Alcoa Corporation

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Sathish Kasinathan: Hi, good morning. Thank you for joining the Deutsche Bank's Global Basic Material Conference. I am Sathish Kasinathan, and I am pleased to have Alcoa with us today for this conference.

We have with us the [Executive] Vice President and CFO, Bill Oplinger. The format today will be a hybrid. It will be a short presentation followed by a Q&A. I would like to remind everyone to please submit your questions to the Q&A box that you have on the left-hand side of your screen.

I would now like to hand over to Bill Oplinger for his presentation.

William Oplinger: Thanks, Sathish. As you said, I have some prepared remarks for today, and after that, I will be happy to take your questions. There are a couple of slides at the front that I ask investors to take a look at their leisure, it is the non-GAAP and safe harbor messages.

But if you jump to one of our first slides, just for those of you who are not familiar with Alcoa, you should get familiar with us. We have about 13,000 employees globally. We are in 16 countries. We are an industry leader in all aspects of the upstream aluminum business. We are vertically integrated in bauxite mining, alumina refining, and aluminum smelting, and the company has been in business since 1886, when our founder started the modern industrial aluminum business.

When we started, we essentially started with three simple values, and we live by these values every day: act with integrity, operate with excellence, and care for people. And I would say that those values continue to serve us very well.

We also employ three strategic priorities; again, investors should keep these in mind, because we follow these on a regular basis. First priority is reduce complexity, which helps us be low cost; second is to drive returns from our investments; and thirdly, is to advance sustainably which means we are creating an enterprise that is sustainable financially, operationally, environmentally, and socially. And we are on an exciting journey over the last five years.

If you turn to the next slide, you will see in our three business segments, we are extremely well positioned. In Bauxite, we are amongst the world's largest bauxite producers with efficient, sustainable mining operations. We maintain a first quartile cost position and supply our own internal refineries and have external third-party customers also.

In the refining business, we are the world's largest alumina producer outside of China, and we have a first quartile cost position. We also have the world's largest third-party alumina business. Importantly, we are the lowest CO_2 intensity producer in the industry. And we recently launched the EcoSource™ low carbon alumina product. That is the only smelter grade alumina product on the market that guarantees low carbon emissions.

In the Aluminum segment, we are currently a low second quartile cost producer, but we aim to move to the first quartile following our ongoing portfolio review. And that should be completed by the end of 2024. Roughly 78% of our smelters are powered by renewable energy, and we are targeting 85% after the portfolio review. And we do have a green aluminum product suite, and we continue to make increasing sales of our EcoLum™ and EcoDura™ green aluminum products.

We then turn to some of the recent actions that we have had, in 2021 we have substantially strengthened our balance sheet. We have also substantially reduced cash requirements for the future years. We closed the Warrick rolling mill sale in the first quarter. After doing that, we improved proportional adjusted net debt over $700 million compared to the end of 2020. Currently, we have a target range of $2 billion to $2.5 billion of proportional net debt, so at the end of first quarter, we are only $200 million higher than our target range of proportional net debt.

We funded $500 million of pension funding in April and that improved our pension funded status over 90% globally. In the U.S., which is where our largest pension liabilities and assets are, we are over 95% funded. We have got a $1 billion prefunding balance and we anticipate using that $1 billion prefunding balance in the U.S. to lower our expenditures over the next few years. Assuming the use of the prefunding balance, our expected total pension and OPEB cash funding requirements in 2022 are now only $90 million, and even less than that going into future years.

We have also reduced our interest costs. We called $750 million of bonds, those were 6.75% coupon that were maturing in 2024. We have no significant maturities until 2026. The balance sheet is in a very strong position. Not only is the balance sheet in a strong position, the actions that we have taken have really cleared the runway for future capital allocation decisions.

Should market conditions remain favorable and we generate excess cash, we will deploy it in one of four ways. You see that in the bottom right-hand corner of this chart, these are in no particular order: we will continue to make progress against our targeted net debt ratio; potentially return cash to shareholders; transforming the portfolio will continue to cost money, and we have done actions on that recently, but could continue to cost us; and then on top of that, we have value-creating projects that we are evaluating on whether it would be a good time to invest in these value-creating projects.

We move more broadly to the market. If you followed the aluminum story over the last decade, it has been a story of solid demand growth. However, prices have been constrained by Chinese supply growth.

If anything, today's demand growth is stronger than we have seen. We have seen significantly strong demand growth on a year over year basis in all of our regions, all of our industries, but it seems that the supply dynamic is also changing for the better. And aluminum prices in China and the rest of the world have risen 40% this year, and that is even considering the Chinese government's recent attempts to rein in some of the commodity prices. And supply growth has slowed over the last four to five years due to a combination of slower developments in manufacturing as well as China's supply side reforms. Those reforms include strictly enforcing a 45 million metric tonne limit on permitted smelter capacity.

In addition to that, China has announced other policies impacting aluminum industry supply and costs. China set targets of achieving peak carbon emissions by 2030 and carbon neutrality by 2060. China has announced in its latest five year plan to target to reduce by 18% its carbon intensity per unit of GDP by 2025, as well as targets for individual provinces.

And we are already seeing those changes on the ground, with some provinces preventing the launch of new energy-intensive industrial projects, and others cancelling preferential power tariffs for smelters. In addition, China Nonferrous Metals Industry Association announced, in April, a draft goal that called for peaking emissions in the industry by 2025. That is five years ahead of the national carbon peak goal, as well as a target to reduce by 40% industry carbon emissions by 2040.

That implies annual aluminum production peak is approximately 41 million metric tonnes in 2025. Furthermore, China has launched its own national emissions trading scheme, which will first target the power industry, including captive power; it is likely that the next round will focus on emissions-intensive industries that include primary aluminum. With more than 80% of its aluminum smelters powered by coal, adding carbon-related costs and supply restrictions will be a challenge for primary aluminum in China.

In summary, we think China's recent moves toward decarbonization have the potential to address persistent overcapacity in the country, and that can drive significant positive change in the global aluminum industry fundamentals.

And I told you, I would try to make it brief, but I am going to finish my comments around how we view Alcoa. And if I could just summarize it very briefly, we think we are the right company in the right industry at the right time today.

The company is in its best position since becoming a standalone company in November 2026 [sic: 2016]. Our business fundamentals have strong foundations and we have been able to accomplish a number of our key aspects of our strategic plan.

Commercially, it is important for you to know that we offer the broadest suite of sustainable aluminum industry products. We sell to third parties all along the upstream value chain and we have long term smelter contracts based on renewable energy. And as I said, 78% renewable energy, moving to 85% over time.

Operationally, our reputation as a values-driven, EHS-focused, proven operator supports our license to operate around the world. That is probably more important today than it has ever been in our industry.

And financially, we are maintaining our targeting first quartile cost positions in all three segments of our business. Our proportional net debt is approaching the target range ahead of schedule and we have cleared the runway of many of the major cash requirements over the next four to five years, with no maturities until 2026 and greatly reduced pension and OPEB cash requirements.

That is not the only thing. At the same time ESG considerations are more important than ever, and Alcoa is well positioned there also. We are already one of the lowest carbon intensity producers. We have set aggressive targets to get even lower. And at the same time, we are working on breakthrough technology called ELYSIS™ with partner Rio Tinto, and that could change the aluminum smelting business forever. We have an excellent reputation in our local communities, and we have state of the art corporate governance practices that we launched back in 2016.

I think we are right company. I think the industry is the right industry today. Aluminum is an integral element of today and tomorrow's low carbon economy. It has unrivalled properties and infinite recyclability. And that makes it a preferred solution for transportation, electrical, packaging, building construction, machinery, and other segments. We are the right company, it is the right industry, and now is the right time for Alcoa.

So with that, I will turn it over to you, Sathish, and we will take some questions.

Sathish Kasinathan: Thank you for that. And I would like to remind everyone to keep submitting their questions. We already have a few. I will just start. You already touched upon the supply/demand dynamics for aluminum, but I just want to drill down on the supply side a little bit. With the current aluminum prices, what is your view on the potential for restarts, both from an overall industry perspective as well as within Alcoa?

William Oplinger: Sure, so let me just further elaborate a little bit on some of my comments around the supply side. Many of you have heard, and just to reiterate, there have been supply side cuts in China in the near term in a number of different provinces: Inner Mongolia, Xinjiang, Ningxia, and now Yunnan are all starting to cut capacity for a variety of reasons. Whether it is environmental reasons or energy reasons, we have started to see some of those cuts.

As I said, we think the Chinese are committed to the 45 million metric tonne cap and as I said, they could even target a lower cap than the 45 million metric tonnes. They are very focused on driving the carbon agenda and really driving towards peak carbon emissions by 2030 and carbon neutrality by 2060. Our view is, in the near term, the supply-side restrictions in China are positive and we see the dynamics in the longer term being positive.

As we consider our portfolio, Sathish, we have put up a portfolio review in place back in 2019, 1.5 million metric tonnes of [aluminum smelting] capacity. We curtailed the Intalco facility; was roughly 280,000 metric tonnes of capacity. We have announced back in 2020 the potential layoff of folks and the potential curtailment of San Ciprián in Spain. And so we took action there. We are now working through a process of potentially selling that site to the state-owned entity called SEPI.

We actively review all of our assets for both curtailment opportunities when costs are higher than market, but also potential restarts. You have probably heard us talk most recently that the Alumar facility down in Brazil is being evaluated for a potential restart. That facility, as I have said publicly before, it is well located in that it is next to a refinery, has a great labor force, and right now, the U.S. dollar is very strong in relation to the Real. We still need to work through the power supply there. We will also need to work through raw materials supplies and things like that. At this point, we continue to evaluate whether that makes sense to potentially restart Alumar.

I hope I answered your question, Sathish.

Sathish Kasinathan: Yes, just a follow up on Alumar. I think you already you also have like $100 million VAT credit, which would be useful when you restart? And then in terms of any comments on what the restart cost could be, and timeline on when you can get the power contracts in order?

William Oplinger: Yes, so no timeline at this point. We have a number of things that have to be lined up. That is power, that is raw materials. We have a partner in Saõ Luis. So, working through all of that. At this point, we are not prepared to make any announcement in either direction on Alumar.

To put it in perspective, we have restarted a number of facilities over the last five years for a variety of different reasons. We restarted the ABI facility when it came out of a lockdown situation. Typically, restarts for us take about approximately a year from the time of announcing the restart, and the costs have been anywhere between $50 million and $100 million to restart the facility.

All of that goes into the consideration of whether a facility would be restarted.

Sathish Kasinathan: Okay. Switching to the low carbon side, there has been news that the European government would consider including aluminum and steel into the carbon border adjustment tax, with an announcement expected probably next week, I think. Any thoughts on what the implications could be for the overall industry and for Alcoa. Do you see any increase in premiums for value-added products from that announcement? And any other views?

William Oplinger: Yes, Sathish, it is too early to speculate on, first of all, what the adjustment could actually look like; and secondly, the impacts of the adjustment. At this point, we are going to wait to see what the adjustment mechanism looks like and then we will decide how we react to it and what we say externally. But it is just too early to make any type of determination.

Sathish Kasinathan: Okay, yes, I understand. Maybe we can then talk about your own low carbon initiatives. You already touched upon it on a couple of your slides, but any further comments you would like to add, mainly the recent announcement about the mechanical vapor compression technology you are going to use for the refining of alumina.

And also, you touched upon that you are already seeing some success in your green products. Have you been able to realize any premiums on those products?

William Oplinger: It is the right direction of questions, Sathish. So there are two areas for us on green aluminum and further decarbonization of our processes. The first is obviously the suite of products that we sell. We have, as I said, the broadest suite of products in the industry. Nobody offers the suite of products that we do, which includes the EcoSource low carbon alumina product.

A little bit of a commercial here: if smelters want to reduce their carbon footprint, one of the things that they can do is buy low carbon alumina from our AWAC joint venture, and that provides them a certified low carbon alumina source. And nobody else offers that at this time. We are selling now EcoSource; we have now made our first shipment of EcoSource this month, in fact, so that is a positive.

On the EcoLum and EcoDura side, we have been selling those products for a while now. The amount of product is fairly small because we are just starting to see the burgeoning interest in the industry for low carbon aluminum products. But we are having customers pay a premium to be able to buy low-carbon aluminum products.

On the other side of the equation is what we are doing around decarbonization for the company. Again, going from a 78% renewable energy to 85% renewable energy on our smelting portfolio is not a trivial task and that will position the portfolio extremely well.

We announced an investment by part of the Australian government in some research that we are doing around decarbonizing the refining portfolio, the refining process, and that was specifically the question that you asked about mechanical vapor recompression. That is an ability to take essentially waste heat, and turn it into usable steam in the process in the refinery. So we are working on that. It is a technology that is been used in other industries. It has not been extensively applied to the alumina refining processes, but we think it could be a significant breakthrough in lowering our carbon footprint in refining.

And then, on top of all that, we still have the ELYSIS project. And ELYSIS is a breakthrough technology that will fundamentally shift the way aluminum has been made since 1886, since our industry started. It would be using an inert anode, an anode that does not get consumed in the process of making metal. It will lower the overall cost structure by 15%. It is projected to lower capital costs by 15%. And it is projected to make no CO_2 emission, so it would produce oxygen.

And by 2024, we are projecting to have a commercialized package for ELYSIS. And all of those three activities – the green aluminum portfolio, the decarbonization that we have going on across our processes, and the fact that we have got breakthrough technology both on the aluminum side and on the alumina process side – I think positions us well for the future.

Sathish Kasinathan: That is helpful color. Probably I will switch gears a little bit. If you look at the aluminum and steel light weighting, it has garnered a lot of press, but I would like to switch to the copper and aluminum substitution, given where the current ratio is. And do you think it will become a meaningful tailwind for long term aluminum demand in the future, and which end markets or geographies do you see that has the greatest potential?

William Oplinger: Copper prices obviously have run up significantly, so have aluminum, but copper has actually run up faster than aluminum. The ratio of copper to aluminum is approaching some pretty high levels that we have not seen since the early 2010s. That ratio is greater than 3.5 times right now. And that is 3.5 times [higher] copper price to aluminum price. We think that 3.5 times – and we are not alone – according to CRU, the 3.5 times drives substitution away from copper toward aluminum in electrical applications specifically.

It is really hard, Sathish, for us to parse out how much of the demand growth that we see around the world is being driven by substitution and just demand recovery.

While we believe that substitution is ongoing and could increase as copper prices go up, we typically just look at the market demand in aggregate. And I will come back to some of the demand comments that I made earlier in the presentation. We see global demand growth outside of China at over 12%. We see internal China demand growth at over 6%. That adds up to around a 9% year over year demand growth. That is what is driving the strength in metal prices and, honestly, that is what is driving the strength in premiums that we see around the world.

And whether that is, in small part, due to substitution, it probably is but, like I said, it is hard to parse out exactly how much of that is substitution effects.

Sathish Kasinathan: Okay, so you touched upon the premiums a little bit so just on that. Do you have any view on the Midwest premium, which is right now at record highs? Do you have any views on the Canadian import trade situation? Or do you think it will continue in this way or there is chance for more imports from Canada or seaborne markets?

William Oplinger: Yes, so as you said, premiums are at record highs. The Midwest premiums, I think this morning was around $0.27 a pound. And that, in our view, is being driven by a combination of things. One is that really, really strong demand and the fact that we do have the [Section] 232 tariffs. Assuming there is strong demand and 232 tariffs continue, we think that that Midwest premium should continue to be strong.

And the Midwest premium really reflects the fact that the marginal metal unit is coming from outside of North America. And with high shipping prices and premiums around the world being pretty high, we think that persists as long as the demand and 232 is still there.

Sathish Kasinathan: Okay. I am going to switch to the most topical question now in the investors' minds. That is capital allocation. Hearing you over the past few months, even today, it is becoming more and more clear that a dividend position is near. I am not going to ask for the timeline but, maybe, have you started to think about what your dividend policy could look like? Is it going to be a percentage of your excess cash flow or it is going to be linked to LME or any thoughts? Have you have you started to have discussions with your Board regarding that?

William Oplinger: Yes, so discussions around capital allocation are ongoing internally and with our Board of Directors. One of the key things that we do is allocate capital correctly. And so, we consistently have a discussion with our Board of Directors around capital allocation. And as you know, the capital allocation program today has the four parts to it, and I outlined those four parts.

I believe that we will be within our target net debt range within this year. And just to keep that in perspective, that is a massive achievement for our company over the last five years. And as we get to that targeted net debt range, which, again, should be at some point this year, we will be making decisions around capital allocation going forward. Really more to come on that front, Sathish, but the dialogue is ongoing within the company and the boardroom.

Sathish Kasinathan: Okay, switching to 2Q 2021 outlook, so given the higher aluminum price, we are already almost done with the quarter, given the 15-day lag on aluminum. Do you have any update on your 2Q 2021 outlook, especially regarding the tax, or any raw material inflation that you are seeing since your announcement in April?

William Oplinger: It is a very good question, Sathish. In April, if you recall, we gave some guidance around some of the short-term cost headwinds that we were seeing in the second quarter. And it was pretty clear and anybody that was not familiar with it, should go back and look at the comments that we made back in April. Since that time, metal prices have markedly moved up.

The trailing 15-day LME average [plus weighted regional premiums] for first quarter versus second quarter is roughly $400 per tonne higher than what we saw in the first quarter. We are expecting to have all that benefit of higher prices hit the bottom line, and so that is really favorable. Along with those higher prices, you typically see in our industry a little bit of cost creep, and we are looking at around $10 million to $20 million of some higher cost inflation in the second quarter.

But that is, in a small part, offsetting the $400 a tonne, dropping to the bottom line. Taken in total, I think the second quarter will represent substantial improvement versus the first quarter, which will be substantial improvement versus the second quarter last year. We are on target to have a really strong second quarter.

Sathish Kasinathan: Yes, thank you for the color. Switching to alumina a bit, we have talked a lot about aluminum. Alumina prices saw some movement in the last few days, but it is still relatively subdued versus aluminum. What is your medium-term outlook on the supply/demand balance given the higher production within China, and then the freight costs which is impacting the pricing?

William Oplinger: The alumina market, we believe, is fairly well balanced. And the fact that alumina has stuck around the $275 to $280 per tonne range is largely due to higher shipping costs. And higher shipping costs have shifted the balance within China to produce alumina as opposed to buying it externally.

They are the marginal producer of alumina. They typically are very economic about that arbitrage window with higher alumina landed costs, essentially due to the higher shipping premiums. We are seeing them produce more alumina. What that means then is that the marginal alumina unit does not go into China, it goes into the rest of the market, and it has held prices at that $275 to $280 range. What will happen in the future will largely depend on what we see in shipping rates around the world.

Sathish Kasinathan: Okay. You have talked about some medium-term growth projects in the refining segment. Can you share some details on what price would lead to that decision?

William Oplinger: We have three mid-sized growth projects that we have talked about externally; two are in Australia, one is in Brazil. The two in Australia, one is at Wagerup and one is at Pinjarra. They are roughly 1,000 tonne per day projects so you can see they are not huge projects, but they are larger than our typical 1% creep that we try to get out of the facilities.

In all three cases, we currently have those projects on hold. We are reevaluating the economics of those projects and have not said that they are going forward at this point. We are really looking at the capital costs to execute upon building those projects and trying to drive toward a capital cost that can improve the economics of the projects going forward.

Sathish Kasinathan: Okay. One other question on pension. You made a lot of progress on the pension front and you already talked about the reduced funding requirements. What more do you plan to do in terms of maybe amortizing it or anything else that you think you could de-risk on the pension side?

William Oplinger: Yes, to put it in perspective, the pension and OPEB liabilities for our company were, in my view, a large material overhang on our stock price. Investors needed to understand pension accounting. They needed to understand how our assets were invested. And at times, in the last five years, we were sub 70% funded status.

We have made a commitment as a company over the last five years to improve that funded status. We have done a number of things to do that. We have managed the liability by freezing the pension for salaried employees; that took effect this year. We have borrowed the fund twice, now, $500 million tranches that converts a variable rate liability to essentially a fixed rate liability at fairly low costs. And we have changed our asset allocation from what was a fairly esoteric asset allocation to a much simpler asset allocation.

The end result of all that is that, globally, we are 90%-plus funded. As I said, in the U.S. we are 95%-plus funded. We would be looking over the next few years – and this is a question that is on investor's mind, so I answer it proactively – if interest rates were to go up, we would be looking to annuitize that pension liability over time. We have the ability to inoculate the pension liability by putting more assets into a bond portfolio. We are doing that today. But the long term, we would be looking to actually try to annuitize that liability and get it off of Alcoa's balances in total.

Sathish Kasinathan: Okay, I think we are almost at the end of allotted time. I will just ask if you have any closing remarks that you want to make.

William Oplinger: My closing remarks, Sathish, would be it is an exciting time for the industry. The industry is going through what I believe is a sea change on ESG requirements, and Alcoa is at the absolute forefront of that sea change. I will reiterate the point that I made on this slide.

When you consider our company, we have a low-cost position in all three parts of the value chain. We are extremely well-positioned on the environmental and sustainability front through a number of different activities that we have taken. And our balance sheet is now where it needs to be; it is a stronger balance sheet than it has been since we launched.

I come back to the message that I had made here. I think we are the right company. The industry is the right industry. It is finally getting to a point where it will be recognized for the growth opportunities that it has in a low-carbon environment. And it is the right time for Alcoa. So, it is a thrilling time to be part of the company.

Sathish Kasinathan: Okay, excellent. So, thanks, Bill, for your time, and we really appreciate it. And I think that concludes the session. Thanks everyone for joining and have a nice rest of the day. Thank you.

William Oplinger: Thanks, Sathish. See you.