Alcoa Corporation

Morgan Stanley 6th Annual Laguna Conference

Wednesday, September 12, 2018
3:30 PM Eastern (12:30 PM Pacific)

CORPORATE PARTICIPANTS

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

Piyush Sood – Morgan Stanley:
Good afternoon. I'm Piyush Sood. I cover metals and mining. I have with us Bill Oplinger, CFO of Alcoa. Thanks for being here.

William Oplinger:
Thank you for having me.

Piyush Sood:
Bill, any kind of prepared remarks, feel free. Otherwise, I'll just get into Q&A.

William Oplinger:
Just go ahead and fire questions.

Piyush Sood:
So, Alcoa as you know, this is -- it's a big third-party supplier of alumina and aluminum. So, curious to hear your thoughts about what you're seeing in the market, especially around China's winter cuts? The last year, we heard about the cuts. They were sort of promised to be a big deal, and they ended up being a bit underwhelming in the end. This year, the expectation has been built up that they are bigger, but some recent chatter suggests they may not be. So, just curious to hear your thoughts, both on aluminum and alumina, what you're hearing from your perspective?

William Oplinger:
Sure. Just to back up a step, the last time we provided a supply and demand outlook was in July, and at the time, we were projecting approximately a one million metric ton deficit in the smelting business and aluminum globally, and approximately a one million metric ton deficit in alumina globally also. We are projecting a little bit of a surplus, seven to 11 million metric tons of excess bauxite in the world. But, overall, we would suggest to you that the overall market dynamics are pretty strong for alumina and aluminum.

Specifically, around the winter cuts, last year we saw two programs. We saw the NDRC program that was looking to curtail capacity, that didn't have the right operating permits. And we actually saw the winter heating season curtailments. The more effective of those two programs was the NDRC program, which resulted in fairly significant cuts to operating permits and operating capacity in China. The winter curtailments weren't as large as what we had originally anticipated, but still we saw roughly 3.5 million metric tons of alumina refining capacity curtailed and around one million metric tons of smelting capacity curtailed.

As we've projected in the winter heating season this year, we don't have perfect insight yet to be able to determine how that will play out, but I guess our view is that we should see similar levels of curtailments in both refining and smelting going into this year. I think we'll have better line of sight information within the next month or so. But, overall, it's a positive in that it feels like the Chinese government is getting serious about curtailing heavily-polluting industries, and we feel that that's a step in the right direction.

Piyush Sood:
That's good to know. Shifting gears a bit towards pricing, what's driving alumina prices higher? We understand the Alunorte part of it maybe a little bit better than other parts. So, the pricing in the mid-600s at this point, what do you think is really going on in China and outside of China?

William Oplinger:
Yes, so the alumina market has really heated up, and the reasons behind that, just the underlying reasons is that, ultimately, there's very little inventories of alumina held in the world just because of the physical characteristics of the product. And what that means is that any supply disruptions can translate into higher prices fairly quickly.

As you said, spot alumina prices are at $625 currently at -- aluminum prices at close to 30% of underlying aluminum prices, so pretty high levels. What's driving it? Really, in our view, probably three supply disruption-type events. We all know about the Alunorte situation. Secondly, we have seen a number of smaller supply disruptions in the industry at our facilities and other facilities around the world. Put it in perspective, some -- between the strike that we have going on in Western Australia and some equipment issues that we've had, we're projecting to see probably a 2% to 3% reduction in tons per day out of our system in the third quarter over the second quarter.

And the third piece of that is really an overhang around RUSAL and not knowing what will happen on October 23rd with the RUSAL sanctions, and I think that's driving some of the sentiment. Keep it in perspective, though, for Alcoa, significantly higher alumina prices are a good thing. $100 per ton for us on an annualized basis means about $800 million of EBITDA.

Piyush Sood:
Looking at the stock, that's difficult to get.

William Oplinger:
Well, that is the sensitivities. In the near-term, we might have some offsets to that in the third quarter. For instance, we'll have -- just basically on how corporate inventory accounting works, we'll probably see $40 million to $50 million of higher corporate inventory accounting for LIFO and profit eliminations. And then, the other thing we're likely to see in the third quarter is a little bit higher tax rate as we make more money in places like Australia, where we do pay taxes that results in effective tax rate that's higher, and we're projecting that to be in the third quarter probably in the 45% to 50% range. But, like I said in the end, higher alumina prices, it's a good thing. We are -- we've made -- produced 13 million metric tons of alumina annually, and so it's a good position to be in at this point.

Piyush Sood:
So, you did briefly touch on it, but alumina pricing is 30% of aluminum right now, something that we haven't seen happen maybe in a long time?

William Oplinger:
If ever. And the alumina prices are nearly as high as where they were in the April, May timeframe, but aluminum prices are lower.

Piyush Sood:
So, what do you think is pressuring aluminum at this point? Or what is keeping aluminum so low?

William Oplinger:
Yes, it's very difficult to say how we have this dislocation between alumina prices and aluminum prices. One thing that does -- it has historically driven aluminum prices is the strength of the

U.S. dollar. And with the dollar as strong as it is today, we're seeing the marginal producers' costs under a little bit of pressure. So, your marginal producer has lower costs, and therefore prices typically go down. But, that doesn't explain that disconnect, and I think we have a hard time explaining the disconnect between alumina and aluminum prices. At some point, something will give.

Piyush Sood:
And you also touched on the strikes in Australia. Just wonder here, what's the latest there? How are the negotiations progressing? And what sort of disruption, if possible, could happen? And what contingency planning do you have over there?

William Oplinger:
Sure. So, for those of you who don't know, we have the AWU out on strike in Australia. That strike started on August 8th, and it is ongoing today. We're very focused on getting resolution to the situation there. We think we have a good offer on the table for our employees, and we would like to see that resolved.

So, as far as impact, we have said that, in the month of August since the strike started, we've lost about 15,000 tons of production due to the strike. We've been able to continue to have the three operating sites, the three refineries plus the two mines continuing to operate, based on the fact that we've been able to bring in some temporary workers and also have management and staff running the facilities.

So, a minimal impact from the strike, 15,000 metric tons in the month of August. But, as I said, we're really, really focused on getting this resolved. And you didn't ask, but I'll bring it up anyways, the conflict in the strike is really around flexibility of work. And we would like to be able to have greater flexibility. We would like to be able to flex our manpower up and down based on market conditions. And we want to be able to make sure that those facilities are competitive for the long-term. And that's the reason for the dispute.

Piyush Sood:
So, you're probably running those facilities with a skeletal staff right now, and I would assume that you can do it for a while. Just curious, how long can Alcoa weather out a strike like that?

William Oplinger:
Yes. We're really not giving a forward view, and the reason being is we want to get it resolved. We have all of our focus on trying to get it resolved, continue to operate the facility safely, environmentally sound, and be able to meet our customers' needs. At this point, we think we can do that with the staff that we have, and we'd like to get it behind us.

Piyush Sood:
And while we're talking about strikes, how about the ABI strike in Canada? That's been going on for, I think, all of this year?

William Oplinger:
January. So, it's actually a lockout, and you reference ABI, which is a smelter up in Quebec. We are 75% owner of that facility. We locked out our workers in January. Again, it's around having the flexibility to run that plant competitively. We see that plant as a plant that should be successful, should be there for the long haul. It's in a part of the world that is supportive of

aluminum production. It's a good technology facility. We would like to have a competitive labor agreement that allows us to operate that facility competitively on a global basis. And we've locked out the workers. We're in the midst of discussions. We're still at the table. And as long as we're at the table, we have a positive view that we'll get some resolution, but at this point ongoing dialogue.

Piyush Sood:
So, if I were to characterize it versus three months ago, are you kind of coming closer to the -- are the two sides coming closer? Or are they still as wide apart as they were?

William Oplinger:
Yes, we don't like to handicap these sort of things. As I said, we're still at the table, and I would say we're back at the table having discussions. And as long as two parties are talking, I think progress can be made. And we're hopeful that we can make progress so that we can make that plant competitive and successful for the long-term.

Piyush Sood:
And where alumina pricing is right now, and let's say the lockout were to end, would it make sense to ramp up ABI at these kind of cost levels?

William Oplinger:
Let's get to that point first, and we'll make that decision then. But, very similar to our situation in Australia, we'd like to get that resolved. We'd also like to get it resolved in a way that makes those facilities competitive for the long-term. And so, that's what we're focused on.

Piyush Sood:
So, moving from strikes to another elephant in the room, dividends, or some kind of shareholder return, so we've heard that for 2018, target is 50% of excess free cash flow, and seems like 4Q could be setting up to be a quarter where there could be excess free cash flow, and 50% of that could come out. Is that maybe the right way to think about it at this point?

William Oplinger:
Let me give the overall perspective first. So, going way back to November 2016 when Alcoa Corporation was launched, we were launched with debt and pension and OPEB roughly of around $5 billion of those types of liabilities. At the time, we had a trailing 12-month EBITDA of around $1.1 billion. Fast-forward to today, and we've been able to make significant progress on our pension and OPEB liabilities. During the course of when we first launched, we were purely focused on repayment of debt and deleveraging.

Toward the end of 2017, we pivoted a little bit to come out with a capital allocation program to make it clear, based on the earnings that we were seeing at the time, how we would use excess cash flow. Well, what does that capital allocation program look like? It says, hey, we want to hold a $1 billion of cash on the balance sheet. Why do we hold $1 billion cash on the balance sheet? We're a highly cyclical company. Metal prices and alumina prices go up and down. We want to be prepared for when those metal and alumina prices go back down and we can get through the difficult times.

In addition to that, we spend $300 million of sustaining capital. That's a pretty steady number over the years. We allocated $150 million to return-seeking capital, so that's small growth projects and productivity projects. We're not going to spend the full $150 million this year. Again, we'll probably spend about $120 million.

On top of that, we said we're going to spend $300 million of further deleveraging during the course of 2018. We said that that would potentially be either through contributions to the pension plan or actually paying down debt. Through the first half of the year, we have contributed, from a discretionary perspective, an extra $200 million into the pension plan, and that's allowed us to do a lot of things on the pension plan. It's gotten us into a better funded status. It's allowed us to be able to annuitize some of the retirees out of the pension plan. We still have $100 million of deleveraging to do in the second half.

After we've done all of that, what we've told investors is that, once all of that is completed in 2018, if there is excess free cash flow, we will split that excess free cash flow 50% for returns to shareholders, 50% for further deleveraging. We will give a further update on where we stand at the October earnings call, the third quarter earnings call. And at that point, we should be able to give you some more insight into what's going on.

Piyush Sood:
Maybe it's a little early to ask you this, but always worth a try. I think the 50% target is for 2018.

William Oplinger:
It is. We've made it very, very clear.

Piyush Sood:
And that doesn't mean it's a target for 2019, but any early ballparks on where it could land?

William Oplinger:
We haven't provided a 2019 capital allocation program, but let me tell you where we're coming from. We still feel that we're not at the optimal capital structure. And in fact, at the end of this year, if we've done the $300 million of deleveraging that we talked about, the $200 million that we've already done through the first half, the $100 million that we're planning on doing in the second half. If at the end there, and if we have no significant change of interest rates, we would suggest to you that we're still a little bit over-levered by about $400 million to $700 million. We would like to see ourselves at the optimal capital structure. The only thing we haven't said is are we going to do that in a year, two years, multiple years, right? So, at -- in early January, we'll come out with a capital allocation program for 2019, but focused on delivering strong results at the end of '18.

Piyush Sood:
How much more on pension do you think is still left? You said $100 million of deleveraging left this year, and between $400 million to $600 million?

William Oplinger:
$400 million to $700 million.

Piyush Sood:
$400 million to $700 million for the next year.

William Oplinger:
Or beyond, $400 million to $700 million after that to get to an optimal capital structure.

Piyush Sood:
So, let's say, in maybe two or three years, you're able to sort of delever as much as you want. You have small needs for CapEx, both sustaining and growth. So, maybe four to five years into the future, how -- it is probably a little early again to ask this question, but how are you thinking about spending your cash flows at that point? Would it be some kind of growth? Or would it be some more shareholder return? Is there anything in the portfolio that needs some optimization? Like, what is the long-term plan here?

William Oplinger:
Yes, like you said, it's a little bit early to say at this point. What I can say is that we would take a very balanced approach to capital allocation. We would like to get to our optimal capital structure over time. Once we've reached that optimal capital structure, we would be looking at a balanced approach between shareholder returns, potential growth opportunities. And I would remind you, we're in a cyclical industry. So, as we look out four to five years, what I'd like to be able to say is that, four to five years from now, we're a significantly stronger company, so that if we do get into a market like we saw in 2016, not only will we survive through it, but it'll give us an opportunity to be more successful. So, we're positioning the company for strength throughout the cycle.

Piyush Sood:
Happy to open the questions to the audience, if someone -- there's one there, right there.

Unidentified Participant:
Thank you. Just thinking about demand going forward a little bit, how much of an opportunity do you think light-weighting of vehicles, just given how much we've heard about emission standards, particularly in Europe do you see that as a long runway? Is there more opportunity, any kind of quantifying of addressable market there?

William Oplinger:
Yes. So, when you look at the markets for aluminum, there's a series of markets for aluminum. There's construction, transportation, and all the different transportation markets, whether it's aerospace, commercial vehicles, automotive. There's the packaging business, the packaging market that has grown globally fairly substantially this year. So, overall, we see the continued growth dynamics for aluminum to be strong. The industry -- the aluminum industry over the last I would say 15 years has never had an issue around demand growth.

We've seen strong demand growth over that time period. Historically, it's been some of the supply side growth that we've also seen come with it, specifically in China that has caused some of the issues. But, in the case of automotive, there has been a continual trend towards light-weighting of automotive. We see that continual trend of light-weighting to continue again, even with electric vehicles. As you get into more electric vehicles, you need to have more light-weighting that occurs. So, we are very bullish around the trends on automotive light-weighting, especially on aluminum.

I guess our other view is that you will hear from steel producers about high-strength steel. You'll potentially hear from other producers about substitution from carbon fiber. We think that there's probably room for multi-material applications on new vehicles that gives aluminum tremendous growth opportunities. And that would also include growth opportunities for high-strength steel and for carbon fiber. The one that loses in that equation is probably mild steel. And so, you see less penetration of mild steel and more penetration of high-strength steels, aluminum and carbon fiber.

Piyush Sood:
Thank you. I'll just keep going, in that case. So, you did touch upon this a little bit, but one of your large Russian competitors, still not out of the woods yet on sanctions, and there could be a disruption to the aluminum and alumina markets. Let's say if the disruption were to last, it seems like it's a little sustainable for a while. Then, what optionality do you have in your portfolio where you could benefit from it, either on the aluminum side or the alumina side?

William Oplinger:
Sure. It's -- again, it's early to determine where we will be on October 23rd with the potential RUSAL sanctions. At this point, it's hard to say whether those will be in place or not. We are early on in the process of making contracts for 2019. We are starting to see customers consider the fact that those sanctions could be in place. And so, at least in the near-term, they are making contingency plans to be able to not have to supply from RUSAL in 2019. If we were to have RUSAL sanctions, and to answer your question, we do have some flexibility around what we can produce and where we can produce it. We've got -- as you know, we've got smelting capacity in the U.S. that can be restarted if the dynamics are right.

Currently, we're in the process of restarting one smelter in the U.S., three lines at Warrick in Evansville, Indiana. And we're in the process of that restart. We've successfully restarted two of those lines and would be looking to restart the third line this year. We've got excess capacity at Intalco, out in the Pacific Northwest. And we even have curtailed capacity at Wenatchee that could be restarted if the situation was correct. On the refining side, we've got two million metric tons of refining capacity in Point Comfort, Texas. We have not made the decision to restart that at this point. If the economic situation was -- made sense to restart it, we would consider it.

In that particular instance, we believe the restart costs are fairly high, and the time to restart will take us a while. So, we'd have to be very, very certain that a good market situation will continue for quite a while. So, we do have some flexibility. Let's get -- again, let's get to October 23rd and see what happens.

Piyush Sood:
Any thoughts around the exemption process in the Section 232 tariffs portion where the U.S. is structurally deficient in aluminum at this point, and you have smelters in Canada and paying import duty on bringing aluminum in. Is there any scope to get some exemptions from the administration on import of that aluminum for Alcoa proving the case that the market is structurally deficient and that aluminum is available too, as well?

William Oplinger:
Sure. Just to give a little bit of a perspective on the 232 tariffs, with the 10% tariff, we have facilities in the U.S. that get a benefit from having that higher Midwest spot premium. As you know, we saw the Midwest spot premium jump up to $0.21 per pound currently, and we get that benefit in the U.S. During the tariff process, we had the expectation that Canada would be exempted. We make around -- currently around 600,000 tons of metal in Canada.

And we had the anticipation that that would be exempted also, and we found out that has not been exempted. So, as far as the ability to get certain exemptions to the 232, we've applied for certain exemptions specifically to bring in slab into our rolling mill in Indiana. We don't have any insight yet whether that will be approved or not. So, we would like to be able to see that so that we can grow our rolling capacity in Indiana.

Piyush Sood:
Just want to check if there's another question from the audience.

Unidentified Participant:
Thank you. Could you -- would you have any outlook in terms of what could happen in the alumina market with Alunorte being one of the biggest disruptions in the supply side? How are you guys thinking about the outlook there for year-end?

William Oplinger:
Sure. When the Alunorte news first broke, we had assumed -- we had built into our model for supply and demand that Alunorte would be curtailed for six months, 50% capacity. When we put our most recent outlook out in July, we had lengthened out that curtailment to pretty much the full year of this year. At the time, we were assuming that they may get some type of resolution toward the end of the year and take a couple of months to bring it back online. That's our most current view, and any inquiries on how they're doing, you probably should direct it towards them, but that's what's built into our current view.

Unidentified Participant:
Just coming back to the capital structure and understanding you're not giving '19 guidance there, but just so I'm clear, you said $400 million to $700 million is -- you'd still like to get the balance sheet down by that amount. Does all that have to happen in '19, or can you spread that over a couple of years?

William Oplinger:
It doesn't all have to happen, and we haven't -- and again, I'm not really giving a '19 guidance. But, we're not saying we have to do all of that in '19. We'd like to do that over time. And the other piece of that equation that we didn't really talk about is, when we looked at our balance sheet, we're considering funded debt, pension and OPEB as the total quantum of liabilities. And in that particular case, if we were to see an increase in interest rates that lowers the pension liability, we would count that towards the $400 million to $700 million.

So, just to be very clear, we take a fairly theoretical view of our capital structure. We try to determine what the lowest WACC is, because the theory will tell you a firm value's is maximized at the lowest WACC. We believe that an additional $400 million to $700 million after this year of de-levering, either through the pension plan or through actual reduction of debt, gets us to that optimal WACC. We don't target a leverage ratio. We don't target a rating necessarily. We're targeting an optimal WACC, and our belief is that $400 million to $700 million gets us there. And to answer your question, doesn't necessarily need to be next year.

Unidentified Participant:
Thank you. Putting aside the policy in China resulting in less capacity, do you foresee any additional capacity coming out just from the pricing dynamic right now between alumina and

aluminum, given some of the local smelters probably underwater and not even making money at this point?

William Oplinger:
Yes. We alluded to the fact that you have this situation where metal prices are $2,000 and alumina prices are at $625. That dynamic, in our view, results in global underwater capacity of somewhere between 30% or 40%, depending on how you look at it. Back in March and June of this year, we would have said the majority of underwater capacity is in China, right? We would have said that a big chunk of that 30% to 40% is in China.

With the strengthening U.S. dollar and the weakening of the renminbi, that pushes the Chinese capacity down the cost curve. So, at this point, we would still say roughly 40% of the world's capacity is underwater. A big piece of that is now outside of China. So, China is probably running, at least the last time I looked, approximately 10% of their capacity underwater, and the rest of the world makes up that difference.

Piyush Sood:
Couple more questions for me in that case. First one, we didn't talk about bauxite at all. On the bauxite side, I think Alcoa is positioned for growth over the next few years, but that's more based on requirement from customers.

William Oplinger:
It is.

Piyush Sood:
So, if you could talk a little bit about that, how -- where we are in terms of volumes, third-party volumes, where could they be five years from now? And from the Chinese perspective, seems like they have ramped up their investments globally on the bauxite side. Still, is that something that Alcoa is sort of -- it is part of the plan where you see China as the competitor in the bauxite market? Or do you think that changes your equation in any way?

William Oplinger:
Yes, so we have said that we'd anticipated ramping up our third-party bauxite to -- third-party bauxite sales to around 10 million metric tons over the next four to five years, but we caveated that strongly. And the reason why we caveated that strongly was to say that will be based on customer demand. We will ramp up production of third-party bauxite when we see that we have customers that are willing to take the bauxite.

We've got three, really, mining locations around the world that provide the potential for third-party bauxite. We've got Western Australia, which we have started to ramp up production of third-party bauxite. We're doing about 1.5 million metric tons of third-party bauxite out of Western Australia. Currently, we have the ability -- we have the permit to do 2.5 million metric tons. We've got the mine in Guinea. So, we are a participant in CBG, so that's got the ability to ramp up production. And then, probably farthest away from the market is Juruti. Juruti is in Brazil. We expanded Juruti to roughly seven million metric tons, and that serves both the Amazon and the potential for third-party bauxite.

So, I think over the long-term, we're pretty bullish about third-party bauxite. It will depend on whether the Chinese continue to build coastal refineries that use third-party bauxite. So, our view is over the long-term, it's a good market for us. In the near term with higher shipping costs and some of the bauxite that they've been able to get out of Guinea that's put a little bit of pressure on near term bauxite prices.

The Chinese firms have ramped up significantly their mining in Guinea. We're projecting probably 35 million to 40 million metric tons of bauxite coming out of Guinea. That's out of a market of around 300 million metric tons. So, it's a sizable amount of the bauxite that is coming out of Guinea.

Unidentified Participant:
Last one for me, IMO 2020. Is that something that affects your operations in any way? All the regulations around sulfur?

William Oplinger:
Yes, it is something we're studying. I think it's going to affect all of the industry to some extent. It will make shipping costs more expensive. So, yes, we're looking at it and we'll determine how it impacts us in the future.

Piyush Sood:
If there's no further questions let's wrap it up.

William Oplinger:
Good, thank you very much.

Piyush Sood:
Thank you, Bill.

William Oplinger:
Thank you.