Alcoa Corporation

Credit Suisse 33rd Annual Virtual Basic Materials Conference

Tuesday, September 15, 2020, 9:30 AM EDT

CORPORATE PARTICIPANTS

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

OTHER PARTICIPANTS

Curt Woodworth – *Analyst, Credit Suisse Securities (USA) LLC*

Alcoa Corporation
September 15, 2020
9:30 AM EDT

Curt Woodworth: All right. Well, good morning, everyone. I'm Curt Woodworth, Credit Suisse metals and mining analyst. And we're very pleased to have Alcoa with us today for our virtual NDR fireside chat. From Alcoa today is CFO Bill Oplinger. Bill, I think it'd be helpful to maybe just start the discussion, if you could provide a general update sort of operationally, how you've been managing through this COVID crisis, and how you see the business performing going forward into the back half of the year.

William Oplinger: Thanks Curt for having me. It certainly has been a tumultuous year with COVID hitting in the early part of the year. I would, however, get back to the latter part of 2019. And to some extent, I feel some of the actions that we took got us ahead of some of the tumult that's occurred this year.

Going back to October of 2019, we launched three key strategic actions. The first was the new operating model, where we said that we eliminated our business unit structure and went to a Global Chief Operating Officer, Chief Marketing Officer structure. That allowed us to take out significant overhead costs, but also allowed us to really run the business in a more optimized way. And I would tell you, that set us up for good performance through the COVID pandemic.

We also announced non-core asset sales, $500 million to a billion dollars.. We executed on the first of those in the first part of the year when we sold our Gum Springs site. We announced a portfolio review of putting smelting portfolio at 1.5 million metric tons, and refining portfolio, 4 million metric tons, under review. We subsequently acted on the curtailment of Intalco, which was completed in the third quarter of this year. And we're in the process of collective dismissal discussion with the workers in San Ciprián smelter.

In addition to that, we announced in the early part of 2020, as we saw some of the key markets that were struggling before COVID, that we were going after a leaner working capital and lower production costs, each of about $100 million of financial benefit in 2020, and those are progressing well. We believe in aggregate we will achieve the $200 million in 2020.

And then lastly, when COVID clearly hit, we took further actions. And so a number of COVID response actions. First, we reduced our overall capital spending by an incremental hundred million dollars, put our growth programs on hold, and then reduced environmental/ARO, and some hiring and travel reductions. And then a large one is a reduction – I should say – in our deferral of pension contributions from 2020 to 2021. But I think all those actions put us in good position to make it through the pandemic, both from an operational perspective, and from a financial perspective.

If I just briefly touch on how we managed through, or have to this date, managed through the crisis. We've had approximately 600 employees that have been impacted by COVID. Ninety-seven percent of those have returned to work at this point. So we're seeing that haven't had significant impact there. All of our operations have continued to run, and this is really a testament to the work that our operations team put together early on, on having response programs. And looking at staffing and some of the work that they've done to make sure that all the sites are good to operate.

So from my perspective, I think we were able to get ahead of this, and have again, at least till now, managed through things successfully and plan to manage through in the coming month.

Curt Woodworth: Yeah, no, the performance has been great. I think last quarter, alumina and bauxite set records in production, which is pretty remarkable in this type of climate. In terms of the portfolio review, I believe you had identified some of the productivity targets you outlined this year are for 10 to 75 million of benefits from now, which I assume would be maybe some benefit from Intalco or Bécancour coming back up. Can you just walk through operationally how you see the portfolio sort of shifting in the next one to two years? There's been some discussion on the power situation in Australia and to your point, you have other assets under operational review. Can you help frame the opportunity set productivity-wise the next couple of years in the business, different things you're looking at?

William Oplinger: Sure. In October, we announced on the smelting side, 1.5 million metric tons under review. Out of that, there was a certain piece of that that was already curtailed. So there are a number of sites that are curtailed, the Alumar smelter, Wenatchee smelter, parts of Intalco were already curtailed. So, we essentially said that over a five-year time period, we'd be looking to fix, close, or sell those sites. And it's important to understand that fix is included in that list of options, so it's not necessarily that we're looking at curtailing or closing 1.5 million metric tons. We would also consider better power contracts or better agreements to try and make those more competitive. As we get to the end of that 1.5 million metric ton review, one of the things that's important to note is that it will, assuming that many of those are either curtailed or sold, we will be in a much better position from a carbon footprint perspective than what we're positioning today. We're in good shape from carbon footprint, but we'll be, we believe, the lowest carbon producer after that review is done.

So, if we come back to today, we took action early on Intalco, and Intalco was just not competitive at the current pricing in the current situation, so we were able to get Intalco curtailed in the third quarter. We've announced the collective dismissal process on the smelter in Spain. We announced that back in June, we've extended it out a little bit to go through a potential sale process. Later in September, we have a date that we have to meet with the works councils, and the unions, and the government, to see where we stand on that sale process. So we're executing systematically on that review and we'll continue. We've given ourselves five years to do it, and I think have made good progress through the crisis of COVID.

Curt Woodworth: And in terms of the carbon strategy for Alcoa, you've also been somewhat at the forefront on looking at developing carbon free aluminum with ELYSIS™. And then there's been a lot more discussion on green aluminum and I think potentially an LME contract for lower carbon aluminum, which I would think would position you very, very well, certainly relative to the Chinese aluminum producers.

Can you talk to that, and the level of importance within the organization, and maybe any timing on some of those efforts?

William Oplinger: Sure. So, carbon is one part of our sustainability strategy. And so, we'll focus on carbon in this discussion, but sustainability is broader than that for us, than just the carbon footprint. We believe that it is very important for the market to go towards a green carbon standard for the market to continue to increase for green aluminum products that are low carbon. We think that's a positive for the industry. It's positive for the impact on the environment.

We have been on the forefront of this. We have launched a couple of products, one called ECOLUM™ and ECODURA™. ECOLUM™ is a low-carbon product that we've been able to develop, that's based on hydro power. And it builds on the fact that our refineries and bauxite mines are the lowest carbon footprint, and the lowest carbon intensity refineries in the world. So, I think we're well positioned there.

As you've mentioned, we are partners with Rio Tinto in the ELYSIS™ project. ELYSIS™ made good progress in 2019. It was slowed a little bit in 2020, because of COVID, on the building of the research facility up in Quebec, but we continue to make progress there. ELYSIS™ will be a tremendous breakthrough in the industry. It will provide for zero carbon in the smelting process, and will really position us and Rio Tinto as the leaders on low carbon.

Again, I would say, the greenhouse gas emissions are only a part of the ESG strategy that we have. ESG strategy includes things like the community work that we do in each of our communities, leveraging the Alcoa Foundation to make sure that we're investing in the communities that we're in. So, I think from an ESG perspective, we are in pretty good shape.

Curt Woodworth: Okay, great. Maybe shifting gears a little bit to more sort of the macro environment. Clearly, China's had a pretty strong demand recovery and metal prices have responded. It's been a little bit more uneven in the rest of the world. Can you just give us some updated thoughts on what you're seeing supply/demand-wise in aluminum, and then given with interest rates so low, it does seem like we're seeing more activity in terms of the warehouse finance trade going on. So even though you did see some inventory build in aluminum, probably some of that metal is really not even available to consumers. So,just give us an update on what you're seeing or any recent developments in the aluminum market would be great.

William Oplinger: Sure. So, we are seeing some signs of recovery outside of China. We're starting to see an improvement in transportation and construction industries in the rest of the world. There's still uncertainty in the rest of the world, but as you say, the Chinese demand has rebounded in 2020. And so the picture in our view is bright, brighter in China than what it had been. We're seeing rebounding manufacturing activity, continued supportive policies, and so a strong V-shape recovery in China that we believe will drive aluminum demand to be equal or better than what we saw in 2019.

As far as the inventories go, we've seen a little bit of a decline of inventories in between June and August. As you said, the aluminum futures curve is in contango, so there is a cash and carry trade. That contango is pretty strong, and with the low interest rates, we do see a strong demand from inventory financing, like we've seen at times in the past.

Ultimately, supply and demand will dictate the premium in each of the regions. We've seen premiums increase with the elimination of the Canadian exemption in North America. And we believe that we're starting to see a recovery in the rest of the world, and strong recovery in China. And as you said, the LME inventories are supported by the cash and carry trade.

Curt Woodworth: And then, within China, there's always this ever-present kind of fear that they're going to continue to build more capacity and look to export, but the net trade balance has been relatively neutral, and you've had more countries like India recently came out and as evaluating putting tariffs on Chinese materials. China in general is a high cost producer. So, I mean, do you feel like the China supply/demand balance is actually pretty tight just given the demand, and any update on the supply side, in terms of what you're hearing in China and also ex-China?

William Oplinger: Yes. We would expect that full year 2020 supply/demand balance in China is relatively balanced. And the reason that is, is we saw some constructive curtailments earlier in the year and some capacity growth later in the year. But for 2020, we're anticipating that China is balanced.

We have seen an increase in both alumina and aluminum prices, with the recovery in China and the rest of the world. And at this point, we would typically talk about how much capacity in the world is cash negative. And today in the alumina side, we would say that probably less than 5% of the Chinese production is cash negative. That's a little bit lower than what it was reported in the second quarter of 2020.

And on the aluminum side, there's very little production, if any, that is cash negative in China. So the rebound in pricing has resulted in the Chinese facilities to be at least cash neutral.

Curt Woodworth: Okay, and then in terms of the balance sheet, and capital structure, and the pension. You identified the $900 million of cash levers pull, which should set you up to be in a pretty strong position next year, given if aluminum and alumina prices hold. So, can you discuss capital allocation strategy coming out of COVID? It seems like you'll be in a pretty healthy position with over a billion in cash on the balance sheet. What are the strategic uses for cash going forward? And any updates on the pension liability right now as well would be great.

William Oplinger: Yeah. So, let me address the pension liability first. You know that since we launched as an independent company, back in 2016, we've been extremely focused in trying to reduce the pension and OPEB liability and have made consistent progress over the years. We did two large annuitizations out of the pension back in, I believe it was 2018, and have continued to focus on that. We borrowed $500 million to set up a pre-funding balance in the pension.

That pre-funding balance gives us flexibility on being able to make contributions into the pension plan. And then we deferred, under the CARES Act, we deferred approximately $200 million of contributions into the US pension plans from 2020 to 2021. Now, before I go into 2021, let me give you an estimate of what the ending balance in 2020 will look like.

We started the year of a pension and OPEB balance around $2.3 billion, even at the substantially declining discount rates, interest rates, and discount rates, even with having deferred $200 million in contributions in 2020. We would anticipate the end of year, assuming today's discount rates and today's asset return, we would predict to be at around $2.6 billion in pension and OPEB liability. While it's a $300 million increase, it's a significantly better position than what we would have been in, given if we had not taken the actions that we have taken.

Now, let's fast forward to 2021. In our 10-K, we talk about contributing approximately $380 million in cash contributions in 2021, between pension and OPEB. We will, because of the deferral, that will increase to $580 million in 2021. However, like I said, we have a large pre-funding balance set up in the pension that we can take advantage of. The pre-funding balance is projected to be approximately $380 million. So as we go into 2021, we will watch cash flows, and we will use that pre-funding balance, if we don't feel the cash flows are substantial enough to cover the pension contributions, and do all the things we want.

Now, let me take it to capital allocation. And this all ties into the pension. Capital allocation, we start with trying to maintain a billion dollars of cash on the balance sheet. We've not been able to do that the last few quarters because of the COVID situation. But we'd like to rebuild cash on the balance sheet. We will sustain the operations, we've historically spent between $300 million to $400 million of CapEx, and we'll be updating that number in January 2021.

And beyond that, there's four uses of cash, and these are not necessarily in rank order. Those four uses of cash are further de-leveraging. You know, we have a leverage target. It's a proportional net debt target. So it would be further de-leveraging. Second would be returning cash to shareholders. The third would be repositioning the portfolio. It costs money to reposition the portfolio. You see that when we curtail a site, it costs us money.

And then the last is midterm growth projects. As I said, our growth projects were put on hold in 2020. We do have some growth projects, specifically in Australia and Brazil, on the refining side, that we could spend money on.

At this point, Curt, if I were to give you an indication of where my thinking is, a real priority for the company coming out of 2020 is further de-leveraging. And I believe, and we've done some work on this, that de-leveraging the company is the best way to unlock equity value. And so, you know and we've had this discussion before, we target an optimal WACC. We believe that the optimal WACC drives the greatest value of future cash flows. And my belief today, we want to get to our net debt target, our proportional net debt target. So I could see us doing further de-leveraging over time.

Curt Woodworth: And I guess to some degree, the cadence of that will be somewhat dependent on the timing of the asset sales. You mentioned $0.5 billion to $1 billion, I think you've completed roughly $200 million thus far. So, still a potentially significant amount of cash that could come in. Could you talk to any update on timing of that? Are there any material tax consequences of some of the assets you're looking to sell? And just give us an update? Thanks.

William Oplinger: Sure. We announced, back in October, $500 million to $1 billion dollars of proceeds from asset sales. We executed on Gum Springs. Gum Springs generated $200 million. It had very little to negative EBITDA. So it was a really good sale. We have a contingent payment that we're looking to be able to get of approximately $50 million on Gum Springs. Beyond that, the only asset that we've publicly stated that's for sale, is the land down in Texas. And we continue to work through that land sale.

And we've committed that we will have our asset sales completed by the end of the first quarter of 2021. I will tell you things have gone a little bit slower on the asset sales, simply because of COVID. It's very difficult to get people into sites. It's very difficult to do due diligence with some of the restrictions that we've had. We're still committed. We'll give you an update at the end of the third quarter, and we're still working towards those assets.

You asked about tax, and I would make a couple of comments around tax. First of all, depending on where the assets sales are, we have large net operating losses in the U.S. that are trailing. And so we would be able to take advantage of any sales in the U.S., that those would largely be tax free. If I can have a little bit of a tangent around tax, as you know, and I'm sure as you know clearly, we have a fairly complex tax situation. We make money in certain places around the world, for instance, in Australia. Therefore, we pay taxes in Australia. We lose money in certain places around the world, for instance, in the U.S., and therefore we don't pay taxes in the US, and that leads us to having a fairly strange effective tax rate from time to time.

And so, as we look out into the third quarter, we estimated the tax expense, the income statement tax expense to be about $150 million in the third quarter. I think that's going to increase to $225 million in the third quarter, simply because we're changing our projection of full year taxes. Actually, I should say full year profitability. Our view of full year profitability has increased since when we ran the tax calculation for the second quarter, and that will result in slightly higher taxes, third quarter, which should normalize out in the fourth quarter. So, a lot of complexity there, but with an improving market environment, slightly higher full year taxes with a piece of that getting recognized in the third quarter.

Curt Woodworth: So the $225 million for the third quarter, would that include like a catch-up tax payment?

William Oplinger: It does. Absolutely.

Curt Woodworth: Okay.

William Oplinger: It does. It includes a large catch-up tax payment for the year. If you recall, in the second quarter, we had a negative tax rate. And as we're projecting out into the full year, we get to a profitability, a pre-tax profitability level, and therefore drives a catch-up tax in the third quarter, which will to some extent reverse out [in the fourth quarter].

Curt Woodworth: Okay. And then, the working capital targets, I think it was $75 million to $100 million. You still feel like you're on track for those savings this year as well?

William Oplinger: Yeah. If you look at how we performed through the first half, I believe we are already over that at the end of the first half. For us, the real challenge is going to be, as we see higher prices and higher raw material costs through the end of this year, we will be really trying to maintain those lower working capital levels. And so that's the challenge.

As things improve in our environment, that tends to drive working capital, and we'll be working to offset that. But as I say, when things improve, as we're starting to see value add product sales come back and less P1020 sales, that drives higher receivables levels, but we're committed to that $75 million to $100 million target.

I would say the new organization that we set up in place at the end of last year, helps us facilitate that. We used to have three business units. They would manage their working capital within their business units. Now we look at working capital from end to end, from all the way, from raw materials to finished products, and everything in between. So we've got a team in place that is managing and optimizing working capital across the entirety of the organization, which should help us with those targets.

Curt Woodworth: Okay, great. And then, I guess with respect to, you talked about value-add, and value-add was pretty weak last quarter, with low shape premium. Have those markets started to come back? Can you give any update on maybe what your value-add mix looks like today, verse 2Q?

William Oplinger: We are seeing improvements in the value-add business, both in North America and in Europe. That is not necessarily resulting in higher value-add premiums. It is resulting in higher value-add sales. So we're not back to the levels that we saw pre-COVID, but are coming out of the bottom from the second quarter, and getting better in the third quarter.

Curt Woodworth: Okay. And then, I guess, geographically within your markets, we're aware China has come back pretty strong. But can you talk to sort of the cadence of recovery you've maybe seen in the U.S. versus Europe versus Brazil? Has there anything that's stood out to you or surprised you as we've come out of the 2Q low?

William Oplinger: I guess along with everyone else, I think, we were positively surprised by the strength of the Chinese recovery, and that seems to really have been driving alumina and aluminum prices. We are starting to see recovery in transportation and building construction, both in Europe and in North America. And then the other business that is probably not a surprise to anyone that has been very strong is packaging. We continue to see good, strong growth on the aluminum packaging side of the business. And that has, during the course of the first half, offset some of the weakness that we had seen in the other sectors. So that's the roundup of where we're seeing the market.

Curt Woodworth: Okay, and then, on the raw materials side, when you look at some of your bigger inputs, I know a lot of the power is somewhat LME-linked for the business, but when you look at, caustic soda, carbon, coke, other things like that, can you give us a sense for what those pricing dynamics have been like over the last couple months?

William Oplinger: Yes. The raw materials have been largely flat and maybe even slightly down. The only exception to that is some higher costs for Chinese calcined petroleum coke. Caustic prices in the U.S., Gulf, and Northwest Europe spiked up in the second quarter of 2020, but they've declined and are back to levels consistent with earlier in the year in late 2019.

I would say that is before any additional hurricane impacts, and so we'll be watching the various storms that are going through the Atlantic to see how those impact the supply of caustic.

Northeast Asian caustic prices are down about 3% in the second half of the year. Calcined petroleum coke prices are flat in the second half of the year. And they're up slightly in China, but flat in North America and Europe. Coal tar pitch, which has been stubbornly high. CTP's prices that have really been high. We're seeing it come down about 5% in North American and in Europe in the second half, it's flat in China. So I would tell you that raw materials are really just staying at a flat level, maybe even getting a little bit better.

Curt Woodworth: Okay. Then in terms of foreign currency, we've seen some pretty volatile movements. Is there anything to note there in terms of the third quarter?

William Oplinger: Yes. We have a presentation that we provided as part of this conference. In that presentation deck, there is a page on raw materials, I'm sorry, on currencies. It's not new information per se, we just want to make sure that people are looking at what the impact of higher currencies are in the quarter. And so if you look at that chart, and I don't have it in front of me, I think it's page 10 or 11 in the presentation, we're projecting out, as at the end of August, approximately $36 million in higher Forex impact in the third quarter versus the second. And all that's simply doing is looking at the reversal of the balance sheet reevaluation, second quarter and third quarter. But also the fact that the Aussie dollar has strengthened during the course of the third quarter.

Now that's not necessarily a bad thing in that I think it leads to higher alumina and aluminum prices, and we've seen higher alumina and aluminum prices, but it does impact our cost structure. And in the third quarter versus the second quarter, at least as of the end of August, we were projecting that was around a $36 million negative impact. That was based on, at the time, of AUD 0.71. Aussie has further strengthened since that time period. But as I said, this isn't really new information, we're just trying to make sure that people understand that our cost structure is impacted by the change in currency.

Curt Woodworth: Yep. Okay. That's very helpful. All right. Well, we have about a minute or two left, Bill. So I think I've covered everything on my end. Did you have any closing remarks?

William Oplinger: I guess my closing remarks, Curt, are back to where we started. We started to take action toward the end of last year. I really feel that our organization got ahead of some of the issues that we saw this year. I'm particularly proud of the fact that we've been able to operate well through this, through the pandemic, and the strategic priorities haven't necessarily changed. We continue to focus on our three strategic priorities and make progress against them. We announced the portfolio actions last year, we consistently are making progress against those targets. And I think we will get through the next few years, having repositioned our portfolio, strengthened our balance sheet, putthe company in a position where we are one of the lowest carbon providers, aluminum providers, if not the lowest carbon aluminum provider in the world, and really have strengthened the company in a time when it's been a difficult operating environment. So overall pleased with where we're going.

Curt Woodworth: Yeah. Congratulations on that. You definitely were ahead of the curve of a lot of companies, so kudos to you. All right. Well, Bill, thank you very much for joining us today. We really appreciate your time, and look forward to catching up soon.

William Oplinger: All right. Thanks Curt. See you.

Curt Woodworth: Bye.