Alcoa Corporation

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CORPORATE PARTICIPANTS

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

OTHER PARTICIPANTS

Chris Terry – *Analyst, Deutsche Bank Securities, Inc*

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Chris Terry Hi, everyone. This is Chris Terry from Deutsche Bank. Thank you very much for joining our call today. I'd like to introduce Bill Oplinger from Alcoa; he's the CFO. The format of this session will run with – I'll hand across to Bill. He's got some presentation slides for 5 to 10 minutes at the start, and then we'll run it more as a fireside after that. So I'll hand across to Bill now, and thanks very much for listening.

William F. Oplinger Thanks, Chris, for that introduction, and for inviting Alcoa to speak at the Deutsche Bank conference today. I'll make a few brief prepared remarks, referencing the June Investor Presentation, and then we can go to Q&A with Chris.

If you go to the next page, we've included this cautionary statement regarding forward-looking statements that we may make today, as well information on our use of non-GAAP financial measures, which we advise that you should review.

For those of you who are not familiar with the company, Alcoa is a global vertically integrated aluminum company with 30 operating locations and 13,800 employees in 15 countries. We are an industry leader in all aspects of the upstream aluminum value chain, including bauxite mining, alumina refining, and aluminum smelting; with a corporate history that dates back over 130 years. We formed the current iteration of Alcoa in late 2016, and that's when we agreed on three simple values to guide all of the new company's actions: act with integrity, operate with excellence, and care for people. I'm proud to say that those values continue to serve us well today.

We also developed and recently revised three strategic priorities to drive our success: reduce complexity and cut costs, drive returns from our investments, and always advance sustainably and create an enterprise that is sustainable financially, operationally, and environmentally and socially. That strategic journey continues, and we'll talk more about that in a minute.

Let's look at today's market environment first though. The impact of the global pandemic can be seen in alumina and aluminum quoted market prices. I will point to you that these slides ended June 1st, so the numbers have changed upward a little bit since then. While both products saw declines in the first part of the year, and we are starting to see modest improvements. China appears to be leading the way, ahead of the rest of the world, both in the alumina and aluminum markets. This year, Chinese alumina prices have maintained their historical premium to World ex-China prices. Alumina prices, as measured by the Australia spot price index on June 1st, were up 12% from their lows in April, based primarily on the recovery in Chinese aluminum prices, driving alumina demand as China exits their shutdown.

In aluminum, the price recovery is also being led by China, which is showing improved Chinese smelter profitability and temporarily drove China to import primary aluminum in April and May. However, this dynamic has largely ceased, given the recent uptick in the London Metal Exchange prices. Being earlier in the recovery process, the Chinese aluminum price on June 1st was up 17% from its low point, while the World ex-China is still working through the pandemic, and prices are up 6% from the recent lows. That's the broad market picture.

Let's turn to Alcoa. Throughout this pandemic, our most important objective has been, and continues to be, the health and safety of our global workforce. We're monitoring the situation closely and in most countries where we operate, the new case count is either stable or declining. We have implemented comprehensive measures to minimize the risk of exposure to the COVID-19 virus across all of our facilities, instituting protocols that align with the US Centers for Disease Control and Prevention, the World Health Organization, and other public health authorities. These measures not only keep our people and communities safe but have also made it possible for all of Alcoa's bauxite mines, alumina refineries, and aluminum smelters to remain in operation at pre-COVID production levels.

From a commercial perspective, our bauxite shipments and pricing remain largely unaffected, and are based on annual or multiyear contracts. In alumina, stronger Chinese metal prices are currently supporting smelter-grade alumina imports into China, and we're able to place any spot tonnes as they become available.

In aluminum, excess supply and demand for value-added products in Europe and North America continue to put pressure on the market. While June orders have been steady, we are beginning to see improvements in July orders, as businesses reopen. Regional premiums remain soft, as many smelters have been switching production to commodity-grade ingot until downstream business demand recovers.

This COVID-19 pandemic has created a rapidly changing financial environment as well. In comparing the second quarter to the first quarter, we would not only expect impacts from changes in alumina and aluminum prices and aluminum product mix, but based on today's currency, a possible partial reversal of the foreign exchange benefits seen in the first quarter. These impacts also could change our expected operational tax rate, which is highly volatile at these forecasted earning levels. We expect the second quarter operational tax rate to be approximately 40%.

As I said before, we've been guided by our values and our strategic priorities, and they have made us uniquely prepared to face this year's challenges. We have in place three sets of actions. First, we launched a strategic update in the second half of 2019. This new strategy reiterated being low cost, margin-focused, and financially sound to compete in a global commodity industry and was updated to incorporate our inherent advantages in sustainability. The timing of the strategic review was excellent, because it provided a roadmap and clear vision for the future.

We focused on three key actions – a new operating model to improve decision making and reduce overhead costs, the sale of non-core assets to simplify the company and raise cash, and a multiyear review of our mines, refineries and smelters. Since this announcement, we have initiated the new operating model, completed the sale of our Gum Springs treatment facility, closed the Point Comfort refinery in Texas, and announced curtailment of the remaining capacity at our Intalco smelter in Washington State. Most recently at the San Ciprián smelter in Spain, we have initiated with workers' representatives an informal consultation process on the future of the smelter. While in our analysis the production of aluminum at San Ciprián is not viable, no final determination has been made, and we are working to manage the situation and any possible impact on the workforce.

Second, in February of this year, we announced two new programs for 2020 to strengthen the company and improve results compared to 2019, driving leaner working capital of $75 million to $100 million by reducing inventory and optimizing contract terms, and generating $100 million of savings from sustainable annual productivity improvements.

Finally, although these five previously announced actions provide a foundation for us to weather this pandemic, we are undertaking additional initiatives to improve our position in 2020. These actions include deferring pension funding until 2021, reducing capital expenditures, delaying or deferring certain other payments, and implementing global hiring and travel restrictions. Together with the cash proceeds from the Gum Springs sale completed in January, we are targeting $900 million from these actions this year.

In closing, as we move forward through this period of instability and uncertainty, we will continue to focus on protecting our employees and our operations throughout the COVID-19 pandemic and moving forward on our company's three strategic priorities to deliver returns to our stockholders.

So with that, Chris, I'll turn it over to you for questions.

Chris Terry Thanks, Bill. Good to get the update there. I might start on the market and then we can drill back down into the company. So I'll start on the supply side. Given the actions you've taken over the last year or so, and then your announcement on 1Q around West Coast smelting and now the talk around San Ciprián; can you comment a little bit on the industry as a whole, and what you think needs to happen? Is it leadership from others on the smelting side? Is it consolidation, more tariffs, just general closures on the supply side that you need to see from Alcoa, but also what you'd like to see from some of the industry participants?

William F. Oplinger Sure. So let me address first what we're doing, and then we can address the industry participant question. As you said, we announced the curtailment of Intalco, and that should occur by the end of July. That was a fundamentally uncompetitive facility, and given the current market situation, we decided to curtail it to stem losses. It lost around $25 million in the first quarter, so it was a significant loss generator that needed to be curtailed. And as I said in my prepared remarks, we've initiated informal consultation with the workers' unions in San Ciprián. No final decisions have been made yet, but at this point, we are consulting with the workers' unions and getting them to understand what the situation is at that smelting facility.

As far as other industry participants, we acknowledge that the industry participants all have to make their decisions on their own. And so they need to be looking at what makes sense for their facilities. However, when we look out at some of the current market dynamics, I would tell you that both on the alumina side, alumina refining and the smelting side, there is still significant capacity that is cash negative. So for instance, on alumina refining, we would think the rest of the world's cash negative position is around 12%. And in China, that's in excess of 40%. And then when you look at metal, it's a slightly different position on metal, given where the cost curves are and the flatness of the cost curves. Today we would suggest that there's probably a third of the rest of the world's smelting capacity that is currently cash negative, whereas the Chinese are essentially in a position where there's not a lot of their capacity that's cash negative. And that may be surprising, that’s simply due to the flatness of their cost curve and the rebound in the SHFE pricing.

So we are taking definitive action in today's environment to put ourselves in a better position going forward, and each individual company will make their decisions in the industry.

Chris Terry Okay, great. And then in terms of demand and then I'll bring it together just on the overall market, but in terms of the current picture, we're seeing green shoots in China. There's been -- you commented on it a little bit, I think, in your opening remarks. Are you seeing any other bright spots to justify the bounce we've seen in the aluminum price off the bottom? What are you seeing in terms of customer ordering patterns, regions of the world, any evidence that there's a sustained demand improvement here?

William F. Oplinger Yeah, and we are seeing green shoots in various parts of the world. As I said in my prepared remarks, and you alluded to, China is leading the recovery. We are seeing some sectors in China reporting growth in higher than 2019 levels. That's in areas like industrial production, vehicle production, commercial starts, food and drink sales. And then on top of that, with the recently announced Chinese stimulus plan, that makes provisions for investments in traditional and new infrastructure areas. So China is leading the way on a V-shaped recovery. We very clearly see that in China.

As we look around the rest of the world, the rest of the world has been a little bit slower to recover on the demand side, but we do believe there are potential green shoots out there. As we look at our order books, the June order books are as expected. We have seen, as we alluded to in our first quarter analyst conference call, a drop off in value-added products mix. We had said at the time that that was around 20%. In the near months in May and June, it might be a little bit larger than that. However, we are starting to see orders tick up in the July timeframe. So we are starting to see orders in slab and foundry markets coming back as we see the pace of the auto restarts starting. So that's positive on the demand side.

Chris Terry Thanks. Thanks, Bill. And then just to bring that together, just your I guess holistic view of supply and demand together, is it a matter of as we go through the next 12 to 24 months, call it, there's some supply adjustments; demand starts to rebound. And then do you think it's sort of work on both sides of the equation that gets to a more sustainable level where there's not so much of the industry that's loss-making? Or do you think it ultimately needs still pretty decent supply adjustments to get there? I mean it obviously depends on how much demand comes back in the certain pockets, but just trying to get a feel for the current picture versus how it might look over the coming years.

William F. Oplinger Yeah, well the connection between supply and demand, Chris, ultimately is on the inventory levels. And we have seen inventory levels globally grow in the first quarter, and we showed that in our first quarter conference call. I think inventories grew by a couple of million metric tonnes in the first quarter alone. We saw a continued inventory growth through April. So to discuss what it means and how long it will be before that rectifies, really it will come down to both sides of the equation. We are starting to see the demand pick back up, again, led by China. But clearly the world today is producing more aluminum than it needs, and it is resulting in higher inventory levels. So to rectify that, it will be a combination of both higher demand and supply restrictions.

One good point on the inventory side that I would point out is that we have seen a drawdown in Chinese inventories, as the strength of the demand has come back. So that's a positive, but offsetting that is the growth in inventories in the rest of the world.

Chris Terry Okay. All makes sense. Thanks, Bill. And I wanted to shift across onto some of the pricing dynamics now. In terms of the Midwest premium, we're moving down to multi-year lows and there's been a large move down in the last 12 months or so. There's more and more talk around additional changes maybe on Section 232, certain articles around that. I know you've been quite vocal and have spoken about that on some of the conference calls in the past. I was just wondering if you could comment on some of the dynamics there in terms of imports of semi-fabricated aluminum, and just overall restrictions within the marketplace, and maybe tie that back to the Midwest premium pricing.

William F. Oplinger Sure. Let me start where you ended, and that's the Midwest premium pricing. We have seen Midwest premium fall over the last year, and that started even before COVID-19, and accelerated with COVID-19. And I think you've got a couple of things going on there that are interrelated. The first is that we have seen demand decline, as industries were impacted by COVID-19. Along with demand declining, we've seen a shift not only in our own production, but in competitors' production, to switch from making value-add products to P1020, and that drives down the overall Midwest premium to pretty low levels.

So let me come back to some of the discussion around the 232 and potential Canadian tariff exemptions. You know, you alluded to it. We've said all along that we don't support tariffs and that we support free trade, with those who trade fairly, especially the Canadians. Our position is that China's overcapacity and heavy subsidization of the industry is the real problem, and the tariffs are an ineffective tool to address that problem. So that's been our position all along. We are not a supporter of tariffs and we're certainly not a supporter of any type of a quota system, because when we look at the data, we've not seen an influx of a significant amount of metal from Canada, if you're looking at the right time periods. And you have to account for the fact that the ABI facility in Canada was curtailed for about 18 months over the last couple of years. So our view is that tariffs and quotas just distort the marketplace and haven't supported them from the start.

Chris Terry Great. Thanks, Bill. And I wanted to move on to cash flows, you talked about the $900 million cash actions during 2020. I wondered if you could just talk about the progress on some of those items, and step through the big picture here. I guess pension deferral, the $220 million is certainly positive for this year. That's going to come back or you're going to have to return to the pension at some stage. Working capital should flow through, and it's the last three quarters of the year, I believe, where you get a working capital relief. I was just wondering if you can talk through sort of the sustainability of some of those actions into 2021, the overall progress you've made, and then whether there's other opportunities. Some other companies have commented that through the COVID process, they've found ways to be more efficient in their chains and look at things through a different lens. Yeah, so ultimately, just want to get a sense of how you're going, and the opportunities, and then as you head towards 2021 on the cash flow. Thanks.

William F. Oplinger Yeah, so the $900 million is the sum total of the benefits that we're getting from the three programs that I outlined in my prepared remarks. And so just to put it in perspective, out of the $900 million, we're anticipating 2020 to provide $45 million of lower overhead cost. We've implemented those actions, and we will see that benefit starting to flow through in the second quarter. These weren't easy actions to implement, we reduced close to 300 positions across the world, but that is now starting to pay the benefits in the second quarter.

Non-core sales contributed $200 million. That's done with the Gum Springs sale. We achieved $200 million of cash, plus a $50 million contingent payment. Portfolio review will contribute $10 to $75 million in 2020. That's basically the Intalco curtailment. Intalco, as I said, was losing about $25 million in the first quarter, so that will avoid losses.

The leaner working capital and lower production costs, I'm confident we will achieve the $200 million associated with those two programs. Working capital, we've made improvement already in a first-quarter-to-first-quarter look and are striving towards making improvement on the productivity cost side the last three quarters of this year.

As far as the specific actions we've taken around COVID, cutting capital expenditures, I'm confident that we will be able to do that. We've taken our budget down on a forward run rate basis by $100 million for 2020. We're in the process of deferring environmental and ARO spend by $25 million. I'm confident that we will get that. The deferment of the pension funding, $220 million of cash funding that would have occurred in 2020. The CARES Act allows us to defer that to 2021. As you said, it's important to note that is simply a one-year deferral. If we get to 2021 and we need to, we established a prefunding balance in the pension a couple of years back by borrowing. It turned out to be a smart move, because we were able to borrow, put it in the pension, and if we need to, we can use that prefunding balance to not make minimum required contributions. That prefunding balance should be around $375 million at the end of the year, and obviously that will vary, depending on asset return levels. But we could use that prefunding balance in 2021, if we want to offset some of the mandatory required contributions.

So I am confident that the $900 million is within our target range, and we're actioning all of those items today.

Chris Terry Thanks. That all makes sense. Just to explore that a little bit further, I guess in addition to the policies that you've implemented across those sort of three main areas I guess, what about other opportunities around any energy savings or more on the operating cost savings. And then the other question, just to round that out; so you have the $375 million you said in the prefunding that you can use against some of the pension potentially into next year. But is it fair to say that of the items, of that $900 million into 2021, the biggest opportunity is maybe continuing to maybe work down the CapEx? And then most of those other items though will likely come back, as the working capital release probably will be tougher into 2021, and the pension deferral probably will be less than what it is this year, et cetera. And then Gum Springs has already happened. So maybe if you can just talk about the bridge I guess from 2020 to 2021, and as part of that, if there's other broad opportunities in energy costs or anything else in the business that you can see.

William F. Oplinger Sure. So one of the things, and I probably didn't address your prior question thoroughly. You asked me, have we learned anything through the COVID process. I would tell you that in this downturn, we have really rejuvenated our work around underlying productivity of the company. We've got a Chief Operating Officer that is running a productivity acceleration program throughout the company to try to drive systematic productivity improvements. And when I say productivity, there's a broad definition of productivity there. It's not just labor productivity, but better usages of MRO and services, lower capital spending, and really underlying key productivity improvement, KPI improvement across the company. So I think that we will come out of the COVID situation a stronger company, more focused on the productivity side.

When we then get back to your original question, what will revert here. The working capital clearly is a one-time benefit. You don't get working capital savings every year. But the new operating model allows us to look end-to-end at working capital. So we now have a Chief Commercial Officer who has a team that is looking at inventory, payables, receivables, from all the way from energy in bauxite to rolling and finished products, from the very beginning of the process to the very end. And I think that will help us achieve optimization around working capital.

And then lastly, and I probably should have pointed this out in my discussion around 2020; we have targeted $500 million to $1 billion dollars of asset sales. We've not walked away from that target. I should make sure you understand that we are executing upon asset sales that should drive proceeds of $500 million to $1 billion dollars. The Gum Springs asset sale is just the first of those asset sales. So we've given ourselves till the first quarter of 2021 to complete those asset sales. I will tell you with COVID getting in the way of that process, that's taking us a little bit longer than the first quarter of next year. But at this point, we're still targeting to get those asset sales done by the first quarter, but it is more difficult today than it was maybe four months ago, five months ago.

Chris Terry Okay. And then I was going to ask on the asset sales that the $500 million to $1 billion; you've done $250 million of that, as you said. I mean you announced that in that program initially in 2019, I guess versus when you announced those numbers, and how the world stands today, aluminum is much lower. There's been a lot of changes. Demand is trying to recover from where it is. Do you see more or less urgency to get that done? On the one hand, it's probably hard to get the values that you want to get in the current market, but you would like to get the cash flow back in I'm assuming. So I just wondered if you could talk about the progression of the importance of those asset sales within the context of the balance sheet and overall cash flow.

William F. Oplinger Right. And I'm going to agree with most everything you said. And that is the asset sales today are important. They're important just because of the cash flow situation, but also because we had identified these assets as non-core assets and we are streamlining the portfolio, so that we can come out of the COVID crisis in a more streamlined, lower cost, better positioned company. So on the one hand, it's important to get them done. I will tell you, though, that we are not in a fire sale situation here. We are going to take our time to get these asset sales done correctly and try to maximize the value for them.

And then lastly, the assets that we will be selling are, as I said, non-core assets, and not necessarily all linked to the LME cycle. So for instance, the land down in Texas, that is not obviously linked to – the value of that is not linked to LME prices, and therefore, we think that even in today's environment, we can get the right value for that asset. And again, agreeing with what you said, the only piece that I would highlight is that things have moved a little bit slower than what we had probably originally planned. It's harder to get buyers together. It's harder to launch a process for the asset sales, given everything that's going on. But we're still targeting that level of proceeds on that timing.

Chris Terry Thanks. Thanks, Bill. And we have about five minutes left. So I had two final questions for you. One's on the environmental side, and just the opportunities that you have within Alcoa from power generation to be pushing the ESG side, and maybe if you could just highlight any other opportunities within the business. I know you've got some technologies you've been working on further out, et cetera. So if you can just comment on that. And then the other one, just to plan the last five minutes and I wanted to touch on it, is the pension. Last quarter on the 1Q results, you obviously did a good job within the context of the interest rates. So I think there was some confusion around the benchmark being the Treasury or the corporate bond yields, and you did a better job, I think, than the market expected on that. Since that point, asset returns have been very strong, which should have helped the company. So I was just wondering if you could comment on the overall pension liability, and then that environmental question, just the opportunities that lay in front of Alcoa. Thanks.

William F. Oplinger Sure. That is a lot to cram in the last four or five minutes. So let me try to just really gloss over it, and then individual investors can certainly ask these questions one-on-one. ESG is more important today than it has ever been. We are seeing – I would have told you five years ago ESG was a small part of investor discussions. Today it's critically important for companies to act responsibly.

When you look at our three strategic priorities, one of them is advancing sustainably. And what does that mean? That means that through our portfolio actions, over the next number of years, we will continue to be and will become the lowest carbon-emitting producer for alumina and aluminum. We are already the lowest carbon producer in aggregate on the refining side. We will maintain that advantage, and then on the smelting side, we are going to reposition the company through the portfolio actions to be the lowest carbon producer. That is with the existing technologies that we have today. But as you said, Chris, we, along with two of our joint venture partners, Rio Tinto and Apple, are working on a breakthrough technology called Elysis™ that will be a zero-carbon production aluminum cell, and we have said that by 2024, we will have a commercial package for having zero carbon production on the smelting side.

And ESG is not just all carbon. It's important to remember. When you look around the issues that our industry and the mining industry have had over the last year and even over the last few weeks, I think we're well-positioned when you consider how much time and effort we've spent working with our communities and taking ESG seriously for a long time now. So from an ESG perspective, I think we are well-positioned.

If we then jump quickly to pension. You know the pension, we've done a lot of work over the last three years. What work have we done? We've limited the liability by both freezing the pension for salaried employees, and also by taking parts of the pension and offloading that to insurance companies who provide those pension services. In addition to that, we've prefunded it and so we went out and borrowed $500 million in 2018 to prefund it. And that puts us in a good position going into years like 2020 and 2021. And then lastly, we changed our asset allocation. And that change in asset allocation has really served us well. Even in this down cycle, we've seen the portfolio do well. It's a balance between return-seeking assets and the liability-driven investing assets, LDI, hedging assets. So it has done well.

To your point, we said in the first quarter – at the end of the first quarter given that the discount rates which are based on a 15-year bond curve had actually increased at the end of the first quarter, and at the time, the asset returns had been a loss of 7%. We will remeasure that at the end of the year. There's still a lot of time between now and the end of the year. Interest rates, I should say discount rates, can go a lot of different directions. And asset returns can make changes. But I feel pretty good on the work that we've done over the last three years to put the pension in a position where we would like to be over the next seven years, in a fully-funded pension situation, so that we can reduce this liability for the company.

Chris Terry Great. Appreciate it, Bill. I know I've asked a lot of questions there and we covered a fair bit of ground. Hopefully investors can follow up with the company afterwards with anything else, and we've got some one-on-ones. I'd like to thank you very much for your time, Bill, and Alcoa for participating in our conference. Thanks, everyone, for listening in.

William F. Oplinger Thanks, Chris. See you.