AVIALL INC
Form 10-K
March 16, 2005
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-K

(Mark One)

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

For the fiscal year ended December 31, 2004

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.)**
2750 Regent Boulevard **DFW Airport, Texas** **(Address of principal executive offices)**	**75261-9048** **(Zip Code)**

(972) 586-1000

(Registrant s telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Act:

Title of each class	Name of each exchange on which registered
Common Stock, par value $0.01 per share	**New York Stock Exchange**

Securities registered pursuant to Section 12(g) of the Act: None

Indicate by check mark 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 ¨

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§ 229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Act). Yes x No ¨

The aggregate market value of the common stock held by non-affiliates of the registrant as of June 30, 2004 was approximately $398.0 million, computed on the basis of the closing sales price of the common stock on that date.

(For purposes of determining the above-stated amount, only directors, executive officers and 10%-or-greater stockholders have been deemed affiliates.)

The number of shares of common stock outstanding at March 4, 2005 was 33,353,650.

DOCUMENTS INCORPORATED BY REFERENCE:

Portions of the registrant s Proxy Statement to be filed with the Securities and Exchange Commission in connection with the 2005 Annual Meeting of Stockholders to be held on June 9, 2005 are incorporated herein by reference in Part III.

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AVIALL, INC.

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PART I

Item 1: Business

General

Aviall, Inc., or Aviall, is the largest independent global provider to the aerospace aftermarket of new aviation parts, supply-chain management and other related value-added services. We serve this market through our two wholly owned subsidiaries, Aviall Services, Inc., or Aviall Services, and Inventory Locator Service, LLC, or ILS. Aviall Services provides new aerospace parts and related supply-chain management services to the global aviation industry, and ILS operates electronic marketplaces for buying and selling parts, equipment and services for the global aviation, defense and marine industries.

Aviall Services purchases a broad range of new aviation parts, components and supplies from approximately 220 original equipment manufacturers, or OEMs, and resells them to over 18,500 government/military, general aviation/corporate and commercial airline customers, including over 300 airlines. Aviall Services also provides value-added services to our customers and suppliers, such as repair and assembly services, supply-chain management services and information-gathering and delivery services.

ILS operates electronic marketplaces for buying and selling parts, equipment and services for the global aviation, defense and marine industries. With more than 14,000 users in over 85 countries, ILS s electronic marketplaces contain more than 55 million line items representing over five billion parts for sale. ILS also maintains databases of over 119 million cross-referenced United States, or U.S., government records, allowing users to research manufacturers and prices for specific parts, locate alternate parts, find additional uses and markets for parts and review U.S. government procurement histories. ILS has been the leader in aerospace electronic marketplaces for more than two decades.

Between 1932 and 1934, three aircraft service and parts supply organizations combined their operations to form a company that would eventually be the core business unit in the formation of our corporate predecessor in 1981. In 1993, both Aviall and Aviall Services were incorporated as Delaware corporations, and then Ryder System, Inc. distributed the stock of Aviall to its shareholders. ILS was originally incorporated in 1979 as a Tennessee corporation and became a subsidiary of Aviall in 1993. ILS was reorganized as a Delaware limited liability company in March 2001. We have a number of trademarks, including our registered trademarks, Aviall and ILS, and our common law trademarks, Bid Quest and Contact to Contract.

Our Annual Report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and all amendments to these reports will be made available free of charge through the Investor Relations section of our Internet Web site, **http://www.aviall.com**, or **aviall.com**, as soon as practicable after such material is electronically filed with, or furnished to, the Securities and Exchange Commission, or the SEC.

Recent Developments

On January 28, 2005, we entered into a distribution agreement with GE Engine Services, LLC and General Electric Company, or GE, whereby GE has appointed us as the exclusive worldwide distributor of unique parts for the GE CF6-50 and CF6-80A, or CF6, engines. We paid GE a total of $160.1 million for these distribution rights and initial CF6 product inventory. We currently expect that this agreement will generate approximately $5 billion in revenue during its term, with anticipated average annualized yearly sales of $300 million for the initial ten years of the agreement.

On January 28, 2005, we entered into an amendment to our senior credit facility, or the Credit Facility, that increased the facility size from $200 million to $260 million, restructured the borrowing base, extended the termination date and changed certain financial ratios and covenants.

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Our management completed its required assessment of effectiveness of our internal control over financial reporting under Section 404 of the Sarbanes-Oxley Act of 2002, or Sarbanes-Oxley, and concluded our internal control was effective as of December 31, 2004. PricewaterhouseCoopers LLP, or PwC, an independent registered public accounting firm, issued an opinion that our management s assessment is fairly stated in all material respects. Additionally, PwC completed their own evaluation of our internal control over financial reporting for 2004 and issued an opinion that we maintained, in all material respects, effective internal control over financial reporting as of December 31, 2004. See Item 9A: Controls and Procedures in this Annual Report on Form 10-K for management s report.

In January 2004, we filed a shelf registration statement with the SEC relating to potential offers and sales from time to time (1) by us of up to $200.0 million of our debt securities, preferred stock, common stock, warrants or units, and (2) by affiliates of The Carlyle Group, or the Carlyle Investors, of up to 7,000,000 of the 11,363,378 shares of our common stock beneficially owned by them, all at prices and on terms to be determined at the time of the specific offering. The SEC declared the shelf registration statement effective on March 8, 2004. On February 8, 2005, the Carlyle Investors sold 4.0 million shares of Aviall common stock. When aggregated with their sale of 2.5 million shares in May 2004, the Carlyle Investors have now reduced their beneficial ownership of our common stock from approximately 36% to approximately 14%. The shelf registration statement has 500,000 shares of common stock registered on behalf of the Carlyle Investors that remain available for sale in the future. We do not have any current commitments or immediate plans to sell any securities on our behalf. The Carlyle Investors retain approximately 3.9 million shares which have not been registered with the SEC, but they can require us to register these shares at any time.

Industry Overview

Aerospace Parts, Components and Supplies. The global market for aerospace parts, components and supplies generally consists of two related segments: the new aerospace parts segment and the aerospace aftermarket parts segment. The new aerospace parts segment is comprised of parts installed during the construction of new aircraft or engines. OEMs typically sell new aerospace parts, components and supplies for use on airframes or engines under construction directly to aircraft manufacturers and their subcontractors, such as Boeing, Raytheon, Lockheed Martin and European Aeronautic Defense and Space Company. The aftermarket parts segment is comprised of parts needed for the scheduled and unscheduled maintenance, repair and modification of aircraft already in use, and can be further divided into two distinct groups: the new parts group and the redistribution group. In the aftermarket segment s new parts group, OEMs and their distributors sell new aerospace parts, components and supplies for use on existing airframes and engines. In the aftermarket segment s redistribution group, aerospace parts dealers, airlines and others sell used, surplus and repaired aerospace parts or components for use on existing airframes and engines. Many operators in the aftermarket segment also provide maintenance and repair services for aerospace parts and components.

Aftermarket aerospace parts generally fall into two categories: consumable parts or supplies and repairable parts or components. Consumable parts or supplies (such as turbine igniters, lamps, filters, lubricants and other fluids) are consumed during use or disposed of after being used. Repairable parts or components generally can be overhauled and reused more than once.

Generally, new aircraft and helicopters are covered by comprehensive warranties ranging from two to five years after initial delivery. During this warranty period, OEMs and their suppliers provide most repairable parts and components to owners and operators. As a result, aftermarket suppliers generally sell aerospace parts and components for use on airframes and engines that are out of warranty, including out-of-production airframes and engines. Unlike repairable parts, consumable parts and supplies are generally not covered by OEM warranties and are typically purchased from OEMs or their distributors in the aftermarket.

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Aircraft operators replace aerospace parts and components based upon time or usage, either when they wear out or when applicable government regulations or specific manufacturer recommendations require them to be replaced. As a result of increased wear and tear and greater age and usage, older airframes and engines need substantially more parts than newer versions. Aircraft generally undergo more frequent parts replacements and repairs as the age of the aircraft increases.

Aviall Services primarily operates in the aftermarket segment s new parts group, in which Aviall Services provides primarily new aerospace parts, components and supplies on behalf of OEMs mainly to government/military procurement agencies, commercial airlines, airfreight carriers, corporate flight departments, flight schools, fixed-based operations, OEMs, helicopter fleet operators, other U.S. and foreign governmental agencies and other distributors for installation on aircraft. In addition, Aviall Services provides primarily new aerospace parts, components and supplies on behalf of OEMs to maintenance and repair facilities for installation on military, commercial, general aviation and corporate aircraft, including helicopters, undergoing repair. Aviall Services also operates 20 repair and final assembly shops in cooperation with selected suppliers.

ILS principally operates in the aftermarket segments of the industries it serves. Through its electronic marketplaces, ILS provides information and functionality for its subscribers and manages electronic commerce, or e-commerce, technology for buyers and sellers of new and used, surplus and repaired aviation and aerospace parts and components, as well as repair services. In addition, ILS offers similar services for the commercial marine and U.S. defense procurement industries.

According to *Overhaul & Maintenance*, a leading industry publication, the global commercial maintenance, repair and overhaul market in which Aviall Services participates is currently at least $37 billion in size. Based on our experience with maintenance and repair organizations, we believe that approximately half of this amount results from labor or service charges. As a result, we believe the approximate sales value of all new, refurbishable and consumable aerospace parts, components and supplies is at least $18 billion annually. We do not believe the marketplace as defined includes major new components, such as engines or retrofitted and upgraded electronics, nor the work performed on military aircraft by the various military organizations. We believe it does, however, include the parts used in the overhaul or installation of engines and electronics. For additional information concerning our revenue by operating segments and geographic information, see Note 19 - Segments and Related Information to our consolidated financial statements included in this Annual Report on Form 10-K.

Competition. In the new parts group and redistribution group of the aftermarket segment, competition is generally based on factors such as the availability, price and condition of products and services and the level of customer service. Because used, surplus and repaired aerospace parts and components typically sell for substantially less than the corresponding new parts and components, companies in the redistribution group often compete with companies in the new parts group on the basis of price. Despite the price difference, many aircraft operators prefer new parts and components over used and repaired parts and components due to the perceived superior quality and direct traceability to the OEM. There are a number of aerospace-related electronic marketplace competitors, including alliances of OEMs, individual airlines, distributors and independent companies. Competitive differentiating factors include price, product offerings and customer base, as well as product depth and e-commerce innovation.

Industry Trends. Our operations and results of operations are affected by the general economic climate, particularly as it influences flight activity in the government/military, general aviation/corporate and commercial airline sectors. We benefit from our participation in all aviation sectors in the global aviation aftermarket where we generate revenue from the aviation sectors of many countries other than those in North America.

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Beginning in 2001, most commercial airlines and airfreight carriers were affected by the global economic slowdown and reported significant losses, substantially reduced their operations, retired older aircraft and deferred nonessential aircraft maintenance and overhaul services. Since that time, several commercial airlines have filed for bankruptcy protection. These events resulted in a reduced demand for new commercial airline replacement parts that we sell. While domestic commercial airlines saw traffic levels increase in 2004, recent increases in fuel prices have hampered the recovery trend. The length of time required for a full recovery of the global commercial airline sector is not known. At the same time, the U.S. military and certain foreign militaries that utilize airframes powered by the Rolls-Royce Model T56, or RR T56, engine significantly increased their flight activities in connection with their increased military operations around the world producing a higher rate of maintenance activity. We anticipate a continuation of these flight activities in 2005. General aviation/corporate flight activity grew during 2004 and may also grow in 2005, particularly if fuel prices decrease.

We believe purchasers of aerospace parts, components and supplies are increasingly using larger, more technically advanced suppliers that have broad product offerings and provide superior parts availability, customer service and delivery times. We believe these purchasers are seeking to reduce their number of suppliers to lower procurement and inventory costs, streamline buying decisions, reduce delivery times and improve service levels and their knowledge of the marketplace. In addition, OEMs are increasingly seeking to outsource their supply-chain management functions for their mature product lines to parts distributors. The OEMs believe that distributors can more efficiently deliver their products and provide them with valuable forward-looking information on customer demand. We believe these industry trends favor large, well-capitalized, technologically advanced aftermarket providers, such as Aviall Services, that have broad product offerings and can deliver supply-chain management resources. During the past few years, a number of aerospace products suppliers have consolidated or combined their operations, and a number of OEMs have outsourced portions of their supply-chain management functions. We believe OEMs will continue to outsource and that we have already received some of the benefits of this trend.

Aviall Services

New Parts Distribution and Logistics. Aviall Services purchases new aerospace parts, components and supplies from over 220 OEMs and resells them through our network of 39 customer service centers located in North America, Europe, Asia, New Zealand and Australia. Our ISO 9001-2000 registered central warehouse, which is located at Dallas-Fort Worth International Airport, or DFW Airport, stocks nearly 46,000 line items ranging from sophisticated turbine engine parts and components to lubricants, lamps and other consumable items. We also stock high-demand items in various customer service centers located near our customers around the world.

Our customers include government/military procurement agencies, commercial airlines, airfreight carriers, maintenance and repair organizations, corporate flight departments, flight schools, fixed-based operations, OEMs, helicopter fleet operators, other U.S. and foreign governmental agencies and other distributors. The following table depicts Aviall Services percentage of net sales in 2004 and 2003 by customer sector and to its ten largest customers and largest customer:

	2004	*2003*
Customer sector:		
Government/military	51%	53%
General aviation/corporate	25%	26%
Commercial airline	24%	21%
Ten largest customers	50%	50%
Largest customer (Rolls-Royce)	38%	41%

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We currently expect Rolls-Royce to remain our largest customer in 2005. Our sales to Rolls-Royce relate primarily to its role as prime contractor for RR T56 parts to the U.S. military. Pursuant to the RR T56 agreement, we ship U.S. military orders on behalf of Rolls-Royce and then invoice Rolls-Royce for the parts shipped. As a result, because we purchase all RR T56 parts from Rolls-Royce and the majority of RR T56 parts we sell are on behalf of Rolls-Royce, Rolls-Royce is both our largest customer and our largest supplier.

Suppliers. Aviall Services has developed strong relationships and alliances with suppliers to which we offer in-depth sales and marketing coverage, advanced inventory management, forecasting and order processing, and direct electronic communications with end-users of their products. The following table sets forth some of the products we sell for our major suppliers:

Original Equipment Manufacturer	***Product(s)***
Rolls-Royce	Engine parts, modules and publications
Honeywell	Fuel controls, engine systems and accessories, aircraft lighting and electronics, aircraft fasteners, environmental control systems and batteries
Goodrich	Ice protection systems, wheel and brake parts, lighting systems, sensors, fuel nozzles and emergency equipment
Avox Systems	Oxygen systems
TransDigm	Ignition systems, filters, pumps, cables, valves, batteries, chargers and heaters

In addition, we recently entered into the GE CF6 agreement and expect GE to become one of our significant suppliers during 2005.

Our business strategy is to obtain additional aftermarket parts supply contracts, including large, long-term, exclusive contracts with leading OEMs. This strategy is relatively new in the aerospace industry. In the past, we believe most of our suppliers have been forced to make significant investments in the distribution and supply-chain support required when new components are initially incorporated into an airframe or aircraft engine. Specifically, these aerospace OEMs have been compelled to either provide their own distribution or to appoint dealers or distributors, which they sometimes also had to finance. Further, because parts and components can have long product life spans, this distribution and supply-chain infrastructure sometimes has to be available to support a product for more than 50 years. Generally, these OEMs have viewed the distribution and aftermarket supply-chain elements of their organizations to be of limited value to their core manufacturing operations. As a result, Aviall has been able to provide a valuable service to OEM aerospace manufacturers by focusing on the outsourced provision of these ancillary distribution and supply-chain operations from a centralized, technology-driven platform. By contracting their exclusive aftermarket new parts distribution through our extensive network, we believe these OEMs have been able to achieve one or more of the following benefits:

- lower inventory and associated storage costs;
- higher returns on assets and invested capital;
- a clearer understanding of demand and demand timing due to the derivation of all orders from a single source;
- the ability to discretely identify manufacturing costs for new production lines and for spare parts;

lower distribution costs as a result of our extensive global resources that serve more than 220 suppliers; or

use of our leading technology for demand forecasting and supply-chain management, while avoiding related capital investments.

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We believe that this set of competitive advantages is compelling for adoption by OEMs that seek to remove costs from their business despite being saddled with low production volumes and increasing regulation, particularly on new products. However, the aerospace industry has demonstrated a very slow adoption rate of both technology and business management change, so we may not be successful in convincing a significant number of OEMs to adopt the solutions that we offer. If we are unable to do so, our growth strategy would be impaired, and we would then rely on the smaller incremental gains that could be obtained either from the limited market growth, which is often tempered by business cycles, or market-share improvements.

Significant Parts Contracts. We have two significant, long-term agreements with Rolls-Royce. In addition, we have a series of contracts with Honeywell to sell new aerospace parts and components, which in the aggregate are significant. Under each of these agreements, we are the primary aftermarket supplier of these new parts and components, and we purchase these parts and components at a contractual discount from the manufacturers list prices. We also assist in managing the supply-chain functions for these product lines, including marketing, order administration, warehousing, inventory management, including demand forecasting, product sales and documentation support. Additional information about these agreements is summarized below.

Sales of parts from Rolls-Royce accounted for approximately 55% and 60% of Aviall Services net sales in 2004 and 2003, respectively. Sales of parts from Honeywell accounted for approximately 10% and 6% of Aviall Services net sales in 2004 and 2003, respectively.

Rolls-Royce Model T56 Parts Agreement

We have a contract with Rolls-Royce for the worldwide aftermarket fulfillment rights to sell new parts it produces for the RR T56 series gas turbine engine until December 31, 2011.

The RR T56 military turboprop, which includes its Model 501-D commercial turboprop, is the leading large turboprop engine in the world as measured by units sold and operating hours. The RR T56 military turboprop is installed primarily on the Lockheed Martin C-130 Hercules cargo plane, the Northrop Grumman E-2C Hawkeye, or E-2C, early warning aircraft and the Lockheed Martin P-3 Orion patrol aircraft, all of which are flown primarily by the U.S. military and foreign militaries. The Model 501-D commercial turboprop is installed primarily on the L-100/300, Convair 580 and the Lockheed Electra, which provide commercial passenger and cargo service in various countries around the world. Since their introduction in 1954, nearly 17,000 RR T56 and Model 501-D turboprops have been installed on a variety of propeller-driven aircraft. Over 8,000 RR T56 and Model 501-D series engines are currently in service. Rolls-Royce has entered into an agreement with the U.S. Navy to provide new production RR T56-427 engines for the E-2C through 2005.

Rolls-Royce may terminate the agreement for convenience after January 1, 2007 upon 120-days prior written notice. In addition, Rolls-Royce may terminate the agreement:

upon a change of control of Rolls-Royce;

if we are acquired by one of Rolls-Royce s competitors;

if we are acquired and the acquisition causes our credit rating to fall; or

if we become bankrupt or insolvent or materially breach the agreement.

In 2005, we have committed to purchase $411.5 million of RR T56 engine parts from Rolls-Royce. We currently have no future contractual inventory purchase commitments beyond 2005, except those required under normal purchasing lead times, which can be up to twelve months or longer.

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Honeywell Parts Agreements

We have two agreements with Honeywell to sell new Honeywell engine systems and accessories, or ESA, and environmental control systems, or ECS, until March 31, 2011 and June 27, 2012, respectively. ESA includes fuel control units and associated devices that are used on various business, regional and military aircraft. ECS includes cabin pressurization and air conditioning parts and components used on a wide variety of commercial aircraft, such as the Airbus A300/310 and Boeing 727, 747, DC-9, DC-10, MD-11 and MD-80.

Although our rights under these agreements are not exclusive, Honeywell must provide us with a purchase credit towards our future purchases for each part that Honeywell sells directly to a third party, other than excluded customers.

In September 2003, we expanded the parts covered by our aftermarket representation of Honeywell by entering into an additional agreement with Honeywell Lighting & Electronics. The new ten-year agreement awarded us with the aftermarket parts sales, including marketing, order administration, warehousing and product distribution, for Honeywell airline and general aviation lighting and electronic products until September 30, 2013. We expect the market for these products to remain stable over the term of this agreement.

Rolls-Royce Model 250 Parts Agreement

We have a contract with Rolls-Royce for the exclusive right to sell all parts, modules and related technical publications it produces for the Rolls-Royce Model 250, or RR 250, series engine until January 1, 2010. The RR 250 engine powers more than 125 different helicopter and fixed-wing aircraft in both the commercial and military sectors, making it the most popular engine in the turbine-powered light helicopter market. Since the introduction of the RR 250 in 1965, 28,500 RR 250 engines have been delivered and have accrued over 170 million flight hours. More than 14,000 of these engines are currently in service, primarily on commercial helicopters.

Either party may terminate this agreement for convenience by giving 120-days prior written notice to the other. In addition, Rolls-Royce may terminate this agreement on terms substantially similar to those of the RR T56 contract. We currently have no future contractual inventory purchase commitments, except those required under normal purchasing lead times, which can be up to twelve months or longer.

GE CF6-50 and CF6-80A Parts Agreement

On January 28, 2005, we entered into the GE CF6 agreement whereby GE has appointed us as the exclusive worldwide distributor of unique parts for GE CF6 engines. The term of the GE CF6 agreement will continue as long as either CF6 engine is operational on an airworthy aircraft. However, GE may terminate this agreement prior to this time:

- if we breach a restriction that prohibits us from selling, manufacturing or distributing certain engine parts that compete with GE OEM engine parts;

if our on-time delivery of parts to customers falls below a minimum level;

if we experience a change of control that results in us being acquired by a competitor of GE s aircraft engine business or other types of parties more specifically identified in this agreement; or

if we materially breach this agreement.

In connection with the GE CF6 agreement, we entered into a separate agreement with General Electric Company whereby GE and its affiliates have agreed to purchase their requirements for CF6 products from us. This parts supply agreement will remain in effect for the term of the GE CF6 agreement. We expect to sell a significant amount of CF6 products to GE and its affiliates under this parts supply agreement for the overhaul of CF6 engines owned by third parties.

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Repair and Final Assembly Shops. We operate a total of 20 overhaul, repair and final assembly shops authorized by the relevant civil aviation authority in cooperation with selected suppliers. We test, restore and recharge nickel-cadmium aviation batteries at our seven battery service centers. We inspect, repair and modify aircraft wheels and brakes at our seven wheel and brake overhaul and repair shops. We operate five hose assembly shops for selling and assembling a wide variety of aircraft hoses. We also test and repair aircrew oxygen cylinders at our oxygen shop. In 2004 and 2003, net sales from these repair and assembly activities, including parts used in these activities, represented approximately 6% and 5%, respectively, of Aviall Services net sales.

Technology. We believe our order fulfillment, customer relationship management and e-commerce technologies enhance Aviall Services high customer service standards and provide us with a competitive advantage. We also believe the demonstrated scalability of our hardware and software technologies will continue to enable Aviall Services to increase net sales with lower corresponding expense growth. Aviall Services integrated data system accesses information on parts availability, pricing and order status, and performs order entry on a real-time basis from anywhere in the world. This system facilitates same-day shipments to our customers worldwide.

Aviall Services also offers advanced electronic data interchange communications, which provide direct customer access to its inventory management and retrieval system. In addition, customers can access our order-management system over the Internet at our award-winning Web site, **aviall.com**, which enables customers to search for parts using an online catalog, determine parts availability, place orders, request quotes and check order and quote status. We built this enhanced Web site with the primary goal of creating customer- and supplier-friendly functionality and increasing productivity.

We plan to upgrade our enterprise resources planning software during 2005 to our current supplier s latest version. We plan to use internal resources, as well as the supplier and other outside software consultants, to implement the upgrade during 2005. To mitigate the risks associated with the implementation, we have installed a full hardware and software test environment, separate from our operating environment, to thoroughly test and validate the upgrade. While we have experience with the software and a detailed implementation plan, all software implementations of this complexity have inherent risks. We believe our plan mitigates any potential major disruption to our business from implementing the upgrade.

Sales and Marketing. Aviall Services sales and marketing efforts emphasize advanced e-commerce capabilities, breadth of product offering, competitive pricing, attention to customer service and value-added functions through advanced systems and inventory management/logistics applications.

We conduct direct sales and marketing efforts through a team of employees worldwide, supplemented by third-party sales representatives located throughout Europe, the Middle East and the Asia-Pacific region. These employees and representatives meet regularly with our customers to solicit orders by offering solutions to our customers requirements and procurement needs. In addition, these employees and representatives also work with our customers and suppliers to identify new market opportunities and provide support for existing products. This gives our customers the opportunity to improve their inventory efficiency, increase revenue and offer enhanced services to their end-users.

Our sales staff works closely with our customer service center managers and our inventory provisioning group to ensure that inventory availability and customer service levels are maintained. Our staff conducts frequent meetings with key suppliers to provide information to our customers about new product introductions, as well as to obtain marketing and sales training. From time to time, Aviall Services also directly surveys its customers to measure our performance against expectations and to identify opportunities for improvement. In addition, from time to time, Aviall Services sponsors parts and maintenance symposia, with participation by both suppliers and customers, at which suppliers showcase new product lines and provide related technical training. These symposia provide us with an important forum that allows us to communicate with our customers and to obtain candid feedback from both our customers and end-users.

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In addition, we believe Aviall Services parts catalog, which is published approximately every three years, is the recognized industry standard for parts and applications in the general aviation/corporate sectors. We currently offer the catalog in compact disk, Web-based and paper versions. Aviall Services also uses institutional advertising, co-op advertising programs with suppliers and direct mail programs, and sends representatives to a number of industry trade shows around the world to ensure its name, products and services are visible in the market.

Competition. The market for new, repairable and consumable aerospace parts, components and supplies is large but also highly fragmented with no single competitor holding a dominant position. Aviall Services competitors for the sale of new aerospace parts, components and supplies include independent distributors and redistribution suppliers. However, the largest competitors are the captive distribution organizations of aerospace OEMs. Accordingly, we believe the aerospace OEMs, through their captive distribution organizations for their OEM parent companies, represent our primary growth opportunities. Since Aviall Services has maintained and materially strengthened its position as the leading independent provider of new aerospace parts, components and supplies in the aftermarket, we believe we can offer the best and most cost-effective distribution alternative for these OEMs on the basis of availability, price and quality of products and services and the level of service to their customers.

Inventory Locator Service

General. For over 25 years, ILS has profitably served as an electronic marketplace for geographically dispersed buyers and sellers of parts, equipment and services in the aerospace industry and has operated electronic marketplaces for the marine industry and the U.S. and international government procurement markets. At December 31, 2004, ILS had more than 14,000 users in over 85 countries. ILS operates online electronic marketplaces enabling its aerospace, marine and government subscribers to purchase or list parts, equipment and services for sale within a diverse community of users. Sellers list their parts, equipment and services on ILS s databases to attract buyers from around the world, open new markets and increase sales. ILS s parts databases enable buyers to quickly locate new, used and refurbished parts from multiple sources or to locate alternate parts when needed. ILS s parts databases list more than 55 million line items, representing over five billion parts. In addition to its core parts, equipment and services databases, ILS provides access to over 119 million records of U.S. government information. This information allows users to research manufacturers of specific parts, locate alternate parts, find additional uses and markets for parts and review U.S. government procurement histories to determine values for parts. ILS is continually adding to its e-commerce services, which already include online requests for quotes, automated search capabilities, Web-linked communications, maintenance, repair and overhaul e-marketplace, integration capabilities, inventory valuations, catalog services, government bid alerts, e-mail tools and fax capabilities.

Subscribers. ILS s aerospace-related subscribers include OEMs, distributors, resellers, overhaul and repair facilities, fixed-base operators, most of the world s major airlines and U.S. and international government procurement agencies. ILS s marine-related subscribers include manufacturers, repair facilities, distributors and ship owners and operators. Subscribers can select from various levels of service to suit their needs and budgets. In addition, ILS has customized service offerings for specific market segments. ILS s largest users have typically signed multiuser, multilocation agreements that provide for wider access to ILS data by their employees.

Sales and Marketing. ILS markets its electronic marketplaces to both buyers and sellers in the aerospace and marine industries and the U.S. and international government procurement markets. ILS is headquartered in Memphis, Tennessee and maintains regional offices in Atlanta, Seattle, Singapore and Hong Kong. ILS also has independent sales representatives in the United Kingdom, the United Arab Emirates and Canada. In addition, ILS has representatives in areas where it has major concentrations of customers to provide them with training and technical support.

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Each year, ILS demonstrates its services at a number of trade shows around the world as a means of reaching prospective customers. In addition, ILS uses banner advertising, real-time demonstrations held on-site, advertising in major aerospace and marine industry publications, and active public relations campaigns to provide additional exposure and generate leads for the ILS sales team. ILS also offers onsite and online seminars and training sessions to assist customers in maximizing the value they receive from ILS s services.

Competition. There are a number of Internet-based competitors operating aerospace business-to-business marketplaces, including alliances of OEMs, individual airlines, distributors and independent companies. Most of the participants in these alliances remain subscribers and active participants in ILS s electronic marketplaces. ILS competes with these entities primarily on the basis of the size of its customer base, depth and breadth of aftermarket product offerings, electronic marketplace innovation and e-commerce developments. We believe that ILS competes effectively on these bases and also differentiates itself from most other aerospace-related electronic marketplaces due to its neutrality and longevity.

Employees

As of December 31, 2004, we had 939 employees, none of whom is represented by collective bargaining units, except for fewer than ten employees residing in The Netherlands. We believe that our relationships with our employees are good.

Regulation

General. We are regulated by certain federal, state and local government agencies within the U.S., such as the United States Environmental Protection Agency and the United States Occupational Safety and Health Administration, as well as agencies of foreign governments with similar authority in foreign jurisdictions where we do business.

Aviation. In addition to general regulation by these agencies, Aviall Services repair and final assembly operations are regulated by agencies with responsibilities over civil aviation. The Federal Aviation Administration, or FAA, regulates our operations within the U.S. We are also subject to regulation by civil aviation authorities in the foreign jurisdictions in which we operate.

Environmental. Aviall Services business includes parts repair operations that require the use, storage and disposal of certain chemicals in small quantities. These chemicals are regulated under federal, state, local and foreign environmental protection laws that require us to eliminate or mitigate the impact of these substances on the environment. We have implemented programs to detect and minimize contamination. Due to the small quantities of chemicals used and the current programs in place, we do not anticipate any material environmental liabilities or significant capital expenditures related to these ongoing operations will be incurred in the future to comply or remain in compliance with existing environmental regulations.

Additionally, some of the products, such as chemicals, oxygen generators, oxygen bottles and life rafts that we sell to our customers contain hazardous materials that are subject to FAA regulations and federal, state, local and foreign environmental protection laws. If we ship such products by air, we share responsibility with the air carrier for compliance with these FAA regulations and are primarily responsible for the proper packaging and labeling of these items. If Aviall Services mislabels or otherwise improperly ships hazardous materials, it may be liable for damage to the aircraft and other property, as well as substantial monetary penalties. Any of these events could have a material adverse effect on our financial condition or results of operations. The FAA actively monitors the shipment of hazardous materials.

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In addition, some of our previously owned businesses used chemicals classified by various federal, state, local and foreign agencies as hazardous substances. We retain environmental liabilities related to these businesses for the period prior to their sale. Changes in estimates of these retained environmental liabilities are classified as other gains and losses in continuing operations or as discontinued operations depending on the accounting treatment that applied at the time the decision was made to exit the business. For further discussion, see Item 7: Management s Discussion and Analysis of Financial Condition and Results of Operations - Environmental Matters in this Annual Report on Form 10-K and Note 17 - Environmental Matters to our consolidated financial statements included in this Annual Report on Form 10-K.

Factors That May Affect Future Results and Market Price of Stock

This Annual Report on Form 10-K contains forward-looking statements concerning our business, operations and financial performance and condition. When we use the words estimates, expects, forecasts, anticipates, projects, plans, intends, believes and variations of such similar expressions, we intend to identify forward-looking statements.

We have based our forward-looking statements on our current assumptions and expectations about future events. We have expressed our assumptions and expectations in good faith, and we believe there is a reasonable basis for them. However, we cannot assure you that our assumptions or expectations will prove to be accurate.

A number of risks and uncertainties could cause our actual results to differ materially from the forward-looking statements contained in this Annual Report on Form 10-K. Important factors that could cause our actual results to differ materially from the forward-looking statements are set forth in this Annual Report on Form 10-K, included under Item 1: Business Risk Factors. Other factors may cause our actual results to differ materially from the forward-looking statements contained in this Annual Report on Form 10-K. These forward-looking statements speak only as of the date of this Annual Report on Form 10-K, and, except as required by law, we do not undertake any obligation to publicly update or revise our forward-looking statements. We caution you not to place undue reliance on these forward-looking statements.

Risk Factors

Our dependence on the aerospace industry makes us susceptible to negative trends and adverse economic conditions in the aerospace industry.

Virtually all of Aviall Services net sales and operating income are derived from the sale of parts, components, supplies and services to customers in the global aerospace and defense industry. As a result, Aviall Services business is directly affected by trends and economic factors that affect flight activity and costs in the aerospace industry, including fuel prices, economic cycles, inflation, labor demands and instability and regulatory oversight, as well as other factors that affect flying activity by the U.S. military and its allies.

Reduced flight activity and increased fuel and other costs generally result in reduced demand for parts, components, supplies and services by customers in the aerospace industry. Increased fuel and other costs may also affect the financial health and continued viability of customers in the aerospace industry. Because a high proportion of Aviall Services operating costs are relatively fixed, reduced sales have a negative impact on its margins and earnings, as lower gross profits cannot be offset by lower expenses. Further, because we purchase parts, components and supplies from our suppliers in advance of orders from our customers based upon our estimates of future demand, reduced demand may have a materially detrimental impact on our cash flow and earnings. If expected sales do not materialize, our inventory levels could increase, resulting

in increased financing requirements and interest expense and reducing the credit available under the Credit Facility.

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Over the past four years, the demand for commercial air transport has been reduced by a global economic slowdown, terrorist attacks and their aftermath, and military activity in Iraq and Afghanistan, which has accelerated retirement of older aircraft and caused the deferral of nonessential aircraft maintenance and overhaul services. This has reduced the demand for our parts, components and supplies used on commercial aircraft. In addition, some air operations have been reduced because commercial airlines, airfreight carriers and other commercial airline-related firms around the world are experiencing large financial losses, which in some cases have resulted in bankruptcies. Although passenger and freight traffic increased in 2004, we cannot predict the length of time required for a recovery of the long-term viability of the global commercial aviation sector, particularly in the U.S. Further, any recovery could be hindered by a number of factors, including slower economic growth, foreign political instability, acts of war or terrorism or higher fuel prices.

In recent periods, we have relied heavily on increased flight activity by U.S. and foreign militaries of aircraft fitted with the RR T56 series engine to offset the decrease in commercial aviation activity. The U.S. military and certain foreign militaries may not sustain their current levels of flight activity; therefore, the demand for parts and components for military aircraft utilizing the RR T56 engine may be reduced. As a result, we may be unable to realize fully all of the benefits that we hope to receive from our RR T56 engine parts agreement with Rolls-Royce. Moreover, if some or all of these militaries were to effect an extensive, protracted grounding of their fleets of C-130 Hercules aircraft, the primary aircraft on which RR T56 engines are fitted, our business would be severely affected. Under the terms of our agreement with Rolls-Royce, we are required to purchase $411.5 million of RR T56 engine parts from Rolls-Royce in 2005. As of February 28, 2005, we have purchased $58.7 million of RR T56 parts. If demand for RR T56 engine parts decreases substantially, our inventory levels of RR T56 engine parts could grow to be larger than needed to support our sales, increasing our financing requirements and interest expense and reducing the credit available under the Credit Facility.

In 2005 and beyond, we expect to generate significant sales of CF6 engine parts. Currently, the end-users of a majority of CF6 engine parts consist of a relatively small number of commercial passenger and freight airlines. As a result, our ability to realize fully all of the benefits we hope to receive from the GE CF6 agreement will depend on the continued operation of aircraft using CF6 engines by these airlines or by third parties if these airlines discontinue the use of those aircraft. If several of these commercial passenger or freight airlines reduce their demand for CF6 engine parts due to economic or other factors or if there is an extensive, protracted grounding of CF6 engines or aircraft using CF6 engines, our business could be severely affected.

In addition, the demand for our parts, components and supplies could decrease if one or more of our customers were to eliminate or retire one or more of their aircraft fleet types. Further, the demand for our parts, components and supplies could decrease if intense competition in the aerospace industry or other factors cause one or more of our customers to go out of business. Any decreases in demand for our parts, components and supplies could have a material adverse effect on our business, financial condition or results of operation.

We may face difficulty in integrating the GE CF6 agreement to provide CF6 engine parts into our business. If we fail to integrate the GE CF6 agreement successfully, or it is otherwise terminated, our business and the value of our common stock could be materially adversely affected.

On January 28, 2005, we entered into the GE CF6 agreement. Subject to earlier termination, the term of this agreement will continue for so long as either CF6 engine is used on an airworthy aircraft. We currently anticipate this agreement will generate approximately $5 billion in revenue during its term, with anticipated average annualized yearly sales of $300 million per year for the initial ten years of this agreement. The integration into our current business structure of this agreement, and our duties and responsibilities under it, may place significant burdens on our management and operations. Accordingly, our business and future operating results will depend on the ability of our officers and other key employees to implement this agreement effectively and efficiently. Our failure to implement this agreement successfully could have a material adverse effect on our business, financial condition, results of operations or the market value of our common stock.

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Although the GE CF6 agreement is not scheduled to terminate while either CF6 engine is used on an airworthy aircraft, GE may terminate this agreement if we materially breach it. In general, GE may also terminate this agreement if we are acquired by a competitor of GE s aircraft engine business or a party that, in GE s good faith judgment and reasonable discretion, does not have the resources and expertise to perform our obligations under this agreement or does not have a reputation for integrity, sound business ethics and compliance with laws. In addition, GE may terminate this agreement if our delivery performance under it falls below certain specified levels. In the event that GE terminates this agreement, our business, results of operations and financial condition would likely be materially adversely affected.

If Rolls-Royce or Honeywell terminates or limits their relationships with us, our net sales could decline substantially and our business could be adversely affected.

We have two significant, long-term agreements with Rolls-Royce to sell its parts. In addition, we have several long-term agreements with Honeywell to sell its parts, which are significant in the aggregate. During 2004, 55% and 10% of Aviall Services net sales were derived from sales of parts from Rolls-Royce and Honeywell, respectively. We expect these agreements to continue to represent a substantial percentage of our future net sales.

While our agreements with Honeywell and Rolls-Royce are ten-year agreements, each of these agreements, unlike the GE CF6 agreement, contains a termination-for-convenience provision. These provisions allow the other party to terminate the agreement on the dates set forth below, subject to receipt of advance written notice and any other specific requirements of the applicable contract, which in some instances include an obligation for the other party to pay a termination fee or repurchase inventory.

Supplier	*Parts*	*Earliest Date for Notice of Termination for Convenience*	*Notice Requirement*
Rolls-Royce	RR T56 engine parts	January 1, 2007	120 days
Rolls-Royce	RR 250 engine parts	January 1, 2003	120 days
Honeywell	Hydromechanical controls for RR 250 and Honeywell LT101 series engines	January 1, 2002	60 days
Honeywell	Honeywell ESA and ECS	April 1, 2006	60 days
Honeywell	Honeywell ESA and ECS	June 27, 2007	30 days
Honeywell	Hydromechanical controls for RR T56 engines	June 30, 2004	60 days
Honeywell	Airline and general aviation lighting and electronic products	October 1, 2007	60 days

Honeywell and Rolls-Royce may also terminate these agreements if we materially breach or fail to make payments under these agreements, or if we become bankrupt or insolvent or commence bankruptcy proceedings. Furthermore, Rolls-Royce may terminate our agreements to provide RR T56 engine parts and RR 250 engine parts upon 120-days prior written notice upon a change of control of Rolls-Royce, if we are acquired by a competitor of Rolls-Royce, or if we are acquired by a person that is not a competitor of Rolls-Royce and the acquisition causes our credit rating to fall.

In the event that Rolls-Royce or Honeywell discontinues production of the items we sell or terminates or fails to perform under our agreements with them, and we are otherwise unable to obtain the parts we need to fulfill our customers orders, our results of operations would likely be materially adversely affected.

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Our largest customers represent a major percentage of our total business and loss of all or some of these customers could have a material adverse effect on our operating results.

In 2004, Aviall Services ten largest customers represented, in the aggregate, approximately 50% of its net sales, and Rolls-Royce, its single largest customer, accounted for approximately 38% of its net sales. The sales to Rolls-Royce relate primarily to its role as prime contractor for supplying RR T56 parts to the U.S. military. The loss of Rolls-Royce or the loss of the business that we conduct through Rolls-Royce with the U.S. military would, and the loss of all or some of these other large customers could, have a material adverse effect on our business, financial condition or operating results.

Our corporate headquarters, distribution network hub and approximately 90% of the value of our inventory reside in the same building. If we lose access to, or use of, this building, our business would be interrupted, which could adversely affect our business and operating results.

Our corporate headquarters at DFW Airport is the hub for our distribution network. Approximately 90% of the value of our inventory resides in this building, and we receive and ship the majority of our inventory from this location. If we were unable to access this building because of security concerns, a natural disaster or otherwise or if this building were destroyed or materially damaged, our business would be materially adversely affected.

Furthermore, any damage to the building could damage some or all of the inventory stored in the building. If inventory is damaged, the FAA could require us to inspect each item before sale, which could take a protracted amount of time and cause us to lose sales and customers. Any material loss of sales or customers would have a material adverse effect on our business and results of operations.

While we have a disaster recovery plan to manage the use of our information technology and deal with telecommunications interruptions and other disasters, this plan has not been tested in a disaster-equivalent environment. In addition, we have business interruption insurance to both offset the cost of, and compensate us for, any event that interrupts our operations. However, the coverage may not be sufficient to compensate us for all potential losses and the conditions to the coverage may preclude us from obtaining reimbursement for some potential losses. While we have attempted to match our coverage to the most likely potential disasters and events that could interrupt our business, we may not have been able to foresee all the costs and implications of a disaster or other event and, therefore, the coverage may not be sufficient to reimburse us for our losses. Any material losses for which we are unable to obtain reimbursement may have a material adverse effect on our financial results.

Our significant indebtedness and other contractual obligations could adversely affect our financial health.

As of January 31, 2005, we had $307.4 million of debt outstanding, including capital lease obligations. We also had significant commitments under our parts contracts with Rolls-Royce and GE. In 2005, we have committed to purchase significant amounts of RR T56 parts from Rolls-Royce and CF6 parts from GE. We also have significant obligations under operating leases.

As of January 31, 2005, we had approximately $154.1 million of floating rate borrowings outstanding. In addition, the Credit Facility allowed for up to $123.6 million of additional floating rate borrowings as of January 31, 2005. As a result, our floating rate borrowings could increase dramatically in the future. Future interest rate increases will increase the interest expense on our floating rate borrowings, which could be significant.

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Our leverage could have important consequences. For example, it could:

- make it difficult for us to satisfy our financial obligations, including making scheduled principal and interest payments on our 7.625% senior notes due 2011, or the Senior Notes, the Credit Facility and our other indebtedness;
- place us at a disadvantage relative to our competitors;
- require us to dedicate a substantial portion of our cash flow from operations to fulfill contractual obligations and service payments on our indebtedness, thereby reducing funds available for other purposes;
- increase our vulnerability to a downturn in general economic conditions or the industry in which we compete;
- limit our ability to obtain additional financing for working capital, capital expenditures, acquisitions and general corporate and other purposes; and