Alcoa Corporation

Morgan Stanley 8th Annual Laguna Conference

Wednesday, September 16, 2020, 9:45 AM EDT

CORPORATE PARTICIPANTS

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

OTHER PARTICIPANTS

Carlos De Alba – *Analyst, Morgan Stanley Investment Research (U.S.)*

Alcoa Corporation
September 16, 2020
09:45 AM EDT

Carlos De Alba: Good morning, everyone, good afternoon, good evening, depending where you are joining us. Thank you for being present in this webcast, or fireside, with William Oplinger, who is Executive Vice President and CFO of Alcoa. Thank you, Bill, for joining us.

Before we start, I need to read some disclosures, so please note that this webcast is for Morgan Stanley clients and appropriate Morgan Stanley employees only. This webcast is not for members of the press. If you are a member of the press, please disconnect and reach out separately. For important disclosures, please see the Morgan Stanley Research Disclosure website at www.morganstanley.com/researchdisclosures, and if you have any questions, please reach out to your Morgan Stanley sales representative.

So, with that out of the way, Bill, again, thank you very much for joining us. As always, it's good to have you and the company participating in this conference that, unfortunately, it is virtual and we miss being live in Laguna. But nonetheless, things are going well, and we thank you for being here.

So, Bill, maybe before we start, do you want to give us a little bit of an update on what you are seeing regarding the COVID situation in your operations, any potential impact above and beyond what you have already mentioned in the past? And maybe translating, or doing a bridge, into how you see the alumina and aluminum markets amid the pandemic and everything that we are going through this crazy year?

William Oplinger: Sure. Thanks for having us, Carlos. It's always good to do this conference. I can tell you, though, it's a lot better to do it from Laguna than it is from the third floor in Pittsburgh.

It's been a tumultuous year, and I'll give you an update on how COVID-19 has affected our operations. I'm especially proud of the fact that our operations have been able to manage through COVID-19 successfully. We've not had any production impacts across the system. Our mines, refineries, smelters, cast houses, rolling mill all continue to operate and have strong protocols in place for managing through COVID-19.

Through the early part of this month, we've had a total of about 600 employees infected with COVID-19. 97% of those have recovered, and we've been able, as I said, to be able to manage through without any significant impact. Early on, we put together a crisis response team and developed response programs in every one of our operations, and I think that just has really allowed us to manage through successfully.

If we transition to the markets, we are starting to see a rebound in the aluminum markets, led by China, a very strong V-shaped recovery in China, broad-based in all of our major market segments -- construction, transportation, packaging. In the rest of the world, we're starting to see some strength in the rebound, and that, combined with the Chinese V-shaped recovery, has driven aluminum and alumina prices higher, and so that's been favorable. It feels like we've seen the bottom of some of the pricing that we saw at the beginning of the COVID pandemic.

So, overall, a good, strong recovery in many of the regions of the world. And as far as how much of the global supply is cash negative at these levels, we see globally that in alumina, we've got about 10% of the World ex-China that's cash negative at these price levels, probably 5% in China. And then, in aluminum, less than 5% World ex-China, and really very little cash-negative production in China.

So, overall, we're seeing the recovery hit and prices being [supported].

Carlos De Alba: Okay, and Bill, maybe a subset of the market, focusing on North America, this Section 232 has been on and off, on and off. Yesterday, we just had another update. What can you tell us as to how do you see the situation and, you know, and the latest measures announced yesterday? What are the implications, as far as you can say, for Alcoa in particular?

William Oplinger: Well, exactly like you said, Carlos, the tariffs have been on and off again over the last few years. I think that, and I guess our view is that the U.S. has made the right decision in removing the tariffs at this point on the Canadian smelters. You know, we have a presence in both the U.S. and Canada. All along, we have said that tariffs are disruptive. And so, given the fact that Canada is a vital trading partner, we believe that taking the tariffs off is favorable. And we've said all along that having tariffs or quotas is essentially disruptive to the market and runs counter to some of the principles that we believe in, which is free trade.

With that said, we are studying the announcement from yesterday. We need to understand it better. We will be seeking some clarifications on it. I can tell you that retroactive tariffs can be even more disruptive than regular tariffs, and so we need to understand it better. And we'll be reviewing the details of the order when it's released, to seek further clarity on it, but -- so more to come on that subject.

Carlos De Alba: Right, understood. And one of the, I guess, negative impacts of tariffs is on the downstream aluminum supply chain. So, on that, what are the latest views on the company's exposure to the rolling business in the U.S., particularly with Arconic noncompete expiring in, I guess, a month or so from now? How do you see the company strategy, or how does the company want to position on the rolling business going forward?

William Oplinger: Yeah, so the packaging business is one of the stronger markets that we've seen. It's been resilient through COVID-19. It appears to have good growth opportunities over the next few years. So, at this point, we are pleased with our position in the packaging industry. You know that Warrick produces largely end and tab, some body stock, some food stock, so it's a position that allows us to continue to grow with the packaging business. So, at this point, we're pleased with our Warrick rolling facility. Always opportunities for improvement, and they have plans to improve the profitability of the facility in the second half of this year, but at this point, strategically, Warrick is a good asset.

Carlos De Alba: Right. Fair enough. And just, I mean, talking about the portfolio, the company had been very proactive on addressing the difficult situation that the aluminum sector, in particular, has experienced, and it has put in place a streaming portfolio -- or a portfolio review with a focus on streaming it. And also, there are different actions that the company announced earlier in the year to reduce costs. Could you give us an update on both the portfolio review, as well as the successful implementation of the cost-reduction initiatives?

William Oplinger: Yes. I'll take you back to October of 2019. Within the last year, we've announced three sets of activities, and that started back in October of 2019. We came out with a strategic direction in October of 2019 that had a number of activities that we were initiating for 2020. Those were a repositioning of the portfolio, and so we announced a review of our portfolio of 1.5 million metric tons smelting capacity, 4 million metric tons of refining capacity. So we've executed,we've begun to execute on that strategic portfolio review. We've curtailed the Intalco smelter. We've permanently closed the Point Comfort refinery. And we've begun discussions on a collective dismissal process for the smelter in Spain. So, good, strong progress on the repositioning of the portfolio.

Secondly, we announced asset sales. We were anticipating proceeds of $500 million to $1 billion. We had completed the first asset sale in the first quarter, recognized $200 million of cash proceeds from the Gum Springs sale, with a $50 million contingent payment that could come over the next couple of years. We continue to work on our asset sales. The only announced asset that we have for sale is the Rockdale land and continue to work on that. However, we are in various stages of other asset sales at this point.

And then, thirdly, we announced the -- a new organizational design, where we eliminated the business unit structure. I think that new organizational design positioned us really well for going into COVID. At that point, we had reduced overhead by approximately 300 positions, took out, on a run-rate basis, $60 million of overhead costs, and, but more importantly, streamlined the operations, streamlined the reporting relationships, and have an end-to-end commercial activity that looks at the commercial activities, all the way from raw materials in to the product going out the door. And that positioned us well for the downturn that we saw coming out of COVID.

However, before COVID, in February, we saw that some of our markets were being negatively impacted, and so we announced two more initiatives, $100 million productivity challenge and a $75 [million] to $100 million working capital challenge. In aggregate, we feel that we will be able to deliver on those challenges for 2020. So good, strong progress on both of those. Especially on the working capital side, we had already achieved over $100 million of working capital improvement through the first half. Second half for working capital is really going to be trying to offset some of the price increases that we're seeing.

Carlos De Alba: And --

William Oplinger: -- one last thing. And then, in COVID, we announced a series of COVID-related actions -- travel restrictions, hiring restrictions, pension deferral. And so, the aggregation of all those three sets of activities is about a $900 million savings that we're looking to generate, and through the first half, we are on target to be able to generate that $900 million.

Carlos De Alba: All right, thank you for the update on that. And just on the portfolio or asset sales, you have given yourself a few years to complete those. But maybe because of the pandemic, should we expect that maybe you push out a little bit the timeframe on the time that you have given yourselves to complete these deals? I don't know, how much can you -- are you able to really pursue these asset sales under the current situation?

William Oplinger: Yeah, I should have put some timing around some of those programs. On the portfolio review, we gave ourselves five years on the portfolio review. On the asset sales, we only gave ourselves 18 months, and the 18 months is up at the end of the first quarter of 2021. We are pushing for the asset sales, but to your point, it has been harder to get progress on the asset sales than what we had anticipated, largely because of COVID. It's hard to do due diligence on site if you can't get anybody to the site. And as you know in your industry, it's just harder to get people together, given where we're at in the pandemic, so things are going a little bit slower.

Carlos De Alba: Alright. And then, talking about the working capital reduction challenge, I know very well that Alcoa is always focusing on that. I experienced that back in the day. But can you give us a little bit more details as to what are some of the specific initiatives that you guys are pursuing there? I've received questions from investors asking how much factoring, or transactions like that, is the company doing at this time, so if you can explain a little bit what is behind this, that would be great.

William Oplinger: I can, yes. Let me just start with the organizational design. This was a massive, and you remember your days at Alcoa, this is a massive change of our organization. We used to have three different business units. Those three different business units would be tasked with working on their working capital, and we would review how they were doing against their working capital targets. Very different mindset change for our company. We have now put the entire commercial organization, procurement, sales, marketing, and supply chain management, all together in one organization, led by one leader. That one leader oversees everything from raw material procurement, all the way to rolling mill sales. And he has an organization that is trying to optimize working capital across the entirety of the process. So instead of having silos of working capital, you're seeing an optimization. How does that impact it? Can you optimize alumina shipments from the alumina business into the smelting business and run that differently, based on having all of this put together?

Probably one of the best examples of what we're working on is some of the working that we have done around transportation optimization, really trying to minimize demurrage, making sure that shipments come in just in time, hit their slot to come into a port, and be able to minimize inventory levels down.

As far as the factoring question goes, the other nice thing about having this organization is there's a very, very tight linkage between the commercial team and the treasury team. So we know of any type of payment deals that are occurring, and we make sure that anything that's done is done at a cheaper rate than our borrowing cost, right? So there are no embedded terms deals within the organization that may be more expensive than the marginal borrowing cost. So, really, really have tight control over working capital at this point.

Carlos De Alba: All right, and Bill, continue on the line of cash flow generation or cash outflows and cash management, can you give us an update or a review of the pension and OPEB situation for the company? A lot of moving pieces. CARES Act definitely helped. You were proactive in prepayment, making some prepayments in the last few years that really helped, came handy this year and may come handy for the next year as well. So could you give us an update? Because this is also clearly an important focus of investors.

William Oplinger: Yes. One of the things that I think was one of our priorities coming out of Alcoa Inc. was really trying to understand that there would be cycles in our business and that we needed to future-proof our balance sheet. We needed to make significant improvements on the resiliency of the company. As part of that, in 2018, as you mentioned, we went out and borrowed money and established a prefunding balance in the pension. What that allowed us to do, and we knew it at the time, that if there was a down cycle and we wanted to skip pension contributions, we were able to do that through this prefunding balance.

In a cash flow situation like where we saw in the first half of the year, we were very much in a cash conservation mode. It turns out that the CARES Act came out in advance of us using our prefunding balance, and the CARES Act said that we could defer our pension contributions from 2020 into 2021. That's great for 2020. It just means that in 2021, we're going to be making higher pension contributions.

So let me put that into perspective. Our projection for 2021 was that we would need to make $380 million of cash contributions between pension and OPEB. Of course, these will vary, depending on what discount rates end up and asset returns, but a close enough approximation. If we defer $200 million of contributions this year, that means that $380 [million] becomes $580 [million] for next year; $580 [million] is a large number. So we do have the prefunding balance set up. That prefunding balance is currently worth around $380 million, and as we go into 2021, we will determine, based on how cash flow looks, will we make the contributions, or will we use the prefunding balance.

Just to wrap up this conversation, when you look at the balance sheet, and we came into the year with about $2.3 billion of pension and OPEB liability on the balance sheet. Discount rates have declined sharply. Asset returns have been okay. They've not been bad. But as we look forward, if the discount rates stay where they're at today and asset returns are the expected return on assets that we have, we would project that balance to be at $2.6 billion at the end of the year. Now that's a -- you have to keep in perspective, we didn't make our $200 million contribution, so to go from $2.3 [billion] to $2.6 [billion] is not a bad outcome in the environment that we're in. So I feel good that we've managed our balance sheet conservatively over the last years, and it positioned us for a situation like where we saw in the first half.

Carlos De Alba: All right. And where does this leave us, or leave the company, in terms of the outlook for cash returns to shareholders in the next couple of years, say? I know the commodity prices are going to do what they're going to do, but what is the company thinking on that regard?

William Oplinger: Right, so we have a program, a framework, for returns to shareholders. So the capital allocation framework that we have starts with $1 billion of cash on the balance sheet. We have not been able to maintain $1 billion of cash on the balance sheet. We'd be looking to rebuild to that level over time. So $1 billion cash on the balance sheet. Then it gets to sustaining the operations. We spend $300 to $400 million of sustaining capital a year, so we would be looking to sustain the operations. That, as you know, is lumpy, can be lumpy, depending on mine moves and RDA builds.

And then, beyond that, we've got four potential uses of cash flow. One is further de-leveraging. We've got a leverage target that's $2 [billion] to $2.5 billion of proportional net debt. We started the year at $3.3 [billion]; we would like to hit that net debt target. And you say, well, why? We believe that that's the best way to unlock equity value, is to reduce our debt levels.

Secondly is returns to shareholders. Thirdly is repositioning the portfolio. Repositioning the portfolio will cost money. We saw it at Intalco. We had to spend some money to curtail Intalco. You know, Spain will be expensive to curtail Spain, so that will cost money. And then, lastly is midsized growth projects. We have three growth projects across the refining system, two in western Australia, one in Brazil. And we will evaluate these four potential uses of cash.

What I can tell you that, at this point in the cycle, as prices recover, we are looking to do a lot of de-leveraging. We would like to see that leverage target hit. It will either be through prepayments of the 2024 bonds or contributions to the pension.

Carlos De Alba: The pension fund, okay. And talking a little bit about green aluminum, I mean, the company is well positioned due to its low carbon exposure and the initiative that you have in the joint venture with Rio Tinto. What is the outlook for green aluminum products to command higher prices, given that it is a very relevant topic, and at the end of the day, it should be recognized and you guys should be able to monetize those efforts?

William Oplinger: Yes, I think we're well positioned, not only on the green aluminum side, but overall ESG factors, but let me first address the green aluminum side. We've launched two products, ECOLUM™, ECODURA™. We've been able to sell those, and we've been able to command a premium for both products -- not large volumes. This is really a burgeoning industry, a burgeoning part of the industry for green aluminum, and I think we're well positioned.

And the reason why I say we're well positioned, we're one of the lowest -- we have one of the lowest carbon-intensity footprints for aluminum smelting, not currently the lowest, but we have the lowest carbon footprint for bauxite mining and refining industry. So we're well positioned. We think that the market should transition to a green aluminum standard. We've been supportive of the LME's green aluminum initiatives, and ultimately, we think that consumers will pay a premium for green aluminum versus high-carbon aluminum.

As far as ELYSIS™ goes, as you said, we have a joint venture with Rio Tinto. We're making progress. COVID slowed it a little bit in the fact that we slowed down the build of the research and development facility in Canada. But we're back on pace now, and we fully expect to have a commercialized product within 2024. I will tell you, this is an R&D effort, so there's always risk in R&D effort, but we continue to make progress on the ELYSIS™ [side].

Carlos De Alba: Okay, and then, other mining and metals companies are starting to invest in technology and the use of data analytics to improve the way they run things and the way they do business. Is Alcoa doing something similar? Can you comment some of the initiatives that maybe you guys are working on?

William Oplinger: Yes, we are absolutely doing something similar. We're largely doing it through our centers of excellence. As part of our centers of excellence, we've established a digitalization and automation group that is working on these initiatives, and they span from using drones for work out in the field to a lot of advanced sensor work and computation of advanced sensors. So we are spending effort and time. It's always a balance, right? We want to be a low-cost producer, so we're trying to make sure that the investments that we're making are the right investments on automation. But we have a group that is focused on it and, I think, making progress.

Carlos De Alba: All right, looking forward to hearing more details when you guys are ready. And then, we're running out of time, but I wanted to ask you also something that is important. There is a lot of NOLs in the U.S. that you guys have on your books. What is the potential to unlock value from those?

William Oplinger: Yes, and it's a good point, Carlos. We have roughly $2 billion in NOLs in the U.S. because of the losses that have built up in the U.S. over the last few years. We'd be looking at opportunities to monetize those NOLs in the future, but they'd be applied against future earnings in the U.S.

It leads to the point that is important to understand, and that is, we have a fairly complex tax structure. We make money in Australia. We make money in different parts of the world, where we end up paying taxes, and then we lose money in the U.S., where we have a valuation allowance against those losses. What that results in is, it can have, from time to time, extreme swings in our effective tax rate. As we go into the third quarter, we had guided towards $150 million of tax expense. Given our view,and just to be clear, tax accounting is based on a full-year tax accounting, so our view is that our profitability is getting better in the second half than what we had viewed in July. What that means is, we'll be booking a larger tax expense in the third quarter, which will most likely, depending on the market, reverse out in the fourth quarter.

So we're increasing our projected tax expense of $150 million in the third quarter to $225 million. That's based largely on a onetime tax catch-up. And again, it's based on the fact that our view is that full-year profitability will be better than where we had it in the June timeframe. So, a slight update to some of the tax guidance that we provided.

Carlos De Alba: So what was it, the new number? The $150 million goes to?

William Oplinger: $225 million.

Carlos De Alba: $225 million, all right. Okay. All right, well, thanks for that update. And, you know, with that, we'll wrap up. Bill, thank you again for joining the conference. All the best for everyone in Alcoa and with the operations. Good luck in the quarter and the rest of the year, and we'll be in touch soon.

William Oplinger: Thanks.

Carlos De Alba: Hopefully, next year, we'll see you again, live in Laguna.

William Oplinger: Yeah, thanks, Carlos. Very good to catch up.

Carlos De Alba: Thanks very much, Bill.

William Oplinger: All right.