FIRST QUARTER 2021 HIGHLIGHTED HOLDING: MICHELIN

Michelin's business franchise is, in many ways, second-to-none: technical leadership, brand loyalty, and premium pricing. A comprehensive restructuring plan is aimed at delivering structurally higher profitability.

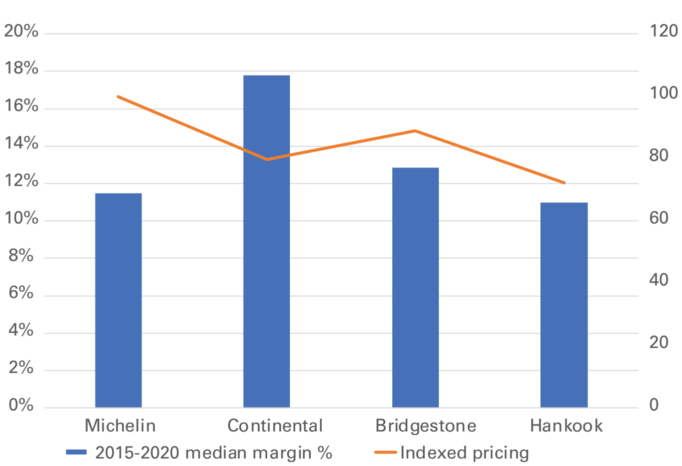
MICHELIN: A LEADING GLOBAL COMPANY AT A VALUE PRICE

In the summer of 2019, we initiated a position in Michelin, a leading global manufacturer of passenger car, truck/bus, and specialty tires. Michelin generates the bulk of its profit from the production of high value-add (HVA) passenger car and specialty tires, where the company's technical superiority and brand appeal results in premium pricing. Michelin's valuation became attractive in early 2019 after falling the prior year due to elevated raw material costs and macroeconomic weakness that hurt sales in both Western European and Chinese auto markets. We believed Michelin's profit headwinds were largely transitory, particularly given the less discretionary nature of replacement tires, which account for the bulk of global tire sales. Then in 2020, COVID-19 severely disrupted near-term tire demand, and consequently, the stock price, providing an opportunity to add to our position.

Like any industry, success in tire manufacturing is predicated on leveraging excellence in R&D/technology to be compensated for value-add, and having scale and operational best-practices that manifest in industry-leading cost structures. The harmony between these two competencies can result in healthy margins and high returns on capital.

Michelin's leading technology position and brand power is clearly demonstrated in product pricing

Figure 1: Michelin's Pricing Premium vs. EBIT[1] Performance



Source: Company reports, Pzena analysis

In EUR	Price	Earning Per Share FY21E	FY22E	Normal*	Price/Earnings FY21E	FY22E	Normal*
ENXTPA:ML Michelin	127.65	9.08	10.88	13.8	14.1x	11.7x	9.3x

Fiscal Year-End March 31
*Pzena estimate of normalized earnings
Source: Company reports, Pzena analysis
Data as of March 31, 2021

(competitors around the world benchmark their pricing relative to how far below Michelin they are), but the company's margins do not fully reflect its pricing advantage due to a sub-optimal cost structure (Figure 1). Michelin's new management team is leading a comprehensive restructuring initiative that, if fulfilled, could represent a structural improvement in the company's future earnings power.

Additionally, the company stands to benefit from disruption and decarbonization via the shift to electric vehicles (EVs). A more rapid move to electrification plays into Michelin's strengths, as tires for EVs require more enhanced performance attributes than tires for internal combustion engine vehicles (ICEs). This creates higher barriers to entry and benefits Michelin, which can already produce EV tires at scale.

A LEADING POSITION IN BRANDED PREMIUM PRODUCTS

Passenger tires fall into two distinct categories: standard and high-value add (HVA). The former is what comes to mind when one thinks of tires: run-of-the-mill, commodity rubber donuts that make headlines now and then due to anti-dumping investigations. Every manufacturer sells standard tires, but this business is commoditized and offers very slim margins.

HVA tires, which are typically found on luxury and premium vehicles, are a growing and very profitable segment of the passenger business, as they require a high degree of technical expertise to manufacture; this creates barriers to entry and a tighter supply-demand dynamic. Automotive original equipment manufacturers (OEMs) demand that tires be engineered to certain specifications, as they contribute to the performance of the underlying vehicle. By way of example, one of the most common tensions is the trade-off between safety and performance – having enough traction to ensure short braking distances and good cornering, and range – not having too much rolling resistance, which lowers fuel economy.

Additionally, there's been a long-term trend toward larger diameter rims (the interior dimension of the tire). A 2021 Chevy Suburban, for example, is the same height as it was 10 years ago, but the diameter of the rim has increased 5 inches, from 15 to 20 inches. The rubber sidewall portion of the tire therefore must be narrower to fit into the progressively smaller space, without sacrificing performance. This is not an insignificant engineering feat, and limited competition in the space allows Michelin to reap the financial benefits by delivering on these ever-challenging criteria.

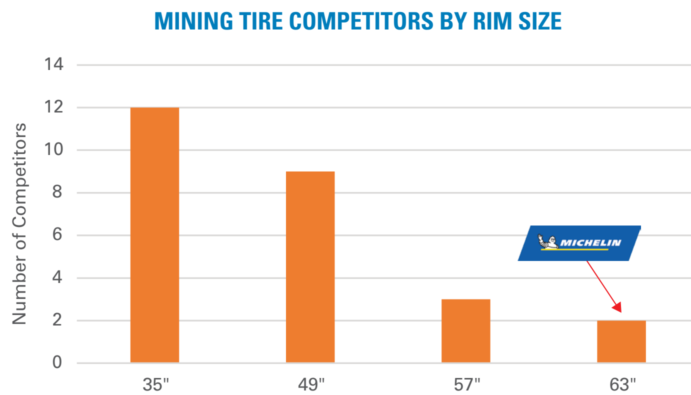
Customers also care about brand, particularly when it comes to replacing tires. Michelin, having invested in brand-building for decades, is the preeminent tire brand in the world. According to Brand Finance's 2021 Automotive Industry report, "Michelin has maintained the title of the world's most valuable and strongest tyres brand, with a brand value of US$6.8 billion and a BSI score of 84.8 out of 100" (BSI stands for Brand Strength Index). Technical excellence and premium brand perception are the main drivers of Michelin's superior pricing and customer loyalty. Tier 1 tire brands such as Bridgestone and Continental typically price 5-10% below Michelin, with tier 2 brands (Hankook) pricing 10-20% below. Additionally, 60% of buyers whose vehicles carry Michelin tires replace them with the exact same model when worn or punctured, compared to an industry average of 20-30%.

Within passenger cars, the industry has been shifting away from low-margin standard tires and toward the HVA variety. This presents a structural tailwind to Michelin's product mix. The company estimates the EBIT uplift at approximately EUR 100 million per year. This organic improvement in earnings based purely on changing industry fundamentals compares to Michelin's 2019 EBIT of EUR 2.7 billion.

MICHELIN LEADS IN SPECIALTY TIRES AS WELL

Michelin's specialty tire business is another strength, projected to grow faster than both the passenger and truck/bus segments while generating significantly higher margins (19% in 2019 versus 9% for truck/bus and 11% for passenger car). Specialty tires are found on mining, aircraft, and other off-road vehicles, and are especially profitable due to the oligopolistic nature of many of the underlying markets. The extra-large mining tire business (where tires stand at over 12 feet tall), for example, is effectively a duopoly in which the two leaders are Bridgestone and Michelin (Figure 2). Michelin reinforced its leadership in specialty tires via a series of acquisitions in 2018, and in addition to the mix benefit of higher growth from this very profitable segment, we expect EUR 30-80 million of synergies via procurement, logistics, and overhead reductions.

Figure 2: Michelin's Duopoly Position in Specialty Mining Tires



Source: Company reports, Pzena analysis

RESTRUCTURING SHOULD LEAD TO MARGIN IMPROVEMENT

Michelin's business model has yielded industry-leading pricing, but that benefit has not flowed through the income statement. Relative to peers, Michelin has smaller manufacturing plants and a higher mix of facilities located in high-cost regions. We believe this represents a clear earnings improvement opportunity, and Michelin's new management team is intent on tackling the cost structure to enhance the cost competitiveness of the group.

[1] Earnings before interest and taxes.

Some of the potential restructuring initiatives include:

1. Reducing overhead in central and manufacturing operations by 2,300 jobs, which could yield EUR 100 million of savings.

2. Continuing to close uncompetitive plants. The company has already announced the closure of facilities totaling approximately 10% of Western European production, which is expected to result in EUR 80 million savings. Management's long-term targets suggest an additional 10% of Western European production could be closed. Indeed, Michelin is making sure to retrain and/or provide assistance to affected employees – a reflection of the company's focus on social responsibility.

3. Localizing production to the end-market that is being served. This improves service levels, increases agility, lowers the company's carbon footprint (via less import/export). Financially, this could lead to a EUR 500 million reduction in working capital, significantly boosting operating cash flow.

We estimate that the benefit to the bottom line from a thoughtful restructuring strategy could be in the range of several hundred million euros, which would represent a material improvement to the company's profitability and drive Michelin toward industry-leading tire margins. These savings will also provide additional firepower to invest in growth initiatives such as B2B fleet management and high-tech materials, two adjacencies that leverage the company's core manufacturing and service competencies.

WELL-POSITIONED TO BENEFIT FROM DISRUPTION AND DECARBONIZATION

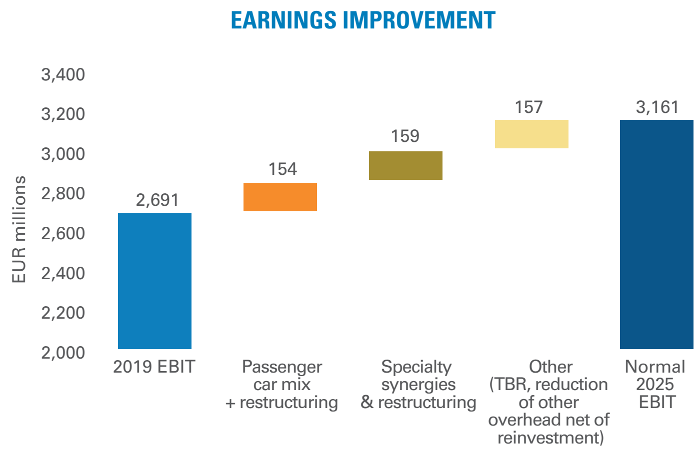
The developed world is aggressively shifting toward broad electrification to satisfy carbon neutrality goals, and Michelin stands to benefit from the inevitable disruption in the automotive industry. The transformation to EVs will amplify the workload on tires, increasing performance requirements and likely augmenting barriers to entry in the process.

EVs are heavier than their ICE counterparts due to the significant weight of the batteries. They also generate higher torque, which adds additional strain on tires. Equally as important, EV manufacturers tout range as a major value proposition, which highlights the need for tires that do not drag on the vehicle. We believe Michelin is well-positioned to benefit from EV growth due to its industry-leading capabilities and ability to mass-produce EV tires at scale. By leveraging this technical excellence, Michelin expects to more than double its current EV market share of 12% over the next 5 years.

CONCLUSION

Winning companies exhibit technical excellence, brand loyalty, and scale to generate industry-leading pricing and margins. Michelin embodies these traits. The most compelling part of Michelin as a value investment is that the prospect of appreciable earnings improvement is not contingent on a dramatic shift in strategy, but rather executing on a self-help plan. A summary of the various components of earnings improvement is shown in Figure 3.

Figure 3: Michelin's Path to Earnings Normalization



Source: Company reports, Pzena estimates

Michelin is a prime example of the high quality businesses that are on offer to disciplined value investors in today's environment. We maintain our stance that Michelin's business franchise is, in many ways, second to none, and that its earnings recovery and realistic growth trajectory will win over investors. Trading at 9.3x our estimate of normalized earnings, we view Michelin as a compelling value opportunity.

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