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# Alitalia

**Shares Fully Valued - Although More  
 Encouraging Outlook for Restructuring**

**SELL**

**Reason for Report:** Reinstating Coverage

**Volatility Risk:  
 HIGH**

## Price:

**EUR.223**

Estimates (Dec)	2001A	2002E	2003E	2004E
Pre-exc. Pretax (EUR)	(355)	(62)	62	74
Tax Charge %	(20.0)	(20.0)	40.0	40.0
Pre-exceptional (EPS)	(0.3)	(0.0)	0.0	0.0
P/E (x)	(0.9)	(8.2)	23.3	19.3
Net Div (EUR)	0.0	0.0	0.0	0.0
Net Yield %	0.0	0.0	0.0	0.0
Cash Flow Per Share (EUR)	0.1	0.2	0.1	0.1
Cashflow Multiple (x)	3.9	1.5	2.0	1.9
EBITDAR (EURm)	496.6	579.3	738.6	820.4
EV/EBITDAR (x)	7.7	4.9	4.6	4.6

## Opinion & Financial Data

Investment Opinion – Local:	C-3-9
Mkt. Value (EUR mn)/ Shares Outstanding (mn):	611 / 2,739.57
Book Value/Share (Dec-01):	0.965
Price/Book Ratio:	0.32
ROE 2002E Average:	-77.5%
Net Debt/Net Equity:	59.1%
Est. 5 Year EPS Growth:	5%

## Stock Data

52-Week Range – Local:	0.81-0.22
Symbol / Exchange – Local:	ALRMF / Milan
Bloomberg / Reuters:	AZA IM / AZPla.MI
Exchange Rate:	EUR1.02/USD

All figures are in Euro except where otherwise noted.

## Highlights:

- We are reinstating coverage of Alitalia with a sell recommendation.
- We believe the business is more stable than it has been at any time since 9/11, and that the new management's restructuring plans are credible.
- However we believe the shares are up with events. Although they are trading at a 14% EV/EBITDAR discount to the European average to December 2002E, this reverts to a sector average multiple to December 2003E.
- The principal investment risks for Alitalia include; a highly unstable geopolitical backdrop at present, a mixed track record on delivery of restructuring in the past (albeit under a different management team) and potential further market incursions from low fares operators.
- In our view, there are still more attractively valued restructuring plays in the European airline sector.
- The EUR1.4bn capital raising exercise (rights issue plus convertible bonds) has restored the Group's balance sheet to stability and provided the necessary capital for the fleet renewal programme.
- Our assumptions imply an estimated operating loss of EUR(59)m for the current year rising to an anticipated profit of EUR70m for 2003E. These compare to a loss of EUR(266)m in 2001.

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**Refer to important disclosures at the end of this report.**

Merrill Lynch Global Securities Research & Economics Group  
 Global Fundamental Equity Research Department

## What Has Changed?

**In July 2002 the Group undertook a substantial capital raising exercise through which it raised €1.4bn. The new capital took the form of an equal split between equity and convertible bonds. The exercise was aligned with a restructuring programme to restore financial strength and flexibility to the Group.**

### Capital Raising Exercise

In July of this year the Group raised €1.4bn of new capital with 2 offerings. Firstly it offered 1,934.7m new shares (nominal value €0.37) at par. Secondly it offered 1,934.7m new bonds, each convertible into 1 Alitalia ordinary share (at €0.37). The convertible carries a coupon of 2.9% and is exercisable between 2002 and 2007.

#### ■ Balance Sheet Impact

We expect the result of the offerings to lower Alitalia on-balance sheet net gearing from 126% at year end 2001 to 15% by year end 2002. As the fleet renewal programme continues this level of net gearing is expected to rise to 72% by December 2004E, well below the European industry average we anticipate by that time of 105%.

### Restructuring Programme

The management team has launched a revised restructuring programme for the Group, designed to address the key challenges going forward. Its main platforms are the following;

#### *Create Focused Business Model – Dispose Non-Core*

This has already involved disposing of non-core activities including Sigma (IT Business), the company's headquarters, eurofly and Italiatour (Leisure). These are expected to have generated proceeds in 2002E of €240m. Furthermore, ground handling and engineering activities are under consideration for placement with JV partners in 2003E.

#### *Restructure Network – Shrink and Simplify*

The network will now focus on both Milan Malpensa (MXP) and Rome Fiumicino (FCO) as multi region hubs rather than previously focusing FCO on domestic traffic and forcing intercontinental flows through MXP – i.e. the network will be adapted to natural traffic flows. Marginal routes (Rio suffers from a leisure focus or West Coast of US) are being eliminated from the network with a tighter focus on point to point trunk routes.

#### *Secure Strategic Alliances - Skyteam*

Alitalia has already become a member of the Skyteam Alliance (July 2001), which includes Air France, Delta, Korean, Aeromexico and CSA. The alliance has anti-trust immunity on the North Atlantic. Alitalia then uses a series of strategic bilateral alliances (e.g. with Japan Air Lines, Varig, Qantas and Air Canada) to strengthen its network.

#### *Restructure Fleet – Shrink and Simplify*

Alitalia will reduce the capacity per aircraft in the fleet which should help to bolster yield (i.e. reduce the need to discount price to fill aircraft). A younger and more homogeneous fleet could be expected to reduce maintenance costs and increase efficiency and cockpit crew productivity. Specifically by 2003E;

1. The number of long-haul aircraft will fall by 14% to 22.
2. The number of seats per long haul aircraft will drop by 14% to 230 by the end of 2003E.
3. The number of long haul aircraft families will halve from 4 to 2 (B777 and B767).

Similar initiatives are being implemented on the short-haul fleet with the MD-80's being phased out and regional jets being introduced for thinner routes.

#### *Reduce Costs*

1. **Cost Efficiency Programmes:** Through a series of 55 projects covering a switch to increase direct distribution to technical and operational process changes the Group anticipates annualised operating cost savings of €120m by December 2003E and €195m by 2004E.
2. **Labour Cost Reduction:** A series of measures from early retirement incentives (860 employees already left the company), wage freezes and reductions in working days the Group anticipates cost savings of €132m in the current year and a further €102m in 2003E.

### Key Assumptions

#### ■ Capacity Growth

For the current year we assume a network-wide ASK reduction of –21.5% followed by an increase in 2003E of +6.9%. For the current year we assume flat ASK growth in the domestic market with a –20.5% reduction in Europe and a –31.5% reduction for long-haul.

#### ■ Traffic Growth

For the current year we assume a network-wide RPK reduction of –25.2% resulting in a load factor decrease of –3.7pp to 67.4%. For 2003E we assume a RPK increase of +9.0% resulting in a load factor increase of +1.3pp to 68.7% (still well below the 69.1% achieved last year). The regional patterns are expected to be broadly similar to capacity growth.

### ■ Yield

For the current year we assume a passenger yield increase of +12.0%. Of this increase, we estimate some +5pp is attributable to the structural impact of a sharper drop in long-haul traffic than short-haul, +2pp is attributable to security and insurance and security surcharges imposed post 9/11 last year, and the remainder is attributable to price increases through less inventory discounting. For next year we assume a +2% yield improvement attributable entirely to price increases.

### ■ Unit Costs

We have assumed that Alitalia management will deliver in full on the cost reduction programme they have set out and which we identified above. The result is we assume a unit cost increase for the current year (of +6.6%) which is a function of the dramatic capacity reduction exercise. For next year we assume a unit cost decrease of –1.1%.

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## New Estimates

Following the new developments outlined above we are reinstating coverage with the following estimates:

### ■ 2002E

For the current year we forecast an operating loss of €(59)m, a pre-exceptional pretax loss of €(62)m and a pre-exceptional fully diluted loss per share of €(0.01).

### ■ 2003E

For next year we forecast an operating profit of €70m, a pre-exceptional pretax profit of €62m and a pre-exceptional fully diluted earnings per share of €0.01.

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## Valuation & Conclusion

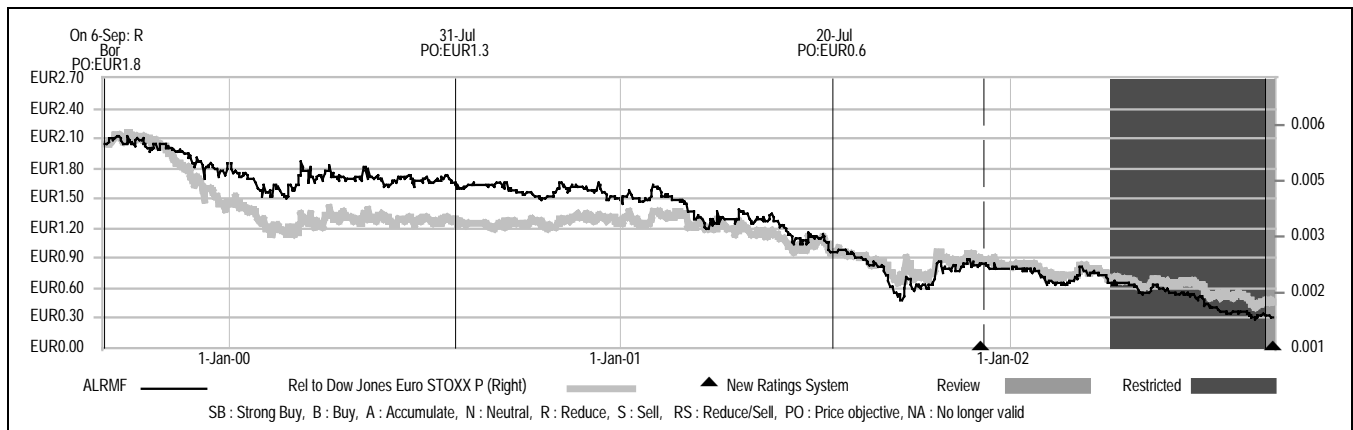
On the basis of the estimates outlined above Alitalia shares are trading on 4.9x current year EV/EBITDAR (versus the European industry average of 5.7x), falling to 4.6x December 2003E (versus the sector average of 4.7x).

While these ratings look more attractive than the prospective premia the shares used to command, we believe there are more attractively priced restructuring plays among the European majors for instance; Air France (AIFRF; EUR8.00; B-1-9) and Iberia (IBRLF; EUR1.22; C-1-9).

The key investment risks are, in our view;

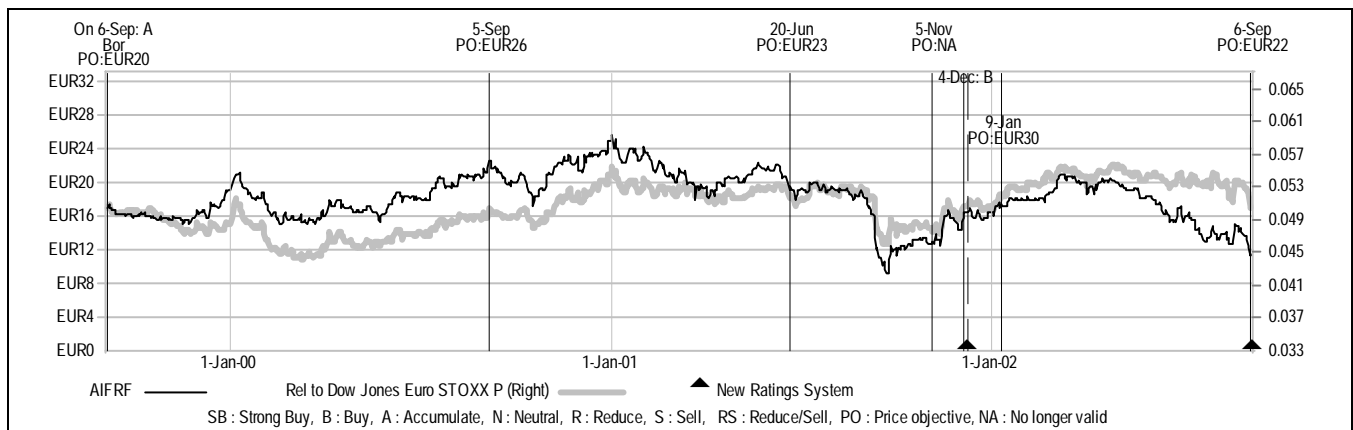
1. The geopolitical backdrop remains highly uncertain. War in the Middle East would be perceived as significantly negative for all the major airlines, including Alitalia.
2. Competition in the Italian market remains vulnerable to the further incursion of low fares' operators, which is not currently assumed in our estimates.
3. The historical track record of delivery on cost reduction at Alitalia – albeit under a different management team – has been mixed at best.

**ALRMF Price Chart**

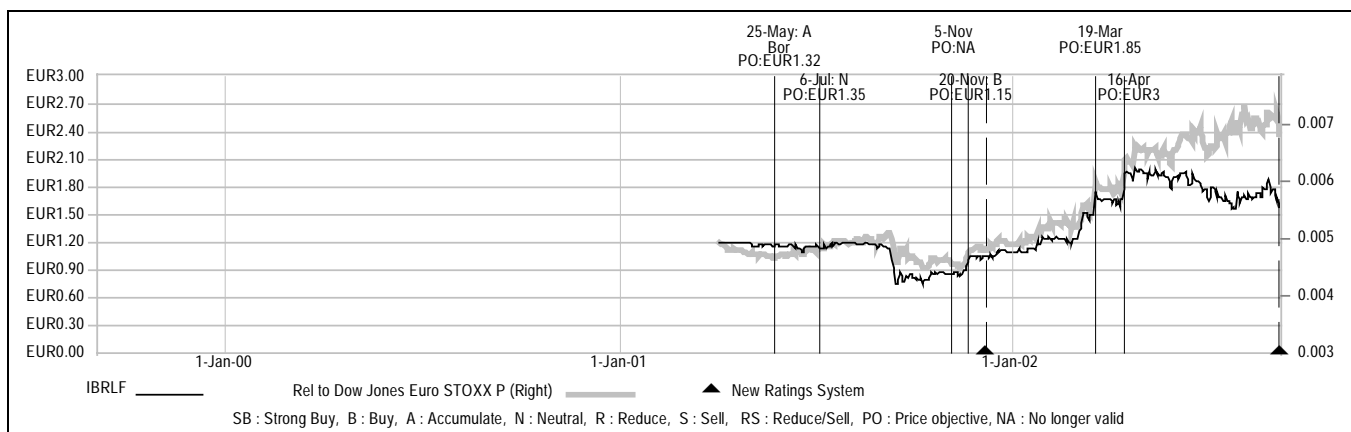


Prior to 8 Dec. 2001, the Investment Opinion System included: Buy, Accumulate, Neutral, Reduce and Sell. From 8 Dec. 2001 to 6 Sep. 2002, the Investment Opinion System included: Strong Buy, Buy, Neutral, and Reduce/Sell. On 8 Dec. 2001 Buy ratings became Strong Buy, Accumulate became Buy, and Reduce and Sell became Reduce/Sell. On 6 Sep. 2002, Strong Buy and Buy ratings became Buy, and Reduce/Sell became Sell. Any exceptions to these rating revisions are reflected in the chart as opinion changes. The current Investment Opinion System is contained at the end of the report. Dark Grey shading indicates security is restricted with the opinion suspended. Light Grey shading indicates security is under review with the opinion withdrawn. Price objectives rounded to the nearest whole number. Price objectives expressed as ranges in research reports are reflected at midpoint. Price charts and price objectives have been adjusted to reflect stock splits.

**AIFRF Price Chart**



Prior to 8 Dec. 2001, the Investment Opinion System included: Buy, Accumulate, Neutral, Reduce and Sell. From 8 Dec. 2001 to 6 Sep. 2002, the Investment Opinion System included: Strong Buy, Buy, Neutral, and Reduce/Sell. On 8 Dec. 2001 Buy ratings became Strong Buy, Accumulate became Buy, and Reduce and Sell became Reduce/Sell. On 6 Sep. 2002, Strong Buy and Buy ratings became Buy, and Reduce/Sell became Sell. Any exceptions to these rating revisions are reflected in the chart as opinion changes. The current Investment Opinion System is contained at the end of the report. Dark Grey shading indicates security is restricted with the opinion suspended. Light Grey shading indicates security is under review with the opinion withdrawn. Price objectives rounded to the nearest whole number. Price objectives expressed as ranges in research reports are reflected at midpoint. Price charts and price objectives have been adjusted to reflect stock splits.

**IBRLF Price Chart**


Prior to 8 Dec. 2001, the Investment Opinion System included: Buy, Accumulate, Neutral, Reduce and Sell. From 8 Dec. 2001 to 6 Sep. 2002, the Investment Opinion System included: Strong Buy, Buy, Neutral, and Reduce/Sell. On 8 Dec. 2001 Buy ratings became Strong Buy, Accumulate became Buy, and Reduce and Sell became Reduce/Sell. On 6 Sep. 2002, Strong Buy and Buy ratings became Buy, and Reduce/Sell became Sell. Any exceptions to these rating revisions are reflected in the chart as opinion changes. The current Investment Opinion System is contained at the end of the report. Dark Grey shading indicates security is restricted with the opinion suspended. Light Grey shading indicates security is under review with the opinion withdrawn. Price objectives rounded to the nearest whole number. Price objectives expressed as ranges in research reports are reflected at midpoint. Price charts and price objectives have been adjusted to reflect stock splits.

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**Table 1: Alitalia Profit and Loss Summary**

Year End 31st December (EURm)	Year 2000	Year 2001	%	Year 2002E	%	Year 2003E	%	Year 2004E	%
Passenger Revenue	3,822	3,782	(1.1)	3,169	(16.2)	3,523	11.1	3,701	5.1
Freight & Mail Revenue	545	465	(14.7)	404	(13.1)	420	4.0	441	5.0
Other Traffic Revenue	247	231	(6.3)	208	-10.0	219	5.0	229	5.0
<b>GROUP TRAFFIC REVENUE</b>	<b>4,614</b>	<b>4,478</b>	<b>(2.9)</b>	<b>3,781</b>	<b>(15.6)</b>	<b>4,161</b>	<b>10.0</b>	<b>4,372</b>	<b>5.1</b>
Service & Other Revenue	780	796	2.0	812	2.0	828	2.0	869	5.0
<b>GROUP OPERATING REVENUE</b>	<b>5,394</b>	<b>5,274</b>	<b>(2.2)</b>	<b>4,593</b>	<b>(12.9)</b>	<b>4,989</b>	<b>8.6</b>	<b>5,241</b>	<b>5.1</b>
Other Income	266	230	(13.6)	181	(21.2)	190	5.0	200	5.0
<b>GROUP INCOME</b>	<b>5,661</b>	<b>5,504</b>	<b>(2.8)</b>	<b>4,774</b>	<b>(13.3)</b>	<b>5,179</b>	<b>8.5</b>	<b>5,441</b>	<b>5.1</b>
Personnel Costs	1,183	1,253	5.9	1,215	(3.0)	1,289	6.1	1,341	4.0
Depreciation	303	320	5.7	339	6.0	384	13.3	408	6.1
Materials and Purchases	1,626	1,434	(11.9)	1,084	(24.4)	1,122	3.5	1,179	5.1
Other Costs	2,802	2,763	(1.4)	2,195	(20.6)	2,314	5.4	2,400	3.7
<b>Group Operating Costs</b>	<b>5,913</b>	<b>5,770</b>	<b>(2.4)</b>	<b>4,833</b>	<b>(16.2)</b>	<b>5,109</b>	<b>5.7</b>	<b>5,327</b>	<b>4.3</b>
<b>GROUP OPERATING PROFIT</b>	<b>(253)</b>	<b>(266)</b>		<b>(59)</b>		<b>70</b>		<b>114</b>	
Share of Associates	1	1		1		1		1	
Interest Payable	(75)	(135)		(43)		(16)		(43)	
Interest Receivable	0	0		4		4		4	
Exchange Losses	0	0		0		0		0	
Other Net Financials	80	45		36		4		0	
<b>Pre-Exceptional Pretax Profit</b>	<b>(246)</b>	<b>(355)</b>		<b>(62)</b>		<b>62</b>		<b>74</b>	
- Gains on Disposal of Fixed Assets	27	28		150		20		20	
- Other	4	(536)		0		0		0	
Net Exceptionals	30	(508)		150		20		20	
<b>REPORTED PRETAX PROFIT</b>	<b>(215)</b>	<b>(863)</b>		<b>88</b>		<b>82</b>		<b>94</b>	
Taxation - Ordinary	(40)	(44)		(12)		(25)		(30)	
Taxation - Exceptional	0	0		0		(8)		(8)	
Minorities	1	(0)		0		1		1	
<b>ATTRIBUTABLE NET PROFIT</b>	<b>(255)</b>	<b>(907)</b>		<b>76</b>		<b>50</b>		<b>58</b>	
Dividends	0	0		0		0		0	
<b>RETAINED EARNINGS</b>	<b>(255)</b>	<b>(907)</b>		<b>76</b>		<b>50</b>		<b>58</b>	
Shares in Issue (m) (Nom. EUR 0.37)	1,548.4	1,548.4		2,739.6		3,868.2		3,868.2	
<b>Pre-Exceptional EPS (EUR)</b>	<b>(0.18)</b>	<b>(0.26)</b>		<b>(0.03)</b>		<b>0.01</b>		<b>0.01</b>	
<b>Pre-Exceptional EPS - Fully Diluted (EUR)</b>				<b>(0.01)</b>		<b>0.01</b>		<b>0.01</b>	
<b>EPS (EUR)</b>	<b>(0.16)</b>	<b>(0.59)</b>		<b>0.03</b>		<b>0.01</b>		<b>0.01</b>	
<b>Net Dividend (EUR)</b>	<b>0.0</b>	<b>0.0</b>		<b>0.0</b>		<b>0.0</b>		<b>0.0</b>	

Source: Merrill Lynch Estimates