

Pirelli & C. S.p.A. 1H 2023 Results conference call transcript

July 27th, 2023

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

Good evening, Ladies and Gentlemen.

The results of the first half of 2023 confirm the resilience of our business model with a performance improving year over year.

The scenario we expect for 2023 remains highly volatile, and is characterised by:

- ▶ the slowdown of economic growth where the main uncertainties concern Europe and China
- ▶ a high inflation rate, in particular of consumer prices, despite the decrease in energy, transportation, and raw material costs
- ▶ the growing volatility of exchange rates, fuelled by interest rate differentials and economic situation in Emerging Markets

In this context, we prefer to take a more cautious view on the external scenario, both:

- ▶ on tyre demand, where we confirm the resilience of High Value, and
- ▶ on exchange rates

While we confirm our Adjusted Ebit and Cash flow targets thanks to the effectiveness of our internal levers. As we are going to see shortly, our solid price discipline and improving product mix allow us to revise the price/mix upwards, offsetting the impact of volumes and ForEx and upgrading our Ebit margin target.

Our results for the first half of 2023 remain among the best in the industry:

- ▶ 7.5% Top Line growth, year on year, supported by the strong improvement in the price/mix and the strengthening on High Value, which now accounts for 74% of the Group's revenues
- ▶ Adjusted Ebit amounted to €517 million with a margin of 15.1%, stable compared to the first half of 2022
- ▶ Net Income of €243 million, up 4% year on year

Net Cash Absorption of €535 million, in line with the usual seasonality of the working capital.

Moving on, I would like to give you an update on Sustainability.

The Group is firmly committed to Safety, as well as Diversity, Equity, and Inclusion of our employees.

- ▶ In addition to the campaigns to raise awareness at Group level, the reduction of accident frequency, and the increase of "gender balance" in managerial positions become part of the objectives in our Short-Term Incentive program for managers.
- ▶ We expanded our welfare portfolio further, to include projects in support of parenthood and psycho-physical wellbeing.

Regarding product sustainability, in mid-July we launched the New P Zero E, a top-of-the-range tyre for Electric Vehicles:

- ▶ which received a triple A European label for Rolling Resistance, Wet Grip and Noise Control, and
- ▶ contains more than 55% of bio-based and recycled materials, verified by third party for maximum transparency.

Such results had never been achieved before in the UHP tyre market.

In terms of sustainable materials, we also announced the acquisition of 100% of Hevea-Tec, the largest independent natural rubber processor in Brazil. This transaction is due to be closed by the end of the year and will allow us to:

- ▶ launch innovative natural rubber projects to increase the use of non-fossil materials;
- ▶ further improve control over the natural rubber supply chain; as well as,
- ▶ expand the FSC certification program.

Finally, the decarbonization plan progressed more than expected, with all our factories involved in the “climate change challenge” program.

We are also helping our suppliers to reduce emissions, in line with our commitment to NET Zero formalised towards the Science Based Target Initiative.

I now leave the floor to Mr. Casaluci.

Andrea Casaluci – General Manager Operations

Thank you, Mr. Tronchetti, and good evening.

Let us analyse the market dynamics and Pirelli's performance.

The second quarter of 2023 recorded an improving trend compared with the first quarter (+1% YoY vs. -4% in 1Q). However, due to the destocking in Europe and North America, together with a slower than expected recovery in China, the market trend in Replacement was below our expectations.

In the first half of the year, the global car tyre demand declined by ~1.3% YoY, with very different dynamics between segments and channels. Pirelli kept overperforming the market thanks to our strong positioning in the more resilient High Value segment.

Positive O.E. market (+8.4% YoY) was supported by a strong demand increase in Europe and North America:

- ▶ In $\geq 18''$, Pirelli saw ~10% volume growth (vs +11% Mkt) with increasing focus on higher rim sizes and electric,
- ▶ In $\leq 17''$ (PI -6.7% vs. Mkt +7.2%), we didn't benefit from the market rebound due to our selective approach in all regions.

However, the Replacement market remained weak (-4.8% YoY), discounting the volatile macro scenario worldwide:

- ▶ In $\geq 18''$, Pirelli outperformed the market by ~2pp (PI +2.9% vs. Mkt +0.8%) driven by a market share gain, and
- ▶ In $\leq 17''$ (Pirelli -10.4% vs. Mkt -6.0%), we continue to reduce our exposure to this segment and focus on a mix more oriented towards bigger rim sizes.

Let's now go through the Key Programs of our Industrial Plan as well as the results achieved in the first half of 2023.

On the Commercial Program we:

- ▶ overperformed in the $\geq 18''$ Car market and
- ▶ reduced our exposure on the Standard segment, which in the first half accounted for 36% of the total Car volumes.

On the Innovation Program:

- ▶ ~150 new technical homologations, focused on $\geq 19''$ (approx. 86%) and EV (approx. 50%);
- ▶ we consolidated our position in the Electric Vehicle segment, with a portfolio of approximately 400 homologations and a market share in Premium and Prestige segment 1.5 times that of ICEs; and
- ▶ our focus on sustainability and performance was further improved with the launch of the new P Zero generation, while new products were introduced in the two-wheel business based on our racing experience.

On the Competitiveness Program: 30 million Euro gross benefits were achieved, in line with the expectations and project development schedules.

On the Operations Program: the level of plant saturation is of approximately 90% (~95% High Value). Finally, thanks to the acquisition of Hevea Tech, the leading independent Brazilian natural rubber processing operator, we shall increase the supply of this raw material from South America.

In the first half of the year, we increased our exposure on the Car $\geq 18''$ by 3 percentage points, which accounts for 61% of the Car volumes.

- ▶ On the OE $\geq 18''$ segment, our performance (~+10% volumes vs. +11% market) is featured by a growing selectivity focused on the $\geq 19''$, where EV accounted for over 27% of the OE volumes (+11 percentage points versus the first half of 2022).
- ▶ On the Replacement $\geq 18''$ (volumes +2.6% vs. a +0.8% market) growth was mainly driven by new products lines introduced over the past year, particularly in North America and APac.

On Innovation, Pirelli launched three new tyres in the P Zero family at the Goodwood Festival of Speed, of which Pirelli is the Exclusive Tyre Partner.

This new range of tyres, developed after the demand of carmakers and consumers, is specifically focused on sustainability and efficiency. These new products were developed in line with our «Eco-Safety Design» approach, an innovative development methodology based on virtualization which is the outcome of our experience in Motorsport.

More in detail:

- ▶ P Zero E, is a concentrate of technology and sustainability, as I am going to illustrate in the next slide.
- ▶ P Zero R is the ideal choice for the Prestige segment, due to its sporty performance and driving pleasure.
- ▶ Finally, P Zero Trofeo RS, a top product in terms of its performance on track. This product is also homologated for road usage and was designed for the Original Equipment of Hyper Cars and Super Cars.

Let's now go into more details about P Zero E.

This tyre integrates the latest technological innovations developed by Pirelli and was designed for electric and sustainable mobility.

It is the first Ultra-High-Performance tyre on the market with:

- ▶ over 55% of bio-based and recycled materials, and
- ▶ a 24% reduction of the CO2 emissions, compared to the previous generations.

Both features are verified by third party for maximum transparency.

P Zero E features a low rolling resistance, a lower noise, coupled with a consistent performance when both new and worn. It is then the first UHP tyre on the market with triple A on the European label across the entire range.

Finally, P Zero E is equipped with the new Pirelli RunForward technology that guarantees support after puncture and allows to continue driving up to 40 kms at a maximum speed of 80 km per hour. This technology is specifically developed for EV cars which do not carry a spare tyre due to their battery on board.

The Competitiveness Programme in the first half of the year recorded gross efficiencies of ~€30M, equal to 30% of the annual target and is in line with the project development schedule. Higher contribution of the efficiencies will be in the second half of the year.

In more details:

- ▶ Our main efficiencies come from Product cost, where we continued our modular design and design-to-cost approach, aiming at reducing the complexity of the structure and the weight of tyres.
- ▶ In the Manufacturing area, the results of which will be concentrated in the second half of this year, projects to improve the production process are being implemented by leveraging on Industrial IoT (Internet of Things) with particular focus on predictive maintenance.
- ▶ In the SG&A area, logistic and supply chain optimization processes continue along their roadmap.
- ▶ Finally, in the Organization area, the process of digitization and staff upskilling follow their schedule.

Finally, I would like to comment on the Hevea-Tec acquisition, leading independent natural rubber processor in Brazil and our supplier. The transaction is expected to be closed by the end of 2023 and it is worth approximately 21 million euro (Enterprise Value) with no impact on our 2023 Cash Flow target.

Through the Hevea-Tec acquisition, Pirelli will increase its natural rubber supply share in Latam and ensure continuity of supply in the Region and, therefore, greater efficiency and benefits in terms of stock management.

In addition, the operation will facilitate the launch of innovative natural rubber projects aimed at increasing the use of non-fossil-based materials in the production of tyres, in line with Pirelli's sustainability goals.

As just mentioned, and always in terms of Sustainability, the Hevea-Tec acquisition will also enable the company to further improve its control of the natural rubber supply chain, reduce CO2 emissions thanks to a local-for-local supply and launch new FSC certification projects.

Thank you, I now leave the floor to Mr. Bocchio

Fabio Bocchio – Senior Vice President Strategic Planning & Controlling

Thank you, Mr. Casaluci and good evening to all.

Let's go through the Revenue dynamics in the first half of the year:

- ▶ The volume trend (-2.1% at Group level) discounts the weakness of the market demand, especially in the Replacement channel. As Mr. Casaluci already explained:
 - we overperformed the market on Car $\geq 18''$;
 - while further reduced our exposure on Standard, in line with our strategy.
- ▶ Strong improvement in Price/mix (+12.5%), expected to be among the best in the industry, was supported by a solid price discipline and a continued product mix improvement.
- ▶ The ForEx impact was negative (-2.9% in the first half, equal to -€94 million Euro), with a worsening trend in the second quarter, following the depreciation of the dollar and other major currencies against Euro.

In the first half of 2023, adjusted EBIT was €517 million, with a 7.4% growth year-on-year, and a stable margin of 15.1% compared to the first half of 2022.

Internal levers more than offset the weak external scenario. More specifically, the price/mix (+€345 million) and efficiencies (+€30 million) more than covered:

- ▶ the drop in volumes (-€29 million), linked to a weak market demand;
- ▶ the increase in cost of raw materials (€99 million, including their related exchange rate impacts);
- ▶ input cost inflation (-€131 million): energy, labour and transport;
- ▶ the negative Exchange rate impact (-€51 million), due to two different dynamics:
 - on one hand, the revaluation of the Mexican Peso (+13% vs Euro) with a direct impact on costs, given that Mexico is the production hub for North America;
 - on the other hand, the devaluation of the Renminbi, Latin American currencies and the devaluation trend in the second quarter of the Dollar.
- ▶ Finally, the impact of depreciation, amortization and other costs was negative (-€16 million and -€14 million respectively); the latter were concentrated in the second quarter and relative to marketing expenses, R&D and stock reduction.

Profitability improved in the second quarter reaching a margin of 15.5% (15.1% in Q2 2022) thanks to the strong contribution of price/mix (+147 million Euro) and the efficiencies (+21 million Euro) which in total covered 1.4x the negative impact of:

- ▶ raw materials (-22 million Euro);
- ▶ inflation (-62 million Euro); and
- ▶ exchange rates (-36 million Euro).

Let us now analyse the Net Income dynamics in the first half of the year, a 4% year-on-year growth.

This trend reflected the already mentioned improvement in operating performance which more than offset:

- ▶ the increase in net financial charges, related to interest rates hikes in the Eurozone, and
- ▶ the higher tax impact linked to the better operating result, with a 28.5% tax rate.

The adjusted net income was 298 million euro, versus a 288 million Euro in the same period of 2022.

The Net Cash Flow in the first half of 2023 was negative for €535 million, in line with our business seasonality.

Excluding the impact of the three-year management incentive plan for 2020-2022, worth 67 million Euro paid in the second quarter, the net cash flow before dividends was stable year over year.

The variation of the Operating cash flow mainly reflects:

- ▶ the improvement of the operating performance,
- ▶ the higher absorption of investment activities,
- ▶ the working Capital and other items trend.

Let us discuss the dynamics of the latter:

- ▶ Thanks to a careful stock management, inventories were reduced in 1H of the year, reaching 20.7% on sales, -1 percentage point vs. end of March. The reduction was related mainly to raw material inventories. It should be remembered that in 2022, the high incidence of these stocks was due to both rising inflation and actions to contain supply chain risks. Finished product inventories, on the other hand, remained stable.
- ▶ The other elements of the Working Capital reflect the usual seasonality of our business, with:
 - an increase in trade receivables to 13% of sales, +3.5 percentage points versus the end of 2022; and
 - a reduction of trade payables versus 2022-year end, due to the investment trend and the normalization of raw material stocks. Trade payables on sales is expected to return to around 30% at the end of 2023, in line with previous year.
- ▶ Finally, we would like to remind you that the non-recurring impact from the incentive payment was related to the three-year Long-Term Incentives Plan 2020-2022. This ~67 million Euro impact was included under the item «other payables». From 2024, with the transition to the rolling system, incentive payments will be on an annual basis with a substantial alignment expected between the impact on the income statement and cash outflow.

The group gross debt as of June 30, 2023, amounted to approximately 4.8 billion Euro. Considering the ~1.7 billion Euro financial assets, our Net Financial Position stood at 3.1 billion Euro.

The 2.8 billion Euro Liquidity Margin allows us to cover the debt maturities up to 2025-year end.

In the first half of the year, two new sources contributed to the liquidity margin:

- ▶ The first was the 600 million euro 5-year bond issued in January which marked Pirelli's debut as an investment grade company and represented the world's first sustainability-linked benchmark issue in the tyre sector.

- ▶ The second was a €300 million bilateral loan benchmarked to sustainability targets, maturing in February 2026. This loan, as of June, had not yet been drawn and therefore positively contributed to increasing the liquidity margin as undrawn committed lines. The utilisation of this new bank line happened in July and facilitated using partially the liquidity already available the voluntary early repayment of EUR 600 million loans maturing in February 2024.

Financing with ESG characteristics now accounts for 58% of total debt.

Finally, the cost of debt stood at 4.46%, up 15 basis points from 1Q 2023, impacted by the restrictive monetary policy mainly in the Eurozone.

I now turn the floor over to Mr. Tronchetti.

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

Thank you, Mr. Bocchio.

Let us now turn to 2023 outlook. As already mentioned, the macroeconomic picture is still characterised by volatility and a mild economic growth. Major uncertainties concern:

- ▶ Europe, penalised by the monetary tightening, and
- ▶ China, discounting a slower-than-expected recovery, impacted by a weak foreign demand and low domestic consumption. This situation led the Government to launch new measures to support domestic demand at the end of June.

In this context and based on the lower-than-expected market trend in the second quarter, we adjusted our outlook on the Car tyre market. For 2023, we expect that demand will be down 2%, with High Value and Standard following opposite trends:

- ▶ High Value confirms its resilience, with a growth rate of 3% in Car $\geq 18''$, whereas Standard is due to fall by -3%. More in detail, regarding $\geq 18''$, we expect a mid-single digit growth for OE, lower than our previous estimation, due to a lower demand in the Chinese market.
- ▶ For Car Replacement $\geq 18''$, we expect a low-single digit growth rate: +2% against the +3% in the previous guidance, with a more cautious view on Europe, due to the weak trend recorded in the first half of the year, and China.

Nevertheless, the progressive recovery of Replacement is confirmed in the second half of the year.

In this context, we confirm our strategy which aims at consolidating our leadership in the High Value, especially in the $\geq 19''$, featuring a faster growth, Specialties and EV.

Based on the results achieved in the first half and the scenario just described, we confirm our Adjusted Ebit and Cash flow targets, although with a different mix of drivers.

More in detail, we expect:

- ▶ Volumes slightly dropping, due to the market slowdown, with a low single-digit growth of High Value and a reduction in the exposure to Standard
- ▶ Price/mix significantly improving thanks to the better performance in the first half
- ▶ Instead, the ForEx impact reflects the higher volatility of the major currencies against the euro

Revenues are therefore expected to amount between 6.5 and 6.7 billion euro.

Adj Ebit margin improving compared with the previous guidance and reaching between approximately 14.5% and less than 15%, due to a greater contribution from the price/mix.

Adjusted Ebit is confirmed: approximately 970 million euro is the mid-range of the guidance, where the price/mix and efficiencies offset the impact of the external scenario.

In line with the previous guidance, we confirm investments of approximately 400 million euro, devoted to the technological upgrade of our plants, mix improvement and the increase in High Value capacity in Romania and North America, which is to be completed before the end of 2025.

Net cash before dividends is confirmed between approximately 440 and 470 million euro, due to the operating performance and an efficient management of the working capital. This target includes the amount relative to the acquisition of Hevea-Tec, announced on 4 July.

The Net Financial Position is expected to be approximately -2.35 billion euro with a leverage between approximately 1.65 and 1.7 times the Adjusted Ebitda, in line with the de-leveraging process outlined in the Industrial Plan for the 2021-2025 period.

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

Questions & Answers

Martino De Ambroggi – Equita SIM

Thank you. My first focus is on price/mix. It's clear, the trend was so strong that you are revising upwards the price/mix expectation for the full year. But what is exactly going better than expected at the beginning of the year? Is it just an adjustment where you have ForEx devaluation? What else?

And the second question still on prices. Can we assume that the Original Equipment is entirely with automatic adjustments indexed to raw materials? And when do you expect to start to see reduction in prices? I suppose this is not an event for the second half of this year.

And the third question is on profitability, focusing on Standard. If you could share with us what was the profitability in the first half? And what do you expect in the full year, considering that the market is worsening. I understand you are selective, but this business is probably more under pressure compared to High Value.

Andrea Casaluci – General Manager Operations

Concerning the price/mix, the improvement compared to the last guidance is around 2 percentage points, so from 5.5% up to 7.5%. I would say, half of the improvement is coming from price and half from mix. On price, what is leading the improvement is price discipline. We don't see a major movement on price, but we decided to keep the price discipline as a priority of our commercial strategy. So, this is the major impact coming from the improvement of price mix and mainly price.

Regarding Original Equipment, the first negative impact on price will come in the second half of 2023. So, the price performance on Original Equipment will be slightly negative in the second half, which is related to the cost metrics that is more or less 70% of the Original Equipment business for us.

The last question, the profitability of Standard in first half was quite positive, around 9%. And all in all, we target to have this performance for the full year. So, we don't see major differences between the 2 semesters. You are right, the price volatility in Standard is higher than High Value, the latter being more protected. Nevertheless, the presence of Pirelli in the Standard segment is very limited, and we keep our focus only on the most profitable segments of the Standard, like the All season, the 17 inches, the homologated tires. We prioritize the price discipline and in case we lose as is happening, market share, because it's not our focus. We will not reach within 2023 the double-digit profitability that was planned in our industrial plan because of the effect of the Russian operations and the lower saturation of the plants, but the target of reaching the double-digit remains, we simply have 1 year of delay.

Martino De Ambroggi – Equita SIM

If I may, just one more on price/mix. So, if you could split for your full year projection, what percentage out of the 7%~8% is price, and what is mix?

Andrea Casaluci – General Manager Operations

You can consider more or less 4.5% is the price.

Monica Bosio – Intesa San Paolo

As for the Replacement market, when do you expect the de-stocking process might come to an end? Can we expect a rebound of the Replacement market already from the very beginning of 2024?

The second question is on EV tires in the Original Equipment. I remind that in the first quarter, the shares of EV tires in ≥ 18 inches in the Original Equipment was at 25%. The target for the full year was 30%, if I remember well. Can you give us an update on this?

And as a third question, as for EV tyres in Original Equipment, what is the share of the local Chinese car players, if you can give us? Thank you.

Andrea Casaluci – General Manager Operations

So, for what concern the Replacement Market, I would not talk about a rebound: market is expected to be better in the second half vs the first half, mainly because of the favorable comparison versus last year and because destocking trend has almost been finalized both in Europe and North America. I would see a more stable Replacement market in 2H. The resilience of the High Value in the Replacement market is confirmed. We maintain a gap between the ≤ 17 inches and the High Value of 6 percentage points, which is the most important aspect for our business model.

Moving on to the Electric vehicle, yes, you are fully right, and we do confirm our target of market share in the High Value at 30%, which means 1.5x the internal combustion engine in the premium and the prestige segment. The electric vehicle all in all today represents around 27% of the ≥ 19 " Original Equipment volume in the first half. More detail, specifically on the Chinese carmakers, we will provide you after the call.

Michael Jacks – Bank of America

Good evening, I hope you can hear me clearly. I have 2 questions. The first one on volumes. Your 2 percentage point cut to your OEM channel assumption speaks to a double-digit downgrade for China. If you attribute all of that to the region, can you just provide a little more color on that, given that your weighting is more towards the High Value segments and EV tires in that market. And we've seen that the EV car makers in China have been strongly outperforming the domestic market.

Secondly, on volumes, would you agree that the comparative base for the overall Replacement tire market is quite low from the second half of last year. So, would it be crazy to expect some growth year-on-year in that market?

And then finally, just on cost inflation, could you share with us your updated assumptions for the year and whether or not you've made any changes to some of the individual cost buckets.

Andrea Casaluci – General Manager Operations

Yes. So, concerning China, you are right. There is a reduction in the expectation of the market. For the High Value, in this market, we project a 3.4% volume decline, mainly driven by Original Equipment where we do expect a slowdown of the market in the second half also because of the less favorable

comparison versus last year. I do remember that there was a rebound of the Original Equipment market in the second half 2022.

In 2023 Pirelli is projecting to gain 1 percentage point in market share in China on total $\geq 18''$. So, you are right, the expectation of the market is not as brilliant as was in the previous 3 months. Nevertheless, remains more resilient than the Standard.

In terms of inflations and cost, generally speaking, what we can tell you that for raw materials - that accounts for roughly 37% on sales - we had a headwind of around EUR 100 million in the first half and we do expect to have more or less the same amount positive in the second half. So, all in all, the impact of raw materials is expected to be neutral on 2023.

Let's move to the inflation of the other input costs. Logistics - that represents roughly 9% of our total cost - generated in the first half a headwind of around EUR 15 million; we expect a similar impact in the second half.

Energy cost is around 5%, 4.8% of our sales. The headwind in the first half was EUR 52 million. We do expect a 38 million headwind roughly in the second half. So still a negative impact on full year, mainly due to our hedging policy: we bought energy at a higher price compared to the market price.

Labor cost accounting for around 18% on our own sales, on our cost base, as a similar trend of inflation first half and second half: around EUR 40 million in the first half and EUR 45 million in the second half. And finally, the other inflations for roughly EUR 60 million on full year: half in the first semester and half in the 2nd semester. This is the general picture on cost base.

Michael Jacks – Bank of America

If I may just follow up on the volume question, just to try to understand your reduction assumption for the $\geq 18''$ by 2 percentage points. Given your weighting towards China is less than 20%, a 3.4% reduction in the market isn't quite congruent with the 2 percentage points cut that you've made to the market forecast. Where is the rest of that cut coming from?

Andrea Casaluci – General Manager Operations

So, the total $\geq 18''$ market at the global level for 2023 is expected to be around 310 million tires, growing by 3.2%. That was the number in our presentation as expected volume growth at global level for $\geq 18''$ total market. In China, the market is counting 43 million tires. So, it's a bit above the 10% / 12% weighting on the total market and is expected to be negative by 3.4%.

Michael Jacks – Bank of America

Thank you. Maybe I should take this offline afterwards, but I was referring to the OE channel, which you've cut to 5% versus the previous 7%.

Andrea Casaluci – General Manager Operations

Yes, out of the 310 million tyres global, 125 million are the Original Equipment. If we move to China, out of the 43 million, 31 million is Original Equipment and is expected to decrease by around 6%. So, the weight of the regional equipment in China market is higher than the average of the global market because it's still a young car park. And so, the weight of $\geq 18''$ in the region equipment is on average higher than the global picture.

Akshat Kacker – JPMorgan Chase

Two questions from my side, please.

The first one on your plants saturation when it comes to High Value capacity. To what extent does the 95% capacity utilization restrict or contain growth in this segment as we think about growth into 2024? And can you also remind us on your current CapEx assumptions for 2024?

And the second question is more of a medium-term question. In your view, what protects the higher margins of bigger rim sizes in the medium to long term? Is it more down to technological and material know-how or is it a structural cost advantage versus your competition, or is it just a function of relatively low competition in the space right now?

Andrea Casaluci – General Manager Operations

So, as we mentioned in the presentation, we have a 90% of global saturation, out of which 95% in the High Value. There is all the necessary capacity in our plants to catch all the demand opportunity for the coming years because I remind you that at least 10% of our capacity in High Value - that represent 3 million tires more or less - is used to produce Standard tires. This is the way we always keep the spare capacity to catch in advance the sales growth. So, 95% of our High Value capacity saturated means that we have 5% spare non-used, plus 10% used for Standard.

In terms of CapEx, in 2024 we don't have already the numbers ready to be communicated. Anyhow, we target to maintain a ratio of around 6% on sales, which is our ratio of the last years. And we do consider this is a well-balanced target, considering that more than 50% of our CapEx are and will remain concentrated in technological upgrade, mix improvement and digitization of our factories. That remains our main target. For the remaining, 25% is capacity increase in High Value and 25% is business continuity.

The answer to your last question is always the same: pushing on innovation; that is the way we raise the barrier, and we protect our mix and our positioning for the most important premium and prestige carmakers in the world.

Ross MacDonald – Morgan Stanley

I'm just looking at Slide 32 in your presentation, and you state that raw material costs are now 34% of revenues, which is down from 36% in the first quarter. So raw mat cost obviously coming down quite quickly. What do you see as a normalized level here for raw materials as a percentage of sales? Is that 34% actually quite low now versus history?

And then my second question, you have lower raw material costs, you have a cost-cutting program that's accelerating in the second half, and it doesn't sound like you're going to cut tire prices. That sounds like a very cash generative period for Pirelli. So, I'm just curious, what factors offset those positives and keep the free cash flow guidance flat?

And then final quick question just on ForEx. Just so I understand it, your ForEx assumptions for a 6.5% drag on revenues is just assuming that the ForEx rates remain unchanged from their current levels for the rest of the year?

Andrea Casaluci – General Manager Operations

Thank you for your questions. I will answer on the raw material environment, and then I will ask Mr. Bocchio to answer on ForEx side.

As I said before, raw material impact is around 36.5%~37% on sales and this is a normalized impact. We had a negative headwind of EUR 100 million roughly in the first half, and we will have a positive impact of around EUR 100 million in the second half. That's the reason why it's a flat impact on a yearly base. And this is 100% related to the commodity markets because there is a reduction on the inflation that started months ago; now we have the impact on our COGS starting from the second half.

Fabio Bocchio – Senior Vice President Strategic Planning & Controlling

I will take the one on the ForEx. As we said, our renewed guidance is taking into consideration an impact of ForEx between -6% and -7% and we are considering a devaluation of the US dollar, meaning that in second half, we are expecting the EUR/USD to remain in the range of 1.10 to 1.12, a devaluation compared to the second half of previous year of about 9%. We have expected another 9% devaluation from the Renminbi in the second half in the range between 7.7 to 7.9. We are assuming a higher volatility on the Latin America currencies, which will represent a significant part of the ForEx impact and some uncertainty on the Russian ruble, but reasonably stable compared to the evaluation that we have had on the market in last few weeks.

Ross MacDonald – Morgan Stanley

Maybe I could just rephrase my second question. A lot of investors are expecting price cuts, just to be clear. It sounds like that's not your intention. So, with these lower raw material costs, would it be fair to say that this is a very cash generative period for the tire sector?

Andrea Casaluci – General Manager Operations

No, we don't plan any price reduction and we will keep our price positioning. Also, we don't have any more opportunity to increase pricing in this environment, both because of raw material and because of the reduction on the demand.

So, we don't plan to increase price anymore in the second half nor to reduce price in the second half. We keep the price discipline as far as the Replacement channel is concerned. As far as Original Equipment, as I said before, because of the cost matrix mechanism, we do expect the price reduction in the range of 1 to 2 percentage points, which is already included in our numbers and in the contracts we have with carmakers.

Philipp Koenig – Goldman Sachs

I've just got a question on the new margin guidance. I know that you obviously listed it, but you did over a 15% margin in the first half, inflation is improving, pricing is remaining stable, and it seems like the volumes in the Replacement market, especially in the High Value are also recovering. So, I'm just wondering, why even the mid or the high point of your guidance would still imply the second half margins to be lower? I know there's a bit of a ForEx headwind here, but there seems to be quite a bit of offsets from deflation and higher efficiencies. So, is it just the ForEx or is there anything else?

Fabio Bocchio – Senior Vice President Strategic Planning & Controlling

Related to the second half profitability that is implicit in our guidance, we have to say that it is discounting some cautiousness on the external scenario, as we said, related to demand and to the ForEx.

So, the volumes are expected to decline year-on-year in the second half. ForEx is expected to deteriorate due to higher devaluation of the Dollar and the Renminbi, the volatility of the currencies of the emerging markets, and a revaluation of the Mexican Peso. All of these impacts, jointly with the inflation headwind will be offset by

- the price mix - especially the price discipline whose contribution at the end will be lower compared to the first half given that the higher base –
- efficiencies, and
- raw material tailwind.

Overall, at the end, this are the assumptions that we are including in our second half implicit guidance.

Philipp Koenig – Goldman Sachs

Could you maybe answer what type of drop-through are you assuming on the FOREX?

Fabio Bocchio – Senior Vice President Strategic Planning & Controlling

The drop-through that we are expecting for the second half is pretty similar to what we experienced in second quarter, about 40%. Regarding the currency movements, we are expecting:

- EUR/USD to stay between 1.10 to 1.12 in second half, a devaluation of 9% compared to second half in the previous year;
- a weakening of the Chinese Renminbi, with EUR/CNY expected to stay in the range of 7.7 to 7.9, so again a devaluation of roughly 9%;
- volatility of the Latin American currencies, especially on the Argentinian peso;
- and some uncertainty on the Russian Ruble, which is expected to stay more or less at the level that we experienced in the last few weeks.

Operator

Mr. Tronchetti, there are no further questions to register at this time. Back to you for any closing remarks.

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

Ladies and Gentlemen, this will conclude today's program.

Thank you for your attendance and have a good evening.