Pirelli & C. S.p.A. 9M 2019 Results Conference Call Transcript

October 29, 2019

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

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

We are witnessing a harsher market and competitive environment. Two key dynamics are in play:
- lower O.E. tyre sales, both in terms of Volume and prices
- … affecting Replacement prices, especially in Standard and High Value product with lower technological contents, as competition scrambles to keep plant running

We countered this downturn by:
- reinforcing our position in the High Value market
- progressing with our program to lessen the exposure to Standard, by reducing volumes and stocks, and
- continuing the implementation of our restructuring plan launched in the 1st half

Through these actions we were able to limit the impact of the external headwinds on profitability while protecting our cash flow.

We are preparing a new 3-year plan. In view of a difficult market and competitive scenario in 2020 - 1H 2021, we are frontloading a major cost and break-even point reduction. This is a company-wide effort, involving all functions and regions. The New business plan will be presented in the 1st quarter 2020.

Let's start by looking at how the market environment has changed compared to the scenario we described in August.
- the global car production outlook for the Full Year 2019 is weaker than expected, mainly in Europe, Asia Pacific and North America in both Synergic and Premium segments
- the overall weakness impacted the O.E. tyre market with a Full Year decline now expected to reach -8% on Standard and ~-1% on ≥18"
- the ≥18" Replacement volume trend is confirmed to be in line with a double-digit growth

In this scenario, pressure on Car tyre pricing has not eased, especially in Europe during the 3rd quarter
- in the O.E., the downturn in demand pushed major car makers to ask for price revisions, and
- in the Replacement, the largest tyre makers re-directed their production, originally planned for the OEMs, to the Aftermarket, creating pressure on prices

Tier 1 price increase in the 4th quarter in Europe will have to be faced by a still weak demand.

In this environment, we reacted through the following actions:
- in the High Value, we strengthened our leadership:
    - by seizing new profitable opportunities in the O.E. channel, diversifying our portfolio and increasing our presence outside Europe
    - by leveraging on pull-through in the Replacement channel, and
    - protecting the value on Specialties
- in the Standard, we are
    - proceeding with lowering the exposure to the less profitable products
    - accelerating the reduction of inventories (-22% YtD at 9M, was -16% in 1H), and

- continuing the implementation of the Restructuring plan

- in cost cutting, we are accelerating towards a company-wide structural program aimed at lowering the break-even point from 2020 onwards

Let us now briefly review Pirelli's key performance in the 1st nine months of 2019.

The top line trend was marked by an increase in the High Value segment, now accounting for more than 67% of our total revenues and the ongoing reduction of the Standard segment.

In a very tough market environment, we were able to limit the impact of external headwinds on our profitability through our internal levers such as price/mix, efficiency and further efforts in our cost-cutting program.
The profitability trend is also affected by unabsorbed fixed costs, following the decline in production to reduce Standard inventories.

The net income reached a 10% weight on sales in the 1st nine months of 2019. We remind you that a positive one off is included in both 2018 (Patent Box) and 2019 (Brazilian Fiscal credit).

Finally, we closed the 9 months, with a Net Financial Position of €4 billion, or €4.5 billion including the IFRS 16 impact, discounting the usual seasonality of the working capital and the dividend payments in the 2nd quarter of the year.

The trend of Net Debt improved in the 3rd quarter with a positive cash flow generation of €12 million, versus a cash absorption of €131million in 3Q 2018, benefitting from the above-mentioned reduction in inventories.

Based on the nine months results and on the trend we envisage for the 4th quarter of the year, we are updating our Full Year guidance.

Revenues are expected to be at least €5.3 billion, with a growth of ~2.5%, assuming:

- a slightly lower reduction of Standard volumes
- a price/mix improvement in the low range of the previous guidance, reflecting the challenging price scenario and a different mix (a more contained reduction of Standard), and
- a better forex

Mr. Casaluci will comment on that later.

High Value weight is confirmed at 67% of our Revenues and 85% of the adjusted EBIT before start-up costs.

As for profitability, we now forecast an adjusted EBIT margin higher than 17% - up to 17.5%, where the delta versus the previous guidance is due to:

- external headwinds
- the progression of Standard inventories reduction, and
- the inclusion of some of the short-term cost-cutting actions planned for 2019 into a wider and more structural plan aimed at reducing the break-even point from 2020

The net cash flow generation before dividends is now expected between €330 and €350 million versus a previous guidance of €350 / €380 million.

Mr. Sala will comment on that later. Let's now look at the medium-term scenario.

The scenario we envisage for the short-term, in 2020, is very challenging.

Current forecasts are pointing to a weakening economic environment likely to worsen due to a more troubling Global Trade Outlook.

In U.S., growth is slowing down, affected by Trade Wars and decreasing manufacturing confidence.

In Europe, the manufacturing sector continues to slide, and Trade War fears continue to weigh on business confidence.

In China, GDP growth is gradually slowing as a result of de-leveraging, trade tensions and weaker global growth. The greatest risk for this area is a full-blown trade war with the U.S.

Looking at the markets, we confirm our positioning as the only Consumer Tyre Specialist and the focus on the High Value (H.V.) that continues to grow faster than the rest of the market, backed by a world car parc that keeps growing at a positive pace

- Premium & Prestige parc will proceed its expansion, on average +5% between 2019 and 2022
- Synergic car parc will also grow at +3% CAGR; within this segment, there is an upper layer of “Premiumizing” Cars that is growing fast, and demanding High Value tyres

World ≥18” Tyre Demand, considering both Original Equipment and Replacement, will exceed 300 million tyres in 2022, slowing down from “double digit” to “high single digit” and still highly concentrated in the 3 High Value Regions (>95%)

- in a worsening Car production outlook on the medium-term, O.E. demand is expected to slow down, with many Auto and Parts players anticipating non-recovery in the next two years; nevertheless, the ≥18” will continue to grow while Standard demand will be negative; Electrification and SUVs will keep pushing for large rim sizes and high technology tyres, enhancing technological barriers
- Replacement demand will capitalize on the circulating Premium & Prestige parc

We do continue to believe that High Value is a more resilient segment in an economic downturn and defendable through our barriers to entry, with:

- technologies (materials, processes, product design, …)
- application innovation (e.g. Run-Flat, Noise Cancelling, E.V., …)
- brand awareness and consideration
- customer loyalty rates, both OEMs and end users

Strategic Focus is confirmed, but a worsening external scenario calls for a strengthening of the competitiveness of our Business Model

The New Plan’s goals are greater cash generation and maintaining leadership in Sustainability

The reinforcement of the Business Model will be based on four pillars:

- consolidation of technology and innovation leadership, bringing to the market innovative products and future mobility solutions increasing - and the same time - products’ environmental efficiency
- significant reduction of the cost base and the breakeven point, already beginning from 2020
- selective approach to High Value growth
- containment of investments, in particular those aimed at increasing production capacity

Considering that the external scenario is becoming more challenging compared with the expectations of recent months, we are strengthening significantly the plan to reduce break-even already in 2020. Therefore, the presentation of the Industrial Plan will take place in the 1st quarter of 2020.

And now I leave the floor to Mr. Casaluci.

Andrea Casaluci – General Manager Operations

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

The 1st 9 months of 2019 closed with €4 billion revenues, growing organically by +2.3%, or +2.8% including the FX impact. The growth was much more pronounced in the 3rd quarter: +4.1% organically or +6.7% in total.

High Value volumes increased by +6% in the period, with a strong improvement in the 3rd quarter: +10.2%, compared with +3.4% in 2Q and +4.5% in 1Q.

In the 3rd quarter, we increased our global market share in Car ≥18” by almost 1 percentage point, recording a +12.7% volume growth, +5 percentage point higher than the market. This trend was sustained in both channels:

- in the Replacement, by the pull-through effect and the success of Specialties ≥18″
- in the O.E. channel we benefitted in Europe from new vehicles launches fitting High Value tyres, compliant with the new CO_2 emission rules; and from new contracts in North America and Asia Pacific

Trend remains weak in Standard (-12.2% in the 1st 9 months, -8.8% in the 3rd quarter) discounting:

- the global slowdown of the Car ≤17″ market
- Pirelli’s decision to cut less profitable products

Price/mix improved by +5.4% in the 1st 9 months. The trend in the 3rd quarter was consistent with our full year guidance, and discounts:

- the higher sales in the O.E. channel, turning the channel mix negative
- a positive product mix, in line with 1H trend
- pressure on prices, less pronounced in the High Value thanks to our high exposure to Specialties.

A couple of words on pricing:

- in the O.E., the weak car demand is pushing major car makers to adopt exceptional cost measures. This is affecting some of the current contracts. Looking forward, we are working to limit the impact by being more selective in serving OEMs, focusing more on O.E.-Replacement integrated profitability and expanding our partnerships to include new Premium and EV clients
- in the Replacement channel we are experiencing pricing pressure on Standard and on ≥18” not Specialties (especially in Europe) which is becoming a more competitive segment. Pirelli announced a price increase effective from early October in Europe (about to 3% in Summer and Winter) and its successful implementation will rely on market trend dynamics.

Forex trend was positive (+0.5% in the 9M, +2.6% in the 3Q), after some US Dollar appreciation and some lower volatility of emerging market currencies.

Moving to profitability, Pirelli closed the 1st 9 months with an adjusted EBIT of €685 million, a 17.0% margin.

Internal levers (price/mix, efficiencies and cost-cutting actions) contributed to limit the impacts of the external scenario (exchange rate volatility, increase in the cost of production factors, weakness in market demand and the pressure on prices). In more detail:

- price/mix offset the raw material headwind and the volume reduction
- industrial efficiencies generated savings for 1.4% of sales, which compensated rising inflation costs
- cost-cutting actions contributed to limit the increase in the D&A and other expenses and the unabsorbed fixed cost of Standard
- stable start-up costs and Forex

In particular, 3rd quarter was mainly impacted by
- the lower contribution from price mix with a drop-through of 45%, mirroring the dynamics already explained
- the above mentioned actions on inventories resulting in €10 million cost impact
- higher costs related to sponsorship, logistic and other operative costs
- €10 million from cost-cutting

Let's now have a look at the performance by Region.

EMEA closed the 1st 9 months with organic sales of -2.0%, impacted by the strong decline of Standard (-12.3%) which now accounts for about 35% of total car volumes (above 40% in 9M 2018).

In High Value we recorded a +2.3% organic growth, improving versus the +0.6% in 1H thanks to the rebound of O.E. sales and a stable sound performance of Replacement.

Overall, profitability was in the Mid-Teens range for the Region, lower than the 1st 9 months of 2018, due the weak volumes trend in Standard - followed by a lower production - increasing inflation in Romania due to the local currency devaluation, and the above mentioned pressure on pricing.

Winter inventories are at a normal level. The success of the Winter season, as usual, will also depend on favourable weather conditions.

In North America, we recorded an organic growth of +5.7%, driven by High Value Sales and improved market share
- in the Replacement, through the success of our Specialties ≥18", and our regional All-Season products
- in the O.E. channel, with the expansion of our customer base; we started delivering High Value products with high technological contents to "Premiumizing" models of U.S. and Asian Synergic OEMs, an opportunity to strengthen our future pull-through market

Profitability is confirmed in the Twenties range, improving vs. 2018 as a result of the higher weight of High Value sales, cost efficiencies and the progressive strengthening of the U.S. Dollar.

In Asia Pacific trends are improving with an organic growth of +5.2% versus +4.2% in the 1st half 2019.

In the High Value we consolidated our leadership with a solid performance in both the car and moto business. New OEMs contracts are reaching the delivery phase both with Asian and German Premium manufactures.

Profitability confirmed in the Twenties range, stable YoY.

Russia and Nordics grew organically by +5.4%. The focus on the most profitable segments and the market recovery impacted favourably on the Region 9 months' results, with an organic growth of +34% in High Value revenues, compared to a 3% decline of Standard organic sales.

Profitability confirmed in the Mid-Teens range, slightly lower than the same period of 2018, on the back of higher unabsorbed fixed costs in Standard. Local production, increasingly devoted to Europe, was reduced in the 3rd quarter in order to optimize Europe's inventories level.

South America results are reflecting the implementation of the new go-to-market in the region:
- the pruning of the less profitable rim-sizes in the Standard Segment, combined with the repositioning of the profitable standard products. This is leading to a double digit decline in volumes, balanced by a even higher price/mix increase
- strong acceleration on the High Value, still a smaller segment within the market but with promising growth opportunities
- stronger distribution strategy more focused on profitable trade channels

Profitability (High-Single-Digit) has so improved in the 1st 9 months of 2019. Cost cutting measures limited the unabsorbed fixed costs in local plants, where production was lowered in order to optimize the inventories level.

Let's finally move to the Operational Drivers of our guidance.
- we foresee a High Value growth of at least 7.5% in volumes, outperforming the market in both channels and with an improving trend in the last quarter of the year supported:
    - in the O.E., by the contribution of our homologations and new supply contracts in North America and Asia Pacific
    - in the Replacement, by the pull-through effect
- for Standard we forecast a double digit decline: -11%, an improvement versus the previous indication, mainly in South America.
- the combined trend of High Value and Standard will bring volumes down 2%
- price/mix improvement is now expected at the lower end of the previous guidance +4.5% (+4.5% ÷ +5.0% the previous indication) factoring the challenging pricing environment in the Standard business and in the non-Specialties High Value and a different product and channel mix
- FX almost stable
- hence, the top line is expected to be at least €5.3 billion
- High Value weight over sales is confirmed at 67% (in line with the previous indication)
- adjusted EBIT margin is expected to be in the range of higher than 17% up to 17.5%.
- The delta versus the mid-point of the previous guidance is mainly explained by:
    - higher Input costs for €10 million, due to increase in cost inflation in Romania, U.K., Turkey and Argentina
    - a lower contribution from cost cutting (from €70 million to €50 million), since some of the planned actions are now replaced by a medium term cost reduction initiatives
    - €20 million of unabsorbed fixed costs on Standard due to the lower production
- we confirm the following drop-through: 40% on volumes, ~55% on price/mix and 15% on Forex

I now leave the floor to Mr. Sala.

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

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

Net Income in the 1st 9 months of 2019 was €386 million, or 9.6%, in line with the previous year.

We remind you that both 9M 2018 and 9M 2019 include a positive one-off impact:
- Patent Box in 2018
- Brazilian tax credit in 2019, with a net impact of ~€100 million

Tax rate in the 1st nine months of 2019 is equal to 26%, in line with full year target

Excluding all the one-offs and non-recurring items, Net Income adjusted amounted to €380 million vs. €404 million in the same period of 2018, where the difference is mainly related to the Argentina hyper-inflation impact.

We ended the 1st 9 months with a Net Financial Position of €4 billion, €4.5 billion including the IFRS 16 impact, discounting the usual seasonality of the working capital and the dividend payments in the 2nd quarter of the year.

Net Cash Flow before dividends improved year over year by €349 million (-€612 million in 9M versus -€961 million in 9M 2018).

This result is attributable to a better Operating Cash Flow which saw:
- lower CapEx year over year, consistent with the FY guidance
- a limited cash absorption from working capital (-€963 million versus -€1,245 million at the end of September 2018) benefitting from the already announced recovery actions on standard inventories

More specifically, inventories in the 9 months saw a reduction in volumes of 9% (-4% in June), with:
- a -22% of Standard volume decline (-16% in 1H)
- a +1.5% of High Value products (+5% in 1H)

Following the actions taken, we already reached an inventory level in line with the end-of-year target of a 20.5%/21% weight on revenues, compared with 21.7% at the end of 2018.

Despite the usual seasonality of the business, the quarter saw a positive Net Cash Flow of +€12 million vs. a negative cash absorption of -€131 million in 3Q 2018, driven by the recovery actions on inventories and a lower year over year CapEx.

For the Full Year 2019, we expect to generate a solid net cash flow before extraordinary operations and dividends between €330 million and €350 million. This result will be achieved through a tight control on the working capital and lower Investments (€380 million) vs. 2018 (€463 million).

The new guidance is only slightly below the one of August (between €350 million and €380 million) thanks to:
- additional recovery actions on Raw Material and Controlled Distribution stocks, pursuing the low-end of the inventory over sales guidance (20.5%)
- lower dividends to minorities, and
- lower cash-out for taxes

that partially off-set the reduction of EBIT adjusted.

In line with the usual seasonality of the business, in the last quarter of the year we expect a positive reversal of Working Capital and Other by more than €900 million (€857 million in the 4th quarter of 2018), deriving from

- the receipt of trade receivables in conjunction with the Winter sell-out;
- further reduction of inventories;
- the increase of trade payables, also due to the usual weight of investments in the last quarter of the year

Pirelli's Gross Debt amounted to €5.6 billion at the end of September 2019, with an average life of 2.4 years, as ~70% of it is now due beyond 2021.

We remind that we have the right to extend, at unchanged economic conditions, the maturity of 2 of our committed bank lines to 2022 and 2024 respectively.

Our cost of debt on an annual basis (related to the last twelve months) stands at 2.99%, from 2.95% in December 2018.

Now I leave the floor back to Mr. Tronchetti.

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

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

Questions & Answers

Kai Mueller – Bank of America Merrill Lynch Analyst

You are, obviously, seeing better volumes in 3Q and also now guiding us towards the upper end of your prior range at the same time take down some of your margin expectations. When you think about your business, how you're thinking going into the end of this year and also into next year, how you prioritize volumes versus prices? And then the second question is really on the cost cuts you mentioned. You said, obviously, some are not coming through this year. You are planning to do them more structural into next year. Can you outline a little what those structural changes are in order to take the breakeven point down further?

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

I'll start from the second question and then I leave the floor to Mr. Casaluci for the first question. So as you see we postponed the plan in order to enhance the 2020 breakeven point reduction. The actions we are implementing both on costs of headcount, costs related to purchasing, the largest part comes from a different approach to the design to cost, designed to value of the products and the industrialization cost and the cost of production in our factories. So we are now working in a more integrated methodology between the cost design and the evolution of the production in our factories. And we see the largest part of our cost reduction will come from these area. It's a very analytic job we are doing, which involves all functions, technical functions and industrial functions together with the commercial side because altogether we are now working on a value-based evolution of our products, also to the Replacement in the market with a continuous control on value creation and pricing. So that is why we are postponing. To answer it in a simple and easy way, the largest part of this will come from the cost of the products and the cost of production. These are the major changes we are putting in place. Mr. Casaluci?

Andrea Casaluci – General Manager Operations

Thank you, Mr. Tronchetti. As far as price/mix versus volume, clearly, the priority for us is and will remain to support the price/mix grow and, as a consequence, the profitability. And also in 4Q, our priority is to capitalize the price increase that we have announced. You see a better performance in terms of volume mainly because of 2 reasons.
First, because we are enlarging our customer base in the O.E. as we announced at the beginning of the year, mainly in North America and in Asia Pacific. We see there are a lot of important synergy carmakers that are entering into the Premium segment with new interesting models, and we want to stay with them in these development and we want to enlarge our coverage, mainly in Asia Pacific and North America, as I said before.
Second point, the reduction on Standard is lower than before, and you will see that we do not target any more a double-digit decrease on Standard, simply because we have already cut and phased out all the second brands and the less profitable segments. So now we are following more the speed of the market instead of accelerating as happened in the last 2 years.

Gabriel Adler – Citi Analyst

On price/mix in the High Value segment, it was quite weak, ~-2% in 3Q, could you talk through the key drivers of the weakness in price/mix in High Value? And would you agree that it's a sign of increased

competition, particularly on ≥18" products? And then my second question would be on the lowering of inventories through reducing production in the Standard segment. I just like to understand whether you think this is a longer-term issue relating to tyre oversupply in the market? And whether you expect Standard production to remain low at 2020 in order to address this oversupply?

Andrea Casaluci – General Manager Operations

So I'll start from the question on price/mix in the High Value. Price/mix in the High Value in 3Q was slightly negative. This is mainly linked to 2 reasons. The first, which is the most important, is the negative channel mix. It is accounting for more than the half of the price/mix reduction and is related to our growth in 3Q in the Original Equipment in the High Value higher than the one on the Replacement channel. And the second, the discounting for 1/3 of the impact is the price pressure in the products ≥18" non-Specialities, which are not protected by different technologies. All in all, the price/mix that we recorded in 3Q, +3.5%, is the best performance of the industry. So to answer to the first question, in the benchmark, we always perform more than the double than best performers of the industry in the price/mix and these remain our target for us. As far as the outlook on 2020, sorry, but I haven't understood the question, is it related to volume or market or what?

Gabriel Adler – Citi Analyst

It's relating to reduction of production in the Standard segment. Was that to be thought of as a one-off in 3Q or is this the new normal?

Andrea Casaluci – General Manager Operations

In 3Q, you'll see a lower reduction in the Standard versus 1H, because we compare ourselves with a previous year, where we had an acceleration in the reduction of the Standard, which happened mainly in 3Q and 4Q, linked to the South American market price and also because we are now accelerating the program of reduction of inventories in the Standard.

Martino de Ambroggi – Equita Sim Analyst

The first question is on the price increases that you mentioned during the speech. Are they fully implemented? And if you could separate your comment by region and by segment, please?

Andrea Casaluci – General Manager Operations

The price increase are already implemented effective from 1st of October in Europe and in the U.S. up to 3%. The price increase are not flat but different product by product. And we have focused the price list increase mainly on the products where we have a leadership in the Original Equipment, where we are protected by different technologies and Specialties, and in the lower end of the Standard where we want to continue our exit strategy from the segment.
If we move on the other regions, we have applied another price increase of 5% in Brazil following the local inflation and opportunities to improve the price/mix performance as I explained that is one of the main driver of the increased profitability in South America.

Martino de Ambroggi – Equita Sim Analyst

Okay. In any case, no problem to implement these price hikes. That's the major point. The second question is on the restructuring actions that you mentioned. If you look, as you mentioned, major importance will be the design to cost and different industrialization. I don't know if I'm right, but this takes time and thus the benefits will be probably more evident in 2021 rather than in 2020, or maybe I'm wrong on this and this seems to be the most important portion of the cost savings that you have in mind?

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

I answer to the second part and then I will leave the floor to Mr. Casaluci for the first part of your question. What you're saying here is true that these actions are effective later. What we are doing is a bit different because we are on one hand simplifying the so-called SKUs, or as we call them IP codes. So we are reducing the number of items, which is an analytic process. Combining products that can have the same mix of raw materials to simplify things. We are combining this with actions in the factories to standardize some processes thanks to the automation we have in our factories and to simplify in a drastical way, the cost of production, increasing productivity in our factories. This is not a process we started in the last couple of months. We started last year this process. We accelerated the process in June, when we started watching market deterioration and to the need of implementing action faster. These actions are now already in place in some factories and we see the possibility, more than the possibility, the certainty that these actions will be implemented, having effects in large part already in 2020.
It is not something we have done at the last minute. And in this process are helping a lot the modelling of products, and also, the simulators we are using.
So we are facing a demand from the Original Equipment that is a drastic process of cost cutting on this side, asking for prices decrease already in 2019 that are affecting our accounts. And taking into account all of these, we made all the actions in order to reduce the cost of product.
So the simplification is possible today, thanks to digital, thanks to simulators, thanks to the mathematic model and in our plan, what we have is a continuous investment in technology that allow us to implement all these actions, reducing drastically investment on capacity because obviously, year-end, we have capacity available that, as it was already announced in our IPO from 2020, the demand of capacity for us will come down drastically.
And we are moving investments to the technological side, and this is why we are ready to deliver already in 2020 a consistent result out of these actions. Mr. Casaluci?

Andrea Casaluci – General Manager Operations

Thank you, Mr. Tronchetti. So as far as our capability to increase the price, I have to divide. The products where we have the leadership in the Original Equipment that we are more protected, we are confident to apply successfully the price increase we announced. On the other High Value products and on the Standard is our priority and we will do our best to apply the full price increases. Clearly, in this segment, it will depend also from the price discipline of the market. The first signals on the month of October are positive, but we are monitoring the impact on a daily basis.

Martino de Ambroggi – Equita Sim Analyst

Okay. If I may, very last question on the drop-through for price/mix in 3Q was 49%, maybe you mentioned it during the presentation, but what should we expect for 4Q?

Andrea Casaluci – General Manager Operations

It's 55% on the full year basis, which is a bit higher than 40% in the last quarter as expectation.

Sascha Gommel – Jefferies Analyst

The first one would be, again, on price/mix. So we see a significant deterioration again in the 1Q implied by your guidance. I was wondering if you can share a few thoughts about price/mix in 2020, how you see that shaping up? And then my second question would be on the cost line item, D&A and others. It seems that especially the other parts has been changing from 1H to 3Q quite a bit, so I was wondering if you can give more details around the other part of that line, what changed then? And then very finally, you upped your cost cutting from €50 million to €70 million with 2Q results and now you take it down back to €50 million again. What is that €20 million gap? What kind of are we taking out again?

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

So before leaving the floor to Mr. Casaluci, I want to underline one thing on price/mix. The recent deterioration is visible and we are implement tougher actions in 2020 to protect our profitability, we have to reduce the cost of our products. In this environment cost reduction are needed.
Mr. Casaluci?

Andrea Casaluci – General Manager Operations

Yes. I have to add that the deterioration of the price/mix is not so materially significant versus the guidance, while it is if we compare the 3Q versus 1H. In 1H, the price/mix performance was +6.4% and 3Q was +3.5%. And this was more or less expected in our previous guidance. The delta between the 3Q and 1H is linked to two effects: 2/3 of the impact is related to the negative channel mix. So higher weight on the O.E. The second effect, accounting for 1/3 of the delta versus the 1H, is related to price pressure on the High Value segment non Specialties and in the Standard. Expectation for 2020. It's not yet time to disclose the price/mix because we're still working on it, but I do expect a stabilization on the channel mix effect. We are discounting a negative channel mix effect in the third quarter, and we will also discount also negative one in the 4Q 2019 because of the comparison versus last year. If you go back to the 3Q and 4Q 2018, you will see a particularly outstanding price/mix performance. So I do expect that these effects will be stabilized in 2020. I do expect a reduction on the impact of less Standard sales because we will move from a double-digit decrease into a high single-digit decrease on Standard. So we will have a less positive impact coming from the Standard reduction, while the growth on the High Value and the micro mix effect will be confirmed. So it will be closer to what we have seen in 1H 2019 than in what we see in 2H.

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

And Mr. Sala, can you please answer on depreciation?

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

Yes. For your concern on depreciation, the variation in 3Q versus the previous quarters, 1/3 is related to the depreciation that in the region of the year has grown by €30 million and the remaining part is coming from the fact that last year we increased the action on cost starting from 2H. So €20 million in 3Q and €30 million in 4Q. So practically the comparison base now for this point of view is comparing

3Q 2019 versus 3Q 2018, in which the action already increased. There are no major differences from this point of view quarter-by-quarter.

Henning Cosman – HSBC Analyst

Sorry, I need to come back to the price/mix again. Also looking at deterioration and the drop-through, is it possible at all to give us, as a one-off maybe, the proportion of price and the proportion of mix within that? I'm just assuming that the price has become more negative within it because if we assume that the drop-through on price is 100%, that it would explain the various drops. So that's my first question. And ultimately, to reconcile just why the price is so weak because you're main competitor, the French competitor doesn't appear to have similar issues on the pricing in the Premium segment. So that's the first question. Second question, I'm afraid I still don't fully understand why you moved the timing of the announcement of the comprehensive financial plan? I appreciate the extra granularity that you've given today, but I'm just wondering what's changed compared to 5 weeks ago when you announced the timing to be in December? Or for what reasons you think you might have better visibility in 1Q than what you would have in December? So if you could please just tell as one more time why you're moving it? And what's the benefit of doing it in 1Q rather than in December? And then just finally, on the coverage of the fixed cost, if you could just explain, again, why there's now an under coverage of fixed costs even though you're seeing the reduction in Standard less negative than in the previous plan? Why is there now a bigger under coverage of fixed costs?

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

I'll answer to the part of your question related to the postponement of the plan. Postponement of the plan is due to the effective deterioration of the market. We see this through the requests that are coming from the Original Equipment. We are now finalizing the contracts for next year related to prices. We saw that the pressure on prices in our Original Equipment is becoming more and more visible and combining this with the existing situation in the Standard business and in the lower part of the ≥18" made us confident that the only way to continue growth in profitability looking forward is to act deeper into our cost basis and to implement all these actions effectively in 2020. We wanted to have more time available to be really active from 1st January 2020, and bringing backward some actions that we're expected to have results in '21, '22 because we see the toughest time coming sooner than expected. That is the situation. And the real pressure, obviously, today comes from the Original Equipment. We have to answer to this through technology and cost basis reduction to keep profitability already in 2020 at a level that is in line with the expectation of us and of the market. Mr. Casaluci?

Andrea Casaluci – General Manager Operations

So as far as price/mix performance and the worsening of the drop-through, I sum up what I said before. The difference between 3Q, +3.5%, and the 1H, +6.4% on the price/mix, is 3 percentage points. Out of these 3 percentage points of worsening of the price/mix, 2 are linked to the channel mix, and again, it's something that we do expect also in 4Q and then will be recovered when we will be back to the normal channel mix from beginning of 2020. And 1 percentage point is the price environment. If we compare the Pirelli price performance into the market based on the public information we have, we see that the performance on price of Pirelli is better than the average of the Tier 1 into the market. Having said that, we know we have opportunity to do better and better, and this is our main focus for the coming months and as I said before, we are confident we can improve.

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

For what concerns the undercover of fixed cost, you are right, considering the fact that in term of sales, the sales of Standard were reduced by 8.8% in 3Q, while in the cumulative data were -12%, -13%. But this is what we have in terms of sales. What is important here is what happened in terms of production in 3Q in order to reduced the stocks. So by acting on the production volumes we reduced the stock versus the end of last year: -22% on Standard in the first 9 months. So this was the action that we did in order to have a better control of the stocks and for the cash management and to reach targets of the cash.

Henning Cosman – HSBC Analyst

Can I just follow up on the price? Would you say it's fair to say that price was already negative 1% year over-year in the 1H, so the 1 percentage point deterioration is order of magnitude minus 1 in the 1H and minus 2 year-over-year in 3Q? Is that roughly so?

Andrea Casaluci – General Manager Operations

No, it's not correct, it is too high. We don't disclose the difference between price and mix. We never do. But your estimation in terms of pure price negative impact is too high.

Monica Bosio – Banca IMI Analyst

Most of my questions have been already answered, but just a follow-up on the drop-through of the price/mix. The slowdown of the Original Equipment has created available capacity, which has reversed into the aftermarket. But I've noticed, and correct me if I'm wrong, there is also some pricing pressure on new contracts for Original Equipment. So does this mean that the price pressure is going to intensify? And if yes, what kind of drop-through do you expect in 2020? It will be 55% on the full year, maybe, it could go down in 2020 or am I wrong? And the second question is on the saturation rate of the plants. What is the saturation rate of the plants for High Value tyres? And what about that rate of saturation for Standards? And do you still expect unabsorbed fixed cost in 2020 reasonably as you have reduced the stock? This kind of unabsorbed cost that should be one-off, am I right?

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

So I'll answer to the first part of your question. Mr. Casaluci will answer to the second part. You are right, on Original Equipment, there is price pressure that will go on in 2020, even in a tougher way than what we saw in beginning of 2019. That's why, as I mentioned before, we see an opportunity coming from reduction of the break-even in 2020 to continue our policy of serving our customers at a convenient price, but with costs that allow us to be profitable in this segment. We, obviously, do not comment on drop-through on 2020 because it will be part of our plan in 2020. But you can imagine that the figures of 2020 will be affected in a very consistent way by the plan we will present. So any comment that I make today could anticipate something that we will deliver with the plan. Mr. Casaluci?

Andrea Casaluci – General Manager Operations

Thank you, Mr. Tronchetti. Yes, we confirm higher pressure on price coming from new contracts, which is part of the environment we are facing in this period of time. Our reaction is, first, as Mr. Tronchetti mentioned, to work deeply on the product cost both in production and product specification. And second,

to be more selective in approaching the new projects, always evaluating the interest of new projects, we are looking at the integrated profitability between the Original Equipment sales and the expected future Replacement sales. This is also one of the reasons why we are enlarging our customer base, entering a new Premium segment of new customers. Moving to the saturation: our saturation on the High Value capacity is higher than 95%, while our saturation on the Standard capacity today is close to 75%, which means ~6 million of non-saturated capacity. This is due to the reduction of that demand and due to our target to reduce the stock, as Mr. Sala was mentioning before. Our restructuring plan already announced as a target to close this gap and to arrive to a full saturation of the capacity also on Standard. For the time being, we have in our numbers the inefficiency of the fixed costs not absorbed by production.

Monica Bosio – Banca IMI Analyst

Okay, but not for other impact?

Andrea Casaluci – General Manager Operations

No. Only Standard. The High Value is fully saturated capacity.

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

On this topic to remind you that we announced the restructuring in Brazil and the change of scope of our factory in Italy that are part of this reduction of the breakeven point and upgrading of our mix. Obviously the economic effect of this will start coming in 2H 2020 and full effect will be in 2021.

Gaetan Toulemonde – Deutsche Bank Analyst

I'm going to be extremely brief in my question. If I look at the raw material price today, am I my right to assume that next year it could represent a tailwind by ~€50 million to €70 million, or I do my math absolutely, wrong?

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

I have an easy answer, it's too early to say. Contracts we already have in our portfolio are making us in a position to begin next year in line and a bit better than last year. That's the situation we foresee for the beginning of next year for contracts that are effective January 1. But we are talking about a minor part of the raw material, so it's too early to give you an answer.

Thomas Besson – Kepler Cheuvreux Analyst

I'll try to be brief as well. Two questions please. The first one is could you please give us an idea of the indirect contribution you still get in 2019 from your industrial tyre business through the technical assistance and the supply of semi-finished products? The first one. And the second, when I look at your 3Q, it seems that price/mix has been better in Standard than in High Value, should we assume that in 3Q, the profitability gap between the 2 segments actually declined and the profitability of High Value tyre decline while Standard improved or is it incorrect?

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

I'll answer to the second question. Can you please repeat the first question because we couldn't hear it well?

Thomas Besson – Kepler Cheuvreux Analyst

Sure. So I'll repeat the first question. Could you please indicate what we should expect from the indirect contribution of your former industrial tyre business to the group adjusted EBIT in 2019?

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

We have royalties, that's the only thing we have, so there is nothing new in this area. Related to the second question on profitability, I have to confirm that the profitability on Specialties tyres continue to be in line with the profitability we had in the past. And the only effect we see in the last months of this year is the reduction in profitability of the Original Equipment that is the point we see the only difference. But all in all, we don't see a reduction of integrated profitability and the action we are putting in place are focused to consolidate this business model.

Ashik Kurian – Exane BNP Paribas Analyst

I've just got two questions. The first one is you've said you're destocking on the Standard tyres that should normally translate into some free cash flow support from destocking. I'm just wondering if that is factored into your new cash flow guidance because I would have expected some support to free cash flow from the destocking that you're doing on the Standard side. And also wondering whether you now are anticipating higher restructuring charges to offset some of the destocking benefit you are having.

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

I'll answer to the second question and Mr. Casaluci will answer to the first part. The cost related to restructuring, thanks to the balance sheet we have, will be such that not to affect the result, the net result can be in line with last year. You know that we had the advantages related to the positive effect of the fiscal recognition of our rights in Brazil and the Patent Box. So this allow us to have year-end not negative effect compared to last year to our net result. And there will be, obviously, cost related to restructuring to pay the cost of next year. Mr. Sala?

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

For your concern, the Standard, the major action that we have in term of impact on the cash flow on the Standard is coming from the reduction of the inventories from this point of view that we target at the end of last year and we reached already in 3Q. We want to keep also for 4Q. And then for sure, the Standard is contributing to the cash with the results generated by the activities on Standard. Also if it is with a lower profitability in any case is a business in which the investments are lower because the capacity is already there. So practically each activity that we are doing is we don't have any larger CapEx or any investment in CapEx. So in terms of profitability in any case is currently a good contribution to the full picture of the cash flow of the company.

Ashik Kurian – Exane BNP Paribas Analyst

I know it's maybe a bit too early to comment on the 2020 plan, but you said it's based on improving the free cash flow. Can we assume that the current CapEx levels can be sustained? I mean is that part of you reducing the cost of producing tyres? So would some of the free cash flow support for 2020 and beyond come from a lower than previously planned level of CapEx?

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

We already, as I mentioned before, during the IPO process, we said that at the beginning and for the first 2 years, we would have had ~8% of investments going down to 7% and landing to ~6% on sales in 2020. So I think, that you have to keep in mind these figures, looking to the fact that the capacity installed doesn't need to be supported with more investments, sorry. The investment in the 3 years will be lower than the investments we had the last 2 years. That is a way to answer to your question without answering to the planned figures.

Ralf Stromeyer – Allianz Global Investors Director

Could you comment on the pricing pressure in the OE business? Is this structural issue because of new competition? Or is it rather a cyclical issue because of excess capacity?

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

It's the automotive industry that is facing major restructuring. It is visible problem of high investment in new technologies, reduction of growth in China and in Europe, strong reduction in core countries in Europe, that is Germany, all and each of investments are putting pressure on the automotive industry and the automotive industry is putting pressure on our suppliers and we are putting pressure on our suppliers. So the world is changing and we have to accelerate the changes inside our company to continue successfully the performances we had. And so I think it is a structural change as it will be structural change in our cost basis we are going to implement and we are implementing now accelerating the process in the last few months. And so we cannot talk about cycle. We talk about an industry that is facing different times compared to the past.

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

So thank you to everybody. This concludes today's program. Thank you for your attention, and have a good evening.