ALCOA Inc.

Abstract

12th July 2011 – A Bloomberg article (Exhibit 1) is titled, "Alcoa Profit Doubles as Aluminium Price Gain Outweighs Costs". In this article, the journalist mentions, "Aluminium prices have advanced in the past year in London as usage soared in China, the biggest consumer, and demand from the U.S. automotive and aerospace industries improved. Alcoa Chief Executive Officer Klaus Kleinfeld reiterated his forecast for global demand to increase by 12 percent in 2011 and double by the end of the decade as Asian countries build more office blocks and buy more aircraft, cars and trains." [1]

5th August 2011 – Another Bloomberg article (Exhibit 2) is titled, "U.S. Stocks Sink in Biggest Drop Since 2008 on Economic Concern". In this article, the journalist begins by saying, "U.S. stocks fell the most in 32 months this week, erasing the Standard & Poor's 500 Index's 2011 advance, as investors fled equities amid signs that the economy is stalling." Furthermore, the journalist highlights, "Alcoa Inc. tumbled more than 13 percent, leading losses in the Dow Jones Industrial Average". [2]

Less than one month's time, and the entire image of Alcoa as a highly profitable, multi-billion dollar, multinational company has changed! With such uncertainty in the global marketplace, Alcoa requires a dynamic approach to its strategy formulation and implementation to ensure that its long-term competitive advantage is maintained and enhanced.

Exhibit 3 illustrates Alcoa's price chart over the past year. Notice in particular the steep decline in the market value of the company over the period from July 2011 to August 2011. [3]

Case Question

The essence of this paper can be phrased into one question - In an environment of global economic uncertainty, how can Alcoa maintain and enhance its competitive advantage?

This case will begin with an introduction to Alcoa, its management structure, and its recent strategies. We shall then introduce the aluminium industry and perform a brief analysis of it using the five forces model. Further to understanding the aluminium market, we shall return back to Alcoa and assess its competitive advantages by conducting various internal and external analyses (SWOT analysis, financial analysis, competition analysis). We shall then evaluate possible strategies that Alcoa could implement using various levers, and conclude the case making specific recommendations for the company to maintain and improve its competitive position in the global aluminium industry.

Introduction to Alcoa

Alcoa Inc. is the world's third largest producer of aluminium, behind Rio Tinto Alcan and Rusal. It is also the world's largest miner of bauxite and refiner of alumina. In addition to inventing the modern-day aluminium industry, Alcoa's innovation has been in the aerospace, automotive, packaging, building and construction, commercial transportation, consumer electronics and industrial markets. Alcoa was established in 1888 (over 120 years ago) in Pittsburgh, Pennsylvania, USA. Exhibit 4 gives a summary of the company's background since establishment. The company is currently listed on the New York Stock Exchange, and is a component of the Dow Jones Industrial Average and the S&P 500. Its symbol is 'AA' and it falls under the basic materials sector, in the aluminium industry. Alcoa employs approximately 59,000 people, in over 200 locations in 31 countries across the world.

The company currently holds a 33.3% global market share of the aluminium manufacturing industry and is active in all major industry segments within the materials industry including technology, mining, fabricating, smelting, refining, and recycling. The company's products fall into the following industry divisions: alumina and chemicals; primary metals; flat-rolled products; and engineered products and solutions. Aluminium and alumina represent more than three-fourths of Alcoa's revenue. Non-aluminium products include precision castings and aerospace and industrial fasteners. Exhibit 5 shows a list of Alcoa's products and services. [4] [5] [6]

Management Structure

The current chairman and CEO of Alcoa Inc. is Klaus Kleinfeld - born in Bremen, Germany, and educated at the University of Goettingen and University of Wuerzburg, both in Germany. He holds a PhD in strategic management and a master's degree in business administration. He joined Alcoa in 2007 as president and chief operating officer, and seven months later assumed

CEO responsibilities. He has served on Alcoa's board of directors since 2003 and was named Chairman in April 2010. Before Alcoa, he had a 20-year career with Siemens, the global electronics and industrial conglomerate, based in the U.S. and Germany, where he served as chief executive officer of Siemens AG starting in 2005. During his tenure, Mr. Kleinfeld presided over a dramatic transformation of the company, reshaping the company's portfolio around three high-growth areas, resulting in an increase of revenues and a near doubling of market capitalization. [5] [11]

Klaus has not been within Alcoa for a very long period, and hence his leadership at a 120-year old company can be questioned. However, having worked at Siemens, which is also a firm in a (relatively) cyclical industry like Alcoa, makes his position stronger. Furthermore, his role at Siemens as a successful transformer of a loss-making business certainly gives him credibility. However, it is also true that Klaus was placed under corruption investigations while at Siemens, and also failed to 'modernise' the company due to strong opposition from those who wanted the company's culture preserved.

Exhibit 6 shows Alcoa's organisational structure. Its organisational structure is a multidivisional structure that allows it to be decentralized and flexible, with many of the day-to-day business decisions made within the various business units and regions. This is a good setup for a multinational company with such a large employee base. However, there may be areas within the company where resources are duplicated or inefficiently utilised.

Exhibit 7 describes Alcoa's corporate culture. The culture at Alcoa has been maintained over the past 120 years, making it an organisation with strong beliefs and values. These virtues encompass its duties to all its stakeholders. Exhibit 8 contains information about Alcoa's corporate governance. It details the regulations binding the owners and directors who vastly contribute to the company's success. As notable in this document, there is a Business Conduct Policies document that all employees of Alcoa are provided and expected to adhere to. This proves that Alcoa is determined to conduct its business activities in an ethical and suitable manner, and has taken practical steps to do so. [7] [8]

Recent Strategies: Three Strategic Priorities and the Cash Sustainability Program

In early 2008, before the financial crisis, Alcoa developed the Three Strategic Priorities: Profitable Growth, the Alcoa Advantage and Disciplined Execution. To achieve Profitable Growth, Alcoa restructured its cost base and reshaped its portfolio to focus on businesses that were number one or two in their markets. The Alcoa Advantage highlighted five corporate levers that provide distinctive competitive advantages to Alcoa's businesses: talent, technology, customers, procurement and operating system. Disciplined Execution focused on using those advantages to create a high performance culture across Alcoa.

During the financial crisis, Alcoa protected its position as a successful aluminium company through the Cash Sustainability Program. By early 2009, the price of aluminium had dropped more than 50% since its peak in 2008. Alcoa and other companies in the materials industry had to make significant changes to fight the huge drop in material prices. In an attempt to hold on to market share Alcoa implemented a Cash Sustainability Program. Alcoa set out seven financial and operational goals that were aimed at strengthening Alcoa's balance sheet, restoring liquidity, and making Alcoa's free-cash-flow neutral by the end of 2009. Alcoa applied the following financial levers:

- Divested low growth assets and businesses where Alcoa had a small market share.
- Redeemed their shares in Rio Tinto for a premium.
- Focused on completing those projects that lowered cost position and provided the greatest opportunity for future growth.
- Curtailed additional refinery and smelter capacity and halted non-critical capital expenditures.
- Instituted programs to identify procurement efficiencies, overhead rationalization, and working capital improvements.
- Reduced the quarterly common stock dividend.
- Issued new equity and debt instruments.
- Reduced global headcount.
- Suspended its existing share repurchase program.

These strategies greatly strengthened Alcoa's cost structure and cash position. It reversed the cash drain caused by the sharp drop in aluminium prices and the decrease in demand in many end markets. Furthermore, it instilled a discipline in Alcoa of cash and cost management. Though the crisis has ended, these strategies have still been maintained, and are proving to be very effective for Alcoa's future in this uncertain environment. Exhibit 9 shows the results of these strategies in a message from Klaus Kleinfeld in the Annual Report of 2010. [5] [9]

The Aluminium Industry

The global aluminium industry is an oligopolistic structure. Firms in the industry are active in extracting and converting aluminium bearing ore into alumina products as well as procuring recycled aluminium from scrap metal. While dominated by a few multinational firms, there are hundreds of firms competing in the aluminium industry, operating individual facilities worldwide. The industry is currently in the maturity stage of the business life cycle, meaning the industry has stabilized and trends closely mirror the general economy. Firms are competing for market share and can grow by offering superior products that attract more customers, or even through acquisitions of smaller companies.

Because demand for aluminium relies heavily on the performance of its supply-side industries (transportation, construction and automobiles), Alcoa's industry is highly cyclical. The industry was hit hard in recent years by the economic recession and the global decline in GDP. As the economy entered the recession, firms in the aluminium industry experienced significant declines in revenue and substantially decreased both expenditures and production. However, as the world's economy rebounded in 2010, the aluminium industry experienced a 37.6% recovery in both aluminium shipments and prices. This allowed Alcoa to perform well in the year 2010. However, the first half of 2011 has shown weak economic growth in Europe and the USA, making these markets with low demand for aluminium-related products in the near future.

Alcoa's products fall into different industry divisions: alumina and chemicals; primary metals; flat-rolled products; and engineered products and solutions. All these industries have different price elasticities of demand, making the price, product and industry structure different from each other. Alcoa has previously been accused of antitrust practices due to this fact.

Exhibit 10 lists the key characteristics of the aluminium industry. [9] [10] [12]

Porter's Five Forces Analysis

Exhibit 11 shows Porter's five forces model. Particular points to note from this model are the homogeneity of primary aluminium, the secondary aluminium (recycled) market, and the effects of globalisation on entry barriers. [12] [13] [14]

SWOT Analysis

Exhibit 12 provides a detailed set of risk factors that Alcoa faces as a company. Consolidating Alcoa's risks together with its success factors, and assessing the threats and opportunities that the aluminium industry faces, we can perform a SWOT analysis for Alcoa. Exhibit 13 shows Alcoa's SWOT analysis results. [5]

Financial Analysis

Exhibit 14 contains a financial analysis (ratio analysis) of Alcoa in 2010. Notice the variation in performance of the company between 2008, 2009 and 2010. In particular, make note of the return on equity (ROE), which was -9.3% in 2009, and increased to 1.9% in 2010. Though the expected ROE in 2011 was 4.2%, it is now likely to be a negative figure. These figures reflect the impact of the global economy on Alcoa as a company. [10]

Competition Analysis

Exhibit 15 lists Alcoa's competitors.

Alcoa is a vertically and horizontally integrated company that has its hand in every part of the aluminium process and market. From the mining of bauxite to the recycling of aluminium cans, the magnitude of Alcoa's operations reaches globally in 31 countries. As a result, it is difficult to find direct competitors who operate within the same industry and on the same scale as Alcoa. The Aluminium Corporation of China Limited is one of the only publicly traded companies that perhaps is a 'direct competitor' in the aluminium industry.

However, besides looking at the aluminium industry, another key commodity market that is a competitor to aluminium is steel. Both steel and aluminium compete for market share in every market segment. Steel is also a cyclical industry that relies heavily on commodity prices.

The largest four firms in the aluminium industry account for 51% of its sales. Alcoa currently has 33.3% of the global aluminium market share. There has been major restructuring for Alcoa and other companies in the industry in the last 10 years, and the firms that dominate the industry in global market share do so in part through mergers.

The main factors that sets Alcoa apart from its competitors are:

- It is the largest aluminium company in the world.
- Persistent social responsibility that leads to strong customer loyalty.
- Push towards more efficient and lighter products in mid-stream industries such as aerospace and automobiles is giving aluminium the advantage over steel. [9] [12]

Possible Strategies for Alcoa's Uncertain Future

Considering the aluminium industry's structure, one of the most common ways for the firms in the industry to gain a competitive advantage is through market dominance and price influence. This is clearly a competitive strategy in the aluminium industry, considering the fact that large companies have recently been competing to take over smaller companies with localized operations in various countries around the world.

Increase Acquisition of Smaller Companies

In an industry with tough competition and a homogenous product, global efficiencies are crucial to maintain the low-cost position. Though the current global economic climate may be that of uncertainty, Alcoa should maintain its search for small companies in the commodities sector with low price-to-earning ratios. These companies will be inexpensive for Alcoa to buy at present, and their growth in the near future will mean that they will generate high value for Alcoa's shareholders too.

There is a case for acquiring companies within the aluminium sector, as these will help Alcoa to enhance its vertical integration even further. However, there is also a case for acquiring companies outside the aluminium industry, as this will allow Alcoa to diversify its portfolio, and reduce its exposure to aluminium prices and the global commodity markets. Commodities that could be negatively correlated to financial markets are those such as gold and silver.

Increase Global Alliances

Joint ventures and partnerships, both vertical and horizontal, are another method of expanding into new markets. Alcoa's current market position enables it to negotiate joint ventures and partnerships with other firms in the industry that may be based in countries where Alcoa does not have a presence. By utilising the already-established customer networks of such allies, Alcoa will be able to tap into an existing market in new countries, which could provide it with alternative sources of revenues when its main markets are struggling economically. One option for Alcoa may be to export its products to such countries and not have any production processes there. However, if it intends to maintain its low-cost position, then it might need to set up its facilities locally in these countries.

Consider Corporate Spinoff

Considering the size and complexity of Alcoa Inc, one suggestion for the company would be to split its business into two. This would help Alcoa reduce its diseconomies of scale, and make the business more cost efficient. The downstream businesses can be split from the upstream, which will then allow the upstream business to think of more tactical methods of reducing volatility in its product demand. Meanwhile, the downstream business can explore new markets for its consumer products. Corporate splits are particularly common when companies believe that the market is not valuing the company as a whole because of the potential problems involved in large organisations – Alcoa could be one of them.

Mitigate Risk of Rising Energy Costs through Alcoa Energy

Alcoa Energy is a producer of electricity controlling more than 3 Giga-watts of generating capacity to provide for the energy needs of Alcoa's smelting and refining system as well as the needs of regional wholesale markets. Alcoa should actively develop new energy assets to increase Alcoa's energy self-sufficiency and grow the company's energy portfolio. Alcoa Energy currently generates approximately 22% of the power used at its smelters and purchases the remaining power using long-term contracts. Some of Alcoa's contracts involve partnerships with subsidiaries or companies in which Alcoa has a large stake. If new plants of Alcoa Energy would be opened, there would be a lower dependency to external sources of renewable energy, and this will vastly reduce Alcoa's risk of rising energy costs. [9]

Modernise Systems and Processes

Due to the sheer size of Alcoa as an organisation, one strategy for Alcoa would be to implement modern systems and processes on the mining, fabricating, smelting, refining, and recycling sides of the business. These cost centres require skilled labour and heavy machinery, and account for most of the company's costs.

One option for Alcoa would be to implement the lean manufacturing process. By focusing on ways to reduce wasteful activities on the input side of the business, Alcoa will be able to substantially lower its production costs, and in turn, enhance its position in the price sensitive industry.

Looking at Alcoa's highlights, we notice that the company had 87,000 employees in 2008 before the economic downturn. This means it had to make 28,000 employees redundant due to the economic recession. One method of reducing such severe scale-downs of the workforce may be through automation in various areas of the business, where manual labour is replaced by machines. Another method may be through making staff hours and rewards more variable (flexible).

A more complex (but viable) option for Alcoa may be to implement the balanced scorecard system. This system would use different indicators to measure Alcoa's performance in various divisions of its value chain, enabling management to make more accurate decisions regarding its implementation of resources and capabilities. Such a system would also allow Alcoa to make comparisons between similar operations in different countries, hence be able to identify potential problems and enforce possible solutions. This system could also help solve the wages problem by paying employees based on behavioural control rather than outcomes.

However, it should be noted that Klaus Kleinfeld might not be able to modernise the company solely. His previous experience at Siemens proved that changing the systems and processes of a company changes the entire culture of the firm, and many firms with a long history (such as Alcoa) would face resistance to such changes.

Recommendations

Diversify

Alcoa, with 75% of its revenues coming from aluminium, is highly dependent on the metal for its growth and profitability. While Alcoa's size and specialization in this metal is its strength, one method of reducing the company's volatility in business activity is to diversify into other commodities. By doing so, Alcoa will be able to stabilize its performance on an annualized basis, and also benefit in other ways such as economies of scope and better employment prospects.

Another means of diversification is through marketing Alcoa's products in emerging markets. Countries such as China, India, Brazil and South Korea have growing middle classes, which will drive demand for housing and transportation in the near future. Alcoa may choose to exploit these markets by expanding its own operations, or through joint ventures and partnerships. However, the choice of new markets must be made after assessment of cultures, environments, policies, etc.

Split the Organisation

At a time when there is high levels of uncertainty about future growth prospects, and firms such as Alcoa are struggling to reveal the company's true market value, one good option for creating value is corporate spinoffs. Considering that Alcoa is vertically integrated and combines all its operations from the primary sector to the service sector into one, a clear way of repositioning itself is as two separate businesses, one that focuses on the primary sector and deals with manufacturing customers (including its own manufacturing company), and another that focuses on the finished products (such as Reynolds Wrap) for the retail and corporate customers. Such spinoffs will increase Alcoa's value by 10 to 15%, depending on the extent.

Implement Lean Manufacturing

Considering that Alcoa is a heavily manufacturing-oriented company with high production costs (including raw materials, energy and wages), it is of utmost importance for the company to control these costs and maintain efficient means of producing its products. Implementing lean manufacturing will help Alcoa streamline its production processes, and help implement controls that will ensure that efficient manufacturing is practised in all its production sites around the world. After all, achieving global efficiencies is what Alcoa's focus should be on. To facilitate this process, Alcoa should recruit an experienced individual into the firm who can implement the modernisation process. The implementation should be done in phases, perhaps starting with operations locally in the US and later expanding the system.

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