Alcoa Corporation

Third Quarter 2018 Earnings Presentation and Conference Call

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CORPORATE PARTICIPANTS

Roy Harvey - *President, Chief Executive Officer*

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

James Dwyer - *Vice President of Investor Relations*

PRESENTATION

Operator
Good afternoon everyone, and welcome to the Alcoa Corporation Third Quarter 2018 Earnings Presentation and Conference Call. All participants will be in listen-only mode. Should you need assistance, please signal a conference specialist by pressing the "*" key followed by "0." After today's presentation, there will be an opportunity to ask questions. To ask a question, you may press "*", then "1" on your touchtone phone, to withdraw your question, please press "*", then "2." And please note that today's event is being recorded.

I would now like to turn the conference over to James Dwyer, Vice President of Investor Relations. Please go ahead.

James Dwyer
Thank you, William, and good day, everyone. I am joined today by Roy Harvey, Alcoa Corporation President and Chief Executive Officer and William Oplinger, Executive Vice President and Chief Financial Officer. We will take your questions after comments by Roy and Bill.

As a reminder, today's discussion will contain forward-looking statements relating to future events and expectations that are subject to various assumptions and caveats. Factors that may cause the company's actual results to differ materially from these statements are included in today's presentation and in our SEC filings.

In addition, we have included some non-GAAP financial measures in this presentation. Reconciliations to the most directly comparable GAAP financial measures can be found in the appendix to today's presentation. Any reference in our discussion today to EBITDA means adjusted EBITDA.

Also, a note on our financial statements. Consistent with our first and second quarter earnings presentations, our presentation today for the current period, as well as prior periods, has been updated in accordance with the Financial Accounting Standards Board's recent change to the presentations of non-service pension and OPEB costs. This change resulted in Alcoa moving such costs out of EBITDA and into other income expense. Finally, as previously announced, the earnings release and slide presentation are available on our website.

With that, here is Roy.

Roy Harvey
Thank you, Jim. And I appreciate everyone joining today's third quarter earnings call. Since we launched Alcoa Corporation as an independent publicly traded company almost two years ago, we've used our strategic priorities to reduce complexity, drive returns, and strengthen the balance sheet to position our company for a brighter future. In that time, we've streamlined our structure and processes, we've pushed our operations to drive returns, and we've addressed a significant portion of our liabilities. As a result, Alcoa is much stronger today [than] when we launched in late 2016.

As proof of our strategies' success, we're pleased to announce today a $200 million stock repurchase program. The program is a key component of our 2018 capital allocation framework and a commitment we made to stockholders. We will provide more details on the repurchase later in the call, but for now, let's review our third quarter results.

We reported a net loss of $41 million or $0.22 a share as we proactively continued to address our net pension and OPEB liability. In the third quarter we used $194 million in available cash to further reduce both our net pension liability and to prepay debt.

On an adjusted basis, excluding special items, net income was $119 million or $0.63 per share. On an adjusted EBITDA basis, excluding special items, we generated $795 million, up 37% year-over-year. And from a cash perspective, we closed the quarter with a $1 billion balance.

Turning to our business update, I will start with safety, our most important measure across our global operations. And as a reminder, our focus is on preventing serious injuries defined as life ending or life altering. We had one serious injury during the quarter; specifically an employee at one of our U.S. smelters experienced a life-threatening case of heat stress and, after ending his shift, suffered a seizure. He was transported from our facility to an intensive care unit and the employee is now recovering at home.

After this incident, we strengthened and we recommunicated the safety leadership standard for heat stress prevention at every one of our locations. Most importantly, this standard is included as part of an ongoing improvement initiative that will evaluate and improve how we manage all critical risks across our operations.

This quarter we made further progress in reducing the liability from pensions and other post-employment benefits that now stands at $2.2 billion, down $500 million sequentially and a sizable improvement from $3.5 billion at the end of 2017.

On the labor front, union employees who had walked out of our mines and refineries in Western Australia are back at work and are voting this week on a new proposed labor agreement. Today, in Spain, we announced our intention to begin a formal consultation process for collective dismissals that will affect all employees at our Aviles and La Coruna aluminum plants. These types of communications are never easy because of the personal impact they have on employees, their families, and communities. But these two plants in Spain have inherent structural issues, including older, less efficient technology, which makes them globally uncompetitive. We are committed to minimizing the impact of any outcomes on employees and we will negotiate with workers' representatives on reaching a social plan.

Turning to our markets, we will provide our outlook for the remainder of what has been a very interesting and volatile year. At a high level, we continue to project a global deficit for both alumina and aluminum and see the bauxite market remaining in surplus with increasing stockpile growth. And while markets may remain volatile, we are modifying our projection for full year adjusted EBITDA, excluding special items, to range between $3.1 billion and $3.2 billion, targeting the upper half of the range announced last quarter.

And lastly, to strengthen the organization and support our operator centric approach, effective November 1st, the presidents of our Bauxite, Alumina, and Aluminum segments will report directly to me. In addition, at that time, Tómas Sigurdsson will assume the role of Senior Vice President, Strategic Alliances. He will continue to report to me with primary responsibilities for managing and developing the company's key strategic relationships. The Chief Operating Officer role will be eliminated.

With that, Bill is ready to give us a detailed look at our third quarter results.

William Oplinger
Thanks, Roy. Let's start with the income statement. Sequentially, revenues are down 5% on lower aluminum prices. Compared to last year revenues are up 14% on higher prices for both alumina and aluminum. In the quarter, the net loss attributable to Alcoa Corporation was $41 million, or $0.22 per share on 186.5 million shares outstanding.

Special items in the quarter totaled $160 million after tax and non-controlling interest of which $174 million relates to recent pension and OPEB actions in our US plants. In an August annuitization we transferred pension assets and liabilities totaling approximately $290 million to a third-party insurer, who assumed benefit payments for roughly 10,500 plan participants. Also, effective September 1st, 2018, we ceased providing salaried retiree life insurance. All other items netted to a positive impact of $14 million.

Our third quarter adjusted net income, excluding special items, was $119 million or $0.63 per share. Adjusted EBITDA, excluding special items, was $795 million, down $109 million sequentially, primarily due to lower metal prices. Our third quarter EBITDA margin was 23%. A few other items of note on a sequential comparison basis, currency moves impacted several areas on the income statement this quarter, including helping drive lower SG&A and R&D expenses, as well as lower depreciation.

On the unfavorable side, lower foreign currency revaluation benefits netted to higher other expenses. Interest expense increased $4 million in the third quarter due to the $500 million bond offering that closed in May. Our operational tax rate in the quarter was 45.6%, as rising alumina prices changed our mix of taxable earnings and non-taxable losses and we increased our provision by $48 million to catch up the lower rates recognized in the first half of the year.

Let's take a look at the drivers of the sequential change in adjusted EBITDA. Lower metal prices and higher alumina costs in our Aluminum segment drove $175 million of the decrease. The stronger dollar provided currency benefits of $32 million. Positive price mix in the third quarter was primarily in our Alumina segment. First, the negative alumina price mix from the second quarter did not recur, generating a sequential benefit. Second, shipment timing meant some cargos were priced in more favorable pricing periods than in their shipment month, and full year contracts were trued up to recent higher market prices. We do not expect the sequential benefit to recur in the fourth quarter.

Stronger energy sales in Brazil completely offset higher power costs at several of our smelters, especially in Spain, and as expected, raw material costs continued to increase in both the Alumina and Aluminum segments. And the sequential impact of a full quarter of Section 232 tariffs is $19 million and is included in Other. While we paid tariffs, mostly on Canadian production, that's not the entire Section 232 tariff story. Our U.S. smelters benefitted from tariffs pushing up the Midwest regional premium, so the impact of tariffs in the quarter, compared to not having tariffs, was a net benefit to Alcoa of $27 million.

Now, let's shift our focus to the segments. In the segments, Bauxite adjusted EBITDA improved $6 million on favorable currency and price mix, partially offset by lower earnings at the equity owned mines. Alumina adjusted EBITDA improved $22 million. Favorable price mix and currency overshadowed lower alumina index prices, unfavorable operational impacts and higher raw material and energy costs. The Aluminum segment, down $158 million, primarily on lower metal prices and higher alumina costs. Bright spots were strong sequential improvement from the Brazil hydroelectric facilities and flat rolled products.

Outside of the segments, corporate inventory accounting improved sequentially, but volatile alumina prices have made it difficult to predict. For example, in the last two weeks of September, alumina prices dropped from $625 to $458 at month end, so actual results changed substantially from the outlook we'd provided at mid-month.

Turning to cash. Our cash balance is slightly over $1 billion at the end of the third quarter. We continue to use available cash to strengthen the balance sheet and improve the business. Two points to make here. First, over the last three quarters, strong cash flows have allowed us to make additional discretionary and one-time payments, totaling nearly $500 million to strengthen the balance sheet, including additional pension funding, debt prepayment, and legacy payments and settlements.

Second, in the third quarter alone, substantial cash flows allowed us to make pension and OPEB payments of $299 million, including $100 million of discretionary funding into certain of our U.S. pension funds, dividend payments to our minority interest partner of $181 million and $98 million in debt payments, including prepaying $94 million of debt in Brazil as part of our capital allocation framework.

This quarter, we continued strengthening the balance sheet. Pension and OPEB net liability is down to $2.2 billion and our net debt to EBITDA is down to 0.26 times. Return on capital continues to strengthen and is at 12% on an annualized year-to-date basis.

Our days working capital this quarter was 26 days, up two days from the second quarter and up nine days versus the third quarter last year. The year-over-year change in inventory days is primarily related to the higher cost raw material inventories in the system and inventory build for the Warrick restart. Higher days sales outstanding and lower days payable are primarily due to recent higher alumina prices. We expect sequential improvement from the third quarter DWC to the fourth quarter DWC, but the amount will be dependent on sales price changes.

Now let's discuss the improvements in pension and OPEB. As I said, we continue to decrease our net pension and OPEB liabilities, and the net liability of $2.2 billion is down from $3.5 billion at the end of 2017 and down from $2.7 billion at the end of the second quarter. Taken many actions throughout the year, and this quarter, we annuitized $290 million in gross liabilities related to our U.S. pension plan.

We contributed $100 million in discretionary funding and ceased our salaried retiree life insurance program. These actions drove a reduction in the net liability of almost $200 million. With the actions taken in Canada and the U.S., we re-measured the effected plans for changes in the discount rate and other factors. We re-measured 62% of our Canadian plans in April and 97% of our U.S. plans in July. These interim re-measurements reduced the net pension liability by approximately $200 million.

All plans, as we usually do, will be re-measured at year-end, factoring in demographic changes, discount rate changes, and investment performance. After our actions, our current sensitivity is in approximately $170 million change in net pension and OPEB liability for every 25 basis points change in the applicable discount rates. That's down from $220 million from the end of 2017 based on the actions that we've taken this year.

As Roy mentioned, and fully aligned with our 2018 capital allocation framework, our board of directors has authorized a $200 million stock repurchase program. We expect to start the program this quarter and repurchases will be based on cash flows, market conditions, and other relevant factors. Shares purchased will be retired, not held in treasury stock.

For the rest of the year, we expect to have addressed all components of the 2018 capital allocation framework: cash balance maintained at least $1 billion, roughly $300 million of sustaining capital expenditure spent, lower return seeking capital expenditures, now expecting approximately $100 million, the recently completed $300 million liability optimization, and with the newly announced stock repurchase program, returning cash to stockholders.

We've been focused on the capital allocation program for 2018. In January, we'll provide an update on our future capital allocation framework, in that next iteration as we did for 2018, we will be balancing many factors in light of expected market conditions, challenges and opportunities, including, maintaining liquidity throughout the year, investments required to sustain the business and drive value, optimal capital structure, and returning cash to stockholders.

Now let's review the full year outlook for 2018. We are tightening our full year adjusted EBITDA outlook to $3.1 to $3.2 billion based on un-priced sales at $2,000 LME, $500 API, and $0.20 Midwest regional premium. Some slight changes in the full year shipments outlook for Bauxite and Alumina: we've adjusted the shipment outlook ranges downward, down 1 million tons in Bauxite and 100,000 tons in Alumina. Aluminum shipments outlook is unchanged.

For full year 2018 earnings, we're expecting modest improvements in several categories. Transformation impact is improving $20 million on lower net spending, primarily in Suriname. Other corporate is improving $15 million on lower overhead spending and currency benefits. Net pension and OPEB is improving $10 million as a result of our recent actions. And depreciation and amortization is improving $35 million primarily due to foreign currency benefits.

We expect our full year operational tax rate to be approximately 38%. Also, we expect some full year cash uses to be slightly lower than what we had previously projected. Minimum required pension OPEB funding is down $10 million to $415 million, return seeking capital expenditures are down $20 million to approximately $100 million, due to slower spending on the Western Australia port expansion and currency benefits. And lastly, environmental and ARO spending will be at the low end of the previous range of approximately $110 million.

I'll turn it back over to Roy.

Roy Harvey
Thanks, Bill. I'll begin with a look at our markets. We continue to expect 2018 deficits in both the alumina and aluminum markets, but now see bauxite in a larger surplus. As we've noted in our presentations throughout this year, we're likely to see Chinese stockpiles grow in 2018. While we're expecting a slight increase in Chinese demand for seaborne bauxite, it is more than offset by higher demand in bauxite supply. As has been the case in the past, Chinese customers use the surplus to bolster operational stockpiles.

In alumina, the market continues to be in deficit. While alumina demand is down compared to our estimate last quarter that is being offset by ongoing supply disruptions that are keeping alumina supply at relatively lower levels. We have revised our expectation for alumina trade flows and are now projecting that China will be a net exporter of approximately 300,000 metric tons of alumina in 2018. This is being driven by relative pricing between the two markets and continued tightness in the world ex-China.

In aluminum, we continue to forecast a deficit for the year. We have reduced our estimate of Chinese aluminum supply due to curtailments and delayed expansions. However, that supply reduction has been matched by a reduction in demand growth. As a result, we have reduced by 50 basis points our 2018 global demand growth figures from 4.25% to 5.25% last quarter to 3.75% to 4.75% this quarter.

The causes of this lower demand growth come from both China and the rest of the world. Data released over the past two months have shown that in China, the transportation and electrical sectors particularly had weaker year-over-year growth than projected. Outside of China, we are forecasting lower demand growth in several countries dealing with significant economic issues, including Turkey, Iran, Argentina, and Venezuela.

As we mentioned earlier this year, considerable uncertainty remains in our markets, driven by supply disruptions and policy and trade actions taken by governments in the United States, China, and elsewhere. These dynamic conditions could have impact in the last quarter of 2018 and into 2019.

Next, here is the 2018 view of our three markets represented on global cost curves. While cost curve positions only reflect a portion of our story, they do provide some important insight. Our Bauxite cost structure remains highly competitive at the 20th percentile. Producing approximately 44 million metric tons per year, we continue to partner with third-party customers that value the high quality, consistently delivered bauxite that Alcoa provides.

Alumina made a small move up the cost curve, from the 12th percentile last year to the 15th percentile this year. As the largest producer of alumina outside of China and the largest commercializer of third party alumina, our Alumina segment will produce approximately 13 million metric tons, with more than two-thirds sold externally.

The third cost curve, Aluminum, shows an increase from the 37th percentile last year to the 58th percentile this year. With such a change, I'd like to discuss the underlying fundamentals in more depth.

Let's start with a closer look at alumina prices and what has been a truly extraordinary year for the raw material. As you can see on the left, Chinese alumina prices depicted in gray are typically higher than Australian alumina prices. Since China is usually short alumina, its pricing relationship has enabled alumina to flow from the rest of the world into China to fill its deficit. However, something interesting that's happened in 2018. The world ex-China alumina market has experienced a lot of turbulence, driven largely by the supply disruptions in Brazil and to a lesser extent elsewhere. This has pushed world ex-China alumina prices up and over Chinese alumina prices. This pricing inversion has produced a number of direct impacts, including higher refining margins for producers outside of China, shown below the graph for our Alumina segment, and net exports of alumina from China that we mentioned in a prior slide. This unique situation has also had knock on impacts in the aluminum market.

Turning to the right side of the slide, we see that smelting costs have increased, and that Alcoa's smelting cost position has moved up from the second quartile last year to the third quartile this year. While the partial restart of our Warrick smelter contributed slightly to this move, the more significant driver by far has been alumina prices. In fact, higher alumina prices outside of China have given our Chinese competitors a relative benefit of about $200 per ton year-over-year. That relative change in alumina cost has moved our smelting portfolio up the cost curve and into the third quartile.

However, we recognize that the current dynamics which have pushed world ex-China alumina prices above Chinese alumina prices may not persist. China is building new smelters that are expected to increase alumina demand and rest of world supply disruptions are likely to be resolved at some point. Those factors could restore the traditional market dynamic, essentially restarting the rest of world exports of alumina to China. If that happens, if China returns to importing alumina and its price moves back above rest of world prices, then we would expect our smelting cost position to benefit from those changes and move back into the second quartile as illustrated by the dotted line.

This situation illustrates that our markets are volatile, while prices for our products and our raw materials continue to move at times in dramatic and unpredictable ways, we maintain our focus on continuously driving out cost and improving the efficiency of our global assets. Alcoa has a strong integrated position in the aluminum value chain, including third-party sales in each of our three segments. Our Alumina business is unrivaled; we are the world’s largest producer outside of China. So while increased alumina prices represent an added cost for our smelters, Alcoa benefits overall due to the strength in the third party alumina sales.

Now, let’s look at how we can create value through all market cycles. Since launching as an independent publicly traded company, we’ve been focused on creating sustainable value in all parts of our business, so we can succeed for the long-term through the market cycles. To achieve that objective, we’ve been pulling on both business and financial levers in alignment with our three strategic priorities. This slide demonstrates a simple model for how we approach the creation of value across both areas.

I would like to give a few examples to illustrate each lever. We continue to focus on improving the underlying results of our operations in each of the three businesses. The restart of our Warrick smelter, due to reach conclusion at the end of this year, provides a true benefit to our rolling mill, improving its operational and financial performance. Additionally, we’re investing approximately $100 million in return seeking capital projects this year. These investments will help us to improve operational efficiencies or creep production at several of our refineries and smelters, enable further cost reductions in our flat rolled business and promote future growth in bauxite.

We are also actively managing our assets to control operating costs and improve the stability and efficiency of our overall portfolio. This has required some difficult actions, such as the ongoing labor issue at the Bécancour smelter in Québec, and today’s announcement that affects employees at two of our Spanish smelters. Actions and announcements that affect employees are not taken lightly, but we must always consider the long-term success of each of our operations.

Our ability to maximize stockholder value also includes several financial levers. Aligned with our strategic priority to strengthen the balance sheet, and as Bill detailed, we have substantially reduced our net pension and OPEB liability this year. Reducing the size of our liability is important because it also lowers the company’s risk associated with the volatility of our pension and OPEB obligations. We remained focused on this liability and we will look for opportunities to reduce it further over time.

While we've used available cash to optimize liabilities, we also regularly seek opportunities to either sell or generate income from our idled assets, to help minimize or offset some of the cash impact at these sites. On the cash and equity investment side, we are focused on maintaining our target cash balance for the business and we continue to make progress with our joint ventures.

As we shared with you last quarter, we are working to develop and commercialize our carbon-free smelting technology with our Elysis joint venture, which launched in May. These are examples of how we are thoughtfully and rigorously improving the underlying value and strength of Alcoa for our stockholders. While there is still much to do, it is clear that we are making progress.

In closing, since our launch we've used our strategic priorities to strengthen our company for a brighter future. We have simplified our structure, generated returns from our assets and addressed our balance sheet liabilities.

As a result, the company is stronger today than it was in 2016, and our significantly smaller pension and OPEB liability, our operating results since launching nearly two years ago, and our stock repurchase plan point to the success of our strategy. While we're mindful that volatile market conditions may persist, we're targeting the upper half of the projected EBITDA range announced last quarter. The new projection is now between $3.1 billion and $3.2 billion.

Now, into the fourth quarter, we look forward to strengthening our company even further for a strong close to the year.

With that, Bill and I will be happy to take your questions. Operator, if you could please remind us of the protocol and let's go ahead and get started.

QUESTION AND ANSWER

Operator
Thank you. And we will now begin the question-and-answer session. To ask a question, you may press "*", then "1" on your touchtone phone. If you are using a speakerphone, please pick up your handset before pressing the keys. To withdraw your question, please press "*", then "2." And at this time, we will pause momentarily to assemble our roster.

And the first questioner today will be from Piyush Sood with Morgan Stanley. Please go ahead.

Piyush Sood
Roy and Bill, congratulations on a strong quarter.

Roy Harvey
Thanks, Piyush.

William Oplinger
Thanks, Piyush.

Piyush Sood
Good to see a large $200 million buyback plan. What was your thinking about starting with only a buyback and not a mix of a regular say a 1% small dividend and the remaining through buyback. Just want to understand the thinking behind the decision?

William Oplinger
Sure. Thanks for the question, Piyush. We…since we announced the capital allocation framework over the last year, we've been talking to a lot of investors during the course of the year. And in general, we felt that investors favored a buyback over a dividend and the reason being is that it provides the opportunity for the shareholder to take advantage of the capital return if they desire, and then also it provides us flexibility on when to execute upon it. So we ended up going with the buyback.

Piyush Sood
Okay. Fair enough. And one more from me and I'll get back in the queue. So the USMCA has been signed and there is a possibility that we could see Section 232 tariffs and Canada converted into quotas. So if that happens, your import bill will come down. But what do you think that does to U.S. Midwest premiums? Should we expect to floor in the high teens cents per pound at this point? Assuming that it's more like a duty paid premium at this point?

Roy Harvey
Yes, Piyush, I appreciate the question. To be quite honest, we don't typically speculate on where regional premiums will go one direction or the other. We continue to be very focused on two things I'd like to highlight. First and most important is that, we are trying to deal with Chinese overcapacity. So we are trying to make sure that we can align all of our global partners around the world of market-based economies to try and ensure that we have as level of playing field as possible. When it comes to the Section 232 tariffs, we're focused on ensuring that Canada remains tariff-free for all of the exports into the United States. And we are also very focused on being able to discuss and talk with the administration in the United States, in Canada, and elsewhere. And how we can make sure that we have…we're applying the right kind of pressure on China in order to reel in increasing production.

And so, I understand where your question was going, but I also think it's somewhat unpredictable as to where this process will end up as part of…whether it's part of the USMCA or whether it's a separate process, where the Section 232 issues are resolved between the United States and Canada.

Piyush Sood
And sorry, one more question, and this is more to just clarify a comment, Bill, when we are thinking about making a sequential bridge 3Q versus 4Q, should we exclude $60 million price mix benefit in the Alumina segment and is there any other 3Q bridge item you think is non-repeatable?

William Oplinger
I think going into the fourth quarter the price mix impact in the Alumina side will vary depending on what prices end up being during the course of the quarter. And with the volatility of API prices that we've seen, it's pretty difficult to predict. With that said, out of the $60 million, $30 million was a non-recurrence of a negative that had occurred in the second quarter and $30 million was the benefit of having a positive shipments in the third quarter. So if you're going to back anything out, I would say that the $30 million that occurred in the third quarter will not recur in the fourth.

Piyush Sood
Alright. Thanks, guys. And once again congratulations on the quarter.

Roy Harvey
Thanks, Piyush.

Operator
And our next questioner today will be David Gagliano with BMO Capital Markets. Please go ahead.

David Gagliano
Hi, thanks for taking my questions. I just have a...I have two or three, relatively minor questions, but I just wanted to cross a few off the list in terms of the numbers here. First of all, the $30 million quarter-over-quarter improvement in EBITDA contribution from flat-rolled business versus the second quarter, is that new level of EBITDA contribution for flat-rolled reasonable moving forward?

William Oplinger
Yes, we saw a good improvement in flat-rolled in the third quarter, and...but there is really two things driving it. The first was better volumes in flat-rolled, which I think is sustainable. And the second is we did have some one-time inventory adjustments in the flat-rolled segment that were positive impacts that...that were really catch-ups from the first two quarters of the year. I would suggest to you going into 2019, Dave, that we're targeting around a $25 million run rate result in the flat-rolled business on a quarterly basis. That may vary during the course of the year. There's a little bit of seasonality in that business in that first half is typically not as strong as the second half. But we'd be targeting around that level of performance in our flat-rolled business.

David Gagliano
Okay, that's helpful. Thanks. And then, just could you just give us the average alumina costs...alumina cost, that flowed through the aluminum segment in the third quarter?

William Oplinger
I don't have that one, Dave. So you'll have to follow up with Jim after the call.

David Gagliano
Okay, I will. And then the last one, just from the closures, the two smelters in Spain. I realize they were relatively small and likely even smaller from a profitability contribution perspective, but I was wondering, if you could give us a bit of a framework around on expected benefits, however, you want to frame it, perhaps relative to the most recent quarter on an EBITDA basis, once those are shut down?

Roy Harvey
Yes, Dave...how you doing? It's Roy. I appreciate the question, to be quite honest, for Spain, because we're just starting this consultation process, and it is a very formal process of discussions with the workers' representatives. I think right now, it would simply be too early to comment on changes quarter-over-quarter. So I think we'll leave that one for a future discussion once we reach the end of that process.

David Gagliano
Okay. Understood. Thanks very much.

William Oplinger
Thanks.

Roy Harvey
Thanks, Dave.

Operator
And the next questioner will be Chris Terry with Deutsche Bank. Please go ahead with your question.

William Oplinger
Hi, Chris.

Chris Terry
Hi there. Hi Roy and Bill. A few from me, I'm just following up on the detail from the 3Q. Can you just talk through the conversion costs in the smelting just around electricity, carbon, et cetera? I think that's where a lot of the beat came versus analysts' expectations. So just trying to get a gauge of the numbers heading into 4Q?

William Oplinger
Yes, it's always hard to judge against analysts' expectations, right? So as we look at it, I would say there is a couple of areas from improvement versus maybe where we're looking at it. We think the flat-rolled products business probably did a little bit better than what people had expected. The hydros in Brazil did very, very well in the third quarter.

And then, as far as the costs in the smelting business essentially came in line, where we were anticipating them. Year-over-year, just to be clear, we've talked about raw material costs year-over-year of around $400 million that is a little bit less. We're taking that down a little bit from where that $400 million was, but that is not in the smelting business, that's more in the refining business, we are seeing a little bit lower costs in refining. But on the smelting side, costs came in about where we anticipated, coke prices have seemed...have flattened out a little bit. Pitch prices continue to go up. But overall where we expected.

Chris Terry
Okay. Thanks for the details there. And then just overall, thinking about the pension versus buyback versus dividend debate. What's the timing that you expect to do the actual $200 million buyback and how will you actually decide when to do that, i.e. is it realistic that you actually complete that buyback in the next year?

William Oplinger
Well, we will start it...we'll kick it off in the fourth quarter. I'd remind you that the buyback was an integral part of the capital allocation program that we announced over a year ago. So we committed to our investors that after having done all the various things that we had talked about including holding cash on the balance sheet of $1 billion, $300 million of sustaining capital, $300 million of optimizing the liabilities, we would do a return to shareholders. And the commitment was to return excess cash above $1 billion. And at this point, we're projecting that we'll do $200 million. Haven't given a timeline on how quickly it will be done, but we'll get it kicked off in the fourth quarter.

Chris Terry
Okay, great. And the last one from me just on the Western Australian operations, are there any I guess bonus payments or one-off fees we should expect in the fourth quarter coming through the result?

Roy Harvey
I'd say that we still have a road ahead of us in Western Australia. So I don't think we could speculate on any kind of bonus payments, because we still need to get to an agreement that our workers have ratified and agreed to. So still some work ahead on that one.

Chris Terry
Okay. Thanks guys. I'll leave it there.

Roy Harvey
Thanks, Chris.

Operator
And the next questioner today will be Curt Woodworth with Credit Suisse. Please go ahead with your question.

Curt Woodworth
Yes. Hi, good evening.

Roy Harvey
Hi, Curt.

Curt Woodworth
So, just drilling down into your cost structure for the smelters, you do provide the pie chart looking at the breakout. And it seems a little odd that the alumina cost would be flat at 42% quarter-on-quarter given that my numbers the lagged alumina price went from $380 to $520. And if you just sort of calculate the implied delta from your pie chart, it’s about a $50 per ton, delta versus $142. So I have a feeling that maybe that’s part of the delta here in the modeling. Can you talk to that?

William Oplinger
Yes, it’s really difficult to walk you through your model on the call, but essentially...yes, go ahead.

Curt Woodworth
Why would the cost be 42% both quarters, when you had a massive inflation in alumina sequentially?

William Oplinger
Well, if you look at the...just the 90-day lag of API, right, so yes, we did have an increase in alumina cost in the third quarter associated with the 90-day lag of API. It really is dependent on some of the timing of shipments that we had in alumina into our smelters. And at this point, we saw a little bit of a jump up in alumina cost in the third quarter that are reflected in the results. We'll see a little bit more impact in the fourth quarter as we get into the fourth quarter.

Curt Woodworth
Okay. It just seems like a pretty big delta. Because like the API lag is $140, so call it $280 on a cost number of say 25...okay, that's fine. And then I guess the second question is just thinking about the cadence of cost going forward in smelters outside of alumina. So you talked about I think Spanish power was higher this quarter, coal tar pitch flat was going up, coke flat. Do you think that costs peak in the 4Q or do you get further inflation into 1Q given where the lags are? If you kind of assume that we stay flat where we are?

Roy Harvey
Let me hit that and Bill can maybe jump in with a few additional details as well. So when you look at the important components, power is one that will depend on a lot of different factors, depends on what's going on in energy markets around Europe or North America and the rest of the world. So that one will depend on market conditions. Coke and pitch are two carbon materials both seem to have reached a bit of a flattening off point from where they have been in our rising environment over the last year and half. And so, that means that we should start to see some stability in those costs going forward. The caveat I would make is that it depends a lot on what's happening in the general aluminum industry. If we see growth of expansions or growth inside of China, you might start to see some of those materials with additional demand for the opposite. And it's also tied over with what's happening in the pricing environment for aluminum.

What I would say is that when you look at the price of aluminum today, and you think about where that sits relative to full cost structure both alumina, but then all these other components, you're at a point where half of the smelters outside of China are now cash negative and under water. And that simply means that there is very little incentive to continue to operate many of those plants and certainly no incentive to invest. So I think that…I think, when you look at how the raw materials connect with what's happening in the pricing environment today, there really isn't a lot of room unless aluminum prices to go up for raw materials to continue to increase without starting to see a significant supply reduction, because plants can't continue to operate at these types of cash losses.

Curt Woodworth
Yes, I totally agree.

William Oplinger
And to put some finer point around it, when we look out at coke prices for instance we think they've peaked largely in the third quarter, coke should come off our view a little bit in the fourth quarter. Pitch should stay around flat; pitch as Roy has said has been persistently high, and we should start seeing some of the decline in caustic prices flowing through our results in the alumina business.

Curt Woodworth
Got it. Alright, well, I really appreciate it. Thanks for your time.

Roy Harvey
Thanks, Curt.

Operator
And the next questioner today will be Timna Tanners of Bank of America Merrill Lynch. Please go ahead with your question.

Timna Tanners
Yes, hi guys. Good afternoon.

Roy Harvey
Hi, Timna.

Timna Tanners
First off, I was wondering if you could talk to us a little bit about how Rusal's uncertainty or the operating status or the uncertain operating status of Rusal is affecting you. Curious because of negotiating season perhaps if that's a factor. You are the world's largest alumina supplier and then their status being uncertain. I am just curious, how that has affected you and how you see that affecting you to the extent that you can elaborate on that near-term?

Roy Harvey
Yes, Timna so I think there is an impact on the uncertainty around whether what will happen with sanctions on Rusal that impacts the general market. And so, much like everybody else, that impacts us on how the pricing trends are going and how people are entering or not entering into contracts. When you think about where we stand, I think we have a period of time where you can continue to enter into contracts. However, you don't have any assurance of supply…of physical supply, because if those sanctions continue that's going to create an inability for them to sell product into Western companies. So from our perspective, we're just at the very beginning of what we call the mating season, when we start to get into on aluminum and elsewhere, some of those 2019 contracts. The fact is that certainly supports our discussions and our arguments with our customers because they see us as a reliable supplier that won't be subject to these types of sanctions. But we are still pretty early in the process. And so, I would say that everybody still is waiting to see what happens in these next critical weeks.

From a premium standpoint, I think we've seen some increases in premiums both in North America, but also in Europe. As we go into this next season we are starting to see some opportunities in premiums as well. Although still again we're just at the beginning of that critical period, so more to come.

Timna Tanners
Okay. I mean, given that alumina supply is uncertain and your supplier and assuming that this can continues to get kicked. Is it not…can you not say that you are getting more appetite as a second supplier or as an alternative supplier to some of those aluminum smelters that used to depend on Rusal, Or I mean, is there…is that not a likely benefit to you? I am just not understanding if you are just reluctant to say because you are in negotiations or if there is something else going on?

Roy Harvey
Yes, so for alumina specifically, I think, Rusal is important, but also the shortness of the market outside of China is also very important. So absolutely, we have a lot of interest in additional cargoes of alumina. And when we look forward, it's typically not the same type of next year contracting period it tends to be longer termed contracts. But when we have any available cargoes, and we do try and keep a certain number of cargoes that we can sell either on a spot basis or on an API basis, there is a significant amount of interest and that's pretty typical for us because we have very high quality alumina, but I think that is particularly important now because of the uncertainty around Rusal, but also the uncertainty around other places where there is instability and uncertainty of supply over these next three, six, twelve months.

Timna Tanners
Okay, thanks. And then just my second question just high-level, I'm fascinated with this continued alumina price out performance relative to aluminum. You've seen it in your results, you know, we've been talking about this for a while. And I know you've also mentioned for a while the Chinese aluminum producers are not profitable. And I'm just wondering how did your economists or forecasts project this playing out? And not just in China, but even here in the

U.S., there is some capacity restarting despite these really high alumina prices. So I am just wondering, if you think at some point this stifles some of the restarts that are being discussed as a new capacity or do you think we could see a protracted period of divergence between the commodity prices? Thanks.

Roy Harvey
So in aluminum specifically or alumina?

William Oplinger
The mix between aluminum and alumina prices.

Timna Tanners
The divergence, how long can we see that vast divergence in the aluminum producers hit pretty hard and if it not loss making in some cases, right? As you said in the past that that just continues to play out, I am wondering how long can these Chinese producers be loss making, how long can these U.S. producers talk about restarting, despite high alumina prices that don't make them economic?

Roy Harvey
So remember first of all that there's a pretty significant difference between the rest of world and the Chinese market. So again, going back to the one slide that I presented, it's…we're actually finding that today, it's the rest of the world aluminum producers that are underwater and not necessarily China, because there is a $200 per aluminum ton difference in the cost of alumina.

And so, it's creating this pull because there is such a high price for alumina outside of China. It's starting to create this export connection that then starts to supply the rest of world market. Now that's all predicated upon what's happening in Brazil also to a certain extent like you were just asking on Rusal. So how long can that last? It's really a question of when Alunorte can restart again and under what conditions? And it's also dependent on how much exports China can get out. It is a very laborious and cost inefficient process to go from a refinery to big bags then cut open the big bags to put it onto a bulk carrier. So it ends up creating inefficiencies and frictions in that whole system.

So in the meantime, I think, it's…when you have this divergence where aluminum prices really haven't shown a reaction to that inflation of alumina prices, it makes it very hard to be a smelter, particularly outside of China. And in the…in alumina, it means that it's an opportunity to operate, to sell, to find those spot cargos, but there is no real certainty around how long that market will stay like that. It's really a matter of when supply comes back on.

Timna Tanners
Got you. Okay, thank you.

Roy Harvey
Thanks, Timna.

Operator
And the next questioner will be from Matthew Korn with Goldman Sachs. Please go ahead.

Matthew Korn
Hi, thanks guys, appreciate you taking my question. I had a bit of a market question for you. China has been making some aggressive signals on their scrap import policy for metals, non-

ferrous metals in particular, where they want to go over the next two-three years. Does this change in your view the calculus for users of aluminum as they are looking at primary…the cost of primary, costs of investing these more secondary? Do you think there is any potential to see a substantial lift in the use of scrap in North America or other ex-Chinese markets? In the end, does that matter for the markets that you are selling into?

Roy Harvey
Yes, Matthew. Thank you for the question. I think the answer is, yes, it does have an impact. So the less scrap that flows and take the United State specifically, the less scrap that flows from the U.S. to China as an example, it means that you are…there is more plentiful scrap available inside the U.S. And so, you are starting to see a downwards change, or an increase of the discount to what is regular prime P1020 metal. And so, because that happens, it starts becoming even more attractive to use the scrap, and in a time where you are actually seeing the cost of bringing metal in, importing metal increasing, it's starting to act as a way for them to avoid the imports and actually start to bring that into their process. So what does it do, it helps to bring down in general the price of production for the U.S., which is then offset by the fact that metal in the U.S. is now more expensive than it is in the rest of the world. And so, that has a bit of an offset to some of those impacts that are happening because of the tariff situation right now. I don't think because the U.S. is such a short market, because there are so many imports of metal in order to fill the consumption of aluminum in this country. It hasn't been a significant impact right now, but the more…the less scrap China takes, the more that will end up being used in the U.S. or elsewhere. So it starts to have more and more of an impact going into the future.

Matthew Korn
Got it. Let me follow that up with another question on China then. There has been a lot of mix messages coming out of the government arguably on the way that the pollution controls are going to be applied over there this coming winter season. Do you see any risk around the production restraints being substantially diluted this year versus last, and how might that play out for aluminum versus alumina if that indeed is the case?

Roy Harvey
Yes, so first and most importantly, we incorporated into our 2018 balances and then we will also incorporate into our 2019 balances, our best estimate of what all the impacts have and particularly including the winter curtailments. I think your point is well taken in that, we expect winter curtailments to be less than they were last year. At the same time, I'll also argue that the winter curtailment program was the lesser important of the two important changes in China. The first being winter curtailments, but the second and much more important was the enforcement of the operational permits. So, what I think has the biggest impact is the fact that there still are serious requirements in order to bring down or shutter older capacity, transfer those operating permits to any new expansions or existing capacity that is unpermitted before it can ever start inside of China.

So, I think that the point is, yes, there'll be less winter curtailments, and it's already incorporated into our balances. So I think that is part of what we've already been talking about. But again, as long as China continues down this path of enforcement of environmental controls and operational permits, it does start to create a more level playing field. And we're now seeing a lot more action less so in aluminum was already pretty well active, but we're also seeing a lot of work inside of bauxite that's constraining bauxite export, ensuring that bauxite mines have the permits in place and that they are following operating practices. It tends to bring the cost of bauxite up for those alumina refiners inside of China.

Matthew Korn
Got it. I appreciate it. Best of luck.

Roy Harvey
Thanks, Matthew.

Operator
And as we are approaching the top of the hour we do ask that you please limit yourself to one question. And our next questioner today will be Lucas Pipes with B. Riley FBR. Please go ahead with your question.

Lucas Pipes
Thanks, for taking my questions and great job this quarter. Roy and Bill, I wanted to follow-up a little bit on your capital allocation strategy. And you've made a lot of progress on optimizing your liability. So, as you look into 2019, and obviously market conditions have been pretty volatile, but should we continue to think about a 50:50 split of cash between optimizing liabilities and capital returns if it is in excess of $1 billion?

William Oplinger
Yes, Lucas, let us get through 2018 and we'll come out with a capital allocation program in early 2019 for 2019, and potentially even for longer than 2019. As we go through 2018, we still have to execute on the share buyback of $200 million. We've talked about the fact that once they…once we achieved all the goals of the capital allocation program, we'll be returning cash to shareholders in addition to further de-levering. So, we still have that to do. So, let us get through 2018, and see what the balances look like at the end of 2018 and early 2019 we'll let you know what the allocation program looks like past that.

Lucas Pipes
And maybe really quickly on the balance at the end of 2018. If I recall correctly, you generate more cash in the second half of the year. And I think even more in the fourth quarter. So, at the midpoint of guidance, do you have a rough sense excluding any share repurchases where your cash balances would shake out December 31st?

William Oplinger
We don't provide an exact guidance on that. But what I would tell you is that we talked about splitting excess cash above $1 billion between share repurchases and further de-levering. We've announced the $200 million program. So, it should give you a pretty good indication of where we anticipate cash to end before any share repurchases.

Lucas Pipes
Got it, okay.

William Oplinger
And you're right. We generate a lot of cash in the fourth quarter typically if you look back at our fourth quarters. Even as part of Inc., we generated a lot of cash in the fourth quarter.

Lucas Pipes
Okay. All right well, I appreciate the detail. Thank you.

Roy Harvey
Thanks, Lucas.

Operator
And our next questioner today will be Justin Bergner with Gabelli & Company. Please go ahead with your question.

Justin Bergner
Thanks guys for fitting me in. The step up in the profitability of flat-rolled, which I guess you alluded to being about $25 million per quarter run-rate in 2019, how much of that is just related to the Warrick restart and how much of that is due to other factors, because that's obviously at a much, much higher run-rate than anything in recent history.

William Oplinger
Yes, I don't have the exact breakdown of the percentages. But I would say less than half of that is related to the restart of the smelter. We have grown and are in the process of growing our shipments out of that mill from when we got it from 600 million pounds to over 720 million pounds this year and would like to see it higher going forward. We've been able to put a lot of volume through the mill. And we'd like to see stability of returns and stability of the results out of that mill. So, projecting at about that rate going into 2019, and I'd personally believe that mill has a bright future and can do better than that run-rate. So that's where we're at today.

Justin Bergner
Okay, great. And then one additional question, I think you mentioned a $27 million net benefit from the tariff regime this quarter, if I heard you correctly. How did you calculate that, or what Midwest bump did you assume to get to that?

William Oplinger
I don't have the Midwest bump. What I can tell you is roughly on a gross basis, we had roughly $56 million of the improved revenue and $29 million of higher costs on a year-over-year basis. And that's what gives you the $27 million benefit. I don't have the calculations in front of me, but I'm guessing that's probably around a $0.10 benefit from the premiums, which would make the math pretty simple, but around a $0.10 improvement in premiums.

Justin Bergner
Okay, thank you for taking my questions.

Roy Harvey
Thanks, Justin.

Operator
And the next questioner today will be Alex Hacking with Citi. Please go ahead with your question.

Alex Hacking
Hi, Roy and Bill. Our main questions were answered. So I'll refrain from asking a question and follow-up with Jim later. Thanks.

Roy Harvey
Thanks, Alex.

William Oplinger
That was easy.

Operator
Okay. And the next questioner will be from Paretosh Misra with Berenberg. Please go ahead with your question.

Paretosh Misra
Hi, guys.

Roy Harvey
Hi, Paretosh.

Paretosh Misra
Hi. So, just a couple of quick ones, so one, I don't know if you already said that on the call, but can you provide the caustic and Aussie dollar assumptions that are baked in your guidance for the fourth quarter?

William Oplinger
Don't have the caustic number per se in front of me and I believe the Aussie dollar is $0.72.

Paretosh Misra
Got it. And then second on the Bauxite side, in the Bauxite business, what kind of growth opportunities you have still available in Australia and what are the bottlenecks? Is it permitting, or the infrastructure, or what is that?

Roy Harvey
Yes, so the first and most important is that we want for any growth project we need to make sure that we have a reliable customer at the other end that is going to pay us fair value for what we believe is very high quality bauxite, particularly at a moment where caustic prices are high. So…and quite simply, there are customers out there and part of what we've been doing over these last couple years is finding ways to work with them and to build those partnerships. So, that's a very positive thing.

In Australia, Western Australia particularly, we have the ability to increase our production. Right now we have an operating permit in order to export up to $2.5 million. We will need to renew that coming up in about a year. But also we're able to get close to the 2.5 million tons out. But we do have some logistical bottlenecks to make sure that we can do it at an economic…a very economic way, essentially to lower the cost of logistics from the mine to the port and then get it over to our customers.

So still some growth that we can see in there. And in fact, some investments that we're planning on making that once we finish the permitting process that makes it more attractive financially. We also have opportunities in Guinea and in Brazil. It depends a bit on what's happening with freight rates and prices of bauxite. But again, I think the qualities that…and the consistent delivery that we have of bauxite helps to make that a very attractive business going forward, Paretosh. Thank you.

William Oplinger
And Paretosh, I did check, it is $0.72.

Paretosh Misra
I see, thank you.

Operator
And our last questioner today will be Andrew Cosgrove with Bloomberg Intelligence. Please go ahead with your question.

Andrew Cosgrove
Hi, guys. Thanks for taking my question. Just quickly on caustic, just looking at the…how the Southeast Asia and Northeast Asian prices collapsed more recently and how they've compared to your costs or your alumina-implied costs back in 2017. Is it kind of fair to assume that those alumina costs might come back into play that we saw mid-2017, as we move throughout 2019, considering the drop we've seen?

William Oplinger
Yes. So, it's hard to say, we have seen in aggregate caustic, and this does not bifurcate between Asia and rest of the world, but caustic prices kind of peaked out at $630 a metric ton at the very beginning of this year and have trended downward from there. That's up sharply from what we had seen in the third quarter and fourth quarter of last year. So you know that we have about a six month lag on our caustic costs. So we will continue to see those higher prices that we've seen earlier in the year. But, they will, assuming the prices continue to trend downward, they'll continue to come down.

Andrew Cosgrove
Okay, just wanted to just double check that. Okay, thank you. Won't keep you guys any longer, appreciate it.

Roy Harvey
Good. Thanks, Andrew.

Operator
Okay. And this will conclude our question-and-answer session. I would now like to turn the conference back over to Roy Harvey for any closing remarks.

CONCLUSION

Roy Harvey
Good. Once again, I'd like to thank everyone for joining us today. As we approach our two year anniversary next month, we remain focused on our strategic priorities to reduce complexity, drive returns, and strengthen the balance sheet. Our company is much stronger today. It's clear that our strategy is working and we will continue to build upon our solid foundation for an even brighter future. Thank you, and William, back over to you.

Operator
Thank you, and the conference has now concluded. Thank you all for attending today's presentation. And at this time you may now disconnect your lines.