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Aluminium market in need of supply rebalancing

- **We summarise the read-across from Alcoa's Q3 results and our global channel checks**
- **With demand decelerating, the global market needs additional supply curtailments – on top of the 1.6mt of cuts so far – to rebalance**
- **Potential sanctions on Russian metal could impact the global trade balance provided the restrictions rein in global traders**

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Alcoa reports weak Q3: Alcoa (AA, Not Rated) reported adj. EBITDA of US$ 210mn in Q3CY22, down 77% QoQ and as much as 17% below consensus expectations despite a prior profit warning from the company. The decline was driven by a sharp drop in EBITDA/t to US$ 245/t (-75% QoQ) for aluminium and US$ 21/t (-79% QoQ) for alumina. The sequential fall-offs stemmed from lower realisations (72% of the decline), increased raw material and energy costs (18%), and other factors. Alcoa expects the weakness to continue into Q4.

Indian aluminium players to also report a weak Q3: We expect Indian players to report a significant QoQ decline in profitability as realisations have plummetted. Indian players may face a deeper impact from coal inflation due to significant exposure to imported coal.

Aluminium prices to be under pressure near term: Per our channel checks, near-term challenges from a global slowdown along with sticky, high raw material and energy costs (carbon, caustic soda, coal, natural gas) are likely to keep aluminium prices range-bound at US$ 2,100-2,400/t till the market rebalances. Easing of energy inflation, if any, could add further downward pressure.

Supply adjustments essential to rebalance global markets: With the demand slowdown, the global aluminium market is likely to turn into surplus in Q4CY22 from a deficit of 0.4mt in 9MCY22. In response to weakening fundamentals, Europe has already shuttered 1mt of capacity, taking the total closures this year to 1.6mt globally, but this is still not enough to rebalance the global market. At current prices, 20-30% of Chinese supply and 45-55% of ex-China supply is cash-negative, per Alcoa.

Russian metal sanctions: impact depends upon restriction of global traders: Sanctions on trade by global traders such as Glencore could materially disrupt global aluminium trade rebalancing by restricting diversion to China and other Asian countries, potentially tightening the market near term. However, sanctions on usage by developed countries alone may not have a material impact as our checks indicate that China could absorb close to 1mt of the Russian metal against the current 0.3-0.4mt.

Global aluminium market: Key developments

We summarise key takeaways from Alcoa's Q3CY22 results and earnings commentary, along with insights from our global industry channel checks.

Near-term challenges ahead

Prices under pressure

Per our channel checks, near-term challenges from a global slowdown along with sticky, high raw material and energy costs (carbon, caustic soda, coal, natural gas) are likely to keep aluminium prices range-bound at US$ 2,100-2,400/t till the market rebalances. In the current environment, easing of energy inflation could lower the energy curve and put further downward pressure on aluminium prices. Alcoa highlights that carbon costs have peaked out and could ease somewhat in Q4CY22, but caustic soda costs are likely to remain high.

Supply adjustments essential to rebalance global markets

Demand for aluminium has decelerated with slowing housing markets not just in China but also globally. Higher interest rates and energy costs are likely to compress demand till H1CY23, per our channel checks.

With this demand slowdown, the global aluminium market is likely to turn into surplus in Q4CY22 from a deficit of 0.4mt in 9MCY22. In response to weakening fundamentals, Europe has already shuttered 1mt of capacity, taking the total closures this year to 1.6mt globally, but this is still not enough to rebalance the global market.

At current prices, 20-30% of Chinese supply and 45-55% of ex-China supply is cash-negative, according to Alcoa, and supports the possibility of a further supply response. Alcoa highlights that another 1mt of European capacity is at risk of closure. Our channel checks indicate that 0.5mt may be shut down over the next six months by way of partial closures of high-cost smelter lines in Europe and the US.

Alcoa believes the recent addition of 0.2mt of LME warehouse supply is not a sign of excess production but rather a transfer of inventory from non-LME sources. We understand from channel checks that this is a combination of supply from Russia, India and the Middle East.

Russian metal sanctions: Impact depends on restrictions on global traders

- **Trade rebalancing is possible in case of increased self-sanctioning.** While we have seen limited self-sanctioning of Russian metals by customers in CY22, this is likely to change in CY23 as contracts are renegotiated for the next calendar year. This Russian metal will have to be redirected to China and other Asian markets. While Russia has been supplying 300-400kt of metal on average to China annually, our industry interactions indicate that China has the potential to absorb ~1mt of supply.

- **US sanctions could impact trade rebalancing if it restricts global traders.** Sanctions under consideration on the use of aluminium in the US market alone may not impact trade flow materially. Russian metal supply into the US market has been limited after the imposition of S232 sanctions in 2016. And there are several ways in which restrictions on usage in developed countries can be worked around. However, sanctions on activities by global traders such as Glencore could materially disrupt global aluminium trade and tighten the market.

Medium-to-long-term outlook positive

- **Sticky supply closures will help aluminium prices on the way up.** Our channel checks reveal that close to 1mt of capacity may not return in the medium term, out of the 1.6mt of closures effected so far.

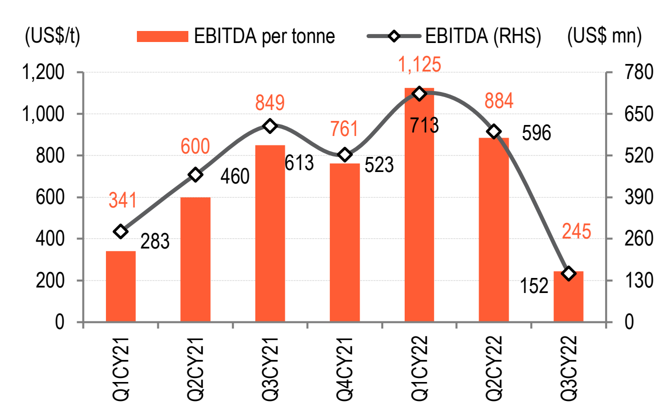
- **Long-term demand drivers remain intact.** Long-term aluminium demand growth is supported by its use in lightweighting vehicles and increasing penetration in electric vehicles, packaging, renewables generation and related infrastructure. We estimate that aluminium demand growth could return to its annual growth trajectory of 3%.

- **Decarbonisation will be a key driver for aluminium** with its high energy intensity. Of the 15mt of new smelting capacity required by 2030, only 6mt has been planned with renewable energy and another 4mt still needs clearance for implementation.

Alcoa: Q3 earnings highlights

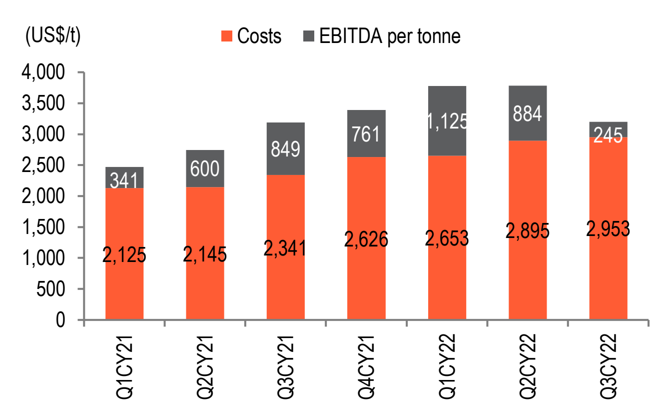
Alcoa reported adj. EBITDA of US$ 210mn in Q3CY22, down 77% QoQ and only 17% below consensus expectations after a prior profit warning from the company. The decline in EBITDA was driven by a significant pullback in aluminium and alumina realisations, increased raw material costs (carbon and caustic soda) and higher energy costs.

Fig 1 – Alcoa's aluminium EBITDA/t declined sharply QoQ but was only marginally below consensus



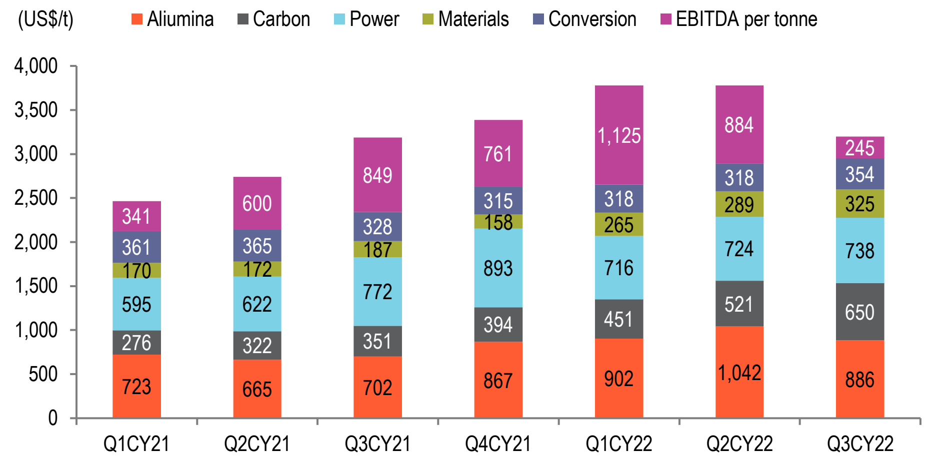
Source: Company, BOBCAPS Research

Fig 2 – Aluminium EBITDA/t declined mainly due to lower realisations and, in part, higher energy costs



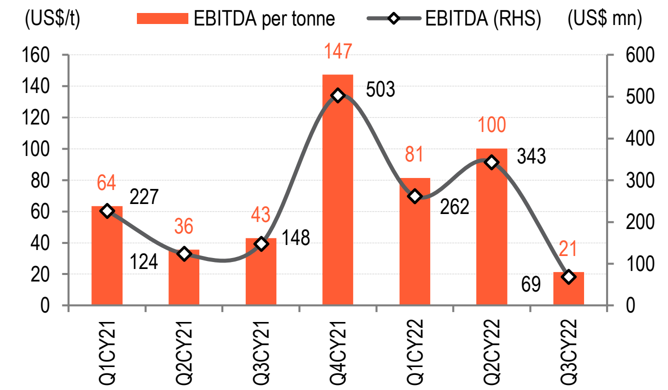
Source: Company, BOBCAPS Research

Fig 3 – Alcoa's aluminium cost and profit breakup



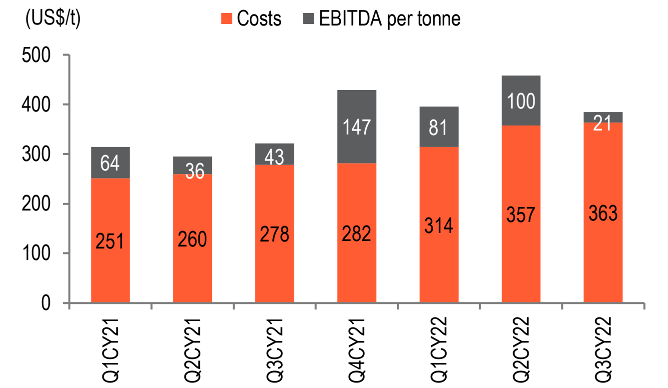
Source: Company, BOBCAPS Research

Fig 4 – Alcoa's alumina EBITDA also declined sharply, in line with consensus expectations



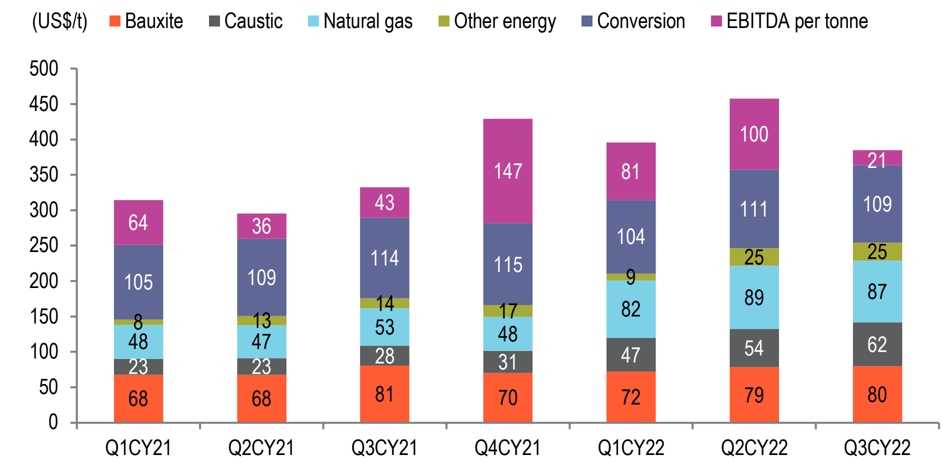
Source: Company, BOBCAPS Research

Fig 5 – Alumina EBITDA decline was driven by lower realisations and higher raw material/energy costs



Source: Company, BOBCAPS Research

Fig 6 – Alcoa's alumina cost breakup



Source: Company, BOBCAPS Research

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