

Hawker Beechcraft (HBAC) — Approaching Heavy Weather

Figure 1. Hawker Beechcraft — Debt Structure

Description	Coupon	Maturity	Outstanding	Price/ Yield	Rating	Recommendation
Loans						
Term Loan B	L+200	3/14	\$1280	75/ 13.12%	Ba3/BB	Buy
Bonds						
Senior Notes	8.5%	4/15	\$400	72.5/ 15.368%	B3/B-	Wait
Senior PIK Notes	8.875-9.625%	4/15	\$400	70.5/ 16.467%	B3/B-	Avoid
Sr. Sub. Notes	9.75%	4/17	\$300	67.25/ 17.25%	Caa1/B-	Avoid

PIK Pay in kind.

Source: Beach Research and Company reports.

Figure 2. Hawker Beechcraft — Financial Ratio Highlight Estimates

	6/30/08	6/30/08 LTM
Pro Forma Adjusted EBITDA	\$180.1	\$509.5 ^a
EBITDA/ Interest	1.91x	2.70x ^b
EBITDA-Cap Exp/ Interest	1.45x	2.05x ^c
Total Debt/EBITDA		4.88x

^a Pro forma adjusted EBITDA adds back \$53.5MM of non-cash inventory step-up purchase accounting. ^b Six-month interest annualized. ^c Six-month capital expenditures annualized. Cap Exp Capital expenditures. EBITDA Earnings before interest, taxes, depreciation and amortization. LTM Latest-12 months.

Source: Beach Research and Company reports.

Investment Summary and Recommendation

Investment Summary:

In March 2007, Goldman Sachs Capital Partners and Onex Partners formed Hawker Beechcraft Acquisition, LLC (HBAC) to finance the purchase of Raytheon Corporation's general aviation operations. Total consideration was \$3,218 million, or approximately 10.1x of \$318.6 million 2007 *pro forma* EBITDA. (Utilizing June 30 LTM adjusted *pro forma* EBITDA of \$509.5 million, the acquisition multiple would be 6.3x). Under the Hawker and Beech brands, HBAC is a leading manufacturer of business jets, turboprop and piston aircraft. Due to the general global prosperity of the last several years, general aviation has experienced consistent growth in demand. Since the March 2007 acquisition, HBAC's backlog has grown from \$3,937 million to \$7,400 million at the end of the second quarter, in part due to the introduction of the Hawker 4000, a wholly new composite corporate jet.

Investment Recommendation:

HBAC's bonds have traded off by approximately 20 points with the general market downturn since mid-September. The overall High Yield market's decline aside, there are obvious new concerns about whether HBAC's order book will hold up in light of the global economic downturn, and the contraction of credit.

NetJets, the world's largest fractional corporate jet operator (a wholly owned subsidiary of Berkshire Hathaway) is HBAC's largest customer, representing 34% of the Company's \$7.4 million backlog and 6% of second-quarter sales. As a slow down in business aviation activity accelerates, NetJets and others may postpone or cancel some of its orders, placing pressure on production.

Although in early October, HBAC's chief executive stated that he expects the Company's backlog to remain stable through next year, we expect deterioration, and therefore would recommend purchase of the Senior Secured Term Loan now. At 75, the L+200 Term Loan B has a yield to maturity of 13.12%, and is currently covered by cash and inventories 1.6 times. When adding the Senior Notes, the coverage is currently 1 times. We expect that a better entry point for purchasing the Senior Notes may present itself in coming months, and will follow HBAC's progress through the potential heavy weather it is facing. We believe that due to the Company's current liquidity position, excellent product line and seasoned management team, it will manage its way through the general aviation slow down successfully. (See Appendix for current business jet market conditions.)

Recent Financial Performance

The Company posted second-quarter highlights and results for the period ended June 29, 2008 (The Company has not restated the predecessor company's first-quarter '07 results, making 6-month comparisons to '07 performance difficult).

On June 12, 2008, the Hawker 4000 new composite, super midsized business jet received FAA certification, with a June 18 first delivery. Early production deliveries of the approximate \$20 million per copy jet could be delayed by certain product enhancements to the aircraft design. Also in June, military trainer deliveries were halted to check quality issues with a vendor. For the 3-month period, sales increased by \$311.4 million due to a major increase in business aviation deliveries. Aircraft delivered in the period totaled 129, compared to 95 in 2007. Operating income was \$86.4 million versus a loss of \$(36.6) million in 2007. Increased business aviation deliveries, improved margins, customer support and purchase accounting adjustments to 2007 results contributed to better performance.

Due to the impact of step-up purchase accounting used in the acquisition, we are relying on the Company's *pro forma* adjusted EBITDA for the 3-months ended June 29, 2008 of \$133.1 million versus \$74.9 million in 2007. For the 6-months ended June 29, 2008, the company reported \$180.1 million in EBITDA versus \$158 million, with an LTM non-GAAP *pro forma* adjusted EBITDA of \$509.5 million. This is compared to 2007 unadjusted EBITDA of \$318.6 million.

Another important operating event following the second quarter was the Company's \$105.8 million sale of six domestic fuel and line operations. In August, the Wichita union engaged in a strike that has since been resolved. Our estimated *pro forma* operating financial ratios, taken from the Company's 8-K are listed in Figure 2 above. We will prepare projections following the November 11 third-quarter conference call.

Risk Factors

Positives:

- **Market Position** – With more than 75 years of experience, the Company is one of the most respected manufacturers in general aviation. The Hawker and Beech product lines have a reputation for innovation, performance, quality and value. The Hawker 900XP and King Air product families and platforms are the best selling business jet and turboprop lines in their categories, respectively, in the history of general aviation.

- **Recurring Revenue from a Diverse Customer Base** – The Company sells aircraft to a diverse customer base comprised of corporations, fractional and charter operations, governments and individuals throughout the world. HBAC provides parts, maintenance and flight support services through an extensive network of service centers in 25 countries to an estimated fleet of 36,000 aircraft. In addition, the Company is the sole source provider of primary trainer aircraft to the US Air Force and Navy. Collectively, the customer support and trainer aircraft segments contributed 37% of first-quarter sales.
- **Moody's Liquidity Upgrade** – In April, Moody's upgraded HBAC's speculative grade liquidity rating from SGL-3 to SGL-1, while reaffirming the B2 corporate family rating. Moody's cited the coming cash flow working capital requirements for the new Hawker 4000 program, but anticipated that the \$400 million available under the Company's revolving credit agreement would not be used this year. In addition, the Company was expected to maintain ample room under the Term Loan Agreement's net secured debt/EBITDA financial covenant, which steps down from 4.63x to 4.13x at the end of March 2009.
- **Technologically Advanced Product Line** – With the planned derivative upgrades to the Company's existing models, and its entry into the midsized jet segment with the Hawker 4000, HBAC is strongly positioned across all segments of general aviation. The Hawker 4000 is the Company's second carbon composite construction jet, after introducing the first smaller carbon composite jet, the Premier. The Company just announced the development of the Premier II. Carbon composite construction allows for greater interior space than other jets in the same class. As the aircraft is lighter than a standard aluminum structure, both maximum range and service ceiling are increased.

Negatives:

- **Cyclical Industry** – General aviation has historically been a cyclical industry, affected by the condition of the US and global economies. Aircraft are discretionary purchases, and general aviation's sales have historically been tied to corporate and consumer spending levels, which are cyclical in nature. Over the past three years, general aviation has recorded consistent growth due to increasing fractional and charter demand, and increasing international demand for general aviation products. In the current economic environment, customers may delay delivery or cancel orders.
- **NetJets Backlog Concentration** – Currently, fractional and aircraft charter demand is softening in the US and Europe. NetJets, the largest global provider of these services, is HBAC's largest customer, contributing 6% of sales and 34% of the overall backlog at the end of the second quarter. Should NetJets experience a decline in demand, it may delay or cancel orders.
- **US Air Force and Navy Fixed Rate Contracts** – For the three-months ended March 30, approximately 15% of sales came from fixed-rate US Government contracts. These contracts are only partially funded at the outset, and potentially can be terminated at the US Government's convenience, due to lack of funding, delays, and so forth. Upon such a termination, HBAC would only be entitled to payment for work done to date, which would have an immediate impact upon financial performance, and make it difficult to obtain future contracts.
- **Major Competitors' Financial Strength** – HBAC currently competes with five major global aircraft producers: Cessna Aircraft, Bombardier Aerospace, Gulfstream Aerospace, Dassault Falcon Aerospace, and Embraer Aircraft. Most of these competitors are part of larger, more diversified companies. The larger size of these competitors, with potentially lower cost funding, will allow them to withstand a prolonged industry downturn more easily.

Company Overview

Hawker Beechcraft Inc. is a leading designer and manufacturer of business jets, turboprops and piston aircraft, with \$3.4 Billion in 2007 *pro forma* sales. The Company operates in the global general aviation industry, which has experienced strong growth since 2003, and reached sales of \$21.9 billion in 2007. The Company operates in three segments: 1) Business and General Aviation, which contributes approximately 65% of sales, and is engaged in the sale of new business and general aviation aircraft, 2) Trainer Aircraft, primarily producing trainers for the US Government, and 3) Customer Support, which services the 36,000 existing aircraft with parts and services, and contributes the remainder of sales.

Capital Structure

In March 2007, Goldman Sacs Capital Partners and Onex Partners formed Hawker Beechcraft Acquisition, LLC (HBAC) to finance the purchase of Raytheon Corporation's general aviation operations. Total consideration was \$3,218 million or approximately 10.1x 2007 *pro forma* EBITDA. The updated six-month capitalization is shown in Figure 3 below:

Figure 3. Hawker Beechcraft — Capitalization, at 6/29/08

	6/29/08	LTM \$509.5 Pro forma Adjusted EBITDA
Revolver (\$400MM Avail.)	\$0	
Synthetic LC (\$75MM)	\$0	
Term Loan B	\$1,287	
Total Senior Secured Debt	\$1,287	2.53x
Unsecured Supplier Credit	\$100.8	
8.5% Senior Notes due 4/15	\$400	
8.875-9.625% Senior PIK Notes	\$400	
Total Senior Notes	\$900.8	4.29x
9.75% Senior Sub. Notes due 4/17	\$300	
Total Debt	\$2,487.8	4.88x
Equity	\$1009.3	
Total Capitalization	\$3,497.1	6.86X

LTM Latest 12 months. EBITDA Earnings before interest, taxes, depreciation and amortization. PIK Pay in kind.

Source: Beach Research and Company reports.

Figure 4. Hawker Beechcraft — Income Statement, at 7/17/08

	<u>Predecessor</u>		<u>Predecessor</u>	<u>Successor</u>	<u>Successor</u>
	<u>Fiscal Year Ended</u>		<u>Three Months</u>	<u>Nine Months</u>	<u>Six Months</u>
<i>Draft from 7/17/08 S-1</i>	<u>12/31/2005</u>	<u>12/31/2006</u>	<u>3/31/2007</u>	<u>12/31/2007</u>	<u>6/29/2008</u>
Sales	\$2,980.80	\$3,095.40	\$670.80	\$2,793.40	\$1,605.20
Cost of Sales	2,587.4	2,585.1	558.6	2,369.6	1,335.1
Gross Profit	393.4	510.3	112.2	423.8	270.1
Selling, General & Administrative Expense	197.6	211.0	59.5	205.4	132.7
Research and Development	73.0	83.2	21.3	70.1	52.5
Provision for Restructuring Costs	0.0	0.0	0.0	0.0	0.0
Goodwill Amortization (Other, Net)	0.0	0.0	0.0	0.0	0.0
Royalty Income	0.0	0.0	0.0	0.0	0.0
Income (Loss) from Operations	122.8	216.1	31.4	148.3	84.9
Interest Expense (Net)	74.2	77.0	15.0	152.3	94.9
Other Expense	(0.9)	(1.5)	(0.1)	1.0	(3.6)
Income Tax Provision (Benefit)	0.0	0.0	0.0	0.0	0.0
Net Income (Loss) Before Tax	49.5	140.6	16.5	(5.0)	(6.4)
Depreciation & Amortization	85.4	88.1	21.9	115.2	78.2
Non-recurring Charges	0	0	0.0	0.0	0.0
<u>Operating Margins</u>					
Gross Profit/ Sales	13.20%	16.49%	16.73%	15.17%	16.83%
SG&A/ Sales	6.63%	6.82%	8.87%	7.35%	8.27%
EBITDA/ Sales	6.98%	9.83%	7.95%	9.43%	10.16%
Operating Income/ Sales	4.12%	6.98%	4.68%	5.31%	5.29%
Interest/ Sales	2.49%	2.49%	2.24%	5.45%	5.91%
<u>Cash Flow Items</u>					
EBITDA	\$208.20	\$304.20	\$53.30	\$263.50	\$163.10
Net Interest	74.2	77.0	15.0	152.3	94.9
Capital Expenditures	39.8	46.1	26.2	61.3	26.2
Other Investment Activities	0.0	0.0	0.0	0.0	0.0
Total Capital Expenditures	39.8	46.1	26.2	61.3	29.7
Income Tax Provision (Benefit)	15.8	50.5	6.4	(5.8)	6.4
Excess Cash Flow from Operations	78.4	130.6	5.7	55.7	32.1
<u>Cash Flow Coverage Ratios</u>					
EBITDA/ Net Interest	2.81x	3.95x	3.55x	1.73x	1.72x
EBITDA/ Interest Expense	2.81x	3.95x	3.55x	1.73x	1.72x
EBITDA-Cap. Exp.- Cash Tax/ Cash Int.	2.06x	2.70x	1.38x	1.37x	1.34x
Total Debt/ EBITDA^a					7.33x

^a EBITDA run rate Annualized. Cap. Exp. Capital expenditures. EBITDA Earnings before interest, taxes, depreciation and amortization. LTM Latest-12 months.

Source: Beach Research and Company reports.

* * *

Appendix**UBS Business Jet Monthly¹:**

The equity research department of UBS publishes *Business Jet Monthly*. A summary of the October 2-3 edition outlines the state of the industry as follows:

- A business jet operators' opinion poll showed a worsening view of the market. The Index is at an all time low of 26. The Index began in March 2003 at 39 (50 being the midpoint) and peaked at 68 in January 2005.
- Used business jet inventories are climbing. Fourteen percent of the fleet in service is still below the 17% record high reached in 2002, but it is on the rise.
- Inventories of young used jets (10 years or less) are on the rise.
- Business jet flight cycles (take offs and landings) are down 8% through August, the last available data. Light jet cycles are down 12%, midsized down 4%, and large jets down are 6 per cent.
- New delivery aircraft positions available for sale were up from 140 in August to 148 in September. Very light jets, the Eclipse 500 and the Citation Mustang made up 36.5% of the total. By manufacturer, Cessna Citations accounted for 35.1% of the total, Eclipse 21.6%, Bombardier-Lear 12.2%, Gulfstream 7.4%, but Hawker contributed only 3.4% of the total (three Hawker 4000s and two Hawker 900XPs).

* * * * *

Copyright 2008, Beach Research™. All rights reserved. The information contained herein is intended for distribution to institutional investors and is for informational purposes only. The securities, instruments or strategies discussed in Beach Research™ reports may not be suitable for all investors. The opinions, forecasts and recommendations contained in this report are those of the Beach Research™ analysts preparing the report and are based upon public information available to them from various sources as of the date of the report. The analysts are basing their opinions upon information they believe to be accurate and reliable and the completeness and/or accuracy is neither implied nor guaranteed. Opinions and recommendations are subject to change without notice. Neither the information nor any opinion expressed constitutes an offer, or an invitation to make an offer to buy or sell any securities. Information about past performance of an investment is not necessarily a guide to, indicator of, or assurance of, future performance. No reproduction, transmission or replication of any of the information or data contained within this document may be done without the expressed written consent of Beach Research™.

¹ UBS Investment Research, *Business Jet Monthly*, October 2, 2008. David E. Strauss, Fadi Chamoun, CFA, Cristina Fernandez.