Alcoa Corporation

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Unidentified Audience Participants
[conversation]

Timna Tanners, Bank of America Merrill Lynch
[abrupt start] in aluminum and alumina. I know it's a broad topic. You can pick which one you want to start with, but I think it'd be really helpful to get an overview of how you're seeing the market.

Roy Harvey
Certainly. So it is a broad question, let's try and break it into the smaller pieces. So from an aluminum standpoint, so we'll start at the top of the value chain, and work our way backwards.

So what we're seeing are some very positive market dynamics, so when you think about the supply/demand situation, and we're in a deficit over the course of 2019, we're in a deficit in '18 as well. What we're also seeing is that inventories are coming down. So we're still not yet at the level where we were prior to the global financial crisis, but we are on the way and continuing to see this year progress.

So relatively positive fundamentals from the supply/demand standpoint. Pricing, on the other hand, has been in a downward trend over the last few months and we're now sitting around $1,800 per ton. One of the frustrating things is trying to understand why, when you have positive supply/demand and what actually looks like improving supply/demand fundamentals, why you continue to see some of the pressure on pricing.

One of the places that we've been pretty focused on recently is around some of the general uncertainties inside of the economic environment. The ongoing trade deliberations or trade fights or trade wars, however you want to term it, and their knock-on impact, both on aluminum specifically and you look at the tariff barrier between Canada and the U.S. as an example of a place that doesn't make a lot of sense, or you also look at just the general economic uncertainties about the trade war between China and the U.S.

And so I think, while there are many potential upward catalysts to start seeing some improvement in pricing, because I would argue that cost curves and alumina pricing, which we'll talk about next, and then also the general supply/demand trends, we've not yet seen that upward spin, although we're up $25 today. So that's a good start.

On the alumina side, I think 2018 particularly was marked by a lot of volatility and a lot of turbulence and that while demand was relatively constant, it's not really a demand-side issue. What we're seeing is a lot of volatility inside of production, inside of the ability to actually see both the environmental side, and I think some of the disruptions in Brazil are a good example of places where environment can have a big impact, and also just operational, and we see some of those in the Caribbean. And also, we had our labor strike in Western Australia, which for the most part, we were able to continue to operate. However, that does have knock-on impacts and uncertainty.

So in 2018, we saw a jump up in prices. We've seen that come back down a little bit here over these last months. However, some of the recent developments as well, particularly in China, and this back on the environmental side, what we're seeing is more and more focus on the environmental impacts, both the bauxite residue, but then on the environmental operational environment in refining that could give you a catalyst, both in China, but also in the rest of the world.

One interesting point we've been talking about at the conference has been proceeding. When you try and sketch together what can happen if we see more and more environmental protection occurring or more permitting occurring inside of China, if that happens in refining and I would argue, bauxite they've started to clamp down on, aluminum they've done more on permitting and in environmental controls. The more environmental aspects we get inside of China around refining and around handling of red muds and around pollution, et cetera, that has a positive impact because it tends to drive the Chinese to a more level playing field when compared with how we operate our plants, which then steepens the cost curve, which then helps to drive a better alumina price, perhaps more scarcity of alumina, which then has knock-on impacts on pricing, which then also should have positive knock-on impacts on aluminum.

Timna Tanners
So on alumina, there's been, as you mentioned, several supply disruptions, can you talk a little bit about the most recent in China that was just earlier this week, right? I don't (multiple speakers) --

Roy Harvey
End of last week, I believe. Yes.

Timna Tanners
End of last week. Okay. So was it 3 million or 6 million tons total. Can you elaborate on that?

Bill Oplinger
Approximately 3 million metric tons. It appears that the one facility is partially curtailed. There is a smaller facility that was about a half million metric tons that's also partially curtailed. So we'll wait and see what comes from that.

Roy Harvey
Yes. I don't think we have a lot of details on specifically what happened. It sounds like there is pollution in some -- in the rivers. What I read from it is more -- is less a specific event, which has its impacts and could drive tightening and supply in China. So that's a very good thing. But also, whether we get more of this environmental focus and more of this focus to make sure that as operators are producing inside of China, they're living up to the standards that we all live up to.

Timna Tanners
Okay. Along those lines, Rio this morning was talking about actually on the smelters side, some confidence that the Chinese would shut down more of the coal-fired smelters in Northern China. And you mentioned that as being an important catalyst for the rightsizing, if you will, of the aluminum industry. What do you think about the probability or the timing of that happening?

Roy Harvey
Yes. I think it will depend on what happens in broader pricing. I think what we've seen is that the Chinese have been acting in an economically rational fashion. Sometimes, that tends to be tied up across the value chain a little more than what we would look at as separate business units and very careful not to subsidize a smelter with a refinery. But still, they act economically rationally.

I think -- and while Bill usually says this, the environmental inspections and environmental awareness seems to come in phases. There's certainly a push towards trying to create less pollution and trying to create bluer skies and air that can actually be breathed. So I think that tends to push against the coal-fired facilities and push it more towards renewables in other parts of China.

And so the other aspect of that is that we've also seen a lot of good progress over these last two years of China actually enforcing its operational permitting and enforce its environmental standards. And I think that has been a sea change of the elimination of unconstrained growth. It doesn't mean you've eliminated growth in China completely, but it does mean it's being done in a more logical and more planned fashion. And in the end, it increases the capital cost because they need to start putting in the pollution controls, et cetera, which then again starts to get to a more level playing field.

Timna Tanners
Fair. So let's switch to the demand side. Last year, Chinese demand growth was at 3%. It was disappointing. Why was that? And is that a change in the dynamic? Or do you think that that was a short-term phenomenon?

Roy Harvey
Yes. When we look at Chinese demand, you need to break it up into its component pieces. There is the domestic demand that will go into infrastructure, into building and construction, into overhead power lines, into automotive, that in the end is consumed domestically.

And then, there's the two types of export demand. There's the semi fabricated products, which is really that first step in the value chain and tends to be can sheet as an example, or simple extrusions. And then there's the fabricated piece that's sort of the content that's aluminum that goes into cars and trains, and et cetera, that gets then exported into the wider world.

So we try and monitor all three of those aspects. And what's certain is that there has been a dampening, particularly in some of the domestic consumption, and that obviously is a place that we have a lot of concern because China has been such an engine for growth. I'm not sure we've yet seen the positive impact for some of the latest measures to try and stimulate growth. So that, to me, is still a place where we can see some more there, but that tends to borrow future demand and puts it into today's demand.

You still are seeing that China is stepping into more and more of the semi fab businesses into the fabricated business, I mean it’s their stated industrial policy. That from a global balance standpoint, isn't a big deal because it's pulling demand, but it's not changing global demand, but it is pulling more of the demand into China, which then stacks to a certain extent the supply/demand in favor of smelting material in China.

So in the immediate term, I think, there certainly is some pressure on demand. I think that we'll see some improvements because of the supply side measures that they're taking to try and stimulate that demand. And when we look forward, I think we continue to see China as a continuing engine of demand growth, but then also of matching supply and that demand and not trying to get into an oversupply position, particularly on primary.

Timna Tanners
Yes. That makes sense. All right. So before we switch over to talking a bit more about Alcoa proper, I just did want to ask you to be fair, we wrote a big primer, our firm did, and a lot of it

really was dedicated to the concerns over Guinea building up excess bauxite and therefore excess alumina and therefore excess aluminum. I wanted to give you a chance to ask you if you think that's a legitimate concern and over what timeframe or why or why not?

Roy Harvey
So I think it's -- I don't know if concern is the right word as much as it is an important consideration. So what is certainly true is that we've seen refining capacity growth -- significant growth inside of China, so the need for bauxite is growing very quickly.

The ability for them to source bauxite domestically has been dwindling. And in fact is, with the environmental measures and just the cost pressures and the quality of the bauxite, it doesn't make a lot of sense to run domestic refineries, which means that growth is being fed by imports, by export of bauxite from other countries.

What's important to remember here is that that market is going to be growing very significantly, whether you look at a doubling or tripling over the course of a number of years. It is a massive growth and a massive need to be able to move material from some place into China.

Now some of that will come from Australia. Certainly, some will come from Indonesia, but Guinea's sort of rampant and almost unconstrained growth up to now has been a very large source in the short term and have expectations to be into the long term.

Guinea, we've been in Guinea now for 45 years, I believe, as part of CBG. We found it to be a very stable place to operate, but we've also taken some very careful consideration on how we operate, how we connect with the community, how we connect with the succession of governments.

So Guinea is very complex. It is not an easy place to do business. I think some of the action up till now has -- or some of the newest capacity up till now has been focused on pulling as much as you can from the sides of the rivers and barging it to a floating transloader. That can only work for a certain period of time before you need to start putting in more capital for rail lines, for transportation hubs, to look at a more optimized view of the deposit.

So I think Guinea is, because of the quality, because of the characteristics of the bauxite, it certainly is going to be a part -- an important part – of that future growth. I think it will naturally evolve into a more sustainable focus and less environmental and more sustainable mining optimization of a mining resource going into the future.

And that again then becomes much more of a level playing field. And we look at Alcoa and our CBG joint venture, create opportunities because we have an existing footprint. We have the ability to expand and, I would argue, we have the reputation that can choose to grow if we find the right business case on the other side.

Timna Tanners
Okay. Helpful. So as promised, let's talk more about Alcoa. So when I think about your initiative, I think about optimizing your existing assets and pruning where necessary. And then we'll talk about capital allocation. Do you mind expanding on those topics and any I missed about kind of the strategy at Alcoa?

Roy Harvey
So we broke our strategy into three pieces, and pruning isn't necessarily one of those, but it's embedded inside. We reduced complexity, and reducing complexity means we try and do things simpler because we recognize we're a commodity player, and thus, the better we can do on overhead, the simpler we can be, the stronger that we'll end up.

We drive returns, which means we're smart about investing in our businesses, but also very smart about what we put into our sustaining capital and to running our operations, maintenance, et cetera. Living through the cycle and not doing dumb at the top of the cycle and not doing dumb at the bottom of the cycle but trying to have a long-term perspective.

And the third is to strengthen the balance sheet. And part of that activity of strengthening the balance sheet is to have the right debt mixture, but more importantly, it's also to deal with some of the long-term liabilities. And some of those can be, for example, the Rockdale power contract, that was a long-term drag, $80 million a year likely on our EBITDA. Some of it dealing with those types of things, but others also looking at our portfolio and across our portfolio.

So the action we took recently and I'll mention two things. Number one, we brought the Warrick plant up to partial operation last year. That was to feed the rolling mill. It is not the newest and most modern of smelters, but it is the best source of material that we have going into the Warrick rolling mill. On the other side is the action we've been taking and are considering or continuing to negotiate or follow along the path we've already negotiated in Spain with the two small Soderberg facilities. We're in the midst of evaluating offers and we'll then move on to the next steps going there.

Other portfolio actions outside of that, I would argue that Alcoa has gotten very good at looking at it on an asset-by-asset basis. We have other assets that need action, whether that is investments or pruning or finding a better home for them. And I think part of our job over these coming years is going to be to continue to act on that portfolio to make it stronger, so that through the downturn, we're not suffering. And that, to me, is tied up in that strengthening of the balance sheet to make sure that we are clearly a growing concern for the long term

Timna Tanners
Okay. I just want to touch on real quick the can sheet side because we talked about kind of all the business, we didn't really talk about the rolling side. Is that on the mend? Can you just give us some quick thoughts about do you want to be in can sheet? Can you move more into automotive sheet? How do you look or the finishing end of the downstream?

Roy Harvey
So pros and cons, we're not necessarily looking to be across the value chain. We try to be very focused on building value at each of the steps and not subsidizing one to the other. So we don't necessarily see that we need to have a rolling mill so that we can keep creeping into more and more value-added activities. We want to be really good at what we do.

The can sheet facility that we got as part of separation needed a good amount of work in order to bring it back to really what makes a can sheet work well, which is better pricing and high volumes. It's just a big set of fixed costs.

So it represented a lot of opportunity for us to improve operations and for us to drive profitability. And I would say, over the course, with a better metal input, the Warrick smelter restart, improving contracts and just getting more volume through the mill, we are seeing a real recovery and a really improved EBITDA generation potential.

However, we lack that strategic portfolio of assets where you can have automotive on this side and can sheet on this side. It means we don't -- we have less of those strategic opportunities. So it's a place where we look for how to continue to make that business stronger and better, while at the same time looking for how can we also partner more with our customers and drive a long-term view with that business.

Bill Oplinger
And in that particular asset, when we took it over at separation, it was about a 600 million pounds facility. We've been able to ramp it up to over 700 million pounds on the way to 800 million pounds. And as far as going into automotive, we've got a non-compete with Arconic that --

Timna Tanners
For now, right?

Bill Oplinger
For now. Lasts four years from the date of separation.

Timna Tanners
Which means it's got another --

Bill Oplinger
2021.

Timna Tanners
Okay.

Roy Harvey
But we've also seen a lot of move towards automotive production in the U.S. and a lot of automotive rolling linked production, which has made can sheet a more interesting place to be because so many people have jumped into it.

Timna Tanners
I was going to ask, has that really played out? Like have we seen so much of a dearth]of supply now to can sheet where can sheet is compelling or is it still in --

Roy Harvey
I'm not sure I would use the word dearth, we have seen improvements. And remember, these are typically three- to five-year contracts and you typically see them -- you see this move at, what, from a commodity standpoint where our cycle seemed to come every nine months now, it moves at almost glacial pace because you're replacing -- you are seeing improvements in margins. You are seeing improvements in these contracts, but it is not reflective of a complete lack of product inside of the States where you're doubling your margins, et cetera.

Bill Oplinger
The other thing to keep in mind is that the environmental footprint of the can is so good that we're seeing growth in can manufacturing in the U.S. So it's a good, strong, growing market.

Timna Tanners
Okay. So we'll ask -- we'll follow-up in 2020 on some of these things, et cetera.

All right. So with that, I did want to start gearing the conversation to more capital allocation. This year, as you mentioned, you're doing some restructuring with the Spanish assets and there's investments or costs involved with that. But as I think into 2020, I think, assuming the pension goes in the right way, assuming equity is cooperating, interest rates don't go down more, I guess, but assuming things move at least steady from here, there -- and you assume all else equal, there should be some cash generation after AWAC and after everything. Can you just remind us about how you think about returning cash to shareholders or are there other big projects that we should be budgeting for when we think about your cash outflow?

Bill Oplinger
Sure. So we went out with a midterm capital allocation strategy at the beginning of this year. And what that capital allocation framework basically says is we want to maintain $1 billion of cash on the balance sheet. We'll continue to invest in the plants. We're currently projecting about $300 million of sustaining capital for 2019, $150 million of return seeking capital for 2019. That's all generally on small growth projects. We will meet -- we plan on contributing to the pension plan for the mandatory payment. That's roughly between pension and OPEB, roughly $300 million.

And then beyond that, there's three areas that we'd be looking at deploying capital. Those three areas that we'd be evaluating, shareholder returns, obviously. Secondly, further de-leveraging. We went out with a deleveraging target of $2 [billion] to $2 and a half billion of proportional debt, pension and OPEB. We stand currently at about $3.3 billion. So we have a little ways to go. We think we can make that target over the next three to five years just by putting in the pension contributions that are required. And then, thirdly, we are looking at growth projects. We have growth opportunities specifically in mining and refining that over the next few years we'll evaluate.

Timna Tanners
Is there anything you'd want to highlight now? I remember I spoke to your team a little bit about the -- some report that we saw about an expansion, if I want to say the Pinjarra refinery in Australia. And just wondering if there's anything that we should specifically be watching for as options.

Roy Harvey
Yes. I think where we're sitting right now is that we're looking at a range of options. And so Western Australia is an incredible footprint located right next to a bauxite deposit. These are massive refineries and have the opportunity to become even more productive, both Pinjarra and Wagerup.

Sao Luis, which is a large refinery, has an integrated smelter that right now is curtailed and is also close to our Juruti bauxite mine, which is expandable as well. I mean, all three of those are sort of competing for what has the best project for that next leg up. And then also has the right market characteristics to make that successful.

So, from a refining standpoint -- and then the knock-on impacts of bauxite, those are the places that I would say, hey, these are places where you really want to be investing money in the future, if you can find the market fundamentals to solve. But again, until we feel confident that market is there, that we have a project that's truly a winner for our shareholders and brings better than cost of capital, we'll highlight more when that time comes.

Timna Tanners
Fair enough. All right. So before we turn over to those in the room, I realize we didn't really ask about trade. I guess I came to the conclusion when Section 232 was announced, that you're kind of in the middle, like you benefit in some ways into the U.S., but you're hurt because of your Canadian operations, but just any updated thoughts about the impact of any of these latest trade discussions, if it does have any impact or your latest thoughts, if any, on 232?

Roy Harvey
So from a financial perspective, there is a positive for Alcoa, given what's happening with 232.

Bill Oplinger
Approximately $100 million a year, right. And essentially, what that assumes is that the 10% tariffs increase the Midwest premium, we saw the Midwest premium go from $0.09 to $0.10 to $0.19, essentially creates a pricing umbrella for our U.S. assets that generates about $100 million of benefit a year.

Roy Harvey
And we would like for the Canadian metal also to flow into the States and not have to be paying a tariff. So that is where there's -- where it is less than what we had thought would be the case.

So take that immediate short-term impact aside and transitioning to a more medium and long-term view. While we enjoy the benefits and that has a very good financial outcome, we're very concerned with two things. Number one, sheltering higher cost capacity and essentially exacerbating the issue that we've seen in our industry now for decades. And so trying to drive an agenda that creates that umbrella around facilities that are significantly older is simply not something that we think makes good economic sense nor does it make for the right example and therefore, that right platform when we go to talk to China about their highly subsidized capacity.

And number two, we try to think about our customers. And the problem that we have now is that as China continues to grow its semi-fabricated and fabricated footprint and tries to steal demand from the rest of the world into China, we're almost making that situation that much easier in the U.S. because now U.S. producers of extrusions and cans, et cetera, their cost of metal is now that many hundred dollars more than their competitors in China. And so it ends up starting to impact the demand inside of the U.S., and that doesn't happen in six months or nine months, it might happen over a course of years.

Timna Tanners
We've seen it in steel, too. So you do not see Section 232 potentially extending to finished aluminum products? Is that not on the table?

Roy Harvey
I don't think we have a forecast of where those tariffs will end up going. I think it could be that direction, but then again, it's just that next level of value. Now you have your U.S. consumers paying more for their cars. And I realize that it might be a rounding error when you look at it in an industrial scale, but when you come to a personal scale, it's different.

In general, so take the 232 piece and set it to the side, we're very clearly -- we just think the tariffs don't make sense. Quotas are almost unworkable because of the rush to get metal in and then not being able to get the material that our customers actually need, so it's that next order of craziness inside of the market.

When you look at the general trade environment, which we find ourselves, and you think about how closely tied aluminum is to the economic cycle, all of this uncertainty, no doubt, is having an impact on aluminum pricing. And how much of that impact, or quantifying, and I don't know, but it is certain to me that all of this uncertainty, all of this unrest, all of these fights and knock-on impacts in economic growth in China, U.S., Europe, et cetera, is having an impact on the broader industry.

And for us, global growth is the right thing because that then feeds into what is already a very positive demand story in aluminum and match then with real supply, real care in how much supply is coming to the market, I think it provides those catalysts that you talked about in the beginning for seeing a sustained improvement in pricing for aluminum.

Timna Tanners
Okay. Super. Do we have questions from the audience? Yes, James?

Unidentified Audience Member
So it looks to me like in China, they're not storing the red mud correctly and there's concerns about the way that tailings dams are being constructed in that country. So hearing the news around Shandong and potential closures there, does it seem like it's a structural issue that they're going to have to address that's going to take years? And if that's the case, what impact will that have on your industry?

Roy Harvey
So tailings are one of those most important topics. They always have been very important, and important for Alcoa, but also important for the broader industry. But with the recent events in Brazil particularly, it just becomes all that much more obvious, the potential catastrophic impact that a failure can have.

So when you look at China specifically and you think about the fact that there has been relatively little supervision on how that bauxite residue is managed, much less how those alumina refineries are growing and are operating, I think it is a relatively undiscovered country for what a closer environmental awareness is going to drive inside of the industry.

You've seen more in aluminum, you've seen more in bauxite. You started to see impacts in both of those, although really dealing at the edges. If they get very serious about dealing with tailings and dealing with alumina permitting and operation, I think it could have a very positive impact on creating a more level playing field.

In Alcoa, we are very proud of what we've developed as far as the tailings management system, but we're also very cognizant of the fact that we need to be continuously improving and finding ways to make those tailings dams even more secure and learning from what happens to some of our peers.

I think this could be a turning point where China takes that much more seriously. As far as the depth and breadth of the problem, it's hard to say for sure, but when you think of the publicity that tailings dams failures has gotten in Brazil, et cetera, this is really the first tailings dam problem in China that's gotten more press and more outrage.

We've seen them before and you've seen the mayor come out two days later that says, “Hey, what's important isn't the failure, it's getting back up and producing at full speed.” So this is a fundamental sea change in the way that they're -- that this is being publicized in what I would hope is a way that they're starting to deal with it for the benefit of the industry.

Unidentified Audience Member
Okay. Just a quick follow-up. I understand there's a movement in the industry towards certificating low carbon aluminium, is that the case? And do you think that carbon emissions will become a differentiator for your company and others?

Roy Harvey
So absolutely, there's move towards a few different fronts. Number one is to have very specific products that might have recycled content or low carbon content that then customers can choose to purchase. So that's sort of a niche market that I would say is growing and where you're starting to command some premiums about very specific products.

On the other side, it’s also -- and I'll take the Aluminum Sustainability Initiative as an example of this, where you’re trying to certify cradle-to-grave in the way that you drive your sustainability, your community outreach, environmental programs from the bauxite mine to the refinery, to the smelter to the end customer. That has that -- not only does that support the product strategy, but then that also supports trying to build back the ability of an industry to compete with places like China where perhaps the environmental standards are not as developed.

The third piece then is to think what are those breakthrough technologies? I'll mention ELYSIS, which is a joint venture that we have with Rio Tinto and Apple where we've been working on technology for decades. In fact, our founder was trying to find how do you work with an inert anode rather than working with a carbon-based anode.

As that joint venture develops, as we continue to make breakthroughs there, that has the ability to make the lowest carbon aluminum in the planet when paired with hydroelectricity or some other renewable form of power. So that is that next step that will then redefine what is possible inside of aluminum, and just changes the whole structure of the industry or could change the whole structure.

Timna Tanners
Well, that's a great note on which to end the presentation. Thank you very much for everything and for joining us today.

Roy Harvey
Great. Thank you, Timna. Thank you for the question.