Pirelli & C. S.p.A. 9M 2021 results conference call transcript

November 11th, 2021

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

Good evening, Ladies and Gentlemen, and welcome to our 9 months conference call.

The industry scenario is confirmed to be positive, despite a weak demand for Original Equipment, due to semi-conductor shortage, and inflation pressure on input costs.

The implementation of our Industrial Plan is proceeding according to expectations for all our programs:

- consolidation of our positioning in High Value, especially in the Car ≥19"
- strengthening on the ESG front, where we achieved an important result in the way of decarbonization: today, in Europe, 100% of the electricity we purchase comes from renewable sources and before the end of 2025, this will be true for the whole Group, a fundamental milestone towards our ambition to reach carbon neutrality before 2030

The third quarter results prove our performance to be stronger, with

- a price/mix at 10.9%,
- profitability at 15.7%, and
- a high cash generation (7.4% of Sales), despite the business seasonality

The external scenario is confirmed to be positive, but characterised by a growing volatility.
The economic recovery is proceeding, with an expected growth of global GDP of +5.5% in 2021, slightly slower than previous forecasts (+5.7% in August), due to:

- supply chain issues in all industries, and
- persistent pandemic outbreaks in different areas

The strong economic recovery has caused supply shortages and a general increase in input costs, with the resulting impact on inflation, which is expected to be +3.7% globally in 2021

In the Tyre industry, the persistent semi-conductor crisis has caused the major car makers to revise their production estimates, with the resulting impact on Tyre demand for Original Equipment. The expectations are now -1% globally in 2021, against +6% in the August guidance.

The outlook for the Replacement channel remains unchanged, especially for the high end of the market, where demand is growing in the high-teens in 2021.

The pressure on input costs (raw materials, energy and transportation), together with the lower stock levels in the distribution chain, favoured a sound price discipline in the tyre industry, with repeated price increases by various players in different regions.

Pirelli promptly responded to external headwinds, through:

- an action plan aimed at mitigating the supply chain volatility, averting production interruptions and a strong stock build-up

- a production and logistic structure, able to manage demand volatility and fully exploit all opportunities in the Replacement business, while Original Equipment is experiencing a setback
- a careful pricing policy which, together with the mix improvement, allowed us to deal with the increases in raw materials and exchange rate volatility

The implementation of the Competitiveness program, which, in 2021, more than offset the impact of inflation.
A growing volatility of inflation and supply chain is expected in 2022.

In order to deal with this scenario, Pirelli will not only continue with the actions I already described, but is also setting up a number of initiatives, to support profitability and, in any case, ensuring that the deleverage is in line with the targets in our Plan for 2022 (Net Debt / adj. EBITDA ~2x).

Results from the first 9 months reflect the gradual implementation of the «key programs» of our Industrial Plan.
At Commercial level, we strengthened our position in High Value, leveraging on a highly technological product portfolio.
In line with our targets, we increased our exposure to ≥19" (which accounts for 66% of H.V. volumes, +3pp YoY) and new technologies, with a volume growth in EV ~10 times higher than in the 9M'20.

At Innovation level:

- we obtained ~240 technical homologations, over 70% of our yearly target [~€330M] concentrated in ≥19" (~85%) and Specialties (~45%)
- Our product portfolio has now another 5 lines devoted to Replacement, to meet the different needs of regional consumers (All Seasons, Winter, push-lines)

At Competitivity level: Step 2 of the Efficiency Plan is going on, with gross benefits worth €110 Million, €59 million net of inflation, which means 74% of our yearly target.

Concerning our Operations Program: the reorganization plan is now over:

- the Gravatai plant is now closed and our moto production has been moved to Campinas. This allows us to supply the LatAm market and exports our products with greater efficiency
- the reorganisation in Burton-on-Trent in the U.K. is over and the focus is now on semi-finished products

Further to this, the process towards reaching the best plant saturation is ongoing, with a filled up capacity of over 90% in 9M'21.

At ESG level, our actions to safeguard the natural environment, sustainability of materials and local communities continue at a fast pace:

- as already pointed out, as of 2021, 100% of the electricity we purchase in Europe comes from renewable sources
- when it comes to sustainability of our supply chain, we are proud of having entered into a multi-year partnership with BMW and the NGO BirdLife International, to enhance the production of sustainable natural rubber, avoiding deforestation in Indonesia; Mr. Casaluci will provide you with more details about it
- last but not least, Pirelli has been reconfirmed on the list of the Global Compact LEAD Companies 2021 by the United Nations; Pirelli is the only company in the Automotive Industry to appear on the list and one of the 30 companies in the world most committed to implementing the Ten Principles of the United Nations Global Compact

Slide 6 sums up the solid performance achieved in the first nine months of 2021:

- the Top Line growth (+28.6% YoY) was supported by a strong commercial performance

- profitability improved, both in absolute terms and margin, driven by the strong volume growth, the effective price/mix improvement and net efficiency gains
- Net Income rebounded, closing with €236 million at the end of September
- €104 million of Net Cash Flow generation in 3Q, or 7.4% of Sales, supported by a tight working capital management; in particular, in inventories, we are benefitting from:
  - a strong integration with our clients, established through the years, which provides us with high visibility into demand, and
  - the flexibility of our manufacturing footprint, specialized on small lots

Let us comment on 2021 expectations, starting from our market outlook.
The persistence of the semi-conductor crisis leads us to review our forecasts on total Car tyre demand for FY 2021, with a current growth expectation of ~+7% versus ~+10% as previously indicated.
In O.E., we forecast a -1% in demand (+6% previous indication), with a worsening of the trend in 4Q.

Demand in Replacement is still vigorous, with a +10% growth, minus -1 percentage point compared to the August expectations. This variation affects the Standard segment and is the consequence of the lockdown impact in APAC during the 3Q.

High Value is confirmed to be the most resilient segment, with a demand in the Car ≥18” of +12%, and higher than before the pandemic (+2% vs. FY’19):

- the Replacement demand trend is confirmed to be +18%. The solid market performance in North America and in Europe offsets the temporary weakness in APac due to the COVID emergency in the 3Q; demand is expected to recover in the 4Q in this market
- in the O.E., instead, demand is expected to have a positive trend (+3%) although values are lower than in the previous indications (+10% August expectation)

In the Standard business, we expect a mid-single-digit growth (+6% vs. +8% as per indication in early August).
We confirm expectations on our volumes, with an expected growth between ~+14% and ~+15% because of our High Value exposure where we are increasing our share.

Based on 9 months results, and our visibility into the external scenario, we revised upwards our FY2021 targets, with the following expectations:

- Revenues between ~€5.1 and €5.15 billion, ~€100 million more than our August guidance:
  - Group volumes growth between 14% and 15% is confirmed; high-teens growth in High Value
  - price/mix, ~+7% (+4.5% and +5% August target) is improving, because of further price increases and a more favourable product and channel mix compared with August;
  - negative exchange rates at -2% (-2.5%÷-2% previous indications)
- adjusted EBIT margin range is confirmed: between ~15% and ~15.5% with an adjusted EBIT improvement of ~€20 million compared with the implicit value of the August guidance due to the higher price/mix contribution that more than offsets both:
  - raw mat. headwinds, now ~3.6% of revenues (3% in August, or €163 million), and
  - the negative exchange rates
  - all other adj. EBIT bridge components are confirmed.
- Net Cash Flow generation before Dividends is improving between €390 and €410 million (between €360 and €390 million the August target), supported by operating performance and an efficient management of the working capital
- Investments confirmed at ~€330 million

I now leave the floor to Mr. Casaluci who will discuss the operating performance.

Andrea Casaluci – General Manager Operations

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

Now, let us analyse both the market dynamics and Pirelli's performance.

Over the 9M'21, the Global Car tyre demand increased by +13%. The recovery was more sustained in the ≥18" segment (+21% year over year) and is exceeding pre-COVID levels (+5% vs. the first 9 months of 2019).

Pirelli confirms its over-performance versus the market with volumes at +24% in the total Car and +31% in ≥18". More specifically, in the high end of the market:

- O.E. growth (Pirelli volumes +34%, market +15%) was supported by exposure to Premium and Prestige, consolidation of Customer Base in North America and APac, as well as by a higher demand of products for Electric Vehicles
- in the Replacement (Pirelli volumes +30%, market +24%), our share in the major Regions is now stronger due to a growth in High Value pull-through volumes and new dedicated lines

Pirelli also recorded a more marked volume growth (+17%) in the Car ≤17" segment versus its reference market (+12%), because of a strong demand recovery both in South America and Russia

In the 3rd quarter, the market trend (-5% total Car) was due to a lower O.E. demand (-20%), caused by the semiconductors shortage. Demand in the Replacement channel, also impacted by the new lockdown rules in Asia Pacific, is only slightly higher (+1%).

In the third quarter, Pirelli keeps on overperforming the 18"and above market (+4% Pirelli volumes while market volumes are -2%):

- limiting O.E. impact (Pirelli volumes -3% while market -15%), because of a greater exposure to Prestige and Premium OEMs, and the new contracts in North America and Asia Pacific
- getting stronger in Replacement (Pirelli volumes +10% versus +8% market) because of our performance in both North America and Europe

In the 3rd Quarter, the volume reduction in the Car ≤17" (-6%) was indeed substantially in line with the market (-5%).

The strengthening of our Top of the Range segment confirms the correct implementation of our commercial program.

The over-performance in the Car ≥18" was driven by our uppermost technological product offering:

- over 75% of the growth was driven by the ≥19" segment
- over 60% of Specialties

Lines sold to Replacement with O.E. homologation were fundamental for the growth of the «pull» volumes, especially in Europe and the USA (~66% of global growth).

The new lines exclusively for Replacement drove a solid performance of the «Push» volumes, particularly in Europe and the USA (>80% of world growth).

The O.E. market share increase was uniform in all Regions. The focus on fitments for EVs continues, since they accounted for ~20% of the growth in the first nine months.

Our innovation program unfolds in line with our Plan roadmap where a higher market share than the typical one is expected in the EV segment already from next year and 1.5 higher in 2025.
The Munich Motor show offered wide visibility in terms of our positioning in the EV segment:

- almost 1 electric car out of 3 (29%) of those exhibited in the Pavilions of the Motor show or in the districts of Munich was fitted with Pirelli tyres; and
- our presence was on average twice as much if compared to our main competitors

The P Zero marked Elect, that couple the motorsport know-how with the Elect technology, was chosen to be fitted on cars such as Porsche Taycan, Ford Mustang Mach-E GT, Polestar 1, BMW iX and Mercedes-Benz EQE.

Monaco was also a showcase for the first tyres in the world certified by the Forest Stewardship Council (FSC) fitted on the new BMW iX5 Hydrogen and on the BMW X5 xDrive45e Plug-In Hybrid. The Pirelli P Zero tyres with natural rubber and rayon with a FSC certification are a new step forward to reach an increasingly sustainable production. Indeed, this certification guarantees full traceability of the raw material throughout the supply chain, in plantations managed so as to preserve biological diversity and improve the life of the local communities.

In the first six months, following the introduction of 4 Replacement Regional lines developed to meet our customers' needs, the upgrading of our product range continued during the 3rd quarter, with the launch of Cinturato Winter 2.

A winter tyre for medium-sized cars and CUVs, Cinturato Winter 2, is the outcome of Pirelli's cutting-edge technologies, such as:

- sipes with variable geometry, guaranteeing better grip and higher safety standards; and
- a special compound, developed through an innovative system of liquid polymers improving performance on wet and snow

In addition, Cinturato Winter 2 was developed through virtual simulation processes.

Cinturato Winter 2, besides being an environmentally safe tyre, is also on the top notch of the European labelling features:

- for its rolling resistance, and
- low noise level

Cinturato Winter 2 offers a level of performance among the best on the market under all driving conditions in winter, as confirmed by tests made by TÜV SÜD, that granted it the Performance Mark.

As already mentioned by Mr. Tronchetti, our commitment to preserve the environment was further developed through a multi-year partnership with BMW and an NGO, called Birdlife International. This is a partnership to increase the production of sustainable natural rubber in Indonesia by sparing the Hutan Harapan area on the island of Sumatra from further deforestation.

It is a project based on two fundamentals:

- a partnership among stakeholders belonging to the value chain of natural rubber and sharing the same values; therefore, they wish to maximise the positive impact of this project; and
- the core of this project is the full creation of sustainable value through the following:
  - preservation of 2,700 hectares of rain forest
  - protection of the rights of the local community
  - promotion of women's participation to social and economic life
  - agricultural and forestry training to locals and natural rubber farmers; and
  - protection of several animal species at risk

This project is a further milestone by Pirelli for the sustainable management of natural rubber.

The Competitiveness Program continues in line with our Plan, with gross efficiencies expected to be worth €155 million this year, of which €80 million net of inflation (~2.1% of the baseline).

Over the 9M'21, the gross benefits from our Competitiveness Program were worth €110 million, which meant a double absorption of the impact from the growing inflation.

Net efficiencies are worth €59 million and account for 74% of the target for the current year.

In the 3rd quarter, gross efficiencies were worth €27 million, €9 million net of inflation.

I wish to provide you with more details on the several projects we have launched:
- within «Product cost», which is worth ~38% of the gross efficiencies during 9M 2021, we continued to implement our new approach to modular design and a more efficient materials purchasing program
- on Manufacturing, which accounts for approximately ~36% of the efficiencies made during the first 9'21, the program to increase flexibility, digitization and sustainability continues; in line with volume rebound and the saturation reached in the factories, Manufacturing has already hit 90% of its yearly target
- on SG&A we have leveraged on further efficiencies to redesign our distribution network and optimize stocks; and finally
- on Organization process digitization and upskilling programs are still ongoing

In the 4th Quarter, we expect a stronger impact from inflation, mainly due to the increase of energy and logistic costs.

Thanks for your attention. I now give the floor to Mr. Bocchio for the financial performance.

Fabio Bocchio – Senior Vice President Strategic Planning & Controlling

Thank you, Andrea, and good evening to you all.

Pirelli closes the first 9 months of 2021 with sales worth €3.98 billion, growing +28.6% year over year, being supported by a definite over-performance versus the market within a framework of demand recovery.

More in detail, revenue growth amounted to €885 million, with a negative impact of €71 million (-2.4%) from exchange rates, due to the depreciation of the dollar and the major currencies of Emerging Countries against the euro. If we exclude the exchange rate impact, the organic growth amounted to 31% in the first 9 months of the year.

Let us go through the commercial variables in detail:
- a positive volume impact on sales, €763 million (+24.7%), particularly due to the growth in the High Value segment (+27.8%), which is confirmed to be at pre-COVID levels both in the Car and Moto segments
- a sustained contribution by the price/mix (€194 million or +6.3%) supported by:
  - Price increases in the Replacement business in both segments
  - Product mix improvement based on the growing demand for bigger rim sizes and products with more technology

In the 3rd quarter, revenue trend reflects a slowdown in market demand, as already discussed by Andrea, with slightly declining volumes (-0.4% in the quarter, at Group level, with High Value at +1.8% and Standard at -2.6%).

Conversely, the price/mix was on a strong rise at +10.9%, supported by:
- Price increases, and
- an improved product mix and channel mix, due to the slowdown in Car production caused by semiconductor shortages

Let us now analyse the profitability trend. In the first 9 months, adjusted EBIT was worth €599 million, with a 15% margin, in line with our FY target.

The solid contribution of all internal levers (volumes, price/mix, efficiencies) more than compensated for the negatives of the external scenario (raw materials, inflation and exchange rate impact).

More specifically, the profitability improvement in the first 9 months is due to:
- a Strong volume contribution (+€310 million)
- a Price/mix improvement (+€150 million) that has more than offset the impact of raw materials
- (-€114 million) and exchange rates (-€18 million)
- Phase 2 of our Competitiveness Plan generated efficiencies worth €110 million (~3% of revenues), €59 million net from inflation which covered:
  - the “reversal impact” from the COVID actions (-€23 million); and
  - other cost increases (-€38 million)

A short comment on the item «Other costs» which includes three macro-clusters:
- R&D, Sponsorhips and Marketing expenses are part of the first cluster, that recorded a €33 million increase, mainly in the 1st quarter;

- the second cluster includes provisions for the short- and long-term Management incentives, with an impact worth €37 million in the 9 months, €13 million in the 3rd quarter. We wish to remind you that in 2020, because of the COVID emergency, the Management short-term incentive plan was cancelled.
- the third cluster includes the impact from stocks, credit impairment, royalties and other costs. In the first 9 months of this year, the variation amounted to +€31 million, which is mainly reflecting the positive impact from stock replenishment

The overall impact of the item «Others» over the year is confirmed to be ~-€30 million, where the provisions for management incentives are compensated for by benefits connected to stock replenishment

Let us now talk about the 3rd quarter 2021 profitability: adjusted EBIT was worth €221 million – a 4% YoY growth – supported by the price/mix contribution that has compensated 1.3 times for the raw material and exchange rate impacts.

The adjusted EBIT margin was of 15.7% (versus 16.7% in the 3rd quarter of 2020), and discounts the "reversal impact" due to COVID actions worth -€12 million in the 3rd quarter, which means almost a 1 point of margin.

Let us move to the Net Income dynamics.

Net Income showed a strong improvement in 2021: about +€254 million year over year. The trend discounts:
- the already mentioned improvement in the operating performance (Δ adjusted EBIT +€318 million)
- restructuring and non-recurring costs, improving from the same period of 2020

Results from Equity participations was positive by €2 million, a +€8 million improvement related mainly to the results of our JVs in China and Indonesia.

Net financial charges were slightly improving YoY, as:
- higher charges on central debt, impacted mainly by the COVID pandemic which caused a temporary increase in the spread of the major credit line of the Group
- were more than compensated for by benefits from financial management at local level

The €91 million increase in tax charges was related to the greater operating results discussed previously, with the tax rate remaining stable at 26%.

Net Income adjusted, i.e. excluding all the one-offs and non-recurring items, is positive for €360 million in the first nine months of 2021.

In the first 9 months of 2021, the Net Cash Flow, in terms of variation of the Net Financial Position, is of -€457 million including - €80 million related to the dividend distribution made in the period
The Net Cash Flow before Dividends was of -€377 million, improving by +€369 million versus the first 9 months of 2020 and of +€252 million compared to the first 9 months 2019. This trend was mainly supported by
- the improvement of the operating performance that has just been mentioned
- lower absorption of the Working Capital / other, through

- a careful stock management (18.8% as a percentage of sales in the last 12 months, in line with the 9M'20 but a two basis point improvement compared with the same period of 2019), and
- trade payables benefiting from the business recovery

In the third quarter of 2021 the net cash flow before dividends was positive €104 million, despite the seasonality of the business, thanks to the already mentioned dynamics of working capital.

The Net Financial Position is of approximately -€3.7 billion at the end of September.

Gross Debt at the end of September is approximately €5 billion, less than at the end of December 2020 because of advanced payment of financial debts worth approximately €1 billion.

The liquidity margin is confirmed to be at approximately €1.5 billion and allows to cover debt maturities until June 2023.

The cost of debt (last 12 months) was of 2.41%, with an increase of 0.47 percentage points compared to FY 2020, mainly because of the temporary impact of the increased leverage following COVID, which impacted on the major corporate financing projects.

For FY 2021, we expect the cost of debt to be of ~2.5% (1.94% in 2020), in line with the Industrial Plan:
- considering the above mentioned dynamics, and
- due to increased local interest rates, in particular in Brazil

Net financial charges are expected to be worth €141 million, ~€20 million less than the assumptions made in the Plan, especially due to favourable dynamics on the hyperinflation in Argentina and to lower commercial edging.

Thanks for your attention. 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

Martino De Ambroggi – Equita SIM Analyst

Two questions on the guidance. The first is on the implicit 4Q mid-point, because it implies significant reduction in terms of top line and absolute value in terms of adjusted EBIT despite some recovery in the O.E. expected, just if you could provide us what are the main reasons for this in 4Q.
And on the free cash flow guidance, I understand that CapEx are confirmed, but what is your assumption on net working capital? Because in its speech Mr. Bocchio mentioned net working capital improvement. I don't know if there is something that could be more positive at the end of the year. And in particular, is factoring at ~€200 million as it used to be at the end of the year?

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

Thank you. And before leaving the floor to Mr. Bocchio to answer about the cash flow. I want to underline that we are not thinking that the last quarter will have a recovery on the O.E. We believe that the O.E. will remain weak even at least for 1Q, but probably until June of next year. So our forecast in terms of results has been confirmed in the highest part of our targets. And we don't see any specific change in working capital policy. But Mr. Bocchio will provide you the answer.

Fabio Bocchio – Senior Vice President Strategic Planning & Controlling

Thank you for the question. I have to reaffirm that on the full year basis, the net cash flow before dividend will be for a generation of ~€400 million. That will be sustained by for sure the better operating performance and a better working capital specifically related with:

- an increase in trade payables, as a consequence of the business recovery,
- a slight increase in receivables, as a consequence of the higher sales expected in 4Q'21, improving in terms of incidence on net sales as a consequence of the improved condition of the market and customer liquidity position that should reduce the volatility in credit risk and collection
- partially compensated by a very moderate stock increase in absolute value in order to sustain the decrease in sales.

The financial income and expenses will amount to ~€141 million, in reduction compared to previous year.
The increase in taxes paid, obviously, is a consequence of the higher result.
Coming back to your point about the factoring, I can confirm you that the company is not changing the policy, and we foresee the value of factoring to be in line with the value of previous year.

Martino De Ambroggi – Equita SIM Analyst

And the follow-up is on Standard segment. If you could provide a rough indication on what is the profitability considering the weakness of the O.E.? And if you are in the same path you expected in order to achieve ~10% return on sales next year?

Andrea Casaluci – General Manager Operations

We confirm we are on the direction to reach the low double-digit profitability in 2022. And what we do expect in the Standard all in all is to arrive very close to the 10% in 2021. In the Replacement channel, over-performing already this return on Sales, while in the O.E. a bit below.

Monica Bosio – Intesa San Paolo Analyst

The first question is on the market share gains. Any colour on your market share gains across the different Regions would be appreciated.
And my second question is on the price mix. Can you just tell us how much is pricing and how much is channel mix? And should we expect for the first part of the next year, a similar price mix trend to the one that we have seen so far in 2H'21?

Andrea Casaluci – General Manager Operations

Thank you. I will start from the price/mix. If we look at the performance of 3Q, that was presented by Mr. Bocchio, we can assume that ~40% of the price/mix is related to price. And what we do expect for 4Q'21 is a similar trend.
For the 2022 is too early to have a clear understanding and picture because there is still a very high level of volatility into the market. But what is given for granted is that with price/mix, we will be able to more than compensate the impact of raw material and Forex in 2022.
Back to the question on the market share. The gain of market share was spread all around the channels and the regions in 2022 versus 2020 is more pronounced in 1H because of the favourable comparison. You most probably remember that in 2020, in the first half we decided to reduce the level of stock in the trade. And as a consequence, we lost market share, in the 2021, we were able to recover. While if we compare versus 2019, there is a clear acceleration in 3Q in terms of gain of market share. This is true in the O.E., even more evident in all the regions because of our exposure to the Premium and Prestige segment of the regional EBIT. As a matter of fact, it has been less affected by the price of the semiconductors compared to the synergy.
And inside the premium product offer, the Carmakers are protecting the high end of their product portfolio because of profitability. And as a consequence, Pirelli took advantage of this. As far as the Replacement is concerned, the 3Q performance, as I mentioned in the presentation, was particularly positive in terms of gain of market share in Europe and in N. America.

Monica Bosio – Intesa San Paolo Analyst

Sorry, just a follow-up, if I may. Did you have any extra cost, one-off costs in 3Q related to the lock-downs in China?

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

No, nothing.

Gabriel Adler – Citi Analyst

Gabriel Adler from Citi. I'd like to come back to the price mix, please, which was clearly very impressive in 3Q. But at what point do you think price increases start to impact consumer demand? Especially for a Premium Tyre Maker like Pirelli, how do you manage the risk pushing prices higher and that possibly result in consumers trading down to cheaper players? Maybe this is less relevant today because supply is obviously still quite tight. But I imagine when imports normalize and capacity

starts growing again, this may become more of a challenge for your business and the industry as a whole?
And then my second question is just whether you could quantify the impact that you expect in 4Q some cost inflation. So raw materials and just on costs or any other costs that you are willing to quantify?

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

For the first question, the price/mix is obviously due to the environment, the price. And it has to be underlined that the consumers in the segment of the market where we are, they are not so much affected by a price increase of a few points. The cost of the cars is average 2x to 3x the cost of Standard car. So it's a question of the market dynamic and luckily, the market dynamics are positive and stocks are not growing. So stocks, we don't see in the market the pipeline being full. So the pipeline is quite empty. And so these price increases leave us in let's say, positive condition considering the entrance in 2022 with the price increases we made. So we don't expect this coming.

Fabio Bocchio – Senior Vice President Strategic Planning & Controlling

Thank you for the question. Going back to the raw material point that we saw on the market and any hit in our accounts for the increase in the cost of the raw materials. Compared to our previous FY view, we see an increase that is ~€20 million. And talking about incidence on net sales, previously, we were expecting a negative impact of raw materials in the ballpark of 3% of net sales. And now we are expecting a negative impact that is ~3.5% of the Top Line. I hope this clarifies your question.

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

I think that an additional point has to be taken into account, that this year, we launched 5 new product lines, dedicated to the Replacement market. In our plan next year, we launch more than 5. And all the new launches are related to products that are performing better than the existing products. So there is value in these new product lines and prices will be protected also by the new lines we launched, and we are going to launch.

Gabriel Adler – Citi Analyst

Maybe I can just follow up on the first question. Given your comment there that stock isn't really increasing. Would you consider pulling forward some of the capacity expansion plans that you currently have in your midterm plan to take advantage of the time supply environment? Are you happy with your capacity levels currently?

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

No, nothing has changed in the capacity. The utilization is ~90%. The increase of stock is related to the higher volumes of sales we have. So that is only a natural consequence of the fact that we increased the volumes. That's why the working capital remains, let's say, balanced, and we have a cash flow that is sound and continue to be consistent.

Thomas Besson – Kepler Cheuvreux Analyst

I have a few questions and I'll ask one by one, if it's possible.
Firstly, I'd like to come back to a question that was raised earlier I think by Martino De Ambroggi. In particular on the revenue guidance, your midpoint implies a substantial sequential decline in revenues, from 3Q to 4Q. But I'd like to understand a bit better if it's possible. It's clear to me that price/mix is going to be relatively close in 4Q to 3Q, unless I missed something. And FX is also going to be a positive. So what is the assumption that I'm missing for explaining that your revenues would decline a lot more than any time before in 4Q?

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

So we already underlined at first compared to the guidance of August last, the top line is growing more than the previous guidance. Regarding the last quarter, we remain conservative considering the reduction on Original Equipment demand, even if in our segment, the effect is lower than in the other segment, but is I think is in a volatile environment, it's better to stay on the safe line.

Thomas Besson – Kepler Cheuvreux Analyst

Looking at your new €1.6 billion financing line, could you discuss the financial charges in 2022? Is it going to have a positive impact? You're already talking ~€145 million net financial charges for this year. Is it going to be lower in 2022, thanks to that as well?

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

We consider until now that they remain in line. So we don't see major changes. We are negotiating, and we don't see not a negative nor a significant positive effect.

Thomas Besson – Kepler Cheuvreux Analyst

Last question, please. You've launched new products on the winter side and you've discussed launching 5 products or more that are in attractive and growing segments that are working fairly well. Could you discuss the development of your market share both in the Winter segment and in the All-Season segment? And whether you managed to reach similar margins in All-Season by in Winter? Or whether like most of your peers, this is relatively dilutive to see the All-Season taking share on the Winter segment.

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

Thank you. So as you can see, we are in a phase of recovering our market share. This trend we expect to continue, thanks to the new product lines we already launched. And also thank you the new product lines we are going to launch in 2022. So they are supporting, obviously, profitability and market share.

Giulio Pescatore – Exane BNP Paribas Analyst

So the first one on Elect tyres. Are you willing to share some insight on the marginal profitability of an Elect tyre versus a normal Premium tyre? Is it just higher or maybe at the same level because despite the higher price, you need to put in more content?

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

So the average selling price is between 10% and 15% higher because of what you were saying about the content of technology and the technology required for performing cars, electric.

Giulio Pescatore – Exane BNP Paribas Analyst

Okay. And then, I mean, what roll-out are these Elect tyres play in the market share gains? Because I know you mentioned it in your beginning remarks, but can you maybe elaborate on what role are they're playing in the increase we're seeing in quarter after quarter?

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

Yes. So electric cars have a different acceleration, which means stress on tyres that is totally different and this continues.
The second main point is that the new electric cars have a weight on average between 20% and 30% higher because of the batteries compared to the traditional cars. But we cannot produce tyres, let's say, with more material to sustain it. We have to do the opposite because of CO_2 emission, there is a need to reduce the rolling resistance. So less material, more sophisticated materials in order to perform in line with the requirement of the clients, which means the use of nano-technology, etc. Those are the main reasons. And this is, obviously, more evident in Premium cars, where the performance is quite stressed. And so that is why there is more value because there is more technology.

Giulio Pescatore – Exane BNP Paribas Analyst

Okay. And that's something that, in your view, it's recognizable by the customer. Is there a brand that is widely recognized?

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

It will be easy to recognize if they don't have it, so which means that if you don't have tyres that are fitting properly the requirements and the performances of the car, your tyres will last very little, and any performance will be affected. That's why we engrave in the sidewall Elect for the cars that are homologated with electric Carmakers. If you use other tyres, which are not Elect, then the customer cannot complain not to have the performance that the carmaker are providing them. So it's easy to be recognized.

Philipp Konig – Goldman Sachs Analyst

My first question is again on price/mix, which was obviously very strong in the quarter. Just if we look at the different segments, it seems a lot of it was driven by the Standard segment. Can you maybe

just elaborate behind the mix? What was the major driver? Did you exit some smaller rim size segments what is possible?
And my second question is also on the standard segment. It seems like the share of the revenues in Standard has gone up this year a little bit again and close to 30%. Could you just sort of clarify what is a level where you're comfortable with the Standard share? Is it ~30%? Are you planning to reduce the volumes further in the next couple of years?

Andrea Casaluci – General Manager Operations

Thank you for the question. As far as price/mix is concerned, the 10.9% performance of 3Q is as I mentioned before, ~40% is due to price and the ~60% related to mix is mainly linked to product mix. And inside the product mix, we have the growth of the High Value and the reduction on the Standard. There is also a first positive signal coming from the channel mix because of the already mentioned crises of the semiconductor that is affecting the O.E. channel and not the Replacement. So all in all, out of the 60%, you can consider ~10% coming from the channel mix. But the majority of the impact is on the product mix.
As far as the Net Sales growth, we are confident to keep on growing in market share in the High Value segment, which is the core of our business model and our major target, while as we presented in the Industrial Plan, the Standard volumes are expected to reach a floor that is confirmed. So you can consider the volume you see in the coming years of the Standard has stabilized. This is what is balancing our capacity, and this is also where we need to stay in terms of commercial policies. Always focused on the Pirelli brand, no more second brand and keeping profitability and focus on the most profitable segment inside the Standard. So 16”, 17” Winter tyres, All-Season tyres, normal 13” and 14“.

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

And I think an information that could be useful. We are still talking about a small market for electric until now growing, growing fast. And to give you two numbers, last year, we did have ~6% of this market, this year, it's 10%. We are talking about O.E. because there is not yet a consistent and material Replacement market. We are confident that this market share will grow for us. And for the time being, obviously, also because there are performing cars coming to the market where we have a larger market share.

Edoardo Spina – HSBC Analyst

Good evening. I have two sets of questions. Let me start with the Standard segment. Can you remind us how much O.E. is percentage-wise of the Standard segment at the moment?
And secondly, after the growth in 1H, should we expect that the Standard segment will start to decline YoY from year onwards?

Andrea Casaluci – General Manager Operations

If we consider the 2021 as a reference, out of the total volume, Standard is no more than 30% and all concentrated in South America and Russia.

Edoardo Spina – HSBC Analyst

Can I ask the growth in the Standard will come back to be negative for the foreseeable future?

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

It's decreasing, obviously. The standard O.E. is going down every year. And so we have changed the mix in the Replacement market, cancelling from our production the 14". We are going to cancel the 15". We have moved our standard production to Russia. In Russia we can produce 17" in a very competitive way. And, let's say, the point in which we will lend with the standard, we'll be in the range of 25 million tyres.
We have been decreasing our Standard volumes for several years by double digit. Now we are reducing high-single-digit every year, but with the profitability that, as Mr. Casaluci was mentioning before, is already now close to double-digit. And next year Standard profitability will be over the 10% adjusted EBIT margin. So that is for us reversal of the situation where both the results and cash flow were affected in the last 3 years, because of the strong reduction of the standard, the investment we made for the layoffs and the write-offs. Now the situation is totally changed, is cash productive, and we will not have any restructuring costs that affect our cash flow. And we will have a better cash flow coming from the profitability of the Standard that until last year was in the range of 4%, 5%. Now it's close to 10%, and next year, it will be double-digit.

Edoardo Spina – HSBC Analyst

Very clear. The last question is on the electric vehicles. Can I ask a clarification about slide 13. You mentioned 29%. I just wanted to ask if that means that 29% of Pirelli tyres in Munich were EV? Or did you have 29% of the all the EV tyres on display from different brands?

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

We had 29% of the fitting for the cars that were in Munich, and the top electric cars. And so that was a sign of where we are, we already have over 190 homologation in our portfolio in electric cars growing. And so we confirm what I said before about our market share targets on electric high-end tyres.

Edoardo Spina – HSBC Analyst

Sorry, the very, very final one is a follow-up from previous questions from Giulio. I think you mentioned that if you put a normal tyre on EV, the tyre will wear out very fast. But what if you put an EV tyre on a normal car? Are you going to create like a super tyre that wears out very slowly? Or is just a normal tyre?

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

We will have a niche. When you test tyres, each car is on its proper fitting. Obviously, the structure of the electric cars is different and you will have a handling different from the one you have for the purpose you have. So it's a nice new market coming.

Gianluca Bertuzzo – Intermonte Analyst

Three questions from my side.

First one on the 2021 guidance. Sorry to come back but I understand your caution on the O.E. market, given the shortage of semiconductor. But as your numbers are, let's say, driven more by the replacement channel, can you help us understand the reason behind what it seems a high level of caution? Is demand reacting negatively to price increase or what else?
Second question is on 2022. Can you share with us your thoughts about market growth and profitability?
Last question is on capital allocation. Given that you are deleveraging now, what are your priorities? Are you thinking about maybe M&A or adding more capacity? Or you prefer to return the cash to shareholders?

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

Thank you. I answer the last question and then I give the floor to Mr. Casaluci. Our target is to reach a 2x Net Debt / adj. EBITDA by next year. And in our plan, we have the objective to further reduce the leverage (1x by 2025). When we will reach the 1.5x leverage we will have different options: M&A or in giving back to shareholders, increasing the dividend as we will see at that time.

Andrea Casaluci – General Manager Operations

So as far as the net sales of the last quarter, first of all, there is a question of seasonality, as always, in the last quarter. Then the only prudence we have is related to the O.E. Today, we forecast the market in the last quarter that is more or less negative for -23%, -24%, which is more or less the estimation of all the Industry. This is due to the issue of the semiconductor and also to a not favorable comparison versus last year. So probably we have a prudence in the net sales of the last quarter, but we do prefer to stay on the safe side, considering the high level of volatility.
No risk of not applying the price increase. Price increase are going through the market, no risk on this side. As far as the estimation of the market for the next year is very difficult to have today a clear picture because there is still a high level of volatility. But I would consider on the Replacement channel, ~2%, ~3%, if I have to make an estimation. Today, while more closer to 8%, 10% of the O.E.

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

So if I can add something to what Mr. Casaluci was saying. So looking to the global market because you wanted, I think, the global market and then our position the global market, we see a positive trend in low-single-digit in 2022 for the entire car market with the ≥18” growing almost double-digit.
In O.E., as I was saying before, we expect for 1H’22, still problems on semiconductor supply and the rebound in 2H. For 2022, we expect the O.E. to grow once high-single-digit, after a weak 2021 (-1%). Better performance on ≥18” driven by vehicle mix favoring more profitable models like the high end because we see them coming, we see the homologation we are making.
A full recovery back of the OE demand is expected between 2023 and 2024. So in that situation, we see our segment, the one that is better performing.
On Replacement, we forecast a moderate growth, more in line with the pre-Covid situation (between 2016 and 2019, the CAGR was 1.6%), with stabilization in all region and ≥18” segment over-performing the total market growing around 3x for all areas compared to standard.
That is what we expect until now, obviously, the precise figures will be given in February when we will provide the final numbers on our 2021 results. So this is in few words what we expect today.

Marco Tronchetti Provera – Executive Vice Chairman and Chief Executive Officer

So turning that there are no more questions and so I want to thank all of you concluding our today's program. I thank you for your attention and obviously I wishing you a very good evening. Bye-bye everybody.

Operator

Ladies and gentlemen, thank you for joining. This conference is now over and you may disconnect your telephones.