Pirelli & C. S.p.A. 9M 2020 Results Conference Call Transcript

November 11, 2020

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

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

In a very volatile environment, in 3Q, we were able to:
- Strengthen our position on the High Value, largely outperforming the global market by 3 percentage points in both O.E. and Replacement; this was particularly true in China, where we recorded an outstanding performance: +33% YoY on Car ≥18" vs. +21% of the market
- Protect profitability better than peers through mix improvement and net savings, coming back in 3Q to an almost 17% EBIT margin
- Reinforce our cash profile, further reducing inventories

Our Cost Reduction plan is progressing in line with expectations, pursuing a flexible cost structure and limiting the effect of the production slowdown and fall in demand.

Our commitment to cash generation is confirmed despite the challenging external scenario (uncertainties on demand following the introduction of new mobility restriction in Europe, forex devaluation).

As we are near the end of 2020, I want to highlight how we are learning from this unprecedented period of extreme uncertainty; unprecedented for:
- the severity of the health crisis
- the magnitude of the economic downturn
- the duration of this crisis
- the rapid pace with which "causes" generate "effects"

Not only have we taken early – and indeed successful – countermeasures, but in these months we are adapting our whole working model to a new era of uncertainty; in particular:
- by staying very close to our Customers, we are monitoring early warning signals, which we review with the whole global Management Team every week, and where we decide key countermeasures;
- our medium- and short-term planning is now integrated, and supported by an enterprise-wide digital platform, where we can simulate actions, and update our Plans and targets, maintaining overall coherence;
- more generally, I am very reassured by the fact that one of Mr. Papadimitiou's key missions as a Co-CEO is exactly to accelerate our pace, capitalizing on Pirelli's many strengths and with "novel eyes", simplify and accelerate our processes so as to capture the many opportunities in the resilient High Value market

This change of pace will be visible in our new Plan.

Mr. Papadimitriou will give some thoughts on the new business plan, while Mr. Casaluci will elaborate on Pirelli's nine months results and market outlook, and Mrs. Leone will discuss our Financial Results.

Cost Reduction plan is progressing in line with our expectations.

The combined gross benefits of the Competitiveness Program and COVID Actions for the Full Year are confirmed at ~€280 million (~6% of the 2019 cost base), or €140 million net of inflation and slowdown. During 9M 2020, consistent with our forecasts, gross benefits from the two plans amounted to 71% of FY target.
Net of inflation and slowdown, efficiencies were equal to ~€84 million, since slowdown was almost entirely recorded during 1H.
For the 4Q, we expect ~€80 million of gross efficiencies, with a major contribution from SG&A, product range optimization, logistic efficiencies and footprint rationalization.
Net of inflation and slowdown, benefits are expected to amount to ~€60 million.

Moving to 2020 targets.
We have updated the outlook for the Full Year taking into account the change of the external scenario, Mr. Casaluci will provide you more details on. To sum it up:

- on the one hand, we see demand improving, mainly driven by a better O.E. in APac and North America, while maintaining a cautious view for Europe, given the recently introduced restrictive measures to cope with the COVID-19 emergency;
- On the other hand, we are expecting a more volatile Forex environment, following the appreciation of the Euro against all major currencies in 2H 2020

We now forecast:

- Revenues ~€4.2 billion
- an adjusted EBIT margin between ~11.5% and ~12%, implying an absolute adjusted EBIT close to €500 million in the mid-point of the range, ~€35 million less compared to the August targets; current indications take into account more negative external headwinds (Forex and its impact on raw materials) and the increase of the other costs, partly non-cash
- a Net Cash Flow confirmed at ~€190 million, in case the EU fine will become due by December 2020, or ~€220 million, should this payment be delayed. The change in the profitability guidance is not impacting the Net Cash Flow targets thanks to a better Working Capital management, benefiting from a larger reduction of stocks than originally expected
- a Net Debt of ~€3.3 billion is also confirmed

And now I leave the floor to Mr. Papadimitriou.

Angelos Papadimitriou – General Manager, CO-CEO

Thank you very much Mr. Tronchetti, and good evening to All.
It is a pleasure to be here as a co-CEO and member of the Pirelli management team.
Since it is the first time I speak to you in public, I would like to say something about my background.

- I grew up in Athens (Greece) & studied in the United States, Economics, Computer Science and Business Administration
- Over the past almost 30 years I have split my professional efforts between the global pharmaceutical industry and the advanced industrial machinery & services business, living between the U.S. and various European countries
- For the last ten years I served as the CEO of COESIA, a global leader in packaging machinery and industrial solutions, where I focused on a strategy of profitable growth, organic and through M&A. Key themes in that journey were innovation through engineering and digital capabilities, service excellence, a global industrial footprint and a resilient international organization. It was a rewarding and enriching experience in which I had to compete within a rapidly changing industry; I will bring the best of that experience to Pirelli

Roughly three months into the job, I have already had the opportunity to appreciate

- the depth of Pirelli's management team
- the clarity of its high value strategy, and
- the progress made towards an integrated business model, designed to support Pirelli's continuous success
- Similarly, Pirelli's premium brand and technology leadership are constant sources of inspiration, and assets we are going to build on for the future

For today, I would simply like to make three general observations from my first weeks of exposure to the business:

- Pirelli's unique High Value strategy presented during the February 2020 Strategic Plan builds on the Company strengths and is clearly the right way forward; there is room for refining and enriching it, progressively accelerating its impact on our business, and the way to implementation is clear
- the market discontinuity caused by the Covid-19 epidemic brought out a solid response by Pirelli's Management, the results of which are already showing in 2H 2020 and prove the resilience of the business
- beyond COVID, an even broader set of discontinuities will offer new opportunities for us: electric vehicles, connectivity, changes in mobility preferences, raising bar on consumer experience expectations, sustainability to mention only a few. Our plan going forward will take stock of these discontinuities and will be based on profitable and sustainable growth

We will have the chance to further discuss Pirelli's strategic outlook during the upcoming presentation of the 2021/25 Strategic Plan in March 2021. The Pirelli management team and I will be spending significant effort in preparing this plan in the coming months under the guidance of Mr. Tronchetti.

Of course, we will remain vigilant and resilient to possible external volatility in the near future as we gradually come back to a more stable business outlook.

And now I would like to turn over to Andrea Casaluci for the review of the market and Pirelli performance.
Thank you.

Andrea Casaluci – General Manager Operations

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

Let me comment the 3Q market dynamics and Pirelli performance.

3Q car tyre demand still is in negative territory at -6% overall, but significantly improved compared with previous quarter level:

- Original Equipment partial recovery (-4%) has been driven by pent-up demand, particularly in the Premium segment (Car Production Premium +4% in 3Q)
- Replacement demand (-7%) was also recovering closer to last year's level, but still negatively impacted by the slow economic recovery in Standard Regions

The High Value trend (Car ≥18" +3% in Repl.) showed again the segment resilience vs. the Standard (-8.0%).

In the Car ≥18", Pirelli outperformed the market in 3Q (+5% vs. +2%) in both channels:

- in the Original Equipment, our performance has been driven by APac, where the higher exposure to the Premium segment in China pulled us ahead of the market. In North America we are benefitting from the widening of the customer base from 2H 2019, with the supply of relevant projects for the market
- in the Repl. Channel (+6% vs. +3%) we gained the share lost at the beginning of the year due to de-stocking of our trade, completed in Europe in April and in 3Q in North America. In 3Q:
    - we outperformed the market in China through an higher presence in both the online channel and Car Dealers
    - in Europe we enhanced our performance leveraging on the product portfolio extension in the Summer and All-Season fast-growing segments

In South America, in the 3Q, we gained share in the Replacement channel of the Standard segment, taking advantage of lower imports in the area while continuing to reduce the exposure to the less profitable products.

On the back of the 3Q market trend, we have updated the scenario for the remaining part of the year, taking into account a better trend in the O.E. in APac and North America, while keeping a conservative stance for Europe. We are now assuming a global Car demand -17% for the full year (2 percentage points better than our previous expectations) and -5% in 4Q. High Value is confirming its resilience.

In more detail:

- in Europe, where the main concerns are the effects of scattered mobility restrictions on tyre demand - such as delayed consumer demand for both seasonal tyre changes and car purchases and reduced mileage - we are assuming a double-digit drop in both O.E. and Replacement demand (almost -10% in both Channels in 4Q)
- APac, instead, pushed by the positive momentum of China, is expected to continue to outpace the global market; this is more evident in the High Value where a positive trend is expected in both:
    - the Replacement channel, and in
    - the O.E.
- in North America, we expect a very positive O.E., also thanks to the weak relative comparison, while Repl. is expected to keep 3Q momentum even in a volatile market environment with very heterogeneous situations in stock levels and supply chains, and a still rather high number of coronavirus cases

- In Standard Regions, LatAm and Russia & MEAI, a gradual recovery is expected. Yet, the slow real economy upturn will limit the tyre market expansion, which is still expected to decline double-digit

Let me give you now an update on the efficiencies and cost cutting programs.

On Product cost, where we achieved 75% of the FY target, we are:
- streamlining the entire product range toward a value-based portfolio,
- working on tyre structure simplification, weight reduction & material portfolio de-complexity, and
- exploiting virtual design process, reducing need for physical prototypes.

On Manufacturing we reached ~80% of the €60 million FY target. In this stream:
- we continue to rationalize our footprint, mainly in Latin America, and exploit benefits from lowered waste, increased flexibility and plant digitalization,
- we focus on quick efficiencies from factory flows optimization and strict control over fixed and variable costs.

On SG&A, in the 9M we registered almost 60% of the FY target since we expect a major contribution from belt-tightening of G&A and marketing and procurement re-negotiations during the last quarter of the year.

Finally, we confirm our efforts toward a leaner Organization that will bring us a FY cost saving of ~€50 million, out of which 75% already saved in the first nine months.

In terms of activities, we are leveraging on:
- footprint rationalization in Latin America,
- development of our existing shared service centers in LatAm and Europe,
- process reengineering, also thanks to Digital Transformation, and
- forthcoming introduction of structural remote-working.

We are fully on track in the deployment of our key projects.

On the Commercial side:
- the stock reduction, also aimed at safeguarding our customers' balance sheet, did not affect the service level, that we kept as best-in class in both Europe and North America
- we increased our focus on the online business in China, also through partnerships, such as the new with JD.com, and the already in place with Tuhu and Alibaba Group. Pirelli is now the top Tier-1 premium brand in ≥18" segment in the e-commerce channel which represents 20% of our Replacement sales.
- the launch of new CRM tools completed in the pilot country is spreading to other EU countries where it will enable increased retail coverage and effectiveness in demand fulfillment rates

On Technology-based Innovation
- leadership in EV tyre technology led to the homologation of one third of new O.E. projects to be fully devoted homologation to EV platforms (in the quarter), thanks to both consolidated partnership with both traditional Pirelli customers, such as Mercedes-Benz, Porsche, Audi, and electric vehicles-only producers in N. America and China
- widening North America presence, as we started to supply the new F-150 iconic model
- extension in Winter and All-season portfolio leading to the widest coverage in the industry in the High Value segment, to serve at best rich homologated market niches (winter marked) and fast-growing market segments (All-Season)

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

Based on the market scenario already described, we now forecast for the Group a volume decline (Car + Moto) between ~-17% and ~-18% (-18%÷-20% previous indication) with High Value volumes recording a ~-11% (from ~-14%) and Standard tyres at ~-25% (from ~-26%). Car ≥18" volumes are expected to be ~-10% (~-13% the previous indication).

Price/mix is now forecasted to be ~+1.5% (~+2% than the previous target) reflecting:

- a more positive trend in O.E. during the second semester, in line with car production recovery; and
- a more cautious view on Europe, specifically in the Replacement channel, following the recent restrictive measures.

A ~-5% on Forex is expected (~-4% previous target) following the appreciation of the Euro versus the major currencies in 2H 2020.

As a consequence, Revenues are now expected to be between ~€4.18 and ~€4.23 billion (previous target between €4.15 and €4.25 billion)

On profitability, we now expect an adjusted EBIT Margin ranging between ~11.5% and ~12% (previous target range: ~12%, ~13%) based on:

- the different external scenario with a worsening of Forex also impacting the cost of Raw Materials (currently expected to be -€15 million vs. -€10 million); and
- the increase of the other costs (from -€70 to -€90 million), partly of non-monetary nature and connected to the significant finished product stock reduction in 3Q, to lower earnings from Prometeon and higher sponsorship expenses

As already pointed out by Mr. Tronchetti, our cash flow generation target is confirmed thanks to a better working capital management.

I now leave the floor to Valeria Leone for the review of the financial results.

Valeria Leone – Executive Vice President Strategic Planning & Controlling, Investor Relations and Micromobility Solutions

Thank you, Mr Casaluci, and good evening, Ladies and Gentlemen.
Let's now review Pirelli 9-month results in detail.

Our top-line performance was impacted by a tough external scenario with:
- global demand falling (-20.5% Car tyre market in the first 9-months), and
- high Forex volatility, due to Emerging Markets currencies

The above headwinds were partially countered by price/mix improvement, driven by our exposure to the High Value segment.

Trends improved in 3Q with a small drop of sales, -1.3% year over year, net of forex.
- a rebound was recorded in the High Value segment (volumes +3.9%), more pronounced in the Car ≥18" (+5.3% YoY) where Pirelli largely outperformed the global market by 3 percentage points in both O.E. and Replacement; this is particularly true for China, where we enjoyed an outstanding growth, consolidating our position in the most prominent market for High Value
- we continue to reduce our exposure to Standard (with volumes -12%), now accounting for ~45% of total Car volumes, without neglecting the best opportunities, as we did in Latin America, to achieve an higher plant saturation and decrease the stock level.
- Price/mix improved by +2.3%, a touch lower than in 2Q, due to a more balanced trend between Replacement and Original Equipment; indeed, the channel mix, which was positive in 2Q, became neutral in 3Q. Product and regional mix were the major contributors. The price component was marginally down, in line with previous quarters, due to a slight trimming in the less technology-intensive segment and to raw-mat index clauses for O.E.
- Forex devaluation was more pronounced in 3Q, when, in addition to Emerging Market currency volatility, the Euro appreciated against all the other major currencies.

In 3Q, we posted a stronger profitability than in 1H, with an adj. EBIT margin close to 17%, again among the best in the Tyre Industry. This was the result of:
- a robust delivery of our net savings (competitiveness vs. inflation and COVID actions vs. slowdown), recording +€51 million, or ~60% of the 9 months progression; this was also possible due to the limited impact of the slowdown (€8 million in 3Q vs. €70 million in 1H) and
- the positive price/mix

These internal levers limited the effect of the following headwinds:
- volume drop
- the volatility of Forex also impacting raw materials, as the main currencies of countries where the Group's production is located (e.g. LatAm, Romania and Russia) depreciated against the Euro, and
- the increase of other costs (-€43 million in the quarter), which were higher than expected, due to:
    - non-cash items, mainly related to the accounting impact of the strong reduction of finished product stocks for the period, and
    - cash items, related to additional costs, such as lower earnings from Prometeon, "transformation" costs and sponsorships

Moving to cash flow, at the end of September our Net Debt stands at ~€4.3 billion, almost flat vs. the end of June.
3Q Net Cash Flow was positive for €12 million and in line with the same period of the previous year, thanks to:

- an EBITDA basically at 3Q 2019 level
- a lower CapEx vs. previous year, however aligned to FY target
- a cash-out of Net Working Capital, reflecting the decrease of inventories now brought to a more normal level (18.8% on Sales in 9M'20 from 21%1 in 1H'20). The inventories reduction partly offset the increase of trade receivables (22% on sales in 9M vs. 14% in 1H) due to the strong improvement of the business in 3Q. In line with usual seasonality of the working capital, trade receivables are to be collected in 4Q;
- lower interests and taxes paid are basically offsetting the cash-out for restructuring and the other expenses

We confirm our Net Cash Flow Target of ~€190 in case of payment of the EU anti-trust fine before the year end, and ~€220 million in case the payment is due in 2021.

The adjustment of €35 million of the FY guidance profitability is not affecting the cash flow target since:
- part of the additional costs (€4 million) impacting the adj. EBIT are non-monetary and relating to the accounting of inventories reduction and credit impairment
- the remaining €31 million are covered by a better working capital management mainly coming from inventories reduction in products, raw materials and semi-finished products

Finally, the €10 million of additional CapEx are not impacting since its cash out is due in 1Q.

Let me close my remarks with our current Capital Structure situation.

As of September 2020, our Gross Debt stands at €5.8 billion in reduction during the quarter also thanks to the repayment of €200 million of Floating Rate Notes which came due in September.

Net Financial Position lands at €4.3 billion while Liquidity Margin remains sound at €1.85 billion, covering debt maturities through the 1H 2023 when sole borrower extension options on our main bank financing are considered.

Last Twelve Month Cost of Debt reduces by 0.84 percentage points to 1.99% thanks to:
- our deleverage which positively impacted the margins of our committed bank lines
- reduced exposure to high-yield currencies
- general trend of interest rates in countries where the Group has its production facilities

Finally let me remind you that during 1H 2020, we have managed our financial covenants and gained appropriate flexibility until year end 2021 so that we can now face the outbreak of the second wave from the most comfortable position.

Now I leave the floor back to Mr. Tronchetti.

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

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

Questions & Answers

Monica Bosio – Intesa San Paolo Analyst

The first one is on the price/mix. I know that maybe it's too early to talk about 2021. But I was wondering what is your feeling on the price/mix for the 2021. And if we can imagine price/mix more in line with your traditional level, let's say, 2.5% on the back of a better balancing between original equipment and aftermarket.

And my second question is on the dealer stock inventories. How do you see the stock inventories so far also on the back of a likely weak winter tire season?

And very last question is on the EV platforms. Could you please elaborate a little bit more on Pirelli's penetration on the Electric Vehicles both in original equipment and maybe if you can, on the aftermarket? And what would you expect going forward?

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

Mr. Casaluci will elaborate on the different questions about price/mix and the trend we expect from 2021.
I just want to make a comment on Electric Vehicles which are becoming an opportunity. This year ~1/3 of our new homologations are for Electric Vehicle and in the coming years we expect that EV will account for 50% of our new homologation.
In 2020, we are going to achieve more than 300 new homologations, of which 100 are for Electric Vehicles, all ≥18”.
Our position on EV will be in line with the position we have today in Prestige and in the high end of the Premium. So we see this as a great opportunity. Please, Mr. Casaluci.

Andrea Casaluci – General Manager Operations

Thank you, Mr. Tronchetti. It's too early to have a clear understanding of the price/mix for 2021. What we can say is that coming out from this volatile environment - that is something we cannot predict when will happen - we expect a more stabilized region and channel mix versus what happened in the last quarters. At the same time, we expect to improve our product mix, out-performing the industry. What is interesting to analyze for the time being, is the price environment.
As we mentioned, there is price stability in the industry and there is a low level of inventory that is supporting some thoughts, positive thoughts concerning the price environment for the beginning of 2021 as well.
So all in all, I don't expect the same performance as we saw in the last years where we reduced the standard much higher than what we did or we will do in the coming future, but we target to overperform the industry.

Monica Bosio – Intesa San Paolo Analyst

Okay. Just a follow-up before the dealer stock inventory question. I can imagine that the increase in penetration related to Electric Vehicles might further support the price/mix given that electric vehicles are mainly related so far to Premium cars. Is it correct? So I was wondering if this could be a driver also for '21 for the price/mix or maybe it's a more long-term driver.

Andrea Casaluci – General Manager Operations

This is more a long-term perspective. The electric vehicle market is still too small to affect the price/mix environment for 2021. But looking forward, you are right, electric vehicle requires a high level of technology. And as a consequence, we do expect to have a better price protection in this segment.
If I can answer to the question related to the stock inventories in the trade. As I mentioned before in all the regions we record quite low level of inventories as far as summer and All Season tyre is concerned, while for winter, it's too early to have a conclusion because the winter season in Europe is still affected by the warm temperature and above all by the restriction in mobility. So the stock is still high, and it's too early to have a clear picture on what will happen at the end of the season.

Martino De Ambroggi – Equita SIM Analyst

The first is still on price/mix. Your comments were clear, but there is also the growing prices of raw mat that sooner or later will lead higher prices in a very disciplined market like the tire one. So when do you expect the first moves -- the first action in order to cover the rebound of raw materials?

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

If I may, there are already signs of price increase. So we expect in the coming weeks and months that something positive can happen in raw materials.

Martino De Ambroggi – Equita SIM Analyst

Just 2 quick questions. One, on cost savings. Could you remind us how much is temporary and how much is permanent of all your cost-saving actions?

Andrea Casaluci – General Manager Operations

Yes. The picture that we have presented in our presentation is showing you on a full year basis, a saving of €140 million net of inflation, which is confirmed for 2020. As mentioned by Mr. Tronchetti, , we already delivered €84 million out of €140 million in the first 9 months, and we are confident to confirm the full target for 2020.
Again, it's we are in the full phase of preparing our new industrial plan. And it's too early to tell you the amount of this cost that will be confirmed and as a structure for the next year. The environment changed a lot. There are a lot of discontinuities. And at the same time, a lot of opportunity and things we learned during this difficult 2020, and we will reflect all these activities and jobs in our new industrial plan.

Martino De Ambroggi – Equita SIM Analyst

Okay. And the last question was on the net debt. Just if you could elaborate a bit more on net working capital trend which is probably also the risk, which could be affected by the more prudent, more cautious view that you have on the aftermarket in Europe. And if you could remind us what is the underlying factor in assumption in your guidance?

Valeria Leone – Executive Vice President Strategic Planning & Controlling, Investor Relations and Micromobility Solutions

Martino, I can you give you a flavor of the working capital for the end of the year. We expect that the operating working capital will reach 4% of sales at the end of this year versus the 3% of the last year. We have 3 different components. Inventories at the end of 2020 are forecasted to reach more or less 21% of net sales.
Trade receivable are expected to reach 15% on sales by the end of the year, thanks to the cash – in 3Q.
Trade payables will follow the usual seasonality of the business. So it will increase in the last quarter of the year and should reach a weight on sales by ~32% by the year-end, versus 30% last year, as a consequence of the general business recovery and stock increase.

Martino De Ambroggi – Equita SIM Analyst

And factoring the underlying?

Valeria Leone – Executive Vice President Strategic Planning & Controlling, Investor Relations and Micromobility Solutions

So with regards the factoring on trade receivables by the end of 9 months '20 was at a standard level versus last year due to the business downturn. And by the end of 2020, we should be just a bit lower than previous year, mainly due to the business downturn.

Henning Cosman – HSBC Analyst

Okay. So the first question is on volume, please. Appreciating that you've outperformed the market. I'm under the impression you have outperformed a little bit less than your European competitors, maybe especially in Europe and the U.S., where you may be not able to take advantage of these potential market share gains as much because you are still conscious of the recent destocking that you've done with your dealers?
And then in that same context, also when we look at pricing or price/mix, are you satisfied with the pricing that you have achieved, considering also the currency effect that you may have wanted to offset and the opportunities you may have wanted to capture. So that's the first question. The second question is on the SG&A.
In Mr. Casaluci part of the presentation, I believe you said in 4Q, you're still looking to renegotiate some agreements and the savings that you're envisaging for the full year are conditional to the success of these renegotiations. So if you could just please repeat what amount we are talking about and how confident you are to achieve that?
And then finally, you're talking about the preliminary industrial plan. So I'm wondering if it's premature to give us a bit of a direction with respect to free cash flow.
Your last industrial plan was obviously indicating €500 million and €600 million free cash flow, respectively, for 2021 and '22 if it's not at all too premature to give us a bit of direction on that. Do you see anything materially changed? Why that would be a lot lower than you saw it at the time?

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

Thank you. Before leaving the floor to Mr. Casaluci, I just answer to the third question related to the industrial plan.
You're right, it's very early to say. It really depends on the speed of recovery, we are going to face in 2021, 2022. So we are confident that the basis and the trend of our plan will be confirmed. We can enhance, let's say, part of the plan. And obviously, the cash flow is a priority. We are able, I think, this year to deliver the consistent results in such a difficult year. We rationalized our stocks. So we made a deep analysis, and we produced new actions in order to have a better control of it.

Andrea Casaluci – General Manager Operations

Thank you, Mr. Tronchetti. As far as volume and price/mix performance is concerned. You correctly said, we gained market share in 3Q, over-performing the market, both in the original equipment and replacement. While in 1H, it was not the case for the replacement or at least was the case in China and Asia Pacific, but was not in Europe and North America where we decided to reduce our stock level in pattern of distribution.
So now we are again on track. We are gaining market share. We do project to gain market share in 4Q, and this will be one of the key targets of the next industrial plan. Price performance, we are never satisfied, of course. We know we can do better always. But considering that the price/mix performance has been the best performance in the industry together with only one of the other Tier 1 player, I think that we can consider the 3Q performance in line with the expectation and with our targets.
Cost Cutting and Efficiencies. So I repeat the numbers. Our target in terms of cost competitiveness and COVID actions cost reduction amounts for €280 million growth that comes to €140 million net of inflation and slowdown. As far as SG&A is concerned, the target comes at €110 million gross out of the €280 million. 60% of this target has been already reached and delivered in the first 9 months. And we are confident to reach the remaining part of the target in the last quarter.
Negotiation with suppliers is part of the normal activities at the end of the year, once we have the clear picture of the volume for the coming year, we will be in the position to renegotiate the majority of the contracts with our suppliers.
And this is what we will do. Of course, if we will not reach the full target with these activities, we will continue well tightening of all the cost, and we will find other sources to do. But today, we can confirm we are fully on target with our objective.

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

One last comment on cash flow looking forward. So we reduced drastically this year investments, but we have consistently invested in the last few years in capacity. And also thanks to the efficiency effect coming from the digitalization at all level of the company. We don't need any additional investment. It's enough to go back to a normal €300 million average investment. So that's why we are confident that the cash flow in the coming years - being a priority regardless of what is going to happen in the market - will be sound.

Gabriel M. Adler – Citi Analyst

I have two questions, please. My first is on the other costs. You've increased the outlook for other costs from €70 million to €90 million. But it looks like a large portion of this increase already impacted 3Q because of inventory destocking. So could you please clarify what precisely are included in the other cost line that you expect to impact 4Q, which means that you reduced the adj. EBIT guidance? That's my first question.

My second question is on the volumes guidance of -17% and -18%. It implies a bit of a deterioration in 4Q. I was interested to understand if the deterioration is linked to what you're already seeing in your sales in the first 6 weeks of the quarter or more reflects that caution regarding a market slowdown because of government restrictions that you mentioned in your presentation?

Valeria Leone – Executive Vice President Strategic Planning & Controlling, Investor Relations and Micromobility Solutions

Thank you, Mr. Tronchetti. So yes, the question regards the costs, I can elaborate on 3Q and then on the forecast for the full year. So for 3Q, we recorded €43 million, including 40% of non-cash items, related to accounting impact of the strong reduction of finished product stocks. So it means ~€14 million for 1.1 million finished cars.
Then we had other provisions accounting for ~€3 million, including impairments for €2 million.
The cash items were equal in 3Q to the 60% of the total amount, and they included the lower earnings for Prometeon. And additional costs related to transformation.
So for us, the transformation costs means serving these other activities digital, plus we had some additional sponsorship costs, more or less equal to €4 million.
The other costs should reach by ~€90 million on FY, out of which 40%, again, will be non-cash items and related to the accounting impact of strong reduction on finished product stocks for a total amount of €23 million, credit impairment of ~€6 million due to more conservative accounting approach on receivables and other provision for €7 million.
As far as the cash items, there should be equal to €50 million, including the lower earnings from Prometeon equal to more or less €28 million. And again, the transformation cost that should stand at €20 million, again, including the same categories already named. That's all for other costs. I hope I was clear.

Andrea Casaluci – General Manager Operations

Our expectation for the last quarter of the year for the entire demand of tires is a minus 5%, as I said before, for Pirelli, we projected to perform in line with the market. While if we move into the High Value segment, the 18 inches and above segment, we do expect a market at plus 2%, and we projected to over-perform the market with a plus 3% plus 4% in our performance.
We see volatility in Europe, as we explained it before, where the market is expected to be down 10%, and we target to perform more or less in line with the market. This 10% is both in original equipment and replacement. In the original equipment, the performance of 10% negative is more or less in line with 3Q. We do not expect a cancellation in the call-offs of the carmakers for October and November, at least because we already have orders on our hands, and we are delivering. We will see what will happen in December, thanks to the slowdown of the Christmas period and in the first quarter.
While the replacement in Europa is affected already by the restriction in the mobility. The month of October, the first, let me say, indication from the market is a negative 6%. And let's consider that October was before the majority of the restriction in mobility that will have taken place in the beginning of November.
So the 10% negative market of Europe is something that today, in our opinion, is reflecting the actual environment and is included in the numbers we presented before. North America and Asia Pacific are more stable. We don't see big changes in the performance compared to what we saw in 3Q.

Gianluca Bertuzzo - Intermonte SIM Analyst

I was interested in the detail you provided about the online development in China with 20% of replacement sales coming from the Internet. Can you maybe elaborate a little bit on how this model works, both maybe operationally and financially? I was also wondering about the pricing dynamics for this type of sale.
And finally, what is the share of online sales in other regions? If you can share with us this detail, it will be helpful.

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

Before leaving the floor to Mr. Casaluci, I want to underline that on these platforms we are leader in the high end segment. We are in partnership with the 3 platforms that represent 98% of the market.

Andrea Casaluci – General Manager Operations

As you said, I would like first to underline the difference we see between the online in China and in the other geographies. As Mr. Tronchetti said, the online is mostly controlled by 3 big players: JD.com, Tuhu and the Alibaba platform in China.
And another important difference is that the mix of product that we see sold in the online in China is representing the average of the mix of the market, also thanks to the high penetration of the online that comes today more or less the 20% of the entire market. While if we move on other geographies, for example, in Europe, the average price sold in the online, I'm talking about the market, is a bit below the average of the market. So it's more a channel, still focused on commodities and low end.
This is the major reason why we decided to serve the growth of the online channel in China. Of course, brand is important. It's key. And we have one of the strongest brands in China with a high recognition, and this also helped us to penetrate the channel. And to assure, let me say, the correct price stability, we agreed with these important partners to develop dedicated product lines for these channels.
And that's also one of the marketing activities we are doing to support our growth there. So mix, positive price control and stability and dedicated products.

Thomas Besson – Kepler Cheuvreux Analyst

I have a few questions. You think I'm going to ask them one by one. The first one is very basic. You guide for High Value volumes in August minus 11% versus minus 14% but price/mix guidance has deteriorated from close to plus 1.5%. So can you help me reconcile that? Because usually, the better High Value trend vs. Standard would imply a stronger price/mix.

Andrea Casaluci – General Manager Operations

Yes, the price/mix in the High Value is more affected, mainly in 2020 by the negative channel mix. Because, as we said before, in the High Value, the original equipment is more resilient compared to the entire market. And so this is, in a way, negatively affecting.
The second element is the price of the original equipment. That is more under pressure compared to the replacement channel. And the third element is also the pure product mix related mainly to Europe, where we are selling, but this is not only Pirelli, the industry, much less winter tires in favor of All Season in summer. So you correctly mentioned that, let me say in percentage point performance on the price/mix of the High Value which is below the average of the entire sales, and I told the 3 elements that are driving the difference.

Thomas Besson – Kepler Cheuvreux Analyst

Second question, if I may. Your drop-through on ForEx is higher than in the past, if I made my calculation correctly. Can you just come back on that point, tell us which currency specifically, lead to this situation. And I've noticed the recent improvements on emerging market currencies in the U.S. selection, should that not help you in 4Q?

Valeria Leone – Executive Vice President Strategic Planning & Controlling, Investor Relations and Micromobility Solutions

Yes. So with regards to the ForEx, the higher drop through is due to a different mix of currency impact with the appreciation of the Euro vs. the dollar, versus the Japanese yen and versus reminbi. So the drop-through is 22%.
The negative effect of Forex on EBIT is twofold:

- we will have the negative consolidation effect from the translation of the local statutory PBT in Euro for an amount of €60 million, more or less corresponding to an impact on revenues that should be by ~€270 million,
- plus the total effect of higher raw material purchase price in local currencies. And you see in the guidance, we should have an effect of -€115 million FX on raw mat. That clearly will be mitigated by cost competitiveness on export flows from our manufacturers located in local countries to mature markets. Remember that more or less, we have 70%, 80% of our plants in local countries.

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

Again, there is lower level of import and export between U.S. and Europe. And so this was rebalancing the currency effect due to pandemic, the exchange between the 2 regions lowering and also the exports from other local countries to Europe and U.S. is low. And so that's why the positive side of the export from low-cost countries is much less the year than previous year.

Thomas Besson – Kepler Cheuvreux Analyst

Can I ask a last question, please. Is there anything to say about your shareholding structure and its possible evolution. Are all the main shareholders still very happy with the current structure.

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

I think that we have a very consistent structure with a very positive relation between all shareholders. And there is no pressure of any sort. I assume that we are comfortable with the structure we have today.

Operator

Mr. Tronchetti Provera, there are no questions registered at this time, sir.

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 day.