

KILEY PARTNERS, INC. CREDIT REPORT

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Alcoa Inc.

Ratings

Moody's
Baa1 (N)

S&P
BBB+ (N)

Fitch
BBB (S)

Summary

On October 14, 2008, Fitch downgraded Alcoa a notch, but changed their Outlook from Negative to Stable. On December 22, Moody's placed Alcoa's ratings under review for possible downgrade. On January 8, 2009, Standard & Poor's placed its ratings for Alcoa on CreditWatch with negative implications, citing a "very weak" operating environment and low aluminum prices. Alcoa will probably lose \$300 million to \$800 million in 2009. Further downgrades are a near certainty, but it is unlikely that Alcoa will fall below investment grade. Alcoa has sufficient liquidity in the form of bank lines to cover debt as it matures, plus its outstanding commercial paper.

Credit spreads have increased to unprecedented levels, higher than at any time in the last fifty years. In the last six months, the spreads on ten-year, Baa3/BBB- industrial bonds has gapped out from around +300 to around +725. In the same period, spreads on ten-year Alcoa bonds have gapped out from around +260 to around +750. Last year would have been a great time to sell Alcoa, but at current levels, even given the probability of a downgrade, Alcoa is likely to outperform other bonds over the next twelve to twenty-four months.

Key Points

- Default risk: low
- Downgrade risk: 90%
- Recession caused first loss since 1992
- 2009 likely to see another loss

Description

Organized in 1888, Alcoa is the world's leading producer of aluminum, both raw and fabricated, and also engages in mining, refining, smelting, and recycling. Aluminum represents approximately two-thirds of the Company's revenues. Its non-aluminum products include precision

castings, industrial fasteners, and vinyl siding. Alcoa is a global company operating in 43 countries. North America is the largest market, accounting for about 60% of revenues. Other sales are diversified across Europe, Australia and Brazil. Headquartered in New York City, the Company has just announced 13,500 layoffs and now has fewer than 100,000 employees versus 129,000 three years ago.

Debt \$8.5 billion in long-term debt and \$2.0 billion in short-term borrowings, including \$1.5 billion in commercial paper.

Finances The recession has hurt Alcoa and will hurt it again in 2009. The price of aluminum is down 56% in the last five months, worldwide demand is down sharply, and Alcoa's fixed costs are high. Expect revenues to decline again this year and that the actions Alcoa has taken to be insufficient to return it to profitability. Depending on how much it can cut costs and how much demand falls, the loss could be between \$300 million and \$800 million.

Alcoa recently issued preliminary numbers for 2008 indicating it incurred a modest loss of \$74 million in 2008. This would be the first loss since 1992. The loss included a \$920 million write down in the fourth quarter for restructuring charges. After three years of double-digit increases in revenues, revenues increased only 1.2% in 2007, and declined 12.5% in 2008. With relatively high fixed costs, the operating margin declined from 11.9% in 2006 to 9.7% in 2007 and to 7.7% in 2008. As a result of the cyclical slide, Times Interest Earned fell from 11.3x in 2007 to 1.7x in 2008. Even without the special charge, TIE would have been under 4.0x. Interest expense is equal to about 1.5% of sales.

Alcoa has sufficient liquidity with about \$2 billion available on its \$3.275 billion bank facilities. Annual maturities are low: \$202 million in 2009, \$526 million in 2010, \$636 million in 2011, and \$524 million in 2012. The current ratio is 1.12 versus 1.13 last year and 1.21 two years ago. It needs to cut back on capital expenditures, which were \$3.6 billion last year, causing free cash flow to turn from +2.1 billion in 2007 to -\$1.7 billion in 2008.

Despite increased leverage, Alcoa has sufficient capital to survive the recession. Long-term debt increased from 12.8% of assets in 2006 to 16.4% in 2007 to 22.5% now. Book equity declined from 47.6% of assets last year to 37.9% now. Tangible equity fell from 39.1% of tangible assets to 28.5%. The market has punished Alcoa, with market capitalization

declining from almost \$30 billion a year ago to \$7.5 billion now, about half of book equity.

Balance Sheet (\$MM)	2008	2007	2006	2005	2004	2003
Assets						
Current Assets						
Cash & Investments	762	483	506	762	457	576
Receivables	2,591	3,053	3,089	3,343	2,999	2,843
Inventory	3,238	3,326	3,380	3,452	2,968	2,505
Other	<u>1,559</u>	<u>1,224</u>	<u>1,378</u>	<u>1,233</u>	<u>1,069</u>	<u>759</u>
Total Current Assets	8,150	8,086	8,353	8,790	7,493	6,683
Net Plant	17,455	16,879	14,007	13,163	12,592	12,500
Intangibles	4,981	5,415	5,499	6,249	6,541	6,443
Other Assets	<u>7,236</u>	<u>8,423</u>	<u>9,324</u>	<u>5,494</u>	<u>5,983</u>	<u>6,085</u>
Total Assets	37,822	38,803	37,183	33,696	32,609	31,711
Liabilities						
Current Liabilities	7,279	7,166	6,879	7,368	6,298	5,082
Long-Term Debt	8,509	6,371	4,777	5,279	5,346	6,693
Other	<u>7,702</u>	<u>6,790</u>	<u>9,096</u>	<u>7,676</u>	<u>7,665</u>	<u>7,861</u>
Total Liabilities	23,490	20,327	20,752	20,323	19,309	19,636
Equity	14,332	18,476	16,431	13,373	13,300	12,075
Income Statement (\$MM)	2008	2007	2006	2005	2004	2003
Revenue	26,901	30,748	30,379	26,159	23,478	21,092
Operating Expenses						
Cost of Goods Sold	22,175	24,248	23,318	21,217	18,623	16,754
Selling, General & Admin	1,167	1,472	1,402	1,352	1,284	1,250
Other	<u>1,480</u>	<u>2,049</u>	<u>2,035</u>	<u>1,459</u>	<u>1,365</u>	<u>1,338</u>
Total Operating Expenses	24,822	27,769	26,755	24,028	21,272	19,342
Operating Income	2,079	2,979	3,624	2,131	2,206	1,750
Other Income (Expense)	(1,811)	1,140	(541)	(457)	(339)	(395)
Income Taxes	<u>(342)</u>	<u>(1,555)</u>	<u>(835)</u>	<u>(441)</u>	<u>(557)</u>	<u>(417)</u>
Net Income	(74)	2,564	2,248	1,233	1,310	938