

Alcoa Corporation

Morgan Stanley 5th Annual Laguna
Conference

Wednesday, September 13, 2017
2:45 PM Eastern (11:45 AM Pacific)

CORPORATE PARTICIPANTS

William Oplinger - *Executive Vice President and Chief Financial Officer*

Piyush Sood – Morgan Stanley:

Today with us we have Bill Oplinger. He is the CFO of Alcoa. He was also the CFO of the previous Alcoa, the parent entity of the current Alcoa, so that was Alcoa Inc. This is Alcoa Corp. Alcoa Corp. is only focused on the upstream side of aluminum. And happy to have you here.

William Oplinger:

Thank you.

Piyush Sood:

So my first question for you is since you've been the CFO over there and the CFO over here you probably are the best person for me to ask this question. Are you happy with the stock's performance right now, the way it's been over the last year or so? And do you think the investment community understands the business and is using the right tools to value the company?

William Oplinger:

Yes, well thanks for the question. It's a good question. We launched November 1st of last year. As you said, Alcoa Incorporated broke up into Alcoa Corporation and Arconic. When we launched, we launched at around \$21.44. We've had a really pretty good run up in the last year. But I still think that there's potential opportunity there. As I look at the valuation of the company, I think we can be perceived as a fairly complex company because we've got three business lines – bauxite, alumina, and aluminum.

And there's some easy tools to help people value the company. In our bauxite and alumina business we've got a joint venture partner who's publicly traded, Alumina Limited; they own 40% of the AWAC joint venture. We own 60% of the AWAC joint venture. So it's easy to determine the valuation of our bauxite and alumina business.

And then if you look at that in comparison to our market cap, I would think that probably analysts are missing one or two areas. Either the valuation of our smelting business – which at today's prices is a pretty valuable part of the business – or potentially just looking at today's pricing and not necessarily thinking that today's pricing will persist.

So overall, we've done well so far, but I still think that there's potential upside.

Piyush Sood:

So something that's been helping Alcoa stock price is the underlying commodity, aluminum, that's gone up. And that's probably driven by China supply side reform. What is your expectation right now on how many steps they're taking to curtail capacity, stop projects from ramping up, shutting down old capacity. What are your thoughts here?

William Oplinger:

Yes, so to put it into perspective, the global market for aluminum is approximately 65 million metric tons. The Chinese are over half of that global marketplace. We've seen the Chinese get serious around curtailments. There are two initiatives within China. There is what we call the MEP initiative, which is the Ministry of Environmental Protection, and the NDRC initiative.

In our July conference call, we were projecting around a 6 million metric ton curtailment from approximately a 38 million metric ton operating run rate. If we were to look at that today, we

would say that 6 million we believe is going to come offline. And there have been significant actions taken to curtail facilities in China. So just recently, we would suggest that probably 4 million of the 6 million is curtailed. And probably the more -- the program that's getting more traction -- is the NDRC program, where the NDRC is curtailing facilities which don't have the correct operating permits. So as we enter into the winter heating season, we'll see how much comes offline. But for the first time in a long time, we're starting to see supply-side curtailments in China.

Piyush Sood:

So we do hear a lot about aluminum curtailments, but I guess are they also curtailing the underlying raw materials, if I can call it alumina. So not going into numbers, but what is your sense there? Is the cut matching the aluminum side? Is it more or is it less than? How quickly can that come back if it does?

William Oplinger:

Yes, so we're seeing supply side pressure at just about every part of the cycle. So alumina curtailments in China, but also caustic curtailments, coke and pitch curtailments and probably importantly, anode curtailments. And so that is putting some supply side pressure on raw material prices and in China raw material availability. So all of that is, we believe, driving some of the upward pressure that we're seeing in both alumina and aluminum prices.

Piyush Sood:

So on the last call, you laid out very clear capital deployment priorities. Hold around I think \$1 billion cash on the balance sheet, repay some debt if you can, then maybe renegotiate the revolver once you get a better credit rating. Then return cash to shareholders. How's that progressing?

William Oplinger:

Yes, so you've laid it out well. When we look at uses of cash, a couple of primary uses of cash, we will sustain the assets. We spend about \$300 million of sustaining capital. We are investing in high return projects. It's one of our key strategic priorities. We're going to spend about \$150 million of return seeking capital. Now these aren't huge numbers, but if you look at it in comparison to what we spent as a business in 2015, we've essentially tripled our return seeking capital spend.

We do have obligations on pension and OPEB. We're going to spend around \$230 million of cash in 2017. That will increase in 2018 due to the underfunded status of our pension plan. So that will increase by around \$200 million. But beyond that, if there's an excess available free cash flow, we will be looking to delever either through additional contributions to the pension plan or potentially paying back some debt that we have that's pre-payable.

And as you alluded to, we do have some covenant revolvers that limit the amount of cash that we can return to shareholders. But over time, as our balance sheet improves, we would be looking at potentially renegotiating that and getting to a point where we can return cash to shareholders.

Piyush Sood:

So maybe let's try to address the CapEx side a little bit. And any thoughts on the Ma'aden side, your joint venture in Saudi Arabia. Either the new MOU you signed or the call options that eventually will come due?

William Oplinger:

Right, so for those of you who aren't aware we are a 25% partner in a JV in Saudi Arabia. That enterprise is one of the world's largest integrated rolling, smelting, refining aluminum complexes in the world. We spent around \$1 billion worth of equity over the last few years in investment in that facility. And we would argue it's probably the lowest cost smelter in the world. We've recently announced an agreement that we will consider adding a third line there. So we'll be running through the analysis of whether that makes sense or not.

But at the same time, we're looking to improve the operations, basically through some small investments that we can do at the facility. As far as the -- you referred to the fact that as part of the agreement there's a put call process that allows us to get an incremental 15% in that joint venture. We currently have 25%. It would take it up to 40%. That will take place five years after last commercial operation of the different parts of the facility, so it's pretty far into the future at this point.

Piyush Sood:

I guess if you decide to expand capacity would it only be on your aluminum side or it would go all the way up to bauxite?

William Oplinger:

Today we've agreed to look at the smelter. And we have the ability to serve that smelter via alumina coming in. It started with alumina that was imported from Western Australia. So at this point, it would be a look at increasing the capacity of smelter. But we wouldn't be limited on our ability to increase the refinery either.

Piyush Sood:

So as China is cutting aluminum capacity, you recently announced a restart of the Warrick smelter. What's the rationale behind that? And what kind of synergies do you expect through your value chain?

William Oplinger:

Sure. You know we announced the permanent closure of the Warrick smelter probably in late 2015. When we were looking at the separation of the business, originally the Warrick facility, which is an integrated power plant, smelter, and rolling mill, the rolling mill was going to go with the Arconic side of the business. About halfway through the process we decided to keep the rolling mill in Alcoa Corp. And at that point, the smelter had already been curtailed.

Since that time, prices have gotten significantly higher. We also have a view that we are going to grow the shipments out of that rolling mill. So we've determined that we need the ability to have molten metal there. And so when we closed that facility originally we had estimated around \$100 million pre-tax impact of bringing in cold metal. We're going to run three-fifths of that facility, so I think it's a safe assumption that we should get around a \$60 million pre-tax benefit from running that facility.

Piyush Sood:

It is quite meaningful if I use your guidance of \$2.1 million EBITDA on the backward looking aluminum price, that is --

William Oplinger:

It's meaningful.

Piyush Sood:

Yes.

William Oplinger:

And you know it's a growth opportunity for us. We'll bring up 150,000 metric tons of smelting capacity. We've got other growth opportunities in the future that are fairly easy for us to pull the trigger on. We've got a couple of other curtailed smelters that at today's prices we run the analysis to see whether it makes sense to restart them.

And if you look at our three key strategic priorities as a company the first one is to cut costs and simplify the business. The second one is to invest in high-return projects. Warrick would fit the bill there, that it gives us a fairly quick turn around and quick payback. And the third is the strength of the balance sheet. And so when we're looking at that middle tier, the middle prong of the strategy, we've got Warrick, but we also have a number of debottlenecking projects around the system that provide good returns.

Piyush Sood:

So that kind of feeds into my next question on there was a payment due this year at the smelter I think it's called Wenatchee and probably a little older smelter. And the payment is now due next year. But you can avoid it if you restart it. So what are your thoughts? Is it a worthy candidate for a restart at today's aluminum price?

William Oplinger:

You know we run the calculus, right? And part of the Wenatchee calculus is that we do have a payment that we need to make to the public utility district out there that was due this year. We were able to negotiate pushing it out a year. When we get to the beginning part of next year, we'll run the numbers again and see if it makes economic value for us to run that facility. So it gives us good optionality quite honestly.

And we've got the same type of optionality down in Brazil. We've got a very good technology facility in Brazil down at the São Luís facility which is a joint venture that's owned between us and South32. And there again we'll run the numbers and if it makes sense, we'll look at potentially restarting it.

Piyush Sood:

While China is cutting capacity Alcoa is looking to at least produce a little more. Do you think that becomes a headwind to the aluminum price?

William Oplinger:

Yes, you know some of the capacity restarts that we're looking at, you've got to keep in mind that the global market is 65 million metric tons. Demand for aluminum is growing at a 5% clip, which the aluminum story has never had a problem with demand, right? Demand growth has

been very, very good. But we see that demand growth continuing. These restarts that we're starting, that we're looking at, are pretty small in the global nature of the industry, right?

So Warrick is about 160,000 metric tons. I believe Alumar would be a couple hundred thousand metric tons. So not necessarily a headwind to metal prices today.

Piyush Sood:

That's helpful. So moving from aluminum to alumina, we typically think of alumina one way or the other as correlated to aluminum price even though there's a distinct market. And maybe a linkage rate or an implied linkage rate of something to do 15% to 20% roughly.

William Oplinger:

Mm-hmm.

Piyush Sood:

Do you ever see that breaking? Is there anything out there that could break that dynamic? Can alumina become much more expensive than 20% or maybe much cheaper than 15%?

William Oplinger:

Well, the industry probably is dating back to 2009 and 2010. Up until that time there was a set linkage for sales of alumina to smelters. It was generally a percent of LME contract. The industry itself switched over to an API-based pricing. And it was a smart thing to do. And the reason why it was a smart thing to do is while there is largely only one use for alumina – there is a smaller non-metallurgical grade market – but largely there's one use for alumina so ultimately, in the end, alumina prices will be tied to aluminum.

You did see different input dynamics in the alumina space. And so what the API does is it allows that alumina to be traded independently of aluminum. Over the long run, if metal prices were seriously high alumina prices need to be pretty high. If metal prices were very, very low, ultimately people will curtail capacity on the smelting side. Alumina prices will come down. So over the long run there should be some equilibrium there.

Piyush Sood:

And so now going further up the value chain to bauxite, given announced plans to expand your exports or production and exports, I guess those contracts are multiyear contracts.

William Oplinger:

They are.

Piyush Sood:

Something between one to three years?

William Oplinger:

Yes.

Piyush Sood:

We did see some contracts starting a couple of years ago, and at some point they would roll over. So it's something that's difficult for us to handicap on how much margin expansion you could see. So maybe you could help us with that risk?

William Oplinger:

Yes, the margins in the bauxite business are strong, right? So if you look at our margins, the margins are in the 30% to 35% range. We would be looking to maintain those margins with growth. So we've announced growth of around 10 million metric tons of third-party bauxite over the next few years. That'll be dependent on the fact that we can get the right contracts. We are very focused on making sure that we have contracts that provide us enough time to earn a decent return on the expansions that we would be doing.

So we've got expansion opportunities down in Brazil at our Juruti mine. Juruti was originally built to be less than 3 million metric tons. We have it running at 6.5 million metric tons today. I believe we can take it to 7.5 and over and with fairly low capital cost.

The other big area that we have for opportunity for growing our third-party bauxite business is in Western Australia. And so we would be looking at exporting bauxite out of Australia to China. And that would have no impact on our refineries. Quite honestly, we've got plenty of bauxite in Australia for the life of the refineries. So that's our two big growth areas on the bauxite side.

Piyush Sood:

And how do you place yourself on the bauxite, say at a cost curve or quality curve once you look at competing sources from Indonesia or now the newly expanding Guinea production? How do you place Alcoa versus those?

William Oplinger:

Yes, you know it's a really interesting – bauxite is an interesting market because it's not a homogeneous product, right? So the bauxite that comes out of Brazil is very high alumina content, but it's also far away from the end market, right? The end market generally being China. The bauxite that comes out of Western Australia is low alumina content, but also has very low reactive silica. And that low reactive silica allows a user or a refinery to use less caustic. With caustic prices going up as quickly as they have gone up it gives a structural advantage to our Western Australia bauxite.

So we use what we call a value-in-use pricing model, which essentially tries to determine how much value a customer will get out of the bauxite. And in an inflationary environment for caustic it makes our WA bauxite that much more attractive.

Piyush Sood:

So if you were pricing your bauxite at this point, how do you do it? Is it like a fixed price contract or does it vary based on any kind of public index that we can look at?

William Oplinger:

You know we've been driving toward fixed-price contracts. Our customers will want some variability in that pricing. At this point, we're going to probably be pretty quiet around the actual dynamics of our pricing. So we're trying to maintain the margins that we have and grow the business.

Piyush Sood:

So you did mention caustic and I think caustic prices and other input prices have been going up. But they run with a lag through your P&L. So do you think we've seen most of the cost increase or is there more to come at least through your P&L?

William Oplinger:

Yes, so generally we give pretty good transparency around the various impacts on our P&L. So we give a sensitivity to EBITDA around metal prices, alumina prices, currencies, caustic soda. We also give a lag on how quickly that will hit. So depending on which raw material you're looking at, if you look at the back pages on our presentations you'll see that there are lags.

So with caustic prices running up typically we see a three to six month lag on caustic. So caustic will hit us in the future. In the near term, you might consider that to be a bad thing. However, we're probably the lowest caustic user out of all the refining companies. We have a structural advantage in the ore that we use in Western Australia. Again the bauxite that we use, that allows us to use much less caustic. So higher caustic prices in the near term put some pressure on margins. But also should be supportive theoretically in higher alumina prices. So we don't view that necessarily as a bad thing.

Piyush Sood:

So those were my main questions. I can go on, but I just want to see if there is something.

Unidentified Participant:

I'm just wondering if you could make some further comments on the demand you're seeing in aluminium. You're saying it's running at 5%, if you could just give a bit more data on that and specifically what is aluminium's exposure to China's fixed-asset investment program? And finally, some comments on copper -aluminium substitution.

William Oplinger:

Yes, lots of questions there. Our exact projection for demand growth is 4.75% to 5.25%. We've recently increased that ever so slightly in the second quarter. The reason why we increased that is we saw good, strong, continued demand out of China. I believe we put our Chinese demand growth between 6.5% and 7% this year. However, outside of China what drove us to increase our demand projection was really some of the strength that we're seeing in Europe. So we underestimated the strength of demand in Europe.

So one of the sources of that demand is clearly fairly strong demand in the transportation side. You asked specifically around exposure to China. We do see, as I said, continued strong demand in China coming from basically all of the different areas whether that's transportation, electrical distribution, construction. So overall the demand picture on aluminum is good. If you followed the aluminum industry over the last ten years it's never really been a demand problem, right? Demand in aluminum has grown fairly consistently over the last decade at a 5% clip plus or minus a percent. It's always historically been a supply problem.

The Chinese have grown from around 1 million metric tons in 2000 to 38 million metric tons in 2017. As Piyush asked the question, we're finally starting to see some curtailments in China. And as we said, we're looking at around a 6 million metric ton curtailment in China on an annual full run rate basis.

As far as substitution goes, I don't have really good data between substitution impacts between copper and aluminum. The substitution that we think is more meaningful in the future is really aluminum versus steel, right? And I was talking with an investor earlier, I think one of the areas that could be a game changer over the next few years is electric vehicles, right? So as the

world goes to more electric vehicle usage, you need to take weight out. And one of the solutions to taking weight out is greater usage of aluminum.

Unidentified Participant:

On your last call you talked about the alumina market going into slight deficits. Since then we've seen prices go up 20% from there. Caustic, as you point out, may be contributing somewhat. But just help me kind of think through supply growth on alumina and do we stay in deficit for the foreseeable future or how does that -- just your thoughts on supply/demand for alumina. Thank you.

William Oplinger:

Yes, I'm going to defer a little bit. We'll actually put our 2018 estimates out in early next year. So we will come out with a view around 2018 supply and demand in the first part of January. But the dynamics that we're seeing on the alumina side, it really starts with bauxite, right? So some of the curtailments that you've seen in bauxite mining in China, very similar to some of the curtailments you're seeing in refining and smelting, is impacting availability of bauxite in China.

Roughly 44% of the mining capacity in China is in Shanxi. And you've all probably heard that Shanxi has been cracking down on some mining in Shanxi. And so what we're seeing is, combine that with significantly higher caustic prices, the alumina prices have gone up fairly dramatically over the last few weeks.

As you said, we're projecting an ever so slight deficit in global supply/demand in alumina in 2017. Very slight surplus on the metal side. But as we roll into 2018, I think you're seeing some dynamics that are favorable and that is higher caustic prices, bauxite prices and bauxite availability that's tightening.

Piyush Sood:

So I have one more question. The way you kind of frame that Warrick would add about \$60 million EBITDA roughly, could you give us an update on the Rockdale land swap, maybe you could describe it? And if you can help quantify how much EBITDA that can add?

William Oplinger:

Sure, so just for those in the audience that aren't familiar with the Rockdale facility, the Rockdale is a smelter that we curtailed probably dating back to the global financial crisis. In Rockdale, we have a power contract that rolls into our transformation business unit. It probably costs around \$50 million to \$70 million of EBITDA each year. We've been working with the local utility supplier down there to potentially to get out of that contract. And at this point those negotiations are still ongoing. If we can't come to a favorable settlement there we'll pursue or evaluate the legal options that are available to us in Texas.

Piyush Sood:

Okay. Any other?

Unidentified Participant:

Can you explain the caustic problem? Why is there a shortage? Why is the price going up? Where is it derived from? Just sort of the rough deal. Thanks.

William Oplinger:

Sure, so caustic is a critical input for the refining business. Caustic basically acts as it enables the splitting of the alumina out of the bauxite. Caustic is also a byproduct of sodium chloride. And so the two products that come out of the sodium chloride atom are bauxite and chlorine, I'm sorry caustic and chlorine. In China with all of the environmental curtailments that are going on, we're seeing some of the PVC production in China being curtailed. With PVC production being curtailed, there's less demand for chlorine. And so there's actually curtailments of the caustic process. So we're starting to see those curtailments, again largely due to the environmental considerations, and that's what's driving prices up. Add onto that that we had some storms down in Texas, in the Gulf Coast, and that has driven, at least in the near term, some tightness around caustic also. Other questions?

Unidentified Participant:

Could you also comment on the profitability of Chinese smelting and refining industry? Obviously the curtailing of 6 million tons, but is the rest of it still loss making?

William Oplinger:

Yes, so the latest look that we did on this was back in July, right? And so you know prices have changed and raw materials have changed. But at the time, on the smelting side we were estimating up to 20% of the Chinese capacity was still cash negative. Now since that time, prices have run up. But also input costs have run up too. So I don't have a latest look at today's pricing, but we'll come out in October and give you an update on how much underwater capacity we think there is in China.

On the alumina side, a similar number back in July. Alumina costs are pretty high in China, and we were looking at numbers north of \$320 a ton for costs in China back in July. And you know the caustic market, as I've said, has just gotten significantly more expensive since then. So the capacity in China has a portion of the capacity that's underwater.

Piyush Sood:

I think we have run out of time. So, Bill, thanks for coming.

William Oplinger:

Thank you.

Piyush Sood:

And handling these rapid-fire questions.

William Oplinger:

Thank you.