AVIALL INC
Form 10-K
March 31, 2003

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, 2002

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
Preferred Share Purchase Rights	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 (Section 229.405 of this chapter) is not contained herein, and will not be contained herein, 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. [X]

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 nonaffiliates of the registrant as of June 28, 2002 was approximately $254.9 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 17, 2003 was 19,747,837.

DOCUMENTS INCORPORATED BY REFERENCE:

Portions of the registrant's Proxy Statement to be filed with the Securities and Exchange Commission in connection with the 2003 Annual Meeting of Stockholders to be held on June 26, 2003 are incorporated herein by reference in Part III.

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AVIALL, INC.
TABLE OF CONTENTS

PART I

Item 1: Business..
Item 2: Properties..
Item 3: Legal Proceedings...
Item 4: Submission of Matters to a Vote of Security Holders.........................
Item 4A: Executive Officers of the Registrant.......................................

PART II

Item 5: Market for Registrant's Common Equity and Related Stockholder Matters.................
Item 6: Selected Financial Data...
Item 7: Management's Discussion and Analysis of Financial Condition and Results of Operations...
Item 7A: Quantitative and Qualitative Disclosures About Market Risk.........................
Item 8: Consolidated Financial Statements and Supplementary Data...........................
Item 9: Changes in and Disagreements with Accountants on Accounting and Financial Disclosure....

PART III

Item 10: Directors and Executive Officers of the Registrant.................................
Item 11: Executive Compensation...
Item 12: Security Ownership of Certain Beneficial Owners and Management and Related Stockholder M

Item 13: Certain Relationships and Related Transactions..
Item 14: Controls and Procedures..

PART IV

Item 15: Exhibits, Consolidated Financial Statement Schedules and Reports on Form 8-K...........

Signatures...

Certifications...

Index to Consolidated Financial Statements and Supplementary Data..................

2

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 aviation industry, and ILS operates electronic marketplaces for buying and selling parts, equipment and services for the aviation, defense and marine industries.

Aviall Services sells a broad range of new aviation parts, components and supplies from approximately 180 original equipment manufacturers, or OEMs, to over 17,000 government/military, general aviation/corporate and commercial airline customers, including over 250 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 facilitates electronic commerce, or e-commerce, for the global aviation, defense and marine industries. With more than 10,000 users in more than 76 countries, ILS's electronic marketplaces contain more than 50 million line items representing over five billion parts for sale. ILS also maintains databases of over 100 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 which would eventually be the core business units in the formation of Aviall in 1981. In 1993, both Aviall and Aviall Services were incorporated as Delaware corporations when Ryder Systems, 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 website, 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.

RECENT DEVELOPMENTS

- In December 2001, we were awarded the exclusive ten-year worldwide aftermarket fulfillment rights to sell new parts for the Rolls-Royce Model T56, or RR T56, series gas turbine engine, which is primarily used for the Lockheed Martin C-130 series, a military transport aircraft. The award, which became effective on January 2, 2002, is the largest in our history and is expected to add in excess of $3.0 billion to our net sales over the ten-year life of the agreement. Actual net sales associated with this agreement were $273 million in 2002, exceeding our expectation of $250 million. This actual net sales amount did not include $74 million of RR T56 sales, valued at our contractual prices, made directly by Rolls-Royce to the U.S. military during the RR T56 transition period, which ended in June 2002; however, our original $250 million sales estimate did include this amount. As a result, sales of RR T56 parts in 2002 exceeded our initial estimates by $97 million.

- Aviall Services' business has significantly changed with the addition of the primarily military-related RR T56 product line. In the fourth quarter of 2002, Aviall Services' net sales were derived approximately 45% from government/military sales, 30% from general aviation/corporate sales and 25% from commercial airline sales. This is a significant change from our historical sources where government/military sales never exceeded 8% on an annual basis. This change has created a more balanced sales mix between the government/military, general aviation/corporate and commercial airline markets.

- During 2002, we expanded our relationship with the Honeywell Corporation, or Honeywell. In March and September 2002, we were awarded an expansion of our worldwide aftermarket distribution rights for Honeywell engine systems and accessories and environmental control systems. Additionally, in July 2002, Honeywell awarded Aviall Services the ten-year nonexclusive fulfillment rights for the fuel control parts and assemblies for the Pratt and Whitney PT6, PW100 and JT15D turbine engines. We project annual sales for these products in 2003 to be approximately $25 million.

INDUSTRY OVERVIEW

AVIATION PARTS, COMPONENTS AND SUPPLIES. The global market for aviation parts, components and supplies generally consists of two related segments: the new aircraft parts segment and the aftermarket parts segment. The new aircraft parts segment is comprised of parts fitted to new aircraft. OEMs typically sell new aviation parts, components and supplies directly to aircraft manufacturers and their subcontractors, such as Boeing, Lockheed Martin and European Aeronautic Defense and Space Company, for use on airframes or engines under construction. The aftermarket 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 aviation parts, components and supplies for use on existing airframes and engines. In the aftermarket segment's redistribution group, aviation parts dealers, airlines and others sell used, surplus and repaired aviation parts or components for use on existing airframes and engines. Many operators in the aftermarket segment also provide maintenance and repair services for aircraft parts and components.

Aftermarket aviation parts generally fall into two categories: consumable or expendable parts or supplies (such as turbine igniters, lamps, filters, lubricants and other fluids), which are disposed of after being used. It also includes repairable parts and components (such as engine parts and components), which generally can be repaired 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, and therefore, aftermarket suppliers generally sell aviation 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.

Aircraft operators replace aviation 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 aviation parts, components and supplies on behalf of OEMs mainly to commercial and regional airlines, general aviation/corporate operators, air freight carriers, U.S. government and foreign governments for installation on their aircraft and helicopters. In addition, Aviall Services provides primarily new aviation parts, components and supplies on behalf of OEMs to maintenance and repair facilities for installation on military, commercial, corporate and general aviation aircraft, including helicopters, undergoing repair. Aviall Services also operates 17 repair and final assembly shops in cooperation with selected suppliers.

4

ILS principally operates in the aftermarket segment's redistribution group. Through its electronic marketplaces, ILS provides information and functionality for its subscribers. ILS also manages 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. The e-commerce industry has developed substantially since the

Internet became generally accessible in 1995. Initially, many analysts expected the Internet would be dominated by a few highly sophisticated, aggregated companies serving many industry verticals. This has not occurred for many reasons, the most important of which, we believe, is that for a marketplace to succeed, it requires participation by a critical mass of buyers and sellers. Few of the initial Internet companies had enough participants to not only demonstrate the depth and volume of transactions necessary to keep existing buyers and sellers, but also to attract new ones. Accordingly, ILS operates in a competitive environment that presently consists of no independent companies of comparable size and a group of OEM and airline alliances that offer limited e-commerce opportunities for the OEMs and airlines to reduce the costs of serving common customers or shared aerospace projects.

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 aviation 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 versus 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. We believe purchasers of aviation parts, components and supplies are increasingly using larger, more technically advanced suppliers who have broad product offerings and provide superior 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 quality controls 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, who have broad product offerings and can deliver supply-chain management resources. During the past few years, a number of aviation 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.

During the last 18 months, several commercial airlines and air freight carriers reported significant losses and substantially reduced their operations, retired older aircraft and deferred nonessential aircraft maintenance and overhaul services. In addition, several commercial airlines filed for bankruptcy protection. However, at the same time, the U.S. military and certain foreign militaries significantly increased their flight activities in connection with their increased military operations around the world. Generally, corporate and general aviation flight activity remained relatively stable during 2002, with the exception of piston-engine aircraft, which experienced a slowdown.

These recent industry trends have had a varied impact on Aviall Services. In the commercial airline sector, Aviall Services has experienced reduced demand for parts, components and supplies, particularly in the U.S. and Europe. However, due to the addition of several OEM product lines to the commercial and general aviation product offering and the increased flight activity of the U.S. military and foreign militaries, as well as Aviall Services' RR T56 engine parts contract, we were able to more than offset the decreased demand for commercial aircraft parts with some new product line sales to commercial airlines and to a larger degree increased sales of general aviation and military aircraft parts, although at lower margins.

In 2002, ILS experienced a slight decrease in aviation-related subscribers, however, this decrease was partially offset by an increase in the number of government-related subscribers. As a result, ILS has not experienced an adverse impact on its business as a result of the general economic downturn experienced in 2002. Additionally, the underlying demand trends for the ILS business offerings may be changing as a result of current economic conditions. We believe companies that would normally make investments in state-of-the-art technology will now look to ILS to provide many of the benefits without the typically large initial and recurring capital investment.

AVIALL SERVICES

NEW PARTS DISTRIBUTION AND LOGISTICS. Aviall Services purchases new aviation parts, components and supplies from approximately 180 OEMs and resells them through our network of 40 customer service centers located in North America, Europe, Asia, New Zealand and Australia. Our ISO 9002 registered central warehouse, which is located in Texas on the grounds of the Dallas/Fort Worth International Airport, or DFW Airport, stocks nearly 50,000 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, air freight 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. In 2002, Aviall Services' net sales were derived approximately 41% from government/military sales, 32% from general aviation/corporate sales and 27% from commercial airline sales. In 2002, Aviall Services' ten largest customers represented, in the aggregate, approximately 42% of its net sales, and Rolls-Royce, its single largest customer, accounted for approximately 30% of its net sales. We currently expect Rolls-Royce to remain our largest customer in 2003. The 2002 net sales amounts did not include $74 million of RR T56 sales, valued at our contractual prices, made directly by Rolls-Royce to the U.S. military during the RR T56 transition period which ended in June 2002. If Aviall Services' net sales in 2002 included the $74 million of RR T56 sales made directly by Rolls-Royce to the U.S. military, Aviall Services' net sales would have been derived approximately 47% from government/military sales, 29% from general aviation/corporate sales and 24% from commercial airline sales. In 2001, Aviall Services' net sales were derived approximately 48% from commercial airline sales, 44% from general aviation/corporate sales and 8% from government/military sales. The sales to Rolls-Royce primarily relate to their role as prime contractor for RR T56 parts to the U.S. military. Pursuant to our parts agreement with Rolls-Royce, we ship U.S. military orders directly to the U.S. military agencies on behalf of Rolls-Royce and then invoice Rolls-Royce for the parts shipped. In 2001, Aviall Services' ten largest customers represented, in the aggregate, approximately 15% of its net sales, and its single largest customer accounted for approximately 3% of its net sales.

REPAIR AND FINAL ASSEMBLY SHOPS. We operate 17 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 six wheel and brake overhaul and repair shops. We also operate four hose assembly shops for selling and assembling a wide variety of aircraft hoses. In 2002, net sales from these repair and assembly activities, including parts used in these activities, represented approximately 7% of Aviall Services' net sales.

SUPPLIERS. Aviall Services has developed strong relationships and alliances with suppliers who seek in-depth sales and marketing coverage, advanced inventory management, order processing, forecasting and direct electronic communications with end-users of their products. Aviall Services sells products such as:

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

SIGNIFICANT PARTS CONTRACTS. Since November 1999, we have entered into several significant, long-term agreements with Rolls-Royce and Honeywell to sell new aviation parts and components. 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, product sales and documentation support. Additional information about these agreements is summarized below.

Sales of parts from Honeywell accounted for approximately 4% of Aviall Services' net sales in both 2002 and 2001. Sales of parts from Rolls-Royce accounted for approximately 51% and 24% of Aviall Services' net sales in 2002 and 2001, respectively. In the event that either Honeywell or Rolls-Royce or both discontinue the products we sell, terminate our contracts or are unable to perform under our agreements with them, we would likely experience a material adverse effect on our business, financial condition, cash flows and results of operations.

ROLLS-ROYCE MODEL T56 PARTS AGREEMENT

In December 2001, Rolls-Royce awarded us the aftermarket fulfillment rights to sell new parts for the RR T56 series gas turbine engine until December 31, 2011. During the transition period, which ended in June of 2002, Rolls-Royce continued to ship orders directly to the U.S. military and paid us a commission on these sales equal to the gross margin that we would have recognized on these orders had we shipped them directly. As a result, Aviall Services' net sales for 2002 did not include $74 million of RR T56 sales that would have been booked as revenues on these orders if we had shipped them directly.

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 wide 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.

Under this agreement, Rolls-Royce is permitted to sell RR T56 engine parts directly to OEMs solely for installation in new airframes, to customers requesting normal levels of spare modules and parts when sold together with new RR T56 engines and to others to comply with pre-existing contractual requirements.

Rolls-Royce may terminate this agreement for convenience after January 1, 2007 by giving us 120-days prior written notice. In addition, Rolls-Royce may terminate this agreement:

- upon a change of control of Rolls-Royce, provided that Rolls-Royce gives us 120-days prior written notice;

- if we are acquired by one of Rolls-Royce's competitors, provided that Rolls-Royce gives notice of termination to us within 30 days of the change of control and sets the termination date at least 120 days after the notice date;

- if we are acquired by a person that is not a competitor of Rolls-Royce and the acquisition causes our credit rating, as determined by Standard & Poor's or Moody's, to fall one notch below our rating prior to the acquisition, provided that Rolls-Royce elects to terminate the agreement within one year of the acquisition and gives us 120-days prior written notice of termination;

- if we become bankrupt or insolvent or commence bankruptcy proceedings; or

- if we materially breach the agreement.

However, if Rolls-Royce terminates the agreement for convenience or upon a change of control of Rolls-Royce, we are entitled to recover termination fees from them, and they are required to repurchase the parts we acquired from them under the agreement at our average cost. In addition, upon termination for any other reason, Rolls-Royce may purchase all, but not less than all, of our inventory of RR T56 engine parts for an aggregate purchase price equal to our aggregate average cost for the parts less our excess and obsolescence reserves for such parts. In 2003, we have committed to purchase $367.4 million of RR T56 parts from Rolls-Royce. We have no future contractual inventory purchase commitments beyond 2003 except those required under normal purchasing lead times.

HONEYWELL ESA/ECS PARTS AGREEMENT

In March 2001, Honeywell awarded us the right to sell new Honeywell engine systems and accessories, or ESA, and environmental control systems, or ECS, until March 31, 2011. This right was amended in 2002 to allow us to sell additional ESA and ECS. ESA includes cabin pressurization and air conditioning parts and components used on a wide variety of commercial aircraft, such as Airbus A300/310s and Boeing 727s, 747s, DC-9s, DC-10s, MD-11s and MD-80s. ECS includes fuel control units and associated devices that are used on various business, regional and military aircraft. We expect the market for these products to remain stable over the term of this agreement.

Honeywell has the right to sell the parts covered by this agreement directly to OEMs for production/retrofit requirements, to U.S. and foreign military customers and to some of its repair and overhaul facilities. Although not granting us exclusive rights to sell these parts, Honeywell must provide us with a purchase credit towards our future purchases for each part that Honeywell sells directly to a third party.

Either party may terminate this agreement for convenience after April 1, 2006 by giving 60-days prior written notice to the other party. However, if Honeywell terminates this agreement for convenience, we can require them to repurchase the parts we acquired under the agreement at their current list price and to refund any outstanding purchase credits owed to us. Honeywell may also terminate this agreement if we become bankrupt or insolvent or commence bankruptcy proceedings or if we materially breach the agreement.

ROLLS-ROYCE MODEL 250 PARTS AGREEMENT

In November 1999, Rolls-Royce awarded us the ten-year exclusive right to sell all parts, modules and related technical publications it produces for the Rolls-Royce Model 250 series engine.

The Rolls-Royce Model 250 series engine powers more than 125 different helicopter and fixed-wing aircraft in both the commercial and military markets, making it the most popular engine in the turbine-powered light helicopter market. Since its introduction in 1965, 28,500 Rolls-Royce Model 250 series engines have been delivered, and, in that time, they have accrued over 150 million flight hours. More than 16,000 of these engines are currently in service, primarily on commercial helicopters.

Under this agreement, Rolls-Royce is permitted to sell its Model 250 engine parts directly to OEMs solely for installation in new airframes, to the U.S. military and to others to comply with pre-existing contractual requirements.

Either party may terminate this agreement for convenience after January 1, 2003 by giving 120-days prior written notice to the other. In addition, Rolls-Royce may terminate this agreement:

- o upon a change of control of Rolls-Royce, provided that Rolls-Royce gives us 120-days prior written notice;
- o if we are acquired by one of Rolls-Royce's competitors, provided that Rolls-Royce gives notice of termination to us within 30 days of the change of control and sets the termination date at least 120 days after the notice date;
- o if we are acquired by a person that is not a competitor of Rolls-Royce and the acquisition causes our credit rating, as determined by Standard & Poor's or Moody's, to fall one notch below our rating prior to the acquisition, provided that Rolls-Royce elects to terminate the agreement within one year of the acquisition and gives us 120-days prior written notice of termination;
- o if we become bankrupt or insolvent or commence bankruptcy proceedings; or
- o if we materially breach the agreement.

However, if Rolls-Royce terminates the agreement for convenience or upon a change of control of Rolls-Royce, we are entitled to recover termination fees from them. In addition, upon termination, Rolls-Royce may purchase all, but not less than all, of our inventory of Rolls-Royce Model 250 engine parts for an aggregate purchase price equal to our aggregate average cost for the parts less our excess and obsolescence reserves for such parts. In 2003, we have committed to purchase $112.5 million of Rolls-Royce Model 250 parts from Rolls-Royce. We have no future contractual inventory purchase commitments beyond 2003 except those required under normal purchasing lead times.

OTHER AGREEMENTS

In addition to the agreements discussed above, we also have an agreement with Honeywell to sell new Honeywell fuel control products for Rolls-Royce Model 250 and Honeywell LT101 series engines until December 31, 2010, to sell new Honeywell fuel control parts and assemblies for RR T56 series engines until June 30, 2011, and to sell Honeywell fuel control parts and assemblies for Pratt and Whitney PT6, PW100 and JT15D turbine engines until June 27, 2012, in each case subject to rights of early termination.

TECHNOLOGY. We believe our order fulfillment, customer relationship management and e-commerce technologies are key factors that accentuate Aviall Services' high standards for customer service and provide us with a competitive advantage. We also believe we have demonstrated that our hardware and software technologies are scalable and 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, or EDI, communications, which provides direct customer access to its central inventory management and retrieval system.

In addition, customers can access our order management system over the Internet at our award-winning website, 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 website with the primary goal of creating customer- and supplier-friendly functionality and increasing productivity. We offer order fulfillment and key documentation that is usually essential to permit a part to be installed on the aircraft and then for the aircraft to be flown in accordance with its certification.

SALES AND MARKETING. Aviall Services' sales and marketing efforts emphasize leading edge, 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 and supplement that with third-party sales representatives located throughout Europe, the Middle East and the Asia-Pacific region. These employees and representatives meet regularly with our major customers to solicit orders by offering solutions to our customers' requirements and procurement needs. Their function is not only to sell and provide support for existing products, but also to work with our customers and suppliers to identify new market opportunities. This gives our customers the opportunity to improve their inventory efficiency, increase revenues and be perceived as value-added resellers to the end user.

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. Frequent meetings are conducted 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 polls its customers to measure our performance as compared to expectations and to identify opportunities for improvement. One of our most important means of communication with our customers arises when Aviall Services sponsors parts and maintenance symposia with participation by both manufacturers and customers. These symposia feature new product lines and experienced supplier representatives who provide technical training. They also permit us to obtain candid feedback from both our customers and end users.

For our Rolls-Royce products, we, in conjunction with Rolls-Royce, hold quarterly conferences with our major customers to discuss market trend requirements and jointly forecast parts demand.

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

COMPETITION. A leading aerospace publication has determined that the global marketplace in which Aviall Services participates is approximately $30 billion in size. Based on our experience with maintenance and repair organizations, we believe that approximately half of this marketplace is comprised of labor charges. This means that the approximate sales value of all new, refurbishable and consumable aerospace parts, components and supplies is approximately $15 billion annually. We do not believe this amount includes major new components, such as engines or retrofitted and upgraded electronics, but does include the parts needed to install these components. This amount would not include the work performed on military aircraft by the various military organizations. This market is large but also highly fragmented with no single competitor holding a dominant position.

Aviall Services' primary competitors for the sale of new aircraft parts, components and supplies are independent distributors, redistribution suppliers and captive distribution organizations of aerospace OEMs. 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 aviation 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 20 years, ILS has profitably served as an electronic marketplace for buyers and sellers of parts, equipment and services in the aviation industry and also operates electronic marketplaces for the marine industry and the U.S. and international government procurement markets. ILS operates online electronic marketplaces providing its aviation, marine and government subscribers the ability 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 advertise their inventories and services to active buyers 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 50 million line items, representing more than five billion parts. In addition to its core parts, equipment and services databases, ILS provides access to over 100 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 help establish the value for parts.

ILS brings together buyers and suppliers who are geographically dispersed. ILS's success can be attributed in part to its early aggregation of the vertical markets it services, which began long before the competitive environment intensified with the arrival of commercial access to the Internet. At December 31, 2002, ILS had approximately 10,000 users in more than 76 countries, including over 200 airlines, nearly 100 ship management companies, nearly 700 repair and overhaul facilities and 60 U.S. and international government procurement agencies, including several Defense Logistics Agency divisions, Defense Supply Centers and NATO. The users also include nearly 700 overhaul and repair facilities approved by the Federal Aviation Administration, or FAA, that list more than two million items for repair or overhaul. On average, users access ILS's databases approximately 40,000 times each business day. In addition, we believe that users of ILS have a success rate of almost 80% on parts searches. As a provider of independent electronic marketplaces and information, ILS does not take possession or ownership of any parts, equipment or supplies.

ILS links buyers and sellers through its website, ILSMART.COM, or its private, dial-up data network. Subscribers pay a monthly or yearly subscription fee to access the databases, and suppliers pay a monthly fee to list their inventories in the ILS databases. During 2002, ILS generated approximately 88% of its net sales from subscription and inventory listing services. ILS's databases offer all participants an unbiased, neutral environment. While ILS does not directly generate revenue from the sale of parts, equipment and services listed in its databases, it does generate additional income from providing value-added services, such as cross-reference information on government parts, inventory reports and overhaul capability listings. During 2002, ILS generated approximately 12% of its net sales from providing value-added services to it subscribers.

We believe ILS's services significantly improve aviation, defense and marine industry sourcing, purchasing, marketing and sales productivity, and the global shift to e-commerce will position ILS to simplify its customers' procurement activities.

CONTACT TO CONTRACT INITIATIVE. ILS is continually adding to its e-commerce services that already include online requests for quotes, buyers' auctions, web-linked communications, e-mail tools and fax capabilities. In 2000, ILS announced plans for its next-generation, business-to-business, electronic marketplace Contact to Contract initiative. The goal of the Contact to Contract initiative is to enable ILS's subscribers to conduct a typical procurement transaction entirely online, from order inquiry to processing and fulfillment.

The Contact to Contract initiative commenced with the ILS Exchange in 2001 and initially included the development of several powerful new tools on ILSMART.COM. The ILS Exchange enables customers to conduct transactions, from purchase initiation to fulfillment, entirely online. Additionally, ILS customers have online negotiation capabilities, which reduces the need for phone calls and faxes. Other capabilities of the ILS Exchange include requesting quotes for needed parts and services, managing replies to those requests, generating purchase orders, issuing invoices and tracking the entire negotiation history. The initial tools for use in connection with the ILS Exchange were the e-Supplier Directory and the ILS BidQuest e-procurement system. The e-Supplier Directory enables buyers to locate suppliers by the types of equipment they sell, service or overhaul and also includes company profiles that provide additional information about suppliers and enables buyers to make better-informed purchasing decisions. In addition, the e-Supplier Directory allows suppliers to provide links directly to their own websites for greater online exposure. ILS BidQuest enables buyers to post any item or service they wish to purchase and receive competitive bids online from interested sellers. ILS BidQuest encourages competitive pricing for buyers and allows sellers to reach active buyers with open orders.

The Contact to Contract initiative continued in 2002 with the introduction of the Aviation Aftermarket Analyzer and the ILS Inventory e-Valuator, as well as a subscriber catalog offering called the ILS Quick Catalogue. The Aviation Aftermarket Analyzer is a compilation of supply and demand statistics for the 500 most requested parts and the 250 most requested overhaul items listed on the ILS system. In-depth information and easy-to-read graphs provide insight into the market so customers can identify and take advantage of market trends. The ILS Inventory e-Valuator uses detailed supply and demand statistics and, in many cases, pricing to help customers assess the value of any parts listing or inventory. ILS can provide 12 months of customized supply and demand data for each item. The ILS Inventory e-Valuator is also a tool to assist sellers, inventory owners, aerospace operators and financial institutions with valuing their inventory by using disclosed bid, offer and selling prices in the aftermarket. The ILS Quick Catalogue is an ILS-developed and maintained electronic catalog for subscribers to enable their customers and prospects to search product listings, make selections and submit requests for quotes. The data appears to be listed on the subscriber's website, but it actually resides on ILS's servers where it is maintained.

Customer needs, as well as their hardware and software capabilities or resources, drive enhancements to ILS's services. ILS routinely uses focus groups, questionnaires, industry meetings and surveys to obtain customer feedback on current and prospective services. Accordingly, ILS expects to provide additional services to improve the efficiency of buying and selling aviation and marine parts, equipment and services online.

SUBSCRIBERS. ILS's aviation-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.

ILS has served many of its customers or their predecessors as a neutral information resource since the 1980s. ILS initially used teletype and telex, then progressed to facsimile and point-to-point data transmissions before the advent of the Internet. ILS continues to offer some services to customers who are unable to utilize ILS's Internet services.

SALES AND MARKETING. ILS markets its electronic marketplaces to both buyers and sellers in the aviation and marine industries and the U.S. and international government procurement markets. ILS is headquartered in Memphis, Tennessee and maintains regional offices in: Atlanta, Georgia; Seattle, Washington; and Singapore, Malaysia. ILS also has independent sales representatives in: London and Newcastle, England; Dubai, UAE; and Toronto, Canada. In addition, ILS has representatives in areas where it has major concentrations of customers to provide them with training and technical support.

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, on-site real-time demonstrations, advertising in major aviation and marine industry publications, and active public relations campaigns to provide additional exposure and generate leads for the ILS sales team. ILS also offers seminars and training sessions to assist customers in maximizing the value they receive from ILS's services.

COMPETITION. ILS can be clearly differentiated from most other aerospace-related electronic marketplaces by its neutrality and longevity. We believe ILS's large customer base, depth and breadth of aftermarket product offerings, electronic marketplace innovation and e-commerce developments are key competitive differentiating factors.

There are a number of Internet-based competitors operating aviation 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.

EMPLOYEES

As of December 31, 2002, we had 875 employees, none of whom are represented by collective bargaining units, except for less 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. with authority over businesses generally, 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 FAA regulates locations within the U.S. The various countries' civil aviation authorities regulate locations outside the U.S.

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, which require us to eliminate or mitigate the impact of these substances on the environment. In response to these requirements, we have upgraded facilities and 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 will be incurred in the future related to these ongoing operations 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 protections 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.

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 unusual items 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" and Note 16 - Environmental Matters to the consolidated financial statements included in this Annual Report on Form 10-K.

ITEM 2: PROPERTIES

Our corporate headquarters, Aviall Services' headquarters, central warehouse operations and various product repair shops are located in a 280,000-square-foot facility located on the grounds of DFW Airport. This facility is comprised of 195,000 square feet of central warehouse and product repair shops and 85,000 square feet of office space. As of December 31, 2002, this facility contained approximately 89% of Aviall Services' inventory and the primary information systems for Aviall and Aviall Services. We occupy this facility pursuant to a ten-year lease with two five-year renewal options at the then-prevailing fair market lease rate. In addition, we have a one-time option to elect to expand our premises by approximately 100,000 square feet. We must exercise this expansion right before the fifth anniversary of the lease commencement date.

At December 31, 2002, our principal operating facilities were:

Location	Square Footage	Lease Expiration Date	
DFW Airport, Texas	280,000	December 2011	Corporate h Services' h operations
Memphis, Tennessee	31,000	April 2003	ILS headqua

On December 31, 2002, we occupied 39 other facilities around the world, including administrative, sales, distribution and operations/repair facilities and customer service centers that support our parts distribution business. Each of our domestic real properties is held under an operating lease. In 2003, we expect to pay $4.2 million in rental expense for our facility leases. We believe our material facilities, machinery and equipment are suitable for the purposes for which they are used and are adequately maintained in all material respects. ILS is in the process of renegotiating their existing lease.

14

ITEM 3: LEGAL PROCEEDINGS

We are routinely involved in legal proceedings incidental to our businesses. Pending matters include actions involving alleged breach of contract, employment discrimination, liability for environmental matters, tort claims and other matters. In each instance, we are defending the pending legal or regulatory action. While any legal proceeding has an element of uncertainty, based on presently available information and given existing financial reserves, we believe that the ultimate disposition of all such proceedings and environmental matters will not have a material adverse effect on our results of operations, financial condition or cash flows, although certain matters could be material to cash flows in any one year. For information concerning environmental matters, see "Item 1: Business - Regulation - Environmental" and "Item 7: Management's Discussion and Analysis of Financial Condition and Results of

Operations - Environmental Matters" in this Annual Report on Form 10-K.

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

None.

ITEM 4A: EXECUTIVE OFFICERS OF THE REGISTRANT

Our executive officers are as follows:

Name	Office(s)
Paul E. Fulchino	Chairman of the Board of Directors, President and Chief
Dan P. Komnenovich	Executive Vice President and Chief Operating Officer of
Bruce Langsen	President of ILS
Charles M. Kienzle	Senior Vice President of Operations of Aviall Services
Jeffrey J. Murphy	Senior Vice President of Law and Human Resources, Secret
Colin M. Cohen	Vice President and Chief Financial Officer
Jacqueline K. Collier	Vice President and Controller
Joseph Y. Lacik	Vice President of Information Services of Aviall Service
James T. Quinn	Vice President of Sales and Marketing of Aviall Services

Paul E. Fulchino, 56, has served as Chairman of the Board of Directors, President and Chief Executive Officer since January 2000. From 1996 through 1999, Mr. Fulchino was President and Chief Operating Officer of B/E Aerospace, Inc., a leading supplier of aircraft cabin products and services. From 1990 to 1996, Mr. Fulchino served in the capacities of President and Vice Chairman of Mercer Management Consulting, Inc., an international general management consulting firm. Earlier in his career, Mr. Fulchino held various engineering positions at Raytheon Company.

Dan P. Komnenovich, 50, rejoined Aviall in August 2000 as Aviall Services' Executive Vice President and Chief Operating Officer. From January 1999 to July 2000, Mr. Komnenovich was a Principal with Kincaid Capital Group, an investment management firm. From March 1995 to December 1998, Mr. Komnenovich served as Executive Vice President and Chief Financial Officer of Dallas Airmotive, Inc., a business aircraft engine overhaul company. Mr. Komnenovich held various positions with us between 1983 and 1995, including Senior Vice President of Marketing and Development.

Bruce Langsen, 56, has served as President of ILS since June 1996. Prior to his tenure as President of ILS, Mr. Langsen served as Executive Vice President of ILS. Mr. Langsen joined ILS in 1993 as its Vice President of Marketing and Sales. Prior to joining ILS, Mr. Langsen was Senior Vice President and General Manager for Express Airlines II.

Charles M. Kienzle, 50, has served as Aviall Services' Senior Vice President of Operations since June 1996. Mr. Kienzle served as Senior Vice President of Operations of our domestic engine services division from January 1996 to June 1996. From 1993 to January 1996, Mr. Kienzle was Senior Vice President of Human Resources and Administration.

Jeffrey J. Murphy, 56, has served as Senior Vice President of Law and Human Resources, Secretary and General Counsel since December 1996. From 1993 to 1996, he served as Senior Vice President of Law, Secretary and General Counsel.

Colin M. Cohen, 51, has served as Vice President and Chief Financial Officer since October 2002. From September 2001 to September 2002, Mr. Cohen was Chief Financial Officer of Alterna Technologies Group, Inc., an e-commerce and financial software company. From January 2001 to September 2001, Mr. Cohen served as a consultant to several businesses. From July 2000 to January 2001, Mr. Cohen was Senior Vice President and Chief Financial Officer of OneSoft Corporation, also an e-commerce and financial software company. From 1996 to 2000, Mr. Cohen served as Senior Vice President, Corporate Development and Chief Financial Officer with The Fairchild Corporation, a multi-product international aerospace manufacturing company. Between 1976 and 1996, Mr. Cohen held investment banking positions with Citibank and Citicorp entities in several countries.

Jacqueline K. Collier, 49, has served as Vice President and Controller since 1994. Ms. Collier joined a predecessor of Aviall in 1976 and has held various financial positions with the predecessor company and Aviall since that date.

Joseph Y. Lacik, 47, joined Aviall in January 2000 as Aviall Services' Vice President of Information Services. From January 1999 to December 1999, Mr. Lacik was Senior Director of Information Technology for AMFM, Inc. Mr. Lacik served as Vice President, Strategic Information Systems for Metrocall from January 1998 to December 1998. From February 1997 to January 1998, Mr. Lacik served PRONET as Vice President and Chief Information Officer. Mr. Lacik provided high-level technology consulting services for a number of communications firms from July 1996 to January 1997. Prior to July 1996, Mr. Lacik was Vice President of Information Technology for Cameron Ashley Building Products, Inc.

James T. Quinn, 54, has served as Aviall Services' Vice President of Sales and Marketing since August 1999. From July 1997 to August 1999, Mr. Quinn was Vice President of Marketing and Supplier Services of Aviall Services. Mr. Quinn served as Director, Distribution Services Marketing from 1994 to 1997.

Our executive officers are elected annually by our Board of Directors and may be removed at any time by the Board. With the exception of Mr. Fulchino, no executive officers have employment agreements with us. No family relationships exist between any of the executive officers.

PART II

ITEM 5: MARKET FOR REGISTRANT'S COMMON EQUITY AND RELATED STOCKHOLDER MATTERS

MARKET FOR COMMON STOCK AND DIVIDEND POLICY

Our common stock is traded on the New York Stock Exchange under the ticker symbol "AVL". The high and low sales prices for our common stock for each calendar quarter during 2001 and 2002 are set forth below:

Year	Quarter	Price High	Price Low
2001	First	$ 8.08	$ 4.88
	Second	$ 11.25	$ 6.60
	Third	$ 11.05	$ 6.05
	Fourth	$ 8.05	$ 4.52
2002	First	$ 9.03	$ 6.01
	Second	$ 14.20	$ 8.07
	Third	$ 14.80	$ 9.76
	Fourth	$ 10.64	$ 7.70

According to the records of our transfer agent, we had 9,811 stockholders of record of our common stock as of March 17, 2003.

Our policy has been to reinvest earnings to fund future growth. Accordingly, we did not pay cash dividends on our common stock during 2001 or 2002. Except in limited circumstances, under the terms of (i) our Series D Senior Convertible Participating Preferred Stock, (ii) Aviall Services' senior unsecured notes due 2007 and (iii) our senior secured credit facility, we may not declare, pay or set aside cash dividends without the consent of the various parties thereto. Accordingly, we do not anticipate paying cash dividends on our common stock in the foreseeable future.

SALES OF UNREGISTERED SECURITIES

CONVERTIBLE PARTICIPATING REDEEMABLE PREFERRED STOCK. On December 21, 2001, we sold 45,000 shares of Series B Senior Convertible Participating Preferred Stock, or Series B Redeemable Preferred Stock, for $45.0 million to Carlyle Partners III, L.P., a Delaware limited partnership, CP III Coinvestment, L.P., a Delaware limited partnership, and certain of their affiliates, or collectively, the Carlyle Investors. We issued the shares of Series B Redeemable Preferred Stock to the Carlyle Investors pursuant to exemptions from registration provided by Section 4(2) of the Securities Act of 1933 and Rule 506 under the Securities Act of 1933. At the time of issuance of the Series B Redeemable Preferred Stock, the Carlyle Investors represented to us that each was an accredited investor, as defined in Regulation D under the Securities Act of 1933.

Our Board of Directors called a Special Meeting of Stockholders for March 15, 2002 to consider and vote upon a proposal to approve the terms and issuance of shares of our Series D Senior Convertible Participating Preferred Stock, or Series D Redeemable Preferred Stock, upon automatic conversion of the Series B Redeemable Preferred Stock, the issuance of shares of Series D Redeemable Preferred Stock as dividends on shares of Series D Redeemable Preferred Stock and the issuance of shares of common stock upon conversion of the Series D Redeemable Preferred Stock.

At the Special Meeting of Stockholders, the stockholders approved the terms and issuance of the Series D Redeemable Preferred Stock, the issuance of shares of Series D Redeemable Preferred Stock as dividends on shares of Series D Redeemable Preferred Stock and the issuance of common stock upon conversion of the Series D Redeemable Preferred Stock. Therefore, the 45,110 outstanding shares of Series B Redeemable Preferred Stock automatically converted into 45,110 shares of Series D Redeemable Preferred Stock and such shares were issued to the Carlyle Investors. Upon conversion of the Series B Redeemable Preferred Stock, we recorded a $20.5 million deemed dividend reflecting the difference between the $8.44 closing market price of our common stock on the New York Stock Exchange on March 15, 2002 and the $5.80 conversion price of the Series D Redeemable Preferred Stock negotiated in December 2001, multiplied by the total number of shares of common stock into which the Series D Redeemable Preferred Stock could have been converted on March 15, 2002. As of March 15, 2002, the 45,110 outstanding shares of Series D Redeemable Preferred Stock were convertible into an aggregate of 7,777,584 shares of common stock at a conversion price of $5.80 per share.

Unless there is a continuing event of default under the Series D Redeemable Preferred Stock, the Series D Redeemable Preferred Stock has a 9.0% cumulative dividend rate per annum, and the dividends are payable in additional shares of Series D Redeemable Preferred Stock for the first four years and then payable in cash thereafter, if permitted. From March 15, 2002 to December 31, 2002, we issued an additional 4,191 shares of Series D Redeemable Preferred Stock in payment of the quarterly dividends due March 31, 2002, June 30, 2002, September 30, 2002 and December 31, 2002. As of March 17, 2003, there were 49,301 shares of Series D Redeemable Preferred Stock outstanding, which were convertible into an aggregate of 8,500,171 shares of common stock at a conversion price of $5.80 per share representing 30% of the total voting power of our stockholders.

The Series D Redeemable Preferred Stock (i) has an aggregate liquidation preference of $1,000 per share, (ii) votes with the common stock as if it were deemed converted at the voting date, (iii) is convertible at the option of the holder into common stock and (iv) has antidilution protection and other protective provisions. We are required to redeem all of the Series D Redeemable Preferred Stock in cash for the aggregate liquidation preference on June 21, 2008. Unless there is a continuing event of default under the Series D Redeemable Preferred Stock, the holders of Series D Redeemable Preferred Stock are entitled to elect two members to our Board of Directors and have elected Messrs. Peter J. Clare and Allan M. Holt to those positions. In addition, the Series D Redeemable Preferred Stock will participate with the common stock on an as-converted basis in the payment of dividends, other than a dividend payable solely in shares of our common stock, and will participate with the common stock in the distribution of assets upon liquidation, after first receiving $1,000 per share of Series D Redeemable Preferred Stock, plus all accrued and unpaid dividends. Accordingly, pursuant to Statement of Financial Accounting Standards No. 128, or SFAS 128, "Earnings per Share," our earnings from continuing operations available for distribution, for the calculation of basic net earnings per share, reflect the allocation of these earnings between the common and preferred stockholders based on the required "two-class" method.

We issued the shares of Series D Redeemable Preferred Stock to the Carlyle Investors pursuant to exemptions from registration provided by Section 4(2) of the Securities Act of 1933 and Rule 506 under the Securities Act of 1933. The Carlyle Investors had represented to us that each was an accredited investor, as defined in Regulation D under the Securities Act of 1933. The issuances of the shares of Series B Redeemable Preferred Stock and the shares of Series D Redeemable Preferred Stock were not underwritten.

In connection with the sale of the Series B Redeemable Preferred Stock to the Carlyle Investors, we amended our Preferred Stock Rights Plan, or the Rights Plan, to provide that it would not be triggered by the Carlyle Investors' acquisition of (i) the Series B Redeemable Preferred Stock, (ii) the Series D

Redeemable Preferred Stock, (iii) any dividends on the Series D Redeemable Preferred Stock paid in additional shares of Series D Redeemable Preferred Stock or (iv) any shares of common stock issued upon conversion of the Series D Redeemable Preferred Stock or upon exercise of the warrant issued to the Carlyle Investors as a holder of an Aviall Services' senior unsecured note. The amendment only exempts the Carlyle Investors from triggering the Rights Plan for so long as they are subject to a standstill agreement with us. The terms of the standstill agreement are generally described below.

In general, we also exempted from the provisions of the Rights Plan subsequent owners of the Series D Redeemable Preferred Stock and the common stock issued upon conversion of the Series D Redeemable Preferred Stock or upon exercise of the warrant issued to the Carlyle Investors, subject to certain restrictions. We also amended the Rights Plan to provide that, upon the triggering of the Rights Plan, each outstanding share of Series D Redeemable Preferred Stock would be issued a number of rights under the Rights Plan equal to the number of shares of common stock issuable upon conversion of such share of Series D Redeemable Preferred Stock.

On December 21, 2001, in connection with the amendments to the Rights Plan, we entered into a standstill agreement with the Carlyle Investors. The standstill agreement prohibits the Carlyle Investors from taking certain actions without the prior approval of our Board of Directors for so long as the Carlyle Investors or their affiliates own 15.0% or more of our outstanding voting securities. Such prohibited actions include acquiring more than 5.0% of any of our securities entitled to vote or convertible into or exercisable for voting securities (other than Series B Redeemable Preferred Stock, Series D Redeemable Preferred Stock, any dividends on Series D Redeemable Preferred Stock paid in additional shares of Series D Redeemable Preferred Stock or any shares of common stock issued upon conversion of Series D Redeemable Preferred Stock or upon exercise of the warrant issued to the Carlyle Investors), soliciting proxies, calling a meeting of stockholders, commencing a tender offer or making a proposal with respect to the acquisition of a substantial portion of our assets or a merger involving us. The standstill agreement terminates as to each Carlyle Investor on the date such Carlyle Investor and its affiliates no longer own 15.0% or more of our outstanding voting securities.

SENIOR NOTES. On December 21, 2001, Aviall Services issued senior unsecured notes, or the Senior Notes, due 2007 to: J. H. Whitney Mezzanine Fund, L.P., a Delaware limited partnership; Whitney Private Debt Fund, L.P., a Delaware limited partnership; Whitney Limited Partner Holdings, LLC, a Delaware limited liability company; Carlyle High Yield Partners, L.P., a Delaware limited partnership; Blackstone Mezzanine Partners L.P., a Delaware limited partnership; Blackstone Mezzanine Holdings L.P., a Delaware limited partnership; Oak Hill Securities Fund, L.P., a Delaware limited partnership; Oak Hill Securities Fund II, L.P., a Delaware limited partnership; Lerner Enterprises, L.P., a Delaware limited partnership; and P & PK Family Limited Partnership, a Delaware limited partnership, or collectively, the Lenders. The Lenders purchased the Senior Notes in exchange for consideration in the aggregate amount of $80.0 million. We issued the Senior Notes to these Lenders pursuant to exemptions from registration provided by Section 4(2) of the Securities Act of 1933 and Rule 506 under the Securities Act of 1933. At the time of issuance of the Senior Notes, the Lenders represented to us that each was an accredited investor, as defined in Regulation D under the Securities Act of 1933.

Subject to approval by our stockholders, we also agreed to issue to the Lenders 1,750,000 shares of our common stock (subject to adjustment for certain antidilution events) upon exercise of warrants at a purchase price of $0.01 per share. On March 15, 2002 at the Special Meeting of Stockholders, our stockholders approved the issuance of the common stock pursuant to the exercise of warrants. The issuance of the warrants was not underwritten.

Each warrant is exercisable for shares of our common stock at an initial exercise price of $0.01 per share and will expire on March 15, 2012. Each warrant contains antidilution protection tied to the conversion price of the Series D Redeemable Preferred Stock. If the conversion price of the Series D Redeemable Preferred Stock is adjusted pursuant to its terms, the number of shares of common stock for which the warrants may be exercised will be adjusted proportionately. If the holders of Series D Redeemable Preferred Stock waive the adjustment to the Series D Redeemable Preferred Stock conversion price, then the antidilution provisions in the warrant will be deemed waived by the respective holder of the warrant.

19

The holders of the warrants are also entitled to receive all dividends paid with respect to the common stock as if such holders had exercised the warrants for common stock prior to the dividend, unless such dividend results in an adjustment to the number of shares of common stock for which the warrants are exercisable.

On September 12, 2002, we issued the following shares of common stock to each respective Lender after receipt of such Lender's notice to exercise its warrant in full: 76,563 shares to Oak Hill Securities Fund, L.P.; 76,562 shares to Oak Hill Securities Fund II, L.P.; 16,406 shares to Lerner Enterprises, L.P.; and 5,469 shares to P & PK Family Limited Partnership. On December 26, 2002, we issued the following shares of common stock to each respective Lender after receipt of such Lender's notice to exercise its warrant in full: 424,375 shares to J.H. Whitney Mezzanine Fund, L.P. and 328,125 shares to Whitney Private Debt Fund, L.P. We issued these shares of common stock to the Lenders pursuant to exemptions from registration provided by Section 4(2) of the Securities Act of 1933 and Rule 506 under the Securities Act of 1933.

20

ITEM 6: SELECTED FINANCIAL DATA

The following table summarizes selected financial information that has been derived from our audited consolidated financial statements. You should read the information set forth below in conjunction with "Item 7: Management's Discussion and Analysis of Financial Condition and Results of Operations" and the consolidated financial statements and notes thereto included elsewhere in this Annual Report on Form 10-K.

(In Thousands, Except Share Data)	2002	2001	2000

Selected Operating Data:			
Net sales (a)	$ 803,293	506,160	485,920
Cost of sales (b)	$ 646,477	398,821	377,379
Gross profit	$ 156,816	107,339	108,541
Selling and administrative expenses (c)	$ 95,412	87,729	82,042
Unusual gain (loss) (d)	$ 1,024	(2,810)	--
Operating income	$ 62,428	16,800	26,499
Interest expense	$ 22,578	10,291	8,407
Provision (benefit) for income taxes (e) (f)	$ 13,199	3,046	7,526
Earnings from continuing operations (e)	$ 26,651	3,463	10,566
Earnings from discontinued operations (g)	$ 3,026	322	1,062
Earnings before extraordinary loss	$ 29,677	3,785	11,628
Extraordinary loss (h)	$ --	(1,026)	--
Net earnings	$ 29,677	2,759	11,628
Deemed dividend	$ (20,533)	--	--
Preferred stock dividends	$ (4,199)	(113)	--
Net earnings applicable to common shares	$ 4,945	2,646	11,628
Other Financial Data:			
Net cash (used for) provided by operating activities	$ (37,084)	(81,103)	(7,612)
Net cash used for investing activities	$ (17,137)	(37,008)	(16,581)
Net cash provided by (used for) financing activities	$ 56,692	115,772	27,673
Total assets	$ 652,464	533,229	395,451
Total debt	$ 221,407	200,854	90,422
Convertible redeemable preferred stock	$ 44,370	40,161	--
Total debt to total capital (i)	49.2%	50.8%	32.1%
Basic Net Earnings (Loss) Per Share Data:			
Earnings from continuing operations	$ 0.08	0.18	0.58
Earnings from discontinued operations	0.11	0.02	0.06
Extraordinary loss	--	(0.06)	--
Net earnings	$ 0.19	0.14	0.64
Weighted average common shares	18,478,102	18,380,975	18,313,401
Diluted Net Earnings (Loss) Per Share Data: (j)			
Earnings from continuing operations	$ 0.08	0.18	0.58
Earnings from discontinued operations	0.11	0.02	0.06
Extraordinary loss	--	(0.06)	--
Net earnings	$ 0.19	0.14	0.64
Weighted average common and potentially dilutive common shares	27,565,957	18,718,979	18,337,161

(a) Net sales for 2002 do not include $74 million of RR T56 sales, valued at our contractual prices, made directly by Rolls-Royce to the U.S. military during the RR T56 transition period, which ended in June 2002.

Net sales for the years 1999 and 1998 were restated as a result of the implementation of EITF 00-10 in 2000.

(b) In 2001, cost of sales included a $7.0 million inventory and intangible write-down resulting from the downturn in the aerospace industry. This write-down was reclassified to cost of sales from selling and administrative expenses to conform to this year's presentation.

(c) In 2001, we expensed $1.4 million, which was included in selling and administrative expenses, related to the relocation of our Dallas, Texas facility.

(d) The unusual gain in 2002 resulted from the reversal of environmental reserves related to our previously owned businesses that do not qualify as discontinued operations. The unusual loss in 2001 consists of unfavorable leases and doubtful accounts related to the downturn in the economy in 2001 and costs related to our new capital structure. The unusual loss in 1999 resulted from costs incurred for the strategic review process and executive severance pay.

(e) In 2002, our tax expense was net of a $0.8 million release of state net operating loss valuation allowances determined to be realizable. Earnings from continuing operations and net earnings in 1998 included a $32.2 million tax benefit due to the release of a $33.5 million deferred tax valuation allowance offset by provisions of certain U.S. state and foreign taxes.

(f) Our cash payments for taxes are substantially lower than reported tax expense due to our use of net operating losses, which are not expected to be fully utilized for several years.

(g) In January 1996, we exited certain businesses and, accordingly, reported these businesses as discontinued operations. The earnings from discontinued operations resulted from changes in estimates for certain retained liabilities.

(h) The extraordinary loss in 2001 resulted from the write-off of unamortized financing costs in connection with refinancing our senior credit facility.

(i) Total capital consists of total debt and shareholders' equity.

(j) Diluted net earnings per share were not dilutive, or lower than basic, in 2002 and 2001. Therefore, diluted net earnings per share for 2002 and 2001 is presented equal to basic net earnings per share.

ITEM 7: MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

OVERVIEW

Our businesses consist of Aviall Services, the largest independent global aftermarket provider of new aerospace parts and related supply-chain services to the aviation industry, and ILS, a leading independent information provider and operator of global electronic marketplaces for buying and selling parts, equipment and services for the aviation and marine industries and the U.S. and international government procurement markets.

NET SALES. Aviall Services' net sales are generated primarily from the sale of new and OEM-remanufactured aerospace parts, components and supplies. We sell these products at prices based upon either a discount from the manufacturers' published list prices or with a margin above our cost to buy the product. ILS's net sales consist mainly of monthly or yearly subscription fees to access ILS's online databases, fees charged to firms listing inventory in the databases, communications fees, income from the sale of custom reports and decision support products and fees for developing and hosting customers' catalogs. ILS is an information service provider and does not own or sell the parts, equipment or services listed in its databases.

COST OF SALES AND GROSS PROFIT. Aviall Services' cost of sales consists primarily of costs incurred to purchase parts and supplies from OEMs, inventory carrying costs such as shrinkage and excess and obsolescence, and the amortization of the licensing fees for our significant long-term agreements with Honeywell and Rolls-Royce. We purchase parts, components and supplies based on discounts from the manufacturers' published list prices as specified in agreements with our suppliers. Because the product sold by ILS is information, we include the expenses required to maintain and operate the central ILS computer system and communications network in our cost of sales. These expenses include the salaries and benefits of the computer operations staff, depreciation and lease costs for computer and communications equipment, telecommunications expenses and software costs. Gross profit is the difference between the sales generated and the costs related to those sales.

SELLING AND ADMINISTRATIVE EXPENSES. Selling and administrative expenses include all costs related to marketing, sales, planning and purchasing, accounting, finance, and other administrative departments of the two business units and the corporate staff. In addition, Aviall Services' selling and administrative expenses include costs related to operating its central warehouse and our worldwide customer service centers.

CRITICAL ACCOUNTING POLICIES

The process of preparing financial statements in conformity with accounting principles generally accepted in the U.S. requires us to use estimates and assumptions to determine certain of our assets, liabilities, revenues and expenses. We base these estimates and assumptions upon the best information available to us at the time the estimates or assumptions are made. Our estimates and assumptions could change materially as conditions both within and beyond our control change. Accordingly, our actual results could differ materially from our estimates. The most significant estimates made by our management include our allowance for doubtful accounts receivable, reserves for excess and obsolete inventories, deferred tax asset valuation allowances, environmental reserves, pension and postretirement benefit obligations and valuation of goodwill and distribution rights. The following is a discussion of our critical accounting policies and the related management estimates and assumptions necessary in determining the value of related assets or liabilities. A full description of all of our significant accounting policies is included in Note 2 - Summary of Significant Accounting Policies to our consolidated financial statements included in this Annual Report on Form 10-K.

REVENUE RECOGNITION. Revenue from the sale of parts, components and supplies and the repair of parts is recognized based on shipping terms with our customers. Revenue from information services and point-of-purchase subscription fees is recognized as services are rendered. Revenue from pay-in-advance subscription fees is deferred and recognized as services are rendered. Shipping and handling costs billed to customers are recognized as revenue.

ALLOWANCE FOR DOUBTFUL ACCOUNTS. An allowance for doubtful accounts receivable is established based on our estimates of the amount of uncollectible accounts receivable on a customer-by-customer basis. We determine the required allowance using information such as customer credit history, industry and market segment information, economic trends and conditions, credit reports and customer financial condition. The estimates can be affected by changes in the aviation industry, customer credit issues or customer bankruptcies.

INVENTORIES. We value our inventory of aerospace parts at the lower of average cost or market. We make provisions for excess and obsolete inventories based on our assessment of slow-moving and obsolete inventories on a part-number-by-part-number basis within each product line. Historical parts sales and estimated future demand adjusted for known or expected aviation industry trends or conditions provide the basis for our estimates. These estimates are subject to volatility and can be affected by reduced flight hours, the retirement of aircraft, changes in distribution agreements and other changes in the aviation industry. We make provisions for inventory shrinkage based on periodic physical inventory counts. During the second quarter of 2002, we changed our classification of inventory obsolescence and inventory shrinkage from selling and administrative expenses to cost of sales. Prior periods have been reclassified to reflect this change.

DISTRIBUTION RIGHTS. From time to time, we enter into long-term supplier distribution agreements that implicitly include a payment for distribution rights. When we enter into these agreements, we must value the distribution rights and amortize them over the life of the agreement. We calculate the value of the distribution rights using a discounted cash flow model of the expected net contract cash flows related to the specific distribution agreement. The most significant variables used in the model include expected sales, inventory value, incremental costs and working capital requirements. We base our valuation of inventory acquired on the contractual purchase discount off of list price adjusted for historical and expected parts sales. The determination of the amounts for the other factors used are based on information acquired during the agreement negotiation process. We amortize the value of the distribution rights over the term of the agreement using the straight-line method, which approximates the operating cash flows expected over the life of the agreement. In the event one or more of our material suppliers discontinue the products we sell, terminate our contract or are unable to perform under our agreement, the value of the distribution rights could be impaired, and we might be required to write-down or write-off the unamortized value of the distribution rights.

DEFERRED TAXES. We establish our deferred tax assets and liabilities based on our profits or losses in each jurisdiction in which we operate. Associated valuation allowances reflect the likelihood of the recoverability of these assets. We base our judgement of the recoverability of these assets, which includes federal and, to a lesser degree, state net operating loss carryforwards, primarily on historical earnings, our estimate of current and expected future earnings, prudent and feasible tax planning strategies, and current and future ownership changes. The likelihood of an annual limitation on our ability to utilize our U.S. federal net operating loss carryforward to offset future U.S. federal taxable income is increased by certain historical changes in our equity ownership when combined with potential future ownership changes occurring in the rolling three-year testing period. The amount of an annual limitation can vary significantly based on certain factors existing at the date of the ownership change. If such limitations were imposed, they could have a material adverse impact on our results of operations and cash flows.

PENSION AND POSTRETIREMENT BENEFITS OBLIGATIONS. The value of our pension and postretirement benefits assets and liabilities is determined on an actuarial basis. These values are affected by the market value of plan assets, our estimates of the expected return on plan assets and the discount rates we use to value our projected benefit obligation. We determine the discount rates using changes in the rates of return on high-quality, fixed-income investments. Actual changes in the fair market value of plan assets, differences between the actual return and the expected return on plan assets and changes in the discount rate we use affect the amount of pension expense we recognize.

VALUATION OF LONG-LIVED ASSETS. We periodically review the net realizable value of our long-lived assets, including distribution rights, whenever events and circumstances indicate an impairment may have occurred. In the event we determine that the carrying value of long-lived assets is in excess of estimated gross future cash flows for those assets, we then will write-down the value of the assets to a level commensurate with a discounted cash flow analysis of the estimated future cash flows.

GOODWILL. Goodwill represents the excess of the purchase price over the fair value of net assets acquired. In accordance with the provisions of Statement of Financial Accounting Standards No. 142, or SFAS 142, "Goodwill and Other Intangible Assets," we ceased amortizing goodwill effective January 1, 2002. On an annual basis, we compare the fair value of our reporting units with their carrying values. If the carrying value of a reporting unit exceeds its fair value, we would recognize an impairment equal to the excess of the fair value of the operating unit's goodwill over the carrying value of its goodwill. The fair value of our reporting units is estimated using the discounted present value of estimated future cash flows.

ENVIRONMENTAL. The costs relating to our environmental liabilities have been estimated, including exit costs related to our previously owned businesses, when it is probable that a loss has been incurred and such loss is estimable. We base our probable environmental cost estimates on information obtained from independent environmental engineers and/or from our experts regarding the nature and extent of environmental contamination, available remedial alternatives and the cleanup criteria required by relevant governmental agencies. The estimated costs include anticipated site testing, consulting, remediation, disposal, postremediation monitoring and related legal fees. They are based on available information and represent the undiscounted costs to resolve the environmental matters in accordance with prevailing federal, state, local or foreign requirements. Our estimates may vary in the future as more information becomes available to us with respect to the level of contamination, the effectiveness and approval of selected remediation methods, the stage of our investigation at the individual sites, the recoverability of such costs from third parties and changes in federal, state, local or foreign statutes and regulations or their interpretation.

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 will be incurred in the future related to ongoing operations to comply or remain in compliance with existing environmental regulations. Based on information presently available and our programs to detect and minimize contamination, we believe that the ultimate disposition of pending environmental matters related to our previously owned businesses will not have a material adverse effect on our financial condition, results of operations or cash flows. However, environmental matters related to our previously owned businesses could be material to our cash flows during any one year.

RESULTS OF OPERATIONS

The following table sets forth our results of operations as a percentage of our net sales during the periods shown:

	Year Ended December 31,	
	2002	2001
Statement of income data:		
Net sales	100.0%	100.0
Cost of sales	80.5	78.8
Gross profit	19.5	21.2
Selling and administrative expenses	11.9	17.3
Unusual items	(0.1)	0.6
Operating income	7.7	3.3
Interest expense	2.8	2.0
Earnings from continuing operations before income taxes	4.9	1.3
Provision for income taxes	1.6	0.6
Earnings from continuing operations	3.3%	0.7

RESULTS OF OPERATIONS - YEAR ENDED DECEMBER 31, 2002 COMPARED TO YEAR ENDED DECEMBER 31, 2001

NET SALES. Net sales for Aviall Services were $776.2 million, an increase of $296.5 million or 61.8%, from the $479.7 million recorded in 2001. Sales for Aviall Services were mixed by geographic region: the Americas region increased $294.6 million or 84.3%; Europe fell $2.6 million or 4.7%; and the Asia-Pacific region increased $4.5 million or 6.0%. Sales in the government/military segment increased $285.2 million related to the RR T56 program, while sales in the general aviation/corporate segment improved by $36.3 million, primarily as a result of what management believes to be increased market share. Sales in the weaker commercial airline segment declined $25.0 million due to reduced demand for commercial airline travel. Sales of products under the RR T56 distribution agreement were $273.1 million in 2002. The 2002 net sales amounts did not include $74 million of RR T56 sales, valued at our contractual prices, made directly by Rolls-Royce to the U.S. military during the RR T56 transition period which ended in June 2002 but do include our full margin on these sales. Sales of products supplied by Rolls-Royce and Honeywell were $433.2 million and $132.4 million in 2002 and 2001, respectively.

Net sales for ILS of $27.1 million were up $0.7 million year-over-year.

GROSS PROFIT. Gross profit of $156.8 million for 2002 was up $49.5 million or 46.1% from the 2001 level of $107.3 million. As expected, gross profit as a percentage of net sales fell to 19.5%, reflecting the incorporation of lower-margin RR T56 sales. The 2001 gross profit was negatively affected by the $7.0 million inventory and intangible write-down resulting from the downturn in the aerospace industry. This write-down was reclassified to cost of sales from selling and administrative expenses to conform to our 2002 presentation.

SELLING AND ADMINISTRATIVE EXPENSES. Selling and administrative expenses increased $7.7 million to $95.4 million in 2002 from $87.7 million in 2001. The increase in selling and administrative expenses is largely attributable to the RR T56 and Honeywell product lines and higher depreciation costs associated with increased spending on technology infrastructure. This increase in selling and administrative expenses was partially offset by the implementation of SFAS 142, which reduced goodwill amortization by $1.9 million in 2002 as compared to 2001. Selling and administrative expenses as a percentage of net sales fell 5.4 percentage points to 11.9% in 2002 from 17.3% in 2001.

UNUSUAL GAIN. The unusual gain of $1.0 million in 2002 resulted from the reversal of environmental reserves related to our previously owned businesses, which did not qualify as discontinued operations, due to changes in estimates for these liabilities.

INTEREST EXPENSE. Interest expense increased $12.3 million to $22.6 million in 2002 from $10.3 million in 2001. In 2002, our interest expense included $4.8 million of noncash expense. The increase in our interest expense was primarily due to our new capital structure, which resulted in higher borrowings, higher amortization of debt issuance costs and debt discount and the issuance of the Senior Notes.

INCOME TAX EXPENSE. Income tax expense from continuing operations for 2002 was $13.2 million, and our effective tax rate was 33.1%. Our 2001 income tax expense from continuing operations was $3.0 million, and our effective tax rate was 46.8%. The reduction in the effective tax rate year-over-year resulted primarily from the higher earnings in 2002 compared to 2001, the elimination of goodwill amortization expense beginning in 2002 as a permanent difference, Extraterritorial Income exclusion tax benefits and the release of a valuation allowance related to our state net operating loss carryforwards.

EARNINGS FROM CONTINUING OPERATIONS. Earnings from continuing operations in 2002 were $26.7 million, an increase of 669.6% compared to the $3.5 million reported in 2001.

EARNINGS FROM DISCONTINUED OPERATIONS. Earnings from discontinued operations in 2002 of $3.0 million, net of tax expense of $1.8 million, resulted from revised environmental liability estimates.

DEEMED DIVIDEND. The deemed dividend of $20.5 million in March of 2002 resulted from the conversion of all of our outstanding Series B Redeemable Preferred Stock into 45,110 shares of Series D Redeemable Preferred Stock on

March 15, 2002. The deemed dividend reflects the difference between the $8.44 closing market price of our common stock on the New York Stock Exchange on March 15, 2002 and the $5.80 conversion price of the Series D Redeemable Preferred Stock negotiated in December 2001, multiplied by the total number of shares of common stock into which the Series D Redeemable Preferred Stock could have been converted on March 15, 2002.

PREFERRED STOCK DIVIDEND. The noncash preferred stock dividends of $4.2 million paid in 2002 resulted from the issuance of 4,191 shares of Series D Redeemable Preferred Stock in payment of the quarterly payable-in-kind dividends on the Series D Redeemable Preferred Stock, which as of December 31, 2002 were convertible into 722,585 shares of common stock.

RESULTS OF OPERATIONS - YEAR ENDED DECEMBER 31, 2001 COMPARED TO YEAR ENDED DECEMBER 31, 2000

NET SALES. Despite the aviation industry downturn, Aviall Services' net sales increased $21.7 million or 4.7% in 2001 compared to 2000. The increase was primarily due to sales under the new Honeywell agreements in 2001 and increased Rolls-Royce Model 250 product line sales. Sales of products supplied by Rolls-Royce and Honeywell were $132.4 million and $109.9 million in 2001 and 2000, respectively. Sales for Aviall Services were higher for each major segment of the aviation industry but were mixed by geographic region: the Americas region increased $13.1 million or 3.8%; Europe fell $2.4 million or 4.2%; and the Asia-Pacific region jumped $11.0 million or 17.2%.

ILS's net sales decreased $1.5 million or 5.4% in 2001 compared to 2000 primarily due to continued customer acceptance of the annual prepayment discount initiative and the loss of communications revenue as customers migrated to accessing ILSMART.COM through the Internet rather than through billable dial-up connections.

GROSS PROFIT. Gross profit of $107.3 million decreased $1.2 million or 1.1% in 2001 compared with $108.5 million in 2000. The decrease was due to a $7.0 million write-down of inventory and intangibles offset by sales under the new Honeywell agreements in 2001 and increased Rolls-Royce Model 250 product line sales. Gross profit as a percentage of net sales decreased to 21.2% in 2001 from 22.3% in 2000. A slight increase in gross profit as a percentage of net sales at Aviall Services, resulting from changes in product mix, was mostly offset by lower margins at ILS due to technology infrastructure investment costs.

SELLING AND ADMINISTRATIVE EXPENSES. In 2001, our selling and administrative expenses increased $5.7 million or 6.9% from 2000 primarily due to development expenses for our e-commerce initiatives, integration of the new Honeywell product lines and expenses to relocate our corporate headquarters and Aviall Services' headquarters and central warehouse operations. This relocation was completed on time and at a cost of $1.4 million, which was $0.6 million less than the estimate previously disclosed. Tax incentives at this new site will allow us to maintain our ad valorem taxes at the 2001 rate, even though the tax basis of our assets increased substantially.

UNUSUAL LOSS. Our 2001 results included a $2.8 million unusual loss primarily related to the aviation industry changes resulting from the downturn in the economy in 2001, consisting of $1.1 million for the write-down of unfavorable leases, $1.0 million for doubtful accounts increases and $0.7 million in costs related to our new capital structure.

INTEREST EXPENSE. Our interest expense increased $1.9 million in 2001 compared to 2000 reflecting increased borrowings primarily due to higher working capital requirements associated with the new Honeywell product line additions, partially offset by decreased interest rates.

INCOME TAX EXPENSE. For 2001, our income tax expense from continuing operations was $3.0 million, and our effective tax rate was 46.8%. This rate exceeded the statutory rate primarily due to the amortization of nondeductible goodwill and foreign taxes in excess of the statutory rate. For 2000, our income tax expense from continuing operations was $7.5 million, and our effective tax rate was 41.6%. This rate exceeded the statutory rate primarily due to the amortization of nondeductible goodwill.

EARNINGS FROM CONTINUING OPERATIONS. For 2001, earnings from continuing operations were $3.5 million compared to $10.6 million in 2000. As previously discussed, our 2001 results included a $7.0 million inventory and intangible write-down and a $2.8 million unusual loss related to the economic downturn and costs related to our new capital structure.

EARNINGS FROM DISCONTINUED OPERATIONS. Earnings from discontinued operations in 2001 of $0.3 million, net of tax expense of $0.2 million, were due to revised environmental liability estimates.

EXTRAORDINARY ITEM. The extraordinary item in 2001, net of income tax benefit of $0.6 million, resulted from the write-off of $1.6 million of unamortized debt issuance costs related to refinancing our senior credit facility in December 2001.

FOREIGN OPERATIONS

Aviall Services operates customer service centers in Australia, Canada, Hong Kong, The Netherlands, New Zealand and Singapore, as well as repair facilities in Australia and the United Kingdom. These foreign operations use the U.S. dollar as their functional currency because the majority of sales and inventory purchases are denominated in U.S. dollars. Foreign currency translation and transaction gains and losses are included in our net earnings. There are no current legal restrictions regarding the repatriation of cash from the foreign operations to the U.S. However, our general policy is not to repatriate cash.

The following table shows our foreign operations' net sales and earnings from continuing operations before income taxes during the periods shown:

	Year Ended December 31,		
(In Millions)	2002	2001	2000
Net sales	$ 112.8	107.7	96.9
Earnings from continuing operations before income taxes	$ 4.9	6.7	4.6

INCOME TAXES

Cash tax payments made for federal, state and foreign income taxes were $0.6 million, $2.0 million and $2.3 million in 2002, 2001 and 2000, respectively. Our cash income tax expense is primarily related to foreign taxes on our foreign operations. Our cash income tax expense continues to be substantially lower than the U.S. federal statutory rate through the use of our U.S. federal net operating loss carryforwards. As of December 31, 2002, our estimated U.S. federal net operating loss carryforward was approximately $115.4 million and substantially expires between 2009 and 2011.

We periodically assess the likelihood of realizing our deferred tax assets and adjust the related valuation allowance based on the amount of deferred tax assets that we believe is more likely than not to be realized. In 2002, the valuation allowance decreased $0.9 million to $5.9 million primarily due to our determination that $0.8 million of state tax net operating loss carryforwards could be utilized. While we believe we will generate sufficient future U.S. federal taxable income to utilize our U.S. net operating loss carryforwards before expiration, we also believe that we may not generate sufficient future taxable income in primarily state and foreign tax jurisdictions to utilize all of our net operating loss carryforwards before their expiration. To fully utilize our $60.3 million net deferred tax assets as of December 31, 2002, we must generate $160.6 million of U.S. federal taxable income, based on current U.S. federal tax rates. We generated U.S. federal taxable income of $28.1 million, $13.8 million and $12.0 million in 2002, 2001 and 2000, respectively. We will continue to monitor and assess the likelihood of realizing our deferred tax assets. Future changes in the valuation allowance may occur.

LIQUIDITY AND CAPITAL RESOURCES

OVERVIEW. In December 2001, we (i) sold 45,000 shares of Series B Redeemable Preferred Stock for cash proceeds of $45.0 million, (ii) sold $80.0 million of the Senior Notes due 2007 and (iii) entered into a $200.0 million senior secured credit facility. The proceeds from these transactions were used to (i) pay Rolls-Royce $90.0 million for aftermarket fulfillment rights and the initial payment for RR T56 inventory, (ii) repay our former $160.0 million senior secured revolving credit facility and term loan and (iii) fund working capital requirements.

CONVERTIBLE PARTICIPATING REDEEMABLE PREFERRED STOCK. On March 15, 2002 following stockholder approval, our Series B Redeemable Preferred Stock was automatically converted into 45,110 shares of Series D Redeemable Preferred Stock, which as of March 15, 2002 was convertible into 7,777,584 shares of common stock. Upon conversion of the Series B Redeemable Preferred Stock, we recorded a $20.5 million deemed dividend reflecting the difference between the $8.44 closing market price of our common stock on the New York Stock Exchange on March 15, 2002 and the $5.80 conversion price of the Series D Redeemable Preferred Stock negotiated in December 2001, multiplied by the total number of shares of common stock into which the Series D Redeemable Preferred Stock could have been converted on March 15, 2002. The Series D Redeemable Preferred Stock carries a cumulative dividend at an annual rate of 9%. Dividends paid on or prior to December 31, 2005 will be paid in shares of the Series D Redeemable Preferred Stock. Thereafter, dividends are payable in cash, to the extent funds are legally available for payment of cash dividends. If we fail to pay cash dividends after December 31, 2005, we will be required to pay dividends in shares of the Series D Redeemable Preferred Stock. From March 15, 2002 to December 31, 2002, we issued an additional 4,191 shares of Series D Redeemable Preferred Stock in payment of the quarterly dividends due March 31, 2002, June 30, 2002, September 30, 2002 and December 31, 2002. As of December 31, 2002, there were 49,301 shares of Series D Redeemable Preferred Stock outstanding, which were convertible into 8,500,171 shares of common stock. Without the prior consent of the holders of our Series D Redeemable Preferred Stock, we are prohibited from, among other things, incurring certain types of additional debt, making specified payments and capital expenditures, consolidating, merging with or acquiring another business, or selling certain of our assets. Unless previously converted into common stock, we must redeem all outstanding shares of Series D Redeemable Preferred Stock on June 21, 2008 for $1,000 per share plus accrued and unpaid dividends, if any.

SENIOR UNSECURED DEBT. The Senior Notes bear interest at 14.0% per annum and mature on December 21, 2007, unless previously redeemed at our option. Of the 14.0% interest rate on the Senior Notes, 13.0% is payable in cash and 1.0% is payable in additional Senior Notes. During 2002, we made cash interest payments of $10.8 million, and the outstanding principal amount on the Senior Notes increased by $0.7 million to $80.8 million. On March 15, 2002 following stockholder approval, we issued to the Lenders warrants exercisable for an aggregate of 1,750,000 shares of our common stock, subject to adjustment for antidilution events, at an exercise price of $0.01 per share. We valued the warrants using an option pricing model and recorded an $11.1 million discount on the Senior Notes, which is being amortized over the term of the Senior Notes. As of December 31, 2002, the unamortized discount was $9.7 million. After the issuance of the warrants, the effective interest rate on the Senior Notes is 15.3%. As of December 31, 2002, we have issued 927,500 shares of common stock to the Lenders pursuant to the exercise of their warrants.

In addition, without the prior consent of the Lenders, we are prohibited from, among other things, incurring certain types of additional debt, making specified payments and capital expenditures, consolidating, merging with or acquiring another business, or selling certain of our assets.

We have the option to redeem the Senior Notes prior to their maturity at a premium. However, we do not currently intend to refinance the Senior Notes in 2003 unless a significant event, such as the award of another major distribution rights contract, exceeds the borrowing capacity determined by our current borrowing base. We continue to explore opportunities to acquire additional product lines with a number of major OEMs.

Additionally, we continually review opportunities for acquiring other compatible businesses or operations. If a strategic acquisition candidate meets our quantitative and qualitative thresholds, it is possible that such a strategic acquisition candidate might require us to refinance both our senior secured debt and the Senior Notes.

SENIOR SECURED DEBT. Our senior secured credit facility, or the Credit Facility, consists of a $200.0 million revolving credit and letter of credit facility due as a balloon payment in 2006, with availability determined by reference to a borrowing base calculated using our eligible accounts receivable and inventory and after deducting reserves required by the lenders. As of December 31, 2002, we had $140.3 million outstanding on the Credit Facility and issued letters of credit for $0.7 million. We had $59.0 million available for additional borrowings under the Credit Facility, and our borrowing base was $204.5 million as of December 31, 2002. Borrowings under the Credit Facility bear interest, at our option, based upon either: a Eurodollar Rate plus an applicable margin ranging from 2.5% to 3.0% depending upon our financial ratios, or a Base Rate plus an applicable margin ranging from 1.5% to 2.0% depending upon the same financial ratios. We utilize both of these interest rate options. As of December 31, 2002, the average interest rate on the Credit Facility was 4.71%. A commitment fee of 0.5% is payable quarterly on the unused portion of the Credit Facility. Obligations under the Credit Facility are collateralized by substantially all of our domestic assets and 65% of the stock of each of our foreign subsidiaries. The Credit Facility also contains default clauses that permit the acceleration of all amounts due following the maturity of an event of default at the discretion of the lenders, and lock-box provisions that apply our cash collections to outstanding borrowings. Based on the terms of the Credit Facility and pursuant to EITF Issue No. 95-22, "Balance Sheet Classification of Revolving Credit Agreement Obligations Involving Lock-Box Arrangements," we have classified amounts outstanding under the Credit Facility as current.

We also maintain a revolving credit facility in Canada. The Canadian $6.0 million credit facility renews yearly in late April and had an outstanding balance at December 31, 2002 equivalent to U.S. $0.5 million.

DEBT COVENANTS. The Credit Facility contains various restrictive operating and financial covenants, including several that are based on earnings before interest, taxes, depreciation, amortization, extraordinary gains or losses, and one-time items, or Adjusted EBITDA. Our Adjusted EBITDA for 2002 was $75.1 million, composed of $16.7 million, $20.9 million, $19.3 million and $18.2 million during the first, second, third and fourth quarters of 2002, respectively.

The following table presents a reconciliation of our Adjusted EBITDA to earnings from continuing operations for 2002:

(In Thousands)	First Quarter	Second Quarter	Third Quarter	F Q
Earnings from continuing operations	$ 4,526	7,780	6,922	
Plus:				
Income tax expense	2,894	4,649	3,510	
Interest expense	5,590	5,653	5,600	
Depreciation and amortization expense	3,452	3,127	3,189	
One-time items	320	--	--	
Minus:				
Noncash (gains) losses	(107)	(322)	95	
Adjusted EBITDA	$ 16,675	20,887	19,316	

The Adjusted EBITDA calculation above is prepared in accordance with the terms of the Credit Facility. The one-time items and noncash gains and losses, which are included in the Adjusted EBITDA calculation in accordance with the terms of the Credit Facility, may occur again in the future. Depreciation and amortization expense above excludes debt discount amortization. Adjusted EBITDA is presented solely to provide information on our debt covenants and should not be considered an alternative to operating results or cash flows calculated in accordance with generally accepted accounting principles. On December 31, 2002, after completing one year under the Credit Facility, our minimum Adjusted EBITDA covenant was replaced with a maximum leverage ratio covenant that measures the ratio of our outstanding debt to our Adjusted EBITDA for the trailing four quarters. This maximum leverage ratio covenant was initially set at 4.25 to 1 on December 31, 2002, and it will periodically decline until it reaches 2.50 to 1 for December 31, 2004 and all periods thereafter. In addition, beginning December 31, 2002, we must also comply with a minimum interest coverage ratio covenant that measures the ratio of our Adjusted EBITDA for the trailing four quarters to our interest expense during the trailing four quarters. The minimum interest coverage ratio covenant was initially set at 2.50 to 1 on December 31, 2002 and will periodically increase until it reaches 3.50 to 1 for December 31, 2004 and all periods thereafter. Furthermore, we must maintain a tangible net worth at or above certain levels. At December 31, 2002, we were required to have a minimum tangible net worth of $160.9 million. Our tangible net worth covenant will periodically increase until it reaches $315.3 million on December 31, 2006, at which time it will expire. Finally, we must limit our capital expenditures to no more than $9.6 million for 2002, $14.0 million for 2003, which includes allowed carryover spending from 2002, and $11.0 million for each of 2004, 2005 and 2006.

The Senior Notes also contain various restrictive financial covenants, several of which are less restrictive than those relating to the Credit Facility. On December 31, 2002, after completing one year under the Senior Notes, our minimum Adjusted EBITDA coven