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Transcription

Title: Nokian Tyres Conference Call

Date: 18th June 2019

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Conference Ref. No: EV00089173

Duration: 00:44:24

Presentation

Operator

Hello everyone and welcome to the Nokian Tyres Conference Call. Throughout the call all participants will be in listen-only mode and afterwards there'll be a question and answer session. And just to remind you, this conference call is being recorded. I'll now hand the call over to your speakers. Please begin.

Päivi Antola

Good afternoon and welcome to Nokian Tyres end of quarter conference call. My name is Päivi Antola. I am the head of investor relations at Nokian Tyres. Together with me in the call I have Hille Korhonen, the President and CEO of the company, and Teemu Kangas-Kärki, the CFO. We will start the call with a brief introduction by Hille; then take those questions which we have received in advance and then take questions from the audience. So, Hille, please.

Hille Korhonen

Thank you, Päivi, and hello and good afternoon to everybody and thank you for joining our call today. I'm starting from our Friday guidance update and I said we updated our guidance page on our best understanding of the market outlook at the moment. So what we are stating is that in 2019 net sales with comparable currencies are expected to be slightly higher and operating profit to be lower compared to 2018. And what we at the moment see as market outlook is the continuous softness in central European market driven by the decline in new car sales and also quite competitive situation and despite of the original thinking that the situation will be recovering during the second half of the year, it doesn't seem to be the case. Then, when we are looking at the other markets, in the Nordic markets, no big changes in the replacement market as such, but also there the new car sales decline compared to previous year, continues to take place and that has some impact on the winter tyre sales as well.

When we are looking at the Russian market, there we see summer tyre sales still proceeding as planned, but we don't yet have any visibility to the sell-out. So the high inventories that the customers have been carrying are still on a quite high level and the final results will be seen after the summer season. Overall, when we look at the market outlook, we see slight growth in total market volume, [ph 00:03:54] premium will continue to suffer and summer tyre sales will be lower compared to last year so all the growth will be coming from winter tyres.

When we look at the North American market, no major changes compared to our previous updates. Then, when taking a look at our strategic, very important projects, our Dayton factory project is proceeding according to the plan. We have recruited the first team which is now returning back to US this week after being in training in Finland and Russia for almost six weeks and they will be starting to ramp up the factory after we have commissioned the last machineries in the factory. And it's good to remember also that we will be carrying quite high costs in the Dayton factory this year while ramping up the operations and as we are not busier selling any of the products that we will be producing. And the commercial production will be starting beginning of next year as planned.

Then we have the test track project in Spain which is also proceeding in line with budget and will be completed by end of next year. And also, the heavy tyres capacity expansion including also new testing facility for the new products is proceeding in line with the plan and the new capacity adding 50% of the current capacity will be in years beginning of 2021. So, this was my summary and we are now ready to take questions.

Q&A

Päivi Antola

Let's take first the questions which we have received in advance. And these are about the competitive advantages what Nokian Tyres have and also on profitability. So, the first question is: 'Nokian Tyres has an impressive track record looking at return on investments and also with stable market shares in Nordics and Russia. What are the main reasons that these tyre companies have not been able to take market share from Nokian Tyres?' So, Hille, I assume you will take this first question?

Hille Korhonen

Yes. Thank you, Päivi. So, Nordics and Russian markets are our home markets. We have been long-time, long-term in these markets building our brand positioning, building our distribution, and also having great partners both in the Nordics and in Russia, long-term partners, and especially in Russia, we have not been leading the market when there has been hiccups in the market but we have been staying with our customers and supporting their business. So, we have also very wide distribution there, not only to the wholesale, but we have own direct delivery in some areas and we are involved in online business and also in car dealer business both in Russia and in the Nordics. So, we have multiple channels and very strong position.

Päivi Antola

Good. Then the next one is maybe more a question for Teemu. Do you expect a new factory in the US to produce margins and returns on capital employed at the company average?

Teemu Kangas-Kärki

As you remember one of our discussion in the capital markets day where we discussed the relative profitability by business area and there we showed to all investors that the gross margin in US is below the company average. So in that sense we are not expecting to deliver company average gross margin in US. And then in terms of return on capital employed, now when we are investing 360 million USD. Clearly there is a pressure on our return on capital. Despite these factors we are predicated on the fact that we are growing in our home markets and be able to deliver high profitability and high return on capital employed.

Päivi Antola

Thank you, Teemu. And maybe you can remind us all what you told in the capital markets day what will be the impact of the US factory ramp-up this year and in the coming years please.

Teemu Kangas-Kärki

So, this year, in year 2019, the negative impact on our EBIT margin is on a level of between 100 and 200 basis points on EBIT margin. Next year, the impact will increase to be on a level of between 200 and 300 basis points and then going back to level 100 and 200 in the year 2021.

Päivi Antola

Thank you, Teemu. Then the next question in some older [ph 00:10:35] sell-side reports, some [ph 00:10:38] sell-side firms claim that Nokian Tyres Russia sales were at 45% operating margin. The question here is if that is still the case. Well, unfortunately we don't comment on regional level profitability more than what we did in the capital markets day last year in Teemu's presentation, but Teemu maybe you can open up a bit why the operating margin differs in each region.

Teemu Kangas-Kärki

I would say that in its simplicity, it's a factor of market position and here in the Nordics and in Russia where we have a strong market position that helps us to maintain our operating margin on a different level, compared to for example North America which is a new expansion market for us.

Päivi Antola

Thank you. And then the last question which we have received in advance, the company's operating margin and return on capital is significantly higher than peers [ph 00:11:42]. Can you explain what competitive advantages and barriers to entry explain the higher and consistent returns?

Hille Korhonen

If I would need to simplify the answer, I would take three points. One is that we are focused on replacement tyre market. Secondly, we have strong winter tyre focus – winter tyres being 70% of our passenger car tyre business – and the third advantage is that we have one big, very efficient production facility which is located in Russia in a low-cost country. So, all in all we are a very focused company.

Päivi Antola

Thank you, Hille. And now operator, we would be ready for the questions from the audience please.

Operator

Thank you. And if you do wish to ask a question, please press 01 on your telephone keypad now. If you wish to withdraw your question, you may do so by pressing 02 to cancel. And the first question is from Panu Laitinmäki from Danske bank. Please go ahead. Your line is open.

Panu Laitinmäki

Hello, can you hear me?

Päivi Antola

Yes.

Operator

Yes.

Panu Laitinmäki

All right. Yeah, sorry, I have two questions. First one is on the guidance. So you are saying that EBIT will be on lower than last year, but can you be more specific what do you mean by that? Is it safe to assume that it's in a range of 5% to 10%? Or even better, could you give a margin guidance because you have this three-year margin target of 22? So that's the first question. So, what does lower mean? And the third question is on the profit warning. So, is it more Q2 specific— so that Q2 was so weak that you cannot raise the previous guidance or is it more about second half being much weaker than you earlier expected? Thank you.

Teemu Kangas-Kärki

So if I start with the EBIT guidance. So, the previous was, the guidance was that approximately on the level and that meant negative couple of percentage points and now it is more than that, but still a single-digit decline.

Panu Laitinmäki
Thank you. What about the second question? Is it Q2 specific or second half outlook being weaker?

Teemu Kangas-Kärki
So that is our current view on the balance of the year; so including all the months to come.

Panu Laitinmäki
Okay. Thank you.

Operator
Next question is from Mattias Holmberg from DNB Markets. Please go ahead. Your line is open.

Mattias Holmberg
Thank you. I'm thinking a bit about your strategic ambitions in Central Europe where you target to increase sales by 50% from 2017 to 2022 and since 2017 to date, sales is essentially unchanged and you're talking about an increasingly tougher market here so, my question is essentially what makes you confident still in reaching these targets given the relatively poor development thus far in the region and what you see in the end market today? Thank you.

Hille Korhonen
Thank you, Mattias. We are still keeping the ambition level unchanged, but I would say that at this point of time, as you have noted, we are behind our schedule but the ambition is to grow in Central Europe and we feel confident that there is room to grow and now we have new head of Central Europe who will, as a first thing, go through the plans and update the strategic plans for the coming years and we definitely aim at moving forward there.

Mattias Holmberg
Do you think that there's anything that you can do to catch up to the part that you've fallen behind here?

Hille Korhonen
Of course, we are hoping the market to support that as well but, as stated, this year the market situation has been very soft for everybody and when we look at, for example, the summer tyre market it has been declining and despite of the fact that we have been increasing our share in summer tyres, of course, the total volume and business has not been growing.

Mattias Holmberg
Great. And just a final question from me. You, in your updated guidance here for 2019, you talked about the Central European market in particular and new car sales being quite soft and we all know that replacement is your main segment in terms of sales and we know that in the Nordics and in Russia, you have some winter tyre sales that are made in relation to a new car being sold. But can you please elaborate a bit on how you are impacted by the new car sales cycle in Central Europe?

Hille Korhonen
In Central Europe the impact is mainly coming from the fact that when the OE business is down, it means that there is more volume coming to the replacement market and that is then bringing the competition to the next level I would say. In the Nordics and in Russia, of course, when people buy new cars they buy also winter tyres and there, for example in Russia, one third of the market

is driven by the new car sales but that is very market-specific and, as I said, for our business it's not brining direct impact in Central Europe, but it's impacting the competitive situation.

Mattias Holmberg
That's very clear. Thank you so much.

Operator
Next question is from Sander Intelmann from Paradigm Capital. Please go ahead. Your line is open.

Sander Intelmann
Hello, can you hear me?

Operator
Yeah, you're coming through clear. Please go ahead with your question.

Sander Intelmann
Thank you. There's been some commentary just now about weakening OE market pressuring, your sales and so on. Could you comment on what flexibility you have to increase and reduce production perhaps to the extent of operating cost, leverage in your business, and share what costs are variable and fixed so we can understand how your margin will move around depending on what happens to sales?

Hille Korhonen
Well, basically, as we are running two factories today. We have the Russian factory, the big volume factory, and then we have a factory in Finland. The strategy that we have had is that we aim to run the Russian factory at full speed all the time and the flexibility is in Finland where the flexibility is coming then from the labour. So releasing labour from the factory and reducing the number of seats we are working with. And of course, it always comes with certain delay. So like this year we have been now having temporary layoffs in the Finnish factory, but the higher cost base we have been still having during the first months of the year.

Sander Intelmann
Thank you very much. And as a follow up to that, if I may, if you were to, say, reduce production in Russia by 10%, what would that do to your cost per unit in Russia?

Hille Korhonen
Well, I said our primary tool is always to reduce production in Finland if needed because the labour cost and cost of production therefore is much, much higher in Finland compared to Russia.

Sander Intelmann
Okay, thank you.

Operator
The next question is from Olof Cederholm from ABG. Please go ahead. Your line is now open.

Olof Cederholm

Hi, it's Olof Cederholm with ABG. I just have a question about the US ramp and maybe not the ramp in itself but the work to find new distribution and new channels coming to the market. How is that work going and are you confident that you will be able to find buyers for your tyres starting 2020?

Hille Korhonen

So regarding North America, we are starting the commercial production beginning of next year and we are planning to produce roughly 1 million tyres next year. The growth plan for the US and Canadian markets is based on the volume growth in the factory so that once we have the 4 million capacity in place after three years' time we are able to sell the planned quantity in the market. And our plan is to double our sales in five years' time in North America which we have been already doing in the past five years and we have a plan how to increase the sales per product category and in different geographical areas.

So, we still have a potential to grow in winter tyres in both A and B segments and some all-weather tyres, but that market is quite small, but we have potential there and we will be focusing on growing the all-season tyres. Specific segments for SUVs and light trucks and also then complementing the offering we have in terms of basic all-season tyres. We are proceeding in a way where we are growing with our existing customers by adding the new products and also looking for new customers. And we have identified as the main customer segment to be grown with the independent tyre dealers and there our strategy is to go for our selected distribution in order to have the possibility to earn well with our tyres so not to have multiple customers in the same area. So, we have quite detailed plans and we track and follow up these on a monthly basis.

Olof Cederholm

Perfect. Thank you for that. And could I also have a follow-up if it would be possible for you to explain in greater detail why the margin pressure will increase next year from the expansion? Since you're producing volumes next year, there is also some revenue coverage so I was just curious as to why the margin pressure would increase?

Teemu Kangas-Kärki

So, the ramp-up is starting this year and the full effect will take place next year. And that is our current estimate for 2020.

Olof Cederholm

Okay. Thank you.

Operator

Next question is from Artem Beletski from SEB. Please go ahead. Your line is now open.

Artem Beletski

Yes, hi there, this is Artem from SEB. A couple of questions from my side. So first, starting with Russia, could you provide maybe an updated outlook in terms of market development in 2019? I remember in Q1 you had been guiding for car sales growth of 5% to 7% this year in light of fairly big development for example in May, have you taken more cautious stance on it? and the second question is relating to pricing pressure of what you are, especially highlighting for Central Europe, how long do you expect it to continue and where the situation is much better in terms of pricing what comes to other regions?

Hille Korhonen

So, when we look at the Russian market, there are couple of basic economical factors. So, decline in consumers' real incomes and this is driving the weaker car sales. And the second thing is the high summer tyre inventories at our customers and this is impacting the sell-in. So, when looking at the new car sales, it decreased by 6.7% in May compared to last year and the first five months show a 2% decline. So, we still believe that there will be some growth regarding the full year in new car sales but it will be lower than what we have originally estimated beginning of the year. So it might be closer to the range of 3% to 5%.

And, then you asked about the pricing in Central Europe. The pricing situation is not stable, I would say, so it means that the customers are looking for opportunities to buy with lower prices and that's also delaying the purchases of winter tyres, so we see clearly postponement of orders closer to the season. And, I would say it's not at all stable the pricing situation in Central Europe. And, what comes to other markets like Russia or Nordics, there we see slightly less pressure on prices.

Artem Beletski

Okay. Great, thank you. Can I actually follow with one additional question? What comes to volume development, when do you expect volume growth to return back to positive this year? Is it fair to assume that comparisons for second half of this year will be much easier?

Hille Korhonen

Well, I think you had the answer. So, comparisons to second half last year is of course easier so we are expecting the volume increase during the second half of the year.

Artem Beletski

Okay. Great, thank you.

Operator

Next question is from Akshay Katkar from JP Morgan. Please go ahead. Your line is now open.

Akshay Katkar

Thank you. Three quick questions. First on coming back to volumes. Your selling assumptions for 2019 are you still assuming some growth or probably flat volumes for 2019 for the full year please? And the second question is one of your competitors has been talking about more capacity coming online in Central Europe, mainly from Korean tyre makers, are you seeing more competition in the market and more pricing competition as a result? And the third question is, could you just remind us of your total CapEx guidance for 2019?

Hille Korhonen

So, we are expecting volume growth during the second half of the year.

Akshay Katkar

And for the full year as well?

Hille Korhonen

For the full year, yes. Yes, for the full year, yes.

Akshay Katkar

Okay.

Hille Korhonen

And then when looking at the capacity situation in Europe, there is definitely over-capacity at this point of time when the OE business is down compared to last year.

Teemu Kangas-Kärki

And then with regards to CapEx level this year, we have been indicating that to be on a level of 300 million.

Akshay Katkar

Thank you.

Operator

And next question is from Henning Cosman from HSBC. Please go ahead. Your line's open.

Henning Cosman

Hi, good afternoon. Please can I ask one shorter term question on Russia first. That was for yourself, in volume terms, obviously quite strong in the first half. On a comp level that was already quite tough and inverse to the relatively weak market environment in Q1. Now, being towards the end of Q2 already, could you just update us on how Russia has been going? Have you seen some sort of payback for you individually as compared to your strengths in Q1, maybe in line with the market or even worse than the market because you had quite a strong Q1? That's my first question please.

Hille Korhonen

Okay, if I repeat what we did in the first quarter regarding Russia. Normally we would be shipping primarily summer tyres but now due to the high inventory levels of summer tyres in the distribution, we started to deliver already also winter tyres. And our expectations for the full year is that winter tyre replacement market will be growing. The B segment will be growing more than A so the premium product sales will be lower compare to previous year. And, the summer tyre replacement will be going down compared to previous year and what comes to the fourth quarter summer tyre sale in that very much dependant then on the summer season sell-out.

Henning Cosman

But it would still be correct to think that there was a certain pull forward of winter tyres sale in from Q2 into Q1 right? So, everything else equal, you should see fewer winter tyre sales in Q2?

Hille Korhonen

Well, when we look at the full year of winter tyre sales, we are planning to sell more winter tyres compared to last year overall.

Henning Cosman

Okay, and then little bit more longer term, do I remember that correctly that with respect to your plus 50% in Central Europe and double in North America ambitions, that was mainly going to come from volume, right? Or, have you ever given us a breakdown as to what you think the contribution from price and mix within the revenue ambitions in the regions respectively was?

Hille Korhonen

Yes, so it's not only volume we are talking about both volume price and mix development impacting our sales growth.

Henning Cosman

Are you prepared to quantify that a little bit between the volume price and mix or could you at least give a little bit of colour, I think you commented earlier that you're a bit behind in Europe specifically with respect to the 50% target, I assumed a lot of that is from a tougher pricing environment as well, so if that doesn't go away, barring obviously a normalisation in the OE market, is it also in volume that you think you're behind or is it more in price?

Teemu Kangas-Kärki

So, in terms of [ph 00:34:40] mainly, clearly, in our approach story, volume is the main driver, but then there are differences between the business areas and as we have been indicating already earlier, for example indication of North America, we also believe that price is one important factor there together with the mix as well.

Henning Cosman

And in Europe it could even be negative over the five-year period now?

Teemu Kangas-Kärki

In terms of price, in Central Europe, our original plan was not predicated on the price reduction.

Henning Cosman

Okay, great. Thank you. And then just very finally, when you said winter purchases are being delayed in anticipation of lower prices, can you just say why do you think your customers are anticipating lower prices? It's not raw material, I don't assume, so is that because of that increasing over-capacity in Europe?

Hille Korhonen

Yeah, that's because of the competitive situation. The other reason why they are postponing orders is that their inventories are quite full, so they are not able to take in the seasonal products yet.

Henning Cosman

This is winter tyre inventories in Europe, yeah?

Hille Korhonen

That's summer tyre inventories in Europe. Summer tyre inventories are on high level bought in Europe and in Russia and if the inventories are full it's quite tricky to take in another product.

Henning Cosman

Great, thank you very much.

Operator

And just as a reminder, if you do wish to ask any further questions, please press 01 on your telephone keypad now. We have a question from the line of Thomas Besson from Kepler Cheuvreux. Please go ahead. Your line is now open.

Thomas Besson

Thank you very much it's Thomas Besson from Kepler Cheuvreux. I have two quick questions please. Can you say a few words about your specialty business end markets? Are they also suffering some challenges in terms of volumes and pricing or is it easier for you to develop your strategy as planned in terms of CapEx and volume expansion? The first one. And the second, your own inventories were fairly high at the end of Q1. Can you discuss how much you want to bring these down in Q2 or Q3 and how much it will impact the sales or results of second or third quarter if you effectively need to end up producing versus what you deliver? Thank you.

Hille Korhonen

Thank you. So, if I start from the heavy tyres. This year of OE business is about 50% at this point of time so they're dealing more directly with the machine builders. And the main markets and segments for us are forestry and agricultural machinery and in the forestry business the order books for the forestry machinery suppliers are fully booked I would say until end of next year so there we have a very stable order book from that business.

In the agri side, this is the new segment we have been developing and innovating new products for this segment. There we see some, I would say not downturn but balancing of the demand in Central Europe which is one of our core markets. The other core market for us is North America. So, at this point of time we have long order book and we are still prioritising orders because we are not having all the capacity yet in use which we are currently building. Then, also the truck tyre business has been doing well and there we are not dependent on our own capacity, so we are having offtake tyres in that segment.

Then, the second question you asked about the inventories and the inventories are a balancing buffer for us because we want to run the factories at stable speed throughout the whole year and of course we are prepared to support the volume growth later this year and for especially for the winter season.

Thomas Besson

Thank you. May I ask a quick follow up please. Just for my own information. There was only a short period of five, six weeks between the Q1 reporting and the decision to adjust the guidance. Can you tell us what have been the drivers for your decision to change these market assumptions for passenger tyre replacement, mainly in Central Europe? You only had one additional data point, where in terms of monthly data, or you had two additional months? What kind of visibility do you have three, six months out to have decided to change the guide mid-June when early May you thought it was feasible, just for my information?

Hille Korhonen

Well, of course, we are careful about changing our guidance and outlook and it's based on, as you said, two data points so we have internal discussions and gathering the best understanding from the market regarding the full year outlook and when we have enough visibility then we of course base our decision and guidance on that.

Thomas

Okay, good. Thank you very much.

Operator

And we have a question from the line of Ashik Kurian from Exane BNP Paribas. Please go ahead. Your line is now open.

Ashik Kurian

Hi just one follow up question. Depending on [? 00:42:00] guidance, I know you've flagged weaker volumes and tougher pricing, but just on your average, should we understand pricing being the key driver because you're still talking about volume growth for full year so at least with respect to your profit projections for this year, has the biggest move been on the pricing line?

Hille Korhonen

Thank you. So, the biggest change compared to original estimate is coming from the volume. So, we see the volume change.

Ashik Kurian

And can I just ask a follow up. If it's on the volume side, because in the previous calls you've highlighted that you have some flexibility in directing additional volumes to the US, I mean of course you're ramping up a plan there to meet additional volume demands, so why wasn't it possible to offset some of the volume by shipping more units to the US?

Hille Korhonen

Regarding the US market, the flexibility to react is very slow because it takes almost half a year to really get the produce and get the products up there to the distribution. So, at this point of time we have already been shipping the winter tyres and of course that market is also [ph 00:43:35] such that we are supplying the market and customers based on demand, so we are not doing opportunistic business there.

Ashik Kurian

Okay, perfect. Thank you.

Operator

And there are currently no further questions registered so I'll hand the call back to the speakers for any closing comments. Please go ahead.

Päivi Antola

Thank you very much everybody for your active participation. If there are no additional questions, then this concludes the end of quarter call this time and talk to you again in August when we publish the second quarter results. Now, I want to wish you all a very nice summer. Thank you.

Operator

And this now concludes the conference call. Thank you all for attending. You may now disconnect your lines.