Management's Discussion and Analysis of Financial Condition and Results of Operations

(dollars in millions, except per-share amounts and ingot prices; shipments in thousands of metric tons [mt])

Overview

Our Business

Alcoa is the world's leading producer of primary aluminum, fabricated aluminum, and alumina, and is active in all major aspects of the industry: technology, mining, refining, smelting, fabricating, and recycling. Aluminum is a commodity that is traded on the London Metal Exchange (LME) and priced daily based on market supply and demand. Aluminum and alumina represent approximately two-thirds of Alcoa's revenues, and the price of aluminum influences the operating results of Alcoa. Nonaluminum products include precision castings, industrial fasteners, vinyl siding, consumer products, food service and flexible packaging products, plastic closures, and electrical distribution systems for cars and trucks. Alcoa's products are used worldwide in aircraft, automobiles, commercial transportation, packaging, consumer products, building and construction, and industrial applications.

Alcoa is a global company operating in 43 countries. North America is the largest market with 64% of Alcoa's revenues. Europe is also a significant market with 22% of the company's revenues. Alcoa also has investments and activities in Australia, Brazil, China, Iceland, Jamaica, Russia, and Trinidad, which present opportunities for substantial growth. Governmental policies and other economic factors, including inflation and fluctuations in foreign currency exchange rates and interest rates, affect the results of operations in these countries.

Management Review of 2004 and Outlook for the Future

Alcoa aspires to be the best company in the world. As part of that mission, Alcoa strives to attain certain financial goals to improve both short-term and long-term profitability, while positioning the company to be successful in the future.

In 2004, Alcoa's focus on long-term value creation through living our values, controlling costs and capital, managing our portfolio of businesses, and focusing on profitable growth contributed to the following financial achievements:

- Significant improvement in income from continuing operations, rising 33% from $1,055 in 2003 to $1,402 in 2004, as four of the company's six segments increased in profitability;
- Highest annual sales in company history, with revenue growth of $2,386 over 2003;
- Strong cash flow generation of approximately $2,200 in cash from operations;
- Strengthened balance sheet and continued cash generation through disciplined capital spending and payment of approximately $2,000 in debt over the past two years, which facilitated a reduction in the debt-to-capital ratio from 35.1% in 2003 to 30.0% in 2004; and
- The substantial completion of our divestiture plan with the sales of the specialty chemicals business, the automotive fasteners business, the packaging equipment business, the South American flexible packaging business, the Russellville, AR and St. Louis, MO foil facilities, and extrusion facilities in Europe and Brazil.

During 2004, the company was faced with a number of challenges including increased costs for energy, raw materials, and a weakening U.S. dollar. Additionally in 2004, significant efforts continued in globalizing the production base as a means to better serve Alcoa's customers and to take advantage of lower costs to produce in certain global regions. The actions surrounding the globalization provide unique challenges including exposure to foreign currency movement against the U.S. dollar, as well as the general business and political risks involved with expanding operations in global regions where Alcoa does not currently have a significant presence. The company expects that it will continue to face these and similar challenges in the future.

To position ourselves for success in 2005 and beyond, we will work toward the following financial goals:

- Continuing to reduce costs in conjunction with the three-year cost savings challenge initiated in 2004, aimed at eliminating $1,200 in costs by the end of 2006. Cost savings are targeted to help offset anticipated higher energy and input costs for materials such as resin and caustic. The cost savings will be achieved through continued implementation of the Alcoa Business System (ABS), procurement savings, and headcount reductions;
- Striving to join the first quintile of S&P Industrials in return on capital (ROC) performance and, in pursuit of that goal, we will seek to provide returns in excess of cost of capital, which is currently 9%;
- Maintaining a strong balance sheet with a long-term target for a 25%–35% debt-to-capital ratio; and
- Strengthening our asset base and improving its productivity, as well as expanding our global reach and positioning our primary businesses lower on the cost curve through various strategies including: expanding alumina refinery capacity in Australia, Jamaica, and Suriname; constructing a smelter in Iceland and expanding smelting capacity in Brazil, China, and Trinidad; expanding fabricating capabilities in Russia; investing in energy projects in Brazil, as well as various other projects throughout other segments of the business. Capital expenditures for these major growth projects and other sustaining projects are projected to be approximately $2,500 in 2005. These projects are outlined in more detail below under Segment Information, Liquidity and Capital Resources, and Contractual Obligations and Off-Balance Sheet Arrangements.

Forward-Looking Statements

Certain statements in this report under this caption and elsewhere relate to future events and expectations and, as such, constitute forward-looking statements. Forward-looking statements also include those containing such words as "anticipates," "believes," "estimates," "expects," "hopes," "targets," "should," "will," "will likely result," "forecast," "outlook," "projects,"