Alcoa Corporation

Bank of America 2020 Leveraged Finance Virtual Conference

Tuesday, December 1, 2020, 10:30 AM EST

CORPORATE PARTICIPANTS

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

OTHER PARTICIPANTS

Matthew Fields – *Managing Director (U.S. Credit Research), Bank of America Global Research*

Alcoa Corporation
December 1, 2020
10:30 AM EST

Matthew Fields: Hey, everyone. This is Matt Fields. I cover high yield metals and mining for Bank of America. It's my pleasure to welcome you all to our 2020 Leveraged Finance conference. And it's my additional pleasure to have Bill Oplinger, the Chief Financial Officer from Alcoa here joining us. Bill, I think, has some prepared remarks. And, I think, if you're ready Bill, take it away.

William Oplinger: Thanks, Matt. Maybe just have a few comments to start out with, and then we can open it up for Q&A. Just briefly, to introduce you to Alcoa, if you don't know us, you should get to know us. We're a vertically integrated primary aluminum company.

We're one of the world's largest bauxite miners. We have a first quartile cost position in bauxite; one of the world's largest alumina producers, first quartile cost position in alumina with a number of plants down in the first decile. And then we're an aluminum producer that is around a second quartile aluminum producer.

We're listed on the New York Stock Exchange. We have Western governance. And we launched as an independent company back in November of 2016, and then made a lot of strides and progress since then.

I transition to what we've been up to over the last year. There's a lot that we've been up to, and I just want to make sure we hit on a few of these things. Back in October of ‘19, a little over a year ago, we announced three strategic initiatives that we had ongoing.

We announced a brand new organization model. That model switched from a BU-centric model to a much flatter organization that has the operations under a single leader and commercial under a single leader.

That new model not only allowed us to take out some overhead, it really has been the groundwork for some of the better operational performance that you've seen out of the company this year. And it also allows us to manage working capital and the commercial activity from end-to-end. So it has been a very favorable change in the organization that was enacted a year ago.

We also announced repositioning our portfolio of assets. We put four million metric tons of refining capacity under review. And subsequently--as soon as we--essentially, since we made that announcement we announced the permanent closure of our Point Comfort refinery that eliminates 2.5 million metric tons out of that 4 million metric ton review.

We also put 1.5 million metric tons of smelting capacity under review. We took action during the course of the year. We curtailed the Intalco facility, which was a high cost facility. We have also announced the initiation of the collective dismissal process in Spain. And we continue to work through that collective dismissal process in Spain.

Once we get through that asset repositioning, not only will we be first quartile in our three segments of businesses, but we will also be the most sustainable primary upstream aluminum business out there. We will have the lowest carbon emissions footprint on the smelting side from an intensity basis, and we'll continue to have the lowest carbon footprint on the refining side continuing where we stand today.

Thirdly, we announced asset sales. So we announced that we were projecting $500 million to $1 billion of non-core asset sales, and those are expected proceeds to occur by the end of the first quarter of 2021. I'll hit on that a little bit later, but we've made very good progress. And you probably saw an announcement last night that we have an agreement to sell our Warrick rolling mill.

In addition to that, we announced two near-term activities that will be completed in 2020, a productivity target that is both volume increases and cost savings, and a working capital target. Between the two of those, we are anticipating about $200 million of benefits. And we feel in combination those two are on target to deliver in 2020.

And then lastly, when COVID hit we were well positioned to manage through the COVID pandemic. We did announce a number of cash sustainability actions, specifically that we would defer our pension contribution that was required to be made in 2020 to 2021. We did that. That was approximately $200 million to preserve cash on the balance sheet.

I then transition to what we're seeing in the fourth quarter. We're seeing better aluminum prices, better alumina prices. And if you look at our sensitivity, that should drive better EBITDA in the fourth quarter versus the third quarter. In addition to that, we had assumed in our fourth quarter outlook that we would still have to accrue for tariffs into the U.S. from our Canadian plants. That has subsequently changed. So that's about a $22 million swing versus what we had projected for the fourth quarter back in October, a $22 million benefit versus what we were projecting.

However, all that adds up to higher profitability. So our projection for tax expense goes from $25 million to $45 million in the fourth quarter. So the higher profitability, which is great, will result in a little bit higher taxes that will be booked in the fourth quarter.

So then lastly, we announced last night the divestiture of the Warrick rolling mill. Total consideration for the Warrick rolling mill is $670 million. $583 million will be-- I'm sorry, $587 million will be in the form of cash; $83 million will be in the form of the assumption of the OPEB liability. We expect that to close in the first quarter.

We're excited about that because it essentially puts us at the top end of our range for expected proceeds from our non-core asset sales. We feel it's a fair price for both us and Kaiser; I should have said Kaiser is the buyer. And we're happy, that we think Kaiser is the right owner for that facility. It puts our plant and our employees in a company that is strategically focused on rolling. And it was our last rolling mill that we had coming out of the process of separating from Alcoa, Inc., and so we're pleased to see that go for a fair price and go to an owner who we believe has great opportunities to make that plant successful. So Matt, that's all I had to cover.

Matthew Fields: All right. I think that's a great summary, Bill. I'm going to jump into the Q&A here and then if we see some from the audience, we'll go ahead there.

So I think we're seeing, and like you mentioned, an interesting move on prices in the fourth quarter. We're seeing a big rally in aluminum, a little bit less of a rally in alumina. What are your thoughts on the recent aluminum price move, and why isn't alumina getting invited to the party?

William Oplinger: Well, they are two very different markets. The aluminum market is traded on the LME, and so there is much more trading of a ton of aluminum than there is a ton of alumina. And alumina is sold between a customer and a supplier via contracts. So in the case of aluminum, what we're really seeing is related to the sentiment in the marketplace as a couple of things are driving that positive sentiment.

First of all, the overall market sentiment with a potential vaccine on the horizon coming out of the COVID pandemic seems to be driving many assets up. And it's also having a positive impact on aluminum.

Secondly, we have seen a very strong V-shaped recovery out of China. And so that has led the way in driving aluminum prices up. We're starting to see some positive moves in the rest of world.

I probably should have mentioned it in my fourth quarter view, we've done a lot of talking about value-add products. And at least, versus the outlook that we gave in October, we're seeing stronger value-add products demand. That is not resulting yet in higher premiums, but we are seeing stronger demands.

You then transition to the alumina side. Alumina prices have also gone up but not at the rate of aluminum. We believe that the aluminum market is fairly well balanced and is creeping up in sentiment with the aluminum prices, as we see from customers trying to lock in some of the prices that we're at, but not to the same extent as alumina.

Matthew Fields: Yeah. That's very helpful. What do you think can help get prices stronger from here? Does Chinese demand matter? Does Chinese smelter refinery profitability matter? What are the sort of key metrics that we're looking for to foreshadow a global rise in aluminum prices?

William Oplinger: So Chinese demand certainly matters, and that has been part of the driver of the recovery that we've seen. We do see a reduction in physical inventory in both China and in the rest of the world. And so that's a positive sign. So the Chinese demand is important.

As far as the rest of the world goes, we're really taking a view that we'll wait to see how strong the rebound will be coming out of COVID. But at this point, as I mentioned, the value-add product markets are recovering, and we're seeing that in a number of our end user markets.

Matthew Fields: Are there any measures you can envision to counter China's sort of continued heavy exports of aluminum?

William Oplinger: Well, there are some measures in place today. And those are, specifically, the U.S. Section 232 tariffs and some various antidumping, countervailing duties against Chinese aluminum exports from a number of countries. And we expect those to continue. There's potentially more tariff measures as the EU wraps up its investigation into Chinese aluminum extrusions and decides whether to levy long term duties there.

There are potential opportunities under a new Biden administration to work with like-minded countries to pressure China's trade distorting policies and take some steps together to end Chinese circumvention efforts, like transshipment through other markets.

The other forum could potentially be the WTO taking a more active role. So we do believe this is an opportunity to try to get more of a level playing field. When you look at the OECD report that has been out now for a while, a big piece of the subsidies in the aluminum industry have been granted to just a small number of the Chinese aluminum companies. So there's still opportunity to level the playing field.

I would say, though, that we do see China itself is shifting a little bit. There are more stringent environmental measures, a new long term domestic carbon neutrality pledge, which should be a positive for supply growth, and really a focus on domestic consumption, on trying to make sure that they increase domestic consumption.

And then the only other thing I would mention as far as the environmental measures go, the Chinese smelters are nearly 90% coal fired. So that puts them significantly higher on the CO_2 emissions curve than us and many of the rest of world's Western players.

Matthew Fields: That's a fair point, and then talking about that environmental impact, something you especially have been speaking about more on your earnings calls has been green aluminum, which has been a point of emphasis. Can you give us a sense of the market size of this potential opportunity time frame until it's really monetizable for you, and kind of how you stack up against peers in the new green aluminum initiative?

William Oplinger: Well, the market is just getting started for green aluminum products. And to put it in perspective, we actually have three green aluminum products. And we've got our EcoLum™, EcoDura™, and now the new EcoSource™ product. EcoLum™ is a low carbon aluminum product. EcoDura™ has a higher recycled content.

And now, with the launch of EcoSource™, EcoSource™ is a low carbon alumina product. And we believe it's the world's first and the only branded low carbon alumina product. This is a growing early stage market for low carbon products. I will tell you, today it's small, but we really believe that this is the way the world is moving.

It just so happens that we are in a very good position to be able to offer low carbon products, especially in comparison to some of the higher carbon emitting facilities in China. A number of our competitors have launched similar products, and we don't necessarily see that as a bad thing. With the new low carbon products from Rio Tinto and from other Western world producers, we think that would help build a low carbon market and hopefully grow the demand for low carbon aluminum.

One thing to note, in our low carbon products we're including, on our aluminum side, both the carbon in production of the aluminum but also in the alumina off-site piece of that.

And then lastly, I would say that we do have a breakthrough technology that's on the horizon. We announced a joint venture with Rio Tinto probably, what, two years ago now, where we are working on research and development of the ELYSIS™ product.

And so ELYSIS™ is a low carbon aluminum product. And it essentially doesn't generate any carbon in the manufacture of the aluminum. It would be the world's leading no carbon aluminum product in the manufacturing of the aluminum itself. So a lot going on both in the industry and for Alcoa.

Matthew Fields: OK. Great. That's very helpful. I want to transition over to the financial side of what you've been doing. You've kind of reviewed some of the steps you took specifically this year with regards to COVID and managing costs. You've talked about idling or curtailing the higher cost assets over the last couple of years.

How do you think about what you need to do on that front continuing into the future? Do you keep some assets kind of open because of significant exit costs, and that's hindering your ability to do that further – just give us a sense of any more potential cost savings or curtailing measures that we can expect in the company going forward.

William Oplinger: Ok. Let me bifurcate that into two things – one is the repositioning of the portfolio and the second is the basic blocking and tackling that we have going on in the company when it comes to cost control.

On the portfolio reposition we gave ourselves five years from October of 2019. As I said, we began taking actions very quickly with the curtailment of Intalco and the initiation of the collective dismissal process for the Spanish smelters. We will continue to work through our repositioning work, and we have another, what, a little bit less than four years to go. So we will continue to progress that.

And I should really say when we look at that, there are really three potential outcomes for the sites that are considered in that portfolio repositioning: the curtailment or closure, the sale of the site, or actually significantly improving the cost structure of the site by either renegotiating the power contract or some other factor. So it doesn't always mean that we will close or curtail the site. There are the potential of either sale or significant repositioning through cost savings.

I then transitioned to more of the basic blocking and tackling that we do on a daily basis. We've been focused, extremely focused this year on really two outcomes of the new organizational structure. And I'll hit the commercial side first.

It's the first time that we've put all aspects of the commercial organization under a single leadership structure. We have end-to-end sight on all commercial activities that allow for better decision making. We also have end-to-end working capital view that allows us to manage working capital for the entire company, all the way from mining bauxite to the sales of rolled products at the end. That's the commercial side.

The other piece is that for the first time as an independent company we went out with a target for improving our cost structure and increasing our volume, and that was a $100 million target, a lot of focus this year on really getting back to the basics of using the Alcoa business system to drive continuous improvement through our plants. And that creeps production or it takes out costs.

And so we've seen good progress on that this year. And between the combination of those two initiatives, are anticipating $200 million of improvement in 2020.

Matthew Fields: Great. Switching over to another side that you mentioned, the portfolio review, the $500 to $1 billion of proceeds. You're, obviously, in that range now with the Warrick transaction just announced. Does this mean you're kind of done with divestitures for a little bit? Should we expect any more?

William Oplinger: So yeah. Let me address that. When we went out with the asset sale, we felt it was important for our shareholders to understand that we were constantly evaluating the portfolio and trying to streamline the portfolio in a way that will drive shareholder returns into the future.

We set a goal of $500 million to $1 billion of net cash proceeds. We sold the Gum Springs facility to Veolia earlier in the year for $200 million, plus an additional potential $50 million, depending on some work that will be done in the future. And then last night we announced the $587 million of cash proceeds on top of an $83 million OPEB assumption for Warrick. So at this point we're at the top end of that range.

Doesn't mean we will necessarily stop on potential asset sales. We will continue to look at the portfolio, and if it makes sense that somebody is willing to pay us more for an asset than what we think it's necessarily intrinsically worth, we'll consider it.

And probably the best example is we continue to try to sell the Rockdale facility down in Texas. It's 30,000 plus acres of land in Texas. It's got a list price of $250 million. And we're working to sell that. So we are in our target range, Matt, but not necessarily stopping.

Matthew Fields: OK. That's helpful. You know you've talked a lot about proportional adjusted net debt in the past as a key metric for you. Can you just, for people who are not familiar, can you please explain what that is and your target parameters around that figure?

William Oplinger: Yes. Proportional adjusted net debt, essentially it is the cash, the debt, pension, and OPEB, all on a net basis attributable to Alcoa after removing the impact of our joint venture. So you know, in our bauxite and alumina business we have a 60/40 joint venture between us and Alumina Limited. We essentially take our portion, the Alcoa attributable portion of the cash, the Alcoa attributable portion of the debt, the Alcoa attributable portion of the pension and OPEB, and that comes up with the overall proportional net debt metric.

At the end of 2020 we were projecting to be at $3.5 billion. We ended 2019 at roughly $3.4 billion. We're projecting 2020 to end up at about $3.5 billion. That's largely due to the fact that the discount rate in the pension has decreased during the course of the year, making the pension liability go up.

And so we have a target of $2.0 to 2.5 billion of proportional net debt. We think we can get to the high end of that target within the next few years simply by making the minimum required pension and OPEB contributions.

So we'll continue down the path of de-levering, both through the either funded debt and the payments into the pension, and in the case of what we just did here, or just announced on Warrick, the buyer is taking $83 million of OPEB liability there. So that will take that off of our books. So that's the target, and we're projecting to get there in the next few years.

Matthew Fields: Now, that $3.5 billion that's the level you had for end of 2020, that's before the Warrick sale, so presumably that would be $600 to $700 million lower.

William Oplinger: That's before the Warrick sale. Remember, the sale won't close until the first quarter. So that will, if we use all those proceeds, and either leave it in cash on the balance sheet, or use it to pay down debt, or put towards the pension, it will lower that number automatically.

Matthew Fields: So that brings you to the next question. You talked a little bit about maybe $1 billion of cash as a target, maybe $3 billion of liquidities as a target, kind of interchangeably. Pro forma for this deal you've got well over $2 billion of cash and $3.8 billion of total liquidity. So you issued $750 million bonds in the third quarter. You're going to have almost $600 million of cash from this sale in early 2021. What's the plan for all this cash?

William Oplinger: That's a good question. We have a capital allocation model that we put out a couple of years ago, and we updated it most recently in October of 2019. That capital allocation model does a few things.

First of all, we like to keep $1 billion of cash on the balance sheet. Why keep $1 billion? We're in a cyclical industry. Prices go up. Prices go down. We saw that in the middle part of this year with the COVID pandemic. Prices went down sharply, yet we were in a position to weather the storm with the cash on the balance sheet. So that's why we do that.

Secondly, we sustain our operations. We typically spend between $300 and $400 million dollars of capital. That capital can sometimes be a little bit lumpy because sometimes you have large projects associated with mine moves or residue deposit areas. But we typically spend between that $300 to $400 million range.

Beyond that, once we've done that, there's four potential uses for excess free cash flow. There's further de-levering, either through debt repayment or through pension contributions. We have some mid-sized growth projects that are available to us in our refining business. At this point, our mid-sized growth projects were all put on hold during the COVID crisis. We'll reevaluate them in the future, but at this point, those are on hold.

A third, potential use of cash, and I should have said, these are not necessarily in rank order, is returns to shareholders. And then the last is the newest potential use of cash, which is the portfolio repositioning. That portfolio repositioning doesn't come free. When we curtailed Intalco that costs us some money. If we get to the point of curtailing the San Ciprián smelter after the collective dismissal process, that will cost us money.

So those are the four potential uses of excess free cash flow. I would tell you, though, that we are very focused on our net debt target, our proportional net debt target. So we will evaluate those four uses of cash, but at this point, I would tell you we're probably shading it toward trying to make sure we get to our net debt target over the next few years.

Matthew Fields: So obviously, the pension is a pretty sizeable obligation, but you have some funded debt. The 2024s are callable now. What's the priority between maybe repaying the near-term bonds and reducing the pension liability?

William Oplinger: We'll be going through that evaluation in the first part of next year. So it'll be an evaluation between what gives us the best economic return for applying that cash. So no definitive answer at this point, Matt.

Matthew Fields: OK. We've had other companies talk to us about pension who have significant pension liabilities not really being an urgent matter, and it seems with you guys, it's a little bit more urgent. Why the urgency to pay down those pensions as opposed to maybe higher coupon-funded debt?

William Oplinger: The urgency around handling the pension is simply due to the size of the gross and net pension and OPEB liabilities versus the size of our company. When we launched out of Alcoa, Inc., we had about 50,000 pensioners. We have, through all of our actions over the last four years, been able to get some of those pensioners over to insurance companies. We're down to probably more like 38,000 pensioners.

When you look at both our gross and our net liability, it is large in comparison to, for instance, our market capitalization. And so it's larger than most other companies. We think that adds complexity and variability that probably it would be better for us to have that complexity and variability eliminated over time.

So we feel that for the investment pieces of the company, we should be a simpler company to understand, and that you shouldn't necessarily have to understand all of the pension and OPEB accounting. So our target is to have that eliminated over the next few years, and we believe that's the best way to unlock shareholder value. And in talking to many of our major shareholders, they tend to agree that the pension can be an overhang. And so we want to get that under control and essentially that would make us a simpler, better company.

Matthew Fields: That's a fair point. It seemed for Alcoa for a number of years now has been trimming higher costs in non-core assets. When and how do we start to think about Alcoa maybe expanding, making acquisitions? Or does this business grow best by shrinking?

William Oplinger: In the near term, Matt, we're going to follow that four-pronged capital allocation model. And so you notice we don't have acquisitions on that four pronged capital allocation model. So we're going to continue to follow that debt repayment, potential mid-sized growth projects, returns to shareholders, and continue to reposition the portfolio.

Just to reiterate where I started, once we have the portfolio repositioned, we will have a first quartile business for all three of our business segments, be an extremely sustainable company, still with Western style governance. So I think it positions the company very well to progress.

Matthew Fields: OK. Great. I think we're a little bit over our time, but I'm going to ask one last question, and that given your increased liquidity and sale proceeds now you have for Warrick and maybe sort of hoping to emerge on the back side of COVID potentially next year with higher metal prices, do you have any updated thoughts on potentially attaining investment grade ratings? Historically, it seems like that's not been a priority for you, it's been a “we're going to accomplish our deleveraging goals and the chips fall where they may with the ratings agencies.” Is that still the way you think, or is there an update for that?

William Oplinger: That's still the case. And just to put a perspective on it, we target an optimal capital structure. We think that optimal capital structure gets us to the lowest weighted average cost of capital. The lowest weighted average cost of capital results in future earnings streams, future cash streams being valued the highest. And so that results in the highest equity value.

So that's how we think about it, optimal capital structure. If that optimal capital structure happens to be investment grade, that's fine. But we don't target it being investment grade. The rating agencies will make their determination, and ultimately the market will make the determination on the credit worthiness of the company. We're targeting an optimal capital structure.

Matthew Fields: OK. Great. I think that's all the time we have we're a few minutes over. So thank you for indulging me there. It's been my pleasure to have Alcoa at the conference. Please join me in thanking Bill Oplinger and the Company for continuing to support the Bank of America's conference. Thanks very much, Bill. We really appreciate your time today.

William Oplinger: Thank you, Matt. I'll see you.