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Siena Market Line
2nd week of March 2015

Alcoa Inc.

NYSE:AA

Analyst: Issam Kaisse
Sector: Basic Materials

BUY

Price Target: $15.76

Key Statistics as of 03/09/2015

Market Price:	$13.70
Industry:	Aluminum
Market Cap:	$17.70 B
52-Week Range:	$11.61-17.75
Beta:	1.58

Thesis Points:

- Structural transformation to avoid negative headwinds
- Strategic acquisitions to diversify fluctuating alumina prices
- Top positions in key financial indicators among its peers
- Presence in emerging markets is moving forward

Company Description:

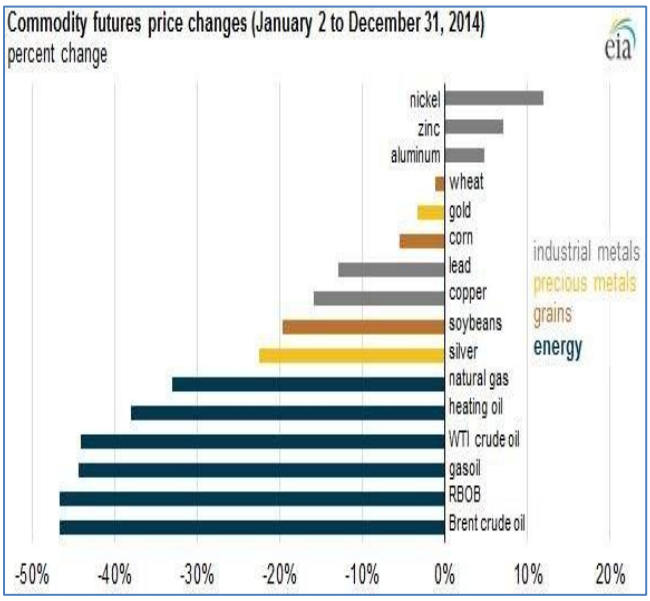
Alcoa Inc. was founded in 1888 and is based in New York, New York. The firm produces and manages primary aluminum, fabricated aluminum, and alumina worldwide. The company operates through four segments: Alumina, Primary Metals, Global Rolled Products, and Engineered Products and Solutions. The Primary Metals segment produces primary aluminum. The Global Rolled Products segment produces and sells aluminum plates, sheets, and foils, as well as rigid container sheets for food and beverage packaging markets. The Engineered Products and Solutions segment offers titanium, super alloy investment, and aluminum castings; fasteners; aluminum wheels; integrated aluminum structural systems; architectural extrusions; and forgings and hard alloy extrusions. The company's products are primarily used in the transportation, including aerospace, automotive, truck, trailer, rail, and shipping; packaging; building and construction; oil and gas; defense; consumer electronics; brazing; power generation; and industrial applications.

Thesis

In September 2013, Alcoa (ticker: AA) has been kicked out of the Dow Jones Industrials and resulted in slushing the price of the company by 50% in just two and a half years. After the painful expulsion from the blue chip index, Alcoa shares started to recapture momentum and make strategic moves that will improve its future earnings growth. Thus, the future prospect of Alcoa is promising because there are signs of turnaround in the aluminum market and tactical acquisitions. Also, AA is well diversified to avoid fluctuating alumina prices and performs well in key financial indicators among its peers. Throughout this report, these points will explain why a BUY recommendation is issued for a target price of $15.76.

Industry Overview

In the recent turmoil in crude oil prices, few commodities have been able to survive the current swings. In fact, aluminum is one of the few metals that is trending up and as you can see on the graph below, several metals are in the bearish trend.



In the long term, aluminum prices are expected to rise because industries such as aircraft and auto will increase their demand for this commodity. According to Harbor, the global leader in aluminum industry analysis and outlook, believes that the stable demand for aluminum will lead to a deficit that could be seen in 2017[1]. The graph below shows a stable aluminum pricing because China is undergoing a sluggish demand growth.

As a matter of fact, China is the world's largest consumer as well as producer of aluminum and accounts for about half of global aluminum demand. Analysts believe that the industry has hit bottom and the reduction in supply in the long term will drive price upward[2].

Structural Transformation

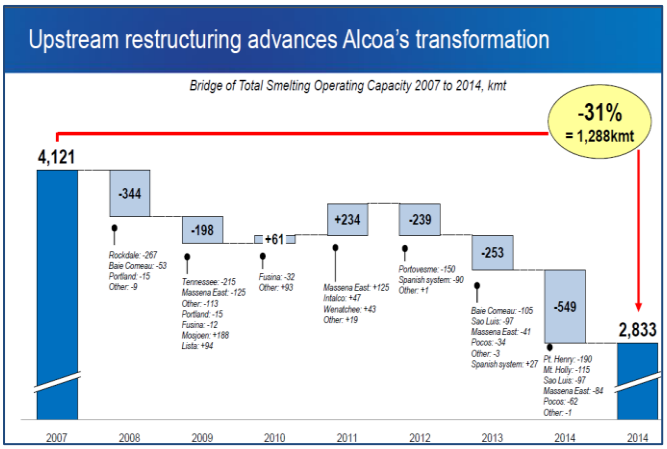
For years, Alcoa has struggled to exceed expectation because of the recent weakening in aluminum prices. As a matter of fact, China accounts for almost half of global aluminum demand and major Chinese producers are flooding the market with cheap aluminum. China is experiencing aluminum surplus and is pushing prices for this commodity to low levels. Thus, aluminum companies, such as Alcoa, are looking for businesses that are less vulnerable to Chinese exports. Alcoa wants to avoid the ups and downs of the aluminum market, so it started to shift toward components and materials that could attract new customers. The company is becoming less dependent on aluminum and becoming more diversified in items such as aircraft components and vehicle bodies. The firm continues to have an interest in the commodity business, but it has been focusing on adding value downstream and expanding its presence in high value advances manufacturing. According to the CEO of Alcoa "the transformation of Alcoa as a new innovation company is truly in high gear and accelerating". This comment shows that the management team is trying to upgrade the company's

[1] http://www.harboraluminum.com/aluminum-price-outlook

[2] http://www.fool.com/investing/general/2014/08/30/why-alcoa-inc-stock-has-skyrocketed-57-in-2014.aspx

business model in order to make it less and less dependent on basic aluminum trade. Hence, Alcoa becomes a supplier of major components in the auto industry and in aerospace. This structural transformation is necessary for AA because it will enable the company to cut costs in its commodity business. In its recent company presentation, Alcoa stated its two pillars of transformation strategy.

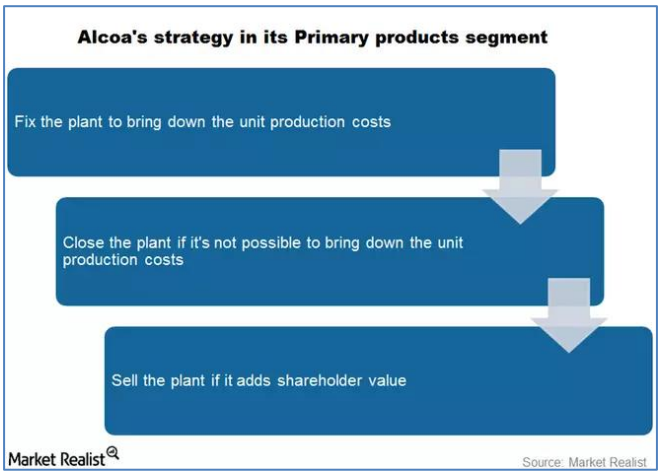
As you can see on the graph above[3], the firm plans to grow by producing innovative products. The company uses most of its capital for value added business in order to increase its share in exciting growth markets. In 2014 the company used approximately 95% of its growth capital toward the value added business. Alcoa is constantly looking to improve its competitiveness by either selling or closing plants that have high unit costs. As you can see on the graph below, Alcoa tries to remain competitive in the commodity business is to reduce costs by closing high cost capacities.



Since 2007 the firm closes facilities that require high electricity costs, maintenance expenses and labor costs.

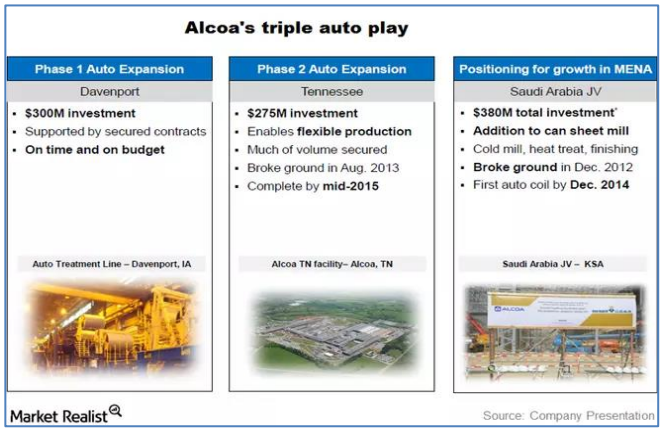
[3] http://finance.yahoo.com/news/why-alcoa-key-growth-drivers-130004552.html#morequotes

Hence, Alcoa wants to be a low-cost producer in order to improve its competitive position. When aluminum prices start falling, the company will be able to survive in economic downturns than their high cost producers competitors. Alcoa`s strategy in its upstream segment can be resumed to the following:



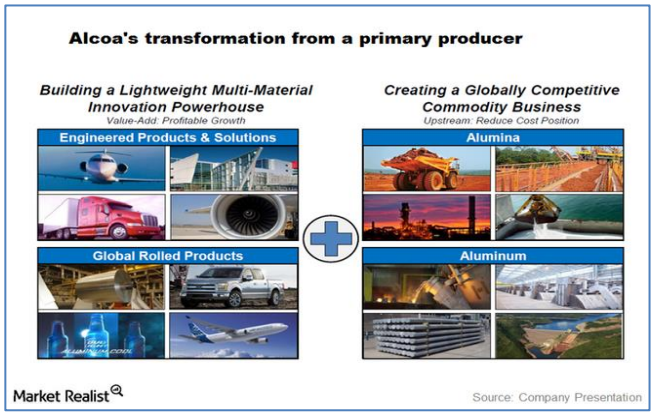
Alcoa's business model is interesting because the company decided to forget the negative event of being kicked out from the Dow Jones Industrials and started to focus on how to be more efficient. The key operations of Alcoa are the following:

The upstream operations focus on aluminum production and include activities like mining, refining, smelting, and energy production. The midstream operations turn the extracted aluminum into sheets and plates for aerospace, transportation and industrial. This segment is important for Alcoa because the demand from automobile companies is expected to drive aluminum companies' future earnings. Companies like Alcoa are excited about the future of this industry, as more automobile manufacturers will start designing vehicles with full aluminum bodies to meet the environmental regulations. Thus, AA is expanding its production capacities and made investments in order to benefit from automotive companies' expected demand.



The downstream operations produce aluminum into custom shapes for several industries such as building and construction and commercial transportation. An example of the products that Alcoa offers can be seen on the chart below:

Thus, the management team is excited about this transformation because it gives the firm the ability to create value-added products. As you can see below, Alcoa is no longer considered only a primary producer.

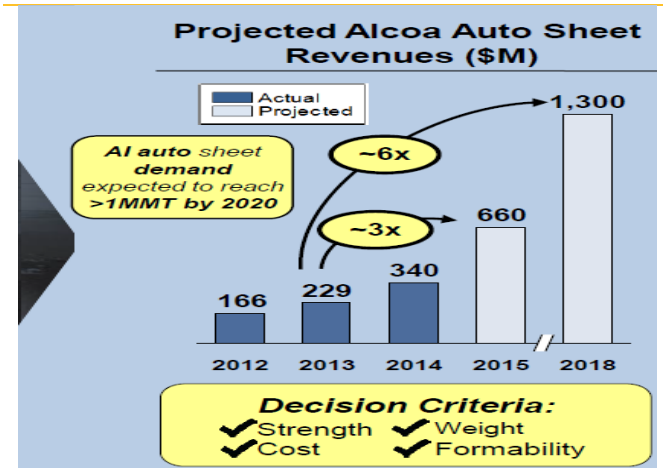


Overall, Alcoa is transforming itself into a multi-material company and focuses on developing innovative products for industries that will achieve high growth in the long term.

Strategic acquisitions

The company is conduction its structural transformation through strategic acquisitions. For example, Alcoa acquired Firth Rixson, a maker of jet engine parts, for $2.35 billion in cash and $500 million in stock. This acquisition will provide the firm with a significant boost to its aerospace revenue. According to the company's press release, "Alcoa's revenue are expected to increase by $1.6 billion with an additional $350 million EBITDA in 2016, and increase by $2 billion in revenues by 2019"[4]. The management team wants to expand its footprint in the aerospace industry and keeps looking for expansion opportunities in the fast-growing aerospace market. Also, Alcoa completed last week the acquisition of Tital, a German manufacturer that makes titanium and aluminum for aircraft. This acquisition will expand the ability of the company to capture increasing demand for titanium jet engine components and enhance its position within the aerospace business. Thus, Alcoa decided to open the world's largest aluminum-lithium facility in Indiana because the firm projects sales to climb from 9% to 10% in 2015 in its aerospace business. The future of Alcoa is bright with these two acquisitions since it believes that strong demand will emerge in 2015 from aerospace products. Also, this week the firm announced the acquisition of RTI International Metals, a worldwide titanium supplier. The firm will use its stocks as a cheap currency in order to acquire a key player in the titanium industry. Thus, those acquisitions will drive Alcoa's strategy of focusing on key growth markets such as aerospace as well as autos and enhance the position of the company as a leading industrial innovator. In fact, the firm has recently signed a partnership with Ford Motor because the latter wants to build an all-aluminum body for its F-150 pickup in 2015. This deal will force other major automakers to look for aluminum suppliers in order to compete and this will increase the demand for aluminum over the next several years. This industry shift from steel to aluminum will give Alcoa a competitive advantage over its peers and it is expected to increase AA's revenues to $1.3 billion in 2018.

[4] https://www.alcoa.com/fastening_systems_and_rings/aerospace/en/news/releases/2014_11_20_firth_rixson.asp



Overall, the company's product portfolio is becoming more diversified and Alcoa is determined to avoid being solely dependent on the aluminum industry.

Financial indicators

For the fifth consecutive year Alcoa has been able to generate good financial results. The firm competes in a market where several new aluminum industry players have recently emerged.

Company Comp Set

Company Name	LTM Gross Margin %	LTM EBITDA Margin %	LTM EBIT Margin %	LTM Net Income Margin
Freeport-McMoRan Inc. (NYSE:FCX)	44,5%	40,6%	22,5%	(6,10%)
China Zhongwang Holdings Limited (SEHK:1333)	27,7%	21,7%	19,1%	15,96%
Hindalco Industries Ltd. (BSE:500440)	25,9%	8,7%	4,9%	2,48%
Alcoa Inc. (NYSE:AA)	19,9%	14,9%	9,1%	1,12%
Kaiser Aluminum Corporation (NasdaqGS:KALU)	17,8%	13,9%	11,6%	6,28%
United States Steel Corp. (NYSE:X)	11,8%	8,8%	5,3%	0,58%
Century Aluminum Co. (NasdaqGS:CENX)	7,7%	6,8%	4,6%	2,30%
AK Steel Holding Corporation (NYSE:AKS)	7,7%	5,8%	2,3%	(1,49%)
Henan Mingtai Al.Industrial Co.,Ltd. (SHSE:601677)	5,8%	4,2%	2,3%	1,68%
Noranda Aluminum Holding Corp. (NYSE:NOR)	5,3%	7,0%	0,2%	(3,45%)
Aluminum Corporation Of China Limited (SEHK:2600)	0,8%	3,0%	(2,2%)	

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As you can see on the table below from CapitalIQ, Alcoa is ranked number four among peers in terms of gross profit margin and third In LTM EBITDA margin. The firm has been able to improve its position within the industry by improving its SG&A management. Also, AA achieved an EBITDA of over $3.6 billion, which is $1 billion higher than 2013. The company continues to reduce its costs and closes facilities that carry high production costs. Alcoa is delivering profitability year over year because the transformation enables the firm to offset most of the risks. The three segments were able to deliver strong operational performance and generate a free cash flow of $455 million, which is an improvement of 18% versus last year. Alcoa has been able to increase its revenue over $790 million because mid and downstream operations generated significant sales from aerospace and automotive industries. It is projected that by 2019 the company will increase its revenue by 25% in order to reach $1.2 billion thanks to RTI acquisition. Despite several acquisitions this year, Alcoa ended the year with approximately $2 billion of cash on hand due to strong operating performance, working capital management, and higher commodity pricing. The only negative point is that Alcoa ended 2014 with a debt to capital of 37.4% because of the strong U.S dollar. Overall, Alcoa believes that 2015 will be a good year because there will be a robust demand for aerospace (9% -10%), automotive (1%-4%) and industrials (2%-3%). The firm is excited about its future as the multi-materials portfolio is creating sustainable value. The innovative differentiation is giving Alcoa a value-add growth and drives profitability to a promising area.

Emerging markets

Alcoa is always looking for opportunities in the emerging markets. According to the CEO, "growth in aluminum industry is expected to double over the next 10 years, as increasing populations in emerging markets such as China and Brazil urbanize and turn to more sustainable products in transportation, buildings and packaging"[5]. The firm wants to lower its materials costs, so it constantly looks for expansions around the globe. Since the global population will continue to grow, demand for Alcoa's products will increase. As you can see on the map below, the company has operations primarily in the United States, Australia, Spain, Brazil, France, Russia, Hungary, the Netherlands, Norway, the United Kingdom, China, Germany and Italy. Recently, Alcoa decided to establish a joint venture in Saudi Arabia and built a low cost facility. The firm is constantly looking for solutions that will decrease its unit production costs, and similar moves like this one will enable Alcoa to become an efficient aluminum producer.

[5] http://qctimes.com/business/business-growth-alcoa-outlines-strong-future/article_cc17b81a-0b3d-11e1-9b14-001cc4c002e0.html

This expansion in emerging markets will help the firm to improve its profitability. In fact, there is a potential growth for the rolled products in these markets and the company is increasing its presence with the establishment of subsidiaries. As stated earlier, Alcoa is trying to become less dependent on the aluminum price; however, the commodity remains the foundation of the company. In fact, emerging markets will achieve growth for the midstream segment of Alcoa. Recently, the firm opened several manufacturing plants in Europe in order to meet the growing European demand for its aluminum truck wheels. Overall, Alcoa wants to capitalize on the demand that will come from the emerging markets for aluminum as their consumption will increase significantly as they become more developed.

Forecasts

In the valuation, Alcoa is expected to grow from 3.8% in 2014 to 15% because they will capitalize on the acquisitions they made. The firm will keep its growth between 14% and 10% from 2016 to 2020; however, starting 2021 the company will have to deal with the increasing competition from Chinese and new emerging aluminum companies. In perpetuity Alcoa will keep growing at a rate of 6% as their multi-material portfolio will sustain their productivity in a competitive industry. The operating costs will remain in the 85% zone because the firm faces competition from Chinese companies that sell aluminum for a cheap price and might need to open some high cost facilities. Alcoa is expected to create value within its industry with an ROIC of almost 16% versus WACC of 11%. AA will be considered conservative if it stays in the $11-$13 range because it won't be able to use its recent acquisitions and answer the growth that comes from aerospace, automotive and industrial. In order to stay neutral, AA will remain in the $14-$15 if it continues to make acquisitions that will benefit the firm in the long term. Alcoa will be considered optimistic if it breaks the $15. As a matter of fact, the management team should use the recent acquisitions and the diversification of the company in order to succeed in the upcoming years.

Conclusion

As a result, AA is constantly rebranding itself in order to improve its profitability. Alcoa will keep building momentum and assert its competitive edges against other players in the industry. Despite no longer being listed in the Dow Jones Industrial, Alcoa has managed to reshape itself in order to benefit from the growth of automakers and aerospace markets. The aluminum markets are recovering and AA found a way to cushion itself from the falling prices of this commodity. Currently, Alcoa's share is priced at $13.7 and it is considered undervalued. The recommendation is a BUY at this level in order to benefit from a target price of approximately $16.

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Alcoa Inc.	AA	Analyst	Current Price	Intrinsic Value	Target Value	Divident Yield	Target Return	
		DJ Sam	$13.70	$12.96	$15.76	1%	15.94%	NEUTRAL

General Info	
Sector	Materials
Industry	Metals and Mining
Last Guidance	Oct-14-2014
Next earnings date	4/8/2015

Market Data	
Enterprise value	$26,265.80
Market Capitalization	$16,744.80
Daily volume	78.23
Shares outstanding	1222.25
Diluted shares outstanding	1180.05
% shares held by institutions	67.27%
% shares held by insiders	0.32%
Short interest	2.47%
Days to cover short interest	1.53
52 week high	$17.75
52-week low	$11.61
5y Beta	1.60
6-month volatility	34.82%

Peers	Market Cap.
Freeport-McMoRan Inc.	$20,383.16
Nucor Corporation	$15,055.83
United States Steel Corp.	$3,287.57
Aluminum Corporation Of China Limite	$88,768.13
Century Aluminum Co.	$1,372.49
Kaiser Aluminum Corporation	$1,327.59
Steel Dynamics Inc.	$4,318.55
Noranda Aluminum Holding Corp.	$205.37
China Zhongwang Holdings Limited	$18,691.69
Henan Mingtai Al.Industrial Co.,Ltd.	$6,441.80

Current Capital Structure	
Total debt/market cap	33.70%
Cost of Borrowing	5.51%
Interest Coverage	484.99%
Altman Z	1.71
Debt Rating	AAA
Levered Beta	1.54
WACC (based on market value weights)	8.06%

Management				
Professional	Title	Comp. FY2012	Comp. FY2013	Comp. FY2014
Kleinfeld, Klaus-Christian	Chairman, Chief Executive Offic	$ 14,326,901.00	$ 14,825,806.00	$ -
Oplinger, William	Chief Financial Officer, Executive	$ -	$ 2,206,091.00	$ -
Strauss, Audrey	Chief Legal Officer, Executive Vi	$ 2,385,807.00	$ 3,304,363.00	$ -
Jarrault, Olivier	Executive Vice President, Memb	$ 3,301,345.00	$ 3,318,410.00	$ -
Meggers, Kay	Executive Vice President, Memb	$ -	$ 3,019,288.00	$ -
Kilmer, Raymond	Chief Technology Officer, Execu	$ -	$ -	$ -

Historical Performance	AA	Peers	Industry	All U.S. firms
Growth	-0.8%	9.2%	3.2%	6.0%
Retention Ratio	176.4%	68.2%	21.9%	61.6%
ROIC		28.4%	36.1%	11.8%
EBITA Margin	7.8%	14.3%	11.8%	13.7%
Revenues/Invested capital	82.7%	126.5%	120.2%	202.3%
Excess Cash/Revenue	7.4%	11.4%	16.3%	18.5%
Unlevered Beta	1.35	1.48	1.41	0.95
TEV/REV	1.2x	1.2x	1.1x	2.4x
TEV/EBITDA	8.4x	7.5x	9.8x	11.3x
TEV/EBITA	11.5x	10.5x	12.9x	15.4x
TEV/UFCF	39.7x	27.7x	28.1x	26.8x

Past Earning Surprises	Revenue	EBITDA	Norm. EPS
Last Quarter	5.5%	1.8%	17.9%
Last Quarter-1	6.8%	17.3%	40.9%
Last Quarter -2	3.3%	8.4%	50.0%
Last Quarter -3	-1.7%	20.6%	80.0%
Last Quarter -4	4.5%	-1.7%	-33.3%

Non GAAP Adjustments			
Operating Leases Capitalization	100%	Straightline	10 years
R&D Exp. Capitalization	100%	Straightline	10 years
Expl./Drilling Exp. Capitalization	0%	N/A	N/A
SG&A Capitalization	50%	Straightline	10 years

Proforma Assumptions		Period	Rev. Growth	Adj. Op. Cost/Rev	Forecasted Profitability Revenue	NOPLAT	Invested capital	UFCF
Operating. Cash/Cash	0.0%	LTM	4%	82%	$23,906.00	$1,648.93	$27,475.28	$3,085.90
Unlevered Beta	1.10	LTM+1Y	15%	82%	$27,491.90	$1,955.70	$30,373.47	$494.49
Rev/Invested Capital	120.0%	LTM+2Y	14%	82%	$31,340.77	$2,308.50	$31,757.39	$924.57
Continuing Period Revenue Growth	6.0%	LTM+3Y	13%	82%	$35,415.07	$2,671.92	$33,724.53	$704.78
Long Term ROIC	16.8%	LTM+4Y	12%	82%	$39,664.87	$3,043.71	$36,029.51	$738.73
Invested Capital Growth	Follows Forward Rev. Growth	LTM+5Y	11%	82%	$44,028.01	$3,419.74	$38,538.03	$911.22
Justified TEV/REV	1.5x	LTM+6Y	10%	82%	$48,430.81	$3,775.80	$41,785.76	$528.07
Justified TEV/EBITDA	10.0x	LTM+7Y	9%	82%	$52,789.58	$4,144.19	$44,451.54	$1,478.41
Justified TEV/EBITA	12.0x	LTM+8Y	8%	82%	$57,012.75	$4,494.01	$47,095.14	$1,850.41
Justified TEV/UFCF	25.0x	LTM+9Y	7%	82%	$61,003.64	$4,822.75	$49,707.92	$2,209.97

Valuation	ROIC	WACC	EVA	Enterprise Value	Total Debt	Other claims	Equity	Adjusted Price
LTM	5.7%	8.1%	-$647.83	$31,119.12	$8,852.00	$5,787.00	$16,480.12	$13.92
LTM+1Y	7.1%	9.3%	-$656.82	$34,101.88	$8,852.00	$6,004.83	$19,245.05	$16.51
LTM+2Y	7.6%	9.9%	-$727.21	$36,956.18	$8,852.00	$4,313.04	$23,791.14	$20.05
LTM+3Y	8.4%	10.2%	-$600.84	$39,681.82	$8,852.00	$3,314.48	$27,515.33	$23.23
LTM+4Y	9.0%	10.3%	-$476.44	$43,137.38	$8,852.00	$2,164.09	$32,121.29	$27.17
LTM+5Y	9.5%	10.4%	-$359.28	$46,884.35	$8,852.00	$256.49	$37,775.86	$31.93
LTM+6Y	9.8%	10.5%	-$277.59	$51,386.82	$8,852.00	-$1,206.62	$43,741.44	$36.79
LTM+7Y	9.9%	10.5%	-$250.36	$55,296.04	$8,852.00	-$3,773.32	$50,217.36	$42.19
LTM+8Y	10.1%	10.5%	-$179.23	$59,266.05	$8,852.00	-$6,917.16	$57,331.21	$48.07
LTM+9Y	10.2%	10.5%	-$126.65	$63,245.14	$8,852.00	-$10,480.75	$64,873.90	$53.08

Monte Carlo Simulation Assumptions	Base	Stdev	Min	Max	Distribution
Revenue Variation	0	10%	N/A	N/A	Normal
Op. Costs Variation	0	10%	N/A	N/A	Normal
Market Risk Premium	6%	N/A	5%	7%	Triangular
Long term Growth	6%	N/A	-1%	9%	Triangular
Terminal Value	0	0.1	N/A	N/A	Normal

Monte Carlo Simulation Results	Intrinsic Value	1y-Target
Mean est.	$13.92	$16.51
σ(ε)	$0.32	$0.25
3 σ(ε) adjusted price	$12.96	$15.76
Current Price	$13.70	
Analysts' median est.		$18.85