Alcoa Corporation

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Roy Harvey - *Chief Executive Officer*

David Gagliano: Okay, we're going to try and stay on schedule here. November this year, or last year, the old Alcoa Inc. separated into two publicly-traded companies, Alcoa Corp. and Arconic. The new Alcoa Corp. is a vertically-integrated upstream aluminum producer, operations that essentially span the entire production process in the aluminum value chain. Presenting today from Alcoa is Chief Executive Officer, Roy Harvey.

Roy Harvey: Thank you, everybody. So, first and foremost, can you hear me okay? I'm going to try and move myself away from the podium. Instead of giving a lecture, I'd rather give a bit of a short discussion about Alcoa Corporation.

So, my goal is very clear. I've been constrained by about 20 minutes to 25 minutes of presentation, at which point, Dave will ask me some hard questions. I will try and constrain my exuberance and enthusiasm into those 20 minutes, but I get pretty excited talking about Alcoa Corporation so I will do my best. I would also like to thank everybody for deciding to be in this room rather than outside in the sun. That is much appreciated.

I think everybody understands the standard discussion on forward-looking statements. I will let you have a good look through that at your discretion and also about non-GAAP financial indicators.

So, I'm going to move through this relatively quickly. This is meant to be something that is applicable to both new investors or also the people that know us a little bit better. I want to give you a flavor for who we are and what we're trying to accomplish after four months as a public company. And the coolest thing about this is that, while we are a newborn, only four months, we have also had the opportunity to take this 128 years of rich heritage and use it absolutely and utterly to our advantage.

I'm going to walk you through four things today. Number one, we're going to talk a little bit about our assets. Number two, I'm going to talk a little bit about financial metrics, what we were able to accomplish in 2016 and what that means for 2017. Number three, I'm going to have a few statements about our markets and specifically about China's impact on our markets and some of the recent developments in aluminum. And then, number four, and you're going to hear this consistently, a consistent drumbeat through the presentation, I'm going to talk about our key priorities.

And they are very simple and they're going to sound like apple pie and ice cream for those of us from the United States in here. We're going to reduce complexity in everything that we do. Simplify, simplify, simplify. We are going to drive a returns-based methodology and make sure that each and every one of our plants, each and every one of our operators understands that when we put capital in the ground and with the capital we already have placed in the ground, we are going to drive returns for our shareholders. And, third, we're going to prepare ourselves for the future. We live in a cyclical world. Aluminum is a cyclical commodity. We understand our place in that world. We will strengthen our balance sheet so that we cannot just survive when times are bad, we can thrive.

So, that's a lot to accomplish in 20 minutes.

Let me start off with a very brief overview of who we are and where we're located. Alcoa Corporation, as Dave very well explained at the beginning, is a spinoff or a separation from the larger Alcoa Inc. We are now a company dedicated that goes from bauxite down to aluminum cast or rolled products. We also have an energy portfolio that's contained within that.

We span a number of continents. We have more than 40 operating locations and joint ventures. We are also in 10 separate countries, from North America to South America, Australia, Europe, and then also with our recent joint venture with Ma'aden, The Ma'aden Mining Company in Saudi Arabia. So, we span a significant amount of ground and that gives us a lot of expertise that comes from around the globe and helps us to succeed.

We have also done significant work to strengthen our portfolio. The story I like to tell best is, at the beginning, in the beginning of the fourth quarter of 2015 when we announced the separation, times looked okay. Almost the first thing that happened as we started that preparation for that spin was that markets dropped to some of the worst conditions that we've seen in a number of years. And that gave us the burning platform to drive forward and to improve our businesses. And it connected with the longer program that's been occurring since the global financial crisis, where we've been trying to strengthen our portfolio and prepare ourselves for winning at all parts of the cycle.

Three very basic businesses. We have both cast and rolled products as well as energy, but I want to focus on our three largest businesses.

Number one, when speaking about external and internal sales, we are the largest bauxite miner in the world. And we're also in the first quartile, specifically on the 20th percentile. We are both the largest and the very low-cost competitor inside of bauxite. And as we're going to talk about here in a couple minutes, we also have significant expansion capabilities.

Number two, our alumina refining business is also the largest producer of alumina in the world and the largest third-party seller outside of China. We also compete inside of China. But a very low-cost position on the cost curve, the 17th percentile, first quartile again, in combination with a very significant portfolio that has been honed to be stronger gives us a truly, truly incredible opportunity as we look at the strength in our alumina markets today.

And, third, smelting, aluminum. This is the place where we've done the most concerted effort over these last years. In 2007, we had a portfolio just shy of 5 million tons and we were almost exactly in the middle of the cost curve, 51st percentile.

The world's changed significantly since that point in time. We're now around 2.5 million tons of productive capacity. We are at the 38th percentile. So, we're sitting in the second quartile and it gives us the opportunity for two things. Number one, we are stronger when pricing is depressed and we also continue to have significant upside as prices improve. Keep that in your minds because we're going to talk more about the profitability of our segment and more about the potential that we have in a strong pricing environment.

But now, I'd like to highlight bauxite and I want to highlight it not because it's our best business; I'm highlighting it, first of all, because I'm a mining engineer and I love the resource, but, second of all, because it's a place where we've had lots of questions with our investors about how quickly and how much we can grow.

So, let's start with a little bit of history before we talk about the future. In 2015, we sold about 2 million tons to third parties, 2 million tons of bauxite. In 2016, and really driven by the curtailment of the Point Comfort refinery in Texas, it freed up additional bauxite and, in addition, we were able to creep our facilities, operate faster, introduce new products that allowed us to grow from 2 million tons in 2015 to nearly 6.5 million tons in 2016. Incredible growth rate, but it's just the beginning.

Think about this first 6.5 million tons as our opportunity to introduce ourselves to a very vibrant marketplace; China particularly, but also outside of China. These are our shipments that we have the ability to start forging relationships, to look at the different consumers in China, some of the large players, some of the smaller players, and start to think about; how can we grow for the future? Who do we want to grow with? What kind of partnerships do we want to create? And how do we get the Alcoa name, which has a long and storied life inside of China already, how do we get that Alcoa name also associated with bauxite?

So, three things I want you to remember as we exit this slide. Number one, we already have a growth project in place at our Juruti mine in Northern Brazil. We will be adding another 0.5 million tons of productive capacity at the end of 2017. So, that means we have improvements coming down the pipeline already.

Number two, we have already shipped our first shipment of Western Australian bauxite to a third party customer in China. We now have an export permit from the Australian government to ship another 2.5 million tons per year. That gives us growth potential sitting very strategically close to some of the largest customers.

And, number three, and this is something new that we put in this presentation because we've been asked it so much; what is our growth potential inside of the mines that we currently own? So, this does not take into account additional green-field capacity, resources that we have elsewhere. This is simply growing what we already have in our portfolio through relatively modest capital investment. We can expand by 10 million tons; 10 million additional tons simply by doing smart things and simply by essentially improving logistics, etc. through capital contributions. So, something important to note.

And we get back to key priority number two. We're not going to build this and hope we can find customers at the other end. We are going to find customers. We are going to create strategic partnerships. We're going to use the 6.5 million tons that we have today to create a customer portfolio that allows us to invest this capital and have returns at the other end of that that we can deliver to our shareholders.

So, now, let's talk a little bit about what drives the business. What do we see in the future and how do these six segments come together? So, first and foremost, let's concentrate on the left part of this slide and I'll work my way across and I'll do it relatively quickly.

Bauxite, we just talked about growing bauxite by 10 million tons. Why do we want to do that? It's pretty simple. We have 35%, 35% EBITDA margins, and it is a significant contributor to our portfolio already. Very great business to grow.

Alumina, alumina sits just shy of 10% EBITDA margins. But, remember, in 2016, we had a market starting at $197 per ton for the alumina price index and ramping up to today's price of just shy of $340 per ton. So, it was a mixed year, a mixed year where we were able to make our portfolio stronger, where we could drive that improved maintenance environment, and where we could make this business ready for the future. Significant, significant earnings potential when you think about the fact of a different pricing environment in 2017 versus 2016.

Metal, aluminum, is another story of a very mixed year in 2016, from $1450 price per aluminum ton at the beginning of the year to now sitting just above $1900 unless it's changed in the last 15 minutes. So, again, a pretty significantly volatile year in 2016. You can see here that it's an important contributor to our portfolio, but not a significantly high EBITDA margin. That changes significantly as we see prices improve. We are leveraged to aluminum prices. Let me make that clear. Every $100 per ton that the aluminum price comes up, that is $230 million in added EBITDA to Alcoa Corporation and to our shareholders.

Now, we go into the transformation businesses, cast and rolled products. Cast products is relatively simple. It's where I started my career. Essentially, you take the molten aluminum, you turn it into a very simple shape, and then you find the best customer who will offer you the best price and where you can essentially lower your total operating cost and your total logistics cost. A very consistent business with very, very positive margins. What you see here is a margin per ton of aluminum. When you look at it as a conversion business, it's also a very, very attractive business and a place where we can drive good positive outcomes both my managing costs and by finding the right customer.

Rolled products, and as you can see here, was not a significant contributor of EBITDA to our portfolio. We essentially have two locations, the Warrick rolling mill in Indiana and a 25% ownership in a rolling mill and automotive mill in Saudi Arabia with our joint venture partner, with Ma'aden. This, let me be clear, this is a fixer-upper.

This is a place where we have assets in the ground, where we need to take immediate and urgent action to drive profitability into this business. Now, we have lived on the cost curves our entire lives. We are commodity people. We know how to do this. And we're going to do three simple things. I looked to make sure it was three fingers and not four. Three simple things.

Number one, we're going to fill the mill. This is a place where the more volume you have coming out, the better you dilute your fixed costs and the more EBITDA you generate. We are not going to run for EBITDA per ton. We are going to run for total EBITDA out of this business.

Number two, we're going to finish the startup and finish qualifications with our Saudi Arabian joint venture. That is the other part of our portfolio offering to our customers in North America. In the North American market where so many rolling mills have gone into automotive, it creates the possibility for an improving can sheet market.

And number three, we're going to run it like a commodity business. We are going to be relentless about driving out costs. We are going to find ways to better source metals and materials. And we're going to run it better. So, as you can see, a lot of upside potential that sits within rolled products.

And, finally, energy. And energy sits outside the typical aluminum cycle. We, in fact, are very leveraged to the Brazilian energy cycle and has a big impact of what's happening with the Brazilian real on us as well, both from a cost side, but, more importantly, from a revenue side. This is a business that has very positive margins, that does have a certain amount of cyclicality, but is a very great hydro-based power portfolio sitting inside of Brazil today. Very important to keep in mind.

So, when you bring all this together and you think about; what does it mean coming from a year in 2016 where we earned about $1 billion of EBITDA and going into 2017 when you bring all this together, you think about a pricing environment much improved, what does it drive from an EBITDA standpoint? The answer is $2.1 billion to $2.3 billion if aluminum prices averaged $1795 per ton and alumina prices averaged $335 per ton. Well, at the moment, we're sitting at $1900 per ton and we're sitting just shy of $340 per ton. That means that we have a lot of earnings potential sitting out there and we're going to be driving for it.

And the other piece I'd like you to keep in mind is what we call net performance. When you take out the pricing impacts of aluminum and alumina and the currency impacts of a global portfolio, take those things which are coming from the market; look at everything else, volume increases, curtailments, the things that you do to make your costs better, raw material increases, between 2015 and 2016 we improved by $290 million in net performance.

This year, we're seeing about $125 million in increases in raw material costs because of a strength in the market. However, we're going to overcome those. We're going to lock in the $290 million. And we're going to drive another $50 million of net performance improvements to the bottom line. That's not gross. That's net. That's what we deliver outside of the prices that are improving.

And now, I want to go through three very quick comments that I wanted to get out there that have been a lot of questions we've got about modeling.

So, I'll make this quick.

Number one, tax rates. When we look at the $2.1 billion to $2.3 billion EBITDA estimate, we estimate tax to be somewhere between 30% and 40%. Something to add to your models.

Number two, when we think about minority interest, think about our bauxite and our alumina segments as part of the AWAC joint venture with Alumina Limited, assume about 40% goes to minority interest.

And, number three, we have a significant amount of cyclicality inside of the business this year. Part of that is coming from market. We had increased power prices in Spain at the very beginning of the year; very, very high, in fact. And then, also, coming from decisions inside for us to optimize the full year. And that includes a decision to drive energy volumes from the first half into the second half, specifically in Brazil, because we found a better pricing environment. So, when we look at those two things plus the fact that we are in the restart phase of our Portland smelter in Eastern Australia, those essentially drive about a 15% difference between first half and second half that I'd like you to keep in mind as we go through the year.

So, now, let me briefly touch upon the balance sheet. So, remember, that was part number three of what we're trying to get accomplished. So, I'm just going to leave you with three very simple numbers.

Our net debt to EBITDA is approximately 0.6. That means we are right-sized from a funded-debt standpoint to be strong in all parts of the environment. And it also means, as we drive better EBITDA, as we drive more improvement, it makes our position even stronger.

Number two, our debt to capital sits around 16%. It's an appropriate capital structure for the type of business that we're in. Even more importantly, also think about the fact that we have a lot of work to do in order to make sure that, as we look at our outstanding unfunded pension and OPEB, we have places that we can continue to strengthen the balance sheet.

And then, finally, we continue to look at working capital as a very strategic lever and a place that we can continue to both maintain our cash, but also potentially drive additional cash into the future. We closed the year in 2016 at 13 days.

Now, let me say a few brief words about the market. And I suspect there will be questions about this. We've been talking about this all day yesterday and have additional conversations today as well.

So, number one, let me just reiterate what we said during our Q4 earnings. First of all, dividing it into the three main products that we sell. Bauxite, bauxite continues to have a voracious appetite inside of China. Any additional productive capacity essentially goes to China where they either consume it or they build up their stockpiles. We see this as a very constructive market and a place that we can continue to sell our tons.

Number two, alumina. We came out at the end of 2015 with heightened inventories and with more sellers than there were buyers. Over the course of 2016, we saw a pretty significant deficit, more than 1 million tons, and we now come into 2017 with those inventories burned off and we now have essentially a balance to a market that's actually in deficit. That bodes well for alumina.

From a smelting standpoint, it's a bit of mixed story. When you think about everything outside of China, we are producing less than we consume, about 1.5 million tons. When you think about productive capacity inside of China, the fact is, is there are more smelters operating than they, in fact, need. Now, there's a lot going on in the market in order to try and correct that, between WTO cases and announcements from the Ministry of Environmental Protection in China, and we're going to talk about that here in just a minute. But when you put it all together, our expectation is that China will be in surplus by about 2 million tons and when you combine that all together, we expect the markets will be in a small surplus of about 300,000 tons to 400,000 tons.

So, now, let's talk about the Ministry of Environmental Protection. They have just, maybe a month ago, released a proposal -- and keep in mind that this is a proposal -- to have curtailments occur both in smelting and refining across four key states in the aluminum industry during a period of time where they typically run their heaters. So, this is a proposal so this is not meant to be a promise. It's not meant to be what we think is going to happen. But, rather, it's meant to indicate how important this could be to the market.

So, first of all, take a quick look at the small table labeled as key provinces as percent of China totals. These four provinces are the lion's share of where alumina and aluminum value chain is produced inside of China. So, it's relevant.

When you look at the table on the right and you think about how this could impact, if it were to occur, each of these different products, it's important, particularly in alumina. And, I will remind you that we are heavily skewed towards alumina in our portfolio. That very specifically means that if something like this or if this proposal were to occur it could be a game-changer inside of the market in China.

Now, the next obvious question is; is it really going to happen? And the answer is we don't know. We don't know if they have sponsorship from the NDRC or if they're acting on their own or if this is done in concert with the other parts of the government. We do know that when they set their minds to trying to rationalize supply and demand they've been successful. They've been successful in coal and they've been working a lot in steel. That means they've got a track record.

But what most interests me is the fact that this signals a growing environmental awareness inside of China. Now, what does that mean? That means if they're forced, number one, to start thinking about rationalizing capacity, that's good for the aluminum industry. Number two, if they start enforcing the environmental regulations already on the books or, even better, think about environmental regulations that look more like the rest of the world, that could help alleviate some of the advantages that Chinese smelters and refiners have versus the aluminum industry and, even more importantly for me standing on this stage, for Alcoa Corporation.

When you look at our portfolio and think about our sourcing of energy, you think about where we operate, and you think about the sustainability practices that we put into place, it drives a sustainable competitive advantage as the world becomes more -- as the world becomes and China particularly thinks more about the environment.

So, now I'm going to return to the very beginning of my speech and I'm going to close this out here in two minutes and then we'll turn it over to questions. Three things we're trying to do and these should be pretty obvious as we've gone through this.

Number one, simplify, simplify, simplify. I would challenge you all as investors or as analysts, as things happen, as we make announcements, think about why we're making the decisions that we're making and how we're simplifying things, from where we do business to how we run our plants to how we make those 14,000 Alcoans successful.

Number two, we're going to drive a returns-based methodology. We're going to be good and wise stewards of capital because we understand you have options. You have other things that you can do with your investment dollars. And so, we are going to be rigorous about how we spend capital dollars.

And, number three, we're going to prepare ourselves, we're going to strengthen our balance sheet, and we're going to be winners through all parts of the cycle.

So, one of our fundamental beliefs is to make this as shareholder-friendly a company as possibly can be the case. And so, we just released an 8-K. I have no doubt you all were sitting at the edge of your seats to read that as soon as it came out. The reason we released it is very simple. We are aligning management compensation, and these are the top managers, the long-term incentives, with what we have heard from our investors. And so, we have split all of our long-term incentives into two pieces, two metrics.

Number one, total shareholder return relative to the S&P 500. We know you have investment choices. We are going to drive this company faster and more efficient and better so that we are the right place for your money. And when our investors win, we'll be winning as well.

And, number two, because we're focused on returns, the second metric is return on capital. And we've put together an aggressive expectation for what we can achieve over these next three years. It is outside of what happens in the pricing environment. It gets back to net performance. We are expected to deliver improvements on the bottom line.

And, bringing this all together, looking at these three things that we're trying to achieve, it's a very simple message here at the end. We are absolutely thrilled to be part of Alcoa Corporation and we think it is a compelling investment for each and every one of you.

Thank you very much. I've left two minutes for questions, Dave.

David Gagliano: And we've got about 20 minutes' worth on the app. So, I'm going to try and bucket or kind of crunch these together, whatever, there's a couple of buckets.

So, first is on the bauxite business. First of all, on some back-of-the-envelope math it looks like, you kind of used 2016 as a run rate, 10 million incremental tons of bauxite could be as much as $500 million, $600 million of EBITDA over the next four to five years.

So, there's three questions. First, does that math sound about right to you? Second, what's the capital cost associated with that 10 million tons? And then, three, if you could just talk through briefly the pricing mechanism for bauxite.

Roy Harvey: So, that's a lot of things and I'll do my best to remember all three of them.

So, number one, let's think a little bit about timetables for when we could bring this online. The way that we look at is a four- to five-year growth rate. And each of these does require some capital. I would say that these tend to be brown fields, brown fields that require less than $50 million to bring them online. So, they're not insignificant, but they're also not large brown fields. So, think about it as we find customers, we start to deploy this, over four to five years we can reach that full 10 million tons outside of any green-field or any resources we want to bring online if we find the right customer as well. So, that was number one.

Number two was pricing. And, actually, that was number three, but you'll come back and remind what number two is. Number two is pricing. How do we price this?

Right now, there is no good index or gauge for how you price bauxite. It is a differentiated product. You typically build a refinery for a certain type of bauxite. What we're selling in China is essentially consistency of supply, consistency of grades delivered, which is something that they don't necessarily have coming from places like Malaysia, and the ability to know that it's going to arrive when you want it to arrive. So, that will help us exercise the best in pricing.

We are believers that we want a fluid pricing environment that allows to recognize what's happening in the market. But we're also very sensitive to the fact that when we put money in the ground, we're going to get a return. So, we will build prices based upon those two priorities.

David Gagliano: Okay. And just the first part of that question was does that $500 million to $600 million of EBITDA sound about right?

Roy Harvey: Okay. I will -- I'm not going to opine about what the EBITDA -- that's a good shot, but we'll not do that until we get there.

David Gagliano: It's a good try. Then the other bucket, just real quick, aluminum, there's two questions related.

Would Alcoa ever hedge aluminum? And, given the increase in aluminum prices, would Alcoa actually ever or is Alcoa considering restarting the Warrick smelter?

Roy Harvey: Okay. So, two very good questions. And we've actually spent a lot of time as a smaller company thinking about; what does risk management mean to us? And how do we manage all of our exposures, whether it's on the revenue side or on the cost side? And where we get to are essentially two things.

Number one, we aspire to be purists. We aspire to be exposed to what's happening in the aluminum market because we believe our investors have better tools available for them to manage and decide where they want to deploy their capital. So, we are going to be exposed to the market, however with one caveat.

That caveat is that we are going to be a going concern and that we're going to understand what is the potential profile and portfolio that we run to make sure that we are not going to be in any kind of bankruptcy or any kind of state, even more importantly, where we are no longer capable of deploying on our promises and where we can't ensure that, in the down part of that cycle, we can be smart and we can be acting constructively as opposed selling assets. So, the hedging profile essentially is exposed to the market. Number two --

David Gagliano: Warrick. Would you restart it?

Roy Harvey: Warrick. So, Warrick was a permanent closure. I would say that we're always looking at every single plant that is capable of restart to see if it fits inside of our portfolio. I also recognize the fact that there's a great amount of uncertainty about what's this administration's priorities and how they are going to be acted out upon. So, I certainly wouldn't take it off the table. At the same time, I wouldn't build up a lot of expectation that it's going to happen.

We have other spots that we could also bring up. San Luis in Brazil certainly doesn't have the connection to the administration. But we have places that we could choose to restart should we find the right cost structure and then also see a constructive environment in the market.

David Gagliano: Okay. And, with that, we've got to wrap it up. But thank you very much.

Roy Harvey: Good. Thank you.