and
- Pirelli positioning in the Dow Jones Sustainability World Index ATX Auto Component sector.

I now leave the floor to Mr. Casaluci

Andrea Casaluci – General Manager Operations

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

In the first 6 months of 2022, the Global Car tyre demand declined by -1%, with a very different trend by segment.

Car ≥18" up +5% benefitting from

- the rebound of the OE tyre demand in 2Q (+2% in 1H, +5% in 2Q) due to the ease of supply chain tensions, and
- a sound Replacement demand (+8% in 1H, +2% in 2Q) despite the impact of lockdown in China.

Car ≤17", instead, was down 3% in 1H, -6% in 2Q, discounting the impact of Covid in China and the Russia-Ukraine crisis.

In this context, we increased our market share on Car ≥18", fully seizing:

- the recovery of the Premium Car production, and
- the solid demand trend in Europe and North America, which I will illustrate in a couple of slides.

1H'22 results reflect the implementation of the "key programs" of the Industrial Plan.

On the Commercial Program, consistent with our strategy, we have:

- Strengthened our positioning on Car $\geq 18''$ outperforming the market (+8% vs. +5% of the market), particularly in the Replacement channel where we gain almost 1 percentage point of market share
- Increased exposure on Original Equipment $\geq 19''$ and EVs
- Reduced exposure on Standard equal now to 40% of car volumes, -3 percentage points compared to H1 2021

On the Innovation Program:

- Achieved ~160 technical homologations, 48% of annual target, concentrated on $\geq 19''$ (about 80%), Specialties & EV
- Introduced 4 new high-performance products including 3 dedicated to SUV segment and 1 to winter extreme for North American, Japanese and Scandinavian markets.

On the Competitiveness Program:

- Phase 2 of the efficiency plan continues with 35% of the annual target achieved, in line with objectives and project development.

On the Operations Program:

- Plant saturation level is at 90%
- In addition, energy containment programs have been launched in Europe
- Finally, the implementation of industrial IoT to improve the efficiency of our production facilities continues.

In the first half, the results in terms of volumes are consistent with both our commercial program, which is strongly focused on the top of the range and selectivity in Original Equipment.

In the Car $\geq 18''$, an 8% growth was recorded, driven by the most technological and high-end products:

- Rim sizes $\geq 19''$ contribute 92% of the growth observed in Car $\geq 18''$,
- Specialties account for over 60% of the volume increase in tyres $\geq 18''$ in the first semester, mostly due to EV products (responsible for approximately 48% of the volume increase in $\geq 18''$)

No doubt that the driver of 1H growth on $\geq 18''$ is the Replacement channel, both in the «Pull» volumes, especially in Europe and North America, and EV products, and in the «Push» volumes, where the new dedicated lines show very good results in the three High Value regions.

On the other hand, in Original Equipment $\geq 18''$, the growing selectivity in projects leads to volumes in line with the previous year, with a higher incidence of EV products.

Pirelli innovation program proceeded in the second quarter of 2022 with an increasingly richer offering for the winter season paying special attention to the different needs of consumers around the world.

Particular care was devoted to SUVs. For this segment of vehicles, bound to become the most widespread around the world, Pirelli developed two further solutions:

- Scorpion Winter 2 focusing on safety in all weather conditions of the winter season. Its wet grip sets new standards of excellence with the whole range ranking in class A. The product is also certified with the prestigious TÜV SÜD «performance mark».
- Pirelli ICE zero Asimmetrico, also ensuring safety and comfort, Designed to offer outstanding performance even in the most extreme conditions, through an excellent traction and braking on ice

and snow, with reduced noise emissions. This product, originally developed for the Japanese market, is going to be also marketed in North America and Scandinavia.

Our EV portfolio is growing, with over 280 homologations, thanks to new partnerships with the most innovative and well-known brands in the world.

The Elect offering was further improved and can now cover the three seasons with our well known and appreciated product families, like PZero, Cinturato and the above mentioned Scorpion.

The EV segment records the strongest growth with Pirelli confirming its targets, namely:

- Doubling its sales in this segment, and
- Reaching already in 2022, that is to say 3 years in advance, a market share in Original Equipment of approximately ~1.5 times that of Premium / Prestige internal combustion vehicles.

In the first half of the year, the Competitiveness Program produced 52M€ efficiencies, in line with expectations, and accounting for around 35% of the yearly target, the latter being confirmed at approximately €150 million.

Looking closely at the first half performance by the single projects:

- In the Product cost project, contributing approximately 34% of efficiencies, the adoption of a modular design and value-driven approach has proceeded
- In the Manufacturing project (32% of the first half efficiencies), we continued increasing flexibility, digitalization and sustainability actions in our plants
- In the SG&A project (19% of the first half efficiencies) were achieved by using different levers, like the redesign of distribution networks, the optimization of warehouses use and renegotiations with our suppliers
- finally, in the Organization project (15% of the first half efficiencies) we made progress in our digitization processes and upskilling of our employees

I now give the floor to Mr Bocchio.

Fabio Bocchio – Senior Vice President Strategic Planning & Controlling

Thank you Andrea, and good evening.

Let's analyse the dynamics of the Top line in the first half:

- volumes slightly down (-1% at Group level) with a different trend between Car, up by 1%, and Motorcycle down by 9% discounting the impacts of the strategic decision of reducing the presence in the standard motorcycles, and consequently the closure of the factory in Brazil in Q3 2021.

Focusing on the two segments High Value and Standard (car + motorcycle), is important to highlight:

- the continuous improvement in High Value volumes (+5.8%, in line with the first quarter), supported by the share gain on the Car $\geq 18''$ Replacement despite price increases
- in Standard volumes were down -8.8%, impacted by increased selectivity on Original Equipment Car, the Russian-Ukrainian crisis and the aforementioned closure of the Gravatai motorcycle factory.

At a record levels price/mix (+20.4%), in line with the first quarter, thanks to:

- price increases to offset rising inflation in raw materials and other input costs

- improved mix across all its components: Product (migration from Standard to High Value), Channel (better trend at Replacement vs. Original Equipment) and Region (increased sales in Europe and N. America)

Positive impact of foreign exchange (€135 million, 5.2%), reflecting the strong appreciation of the main currencies against the euro.

In the first half of 2022, adjusted EBIT was equal to €482 million, up year-on-year by €105 million, with a margin of 15.1%, compared to 14.7% in the first half of 2021, thanks to the strong contribution of internal levers that more than offset the impacts of the external scenario.

In particular, the trend reflects:

- the positive impact of price/mix (+€435 mln) and efficiencies (€52 mln), which covered by as much as 1.3 times the increase in the cost of raw materials (-€236 mln, including the related exchange rate impact) and other input costs (-€141 mln), mainly energy and logistics.
- the contribution of volumes (-€11 million) was negative, while foreign exchange (€15 million) offset the increase in depreciation & amortization (€9 million) and other costs (€1 million).

Adjusted Ebit was 253 million in the second quarter, up 21%. Ebit margin was 15.1%, stable compared to the first quarter of 2022, but down slightly from 15.8% in the second quarter of 2021 due to:

- the dilutive impact of foreign exchange
- the lower increase in finished product inventories compared to 2021 with an impact of -€8 mln, which let us keep the overall level of inventory under control
- the application at the end of June, with effect from January 1st, of hyperinflation accounting in Turkey (-€6 mln).

Both the inventories and hyperinflation impact are included within the “other costs”.

Let us look at the Net Income dynamics for the first half.

Net Income strongly increased YoY. The trend takes into account the already mentioned improvement in the operating performance, lower restructuring and non-recurring costs.

The year over year increase of the Net Financial Charges reflects the rise of interest rates in Brazil and in Russia, partially counterbalanced by the reduction of financial charges at the parent company level. We will discuss this trend in a couple of slides.

The €38 million increase in tax charges relates to the higher operating results, as tax rate is stable at about 27%.

Net Income adjusted, i.e. excluding all the one-offs and non-recurring items, is positive for €288 million at the end of June.

Pirelli closes the first half of 2022 with a negative Net Financial Position of €3.5 billion, with a pre-dividend cash absorption of €463.7 million, lower than the figure for the first half of 2021.

It's worth noting the strong €108 million improvement in operations versus 1H2021 which reflects:

- growth in Ebitda
- lower investment also related to a different timing expected in the implementation of the 2022 projects, and mainly attributable to the geographical reallocation of the same, as an effect of the changed external environment

- a higher cash absorption of working capital due to the increase in inventories:
 - mainly raw materials, both due to inflation and in response to the need to mitigate supply chain risks in an extremely volatile external environment;
 - on the other hand, inventories on finished products (16% weight on revenues) recorded a limited increase and significantly lower than that recorded in 1H'21 thanks to the increasing visibility of trade stock based on the solid partnership with our distribution chain

The general increase in inventories was mitigated by the trend in trade payables and receivables reflecting business growth.

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Significant reduction occurred in non-recurring and restructuring charges which partially offset:

- the increase in financial expenses and higher taxes
- as well as dividends paid to minorities and the negative impact of foreign exchange of -€45.1 mln (+€1.0 mln in 1H2021) attributable to the revaluation of the Russian ruble and the Brazilian real.

Positive net cash flow before dividends for the second quarter of 2022: €209 million, an improvement of €37 million compared to the previous year due to the improved operational management.

The group's gross debt as of June 30, 2022 amounted to approximately €5 billion while the Net Financial Position was €3.5 billion thanks to €1.5 billion in financial assets.

In the first half of 2022, we signed 2 bank lines with a pool of leading domestic and international banks amounting to €2 billion, both of which are parameterized to ESG1 objectives in the decarbonization area. These lines contribute to the liquidity margin of €2.4 billion, enabling coverage of financial debt maturities until the second half of 2024.

The cost of debt at the end of June was 3.03%, up 65 basis points from the end of 2021, and was affected by the dynamics of interest rates in Brazil and Russia where - comparing the first half of 2022 to the first half of 2021 - benchmark rates and management costs for risk hedging activities increased on average by 10 and 9 percentage points, respectively.

We do not expect, during 2022, significant effects related to rising interest rates in the Eurozone, which accounts for about 80 percent of our debt, due to a well-balanced profile between fixed and floating rates and the positive effect of deleveraging that will mitigate the impacts of rising rates.

I now leave the floor to Mr. Tronchetti

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

Thank you, let us now discuss the outlook for 2022 in a persistently and extremely volatile context.

Global GDP is expected to grow by 2.7%. However, risks of a slowdown are increasing:

- in Europe: particularly due to Russia and energy needs
- in the U.S.: due to a very aggressive monetary policy, and
- in China: due to the risk of lockdowns resulting from new COVID outbreaks

Global inflation remains extremely high, at +7.3% with strong pressure on the prices of all production factors, also because of the persistent criticalities in the global supply chains.

In this context, global consumer confidence deteriorated, already reflecting the expectation of an economic slowdown and a reduction of spending capacity.

The expectations for the total Car Tyre segment are of a stable demand year-on-year (+0.5% the previous outlook) due to a more cautious approach to Replacement, mainly in the Standard segment, and, geographically, China and Russia, partially offset by OE recovery

Car tyre demand for rim sizes 18 inches and above confirms its resilience, with a +7% growth, in line with our previous guidance, and a clear over-performance (+9pp) compared with products 17 inches and below, now expected at -2% compared with -1% as in our May guidance.

More in detail on Car 18 inches and above:

- In Original Equipment, we estimate a 10% growth, higher than previously expected (+8%), driven by China due to Government incentives, and Europe.
- In the Replacement, we expect a 5% growth in the 18 inches and above (previous guidance +7%). The slowdown in Chinese demand caused by lockdowns, will be offset by a better trend of sales in the other Regions, especially Europe.

The effectiveness of our business model, as shown by the results of the first half of the year, makes us confident that we can cope with the scenario I have just described.

- Thanks to our distinctive positioning in High Value OE, increasingly focused on specialties, 19 inches and above and EVs, we shall be able to fully seize the strong market recovery expected in the second half
- While pull-through and the renewal of our product range will guide our over performance in the High Value Replacement
- New price increases announced in June, will be fully implemented in the second part of the year
- Price/Mix and efficiencies will offset raw materials and inflation
- Actions on costs are underway, in particular on energy cost in Europe

- As for cash generation, we will continue our careful management on working capital, with particular regard to inventories, whose weight on revenues is expected to go back to 2021 levels (20.5%), mainly due to the reduction of finished product stock.

The solid performance recorded in the first half of the year and the changed external scenario have led us to update our expectations for the Full Year 2022:

- Revenues between approximately €6.2 and 6.3 billion, about €300 mln more than in the previous target, with a growth year-on-year between +17% and +18%
- Volume target confirmed: between +0.5% and +1.5%, but with a better High Value performance, mainly in OE
- Price/Mix at +13.5%/+14.5%, 3.5 percentage points more than in May target, mainly driven by higher prices
- Exchange rates on the rise by 2.5% (flat the previous indication), safely assuming a higher volatility of Emerging Currencies in the second half of the year.
- The profitability target (adj Ebit margin) is confirmed at approximately 15%, and improving in absolute value due to the growing contribution of the Price/Mix which more than offsets:
 - the higher headwind of raw materials and inflation
 - the higher non cash costs linked to inventory reduction
 - the impact related to hyperinflation in Turkey
- CapEx confirmed at approximately €390 million, at around 6% of revenues
- Net cash generation before dividends between approximately €450 and €470 million, about 450 mln the previous target, thanks to a solid operating performance and an effective working capital management
- The deleverage target is confirmed, with a leverage equal or below 2.

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

Questions & Answers

Monica Bosio – Intesa San Paolo Analyst

Good evening, everyone. I hope you can hear me. The first question is on 2023. I know it's really early to say, but in front of the deterioration of the market scenario and looking at 2023, how do you feel confident with the group's pricing power going forward? Do you see as reasonable the maintenance of at least a mid-single-digit price mix for the next year?

My second question is on the increase in expectation in the Original Equipment segment. I was just wondering if you can give us a flavour on the drop-through on the full-year basis, given the higher weight of the Original Equipment.

The third question is still on the price mix. How much is the price? And how much is the mix in the second quarter? And I remember that in the last conference call the company was expecting a weight from price, over the year, in the region, of 80%. Is it still true? Thank you very much.

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

Thank you. Starting with the 2023 scenario, it's obviously early to say and there are many variables ongoing. What we can see now, for the visibility we have in the market, is that on one hand the stocks

of the distribution are not higher than 2019. So, the situation is back to normal and the sell out has been okay until now. On winter we expect to have a positive trend and looking to 2023 there is no overstock on the trade or on our side. So, that makes us confident that until now there are no signs of a weakening of the demand.

Looking into the Original Equipment side, the trend reflects the delay in delivering the new cars up to now. So, we see that there will be a stronger Original Equipment looking forward. This is the overall picture. So no risks for the time being on the distribution and Original Equipment in a less strong, but still higher volumes looking forward.

For what concerns more details on the Original Equipment and on price mix I leave the floor to Mr. Casaluci. Please Mr. Casaluci.

Andrea Casaluci – General Manager Operations

Thank you, Mr. Tronchetti.

We assume that in the second half price/mix it will be mainly price so around 100% price with a flat mix. This mainly due to negative regional mix because of the replacement demand in China that is going back to a normal level slower than what was expected in the previous quarter and also the higher weight of the Original Equipment. So you can assume that the price mix performance of second half will come mainly from price. And as a consequence, drop-through will be around 100%, while the drop-through of the full year we can assume, as price mix, around 90%. Thank you.

Michael Jacks – Bank of America Analyst

Hi, good evening, and congratulations on a very strong set of numbers given the environment in Q2.

I have two questions if that's okay. The first one is just on the price mix as well. I know you just upgraded the guidance to 13.5% to 14.5%. But if I look at the 20.4% you booked in the first half, that's around 11% higher than what you booked in the second half of last year. So I would expect around 11% in the second half of this year just from basic fix, before considering the price increases that you've made in Q2, which would suggest that the full year price mix could be somewhere around 16%.

Are you perhaps expecting a negative channel mix? Or is this just building in some added conservatism to the guidance? That's the first question.

And then my second question is just on the OEM market outlook in Europe for the second half of this year. We had active warning today that Light Vehicle production was weaker than second half, which seems to go against what the other OEMs and suppliers have said over the past two weeks about volumes recovering strongly in the second half. Could you perhaps give us a sense for what your OEM order intake is suggesting for second half?

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

Thank you. So for the price mix I leave afterwards the floor to Mr. Casaluci.

On OE Europe there is this warning but anyhow the volumes were very weak before, so something not negative will happen in the Original Equipment markets. The number of cars expected to be sold are lower compared to the previous forecast, but in terms of improvement compared to the past there will be an improvement. Anyhow, we are rebalancing the mix of our clients of Original Equipment, having reduction on average of the weight of the European car makers and an improvement with the American and Asian carmakers. So, the forecast we make, is taking into account our position in the market being a bit rebalanced. So, this weakening of Europe is not creating something that is affecting our forecast.

And now, I leave the floor to as Mr. Casaluci for the price mix question.

Andrea Casaluci – General Manager Operations

Thank you. So you're right. There is a huge difference between the price mix performances of first half and second half. We can assume based on the last guidance 14% on a full year basis with a 20% in the first half and 8% in the second half. I will try to simplify the major impacts of this difference equal to 12 percentage point: 4 point are related to the yoy price performance. The increase of price will remain in the market. We are fully confident to maintain the performance, but the comparison versus last year in the second half will be less favourable.

And so, 4 out of these 12 point will come from a less favourable comparison on the price performance. The remaining part is mix, half related to a worsening of the region mix as I mentioned before. It is mainly due to a less brilliant replacement demand in China than what was expected before. So, the demand is recovering, but at a pace of growth below our expectation because there is still an impact due to lockdown. And the half is related to the channel mix. The rebound of the Original Equipment in the second half is evident and is already in our numbers in terms of call-offs.

So also back to what Mr. Tronchetti said before, we see the recovery compared to last year in Europe with a sound market growing 22% to 23% in the second half versus last year, because of the recovery of the shortages in the supply and even stronger the rebound in China. Well, thanks to the support of the government the demand on the original equipment mainly in the electric vehicles is growing faster than what was expected in our previous guidance. Thank you.

Michael Jacks – Bank of America Analyst

Thanks. It's very clear. Just maybe just ask one question to clarify. So, do you then see current production levels for the second half and in line with the current IHS forecast of somewhere around 81 million units of global light vehicle production?

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

Following the announcement made by the carmakers lately, EU second half expectation has been reduced. Due to the rebalancing between what is happening in Europe and what is happening in China, the overall picture for us remains the one that we underlined a few minutes ago. And the 81 million you mentioned maybe a bit more, maybe a bit less, but this is what the market is expecting. These numbers are not affecting much our segment, in which we see that the call-off we have are confirming the forecast in our numbers, and our growth in China and America is providing us a quite safe number in our expectation.

Gabriel Adler – Citi Analyst

Hi, thanks for taking my questions.

I have few questions. Firstly, Mr. Tronchetti, could you comment on how resilient the entire replacement market is at this point to these macroeconomic pressures that you spoke about, especially the high-value segment? Because I think we are now trending about 2019 levels in the replacement tyres and given the higher fuel prices and other pressure on consumer, especially you seem probably close to peak for those volumes. And if that is the case, then what levers could Pirelli have to offset these pressures given prices are already elevated and you mentioned very significant process on the efficiency program. My first question is on the sort of outlook for the replacement market.

And then my second question is just on the working capital, because the gap between payables and receivables widened I think by about 4 percentage points in the quarter. This supports the free cash flow. So I just want to better understand how you're managing to increase payables, all coming from manufacturing, and how should we expect this trend of net payables receivables to develop going forward? Thank you.

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

Thank you. So before leaving the floor to Mr. Casaluci, I want to underline that working capital has been kept in the last 12 months in much better control thanks to the transparency we have with the trade: we have more than 60% of the trade that is providing us all data regarding what they have in the stocks.

So we can handle better our programs for the production and our level of stocks. This is embedded now in our structure. Talking about the replacement market, the high value continues to be strong and more than this we have to underline that close to two-third, more than 60% anyhow of our replacement market, is made by specialties. And as for specialties (Run Flat, Sealing side, Noise Cancelling System, EV and also there is a part of the winter 19 inches and above that is like specialty) the competitive arena is more or less certain.

These are reasons why we continue to see in the market that there are no weakness, coming not only from the demand but from competition, because the trading down that we see in the standard between Tier 1 and Tier 2 in some regions, mostly in America and something also in Europe, is not affecting the high value segment.

But anyhow I leave the floor to Mr. Casaluci to go deep into this.

Andrea Casaluci – General Manager Operations

Yes. Thank you, Mr. Tronchetti.

I will try to give you few numbers just to support the message of Mr. Tronchetti.

The $\geq 18''$ market in the second half is expected to grow from 2% to 3%, replacement only, while the standard market is expected to decrease around 2.5%. So the replacement market in the $\geq 18''$ will remain more resilient.

If we go a bit more in detail by regions this 3% is confirmed in Europe, and the same in North America, between 3% and 4%. While in China, that's the reason why we reduced a bit our expectation, the replacement market second half 18 inches and above is expected to be flat, while slightly negative

minus 2%, 3%, the standard market. And this is due to, as I mentioned before, some effect of restrictions in mobility. But if we compare it to Asia Pacific, the market expectation of second half with the performance of the first half, we see the rebound. The first half was minus 9%, the market replacement ≥ 18 ", while the second half is expected to be flat. Thank you.

Martino De Ambroggi – Equita SIM Analyst

Good evening, everybody. Focusing on Russia, could you quantify what's the difference between your expectations of profitability from Russia for the full year now in the new guidance compared to the guidance you had at the beginning of the year? And if you could quantify the profitability that you got in the first half of this year?

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

Thank you. So, in Russia, we have an impact which is mostly related to the export from Russia of 3.3 million tires, out of which half of it was sold in the first half. And in the second half, it will be partially recovered by what we produced in Turkey and in Romania. So, overall, the impact, if we consider all costs related to Russia, let's say repositioning, which means logistics and industrialization in other factories, we are in a range between EUR25 million and EUR30 million to give you a number. This number has been partially offset by the better performance of other regions. And I think that by year-end, this number will be fully offset. That is the performance, that's why we provided a better guidance now than what we presented the last time, since we embedded in this result a growth in the top line and we maintain the level of EBIT margin, which means an improvement that takes into account our ability to offset the negative impact of the costs related to the Russian crisis.

Martino De Ambroggi – Equita SIM Analyst

Just to understand, the €25 - €30 million is only for the repositioning costs or does it include also the lower operating profitability in Russia?

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

It includes the lower profitability in Russia, which is in part off set by the contribution margin of Turkey and Romania, and in part off set by the growth, better than what was in our forecast last time in Europe and the U.S. These are the reason why we are rebalancing our results.

Martino De Ambroggi – Equita SIM Analyst

Okay, thank you. And always on Russia, probably a more difficult question, but some of your competitors decided to leave Russia. What are the differences making you sure you will not take the same decision going forward?

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

They were, let's say, less structured in Russia. In the internal markets their presence was a minor one. We have distribution in Russia that is consistent and that's why we can guarantee what we said since Day 1, that we stay there producing cash enough to pay wages and salaries and social securities. And

that is confirmed because the other competitors you mentioned, like Michelin and Conti, some go, some stay, but they were much less structured in the market. So they didn't have distribution channels as we had. It is reasonable that they have their own reasons, but they were in a different position in Russia compared to us.

Martino De Ambroggi – Equita SIM Analyst

Okay. But Nokian has a stronger distribution network in Russia and they also decided to stay.

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

That is a totally different story. They had 80% of their production in Russia, and their decision is absolutely a total restructuring of the business model. And so what they said is that they left the management handling the operation in Russia and they are, let's say, making programs to replace what they used to export from Russia from other sources. But they had the largest part of their business that was produced in Russia. So that is their strategic decision, nothing to do with us.

Martino De Ambroggi – Equita SIM Analyst

Okay. And last question on changing the subject to CapEx. You are confirming the guidance but you spent €40 million less in the first half compared to last year, and you're still guiding for €40 million more on a full year basis. Am I right in thinking that you will likely be lower than €390 million or probably you will be low?

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

No, we'll be more or less in line. There are part of this investment that were due to be made in Russia with some problem and we move this investment to Turkey and to Romania and to other things. So, the delay is due to the fact that we stopped what we were making in Russia, so we will have a higher concentration in second half. It's only due to this.

Christoph Laskawi – DB Analyst

Good evening. Thank you for taking my questions as well. The first one will be on your energy hedging comments and also moving into 2023. You said you're largely hedged for Europe for the remainder of the year. Could you give a rough comment on how much is still open? And are there any hedges in place into '23? And then considering that the gas shortage is really hitting Europe, could you switch the industrial usage of gas into oil or other energy sources? And in case, do you need to source this energy, then in the market would you be buying at spot?

And the second question would be on the volume side in Q2. The competitors said that they had been observing essentially pre-buy affected other brands because of price hikes that have been conducted in Q2. Did you see any pre-buys on your end? Can you confirm that? Or everything turned as normal? Thank you.

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

So, in 2022, we almost hedged against all energy and gas costs. In 2023 only partially as of today, because there are not adequate market condition, it is illiquid obviously. In September, October, we will

evaluate the opportunities considering price hikes in the next two to three months. What we are doing is that we are storing alternative products and investing it to update our plants, mostly in Germany, in order to guarantee the continuity in the first months of next year.

So with the action taken by the committee that is following carefully since February, the matter is now reaching a very solid, let's say, business model, although first we guarantee the continuity. On prices, we will align as we did in the past, our price in the market to the hikes, if there will be hikes in the energy market. But first we have created a model that is safe in Italy and in Germany, which was the priority. Mr. Casaluci can provide more colour on it, please.

Andrea Casaluci – General Manager Operations

Thank you Mr. Tronchetti. You did the key comments. We are covered for the 2022. So we have the full impact of the cost of energy. For 2023 there are not the condition. In September, we will see that there is no liquidity in the market. We have less than 5%, around 5% of guidance for 2023. So we will work on it.

As far as the business continuity, we have already adapted our boilers to different alternatives to gas, diesel oil mainly in Germany and Italy; we are ready. So Germany is ready and Italy will be ready within the month of October. So we can assure the continuity of the production and we are working with our suppliers in order to analyse their mitigation plan to help the suppliers that need the support. We are buying, increasing the safety stock on the most critical SKUs and these raw material stock is already in our numbers in order to assure also the continuity of the supply of raw material. So we don't see major risk for the winter season '22-'23. As far as the full environment in 2023, we need to weight the development of the market environment, but we are monitoring on a daily base. Thank you.

Philipp Konig - Goldman Sachs Analyst

Thank you very much for also taking my two questions. My first question is just coming back to your margin guidance, you mentioned that you see price/mix coming down to around 8% in the second half of the year. However, you still expect to do around 15% margins. Is that because you're sort of expecting raw materials and inflation to come down? I think together they were around 14%, 15% in the first half. What's the latest update there in terms of the full year guidance for these two headwinds?

And then the second question is back to Russia. How far you have you already shifted capacity to Romania or to Turkey? And in terms of the incremental cost that is associated to that, how much was already reflected in the first half? Or are there any further headwinds coming up in the second half? Thank you.

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

Thank you. I will start with the second question and I'll leave refer to Mr. Casaluci for the price/mix. So, we said before, the total cost of moving out of Russia, including transportation cost, was in the range of at least €25 million. These numbers are offset by the better performance of the units. So this gap should be reduced in 2023 because now we have the cost of industrialization and volumes are low compared to the full year volumes. And so we expect in '22-'23 a contribution margin from the other units that is not the same of Russia, but is much better than what we have this year. But all of this is in the numbers until the year end.

And now I leave the floor to Mr. Casaluci for the price/mix question.

Andrea Casaluci – General Manager Operations

Yes. So, just to clarify, when I mentioned the 8% before, 8% is the price/mix of the second half expected performance, while the profitability of the company, the EBIT margin percentage, we expect that will remain around 15% in the second half. And so we will have less positive balance between price/mix and efficiencies with inflation. Nevertheless, we will more than cover all the inflation with some of price/mix and efficiencies over the second half.

Philipp Konig - Goldman Sachs Analyst

Could I just follow up there? Can you quantify the percentage headwind from raw materials and inflation? I think, previously, it was around 12%. Are you confirming that? Is it now a bit higher or a bit lower? Thank you.

Andrea Casaluci – General Manager Operations

Yes, inflation on net sales is around 13% on a yearly basis, €700 million in absolute value; and this is including all the inflations, raw material, logistics, labour cost, and energy.

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

So, thank you. Thank you, everybody. Thank you for your attention. I wish to all of you a very good evening.