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AVIALL INC
Form 10-Q
August 13, 2001

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SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

(MARK ONE)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934

FOR THE QUARTERLY PERIOD ENDED JUNE 30, 2001

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934

FOR THE TRANSITION PERIOD FROM _____ TO _____

COMMISSION FILE NUMBER 1-12380

AVIALL, INC.

(Exact name of Registrant as specified in its Charter)

DELAWARE
(State or other jurisdiction of
incorporation or organization)

65-0433083
(I.R.S. Employer
Identification No.)

2075 DIPLOMAT DRIVE
DALLAS, TEXAS
(Address of principal executive offices)

75234-8999
(Zip Code)

(972) 406-2000

(Registrant's telephone number, including area code)

Indicate by checkmark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes X No

The number of shares of Common Stock, par value \$.01 per share, outstanding at August 3, 2001 was 18,483,726.

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PART I - FINANCIAL INFORMATION

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ITEM 1: FINANCIAL STATEMENTS

AVIALL, INC.
CONSOLIDATED STATEMENTS OF INCOME
(DOLLARS IN THOUSANDS, EXCEPT SHARE DATA)
(UNAUDITED)

| | THREE MONTHS ENDED JUNE 30, | | SIX MONTHS ENDED JUNE 30, |
|--|--------------------------------|------------|------------------------------|
| | 2001 | 2000 | 2001 |
| Net sales | \$ 134,266 | 121,660 | 264,288 |
| Cost of sales | 103,462 | 93,643 | 204,010 |
| Gross profit | 30,804 | 28,017 | 60,278 |
| Operating and other expenses: | | | |
| Selling and administrative expenses | 22,113 | 21,215 | 44,788 |
| Interest expense | 2,565 | 2,206 | 4,861 |
| Earnings from continuing operations before income taxes | 6,126 | 4,596 | 10,629 |
| Provision for income taxes | 2,557 | 2,072 | 4,358 |
| Earnings from continuing operations | 3,569 | 2,524 | 6,271 |
| Discontinued operations: | | | |
| Gain on disposal (net of income tax expense of \$77 in 2000) | -- | 143 | -- |
| Earnings from discontinued operations | -- | 143 | -- |
| Net earnings | \$ 3,569 | 2,667 | 6,271 |
| Basic net earnings per share: | | | |
| Earnings from continuing operations | \$ 0.19 | 0.14 | 0.34 |
| Earnings from discontinued operations | -- | 0.01 | -- |
| Net earnings | \$ 0.19 | 0.15 | 0.34 |
| Weighted average common shares | 18,483,726 | 18,311,844 | 18,472,688 |
| Diluted net earnings per share: | | | |
| Earnings from continuing operations | \$ 0.19 | 0.14 | 0.34 |
| Earnings from discontinued operations | -- | 0.01 | -- |
| Net earnings | \$ 0.19 | 0.15 | 0.34 |
| Weighted average common and potentially dilutive common shares | 18,713,855 | 18,331,984 | 18,603,808 |

See accompanying notes to consolidated financial statements.

AVIALL, INC.
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(DOLLARS IN THOUSANDS)
(UNAUDITED)

| | THREE MONTHS ENDED JUNE 30, | | SIX MONTHS ENDED JUNE 30, | |
|--|--------------------------------|-------|------------------------------|-------|
| | 2001 | 2000 | 2001 | 2000 |
| Net earnings | \$3,569 | 2,667 | 6,271 | 4,850 |
| Other comprehensive income (loss): | | | | |
| Cumulative effect of change in accounting principle -- adoption of SFAS 133 (net of income tax benefit of \$165) | -- | -- | (262) | -- |
| Fair value adjustment of derivative instruments (net of income tax expense (benefit) of \$21 and \$(88)) | 33 | -- | (138) | -- |
| Comprehensive income | \$3,602 | 2,667 | 5,871 | 4,850 |

See accompanying notes to consolidated financial statements.

AVIALL, INC.
CONSOLIDATED BALANCE SHEETS
(DOLLARS IN THOUSANDS, EXCEPT SHARE DATA)

| | JUNE 30, 2001 | DECEMBER 31, 2000 |
|---|------------------|----------------------|
| ----- | | |
| (UNAUDITED) | | |
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 4,959 | 4,865 |
| Receivables | 89,633 | 83,395 |
| Inventories | 165,598 | 134,156 |
| Prepaid expenses and other current assets | 2,826 | 5,168 |
| Deferred income taxes | 9,723 | 9,723 |
| ----- | | |
| Total current assets | 272,739 | 237,307 |
| ----- | | |
| Property, plant and equipment | 20,998 | 17,389 |
| Intangible assets | 85,340 | 73,906 |
| Deferred income taxes | 58,777 | 62,576 |
| Other assets | 4,990 | 4,273 |
| ----- | | |
| Total assets | \$442,844 | 395,451 |
| ----- | | |
| LIABILITIES AND SHAREHOLDERS' EQUITY | | |
| Current liabilities: | | |
| Current portion of long-term debt | \$ 7,510 | 9,025 |
| Accounts payable | 60,338 | 66,657 |
| Accrued expenses | 28,427 | 29,431 |
| ----- | | |
| Total current liabilities | 96,275 | 105,113 |
| ----- | | |
| Long-term debt | 131,889 | 81,397 |
| Other liabilities | 17,064 | 17,267 |
| Commitments and contingencies | -- | -- |
| ----- | | |
| Shareholders' equity (common stock of \$.01 par value per share; 20,485,728 shares and 20,334,664 shares issued at June 30, 2001 and at December 31, 2000, respectively; 18,483,726 shares and 18,332,662 shares outstanding at June 30, 2001 and at December 31, 2000, respectively) | 197,616 | 191,674 |
| ----- | | |
| Total liabilities and shareholders' equity | \$442,844 | 395,451 |

See accompanying notes to consolidated financial statements.

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AVIALL, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(DOLLARS IN THOUSANDS)
(UNAUDITED)

| | SIX MONTHS ENDED JUNE 30, | |
|---|---------------------------|----------|
| | 2001 | 2000 |
| <hr/> | | |
| CASH FLOWS FROM OPERATING ACTIVITIES: | | |
| Net earnings | \$ 6,271 | 4,850 |
| Gain on disposal of discontinued operations | -- | (143) |
| Depreciation and amortization | 5,219 | 4,503 |
| Compensation expense on restricted stock awards | 114 | 101 |
| Deferred income taxes | 4,055 | 3,141 |
| Changes in: | | |
| Receivables | (6,238) | (15,283) |
| Inventories | (31,649) | (8,710) |
| Accounts payable | (6,319) | 7,002 |
| Accrued expenses | (1,004) | (394) |
| Other, net | 1,359 | (306) |
| | (28,192) | (5,239) |
| <hr/> | | |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | |
| Purchase of distribution rights | (13,767) | -- |
| Capital expenditures | (5,878) | (1,969) |
| Sales of property, plant and equipment | 5 | 10 |
| | (19,640) | (1,959) |
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| | | |
|--|----------|---------|
| CASH FLOWS FROM FINANCING ACTIVITIES: | | |
| Net change in revolving credit facility | 52,485 | 14,949 |
| Debt repaid | (3,505) | (3,000) |
| Debt issue costs paid | (1,011) | (210) |
| Issuance of common stock | (43) | 330 |
| Purchase of treasury stock | -- | (16) |
| ----- | | |
| | 47,926 | 12,053 |
| ----- | | |
| Change in cash and cash equivalents | 94 | 4,855 |
| Cash and cash equivalents, beginning of period | 4,865 | 1,385 |
| ----- | | |
| Cash and cash equivalents, end of period | \$ 4,959 | 6,240 |
| ----- | | |
| CASH PAID FOR INTEREST AND INCOME TAXES: | | |
| Interest | \$ 4,695 | 2,869 |
| Income taxes | \$ 1,385 | 1,186 |

See accompanying notes to consolidated financial statements.

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AVIALL, INC. NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1 - BASIS OF PRESENTATION

The accompanying unaudited financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, these financial statements do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments (consisting only of normal recurring adjustments) considered necessary for a fair presentation have been included. Operating results for the three- and six-month periods ended June 30, 2001 are not necessarily indicative of the results that may be expected for the year ending December 31, 2001. For further information, refer to the consolidated financial statements and footnotes thereto included in the Annual Report on Form 10-K for Aviall, Inc. (the "Company") for the year ended December 31, 2000.

NOTE 2 - SEGMENT INFORMATION

The following tables present information by operating segment (in thousands):

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| | THREE MONTHS ENDED JUNE 30, | | SIX MONTHS ENDED JUNE 30, |
|---|--------------------------------|---------|------------------------------|
| | 2001 | 2000 | 2001 |
| NET SALES | | | |
| Aviall Services | \$ 127,678 | 114,494 | 250,997 |
| ILS | 6,588 | 7,166 | 13,291 |
| Total net sales | \$ 134,266 | 121,660 | 264,288 |
| PROFIT | | | |
| Aviall Services | \$ 7,635 | 5,359 | 14,232 |
| ILS | 2,691 | 3,338 | 5,232 |
| Reportable segment profit | 10,326 | 8,697 | 19,464 |
| Corporate | (1,635) | (1,895) | (3,974) |
| Interest expense | (2,565) | (2,206) | (4,861) |
| Earnings from continuing operations before income taxes | \$ 6,126 | 4,596 | 10,629 |

NOTE 3 - FINANCIAL INSTRUMENTS

The Company adopted the provisions of Statement of Financial Accounting Standards No. 133 ("SFAS 133"), "Accounting for Derivative Instruments and Hedging Activities", effective January 1, 2001, which requires companies to recognize all derivatives as either assets or liabilities and measure those instruments at fair value.

The Company periodically enters into interest rate swap agreements as a means to hedge its interest rate exposure on debt instruments. In addition, the Company's credit facilities require the Company to enter into hedging arrangements to convert the Company's term loan floating interest rate to a fixed rate. At June 30, 2001, the Company had two interest rate swap agreements outstanding with an aggregate notional amount of \$32.3 million. The swap agreements effectively convert the Company's floating-rate debt to fixed-rate debt through March 31, 2002. Under terms of these agreements, the Company pays fixed interest rates of 6.87% and 7.02%, respectively, and receives floating rates based on LIBOR.

Upon adoption of SFAS 133, the Company recorded the interest rate swap agreements at fair value, which was a liability of \$0.4 million, with offsets to Comprehensive Income in the equity section of the consolidated balance sheet. Changes in the fair value of derivatives that do not qualify as hedges will be recognized in earnings when they occur. Changes in the fair value of derivatives that qualify as hedges will generally be recognized in earnings in the same period as the item being hedged. During the first half of 2001, the Company recorded an additional \$0.2 million liability as an adjustment to the fair value of its interest rate swap agreements. Additionally, the Company undertook an evaluation of the effectiveness of its interest rate swap agreements and determined that no material ineffectiveness existed for the three or six months ended June 30, 2001.

NOTE 4 - NEW ACCOUNTING PRONOUNCEMENTS

Statement of Financial Accounting Standards No. 141 ("SFAS 141"), "Business Combinations", and Statement of Financial Accounting Standards No. 142 ("SFAS 142"), "Goodwill and Other Intangible Assets", were issued on July 20, 2001. SFAS 141 addresses financial accounting and reporting for business combinations, and SFAS 142 addresses financial accounting and reporting for acquired goodwill and other intangible assets. The provisions of SFAS 141 apply to all business combinations initiated after June 30, 2001, and to all business combinations accounted for using the purchase method for which the date of acquisition is July 1, 2001 or later. The Company adopted the provisions of this statement as of July 1, 2001, and there was no financial accounting impact associated with its adoption.

The provisions of SFAS 142 are required to be applied starting with fiscal years beginning after December 15, 2001, and must be applied at the beginning of a fiscal year and to all goodwill and other intangible assets recognized in the financial statements at that date. The Company is currently reviewing SFAS 142 to assess its impact on the financial statements. The Company will adopt the provisions of this statement on January 1, 2002.

NOTE 5 - DEBT

In the second quarter of 2001, the Company increased its U.S. revolving credit facility by \$30 million, thereby increasing its total U.S. revolving line of credit to \$120 million and amending certain financial covenants. At June 30, 2001, the Company had \$8.9 million of available borrowings under its U.S. revolving credit facility. In addition, the Company continues to organize the expansion of its capital structure to accommodate additional new product lines and strategic acquisition opportunities.

ITEM 2: MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

OVERVIEW

The following discussion and analysis should be read in conjunction with the information set forth under Item 7: Management's Discussion and Analysis of Financial Condition and Results of Operations on pages 12 through 18 of Aviall, Inc.'s (the "Company") Annual Report on Form 10-K for the year ended December 31, 2000.

RESULTS OF OPERATIONS

THREE MONTHS ENDED JUNE 30, 2001 COMPARED TO THREE MONTHS ENDED JUNE 30, 2000

Net Sales. Total net sales for the second quarter of 2001 were \$134.3 million, an increase of \$12.6 million or 10.4%, from \$121.7 million in the same period of 2000. Aviall Services' net sales were \$127.7 million, an increase of \$13.2 million or 11.5%, from \$114.5 million in the second quarter of 2000. The continued sales growth at Aviall Services was primarily due to stronger

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Rolls-Royce Model 250 engine parts sales, continued core business market share growth and the addition of new product lines from Honeywell in 2001. Aviall Services' net sales increased in each major segment of the aviation industry and in all geographic regions. Aviall Services' sales by region were: the Americas region increased \$8.6 million or 10.4%; Europe increased \$0.3 million or 1.7%; and the Asia-Pacific region increased \$4.3 million or 26.1%.

ILS's net sales decreased \$0.6 million or 8.1% in the second quarter of 2001 to \$6.6 million from \$7.2 million in the same period in 2000. This sales decrease was due primarily to subscribers opting for a full year payment-in-advance discount initiative, which the Company introduced in mid-2000 to combat competitive pressures.

Gross Profit. Total Company gross profit of \$30.8 million was \$2.8 million or 10.0% higher than the \$28.0 million in the second quarter of 2000. Gross profit as a percentage of sales was 22.9% in the second quarter of 2001, which was slightly lower than in the second quarter of 2000, reflecting increased year-over-year sales of lower margin Rolls-Royce Model 250 engine parts and a lower percentage of higher margin ILS net sales to total Company sales.

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Selling and Administrative Expense. Selling and administrative expense increased \$0.9 million to \$22.1 million in the second quarter of 2001 from the same period in 2000. This increase was due primarily to planned increased technology infrastructure costs at both ILS and Aviall Services. However, selling and administrative expense decreased as a percentage of net sales from 17.4% in the second quarter of 2000 to 16.5% in the second quarter of 2001.

Interest Expense. Interest expense increased \$0.4 million in the second quarter of 2001 from the second quarter of 2000, due primarily to increased debt levels required for up-front inventory purchases associated with our new Honeywell contracts.

Discontinued Operations. The gain in discontinued operations in the second quarter of 2000 was due to a revised estimate for an insurance tail expense.

Net Earnings from Continuing Operations. Net earnings from continuing operations in the second quarter of 2001 were \$3.6 million, or \$0.19 per share (diluted), compared to \$2.5 million, or \$0.14 per share (diluted), in the second quarter of 2000.

SIX MONTHS ENDED JUNE 30, 2001 COMPARED TO SIX MONTHS ENDED JUNE 30, 2000

Net Sales. Total net sales for the first half of 2001 were \$264.3 million, an increase of \$27.7 million or 11.7%, from \$236.6 million in the same period of 2000. Aviall Services' net sales increased \$28.9 million or 13.0% in the six months ended June 30, 2001 compared to the first half of 2000. This sales increase was primarily due to stronger Rolls-Royce Model 250 engine parts sales, continued core business market share growth and the addition of new product lines from Honeywell in 2001. Aviall Services' net sales increased in each major segment of the aviation industry and in all geographic regions. Aviall Services' sales by region were as follows: the Americas region increased \$19.1 million or 11.7%; Europe increased \$1.9 million or 6.6%; and the Asia-Pacific region increased \$7.9 million or 26.0%.

ILS's net sales decreased \$1.2 million or 8.3% in the six months ended June

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30, 2001 compared to the same period in 2000. This sales decrease was due primarily to subscribers opting for a full year payment-in-advance discount initiative, which the Company introduced in mid-2000 to combat competitive pressures.

Gross Profit. Gross profit increased \$5.0 million or 9.0% to \$60.3 million in the first half of 2001 compared to the first half of 2000. This increase resulted primarily from Aviall Services' higher net sales volume. Gross profit as a percentage of sales declined 60 basis points to 22.8% in the first half of 2001 from 23.4% in the first half of 2000. The decrease in gross margin percentage was due primarily to increased year-over-year sales of Rolls-Royce Model 250 engine parts, which generally have lower margins than other product lines and a lower percentage of higher margin ILS net sales to total Company sales.

Selling and Administrative Expense. Selling and administrative expenses increased \$2.2 million to \$44.8 million in the first half of 2001 as compared to the first half of 2000. The increase in selling and administrative expenses was due primarily to planned increased technology infrastructure costs at both ILS and Aviall Services.

Interest Expense. Interest expense increased \$0.6 million in the first half of 2001 from the first half of 2000, reflecting increased borrowings due to higher working capital requirements associated with our new Honeywell contracts.

Discontinued Operations. The gain in discontinued operations in the first half of 2000 was due to a revised estimate for an insurance tail expense.

Net Earnings from Continuing Operations. In the first half of 2001, net earnings from continuing operations were \$6.3 million, or \$0.34 per share (diluted), compared to a reported \$4.7 million, or \$0.26 per share (diluted), in the first half of 2000.

FINANCIAL CONDITION

Cash flows from continuing operations, excluding working capital changes, were \$15.7 million in the first six months of 2001 compared to \$12.5 million in the comparable 2000 period. This increase resulted from improved Aviall Services' net sales and earnings. Working capital increased \$43.9 million in the six months ended June 30, 2001. The increase reflects working capital investments, primarily in parts inventory, in connection with our new Honeywell contracts.

Capital expenditures were \$5.9 million in the first half of 2001, consisting of planned spending on technology infrastructure projects at both ILS and Aviall Services. Based upon current plans for improving information technology capabilities, the Company expects capital expenditures to be approximately \$15.0 million in 2001, not including any expenditures for acquiring businesses or new product lines, including the new Honeywell product lines referred to in the following paragraph.

In March 2001, Aviall Services entered into a ten-year agreement to sell Honeywell engine systems accessories and environmental control systems through 2011. In addition, in June 2001, Aviall Services entered into another ten-year

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agreement with Honeywell to distribute fuel control parts and assemblies for the Rolls-Royce Model T56 series engine. The Company will amortize approximately \$13.8 million of cost for these distribution rights over the ten-year terms of these agreements.

Management believes the Company's expected cash flow from operations and availability under its revolving lines of credit are sufficient to meet its current working capital and operating needs. In the second quarter of 2001, the Company increased its U.S. revolving credit facility by \$30 million, thereby increasing its total U.S. revolving line of credit to \$120 million and amending certain financial covenants. At June 30, 2001, the Company had \$8.9 million of available borrowings under its U.S. revolving credit facility. In addition, the Company continues to organize the expansion of its capital structure to accommodate additional new product lines and strategic acquisition opportunities.

INCOME TAXES

The Company's cash income tax expense continues to be substantially lower than the U.S. federal statutory rate due to the utilization of the Company's large U.S. federal net operating loss carryforward ("NOL"). The Company's cash tax expense is primarily related to foreign taxes on foreign operations and U.S. federal alternative minimum tax. For U.S. federal tax purposes as of December 31, 2000, the Company had an estimated net operating loss carryforward of approximately \$161.7 million, of which a substantial portion expires in 2009-2011. Based on current and expected future earnings levels, the NOLs may not be fully utilized for several years. If certain substantial changes in the Company's ownership should occur, there would be an annual limitation on the amount of the NOL that the Company could use. The amount of the annual limitation can vary significantly based on certain factors existing at the date of the change.

NEW ACCOUNTING PRONOUNCEMENTS

The Company adopted the provisions of Statement of Financial Accounting Standards No. 133 ("SFAS 133"), "Accounting for Derivative Instruments and Hedging Activities", effective January 1, 2001, which requires companies to recognize all derivatives as either assets or liabilities and measure those instruments at fair value.

The Company periodically enters into interest rate swap agreements as a means to hedge its interest rate exposure on debt instruments. In addition, the Company's credit facilities require the Company to enter into hedging arrangements to convert the Company's term loan floating interest rate to a fixed rate. At June 30, 2001, the Company had two interest rate swap agreements outstanding with an aggregate notional amount of \$32.3 million. The swap agreements effectively convert the Company's floating-rate debt to fixed-rate debt through March 31, 2002. Under terms of these agreements, the Company pays fixed interest rates of 6.87% and 7.02%, respectively, and receives floating rates based on LIBOR.

Upon adoption of SFAS 133, the Company recorded the interest rate swap agreements at fair value, which was a liability of \$0.4 million, with offsets to

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Comprehensive Income in the equity section of the consolidated balance sheet. Changes in the fair value of derivatives that do not qualify as hedges will be recognized in earnings when they occur. Changes in the fair value of derivatives that qualify as hedges will generally be recognized in earnings in the same period as the item being hedged. During the first half of 2001, the Company recorded an additional \$0.2 million liability as an adjustment to the fair value of its interest rate swap agreements. Additionally, the Company undertook an evaluation of the effectiveness of its interest rate swap agreements and determined that no material ineffectiveness existed for the three or six months ended June 30, 2001.

Statement of Financial Accounting Standards No. 141 ("SFAS 141"), "Business Combinations", and Statement of Financial Accounting Standards No. 142 ("SFAS 142"), "Goodwill and Other Intangible Assets", were issued on July 20, 2001. SFAS 141 addresses financial accounting and reporting for business combinations, and SFAS 142 addresses financial accounting and reporting for acquired goodwill and other intangible assets. The provisions of SFAS 141 apply to all business combinations initiated after June 30, 2001, and to all business combinations accounted for using the purchase method for which the date of acquisition is July 1, 2001 or later. The Company adopted the provisions of this statement as of July 1, 2001, and there was no financial accounting impact associated with its adoption.

The provisions of SFAS 142 are required to be applied starting with fiscal years beginning after December 15, 2001, and must be applied at the beginning of a fiscal year and to all goodwill and other intangible assets recognized in the financial statements at that date. The Company is currently reviewing SFAS 142 to assess its impact on the financial statements. The Company will adopt the provisions of this statement on January 1, 2002.

OUTLOOK

The Company primarily participates in the global aviation aftermarket through Aviall Services and ILS. The Company's operations and results of operations are affected by the general economic cycle, particularly as it influences flight activity in commercial, business and general aviation. The Company benefits from its participation in the global aviation aftermarket by generating revenues from several national economies.

The Company serves a number of customers in the Asia-Pacific and Latin American regions. During 1999, countries in these regions experienced financial market volatility and the currencies of certain countries fell in value relative to the U.S. dollar. These factors reduced demand for air travel in the Asia-Pacific region in 1999, which negatively impacted the Company's sales in that region. Key Asian economies began a slow recovery in late 1999, which accelerated sharply in 2000 and 2001 and had a positive effect on the Company's revenue in that region. Continued volatility in Latin America, compounded by significantly higher fuel prices, led to financial difficulties for major air carriers in that region and significantly hampered the general aviation business in Latin America. Management believes the Company's results in 2001 have reflected and will continue to reflect financial stabilization in the Asia-Pacific region; however, volatility in Latin America is expected to continue.

Commercial airlines in North America and Europe continue to effectively manage their capacity by retiring older aircraft as new aircraft are delivered, thereby limiting growth in demand for replacement parts. Management actively continues to seek new sources of supply for airline products to expand the Company's growth in this segment.

Over the first six months of 2001, aviation operators have responded to the softening U.S. economy by closely monitoring their inventory of new parts.

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Management believes that Aviall Services' competitive strengths in service and availability have enabled the Company to increase its market share in a weakening marketplace. In addition, general economic conditions tend to have a greater impact on aircraft original equipment manufacturing than on the purchase of aftermarket replacement parts. Despite the challenges Aviall Services has faced in 2000 and into 2001, the Company was able to grow through the addition of the Rolls-Royce Model 250 engine parts product line and several new Honeywell product lines, and the recapture of market share in its core North American general aviation business.

Aviall Services' ability to manage its inventory is affected by the relative efficiency of its suppliers and the inventory investments required to secure new suppliers. Also, changes in Aviall Services' portfolio of products and suppliers can result in periodic noncash charges to write-down inventory of discontinued products.

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Information and communication technology is evolving rapidly and developments with respect to the Internet could affect proprietary database companies such as ILS and traditional distribution companies. Management believes the active deployment by the Company of new innovative technologies in its websites, AVIALL.COM and ILSMART.COM, will enable the Company to maintain its technological leadership and minimize the risk of obsolescence. There are a number of entrants in the e-commerce marketplace arena that are competing or are expected to compete with ILS, including manufacturers, distributors and independent companies. Although some of these entities are significantly larger than ILS, management believes a large number of these entrants intend to focus on different segments of the global aviation parts marketplace, and some may in fact be complementary to ILS.

The Company expects to relocate its corporate headquarters and Aviall Services' main operation center to an expanded new state-of-the-art facility located at the Dallas/Fort Worth International Airport. The Company signed a ten-year lease for this facility that will begin upon completion of the building, which is anticipated to occur in the fourth quarter of 2001. The facility is expected to replace various Dallas facilities that have lease expiration dates through December 2003. The Company is seeking to sublease the various Dallas facilities with lease expiration dates after December 31, 2001. The Company will incur a one-time cost of approximately \$2.0 million and could experience a short-term disruption in Aviall Services' sales in connection with the warehouse relocation.

Aviall Services' capital expenditures for 2001 are expected to be approximately \$4.5 million for various system enhancements and \$2.5 million related to the new Dallas facility. System-related expenditures include the next phase of Aviall Services' customer relationship module system, upgrades to its warehouse and procurement software and further enhancements to the AVIALL.COM website. Management believes the introduction of these system upgrades and enhancements will continue to transform Aviall Services into the industry-leading full-service, technology-based supply-chain highway. Aviall Services has spent \$3.2 million in capital expenditures through June 30, 2001.

ILS is in the implementation stage of its ongoing program to evolve ILSMART.COM into a full-service, business-to-business electronic marketplace -- Contact to Contract(TM). The plans include "Purchase On-line" customer catalogs, expanded electronic auction sites and web-hosting for ILS subscribers. In 2001,

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ILS expects to incur an additional \$1.5 million in expenses and \$8.0 million in capital expenditures to implement the Contact to Contract(TM) strategy, of which \$2.7 million has been spent through June 30, 2001.

CERTAIN FORWARD-LOOKING STATEMENTS

This report contains certain forward-looking statements (as such term is defined in the Private Securities Litigation Reform Act of 1995) relating to the Company that are based on the beliefs of the management of the Company, as well as assumptions and estimates made by and information currently available to the Company's management. When used in this report, the words "anticipate," "believe," "estimate," "expect," "intend" and similar expressions, as they relate to the Company or the Company's management, identify forward-looking statements. Such statements reflect the current views of the Company with respect to future events and are subject to certain risks, uncertainties and assumptions relating to the operations and results of operations of the Company as well as its customers and suppliers, including as a result of competitive factors and pricing pressures, shifts in market demand, general economic conditions and other factors including among others, those that effect flight activity in commercial, business and general aviation, the business activities of the Company's customers and suppliers and developments in information and communication technology. Should one or more of these risks or uncertainties materialize, or should underlying assumptions or estimates prove incorrect, actual results may vary materially from those described herein as anticipated, believed, estimated, expected or intended.

ITEM 3: QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The Company has market risk exposure arising from changes in interest rates and foreign exchange rates. The Company from time to time has used financial instruments to offset such risks. Financial instruments are not used for trading or speculative purposes. The Company has experienced no significant changes in market risk during the first half of 2001. The Company's market risk is described in more detail in the Company's Annual Report on Form 10-K for the year ended December 31, 2000.

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PART II - OTHER INFORMATION

ITEM 4: SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

The Company's Annual Meeting of Stockholders was held on June 7, 2001, at which meeting the stockholders took action with respect to three proposals, (i) the election of Donald R. Muzyka and Jonathan M. Schofield to serve as directors of the Company for a term expiring at the Company's 2004 Annual Meeting of Stockholders, (ii) the approval of an amendment to the Aviall, Inc. 1998 Stock Incentive Plan and (iii) the ratification of the appointment of PricewaterhouseCoopers LLP to serve as independent auditors for the Company and its subsidiaries for the fiscal year ending December 31, 2001.

The number of votes cast for, against or withheld, as well as the number of abstentions as to each proposal is set forth below. There were no broker non-votes with respect to any of the proposals.

Election of Directors

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| | ----- For --- | Withheld ----- |
|-----------------------|---------------------|-------------------|
| Donald R. Muzyka | 14,631,761 | 2,222,057 |
| Jonathan M. Schofield | 14,657,687 | 2,196,131 |

Approval of Amendment to the Aviall, Inc. 1998 Stock Incentive Plan

| For | Against | Abstain |
|------------|-----------|---------|
| 11,626,457 | 5,195,034 | 32,327 |

Ratification of Selection of Independent Auditors

| For | Against | Abstain |
|------------|---------|---------|
| 16,802,322 | 38,593 | 12,903 |

ITEM 6: EXHIBITS AND REPORTS ON FORM 8-K

(a) Exhibits

10.1 Amended and Restated Aviall, Inc. 1998 Stock Incentive Plan

(b) Reports on Form 8-K

No reports on Form 8-K were filed during the quarter ended June 30, 2001.

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

AVIALL, INC.

August 10, 2001

By /s/ Jacqueline K. Collier

Jacqueline K. Collier
Vice President and Controller
Principal Accounting Officer

August 10, 2001

/s/ Cornelius Van Den Handel

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Cornelius Van Den Handel
Vice President and Treasurer
Principal Financial Officer

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INDEX TO EXHIBITS

| Exhibit Number | Description |
|-------------------|---|
| 10.1 | Amended and Restated Aviall, Inc. 1998 Stock Incentive Plan |

