Alcoa Corporation

J.P. Morgan Global High Yield & Leveraged Finance Virtual Conference

Wednesday, March 3, 2021, 10:00 AM EST

CORPORATE PARTICIPANTS

William Oplinger – *Executive Vice President and Chief Financial Officer, Alcoa Corporation*

OTHER PARTICIPANTS

Arjun Chandar – *Analyst, J.P. Morgan Securities, LLC*

Alcoa Corporation
March 3, 2021
10:00 AM EST

Arjun Chandar: Morning, everyone. My name is Arjun Chandar. I'm the high yield metals and mining analyst at J.P. Morgan.

We're pleased to have with us today, Alcoa. From the company, we have Bill Oplinger. We're going to run this as a fireside chat. So I'm going to turn the floor over to Bill for some opening remarks and comments on recent activities and Q4 results, and then we'll go into some Q&A.

As a reminder, please use the conference website in the audience "Ask a question" link in order to ask a question. I'll be keeping an eye on that throughout the session, as well. With that, I'll turn it over to Bill.

William Oplinger: Thanks, Arjun. Some overall comments around the company and the state of our markets. As we alluded to in January, our markets are seeing a very strong rebound. Demand globally has strengthened on a year-over-year basis. We're projecting global demand to increase by seven percent. We're seeing strength in all of our regions, all of our industries. So, in China and the rest of the world in places like transportation, electrical, packaging seeing year-over-year growth.

The market story is strong for the company. In addition to that, we're starting to see some reduction in growth in primary aluminum in places like China. China is committed to their self-imposed 45 million metric ton capacity constraint, and they've shown that most recently with some of the curtailments that they're projecting in inner Mongolia.

Overall, the market dynamics are strong for the company. As we look out into the first quarter, we guided towards some higher costs in the first quarter. Since that time, we've been taking action with the resolution of the San Ciprián strike.

In the near term, we think we've been able to close probably $20 [million] of the $50 million of higher cost. Again, not only with stronger market pricing, but better performance than what we had anticipated at the beginning of January.

Combination of those two factors lead us to overall higher profitability than what we had expected, and we'll have the resulting slightly higher tax expense. We are projecting probably an $80 [million] to $85 million tax expense in the quarter, given that higher profitability.

If I step back and look at some of the strategic activities that we have going on, we implemented the new operating model over the last year. Very successful implementation of that new operating model, where we eliminated our business unit structures.

We have executed upon the asset sale program and fully expect to close on the Warrick deal at the end of this month. Once we've done that, between the Warrick and Gum Springs, we will generate $700 [million] to $800 million of cash proceeds, so within the range that we gave ourselves.

That doesn't mean that we're stopping on asset sales. We still have the Rockdale land for sale and we'll be looking on the margin at smaller asset sales, especially in the transformation portfolio.

Lastly, we continue to execute on the priority of repositioning the portfolio. We announced back in 2019 an asset review.

Since that time, we've curtailed the Intalco smelter. We've initiated a collective dismissal process in Spain. Still working on the situation in Portland; the electric contract there ends in June, so we're still working on that.

So, I would tell you that, both from a near-term operational perspective and a longer-term strategic perspective, we're executing extremely well. So with that, I'll turn it back over to you, Arjun.

Arjun Chandar: Great, thanks. I want to drill down a little further on the global supply-demand picture, specifically China versus the rest of the world.

What factors do you think could potentially mitigate the projected undersupply of primary aluminum? Do you anticipate both within China and outside in 2021, and do you see the rest of the world as a bigger risk to the global growth story than China?

William Oplinger: As I said, we are seeing really strong demand across the board. In China, we're projecting that demand growth will be 10 percent on a year-over-year basis and recall that their demand decline wasn't that large in 2020. It's real demand growth over a 2020 that wasn't that bad.

In the rest of the world, we're seeing demand growth, and this spans the industries of transportation, electrical. We are seeing solid double-digit demand growth in the transportation businesses around the world. From a demand perspective, it feels as if the economies globally are strongly recovering. That's reflected in the LME price. It's also reflected in some of the regional premiums that we're seeing.

For instance, in the North American market, regional premiums have increased to over 16 cents per pound. We've seen stronger regional premiums in Asia. The demand side of the story is good.

As far as supply goes, we have not seen significant supply growth outside of China over the last few years. We believe that China is committed to hitting their self-imposed 45 million metric tonne cap and not going over that. They've shown that recently with the actions in inner Mongolia.

Overall, the supply-demand picture for the industry looks very solid.

Arjun Chandar: Thank you. Shifting gears to the bauxite market, your guidance in the Q4 release for 1Q21 called for lower quarterly results in Bauxite. Is that a function of typical seasonality, or are there structural considerations in that market that differentiate its outlook from primary aluminum?

William Oplinger: We made about $120 million of EBITDA in the Bauxite segment in the fourth quarter. We were projecting two large impacts in Bauxite going into the first quarter.

The first is simply a change of intercompany pricing between the Bauxite and the Alumina segment. That would take about $45 million worth of earnings out of the Bauxite segment and put them into the Alumina segment. That's really a reflection of lower bauxite prices globally. The second impact was a $25 million cost increase that was related to some good performance that we got out of our joint venture mines in the fourth quarter.

When I alluded to earlier in the conversation that we're seeing some better performance for the company, in part, that will be in the Bauxite segment. We will be able to offset some of the higher costs that we've seen in Bauxite. While we guided to a $50 million decline in first quarter to fourth quarter, we're able to pick up, we believe at this point, at least 40 percent of that through good operating performance.

Arjun Chandar: Thanks, and then moving to alumina, what steps can be taken to mitigate the impact of rising power costs in Alumina earnings? Can you talk a bit about the broad supply-demand dynamics in Alumina?

William Oplinger: Yes. Let's start with our Alumina position in aggregate. Recall that we make around 13 million metric tons of alumina and we have a first quartile alumina position on the cost curve. Not only do we have a first quartile cost position, but we have the lowest CO_2 intensity of any major producer out there. We have a large, low-cost, low-carbon, which will become more important over time, Alumina portfolio.

As far as the input costs, we have seen increased gas prices due to a contract that we signed back in 2015. That resulted in increased year-over-year gas prices in 2020 and will result in higher 2021 prices. We are taking the opportunity to sign some shorter-term lower-price contracts to offset that. You've seen some announcements out of Western Australia, where we've been able to lock in some lower-cost gas to offset it.

As I step back and look at the supply-demand picture for alumina, a little bit different than aluminum currently, in that the market is fairly well-balanced. We've seen prices hovering around $300 a ton. That's because there's enough bauxite in the world to meet demand, as the Chinese start to import again. We're projecting the Chinese will be importing over three million metric tons of alumina. That is taking up some of the supply in the rest of the world. Overall, a balanced market on alumina.

Arjun Chandar: Moving to ESG, obviously a big topic amongst the investor base over the last year to 18 months. What steps are you taking to increase operating efficiency and lower your carbon footprint at production facilities?

Where do you believe that Alcoa has the ability to differentiate itself on the ESG spectrum in the eyes of investors? Are there any capital initiatives that are being deployed to stay ahead of the curve here?

William Oplinger: Let me start with the second one first. I think that ESG is an opportunity for significant differentiation for our Company. If you disaggregate the words ESG, I think that we do well on all three facets.

If I start with a simple one, from the very start on the governance side, we launched the company with extremely strong corporate governance, shareholder-friendly governance. From having separated chairman and CEO, to a non-staggered board, to proxy access, we started the company with very, very good governance.

If I then move on to the sustainability side, for us, sustainability is, in large part, carbon and environmental considerations, but it's broader than that. It's appropriate engagement with our communities, it's strong respect for indigenous people's rights.

If I then back up to the environmental side, we are in a very good position from a carbon perspective. We are the lowest carbon emitter from an intensity perspective in refining. We have line of sight to being the lowest carbon emitter in the metal area in the aluminum side of the business. On top of that, we're working on breakthrough technology with the ELYSIS™ project that we have with Rio Tinto that would be a zero-emissions process for making aluminum.

If we then go to the product side, we're trying to use that advantage that we have on the process to launch products. We have a complete suite of less carbon-intensive products. We've got the EcoLum™ product, which is low-carbon aluminum. We have some really interesting charts in today's presentation that talk about how a carbon charge could impact the global aluminum cost curve. In addition to that, we're the only company who offers a low-carbon alumina product. We are now offering an EcoSource™ product, which is certified low-carbon alumina, which our customers can get a certification to show how much carbon is emitted in the alumina process. So I think we're really well-positioned from the ESG side.

Your first question was specifically, what are we doing on an operational basis? We've just recently, over the last few years, signed up for wind contracts in Norway to better position our Norwegian assets from a renewable energy perspective. And we actively look at carbon abatement projects throughout the system so that we can determine how we get the most carbon abatement for investments as we go forward.

In my view, overall, a really strong position for Alcoa. Only getting better as we transition over the next few years.

Arjun Chandar: Thank you, that's very helpful. As we move forward, can you talk a little bit about your thoughts on aluminum import tariffs and Section 232, in particular in the US? Where do you see the new administration potentially going, with regards to restrictive measures around global trade, relative to the old administration? How are you preparing your business, and what areas are you most focused on, with regards to adjusting to whatever impact may come on the import side?

William Oplinger: Great. Let's start with the basics. We fundamentally believe in globally free trade. With that said, we have not been supporters of tariffs into North America over the last few years. However, our primary belief is that the source of some of the disconnects on competitiveness is really around subsidies that have occurred in China and continue to occur in China. We reference the OECD report from a couple of years ago, which showed that much of the subsidies in our industry are going to Chinese companies by the Chinese government. We don't believe that necessarily, 232 tariffs solved that problem.

With that said, over the last couple of years, with tariffs on and off and on again, we've managed through that process. We've got a very strong position in both Canada and the U.S. and outside of those two locations. We'll manage through whatever structure gets put in place.

Lastly, I would make the point that we don't believe that, necessarily, this is on the top of the administration's list of things to do. They have a lot of undertakings with things going on and probably not their first area of focus.

Arjun Chandar: Great, thank you. Shifting to value-add end markets, in 2020, with the pandemic, there's clearly been an impact to the aerospace sector. As you look at your exposure in the portfolio to value-add and end markets, how quickly do you see demand recovery?

Could demand growth potentially lag the timing of a broader global reopening post-vaccine rollout as customers work through existing stockpiles, or have inventory levels during the pandemic been fairly well-managed?

William Oplinger: As we look at the market strength that I alluded to earlier, we are seeing our value-add product book [of] business grow. The low point was in the second quarter of 2020. We saw that the third quarter, we had growth in value-add products volumes. Fourth quarter was better than the third quarter. We're projecting first quarter to be better than the fourth quarter.

Overall, our value-add products business is recovering nicely and it's recovering in line with the overall growth in demand that we are seeing in the end markets.

When you referenced the aerospace business, aerospace for primary aluminum is a really small part of the primary aluminum usage. We would put it probably at around two percent of the global usage of aluminum. So, big changes in the aerospace market don't necessarily drive large changes in primary aluminum demand. Versus some of our customers, it's not that large of an impact.

Arjun Chandar: Thanks. Shifting gears to the balance sheet, we have a question from the audience. I'm going to start with, what is the current thinking on making incremental pension contributions versus repaying your bonds maturing in 2024?

William Oplinger: Again, let's step back and look at it in totality. We ended the year of 2020 with $3.5 billion of proportional net debt. We have a target of $2 [billion] to $2.5 billion of proportional net debt. The $3.5 billion is the aggregation of the funded debt, pension, OPEB, offset by the Alcoa share of the cash position. We are committed to getting to that target, the $2 [billion] to $2.5 billion. We think that with the sale of Warrick and some cash generation and contributions to the pension, we should be able to get to that over time. It will potentially be a mix of further pension funding and funded debt reduction.

We are committed to getting our pension funded. We believe that the pension liability, pension/OPEB liability is large in relation to the size of our company. We believe that it ends up being an overhang on the equity value for that large of a pension liability. That's why we're committed to getting to that $2 [billion] to $2.5 billion level. As we get towards that target level, it'll be a combination of contributions to pension and lower funded debt.

Arjun Chandar: Great, thank you. You answered my asset sale question in your opening remarks, with regards to where you currently sit within your $500 million to $1 billion target and what could be, in the near term, additive to that asset sale program. From that perspective, we can move on from that question. You've been very clear on that.

Capital allocation, you just talked about the focus on funding the pension and meeting your expectations around target leverage. Are there any other comments you want to make, with regards to broader capital allocation, as you presumably generate a healthy amount of free cash flow and have money to put to work?

William Oplinger: Yes. We have a capital allocation framework that we've been consistent with over the last couple of years. That capital allocation framework starts with keeping a billion dollars of cash on the balance sheet. We're committed to keeping that billion dollars. We've let that slide to below a billion dollars occasionally over the last couple of years, as the market situation has required, but we would like to keep a billion dollars.

In addition to that, we will spend roughly $425 million of CapEx this year to sustain the operations, but also to invest in some small return-seeking projects. Those small return-seeking projects are a combination of creep, gaining incremental volumes out of the plant, but also cost savings projects.

Beyond those two things, uses of excess free cash flow can go towards four areas. These are not necessarily in rank order, but we talked about the deleveraging. We are committed to hitting that $2 [billion] to $2.5 billion of deleveraging over time. That's the first potential use of cash flow. Second potential use, again, not necessarily in rank order, is returns to shareholders. The third is asset repositioning. The portfolio of assets, the repositioning work that we're doing, it will cost money. When we curtail or close facilities, it costs money for the labor costs, also for the environmental and demolition work. That repositioning does take cash and we'll potentially use some cash for that. The fourth is our mid-sized value-creating growth projects. These are largely in our refining business. At this point, we put all of our mid-sized growth projects on hold in 2020, and they remain on hold at this point.

Those are the four potential uses for free cash flow. As I said, we're committed to that deleveraging target also.

Arjun Chandar: Thanks. A follow-up to that, thinking about the broader aluminum industry, do you see M&A consolidation as part of the narrative over the next year or two?

William Oplinger: It's really difficult to speculate. There's not been a lot of consolidation in our industry over the last few years, so I am hesitant to speculate on what type of consolidation could occur. Where I will speculate is that we have a very defined course laid out for our company, and it is the three things that I talked about earlier. It's focusing on cost reduction, stability in our plants, generated earnings from the plants that we have.

The second is repositioning of the asset portfolio. We're well on the way of repositioning that. Once we've repositioned the portfolio, just to be clear, we will have a first quartile bauxite position, a first quartile refining position that's large and extremely low carbon intensity, and a high first quartile aluminum smelting position that will also be very low carbon intensity and also have the joint venture with Rio Tinto for the ELYSIS™ project, which is a no-carbon-producing process. We will continue to sell non-core assets on the periphery. We continue to work on smaller sales of non-core assets to streamline the portfolio.

As we look out three to five years, the balance sheet will be in much better shape, the pension will be in great shape, and we'll have first quartile cost positions in all three of our business segments.

Arjun Chandar: Great, thank you. A question that we get a lot, especially in a supportive commodity price environment, with regards to high BB issuers like yourself is, as you think about the next step from a rating agency perspective, what type of motivation within the financial policy and capital allocation priorities that you outlined earlier do you have to go investment grade? Have you had recent conversations with the rating agencies in this regard?

William Oplinger: Let me answer the second part of this first. We have had recent conversations with the rating agencies. We also have recent conversations with our board of directors, where we actively talk about capital allocation and the optimal capital structure for our company.

We like to think that we have a good deal of science behind our targeted capital structure. Our targeted capital structure comes back to that $2 [billion] to $2.5 billion of proportional net debt. We think that that level of indebtedness, including pension and OPEB, provides for the optimal weighted average cost of capital. We actually plot out the optimal weighted average cost of capital versus total indebtedness, and the lowest point comes to between that $2 [billion] to $2.5 billion of indebtedness. The theory behind that is that we create the largest shareholder value at that lowest WACC.

We will continue to target the lowest WACC. Whether that results in IG with the rating agencies, that's out of my hands. I think that our metrics, when we get to that level, will look very good. I think our metrics will be IG-level metrics, because we're able to model the rating agencies models themselves.

Whether they determine that we are investment grade, that's up to Moody's and S&P. Quite honestly, I spend no time thinking about whether Moody's and S&P will rate us as IG. I spend a lot of time thinking about, how do we get to our lowest WACC, and what do we need to do to get to our lowest WACC?

If, in the end, we're rated IG, hey, that's great. If not, that's fine too, as long as I can look my shareholders in the eye and say, "I think we've gotten to our optimal capital structure."

Arjun Chandar: Perfect. That ends my list of questions. I'll turn it back over to you, Bill, if you've got any closing remarks before we wrap it up.

William Oplinger: Arjun, I appreciate the opportunity to talk to you and the people at your conference. I think we, as a company, have done a great job being focused on significantly improving the company over the last four years. We've regained a very good level of operational stability in the company. We've implemented the change to the operating model, which I believe makes us much more agile, makes decision making much quicker. We have a market tailwind today. We're enjoying that market tailwind for the first time in quite a while.

As we look forward, we think the dynamics in the industry between the sustainability drive and some of the things that we see in the marketplace are shaping up for a nice period of time where the market is strong, our company is getting stronger.

As I laid out earlier, over time, our company just gets better and better. We're pleased with the progress that we've made but really striving to continue to make more progress, especially in these stronger markets.

Arjun Chandar: Excellent. That concludes our session. Thanks a lot, Bill. Really appreciate the time.

William Oplinger: Thanks, Arjun. See you.