BBB

ISSUER RATING

Long-Term

Outlook	Stable
Initiation date	29/11/2022
Rating date	19/07/2023

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RATING ACTION AND RATIONALE

- EthiFinance Ratings has upgraded its long-term corporate rating, from BBB- to BBB, for Pirelli & C S.p.A., the ultimate holding of Pirelli Group, with a Stable outlook.
- The rating upgrade derives from an improvement in the company’s ESG score as well as financial metrics. Pirelli indeed reported a robust top-line growth of 24% for FY22, primarily driven by an effective price/mix (c. 19.7%) strategy, despite a volatile tyre market (which experienced a decrease in volumes within the standard tyre segment by 2% on a yearly basis). Pirelli's business model has proven resilient due to its specialization in the premium segment, which has helped to mitigate the negative impact of the underperforming <17" tyre segment. Despite this segment's weight within sales, Pirelli is poised for steady growth in revenues thanks to the anticipated recovery in global demand - particularly in China, a rapidly expanding market for tyres - as well as price mix optimization. Our adjusted net leverage ratio has improved significantly, from 3.2x at end-2021 to 2.4x at end-2022, which can be attributed to a combination of better EBITDA and a reduction of €0.3bn in adjusted net debt. We forecast that this ratio will further improve to 1.3x by end-2025, which supports our rating. Moreover, we view management’s target of a net reported leverage ratio of c.1.0x by end-2025 as a strong commitment to reduce leverage, although a higher payout ratio is still possible given the investment grade credit rating.
- Our rating is, however, constrained by our industry risk assessment (BB) as well as the current weaker market trend in the aftermarket tyre segment, which represented 29% of Pirelli’s FY22 revenues. On average, a global decrease of 5% has been observed for the 5 months to end-May 2023, which if it continues would hamper Pirelli’s organic growth and thus limit the improvement in credit metrics down the line. In addition, ‘shareholding & control structure’ is a constraining factor as Pirelli is currently faced with political influences within its ownership and governance structure.
- In line with our methodology, the "auto components industry" has medium-to-high ESG risks (heatmap score of between 3.5 and 4) given its impact on the environment, which slightly constrains our industry assessment. Our assessment of the company’s ESG policy is advanced (company ESG score of between 80 and 100), which weighs positively on our financial assessment - and therefore more than offsets the impact resulting from our industry assessment.

ISSUER DESCRIPTION

Pirelli, based in Milan, is one of the world’s largest tyre manufacturers. The company is the only one in the industry that specializes exclusively in the consumer segment, comprising tyres for cars, motorcycles, and bicycles. The company is listed on Euronext Milan and had a market capitalization of c.€4.6bn as of July 13, 2023.

Pirelli’s customers include both premium (BMW, Audi, Ford Mercedes…) and prestige (Bentley, Ferrari, Lamborghini, Maserati, and Porsche) car makers. The group has c.31,300 employees spread across 18 industrial sites located in 12 different countries; its products are distributed globally through 20,000 distributors and specialized resellers and 303 Pirelli points of sale. For FY22, Pirelli reported revenues of €6.6bn and EBITDA of €1.4bn. Our EthiFinance Ratings-adjusted net leverage ratio was 2.4x at end-2022.

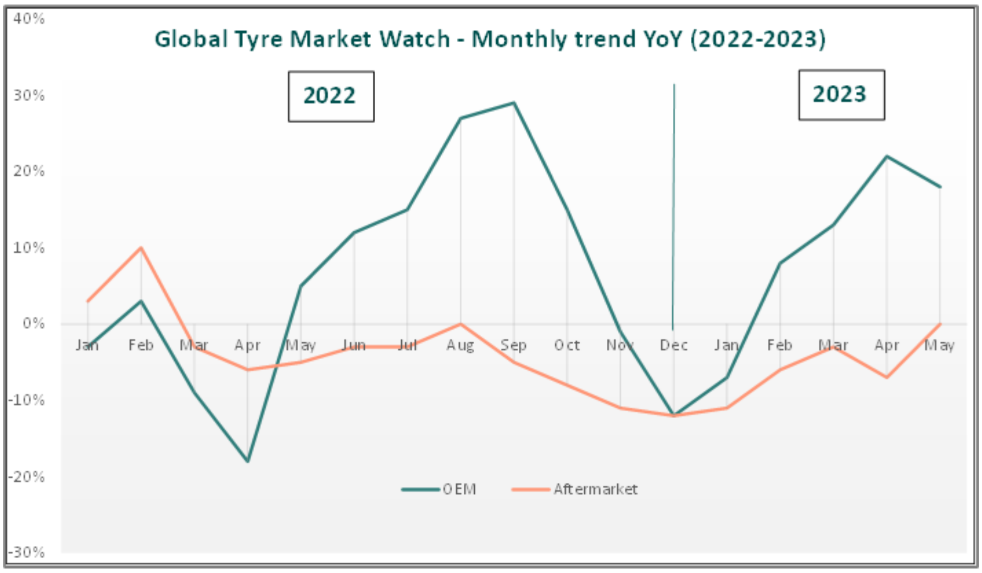
FUNDAMENTALS

BUSINESS RISK PROFILE

INDUSTRY RISK ASSESSMENT

- **Tyre market dynamics: opportunities and challenges amidst the automotive industry's shift to electrification, and supply chain disruptions**

The automotive industry has been shaken for the past two-and-a-half years. The period started with the Covid lockdowns, which halted production lines. Then the industry was hit by the shortage of electronic components that began in 2021 and persisted into early 2022. More recently, the rise in raw materials costs in 2H22 as a result of the macro environment added to the challenges. For 2022, the global automotive tyre market recorded a 1.7% drop in volumes mainly due to lower demand in the aftermarket segment. However, the original equipment market offset some of this decrease and the industry key players - such as Pirelli and Michelin - were obliged to pass on to customers the inflation impact on raw materials costs. The auto components industry has also been involved in a shift from conventional thermal engines to electrification for a few years now. Electric vehicle registrations in Europe increased by 15% from 2021 to 2022 (EV-Volumes.com), a trend we expect to continue in the years ahead. Electrification represents a sound growth potential for the tyre industry, as tyres will need to be adapted to EV characteristics (finding the right balance between a higher load index, energy consumption, and noise reduction).



Source: Pirelli Tyre Market watch (May 2023)

In the first half of 2023, a significant rebound for the overall tyre market along with an upward market trend can be observed on a global scale, following the decline that occurred towards the end of 2022. Original equipment manufacturers (OEMs) registered a robust monthly average market demand increase of 11% throughout the first five months of 2023. Conversely, the aftermarket business segment encountered a decline of 5% during the same period due to the exceptionally high sales to dealers one year earlier in a context of growing inflation.

- **Challenges and barriers to entry in the competitive tyre market**

The tyre market is highly competitive and we believe that the significant capital investments required, along with the need for traditional tyre players to diversify their product range, will continue to weigh on margins going forward. This backdrop does also constitute rather strong barriers to entry as not all competitors nor new entrants will be able to deal with the burden of high capex in a context of limited margin increase and volatile demand.

- **The shift towards eco-friendly materials to meet consumer demand, while reducing environmental impact**

Tyre making is an essential part of the automotive industry, but the manufacturing process requires the use of significant amounts of energy, water, and raw materials, such as natural rubber, synthetic rubber, and carbon black. However, the car-making ecosystem (manufacturers and customers) is leaning towards the use of sustainable raw materials over traditional ones, especially when considering the tyres disposal process. Consequently, the integration of innovative operational means becomes imperative to facilitate the production of increasingly environmentally-friendly and easily disposable tyres.

COMPANY'S COMPETITIVE POSITIONING

- **Pirelli's dominance in premium and niche tyre markets driving sales and margins**

Pirelli is a dominant player in both the premium and prestige segments. Whereas in the field of original vehicle equipment for sport utility vehicles (SUVs) and light commercial vehicles, Pirelli can rely on a premium customer market share of c. 20% globally and c. 25% in Europe, in the original equipment prestige segment, Pirelli's market share exceeds 50%.

Around two-thirds of the group's sales come from the high-value segment (≥18 inches), which has regained and even surpassed pre-pandemic demand/production levels. Pirelli sets itself apart from its rivals by concentrating on high-value markets, unlike Michelin and Bridgestone, which prioritize being full-range and mass-market players. Pirelli's business specialization is reflected in a better margin relative to the benchmark (the industry's average EBITDA margin is 13% whereas Pirelli exceeds 20% on average).

- **Strong geographic diversification with rather limited product offerings**

With its strong focus on the premium and prestige segments and strong branding, Pirelli enjoys a global presence, with some concentration in Europe (including Turkey), where it generated c. 37% of its total revenues for 2022. Nevertheless, its lack of presence in the mass-market tyre segment means a limited range of products. This in turn means that Pirelli is more vulnerable to market fluctuations, changes in worldwide regulations, and shifts in consumer behaviour, all of which could significantly impact its revenue and profitability.

- **Significant R&D efforts towards use of more sustainable raw materials**

R&D activities (4% of net sales in FY22 vs 2.5% industry average) are a strong pillar of Pirelli's business model. Nearly 7% of its total workforce is dedicated to innovation across 12 technology centres located all over the world. In addition, Pirelli partners with some of its strategic suppliers and local universities for the development of innovative materials bearing low environmental impact. These partnerships help the company to introduce materials of mineral origin in partial replacement of precipitated silica and carbon black. Consequently, the share of renewable and recycled materials in a single product reached 38% in 2022 (30% renewable + 8% recycled), compared to 33% (28% renewable + 5% recycled) in 2021.

GOVERNANCE

- **Shareholder profile: partly owned by Chinese state-owned companies**

Pirelli's top shareholders are Chinese state-owned and quasi-state-owned companies. They have a combined stake of at least 46% of total shares through (i) Sinochem Holdings Corp Ltd. (37%), and (ii) PFQY Srl (9%). Another 14.1% is held by Camfin SpA, which is controlled by Marco Tronchetti Provera, current CEO and executive vice chairman of Pirelli. Of the free float of c. 40% c. 17% is held by public entities and 8.3% by institutional investors. As Pirelli operates in a strategic sector in Italy, the Chinese involvement is somewhat constrained by the need for government approval for most of the company's business decisions through the Golden Power regulation, which was recently enforced. To that regard, the current situation of Pirelli's governance is a constraining factor for the company's rating.

- **Management quality: prudent financial policy with good track record**

We continue to view Pirelli's financial policy as prudent, given a sound track record of reasonable payout ratios and M&A operations. The group has also set a strategic goal of reducing its net financial debt position, with the objective of reaching a reported net leverage ratio of c.1.0x by 2025. Over the past few years, the group's strategy has been rather efficient with respect to the deleveraging strategy.

- **ESG policy: ESG score improvement and a progressive integration into the business processes**

In 2022, Pirelli reported a reduction of c.5.3% in its scope 1 & 2 emissions, and of c. 12% in its total energy consumption, all compared to 2020 (the base year for our internal ESG score). As a consequence, its overall EthiFinance ESG score has improved to 88, which is among the highest within our corporate coverage. Looking forward, the group's ESG strategy aims to integrate sustainability factors into the business processes, such as with the recently placed sustainability-linked bond. By setting ambitious objectives, Pirelli aspires to attain carbon neutrality and the use of renewable materials for 60% of its tyre manufacturing operations by 2030.

FINANCIAL RISK PROFILE

CASHFLOW AND LEVERAGE

- **Strong sales growth although impacted by high inflation and low volumes**

In FY22, Pirelli's reported sales amounted to €6.7bn, representing year-on-year nominal growth of 24.1%. The rise was primarily related to price increases, which contributed 19.7% to the surge. However, there was a slight decrease in volumes, of 1%, mainly due to a 9.2% decline in the standard segment (≤17”). The company aims to reduce its exposure to this segment, particularly after the sharp reduction in activities in Russia's 90% standard market. On the other hand, the high-value segment, which is the company's focal point, witnessed a 7.6% increase in volumes with an enhanced product mix. The remaining sales growth is credited to favourable foreign exchange rate movements. Considering the anticipated flattish sales volume in the standard segment and the expected volatility in commodity prices, particularly oil and rubber, we have forecast a growth rate of 1.7% for FY23. Subsequently, we have forecast an increase in revenues of c.2.8% for FY24, driven by robust expansion in the high-value segment and for electric vehicle technology.

In FY22, EthiFinance Ratings adjusted EBITDA amounted to €1.3bn compared to €1.1bn the previous year, with a c.70bps contraction in margin (20.2% vs. 20.9%). The slight decrease was due to the sticky prices in the high-value segment and the considerable decline in standard segment sales volume. In line with management’s guidance, we have taken a conservative approach and forecast that Pirelli's adjusted EBITDA margin will fall to 18.5% for FY23 before stabilizing around 19.5% for FY23 and FY24. The margin is exposed to a set of pressure on input costs such as the cost of energy and overheads.

The EthiFinance Ratings adjusted free cash flow for FY22 was a positive €323m. The high payout ratio of 56% anticipated for 2023 will temporarily lower FCF to €227m. But we expect that it will rebound from 2024 onwards, assuming a payout ratio of 40%, as guided by Pirelli’s management.

- **Pirelli's creditworthiness improves as financial ratios show signs of recovery**

At end-2022, the EthiFinance Ratings adjusted net leverage ratio had improved to 2.4x, compared to 3.2x at end-2021, thanks to EBITDA growth of 19.7% and a reduction of c.€300m in adjusted net debt. With strong cash generation expected over our forecast period, we anticipate a further gradual improvement in the ratio. While the interest coverage ratio improved as well, from 8.2x in FY21 to 9.7x in FY22, it is projected to slightly deteriorate over our forecast period (2023-2025) as a result of the refinancing of debt at a higher interest rate (> 4%).

SOLVENCY AND LIQUIDITY PROFILE

- **A steady solvency ratio, expected to improve as the company continues to deleverage**

As of end-2022, Pirelli’s gross reported debt stood at €4.5bn, a noteworthy decrease compared to €5.3bn as of end-2021. This decline was predominantly the result of the redemption of €0.75bn in bonds and repayment of c.€1.0bn in unsecured credit facilities. Our debt adjustments amounted to c. €0.3bn (mainly employee benefits). We have also been more conservative than the company regarding financial assets included in the calculation of net debt. Pirelli’s solvency is considered average relative to its industry peers due to its high gearing relative to its business scale. Consequently, equity covered 114% of total adjusted debt at end-2022, which is higher than the previous year’s figure of c. 90%, but inferior compared with most tier-1 industry players.

- **Good liquidity profile with strong refinancing capacity**

We consider Pirelli’s liquidity profile to be ‘Adequate’ as the company can repay all its upcoming debt maturities without refinancing for two years. The company can also get financing relatively easily, given its solid financial profile.

MAIN FINANCIAL FIGURES AND FORECASTS

Main financial figures. €m	2021	2022	2023E	2024E	2025E	*22vs21*
Turnover	5,331	6,616	6,727	6,916	7,188	*24.1%*
EBITDA (Adjusted)	1,116	1,336	1,244	1,349	1,402	*19.7%*
EBITDA Margin	20.9%	20.2%	18.5%	19.5%	19.5%	*-0.7pp*
EBIT	482	719	625	730	783	*49.1%*
EBIT Margin	9.0%	10.9%	9.3%	10.5%	10.9%	*1.9pp*
Interest expenses	(136)	(137)	(176)	(192)	(204)	*-0.9%*
EBT	346	581	450	537	579	*68.0%*
Total Assets	13,883	13,898	13,852	14,172	14,141	*0.1%*
Equity (Adjusted)	5,004	5,424	5,581	5,863	6,154	*8.4%*
Total Financial Debt (Adjusted) (1)	5,563	4,768	4,532	4,514	4,111	*-14.3%*
Net Financial Debt (Adjusted) (1)	3,521	3,191	2,830	2,356	1,890	*-9.4%*
Equity/TFD (1)	89.9%	113.8%	123.1%	129.9%	149.7%	*23.8pp*
NFD/EBITDA (1)	3.2x	2.4x	2.3x	1.7x	1.3x	*-0.8x*
Funds From Operations	899	989	932	995	1,026	*10.0%*
FFO/NFD (1)	25.5%	31.0%	32.9%	42.2%	54.3%	*5.5pp*
EBITDA/Interest	8.2x	9.7x	7.1x	7.0x	6.9x	*1.5x*

(1) Net debt adjustments : The adjusted net debt is inclusive of pension benefits, equity components of convertible bonds and other financial assets

CREDIT RATING

CREDIT RATING	
Business Risk Profile	***BBB-***
Industry Risk Assessment	*BB*
Industry 's ESG	***Negative***
Competitive Positioning	*BBB+*
Governance	*BB+*
Financial Risk Profile	***BBB+***
Cash flow and leverage	*BBB*
Solvency	*BBB+*
Company's ESG	***Positive***
Anchor Rating	***BBB***
Modifiers	-
Final Rating	***BBB***

RATING SENSITIVITY

- **Long-term rating positive factors (↑)**

We could upgrade our rating should Pirelli's credit metrics improve further on a sustainable basis. Specifically, a potential catalyst for such upgrade would be an EthiFinance Ratings adjusted net leverage ratio persistently below 1.0x and an interest coverage ratio above 9.0x. Also, an upgrade is subject to stable prospects for the whole tyre industry, which is closely tied to the trend in global automotive production.

- **Long-term rating negative factors (↓)**

We may consider lowering our long-term rating in the event of a significant deterioration in Pirelli's credit metrics, such as an EthiFinance adjusted net leverage exceeding 3.0x and/or an interest coverage ratio falling below 5.0x. Additionally, a less cautious financial strategy pursued by the company, such as significant debt-financed M&A, could constitute another potential catalyst for a rating downgrade.

REGULATORY INFORMATION

LEI: 815600A0C9AFC1F2A709

Initiation report: No

Rating initiation: Initiated at BBB- on November 29, 2022

Last rating action: Initiated at BBB- on November 29, 2022

Rating nature: Unsolicited long-term corporate rating (this report is paid by investors, not the issuer)

With rated entity or related third party participation: No - The report was published without having been reviewed by the issuer.

With access to internal documents: No

With access to management: No

Ancillary services provided to the entity: In accordance with Article 6 (2), in conjunction with Annex I, section B (4) of the Regulation (EC) No 1060/2009 of the European Parliament and of the Council of 16 September 2009, it is reported that during the last 12 months EthiFinance Ratings has not provided ancillary services to the rated entity or its related third parties.

Name of the rating committee chair: Marc PIERRON, Senior Director

Material sources used to support the rating decision:

- Annual reports 2020, 2021, 2022
- Half-year reports 2020, 2021, 2022
- Investor presentations and press releases 2020, 1H21, 1H22, FY22

Limitation of the Rating action:

- EthiFinance Ratings believes that the quality and quantity of information available on the rated entity is sufficient to provide a rating
- EthiFinance Ratings has no obligation to audit the data provided

Methodology used for this rating:

https://files.ethifinance.com/documents/methodologies/CRA_190_V3.CorporateRatingMethodology_Long_Term.pdf

EthiFinance Ratings SL

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