Alcoa Corporation

2018 Bank of America Merrill Lynch Global Metals, Mining and Steel Conference

Tuesday, May 15, 2018, 4:30 PM Eastern

CORPORATE PARTICIPANTS

Roy Harvey - *President and Chief Executive Officer*

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

Timna Tanners, Bank of America Merrill Lynch:
Please join me in welcoming them. Thanks.

So we're going to start and Ron's [*sic*] going to make some quick comments and then we'll go straight into Q&A.

Roy Harvey:
Great. So I'll keep it relatively brief to get started, because I think there'll be more fun in the questions. So we've now been a standalone company for about a year and a half. So we find ourselves in an interesting position in that we have 130 years of what I think is incredible history. And we've now been at this for a year and a half since separation from what was Alcoa Inc. and Arconic.

We've been very focused on trying to simplify ourselves and trying to make sure that we have everybody across the organization aligned with making Alcoa stronger and better and I think we've also had a pretty incredible set of tailwinds behind us. When we look at the moment of separation at the end of 2016, we think about what's happened in the aluminum industry and alumina and bauxite. I think it's been a great opportunity for us to continue down a very defined path. We're reducing complexity, we're driving returns, which means that we look at good projects that make us stronger and we're strengthening the balance sheet. And with cash flow continuing in very good shape, it's allowed us to really accelerate our way through to each of those priorities and continue to drive to make Alcoa brighter and better for the future.

So I appreciate everybody joining us. I'd love to just go ahead and jump into the Q&A.

Timna Tanners:
Excellent. For all of you not focused on alumina and aluminum, it has been a really exciting ride here in terms of a little bit of the macroeconomic and political news flow, but also just raw pricing strength. So Alcoa is still not quite valued as if this is sustainable and I know both of you have had experience in the Investor Relations role and I'm curious what you think it will take for investors to kind of – to take hold of this theme of the higher-for-longer prices.

Roy Harvey:
I can get started then Bill can chime in. We each did spend time in Investor Relations. I always found my time trying to help Wall Street, help our investors understand the story. I found it fascinating because it connects a little bit of marketing with a good understanding of what's happening in the business, but then also it comes down to the fundamental performance of the business.

And so when we think about where we stand now, I think we're trying to simplify the story so that it's very easy to tell. We want our performance to really represent what we're trying to do with our business. So that's why we really try to simplify back so that it's very clear and it's very almost predictable the actions that we take when we talk to each of our investors, when we talk to our analysts, etcetera.

And so I see this as a continuing journey in making sure that everybody out in the investor world understands what we're trying to do. And then connects that with what I think is exactly where you're going, which is what is the view of the market and what do we think is actually happening in aluminum? We've had, particularly over this last month or two, a lot of volatility coming from the questions around tariffs, the trade disputes, what's happening with sanctions on some of our competitors. So there's a lot of discussions, a lot of volatility coming in because of that and our pricing.

But we've lost a little bit of the discussion around what's happening in China. Because really what's happened over the last 15 months is that China has started to enforce what have been years old policies around the requirement of operating permits, better protection of the environment and really a more essentially just making sure that the rules that were already on the books are being enforced.

And that sea-change in what's happening in China means that we're starting to see our market not only come into what is this year a deficit, but also looking a lot more positive for the long term. So I think getting back to some of those basic fundamentals of the story, looking at some of the basics of what's happening, both from a demand side which continues very healthy, but then also a supply side which has fundamentally shifted in this last year, I think will help people to really understand that story and see for the longer term.

William Oplinger:
And the only thing I would add to that Timna is that we can't control what people's view of alumina and aluminum prices are. What we can control is delivering on the performance, sticking to the capital allocation model that we have and ultimately delivering. And as we do that over time, we build credibility and I think as we build that credibility, it should be reflected in the share price.

Timna Tanners:
That makes a lot of sense. Let's tip the discussion to what is it that helps keep aluminum higher for longer instead of maybe making that assumption? I know you mentioned the Chinese discipline. Can we talk a little bit about cost pressure? It seems like there is an argument to be made that the cost curve is shifting higher. Chinese costs are going up like you've talked about with the associated coal-fired plants being shuttered at smelters, the cost of some of the components and energy costs in general. Is that something that you could talk a little bit more as supporting the aluminum price longer term?

Roy Harvey:
Absolutely. And I would look at it in three different buckets. I'd start out with a very basic view of supply and demand. And so when you look at what's happening currently with supply, whether it's in China or outside of China, compare that with demand, and then also think how inventory is influencing that as well. And we've seen a lot of inventories, particularly outside of China, significantly decrease over these last few years. So we're seeing a real change in what's happening in those basic sort of economic theory and that we're no longer overproducing. So that's sort of the first step.

The second step is that concept of cost-push. It's looking at all the different raw materials inflations that we're seeing; and if you look at aluminum, you'd look back at alumina, you'd look back at the price of bauxite which goes into alumina, coke, pitch, caustic, some of those very basic items that go into producing that entire value chain.

And what we're seeing is that across the board we're seeing a lot of competition for each of those. And when you look in aluminum that's particularly in coke, a lot of it in pitch as well. And because China has grown so quickly, both from a demand side, but also from the supply side, I think we've really seen a fundamental change in those basic materials that everybody procures.

You then step back and look what's happening from a regional standpoint. For example, what's happening with energy in China. You have the global energy picture, but in China you also have a lot of regulations coming in about the cost of coal, the cost of generating coal-fired power, or the cost of power from the grid. Another one of those stories that's just developing now is that they're considering and preparing to put together regulations about how coal-fired generating plants also will have a set of operating permits, will also require connection over to the grid. And that could be another fundamental shift in what's happening in our industry. So when you step back and you look at the broad gamut of costs, I think we've seen a lot of inflation.

The third way to look at it is also what is necessary in order to incentivize more production coming online. One of the great stories about aluminum over, really over since I've been involved in the industry, is that we've had healthy demand. We continue to see demand growth both inside China, which is really quite spectacular, but also demand growth outside of China. And so when you think how will those materials be supplied, it makes a lot of sense. In China they have very low capital costs, but they're no longer allowing operating permits to be given so freely. So now they're starting to enforce that those plants can be – need to see other plants retire in order to bring supply/demand in balance.

But when you look at pricing, you think about the cost-push, but then you also think about what is necessary in order to incentivize more production in China as their demand grows, but also some day more production outside of China. And right now, because of the difference in capital costs, it's not readily apparent at these metal price levels today, who would actually build that next smelter, from an economical and financial sense…

Timna Tanners:
So the marginal cost of production is not there, despite the increase in prices because of the corresponding increase in the marginal cost. However, there are some producers with excess capacity. You guys have a lot of excess capacity. And I can't speak to other Russian producers that weren't allowed to come to our conference, or others. But I do think that Alcoa is one of the – you're sitting on the most spare capacity, right?

So I just wonder if you could remind us about how you think about deploying that. The theme of this conference is Back to Value Over Volume and What's Next and so it's appropriate that we ask you that question along with the discussion we've had all day on the same topic. Just generally speaking, and then if you wouldn't mind also addressing any changes to that thinking that might be a function of sections and sanctions, tariffs, quotas, etcetera.

Roy Harvey:
Certainly. Want me to hit this first?

William Oplinger:
I'll take it real quickly. I mean we essentially have capacity in different parts of the world that curtailed. We've got smelting capacity in Brazil, smelting capacity in the States, a little bit in Australia and a little bit in Spain that can be turned back on. We look at long-term pricing assumptions that we've developed internally and we're making the decisions over a longer period of time than over a short period of time to consider restarting.

Each smelter has its own story, so each smelter has a slight twist to the analysis. For instance, in Wenatchee, Washington, we have a payment that we have to make to the Public Utility District if we're not running that facility. So that goes into the calculation. Down in Brazil we've got value-added tax that can be monetized if we're running the facility. So that goes into the calculation.

On the refining side we've got roughly 2.4 million metric tons capacity curtailed on refining that could be restarted. Keep in mind that that's fairly high cost refining capacity. It was curtailed for a reason. It does not have in situ bauxite. So we run the numbers and try to make the determination whether we restart it. We announced nine months ago that we would restart our Warrick facility and it's taken us about nine months and around $75 million to get restarted. But that was a unique circumstance where we had a coal-fired power plant on the one side and a rolling mill that needed the metal on the other side. So we run through the calculations and make the determination.

Roy Harvey:
And I'll add one piece to that. You talked about tariffs and sanctions, etcetera. As Bill I think very well highlighted, we don't look at just the short-term fundamentals, we look at medium and long term. And we need to drive a long-term return for our shareholders on decisions to restart. It costs money and in the end, it adds another plant into our portfolio.

So we understand the dynamics of what's happening today, but even more important are those long-term planning assumptions that Bill mentioned. And so tariffs have an impact, but they don't necessarily have the understanding that they have a lasting impact. And thus are influential, but are not the deciding factor in the decisions that we make on restarts.

Timna Tanners:
Fair enough. And then I know if we think more broadly about the industry, I get the sense that there's also among most of your other aluminum producer colleagues and alumina producer colleagues, not a huge appetite to restart or build new capacity, aside from some specific US examples, maybe where there's some commitments that were made. Do you see a lot of new capacity coming in China or elsewhere that maybe have a different point of view than what you just described?

Roy Harvey:
You know, I think right now what we're seeing is some new capacity coming online in China, but it's coming online with operating permits that were granted years ago. So these are projects that have been in the supply pipeline for a good amount of time. And so it's relatively predictable. And also what we're seeing in all of the articles, all of the developments that we're seeing in Chinese industry is that they are being associated with permits that have actually been issued. So we're not seeing some of the unconstrained growth that we had seen in the past.

So that China continues to grow, but at a much lower rate. Means that they're – and because they're growing slower than what is the growth of their demand, it is automatically bringing them into essentially supply/demand parity. So we're seeing a lot more of a sensible and economic approach and driven through the policies of the Chinese government.

Outside of China, realistically, I think a lot of the tonnage that had been curtailed in the past has been permanently curtailed or are very difficult to restart, because of this decade of difficulty across aluminum. A lot of those plants were not curtailed in a fashion such that they're ready to restart very quickly.

And you're really not seeing outside of the Middle East, where it connects much more with the policy of the country in question, you're not seeing a lot of new smelters on the drawing board.

In alumina, we continue to have some growth, again, it's mostly in the Middle East. And you continue to see some growth in China, but China has continued to be structurally short, and to me, that helps to drive this parity of prices between rest of world and China.

And you see in the situation now where we are extremely tight and short of alumina in the rest of the world; and we've seen a very good increase in prices, albeit a little bit tamed over the last week. We start to see that China actually acts in a pretty economic fashion because there's an arbitrage opportunity between world prices and Chinese prices. They have some tonnage coming out of China. But we've not seen, certainly not outside of China, we haven't seen a lot of growth in alumina.

Timna Tanners:
Well, thanks for pointing out that I'd neglected the refining side of your business, which is more impactful, actually, than aluminum. But would you give us a little bit more on your outlook for alumina and bauxite while we're at it?

Roy Harvey:
Sure. So from an alumina standpoint, the prevailing environment is that it's very hard to store alumina. And so that means that it tends to be relatively self-reinforcing. It means that sometimes the cycles come quicker and sometimes have higher highs and lower lows. But there simply isn't that inventory that sits in the system like there would be with aluminum, with the London Metal Exchange and off-exchange material. And so that means it's relatively self-correcting. As prices come down, you tend to see the marginal producers start to shift and I think a lot of those marginal producers outside of China have already idled those facilities. So now really much of the action you see happening in China.

So over this past several months, really over the course of this year to date, we've seen that aluminum market be pretty close in balance. And then because of some of the issues down in Brazil with production, it's actually driven a short position in the world, less supply than there is demand, and it's created a very favorable environment for alumina. And then also looking forward, because I believe Alcoa specifically has an advantage in technology and our ability to run our plants, it means that it is still is a very good business outside of China; and it also means that we're able to continue to creep and invest in our facilities to continue to grow that exposure to the alumina market.

On the bauxite side, it's all about customers. Bauxite is a very differentiated product. So one bauxite cannot be used in all of the refineries that are in the world. We've seen a pretty significant growth in supply, whether it's in Guinea. You're also seeing some growth in Australia, but then also in Brazil. Our position is that if we best connect with our customers, we have very good deposits that are relatively easy to expand, relatively minimal investments. By ensuring that our customers truly understand what is the value proposition that Alcoa can bring, which is consistently delivered high-quality bauxite that helps them to minimize their exposure to increasing caustic prices, we think that's a very attractive environment for us. And it's relatively attractive capital cost as well.

So that would be a market that continues to develop. It's really one that's only a few years old, as up until China started growing their refining business inside the country, with insufficient bauxite reserves available, you really didn't have a large third-party merchant bauxite business to sell into.

William Oplinger:
Bottom-line, is we're projecting for '18 smelting -- world smelting demand supply picture is that it's in deficit, alumina is in deficit, slight growth in stockpile and bauxite and this was prior to the Rusal sanctions. When the Rusal sanctions hit, alumina prices spiked very, very quickly; and keep in mind that we price at --around 95% of our contracts are on either alumina price index or spot pricing. So we see that benefit flow through quickly.

Timna Tanners:
Either Roy or Bill on this one, but on this sanction side, I listened to a recent third-party webcast and it seems like I'm not the only one who's confused about where this all stands, in terms of if the oligarch at Rusal divests, then they don't have sanctions, but they're not supposed to kick in until October anyway. And then the Russian government doesn't want to take over the stake; and do you have any clarity on where this stands going forward or what this will mean to the market?

Roy Harvey:
I think we have relative clarity at what it is at this very particular moment in time. However, there's still a lot of uncertainty about how that actually plays out in the market. When sanctions were first announced, I think there was a rush to try and procure materials, whether it's aluminum or alumina, simply because the time span that was allowed to actually step away from Rusal completely was very short. Since then, because of the relaxation up until October, it's simply given more time for the market to adjust and react.

Now we also hear that – or we also see the headlines and probably everybody has seen them about whether Oleg Deripaska is going to choose to continue to remain in Rusal or not. That's a story that I think still has more to develop. And so I think the market breathed a big sigh of relief. They realize that there is time to be able to sort their way through this. However, when we get up into the end of the third quarter, beginning of the fourth quarter, as we reach that October deadline, and as we start to put together new contracts for value-added aluminum products for alumina materials, etcetera, I think you're going to start seeing more questions or more concern about how can they balance those risks.

And in the meantime, I think they're going to – I think Rusal will continue to speak with the OFAC in the United States to see can they build a solution that gives them the chance to operate.

Timna Tanners:
That's helpful. Before I turn it over to questions from the audience, Bill, can you remind us of your latest thinking on capital allocations?

William Oplinger:
Sure. Capital allocation for us, we've laid out a pretty clear capital allocation model. Because we're a cyclical business, we'd like to keep a billion dollars in cash on the balance sheet so that we start there. We spend about $300 million of sustaining capital each year. That can be lumpy, but based on large projects, but for now, that's a pretty reasonable assumption. We switched to trying to reinvest in the business, so we're spending about $150 million of return seeking capital. That's triple what we spent back in 2016 and I say switched, it's kind of a mindset change for our people to actually be investing in the business, given the decline in metal prices that we saw since the financial crisis.

We will contribute to the pension plans. We have mandatory contributions of around $450 million this year. We're going to make discretionary contributions $300 million. With those discretionary contributions, we will annuitize retirees out of the pension plan. We hope to annuitize around 10,000 retirees out of the pension plan by the end of this year. And it's a significant reduction. We just recently did that in Canada and had a very successful program to annuitize retirees out of Canada.

After we've done all of that, any free cash flow will be split 50/50 between returns to shareholders and further delevering. You may note that we just did a bond deal. We're in the process of doing a bond deal. We're raising $500 million. What that allows us to do is it's a 10-year bond deal at 6 and an $1/8^{th}$. We will use the proceeds for general corporate purposes, but also contribute to the pension plan and that gives us flexibility, depending on how things turn out over the next few years, it gives us flexibility to not have to make contributions to the pension plan in certain circumstances. So capital allocation process pretty clear.

Timna Tanners:
Okay, helpful, thank you. Let's turn over to the audience to see if you have any questions for Alcoa. Jason's got one.

Unidentified Audience Participant:
Sorry, I came in late, but did you already talk about your fantastic new inert anode technology?

Timna Tanners:
No, ask away.

Unidentified Audience Participant:
How that's going to save the world and how quickly and more importantly, do you actually make any money on it or does it just go out to the whole industry?

Roy Harvey:
So I think the answer is that that is to be determined. So the purpose behind Elysis, which is our new joint venture, is to take a technology which Alcoa has been working on really for a number of years and give it its best opportunity to actually succeed. And so for us, a lot of the cash has been invested over the course of the last few decades. The expense going forward is relatively minimal. And we believe it's a technology that technically works. We need to build it so that it is retrofittable. Part of the reason with teaming up with Rio Tinto is that it allows us to build a solution that can be used in existing smelters around the world. And we also need to create the demand for a product that will be the lowest carbon product in the world.

When you think about the energy source coming into the smelter, you think about the fact that you're eliminating the carbon anode and actually replacing it with a proprietary inert material, it gives you that very lowest carbon product. So it is a really good idea when you think about it from the sense that you can actually lower your operating costs and actually lower your capital costs for the retrofit of a smelter or the build of a new smelter. It's a really great idea if you find that customers are actually pursuing that low-carbon metal and actually willing to pay a premium for it.

And so part of the work that we need to do is to help develop the market, develop that business case for actually how the technology is deployed, and actually prove and show to what will be our future licensing customers that it works. I think for me it's a great way to take what was prior expenses and turn it into what is a pretty exciting option value for us.

Unidentified Audience Participant:
So just to follow-up, I mean are we talking building some kind of a commercial-scale line or are you building a demonstration plant that's 20,000 tons? I mean what do you actually get for 200 million bucks?

Roy Harvey:
Yeah, so it's broken into several phases, and in fact, there is a phase before you get to the 200 million bucks. And so the first phase is a portion of a line, the second phase then takes that to a larger scale-up. And so there won't be additional investments until we can be certain that it works at full-size scale.

William Oplinger:
And it's important to note that our contribution is not $200 million at this point. So we've got us, Rio, Quebec and Ottawa contributing to the project. And just one more sales point, you look at – we've developed this technology over the last 30 years. We've had fits and starts over 30 years. We're now partnering with the premiere technology provider in aluminum and that's Rio. And then you've got a great customer in Apple that needs green aluminum. So if we can get it commercially to be successful, it could be a big deal.

Timna Tanners:
That's a great point to wrap up. Thank you so much for your time.

Roy Harvey:
Thank you everybody.