Alcoa Corporation

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Timna Tanners: Good day, everyone. Welcome. We are delighted next to host Alcoa. We have with us CEO Roy Harvey and Bill Oplinger, CFO. This format will be a fireside chat. You're probably familiar with this by now, but if you do have any questions, please submit them to the Veracast system. Perhaps I'll see them if you send them via Bloomberg, but we'd be happy to take your questions. I already have a few coming in.

So welcome, Alcoa. Thanks for joining us. Thanks for your support of this conference. We're happy to have you virtually and look forward to seeing you in Miami next year.

Roy Harvey: Yeah. Thanks, Timna. It's great to be here, such a great opportunity.

Timna Tanners: We were just speaking about how the dynamic with Alcoa has switched over the years, talking about the opportunities in aluminum, but frankly, prices have been kind of depressed or at least significantly lower than where they are now. If you look at the last decade, the aluminum LME price has been averaged about $1,900 I came up with. So we're now what, 30% or so above that average. And I know you're a big player in the market and I don't want to ask you specifically about your forecasts for prices. But what do you think can support this market or what do you think are the dynamics in supply and demand going forward?

Roy Harvey: Yeah. Thanks for the question, Timna. I think you reached back and talked a little bit about this conference last year and it's interesting to look at what's been happening in aluminum specifically. First of all, because it's so incredibly tied to the economic cycle, and second of all, because I think there have been some significant changes on what's happening with the fundamentals of aluminum.

So when you look at the connection to the economic cycle, first quarter of last year, China was essentially no longer producing or consuming as much aluminum and then that switched very quickly to China starting to recover and the rest of the world really going into the pandemic slowdown. And so, as we got to the end of last year, we started to see demand really picking up inside of China. We started to see the beginnings of that demand come back in the rest of the world. But now coming into 2021, we seem to be firing on all engines.

So you look at the demand and you look at it sort of on an instantaneous basis and you look on it for the remainder of this year, and demand in China and demand in the rest of the world is really just growing very, very quickly.

And that makes perfect sense because when you step back and think about where you're using aluminum, it's in transportation, it's in consumer durables, it's in electrification, it's in automotive, it's a little bit everywhere. And so to me it makes perfect sense that as the world's economy really starts to gather steam and pick up some of that pent-up demand and see some of the end consumers start to spend more of the money that they've saved up over the pandemic, it makes perfect sense.

And so, when I look at aluminum in this short-term, it's obviously a very positive commodity. I think also as you look out in the medium and long terms, it will continue to have significant growth and you will continue to see aluminum just because of all the trends happening in low carbon, in light-weighting of vehicles, and rebuilding some of the infrastructure that we've used for so many years, all of that is very positive because aluminum is used essentially in almost all products. So, I look at the demand side of the equation, which is sort of the first half of your question, the first half of what drives a pricing environment, as very positive.

The second half connects with what's going on in the supply side and I think this is where aluminum has been tripped up over this last decade-and-a-half. And it was really the fact that China was able to come online and essentially had learned to build a coal-fired power plant with a smelter connected onto it and essentially continue that same move over and over and over again. And so, we saw not only significant demand increases but significant production and supply increases as well. And so that has really been the story to me of the cyclical nature of aluminum over these last years.

Looking at today and really starting to look forward, I think there is a very big difference between the world five years ago and the world today. And that is very, very specifically that China has gotten very serious about supply side reform. And that is focused on the permitting process for operations, and it's also focused on the environmental side and whether that's carbon emissions or also just the care being placed into the environmental footprint that different operations are putting, I think it is night and day.

And what we've certainly seen over these last few years is that it's not just a planning document that the Chinese have been talking about on supply side reform, it's been actual execution. And actually, you've seen the slowdown in the new production capacity coming online, you've seen the need for any new capacity to either have a permit from long ago or to trade a permit from another facility that has been shut down. And so that to me is a bellwether and is really signaling that there is significantly less productive capacity coming online in China in the future.

Not to mention the fact that if you look at the ESG trends, and particularly where the carbon intensity of how you produce aluminum comes to play, I think because all of the producers are looking at how can they address a market that is emerging not only from a premium standpoint but from a customer selection standpoint to be as low carbon as possible, that old footprint of building a coal-fired power facility and connecting it to a smelter simply doesn't work anymore. And that very much slows down productive capacity inside of China, but also means that you're looking at that next set of capacity is going to need to find renewable power someplace in the world and at a time when everybody's moving towards renewable power.

So to get back to the pricing question, you have very strong demand and I see that continuing forward, you have more supply discipline at this time driven by environmental considerations and the fact that there are very few projects on the drawing board. I think that creates a real, for me, real optimism in the aluminum market that we continue to see that market evolve. And to me, I think all the fundamentals and everything we're seeing on the ground now, particularly in value-added products, and we play very much in North America and Europe, everything we see is that there is extreme tightness. And part of that is a point in time slowdown in freight, increasing freight costs, but of course, also availability of cargoes. And part of it is just the fact that I think there is an expectation that we can drain out some of these inventories and really see positive fundamentals for aluminum going forward.

Timna Tanners: I want to dig into that supply point a little bit more because I think that you mentioned it, I think is a good point, over the years that's what's been the hang-up. The demand has always been pretty steady, little wobbles here and there right, but it's a growth story and that's always been positive but it's been the supply and sometimes supply out of nowhere.

When we talk to investors, copper has got long visibility, steel's got short visibility. In aluminum, I feel like it's somewhere in between. So I guess my question is, could there be something that just surprises you out of left field like the Middle East adding capacity that we don't know about, or is there some risk on the supply side that we could be missing? You can elaborate on that, and the Chinese at high prices, they get inventive. I get that there will be restrictions on coal-fired capacity adjacent to the smelters and you made that point, but could there be some surprise in China or elsewhere on the supply side?

Roy Harvey: Yeah. I think we would never make the assumption that the world is going to stay exactly as it is today. And so like you said at the beginning, and I won't talk about specific price points or margin points, but in the end, we try and look at a range of scenarios to understand what can surprise us and how can that market cycle change, because in the end it is a cyclical commodity there's no question about it. If you look back at history, I think you hit both pieces, the Middle East decided that they wanted to use some of the natural gas that they had and turn that into employment and into aluminum. And so, they grew pretty significantly over these last couple decades. And China was the other real surprise at how quickly they could bring to bear not just sort of normal capacity, but really start to drive the technological edge also. The Chinese have gotten very good at building highly efficient and highly technologically advanced aluminum facilities with conventional technology.

So, I think there's a number of ways you could be surprised. You could see some additional growth in the Middle East, although again, that would be typically fueled with natural gas because you don't have the renewables infrastructure there at the moment. And you could have a different-- the Chinese could find a new way to bring additional capacity online, either inside of China, where they have real advantages when it comes to subsidization in a lot of the infrastructure provided or whether they start going outside of China and look for either partnerships or look to build in other places around the world.

Now again, I would argue that once they start migrating out of China, they will not have some of the benefits of that very low capital cost, that extremely low capital cost compared to what the Western world can do. Some or all of that starts to get eroded. And so as you think about competing for the future of aluminum, and right now you don't have a lot of these projects on the drawing books, the fact is that it would be a much more level playing field if we're looking at who can bring to bear sort of the next competitive advantages to have that lowest cost aluminum smelter on the planet and be able to build it with the capital costs that can have a very good shareholder return.

And just from an Alcoa perspective, to finish the answer to that question, as we think about investments for us, we try and look at the long-term cycle and not get caught up in the frenzy of how we see the pricing environment today, but really look forward, and it would be for 10 years or 20 years but it would come to a new facility. And so, we're very cautious not to make the assumption that times will always be rosy the same way that in the bottom of the cycle we try to be cautious not to assume that times will always be terrible. And thus, I think we try to really see through the cycle and find ways that we can ensure that our assets are very, very low cost and also fulfill some of these new emerging ESG criteria.

William Oplinger: And if I could just jump in real quick, Timna. One other thing to keep in mind at least on the smelting side is that we're working on a breakthrough technology. We and Rio are working on the ELYSIS™ technology that would be a game-changer in the industry. And so as we consider greenfields in the future, we will have to take into consideration what technology would be used and how quickly that technology will be available.

Timna Tanners: I do want to circle back on more of what Alcoa is doing, but just to finish the discussion, I think you made a good point about outside of China getting more dicey with terms of capital cost but also you have to be certain about trade agreements that you'd be able to bring that back in the country. I want to talk about trade, but just to finish the new capacity story, in the past you and others have talked about a threshold of break-even production capacity or incentive price that is, at $2,500. I thought that was before regional premiums but we're well above that if you include regional premiums, I think. Does that mean that there is some risk? You and others don't seem to be talking about new capacity in the interim, but is that still the right number, and maybe is there an inflation factor to consider?

William Oplinger: So when we're currently looking at incentive pricing, Timna, have to consider what capital costs would be. We have built projects going back a decade ago that had capital costs of over $6,000 a tonne. Today our best view of Western world technology built in the Western world would be that potentially you could get to $5,000 a tonne capital cost. At $5,000 a tonne capital cost we would say that the incentive price is probably around $2,600 LME, that's before the Midwest premium. So clearly, we're at a point where maybe that makes sense, but you'd have to consider that this market goes far into the future to make an investment decision on a smelter.

I think maybe the better question would be is there an incentive price for restarts. And as we look around the world, we would say that the excess curtailed capacity in China is probably around 7.5 million metric tonnes, but out of that we believe probably 4 to 4.5 million metric tonnes of the operating permits have already been transferred. So that leaves only maybe 3 million metric tonnes of excess capacity in China that could be restarted.

When we look at the Western world, there's probably 2 million metric tonnes of capacity that could be restarted. We have maybe 500,000 of that. We have a big chunk of the curtailed capacity in the world. So I think the incentive price to restart curtailed capacity may be lower than that $2,600 a tonne but as you've heard me say before, every smelter has its own story. Every smelter has its own set of economics on whether its local currency, local workforce, energy availability, so I think all the suppliers are looking at those dynamics.

Roy Harvey: And Timna, if I can just inject - one more point before your next question, and going back to Bill's comments on capital cost. This is where it also intersects with the emerging ESG trends around the world, in that there is so much more transparency now about what happens in Brazil or what happens in Indonesia or China and everywhere. And so, while the regulatory scrutiny and the operating environment will be different based upon each of the countries, I think we're seeing more and more expectations from all stakeholders about how you build those facilities. And it starts with safety and health of the employees but then connects over to residue management as an example, inside of the alumina business, which I think is becoming more and more important that you take a very mature and professional view on how you're going to manage that residue. But it also connects over with the social side of the connections you make with your communities and indigenous populations. And of course, governance.

And I think one of the differences, and again, to connect this back to Alcoa, is that when you think about those next facilities and what kind of governance structure is going to be expected by potential investors or by potential governments, they're going to be looking for something that is a step ahead. And that in the end is going to help increase and normalize some of those capital costs such that you don't have such a skew towards players that are willing to take shortcuts because there is so much transparency in the world now. So to me, it tends to really level the playing field yet again to make sure that everybody has the same opportunities to invest.

Timna Tanners: Thanks, Roy. And that's a good pitch for our next panel on green aluminum, where we'll hear again from Alcoa on this topic. So, I'll leave some of the ESG discussion if you don't mind for that opportunity. I did like the segue that Bill set up for to steer it back toward Alcoa and its operations.

So your footprint, over the years Alcoa has taken a lead in talking about curtailing underperforming assets. And a lot of that I think is now behind you, but I'd like to hear in your own words where you stand. I think you're still working on Spain, and for you, what's the incentive price? And again, I know it's about technology, it's about the power agreements, it's about renewables or green energy, but at what price do you start to think about restarting, how long would it take, and where do you stand with your footprint?

Roy Harvey: All right, Timna. So that was a good number of questions. Let me hit the first few and turn it over to Bill for the last few of the ones that I forget. We have a clear view on where we're going. And that is to make sure that across our three lines of business, which is a simplification, but across those three lines of business, we are in the first quartile in each of them. And so, when you think about bauxite, driving the most responsibly produced bauxite being very low cost and being located close to markets, absolutely a place that we are and that we want to continue.

When you look at alumina specifically, continuing to maintain that first quartile cost curve position, maintaining the fact that we are the lowest emitter of carbon dioxide as a system. Again, that's a great place to be, but we need to defend it and make sure the decisions we're making around portfolio can maintain that positioning. It's in smelting and aluminum where we have the most work to do because we found ourselves in the upper second quartile, which is about middle of the pack, and we needed to really drive ourselves down to be first quartile.

And at the same time ensure that as we look at the sourcing of power move towards renewables and ensure that we were also the lowest carbon emitter on the planet as well when it comes to aluminum smelting. So that's really driven the decisions that we make on an operation by operation basis. We had laid out at the end of 2019 a plan for a five-year program in order to address the portfolio that we have, and you've seen some of those changes already.

As you mentioned, we're in the midst of negotiations inside of Spain, just starting to negotiate with a broader set of potential acquirers of the plant and continue to be able to operate that plant stably, which is a very good thing. And so that sort of demonstrates that there's still some work to be done and it is a case-by-case, plant-by-plant basis. And so we look at, of course, we look at the environmental footprint, we look at the past characteristics of the plant, but we also look at those, whether it's energy contracts or raw material contract supplies, et cetera, to see how competitive that plant can be for the long-term. And we don't base it again on today's prices, but we try to look forward and understand the pricing environment that will exist over these next years, or better said, the margin environment. And so, there's still some work to be done on the portfolio review process.

We also have the opportunity and Bill hit this earlier, we have the opportunity to consider restarts. And again, each plant is very different and has a different set of characteristics and conditions but it is something that we absolutely evaluate and see if there is an opportunity for Alcoa to again continue that roadway down to first quartile but also keep very clearly in mind that we want to be the lowest carbon emitter as well. And so, it is a complicated set of calculations. I don't know, Bill if you wanted to add anything from the questions?

William Oplinger: I guess the only thing I would add is, Roy when we announced the portfolio repositioning, I think a lot of people naturally assumed that we would be jumping toward curtailment or closure for a lot of different sites. And when we talk about putting an asset under review at its most direct, it's fix, close, or sell. And we have taken the opportunity to repower Portland. And Portland is a site that we've always talked about having a great workforce, having good technology. We needed to find a power contract that allowed it to exist. And so, we were able to repower Portland.

We've tried to take action at San Ciprián. That still has some work to be done there, but we've made progress on the repositioning. And like you said, we gave ourselves five years, we still have three, and we'll continue to work on repositioning.

Timna Tanners: Can you remind us what the investments could look like to restart capacity or give us a flavor of how to think about that and the process of making that decision? I assume like you said, it's not just today's aluminum price, it's a forecast aluminum price and the return on any investment over time. But if you could talk a little bit how to quantify or if we think about it and financially like what's the impact of some of these potential restarts?

William Oplinger: Sure. Let me take that one, Roy. We've had the experience in restarting over the last five years three different sites. We've restarted ABI, after the lockout. That was not a complete restart, we still had part of a line running there. We've restarted Portland, if you remember all the way back in January of 2017 when Portland had an electrical outage, we made the decision to restart that. And we've restarted Warrick.

In general, Timna, I think that each plant has a little bit difference in variation, but I think if I were to summarize, those plants cost us $75 to $100 million in restart costs and typically take 6 to 12 months. Some of the restarts, I would say two out of three of the restarts were overwhelming successes. In the case of ABI and Portland, really well done, safe restarts. Warrick turned out to be a harder restart. If you recall, we actually had some problems on the restart of Warrick and it was just a very old technology that we were restarting.

So again, if you then fast forward to looking forward, when I look at our current portfolio of curtailed capacity, Alumar is the place where we have, again, a strong U.S. dollar. We've got a potentially great workforce that sits next to the refinery. And we'd be looking for an energy contract that solves in the mid-term to get that plant up and running.

Timna Tanners: OK. That's really helpful. I know we're going to have to grill Bill on the cash uses and the balance sheet in a sec., but I don't want to leave behind the alumina market. So, you guys are long bauxite and alumina and all we've been talking about is aluminum. And alumina price has been kind of left for dead in this rally. And I'd just like to get your perspective on how long that can last, if that's sustainable, and any further thoughts on alumina. Thanks.

Roy Harvey: Yeah. Absolutely, Timna. So, I'd certainly not characterize it as left for dead. It certainly has not enjoyed some of the increases that we've seen in aluminum. I look at the two markets and we can talk about bauxite here in a minute, but comparing alumina to aluminum, they run with different fundamentals. Aluminum is so closely tied to the economics of the world, so it has a broader set of people that are trading in those values. And so you see it very much mirror what's happening in the broader world, as well as what's happening back in supply and demand.

Alumina is different in that it's done really cargo by cargo. And so you can actually see that price forming taking place. And so I think alumina is a very good representation of where we find ourself today, where we don't necessarily have a significant amount of excess capacity, nor do we have a significant amount of excess demand either. You have less demand coming from China and pulling from the rest of the world because freight rates are so expensive and because Chinese refiners are continuing to generate cash and so they're operating almost at full capacity and they're self-supplying their own smelters. As freight rates change, as some of the underlying raw materials costs change, I think you can see that change relatively quickly.

I would also add in, you had asked before, what are the risks that could happen both certainly to the upside on pricing, I think we've seen in the past that there have been pretty significant eruptions or disruptions because of environmental issues, because of residue management. And again, I think this is a place where transparency is key because the more transparency you have, if there is an issue, very quickly you see a response in that market and when that market is balancing on knife's edge, it means there can be very quick responses inside of the pricing.

On the long-term fundamentals, not to leave it behind, I think you look at the fact that for us, our refineries and our bauxite mines essentially are co-located or very short distances apart. I think it gives us a sustainable competitive cost advantage when you look at so much bauxite being sent overseas. And so to me, it is a business where margins should continue to be healthy and where you really see that that cost curve really is going to be dependent not only on your price point but also on how much carbon content you have coming in on the actual energy supply itself. And again, not to toot our own horn, but Alcoa is the lowest emitter of carbon dioxide in the alumina business as well and has the only EcoSource™, low-carbon product that exists out in the market today.

Timna Tanners: Great, thanks Roy. All right, Bill, you're up. We're going to grill you on what you're going to do with cash. I wonder how far away are you from being fully out of the pension business. I know you've joked about that over the years, it wasn't your design to be a pension expert I guess. But can you just remind us where that stands and obviously, the question on everyone's mind is what's Alcoa planning to do with cash as it gets into this nice position of being able to make those kind of decisions again?

William Oplinger: Yeah. Thanks, Timna. When I look at the pension situation, at the end of the first quarter, I should say, after we made the contribution that we did in early April, the pensions are greater than 90% funded. U.S. pension, which has been historically the big overhang on the company is greater than 95% funded. So, pensions for our company from an underfunded status are not a huge liability at this point.

We would like to take the opportunity as we get more funded if interest rates were to increase, that we will take the opportunity to annuitize some of our pension plans. And that essentially eliminates any type of a longevity risk that the plans might have built into them. But at this point, we've done a tremendous job of managing the pensions and it's largely due to the fact that we've contributed recently and we have about a billion dollars of prefunding balance built into our U.S. pension. So what that means is that on a go-forward basis, if we make the minimum contributions and use our prefunded balance globally, we could be looking at $75 to maybe $90 million of total pension and OPEB cash out over the next few years on an annual basis. So significantly less than what we've contributed over the last five years.

You combine that with the fact that our funded debt sits at around $2.4 billion today, we have the ability to call the 2026 bonds in the fall of this year, and we'll make a decision around that depending on what cash looks like. But we have positioned the company to be in a really good spot from a balance sheet perspective. We have a targeted net debt of $2 to $2.5 billion, we ended the first quarter at $2.7 [billion]. I think we'll be well within that target this year potentially, depending on what interest rates do, we could be at the bottom or even below that target range by the end of the year.

Which then gets us to capital allocation. And so we've historically told you that there's four uses for excess free cash flow, and these are not necessarily in rank order, the first was de-levering to get to that $2 to $2.5 [billion], we're at $2.7 [billion] at the end of the first quarter, we're going to get to that $2 to $2.5 [billion]. Second is potential returns to shareholders, third is mid-sized growth projects, we have mid-sized growth projects in the refining business largely, and the fourth is continued repositioning of the portfolio. And as I said earlier, in the case of Portland it didn't cost us to reposition the portfolio. In other parts of the world it may cost us some money to get a plant curtailed or potentially sold.

So, as I look forward to the next five years of our company, we have really cleared the runway of a lot of cash outflows over the next four or five years. We have no maturities through 2025, we have the ability to call the 2026s. Our pension contributions are going to be small. So, we will be spending a good deal of time over the next six months determining what the next capital allocation framework looks like because at this point, I believe our balance sheet is in great shape. So, I guess to answer your question, Timna, more to come here over the next few quarters.

Timna Tanners: OK. We have to wrap up. We had a question come in on the dividend. So, it sounds like you addressed that as one of your possibilities but just know that you did get that question, so we'll be staying tuned as you mentioned.

We do want to thank Alcoa for participating, for your continued support of our conference. Virtually is less fun, we look forward to seeing you in person next year. And with that, I'm going to sign off and go to this aluminum panel and hope that the audience will join me there. Thanks again.

William Oplinger: Thanks, Timna.

Roy Harvey: Thanks, everybody.