

Pirelli & C. S.p.A. 1Q 2021 results conference call transcript

May 12th, 2021

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

Good evening Ladies and Gentlemen, and welcome to our conference call.

Current market and macroeconomic trends confirm the optimism about the 2021 scenario, both for the global economy – whose recovery is connected to the vaccination progress – and for the Tyre Industry, where High Value demand is back to pre-pandemic levels already in 1Q.

Our Industrial Plan implementation continues in line with our expectations:

- a significant increase of the High Value share has been recorded in 1Q, particularly in China (+4.6 pp YoY)

1Q 2021 results are in line with our expectations:

- revenue growth lead by a strong volume rebound and price/mix improvement
- adj. EBIT margin at 13.6%, discounting the impact of some costs with a seasonality concentrated in 1Q, as Mr. Bocchio will illustrate you in more detail
 - profitability is expected to further improve from 2Q, due to the consistent overperformance in the High Value, price/mix compensating the raw material cost increase, the 2021 Competitiveness Plan and normalization of the seasonality of the costs just mentioned
- cash flow improvement related to the operating performance and careful stock management
- Full Year guidance is confirmed

Global economy is expected to grow by +5.3% this year, in line with the assumptions made in our Industrial Plan, with a higher growth in the USA compared to our forecasts (from +5.7% in the Plan to +6.2%) also due to the high vaccination rate in the general population.

Exchange rates, particularly volatile in this first quarter, should stabilize over the next few months, also due to the recovery of the economy and a more favourable comparison with the past year.

In the Tyre business:

- demand is strongly recovering, with the High Value growing +9% globally compared with 1Q 2019; the 2019 levels were exceeded in APac, Europe and North America
- a limited impact during the first quarter of semi-conductors shortages, with Car Makers safeguarding the production of their top-range models and a higher volatility is expected during 2Q; with this background, we keep the situation monitored daily to manage any slowdown in the O.E. and exploit opportunities in the Replacement channel
- the price scenario is favourable, since it is supported by the raw material inflation and shipping costs and low stock at dealers' level; several increases announced in the Industry, which are going to be implemented mostly from 2Q, including the recent price increases¹ in the European Winter tyres
- a raw material inflationary scenario is confirmed, driven mainly by the Oil price trend
- a price/mix improvement will allow us to offset the raw material headwind

Our 1Q results already show the first evidences of our Industrial Plan “key programs”.

Regarding the Commercial program, we have strengthened our leadership in the High Value through:

- a high technology product portfolio; and
- a production and logistic structure that can manage the high volatility of the demand

In line with our targets, we have increased our exposure on $\geq 19''$ (66% of High Value volumes, +2pp YoY) as well as on new technologies: the Electric volumes grew 8 times more than last year figures.

Our performance in China is worth being noted, with over 4 percentage points more in terms of Car $\geq 18''$ market share, +8 percentage points on Car $\geq 19''$.

This has been achieved by having fully intercepted:

- Global Premium OEMs and main local Premium EV Car Makers demand
- Repl. recovery through our distribution chain with more than 4,000 outlets and a strong on-line development, a segment which is expected to grow by over 20% this year too

On the Innovation Program:

- during 1Q, ~70 technical homologation were achieved (>20% of our yearly target) which were concentrated on $\geq 19''$ (~80%) and Specialties (~50%)
- two new product lines for the Replacement channel were introduced in Europe («Powergy» and the new Cinturato All-Season SF2) with already a very good return on the All-Season segment, as Mr. Casaluci will illustrate later on

For what regards the Competitiveness Program: Phase 2 of the Efficiencies Plan has started, with gross benefits worth €26 million (€15 million net of inflation).

Moving to the Operations Program: the plant saturation level improved, with ~90% of the total production capacity, and over 90% in the High Value.

2021 targets are confirmed:

- Revenues between ~€4.7 and ~€4.8 billion
- Adjusted EBIT margin in the range of >14% and ~15%
- Investments – as a percentage on Group Sales – of ~7%
- Net Cash Flow before Dividends between €0.3 and €0.34 billion
- Net Financial Position at the end of 2021 ~€3 billion, with a leverage of ~2.7 times the adjusted EBITDA
- Return on Invested Capital ~16%

With current market environment, strong demand and favourable pricing, we are positioned in the upper part of our Top Line guidance; a further upside will depend on the evolution of 2 factors:

- Semiconductor shortages impact on OE demand
- Sell-out pace of recovery especially in Europe

Adj. EBIT margin guidance more geared to the upper range, already factoring a higher raw material headwind (~2.5% on sales) fully compensated by price/mix.

I now leave the floor to Mr. Casaluci who will discuss in detail our operating performance for this quarter.

Andrea Casaluci – General Manager Operations

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

I shall now comment market dynamics in 1Q 2021 and the relative performance of Pirelli.

In the first three months, the Car Tyre market grew by 12% and Pirelli overperformed it by 10 percentage points (volumes +22%).

The trend is positive for all channels:

- while the market performance of both O.E. and Replacement reached +12%, Pirelli grew 28% in O.E. and 19% in Replacement

As Mr Tronchetti indicated earlier, the Car ≥ 18 " market grew by +20% YoY, a broad recovery from the levels of the 1Q 2019 (+9%).

In this segment, with volumes +33%, Pirelli's leadership is even more marked in ≥ 19 ", with volumes +39% YoY vs +26% of the market. In APac, Pirelli's performance was outstanding, with volumes growing twice those of the market (+119% vs market +73%).

In the Original Equipment, the share increase, which was steady throughout last year, continued in 1Q'21 (≥ 18 " +36% Pirelli vs +18% of the market), due to Pirelli's exposure to the Premium and Prestige segments and thanks to the consolidation of its customer base in North America and Asia Pacific; in the latter Region, Pirelli also benefitted from a favourable comparison base, given the negative trend in 1Q 2020.

In the Replacement Channel, volumes were +31% in the ≥ 18 " segment (vs. +21% of the market), because of the recovery in market demand and thanks to the low inventory at dealers' level, after the significant reduction in the first half of 2020, especially in Europe and North America.

In the Standard Segment, our over-performance was more contained than in the other segments, with volumes growing $\sim +12\%$, +2 percentage points above the market, due to our focus on products with the higher rim sizes.

The excellent performance of volumes registered by high-end products in 1Q is the result of implementation of our Commercial Program.

In particular, in the ≥ 18 " segment, our strong growth was driven by the more technological products in our offering:

- ≥ 19 " products that produced over 70% of the growth in the segment, and
- Specialties, accounting for $\sim 60\%$ of the growth in 1Q

The Replacement volumes, coming from O.E. homologations, were fundamental for the growth of "pull" volumes, especially in China (50% of global growth)

The new product lines, conceived to be exclusively dedicated to replacement, allowed the outstanding performance of "Push" volumes, especially in Europe (50% of global growth)

In the O.E. channel, the increase in market share was similar in all Regions. Fitments for electric cars keep on being a major focus and accounted for $\sim 10\%$ of the growth in the quarter.

The Innovation Program, envisaging an acceleration in the launch of new products in the 2021-22 period, continues at a good pace.

In 1Q 2021, in Europe, we launched two lines dedicated to Replacements to complete and refresh our range

The first product is Cinturato All Season SnowFlake2

- Its new adaptive compound provides the same performance and safety in a wider temperature range than the summer only or winter only products
- in addition, it is certified by Dekra as best-in-class in its category in terms of sustainability, best rolling resistance, lower noise, and 50% longer life than its predecessor

With this new product, Pirelli recorded a relevant growth in the All-Season segment in 1Q 2021 in a steadily expanding European market.

The second product, Powergy, the new summer line for cars, CUVs and SUVs with ≥ 18 " rim size, is ideal for customers who look for high driving safety and low environmental impact.

- Powergy ensures an excellent grip on wet surfaces and indeed the whole product range ranks in the «A» class of the new European labels.
- this is matched with an optimal rolling resistance that allows lower energy dissipation and therefore lower consumptions, with "B" label for the whole range.
- these values, achieved with new technologies, place Powergy as state of the art tyre with a high rating: only 2% of tyres sold in Europe have Eurolabel values in class A-B or higher

Powergy, which reached the market in March, serves the objective of supporting the growth in the ≥ 18 " segment for new CUVs of Synergic brands, where Pirelli does not supply Original Equipment.

The Competitiveness Program is progressing in line with our expectations.

Efficiencies for 2021 amount to €155 million, €80 million net of inflation (~2% of the baseline).

During the 1Q 2021, consistent with our forecasts, Competitiveness benefits amounted to ~20% of the FY target: €26 million, €15 million net of inflation.

More in details, in terms of future projects:

- in Product cost, which is worth ~50% of 1Q gross benefits, we continued to implement the new modular and design-to-value approach
- in Manufacturing, which bears ~20% of quarterly benefits, we continue to optimize the industrial, improve our infrastructure and introduce digitalization in an ever increasing number of processes
- in SG&A we exploited further efficiencies coming from distribution network redesign and warehousing optimization while implementing renegotiations with our suppliers
- last, in Organization we mainly levered on digitalization

Of the €80 million net yearly efficiencies, the bulk will be in 2Q (€30 million, ~40% of the year target) thanks to manufacturing, with saturation levels improving compared to 2Q 2020 when, due to the COVID crisis, production stopped for several weeks.

I'd like to thank you and leave the floor to Mr. Bocchio.

Fabio Bocchio – Senior Vice President Strategic Planning & Controlling

Thank you, Mr. Casaluci, and good evening everybody.

Pirelli closed 1Q 2021 with revenues in excess of €1,2 billion, growing by +18.4% (+10% ÷ +12% the Full Year target), achieved through its clear overperformance in a strong rebounding market. If we exclude the exchange rate impact (-6.1%), the organic growth was +24.5% in 1Q.

Let's review the commercial variables:

- volumes +22.2%, reflecting the stronger trend of Pirelli against the market, especially in the High Value segment (+29.3%), as already pointed out by Mr. Casaluci
- price/mix was positive +2.3%, mainly due to
 - a product mix improvement: strong growth in High Value, particularly in the higher rim sizes and highly technological products
 - a region mix improvement, given the strong growth in Asia Pacific, in particular ChinaIn line with the trend expected, the price/mix in 1Q discounts:
 - a still negative channel mix, due to the higher sales of Original Equipment; We remind you that a rebalancing of the growth rate between O.E. and Replacement is expected in 2H
 - neutral impact of prices, expected to become positive from 2Q, through the increases to be applied mostly in Europe, China and North America

Before moving to the next slide, just a brief comment on the price/mix trend in 2021.

- as indicated at the Investor Day, price/mix is expected to be volatile across the whole year.
- in 2Q we expect a more limited price/mix improvement vs. the other quarters due to the a tough year on year comparison.
- We remind you that in 2Q 2020 we recorded a +3.3%, the highest in the year, supported by
 - a strong region mix, due to the recovery in China, and
 - a positive channel mix, given the very weak O.E. channel
- as a consequence, in 2Q 2021 region and channel mix are expected to be negative, while price and product mix are expected to be positive
- for 2H'21, price/mix trend is expected to be above the FY target
- price/mix is expected to fully offset raw material headwinds in each quarter

Let's now review the trend of profitability in 1Q 2021 on slide 15. The Adjusted EBIT improved by ~+20% YoY.

The internal levers (volumes, price/mix, efficiencies) more than offset the negative impacts of the external scenario (raw materials, inflation, Forex). More specifically:

- the price/mix improvement (+€16 million) more than balanced the impact of raw materials (-€11 million), affected by the depreciation of the main currencies of the countries where Pirelli has production plants (South America, Romania and Russia)
- the Competitiveness Program, as already shown by Mr. Casaluci, generated structural efficiencies amounting to €26 million (~20% of the Full Year target) that compensated for:
 - inflation (-€11 million), and
 - the “reversal impact” of the Covid Plan for -€15 million, equal to the balance between €25 million of discretionary costs (relating to activities cancelled in 2020 to counterbalance the effects of the pandemic), and the benefits stemming from the greater use of plants amounting to €10 million. In 1Q, the effect of the Covid plan “reversal impact” was equal to 50% of what is expected in 2021 (-€29 million)

- the volume component more than offset Forex, D&A and the increase in the “costs for growth & other costs”.

Let's spend a few more comments on the last component of the Bridge, amounting to -€58 million and composed of three cost clusters.

- R&D, Marketing, and Sponsoring cost variance of -€27 million in 1Q; with the market recovery, we concentrated the increase of almost all such costs foreseen for 2021 (~€30 million) in 1Q, namely:
 - marketing costs, linked to the launch of new products, and
 - sponsoring costs, mainly relating to the America's Cup Edition of last February and March, where Pirelli sponsored Luna Rossa
- the second item is linked to the provisions for short- and long-term Management Incentives, €11 million in 1Q, as the Company performance is in line with its targets
- finally, the “other costs” variance amounted to -€20 million. This item typically includes stocks, credit impairment, royalties and other costs. In 1Q 2021, the “other costs” discounted costs relating to activities and events (for instance, Formula 1, motorsport racing, etc.), which last year, due to the Covid emergency, had to be postponed to the second half of the year, with a positive impact of €13 million in the 1Q 2020.

Over the full year, the “costs for growth and others” are expected to amount to -€30 million, approximately half of the impact recorded in 1Q. More specifically:

- R&D, marketing, and sponsoring cost variance is expected to be ~-€30 million, with a residual impact in the next quarters
- provisions for Management Incentives are expected to amount to ~-€35 million; in 2020, this item had a more contained impact because of the cancellation of the short-term incentive plan due to Covid and the resizing of the Long-Term Incentive plan
- for the other costs, instead, a positive impact of ~€40 million is expected, due to:
 - the normalization of cost seasonality, offsetting the negativity of the 1Q, and
 - the normalization and increase of inventories compared to 2020, with a positive accounting impact of ~€40 million (-€35 million in 2020)

Such dynamics will become visible already in 2Q, with a positive impact on the «Cost for growth and others» item.

In the next quarters, we expect a steady improvement of profitability, due to the on-going High Value overperformance, to the price/mix offsetting the raw material increase, to the progressive implementation of 2021 Competitiveness Program and to the dynamics already described, whereby the «costs for growth and other costs» will be reabsorbed.

Let us move to the Net Income Bridge, slide 16.

Net Income in 1Q 2021 was €42 million, from €39 million in 1Q 2020. Trend discounts:

- the operating performance improvement (Δ adjusted EBIT +€28 million)
- an increase of restructuring and non-recurring of ~€19 million, mainly related to the restructuring expenses; more specifically, restructuring and non-recurring costs in 1Q'21 are equal to a total of €43 million (€24 million in 1Q'20), composed by:
 - restructuring expenses, related to the rationalization of our structures and manufacturing footprint
 - non-recurring items related to the retention plan
 - direct COVID-19 costs, which are mainly related to personal protection material

Results from Equity participations was basically flat in the quarter, improving from the -€5 million of the 1Q'20.

Net financial charges increased by €7.5 million compared to 1Q 2020. The increase of €7.5 million mainly reflects costs for commissions related to the early reimbursement of part of the major credit line, expiring in June 2022 (€756 million), as I will illustrate in a couple of slides. This net financial charges increase will be re-absorbed through the year.

In 1Q 2021 Net Income adjusted, i.e. excluding all the one-offs and non-recurring items, is positive for €94 million.

Now the cash flow dynamics. In 1Q 2021, the net cash flow, was negative for €654 million, in line with the seasonality of the business, yet definitely improving with a +€100 million if compared to the same value of 1Q 2020.

This is due to:

- the improvement of the operating performance which has covered the higher investments, mainly devoted to the High Value, quality and mix improvement
- the usual seasonality of the working capital, with a lower absorption versus the first three months of 2020 coming from:
 - careful stock management, substantially stable at the December 2020 levels (19.5% of the revenues over the last 12 months), after growing in 1Q 2020 due to the COVID emergency
 - less cash absorption from payables, connected to the lower investments in 4Q'20
 - such improvement was partially compensated for by a greater cash absorption connected to trade receivables but in line with the business recovery and revenue increase versus 1Q'20

Let's finally move to the Gross Debt structure, slide 18. At the end of March, Gross Debt totalled €5.1 billion, ~€900 million less than in December. More in detail, during 1Q 2021, we:

- used part of the Group's liquidity to early repay some financial debt maturities in advance:
 - €82 million from the Schuldschein financing, and
 - €756 million from the Group's main bank line
- these early repayments allow the optimization of the yearly financial charges;
- early reimbursement of a bank line for €200 million due to expire in September 2021 and underwriting of a new loan worth the same amount expiring on September 2022

The Group liquidity margin at the end of March was of ~€1.5 billion and allowed to cover the financial debt for over 2 years, until June 2023.

The cost of debt (2.1% in the last 12 months) is increasing by +0.16 percentage points, due to:

- the Covid impact on the business which caused a short-term increase of the financial leverage and consequently of some spreads of some central bank lines indexed to this parameter
- wash-down of the fees, yet to be amortized, deriving from the partial early repayment of the Group's main bank line
- these effects were partly offset by the benefits achieved through a decreased exposure of the Group to "high-yield currencies"

The impacts mentioned above were anticipated in our Industrial Plan and in the targets of financial charges already announced to the market and which therefore remain unvaried.

I now give the floor back to Mr. Tronchetti.

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

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

Questions & Answers

Monica Bosio – Intesa San Paolo Analyst

Greeting, everyone, and thanks for taking my question. The first one is on raw materials.

I understood that you are going to offset the raw material impact for each quarters through price/mix. But I was wondering if you can give us the total absolute impact of raw materials that you are expecting for the FY 2021?

And the second question is on China. The growth and the market share gain was impressive. Can you give us some flavour about your market share gains in electric vehicles tyres in China?

And the very last is on the Standard segment, maybe it's too early to ask but can you share with us some colours about the Profitability of the Standard segment in 1Q. Thank you very much.

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

On raw material we expect a headwind equal to 2.5% on revenues. And that is what we are going to compensate with the price/mix improvement. On China, the growth obviously is driven by the high end, and the electric is evolving but is not creating yet a significant profitability. The market share continue to grow. EV market share in the Original Equipment is going to be 1.5x higher than what we have today on traditional Premium cars. The Standard adj. EBIT margin is in the range of 7%÷8%, what we mentioned as the target for this year. So we are in line with the target, considering that next year, we should be very close to the double-digit as it has been planned.

Gabriel Adler – Citi Analyst

This is Gabriel Adler at Citi. I have two questions.

My first is on the market share gains. Could you just comment on what drove the market share gains in 1Q. How much of that was due to the new product that you talked about in the presentation? And should we expect Pirelli to continue to gain market share in all regions in the coming quarters because of that? That's my first question.

And then my second question is around the R&D and marketing expenses and the adj. EBIT bridge. Could you just confirm the total amount again? I missed it in the presentation. And can you explain why the marketing and R&D costs are so heavily weighted to 1Q? Why would we see marketing and R&D costs remain at these levels in 2Q and beyond?

Andrea Casaluci – General Manager Operations

So, as far as market share is concerned, we increase our market share in ≥ 18 ", which is our target segment of 1.3 points in 1Q. And we plan to grow, as presented in our Industrial Plan, 1 point within the FY. So in 1Q, we over-performed the average target of the FY.

Fabio Bocchio – Senior Vice President Strategic Planning & Controlling

As we saw on the bridge on slide 15, the increase in costs are related to R&D and marketing expenses, including the sponsorships. And the vast majority of this increase actually is related to the sponsorship. While we have a limited amount of increase related to the R&D, mainly linked to the launch and the final development of the two product lines that has been put on the market in 1Q 2021. As we said,

between February and March, Pirelli Group was main sponsor in the events of Luna Rossa. So obviously, this was attracting some costs in this specific quarter.

Gabriel Adler – Citi Analyst

Okay. And sorry, could you just clarify your expectations for the FY? I just missed it in the presentation earlier.

Fabio Bocchio – Senior Vice President Strategic Planning & Controlling

Yes. On the FY, for sure, we are expecting not to have a different impact compared to what has been presented in our Investor Day a few weeks ago. So we really expect the cost for growth and others overall to be with a balance of ~€30 million compared to previous year. And this is including overall, the R&D and the marketing sponsorship. So we are fully aligned with the indication we gave a few weeks ago.

Martino De Ambroggi – Equita SIM Analyst

The first question is on the price, because you announced several price increases in different regions. But trying to summarize what is the weighted average of the price increase, just a rough range for the remaining 9 months. What the range for price alone? And based on the current visibility, do you believe you need more price hikes going forward or probably that's already enough already factored in your guidance.

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

We expect to increase price [on Replacement] by +2% and +3% [in 2H]. So that's the price increase. And obviously, it will depend on the trend until July, August because the prices of the raw material are affecting year-end until August, let's say, most of the prices. And so for the time being, these are the price increase and they will contribute to cover raw mat headwind expected to be equal to 2.5% of our turnover. We don't see major problems in passing through the cost of raw material. The market is sound and expecting that.

Martino De Ambroggi – Equita SIM Analyst

Okay. Just to be sure, the last 2%, 3% is price alone?

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

It is price. This is what we see today, as I mentioned before. So this is price.

Martino De Ambroggi – Equita SIM Analyst

Okay. The second question is on the guidance because at the beginning, you mentioned that the visibility allows you to be in the upper end of the FY guidance. Just wondering what are the main drivers? Just a matter of better visibility on volumes, probably better mix, better cost control, or just a flavour.

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

We can stay in the upper side of the guidance. If there are no major events, like the semiconductor issue I mentioned. So we know that in 2Q, we can balance first of all because in 1H 2021 the high-end cars are less affected. So the Carmakers protected this segment of the market. But in 2H, we don't know yet. And also the OEMs are not providing precise information on what is going to happen. So we say that we stay in the higher end of our guidance only if there are no major events. The major event I see is the semiconductor. But anyhow, we confirm the guidance.

Martino De Ambroggi – Equita SIM Analyst

Okay. And very last follow-up on tyres for electric cars. I suppose, it's a very limited business today, so I don't know if you are willing to quantify what's the amount of Sales for electric cars. And you mentioned they had low profitability, but compared to the Original Equipment Sales for the normal combustion engine cars, are they dilutive, having only small volumes today? Or they are not far from the normal Original Equipment profitability?

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

The profitability is a bit better. So there is a price premium on the very high end electric, where the competition is lower. Let's say, it's not significant number in terms of profitability. I mentioned also in the presentation of our Plan that we expect to have some significant result in 2023, where we will have the impact of the starting Replacement cycle and getting the market share we are getting today, we see that it will become with some material effect in 2023.

Martino De Ambroggi – Equita SIM Analyst

Okay. But they are more profitable even today with very low volumes. Okay.

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

Yes, they are.

Thomas Besson – Kepler Cheuvreux Analyst

I'd like to come back to this other cost impact, €58 million in 1Q, ~€30 million for FY. I mean, I would just like to make sure that in 2022 or 2023, we won't have such a concentration of the impact of these other costs in a given quarter and make sure I understood correctly that this is partly linked with the different timing of incurring those costs, like for instance, the Formula 1 you've mentioned. So that we have, let's say, more balanced quarters because if I understood correctly, you are going to have much

better margins in coming quarters. And this is partly linked with this kind of delayed in expenses last year.

Fabio Bocchio – Senior Vice President Strategic Planning & Controlling

Yes, I can confirm your understanding. In 2021, we have a comparison base of 2020 that obviously has been pretty volatile quarter after quarter due to the COVID impact. As I said, on these other cost, for the time being, we see full alignment with our guidance that we gave a few weeks ago.

And your understanding that our profitability in the next quarter will be improving is exactly our view for the next quarters.

Moreover, as you were saying, in the next few years, there is no rebound, no foreseen rebound of the other cost. So there will be just inside 2021, some up and downs due even to the comparison base of 2020 between the different quarters.

Thomas Besson – Kepler Cheuvreux Analyst

Okay. Yes, I think it's an important point here. I have a second question, please. Could you comment about the level of inventories? I think inventory levels for the industry, both for you and for distributions were quite low. Have you rebuilt inventories? Or have you seen already some inventory rebuilds at distribution level? Or do you believe that there is a fairly different cushion ahead for you and your peers because the industry inventory levels are still very low.

Andrea Casaluci – General Manager Operations

Yes. So our inventory, our own inventory is stable. While in the trade, we see that there is still a shortage in terms of availability with a low level of inventories, generally speaking, in the U.S. where the demand started both in sell-in and sell-out, a restocking phase in Europe, but still below the average and the physiological level of stock while is more normalized the inventory level in China.

Thomas Besson – Kepler Cheuvreux Analyst

Okay. One last question, if I may. Linked with your work with Formula 1. You've mentioned in the past that it was kind of a marketing budget for you. And that it was completely worth it. Could you comment on the evolution of the cost for you for this marketing budget given that we are into a more normal season to more races. Is that part of the reason why we've had this bigger 1Q cost? Or is it really just a timing issue?

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

No, the Formula 1 stays at the same level. We do not have an increase in cost because of a couple of grand prix more than the previous year. What we have as a marketing costs are related only to new products and Luna Rossa, which has been already paid in 1Q. So as we mentioned in our presentation, we see that the extra costs are mostly absorbed in 1Q. So looking forward, this marketing cost will not exceed what we have in the plan.

Victoria Greer – Morgan Stanley Analyst

Could you just talk a bit about any view that you have on the rate of sell-out demand in the main regions? You've commented on the restock basis, and that's very helpful. But yes, do you have a view on where sell-out demand is versus 2019 levels now?

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

Obviously, it's too early to give you an exact number related to the sell-out growth. What we see and we are experiencing is the rebound in China, that is in our numbers, at least for the first part of the year. What we see in the U.S., the rebound in Saudi, in the U.S. In Europe, there are some positive signs and we expect mostly in 2H of the year that the, let's say, the effect of the exit of the lockdown will positively impact the demand. Our trade that is directly in touch with the consumers is quite positive. And the first in positive was in Europe, that is what we can see today, positive in Europe as we are positive in the Middle East for the minor part we have there and in Russia.

Victoria Greer – Morgan Stanley Analyst

And then just a second one on production. You mentioned in the presentation, I think that you're back to 90% capacity utilization. Can you talk about how much impact you have had previously from, I guess, mostly COVID safety measures, how disruptive has that been to production so far? And as there is very strong demand, could you push capacity utilization a bit higher for the next couple of quarters?

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

In the first part of the year, obviously, we had a minor impact of the cost of COVID because it was just China that affected us. Then the largest part is coming after. And we see that the rebalancing between the cost and efficiencies as such that is not affecting negatively our efficiencies. So we confirm the effect of the efficiencies we have in the 2021 plan.

Pierre-Yves Quemener – Stifel Analyst

I got three, if I may.

The price/mix is seen worsening in 2Q on mix deterioration. But will it remain positive? That would be my first question.

And over the FY, if the guidance on price/mix is between +2.5% to +3%, my understanding from your previous comments is that for 2021, that should be mostly pricing and less mix. That would be my first 2 questions, please.

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

I give you the answer, and then Mr. Casaluci will elaborate in detail. So the number luckily is higher than the one you mentioned. So we see beyond +3.5%. That is what we see today. But Mr. Casaluci?

Andrea Casaluci – General Manager Operations

Yes. So first of all, 2Q price/mix will remain positive. With the comments that Mr. Bocchio did before, we do expect a performance lower compared to the average of the year because of the negative region mix and channel mix. But we will start to see the positive effect of price increases.

In 2H, we target a price/mix above 4%, with the landing point in the FY that will be higher than the guidance, 2.5%. So we set more or less a target ~3.5%, that is what will allow us to fully compensate in terms of price/mix, the negative impact of raw materials mentioned before. Clearly, from 2H, we will have the full effect of the price increase. So the impact on price/mix will be balanced more or less half and half between price and mix.

Pierre-Yves Quemener – Stifel Analyst

Okay. Perfect. And one last question, if I may. Regarding the other costs, which have been a real headwind. In 1Q, the reversal in the balance of the year, would it be evenly split between the last 3 quarters? It's a partial reversal, I understand. Or will it impact more the 2Q or the 3Q? I'm referring to the €58 million negative in 1Q.

Fabio Bocchio – Senior Vice President Strategic Planning & Controlling

Thank you for the question. Regarding the other cost and the rebound, actually, what we expect is an overall positive rebound in 2Q and a little bit smooth rebound in the second part of the year. As I mentioned before, these different dynamics will bring us again to the level that we envisaged for the FY. But with different dynamics between 2Q and the second part of the second semester.

Gianluca Bertuzzo – Intermonte SIM Analyst

First one, I was looking at the level of sales you reached in 1Q. It wasn't very far from what it was in 1Q 2019. And actually, for your most profitable division, it was also above. However, the level of profitability of the Group is still below the level of 2019. And this came in a context where you announced a cost-cutting plan and a lot of activities are stopped due to COVID. Can you elaborate a little bit on the reasons why the difference in profitability?

Second one, I was wondering if you can provide us the organic growth for the two divisions.

And the last one is on restructuring. Do you confirm the €120 million guidance you gave at the Capital Market Day?

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

So on the third question, we confirm what we said in the Capital Market Day, and I leave the floor to Mr. Casaluci for the other answer. One comment, if you like, on other costs. Other costs, we mentioned in our presentation that in 1Q, we have the impact of the marketing costs and adding costs higher than in the following quarter. So the difference that you see at EBIT level is mostly due to this. And obviously, there is also the price/mix that will provide more support in 2H'21 compared to 1H'21. So we expect to rebalance in 2H. Mr. Casaluci?

Andrea Casaluci – General Manager Operations

Nothing to add to what Mr. Tronchetti said. So the negative impact on EBIT margin is only due to the other costs that Mr. Bocchio explained before in terms of contribution margin. We already overachieved the comparison of 2019, and you will see the improvement of the EBIT margin also starting from 2Q because of all the drivers we mentioned: price/mix, volumes and lower effect of the cost base.

Jose Asumendi – J.P. Morgan Analyst

José Asumendi from J.P. Morgan. I would like to hear is a little bit more with regards to maybe the regions or the products where you're looking to expand the capacity on a 1- to 2-year view and then maybe the other regions where you're looking to reduce capacity as volumes basically normalize in the next 12 months. Are you going to reduce more capacity in the U.K.? Or are you looking to expand more in the U.S., if you could just give us your thoughts and examples either by region or by a product?

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

First of all, we don't see a need to reduce our production, because when I mentioned 90% [saturation], it means that there is still space for growth and some savings still available. For what regards the Regions, in Latin America the market is still very, very weak. In all the other Regions, we are in the range of 90% [saturation]. So there are no major differences. Because in Europe, we are reaching this level, considering also that Europe exports some High Value tyres also to other Regions. And so, all in all, it's well distributed and balanced. So the efficiencies in the factories are improving.

Jose Asumendi – J.P. Morgan Analyst

Additional or follow-up question. You're entering a very strong free cash flow generative cycle in the coming sort of year, 2 years, so if we look at paper, it's a little bit about the use of cash, how do you think about the use of it: either to deleverage, dividend, special dividends or any other activities?

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

Thank you. The dividend policy, as we already mentioned in our Industrial Plan, is 50% for 2021-22 [Net Income] down to 40% for 2023-24. We went up to 50%, considering that we didn't distribute any dividend last year. So we have reserves, which were the profit of 2019 that was not distributed. So that's the dividend policy. About production capacity looking forward, until 2023, we don't see any need of additional capacity, if not that is part of our Plan.

If the market continues this trend, but investment will grow to fulfil the demand in 2025 on. These are the number of the Plan, and we have no reason to change them. We see as you have seen that we did perform better in 1Q, and we expect this also in 2Q in terms of volumes, but it's not affecting the general view. Obviously, if this growth will exceed, looking forward, we have still some capacity available, and we are also making efficiencies that are providing us some reserves in capacity.

Edoardo Spina – HSBC Analyst

Good evening. I have two quick questions.

The first on 2Q specifically, I know you do not provide guidance by quarter, but I wanted to clarify, considering the very strange and difficult comparison last year in 2Q, if you can anticipate any volatility across in 2Q'21? Or I think you mentioned earlier you expect an improvement in profitability already in 2Q itself, not the 1Q?

And the second question is on China, on the Winter tyre market. I was wondering if you could give us some updates. In the past, there was a discussion about the potential regulation for that. I did not hear more updates. I was wondering if you can share your thoughts about the potential niche in China.

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

In China, there are no news about the introduction of a regulation. The news is in France, the introduction of regulation, which is obviously good.

And for the first question, we see in 2Q, a strong recovery of volumes to continue. The drop-throughs remain in line with historical trend: volumes 40%; ForEx 15%. Price/mix is more than compensating raw material headwind and net efficiencies should be ~40% of our FY target.

There was a strong slowdown impact in 2Q'20. So we will see this reversing in 2Q'21. Lower ForEx headwind is expected and positive other costs supported also by the stock effect. These are the main driver. I'm saying more than usually about 2Q.

Operator

Mr. Tronchetti Provera, there are no more questions registered at this time, back to you for any closing remarks you may have.

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

Thank you, Ladies and Gentlemen. This will conclude today's program.

Thank you for your attendance and I have a good evening.