

Edgar Filing: AEROCENTURY CORP - Form 10QSB

AEROCENTURY CORP  
Form 10QSB  
August 13, 2003

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, DC 20549

FORM 10-QSB

(Mark One)

☒ Quarterly Report Under Section 13 or 15(d) of the Securities Exchange Act of 1934 For the quarterly period ended June 30, 2003

☐ Transition Report Under Section 13 or 15(d) of the Securities Exchange Act of 1934 For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number: 001-13387

AeroCentury Corp.  
(Exact name of small business issuer in its charter)  
Delaware 94-3263974  
(State or other jurisdiction of (I.R.S. Employer Identification No.)  
incorporation or organization)

1440 Chapin Avenue, Suite 310  
Burlingame, California 94010  
(Address of principal executive offices) (Zip Code)

Issuer's telephone number, including area code: (650) 340-1888

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

Title of Each Class	Name of Exchange on Which Registered
Common Stock, \$0.001 par value	American Stock Exchange

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

Check whether the Issuer: (1) filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the past 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 ☒ No ☐  
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As of August 13, 2003 the Issuer had 1,606,557 Shares of Common Stock outstanding, of which 63,300 are held as Treasury Stock.

Transitional Small Business Disclosure Format (check one): Yes \_\_\_\_\_ No ☒ \_\_\_\_\_

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## PART I

### Financial Information

#### Forward-Looking Statements

This Quarterly Report on Form 10-QSB includes "forward-looking statements" within the meaning of Section 27A of the Securities Act and Section 21E of the Exchange Act. All statements in this Report other than statements of historical fact are "forward-looking statements" for purposes of these provisions, including any statements of plans and objectives for future operations and any statements of assumptions underlying any of the foregoing. Statements that include the use of terminology such as "may," "will," "expects," "plans," "anticipates," "estimates," "potential," or "continue," or the negative thereof, or other comparable terminology are forward-looking statements.

Forward-looking statements include: (i) in Item 1 "Financial Statements," statements regarding the Company's expectations regarding negotiating renewed lease terms with the lessees and completing the acquisition of four Fokker 50 aircraft, delivery of aircraft for which lease term sheets have been signed, the return of three aircraft pursuant to early lease termination, delivery to a lessee of a Fokker 50 aircraft immediately upon return acceptance by the Company, extension of a lease for a DHC-8 aircraft through the maturity date of the financing, discussions regarding long-term extensions of leases for Fokker 50 and DHC-8 aircraft, discussions with its agent bank regarding waiver of certain covenants in its credit line facility; and the Company's expectation that it will be able to obtain a new revolving credit facility in an amount equal to or greater than \$40 million at reasonable market terms; (ii) in Item 2 "Management's Discussion and Analysis or Plan of Operation -- Liquidity and Capital Resources," statements regarding the Company's discussions with its agent bank regarding waiver of certain covenants in its credit line facility; the Company's expectation that no action will be taken by the agent bank on the financial ratio covenant default so long as negotiations of the credit facility renewal continue; the Company's expectation that it will be able to obtain a new revolving credit facility in an amount equal to or greater than \$40 million at reasonable market terms, including a revision that will resolve the financial covenant ratio non-compliance; the Company's expectation of an extension of a lease for a DHC-8 aircraft through the maturity date of its special-purpose financing, or if the lease is terminated, the Company's ability to meet loan payment obligations through a reasonable six-month remarketing period; the Company's belief that it will have adequate cash flow to meet its ongoing operational needs; (iii) in Item 2 "Management's Discussion and Analysis or Plan of Operation -- Outlook," statements regarding the Company's belief that it will be able to renew its credit facility in advance of the August 28, 2003 expiration date, to add a third lender to its credit facility and to return the credit facility to a \$50 million limit; the Company's belief regarding discussions with its agent bank regarding waiver of certain covenants in its credit line facility and to revise financial covenants in its credit facility to take into account the Company's financial circumstances; the Company's belief that the lessee of the aircraft financed under a special purpose financing will extend the lease through the maturity date of the financing; the Company's belief that it will not experience events similar to the default of a Haitian lessee and the weak credit position of a Brazilian lessee; the Company's expectations regarding return of two Dash-7 aircraft from Haiti and the substantial amount of time required to return these aircraft into revenue producing status; and the Company's anticipation that revenue growth will likely only occur through acquisition of new leased assets (iv) in Item 2 "Management's Discussion and Analysis or Plan of Operation -- Factors that May Affect Future Results," statements regarding the Company's obligation to make repayments in the near term due to collateral base limitations; the Company's expectations

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regarding return of two Dash-7 aircraft from Haiti and the substantial amount of time required to return these aircraft into revenue producing status; the Company's anticipated acquisition of primarily used aircraft; the Company's ability to obtain third party guaranties, letters of credit or other credit enhancements from future lessees; the opportunities available in overseas markets; and JMC's competitiveness due to its experience and operational efficiency in financing transaction types desired by regional air carriers and its global reputation.

These forward-looking statements involve risks and uncertainties, and it is important to note that the Company's actual results could differ materially from those projected or assumed in such forward-looking statements. Among the factors that could cause actual results to differ materially are the factors detailed under the heading "Management's Discussion and Analysis or Plan of Operation -- Factors That May Affect Future Results," including general economic conditions, particularly those that affect the demand for regional aircraft and engines and the financial status of the Company's primary customers, regional passenger airlines and non-U.S. lessees; lack of any further disruptions to the air travel industry similar to that which occurred on September 11, 2001 or the SARS outbreak; the success of the Company's efforts in remarketing or re-leasing aircraft that are currently or are about to come off-lease and in concluding transactions for which term sheets have been executed; the Company's ability to obtain a new credit facility on reasonable business terms at or prior to the expiration of its current credit facility, as well as locate a replacement lender for a departing credit line participant; the financial performance of the Company's lessees and their compliance with rental, maintenance and return conditions under their respective leases; the availability of suitable aircraft acquisition transactions in the regional aircraft market; and future trends and results which cannot be predicted with certainty. The cautionary statements made in this Quarterly Report should be read as being applicable to all related forward-looking statements wherever they appear herein. All forward-looking statements and risk factors included in this document are made as of the date hereof, based on information available to the Company as of the date hereof, and the Company assumes no obligation to update any forward-looking statement or risk factor. You should consult the risk factors listed from time to time in the Company's filings with the Securities and Exchange Commission.

### Item 1. Financial Statements

#### AeroCentury Corp. Condensed Consolidated Balance Sheet Unaudited

#### ASSETS

June 30,  
2003  
----

#### Assets:

Cash and cash equivalents	\$	1,274,370
Deposits		7,844,620
Accounts receivable, net of allowance for doubtful accounts of \$250,000		1,389,670
Aircraft and aircraft engines on operating leases,		

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net of accumulated depreciation of \$19,950,800	63,795,200
Prepaid expenses and other	377,590
	-----
Total assets	\$ 74,681,450
	=====
LIABILITIES AND STOCKHOLDERS' EQUITY	
Liabilities:	
Accounts payable and accrued expenses	\$ 687,230
Notes payable and accrued interest	42,276,140
Maintenance reserves and accrued costs	8,080,060
Security deposits	2,230,850
Prepaid rent	192,390
Deferred taxes	2,759,760
	-----
Total liabilities	56,226,430
	=====
Stockholders' equity:	
Preferred stock, \$.001 par value, 2,000,000 shares authorized, no shares issued and outstanding	-
Common stock, \$.001 par value, 3,000,000 shares authorized, 1,606,557 shares issued and outstanding	1,610
Paid in capital	13,821,200
Retained earnings	5,136,280
	-----
Treasury stock at cost, 63,300 shares	18,959,090
	(504,070)
	=====
Total stockholders' equity	18,455,020
	-----
Total liabilities and stockholders' equity	\$ 74,681,450
	=====
The accompanying notes are an integral part of these statements.	

## AeroCentury Corp. Condensed Consolidated Statements of Income

For the Six Months Ended June 30,		For the Th
2003	2002	2003
----	----	----
	Unaudited	Unau

Revenues:

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Operating lease revenue	\$ 4,637,600	\$ 4,423,540	\$ 2,185,660
Other income	45,360	58,720	21,430
	-----	-----	-----
	4,682,960	4,482,260	2,207,090
	-----	-----	-----
Expenses:			
Management fees	967,630	837,650	480,560
Depreciation	1,680,110	1,366,050	839,310
Interest	952,670	937,240	441,670
Maintenance	1,837,980	225,510	1,736,980
Bad debt expense	1,049,910	-	949,910
Professional fees and general and administrative	418,240	258,340	202,470
	-----	-----	-----
	6,906,540	3,624,790	4,650,900
	-----	-----	-----
(Loss)/income before taxes	(2,223,580)	857,470	(2,443,810)
Tax (benefit)/provision	(807,490)	292,880	(852,610)
	-----	-----	-----
Net (loss)/income	\$ (1,416,090)	\$ 564,590	\$ (1,591,200)
	=====	=====	=====
Weighted average common shares outstanding	1,543,257	1,543,257	1,543,257
	=====	=====	=====
Basic (loss)/earnings per share	\$ (0.92)	\$ 0.37	\$ (1.03)
	=====	=====	=====

The accompanying notes are an integral part of these statements.

## AeroCentury Corp. Condensed Consolidated Statements of Cash Flows

For the Six Months Ended June 30,  
2003                      2002  
----                      ----  
Unaudited

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Net cash provided by operating activities	\$ 1,272,150	\$ 2,177,580
Investing activities:		
Payments received on note payable	17,600	25,160
Purchase of aircraft and aircraft engines	-	(316,600)
	-----	-----
Net cash provided/(used) by investing activities	17,600	(291,440)
Financing activity -		
Repayment of notes payable	(1,723,030)	(2,223,190)
	-----	-----
Net cash used by financing activity	(1,723,030)	(2,223,190)
Net decrease in cash and cash equivalents	(433,280)	(337,050)
Cash and cash equivalents, beginning of period	1,707,650	2,680,160
	-----	-----
Cash and cash equivalents, end of period	\$ 1,274,370	\$ 2,343,110
	=====	=====

The accompanying notes are an integral part of these statements.

### AeroCentury Corp. Notes to Condensed Consolidated Financial Statements June 30, 2003 Unaudited

#### 1. Organization and Summary of Significant Accounting Policies

##### (a) Basis of Presentation

AeroCentury Corp. ("AeroCentury"), a Delaware corporation, uses leveraged financing to acquire leased aircraft assets. The Company purchases used regional aircraft on lease to foreign and domestic regional carriers. Financial information for AeroCentury and its two wholly-owned subsidiaries, AeroCentury Investments LLC ("AeroCentury LLC") and AeroCentury Investments II LLC ("AeroCentury II LLC") (collectively, the "Company"), is presented on a consolidated basis. All intercompany balances and transactions have been eliminated in consolidation.

Although the Company believes that it has included all adjustments necessary for a fair presentation of the interim periods presented and that the disclosures are adequate to make the information presented not misleading, the Company suggests that these condensed consolidated financial statements be read in conjunction with the consolidated financial statements and related notes included in the Company's annual report on Form 10-KSB for the fiscal year ended December 31, 2002.

##### (b) Capitalization

In 1998, in connection with the adoption of a stockholder rights plan, the Company filed a Certificate of Designation, setting forth the rights, preferences and privileges of a new Series A Preferred Stock. Pursuant to the

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plan, the Company issued rights to its stockholders, giving each stockholder the right to purchase one one-hundredth of a share of Series A Preferred Stock for each share of Common Stock held by the stockholder. Such rights are exercisable only under certain circumstances concerning a proposed acquisition or merger of the Company.

As discussed above, AeroCentury is the sole member and manager of AeroCentury LLC and AeroCentury II LLC.

### (c) Cash and Cash Equivalents/Deposits

The Company considers highly liquid investments readily convertible into known amounts of cash, with original maturities of 90 days or less, as cash equivalents. Deposits represent cash balances held related to maintenance reserves and security deposits and generally are subject to withdrawal restrictions.

At June 30, 2003, the Company held security deposits of \$2,230,850, refundable maintenance reserves received from lessees of \$351,620 and non-refundable maintenance reserves of \$5,262,150.

The Company's leases are typically structured so that if any event of default occurs under a lease, the Company may apply all or a portion of the lessee's security deposit to cure such default. If such application of the security deposit is made, the lessee typically is required to replenish and maintain the full amount of the deposit during the remaining term of the lease. All of the security deposits currently held by the Company are refundable to the lessee at the end of the lease, upon satisfaction of all lease terms.

### AeroCentury Corp. Notes to Consolidated Financial Statements June 30, 2003 Unaudited

### 1. Organization and Summary of Significant Accounting Policies (continued)

#### (c) Cash and Cash Equivalents/Deposits (continued)

Maintenance reserves which are refundable to the lessee at the end of the lease may be retained by the Company if such amounts are necessary to meet the return conditions specified in the lease and, in some cases, to satisfy any other payments due under the lease.

Non-refundable maintenance reserves held by the Company are accounted for as a liability until the aircraft has been returned at the end of the lease, at which time the Company evaluates the adequacy of the remaining reserves in light of maintenance to be performed as a result of hours flown. At that time, any excess is recorded as income. When an aircraft is sold, any excess non-refundable maintenance reserves are recorded as income.

#### (d) Aircraft and Aircraft Engines On Operating Leases

The Company's interests in aircraft and aircraft engines are recorded at cost, which includes acquisition costs. Depreciation is computed using the straight-line method over the aircraft's estimated economic life (generally assumed to be twelve years from the date of acquisition), to an estimated

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residual value based on appraisal.

### (e) Impairment of Long-lived Assets

In accordance with Statement of Financial Accounting Standards ("SFAS") No. 144, "Accounting for the Impairment or Disposal of Long-lived Assets," assets are reviewed for impairment whenever events or changes in circumstances indicate that the book value of the asset may not be recoverable. Periodically, the Company reviews its long-lived assets for impairment based on third party valuations. In the event such valuations are less than the recorded value of the assets, the assets are written down to their estimated realizable value.

### (f) Loan Commitment and Related Fees

To the extent that the Company is required to pay loan commitment fees and legal fees in order to secure debt, such fees are amortized over the life of the related loan.

### (g) Maintenance Reserves and Accrued Costs

Maintenance costs under the Company's triple net leases are generally the responsibility of the lessees. Maintenance reserves and accrued costs in the accompanying balance sheet include refundable and non-refundable maintenance payments received from lessees. The Company periodically reviews maintenance reserves for adequacy in light of the number of hours flown, airworthiness directives issued by the manufacturer or government authority, and the return conditions specified in the lease. As a result of such review, when it is probable that the Company has incurred costs for maintenance in excess of amounts received from lessees, the Company accrues its share of costs for work to be performed as a result of hours flown. At June 30, 2003, the Company had accrued maintenance costs of approximately \$2,131,000 related to several of its aircraft.

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Notes to Consolidated Financial Statements  
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## 1. Organization and Summary of Significant Accounting Policies (continued)

### (h) Income Taxes

The Company follows the liability method of accounting for income taxes. Under the liability method, deferred income taxes are recognized for the tax consequences of "temporary differences" by applying enacted statutory tax rates applicable to future years to differences between the financial statement carrying amounts and the tax bases of existing assets and liabilities. The effect on deferred taxes of a change in the tax rates is recognized in income in the period that includes the enactment date.

### (i) Revenue Recognition

Revenue from leasing of aircraft assets is recognized as operating lease revenue on a straight-line basis over the terms of the applicable lease agreements.



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### (j) Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

The most significant estimates with regard to these financial statements are the residual values of the aircraft, the useful lives of the aircraft, the estimated amount and timing of cash flow associated with each aircraft that are used to evaluate impairment, if any, and accrued maintenance costs in excess of amounts received from lessees.

### (k) Comprehensive Income

The Company does not have any comprehensive income other than the revenue and expense items included in the consolidated statements of income. As a result, comprehensive income equals net income for the three months and six months ended June 30, 2003 and 2002.

### (l) Recent Accounting Pronouncements

In November 2002, the Financial Accounting Standards Board issued SFAS Interpretation No. 45, "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others" ("FIN 45"). FIN 45 is effective for guarantees issued or modified after December 31, 2002. The Company has one guarantee, which was issued prior to December 31, 2002. During the second quarter of 2003, the Company recorded a liability for the maximum obligation it has assumed under this guarantee and wrote off the related receivable (Note 5).

In January 2003, the FASB issued interpretation FIN No. 46, Consolidation of Variable Interest Entities ("FIN No. 46"). FIN No. 46 requires a variable interest entity to be consolidated by a company if that company is the primary beneficiary of the entity. A company is a primary beneficiary if it is subject to a majority of the risk of loss from the variable interest entity's activities or entitled to receive a majority of the entity's residual returns or both. FIN No. 46 also requires disclosures about variable interest entities that a company is not required to consolidate but in which it has a significant variable interest. The consolidation requirements of FIN No. 46 apply

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Notes to Consolidated Financial Statements  
June 30, 2003  
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### 1. Organization and Summary of Significant Accounting Policies (continued)

#### (1) Recent Accounting Pronouncements (continued)

immediately to variable interest entities created after January 31, 2003. The consolidation requirements apply to existing entities in the first fiscal year or interim period beginning after June 15, 2003. Certain of the disclosure requirements apply in all financial statements issued after January 31, 2003,

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regardless of when the variable interest entity was established. At June 30, 2003, the Company is a beneficiary of the services of one of its affiliates, the details of which are disclosed in Note 6. The Company is currently evaluating the classification of this entity under FIN No. 46.

### 2. Aircraft and Aircraft Engines On Operating Leases

At June 30, 2003, the Company owned five deHavilland DHC-8s, two deHavilland DHC-7s, three deHavilland DHC-6s, one Fairchild Metro III, two Shorts SD 3-60s, six Fokker 50s, two Saab 340As and 26 turboprop engines. The Company did not acquire or sell any aircraft during the first six months of 2003. In May 2003, the Company signed a term sheet for the acquisition of four Fokker 50 aircraft, which are currently leased to one of the Company's customers. The Company is in the process of negotiating revised lease terms with the lessee as well as financing and anticipates completing the acquisition in the third quarter of 2003.

At June 30, 2003, one of the Company's aircraft and its two spare engines, were off lease. The aircraft subsequently was delivered under a new lease in July 2003. As discussed below, three of the Company's aircraft are in the process of being returned pursuant to early lease terminations.

In April 2003, the Company and the lessee for three of the Company's aircraft signed lease amendments, which cured the lessee's default for rent and reserves due for the Company's two deHavilland DHC-7 aircraft. The amendments provided for deferral of the overdue rent and reserves and for payment of such amounts over time in installments. The Company and the lessee also agreed to terminate the lease for the third aircraft, a Shorts SD 3-60. All rent and reserves due for the Shorts SD 3-60 aircraft were paid by the lessee in April 2003 and the Company anticipates that it will accept the aircraft in the third quarter of 2003, upon completion of the pre-return inspection. The Company has declared an event of default under the leases for the other two aircraft because the lessee had failed to pay non-deferred amounts due in June 2003. The Company is in the process of repossessing the aircraft. As a result, at June 30, 2003, the Company recorded a bad debt expense of \$649,910 for all rent and maintenance reserves owed, as well as \$150,000 for the maximum amount that the Company guaranteed under a spare parts lease between the lessee and a third-party maintenance vendor (Note 5). The Company also expensed \$33,240 in legal fees which would have been amortized over the remaining lease term. In addition, the Company accrued \$1,493,560 of maintenance expense for work to bring all three aircraft up to the return conditions under the leases. Had the lessee performed the required maintenance during the leases and returned the aircraft under the required return conditions, these costs would have been borne by the lessee.

The lease for one of the Company's Fokker 50 aircraft expired in September 2002, but the lessee, which is in financial difficulty, is required to continue to pay rent until the aircraft is returned and accepted by the Company, which is expected to occur in the third quarter of 2003. The Company and the lessee have signed an agreement regarding the return of the aircraft and the amounts owed by the lessee. Although the Company holds a security deposit from this lessee, the amount of the deposit is not sufficient to pay the rent accrued at June 30, 2003 and reimburse the Company for the estimated maintenance work which has been and continues to be performed to meet

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June 30, 2003

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### 2. Aircraft and Aircraft Engines On Operating Leases (continued)

the return conditions of the lease. Therefore, the Company established an allowance for doubtful accounts in the amount of \$100,000 on March 31, 2003 and an additional allowance in the amount of \$150,000 on June 30, 2003. In February 2003, the Company signed a term sheet with another lessee for the re-lease of this aircraft and expects to deliver the aircraft immediately upon its return acceptance.

In April 2003, the Company's Fairchild Metro III aircraft, which was returned by the original lessee in October 2002 was delivered to a new lessee for a term of one year, with options to extend for two additional one-year periods.

In June 2003, the Company re-leased one of its two Saab 340A aircraft to a new customer. The second aircraft was re-leased to the same customer in July.

The lease for one of the Company's Fokker 50 aircraft has been extended on a series of short-term extensions through August 15, 2003. The lease for a second Fokker 50 leased by the same customer has also been extended from its expiration date in June 2003 to August 15, 2003. The Company and the customer are currently discussing a long-term extension of both leases.

In March 2003, the Company and the lessee of one of the Company's deHavilland DHC-8 aircraft agreed to a short-term extension of the lease through November 15, 2003, with periodic options to terminate it, and are currently discussing a long-term extension.

In May 2003, the Company and the lessee of one of the Company's deHavilland DHC-6 aircraft agreed to extend the lease to April 30, 2004.

In May 2003, the Company and the lessee for one of the Company's Fokker 50 aircraft agreed to extend the lease through May 15, 2005.

### 3. Notes Payable and Accrued Interest

The Company's credit facility, originally set to expire on June 28, 2003, bore interest through March 30, 2002, at the Company's option, at either (i) prime or (ii) LIBOR plus a margin of 200 to 250 basis points depending on certain financial ratios. The Company's assets, excluding those of AeroCentury LLC and AeroCentury II LLC, serve as collateral under the facility. On March 7, 2002, the Company and its lenders agreed to modify certain financial covenants contained in the loan agreement for the facility in order to enable the Company to continue to take advantage of business opportunities in the current industry environment of increased market demand for shorter-term leases. The changes, originally in effect through December 31, 2002, were extended through February 28, 2003. In return for granting such changes, the Company's lenders increased the margin on the interest rates chosen by the Company from a floating margin to a fixed margin of 275 basis points, effective March 31, 2002. On March 1, 2003, the margin returned to its original floating rate.

In June 2003, the Company reached an agreement with its lenders to accommodate the departure of one of the participating lenders that had decided it no longer wished to participate in aviation finance, and to extend the maturity date of its credit facility from June 28, 2003, until August 28, 2003. The Company made a repayment to reduce total outstanding indebtedness to \$39,905,000, which was allocated between the two remaining participants. The credit limit was reduced from \$50 million to \$40 million for the remaining term.

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At the same time, the

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3. Notes Payable and Accrued Interest (continued)

Company reached agreement with its lenders to amend its credit agreement to make certain revisions to the financial covenants, relating to net worth and debt coverage ratios, and age of aircraft collateral, under the facility. The amendment also provides for a fixed interest rate margin of 275 basis points.

In accordance with the agreement for the credit facility, the Company must maintain compliance with certain financial covenants. As a result of the substantial net loss incurred during the second quarter of 2003, the Company was out of compliance with a financial ratio covenant on June 30, 2003. The Company has commenced discussions with the agent bank for the credit facility regarding a waiver of that covenant. As of June 30, 2003, the Company was in compliance with all other covenants, \$39,905,000 was outstanding under the credit facility, and interest of \$4,920 was accrued.

The Company and its lenders are continuing to discuss the final terms of the renewal of the credit facility for an additional two years. The Company expects to be able to obtain such a renewal prior to expiration of the credit facility on reasonable market terms. If the Company is unable to secure a renewal of the credit facility, it likely would have to sell assets in order to repay its indebtedness under the facility. Such sales would likely not be on terms favorable to the Company as the full market value of the assets sold may not be realized by the Company in order to expedite the consummation of the sales.

Even if the Company is able to successfully sell a portion of its assets and use the proceeds to repay the credit facility, if a renewed or replacement facility is not obtained, the Company's future ability to acquire assets will be significantly impaired, as this facility is the Company's primary means of financing acquisitions and no other sources of acquisition financing are immediately available. Thus, the renewal or replacement of the facility in an amount equal or greater than the current \$40 million limit will be critical to both the Company's current level of operations and to its asset and revenue growth.

In November 1999 the Company acquired two aircraft using cash and bank financing separate from its credit facility. During 2002, the Company used funds from its credit facility to repay the outstanding bank financing related to both aircraft.

A similar financing was concluded in September 2000, consisting of a note in the amount of \$3,575,000, due April 18, 2003, which bore fixed interest at 8.36% through April 17, 2003, for the acquisition of a deHavilland DHC-8 aircraft. The note is collateralized by this aircraft and is non-recourse to the Company. Payments due under the note consisted of monthly principal and interest and a balloon principal payment due on the maturity date. The balance of the note payable at June 30, 2003 was \$2,362,420 and interest of \$3,800 was accrued. As of June 30, 2003, the Company was in compliance with all covenants of this

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loan agreement. The Company and the lessee have agreed to a short-term extension of the lease through November 15, 2003, with periodic options to terminate it. At the same time, the lender agreed to extend the financing through March 19, 2006, with borrower prepayment options at June 30, 2003 and November 30, 2003. During the term of the extension, payments due under the note consist of monthly principal and interest at the rate of one-month LIBOR plus 3%, with a balloon payment at maturity. The financing also provides for a six month remarketing period at the expiration of the lease or if the lease is terminated prior to its expiration date. Payments due on the financing are reduced during this remarketing period and the balloon principal payment is due at the end of the six month period. The Company anticipates that the lessee of this aircraft will extend the lease through the maturity date of the financing. If the lessee does not do so, and the Company is unable to re-lease the aircraft within the six month remarketing period, the Company would have to re-negotiate the financing. If no such financing were available, the Company likely would have to sell the aircraft.

### AeroCentury Corp. Notes to Consolidated Financial Statements June 30, 2003 Unaudited

#### 4. Income Taxes

The items comprising income tax expense are as follows:

	For the Six Months Ended June 30, 2003	2002
	----	----
Current tax provision:		
Federal	\$ 185,660	\$ -
State	11,260	6,050
Foreign	-	72,130
	-----	-----
Current tax provision	196,920	78,180
	-----	-----
Deferred tax (benefit)/provision:		
Federal	(945,170)	216,960
State	(59,240)	(2,260)
	-----	-----
Deferred tax (benefit)/provision	(1,004,410)	214,700
	-----	-----
Total (benefit)/provision for income taxes	\$ (807,490)	\$ 292,880
	=====	=====

Total income tax expense differs from the amount that would be provided by applying the statutory federal income tax rate to pretax earnings as illustrated below:

	For the Six Months Ended June 30, 2003	2002
	----	----
Income tax (benefit)/expense at statutory federal income tax rate	\$ (756,020)	\$ 291,540
State taxes net of federal benefit	(9,750)	7,260
Tax rate differences	(41,720)	(5,920)

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Total income tax (benefit)/expense	\$ (807,490)	\$ 292,880
	=====	=====

Temporary differences and carryforwards that gave rise to a significant portion of deferred tax assets and liabilities as of June 30, 2003 are as follows:

Deferred tax assets:		
Allowance for doubtful accounts	\$	86,100
Deferred maintenance		776,740
Maintenance reserves		1,868,440
Prepaid rent and other		66,590
		-----
Deferred tax assets		2,797,870
Deferred tax liabilities:		
Depreciation on aircraft and aircraft engines	(5,316,970)	
Unearned income	(17,010)	
Other	(222,320)	
		-----
Net deferred tax liabilities	\$	(2,758,430)
		=====

No valuation allowance is deemed necessary, as the Company anticipates generating adequate future taxable income to realize the benefits of all deferred tax assets on the balance sheet.

### AeroCentury Corp. Notes to Consolidated Financial Statements June 30, 2003 Unaudited

#### 5. Commitments and Contingencies

In connection with the re-lease of two of the Company's aircraft, the Company guaranteed, up to a maximum amount of \$150,000, the lessee's payments under a contract with a third party vendor for spare parts. The agreement provides for the lessee to reimburse the Company for any payments made under the guarantee, upon demand by the Company. If the lessee does not make such reimbursements or does not comply with any provisions of the parts agreement, the Company may declare an event of default under the leases. As discussed in Note 2, the Company has declared the lessee in default of its payment obligations under its leases. At June 30, 2003, the lessee owed the vendor an amount in excess of the guaranty. The Company believes that it will have to pay the guaranteed amount to the vendor and that it will not be reimbursed by the lessee. Therefore, the Company has written off the \$150,000 as bad debt expense at June 30, 2003.

#### 6. Related Party Transactions

Since the Company has no employees, the Company's portfolio of leased aircraft assets is managed and administered under the terms of a management agreement with JetFleet Management Corp. ("JMC"), which is an integrated aircraft management, marketing and financing business and a subsidiary of JetFleet Holding Corp. ("JHC"). Certain officers of the Company are also

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officers of JHC and JMC and hold significant ownership positions in both JHC and the Company. Under the management agreement, JMC receives a monthly management fee based on the net asset value of the assets under management. JMC may also receive an acquisition fee for locating assets for the Company, provided that the aggregate purchase price, including chargeable acquisition costs and any acquisition fee does not exceed the fair market value of the asset based on appraisal, and a remarketing fee in connection with the sale or re-lease of the Company's assets. The management fees, acquisition fees and remarketing fees may not exceed the customary and usual fees that would be paid to an unaffiliated party for such services. The Company recorded management fees of \$967,630 and \$837,650 during the six months ended June 30, 2003 and 2002, respectively. Because the Company did not acquire any aircraft during the first six months of 2003 or 2002, no acquisition fees were paid to JMC. No remarketing fees were accrued to JMC during 2003 or 2002.

### 7. Subsequent Events

The lease for one of the Company's Fokker 50 aircraft has been extended on a series of short-term extensions. In July 2003, the lease was extended through August 15, 2003. At the same time, the lease for a second Fokker 50 leased by the same customer was also extended to the same date. The Company and the customer are currently discussing a long-term extension of both leases.

## Item 2. Management's Discussion and Analysis or Plan of Operation.

### Critical Accounting Policies

In response to the Securities and Exchange Commission's Release No. 33-8040, "Cautionary Advice Regarding Disclosure About Critical Accounting Policies", the Company has identified the most critical accounting policies upon which its financial status depends. It determined the critical policies by considering those that involve the most complex or subjective decisions or assessments. The Company identified these policies to be those related to lease rental revenue recognition, depreciation policies, valuation of aircraft and maintenance reserves and accrued costs.

### Revenue Recognition

Revenue from leasing of aircraft assets is recognized as operating lease revenue on a straight-line basis over the terms of the applicable lease agreements.

### Depreciation Policies

The Company's interests in aircraft and aircraft engines are recorded at cost, which includes acquisition costs. Depreciation is computed using the straight-line method over the aircraft's estimated economic life (generally

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assumed to be twelve years from the date of acquisition), to an estimated residual value based on appraisal.

### Valuation of Aircraft

In accordance with Statement of Financial Accounting Standards ("SFAS") No. 144, "Accounting for the Impairment or Disposal of Long-lived Assets," assets are reviewed for impairment whenever events or changes in circumstances indicate that the book value of the asset may not be recoverable. Periodically, the Company reviews its long-lived assets for impairment based on third party valuations. In the event such valuations are less than the recorded value of the assets, the assets are written down to their estimated realizable value.

### Maintenance Reserves and Accrued Costs

Maintenance costs under the Company's triple net leases are generally the responsibility of the lessees. Maintenance reserves and accrued costs in the accompanying balance sheet include refundable and non-refundable maintenance payments received from lessees. The Company periodically reviews maintenance reserves for adequacy in light of the number of hours flown, airworthiness directives issued by the manufacturer or government authority, and the return conditions specified in the lease. As a result of such review, when it is probable that the Company has incurred costs for maintenance in excess of amounts received from lessees, the Company accrues its share of costs for work to be performed as a result of hours flown.

### Results of Operations

#### a. Revenues

Operating lease revenue was approximately \$214,000 higher in the six months ended June 30, 2003 versus the same period in 2002 primarily because of lease revenue from aircraft purchased during the second half of 2002 and from the re-lease of several aircraft which had been off lease during a portion of the first six months of 2002. These increases more than offset a decrease in operating lease revenue resulting from lower overall lease rates and aircraft off lease during 2003. Operating lease revenue was approximately \$44,000 lower in the three months ended June 30, 2003 versus the same period in 2002 primarily due to lower overall lease rates and aircraft off lease during 2003, the effect of which was partially offset by the increase in operating lease revenue from aircraft purchased during the second half of 2002. Other income was lower by approximately \$13,000 and \$6,000 during the six months and three months ended June 30, 2003, respectively, versus the same periods in 2002 because of lower interest rates earned on lower cash balances during 2003.

#### b. Expense items

Management fees, which are calculated on the net book value of the aircraft owned by the Company, were approximately \$130,000 and \$64,000 higher in the six months and three months ended June 30, 2003, respectively, versus the same periods in 2002 as a result of the purchase of two aircraft during the second half of 2002, the effect of which was partially offset by the effect of depreciation decreasing the net book value of the entire portfolio. Depreciation was approximately \$314,000 and \$154,000 higher in the six months and three months ended June 30, 2003, respectively, versus 2002 as a result of the 2002 aircraft purchases.

Interest expense was approximately \$15,000 higher in the six months ended June 30, 2003 versus the same period in 2002 because of a higher average principal balance during 2003, the effect of which was partially offset by lower average



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interest rates during 2003. Interest expense was approximately \$28,000 lower in the three months ended June 30, 2003 versus the same period in 2002 because of lower average interest rates during 2003, the effect of which was partially offset by a higher average principal balance.

Maintenance expense was approximately \$1,612,000 and \$1,588,000 higher in the six months and three months ended June 30, 2003, respectively, compared to 2002, primarily due to work which must be performed on three aircraft which are in the process of being returned early by the lessee that has been declared in default of its payment obligations under its leases. Such work would have been borne by the lessee if the lessee had performed the required maintenance during the leases and returned the aircraft under the required return conditions.

Bad debt expense was approximately \$1,050,000 and \$950,000 in the six months and three months ended June 30, 2003 versus no such expenses in 2002. In June 2003, the Company recorded bad debt expense of approximately \$650,000 for all rent and maintenance reserves owed by a lessee, mentioned above, which defaulted on its payment obligations under leases for three aircraft. The Company also expensed \$150,000, which is the maximum amount that the Company guaranteed under a spare parts lease between the lessee and a third-party maintenance vendor. The Company also expensed \$100,000 and \$150,000 in March and June 2003, respectively, related to a portion of the amounts due from another lessee for rent and maintenance, which has been and continues to be performed to meet the return conditions of the lease. Although the Company holds a security deposit from this lessee, the amount of the deposit is not sufficient to pay the estimated amounts due.

Professional fees and general and administrative expenses were approximately \$160,000 and \$73,000 higher in the six months and three months ended June 30, 2003, respectively, versus 2002, primarily due to higher legal expense as a result of increased recurring costs and the amount of fees which would have been amortized over the remaining lease term, but which were written off in connection with the lessee default mentioned above. Accounting expense and premiums for aircraft and directors and officers insurance were also higher in 2003.

The Company's effective tax rates in the six months and three months ended June 30, 2003 were approximately 36% and 35%, respectively, versus 34% and 35% for the six months and three months ended June 30, 2002, respectively. The change in rate for the six month periods from year to year was primarily a result of the recognition of tax benefits relating to different state tax rates than had previously been accrued.

### Liquidity and Capital Resources

The Company is currently financing its assets primarily through credit facility borrowings, special purpose financing and excess cash flow.

#### a. Credit facility

The Company's credit facility, originally set to expire on June 28, 2003, bore interest through March 30, 2002, at the Company's option, at either (i) prime or (ii) LIBOR plus a margin of 200 to 250 basis points depending on certain financial ratios. On March 7, 2002, the Company and its lenders agreed to modify certain financial covenants contained in the loan agreement for the facility in order to enable the Company to continue to take advantage of business

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opportunities in the current industry environment of increased market demand for shorter-term leases. The changes, originally in effect through December 31, 2002, were extended through February 28, 2003. In return for granting such changes, the Company's lenders increased the margin on the interest rates chosen by the Company from a floating margin to a fixed margin of 275 basis points, effective March 31, 2002. On March 1, 2003, the margin returned to its original floating rate.

In June 2003, the Company reached an agreement with its lenders to accommodate the departure of one of the participating lenders that had decided it no longer wished to participate in aviation finance, and to extend the maturity date of its credit facility from June 28, 2003, until August 28, 2003. The Company made a repayment to reduce total outstanding indebtedness to \$39,905,000, which was allocated between the two remaining participants. The credit limit was reduced from \$50 million to \$40 million for the remaining term. At the same time, the Company reached agreement with its lenders to amend its credit agreement to make certain revisions to the financial covenants, relating to net worth and debt coverage ratios, and age of aircraft collateral, under the facility. The amendment also provides for a fixed interest rate margin of 275 basis points.

In accordance with the agreement, the Company must maintain compliance with certain financial covenants. As a result of the substantial net loss incurred during the second quarter of 2003, the Company was out of compliance with a financial ratio covenant on June 30, 2003. The Company has commenced discussions with the agent bank for the credit facility regarding a waiver of that covenant. If a waiver is refused, the agent bank could declare the credit facility in default and accelerate the debt repayment and/or force the Company to liquidate its assets. The Company, however, anticipates that no such action will be taken by the agent bank so long as negotiation of the renewed credit facility continues. As of June 30, 2003, the Company was in compliance with all other covenants, \$39,905,000 was outstanding under the credit facility, and interest of \$4,920 was accrued.

The Company and its lenders are continuing to discuss the final terms of the renewal of the credit facility for an additional two years. The Company expects to be able to obtain such facility at reasonable market terms, which will include a revised financial ratio covenant that will resolve the Company's current non-compliance. If the Company is unable to secure such a renewal of the credit facility, it likely would have to sell assets in order to repay its indebtedness under the facility. Such sales would likely not be on favorable terms to the Company as the full market value of the assets sold may not be realized by the Company in order to expedite the consummation of the sales.

Even if the Company is able to successfully sell a portion of its assets and use the proceeds to repay the credit facility, if a renewed or replacement facility is not obtained, the Company's future ability to acquire assets will be significantly impaired, as this facility is the Company's primary means of financing acquisitions and no other sources of acquisition financing are immediately available. Thus, the renewal or replacement of the facility in an amount equal or greater than the current \$40 million limit will be critical to the Company's asset and revenue growth.

The Company's interest expense generally moves up or down with the prevailing interest rates, as the Company has not entered into any interest rate hedge transactions for the credit facility indebtedness. Because aircraft owners seeking financing generally can obtain financing through either leasing transactions or traditional secured debt financings, prevailing interest rates are a significant factor in determining market lease rates, and market lease rates generally move up or down with prevailing interest rates, assuming supply and demand of the desired equipment remain constant. However, because lease rates for the Company's assets typically are fixed under existing leases, the Company usually does not experience any positive or negative impact in revenue

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from changes in market lease rates due to interest rate changes until existing leases have terminated.

### b. Special purpose financing

In November 1999, AeroCentury LLC acquired two aircraft using cash and bank financing separate from its credit facility. During 2002, the Company used funds from its credit facility to repay the outstanding bank financing related to both aircraft.

A similar financing was concluded in September 2000, consisting of a note in the amount of \$3,575,000, due April 18, 2003, which bore fixed interest at 8.36% through April 17, 2003, for the acquisition of a deHavilland DHC-8 aircraft. The note is collateralized by this aircraft and is non-recourse to the Company. Payments due under the note consisted of monthly principal and interest and a balloon principal payment due on the maturity date. The balance of the note payable at June 30, 2003 was \$2,362,420 and interest of \$3,800 was accrued. As of June 30, 2003, the Company was in compliance with all covenants of this loan agreement. The Company and the lessee have agreed to a short-term extension of the lease through November 15, 2003, with periodic options to terminate it. At the same time, the lender agreed to extend the financing through March 19, 2006, with borrower prepayment options at June 30, 2003 and November 30, 2003. During the term of the extension, payments due under the note consist of monthly principal and interest at the rate of one-month LIBOR plus 3%, with a balloon payment at maturity. The financing also provides for a six month remarketing period at the expiration of the lease or if the lease is terminated prior to its expiration date. Payments due on the financing are reduced during this remarketing period and the balloon principal payment is due at the end of the six month period. The Company believes it will have sufficient cash to meet the reduced payment obligations required by the lender if the lease is terminated, assuming that the aircraft is re-leased within six months, which the Company believes is a reasonable period. The Company anticipates that the lessee of this aircraft will extend the lease through the maturity date of the financing. If the lessee does not do so, and the Company is unable to re-lease the aircraft within the six month remarketing period, the Company would have to re-negotiate the financing or refinance the loan using the Company's credit facility. If no such financing were available, the Company likely would have to sell the aircraft.

### c. Cash flow

The Company's primary source of revenue is lease rentals of its aircraft assets. It is the Company's policy to monitor each lessee's needs in periods before leases are due to expire. If it appears that a customer will not be renewing its lease, the Company immediately initiates marketing efforts to locate a potential new lessee or purchaser for the aircraft. This procedure helps the Company reduce the time that an asset will be "off-lease." The Company's aircraft are subject to leases with varying expiration dates through June 2007.

Although the Company has experienced a significant net loss for the six months and three months ended June 30, 2003, given the varying lease terms and expiration dates for the aircraft in the Company's portfolio as well as the anticipated timing of certain maintenance work to be performed, assuming that its credit facility is renewed for two years under market terms, management believes that the Company will have adequate cash flow to meet its on-going operational needs.

The Company's cash flow from operations for the six months ended June 30, 2003 versus the six months ended June 30, 2002 decreased by approximately \$932,000. The decrease was due primarily to the effect of the change in net income,

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deposits and deferred taxes. The effect of these changes was partially offset by the positive effect of the change in accounts receivable, accounts payable and accrued expenses and maintenance deposits and accrued costs.

No cash flow was used for equipment purchases during the six months ended June 30, 2003. Equipment purchases of \$316,600, for equipment added to aircraft already owned, were made in the six months ended June 30, 2002. The decrease in cash flow used by financing activities from year to year was primarily a result of lower repayments on the Company's credit facility in 2003 versus 2002.

### Outlook

The Company's near-term focus will be on renewing its credit facility, which expires on August 28, 2003. Additionally, the Company will be seeking to increase its credit limit under the facility to \$50 million. This will likely require the addition of a lender to the current loan participant group. The Company is in ongoing discussions with the agent bank on these matters, and anticipates that it will be able to renew the facility in advance of the August 28, 2003 expiration date. Based on its discussions with a potential third participant, the Company believes that the credit facility will be returned to its \$50 million limit at the same time that the credit facility is renewed.

As discussed above in "Liquidity and Capital Resources," as a result of its substantial net loss for the second quarter, the Company is currently out of compliance with a debt coverage ratio financial covenant under its credit facility agreement. The Company is seeking a waiver of that covenant from the agent bank, and anticipates that it will receive such a waiver and that further, under the renewed credit facility, the covenant in question will be revised to take into account the Company's current financial circumstances.

If the Company is unable to secure a renewal of the credit facility, it likely would have to sell assets in order to repay its indebtedness under the facility. See "Factors that May Affect Future Results - Renewal of the Credit Facility," below.

The Company has one aircraft financed under a special purpose financing, separate from the credit facility. The loan is collateralized by the financed aircraft and is non-recourse to the Company. The current loan agreement provides for a maturity date of March 19, 2006, with prepayment options at June 30, 2003, and November 30, 2003. The lease for the financed aircraft expires on November 15, 2003. The Company anticipates that the lessee of this aircraft will extend the lease through the maturity date of the financing. If the lessee does not do so, the Company will be required to find another lessee or sell the aircraft. See "Factors that May Affect Future Results - Special Purpose Financing; Lessee Renewal," below.

The default by a Haitian lessee combined with the weak credit position of a Brazilian lessee significantly affected the Company's results for the second quarter. The Company does not believe that it will experience similar events with other lessees of the Company in the near term. If, however, the aircraft industry weakens further, this may affect the performance of lessees that currently appear creditworthy. See "Factors that May Affect Future Results - General Economic Conditions," below.

The Company anticipates that the return of two DHC-7 aircraft from Haiti may require a significant amount of time to repossess and prepare for remarketing.

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Further, the Company believes that the aircraft, once ready, will be relatively difficult to re-lease based on prior experience with this type of aircraft. Therefore, the Company anticipates that a substantial amount of time may be required to return these DHC-7 aircraft into revenue-generating status. See "Factors that May Affect Future Results - Repossession of Haitian Lessee Aircraft," below.

The Brazilian lessee has agreed to sign a note, in an amount equal to the rent and maintenance in excess of the security deposit held by the Company, at the time the aircraft is delivered to the Company. The Company has recorded an allowance against the amounts receivable and believes that such allowance is sufficient.

The current lease rates for the Company's aircraft are depressed due to the weakened financial condition of the airline industry, and the Company does not foresee a recovery in lease rates in the short term. Therefore, as older leases expire and are replaced by renewals or re-leases to new customers at current market rates, it is likely that overall lease revenues will decline further. In the near term, the Company anticipates that revenue growth will likely only occur through acquisition of new leased assets, which will likely only occur after the credit facility is renewed and enlarged, if possible, to \$50 million. See "Factors that May Affect Future Results - Renewal of Credit Facility" below.

The Company continues to review its asset valuations in light of the worldwide economic downturn. Although the Company did not make any valuation adjustments during 2002 or the first half of 2003, any future adjustments, if necessary, would negatively affect the Company's financial results and the collateral available for the Company's credit facility. In addition, the Company's periodic review of the adequacy of its maintenance reserves, as well as routine and manufacturer-required maintenance for off-lease aircraft, may result in changes to estimated maintenance expense, further reducing earnings.

### Factors that May Affect Future Results

**Renewal of the Credit Facility.** As discussed in "Outlook" above, the Company's credit facility will expire on August 28, 2003. If the Company is not able to renew the credit facility for the full outstanding amount, and cannot find suitable alternative financing, it may be required to make a principal repayment of the outstanding balance, or that portion of the balance for which replacement financing is not obtained. The Company does not have sufficient cash reserves to make a repayment of a significant portion of the outstanding credit facility indebtedness and would be forced to sell assets in order to raise funds to make such repayment. Such sales would likely not be on favorable terms to the Company as the full market value of the assets sold may not be realized by the Company in order to expedite the sales.

Even if the Company is able to successfully sell a portion of its assets and use the proceeds to make a required repayment under the credit facility, if a renewed or replacement facility is not obtained, the Company's future ability to acquire assets would be significantly impaired, as the credit facility is the Company's primary means of financing acquisitions and no other sources of acquisition financing are immediately available. Thus the renewal or replacement of the Company's credit facility in an amount at least equal to the current \$40 million limit will be critical to the Company's liquidity. The increase of the credit limit to \$50 million will be critical for the Company's asset and revenue growth.

**Credit Facility Repayment Obligations.** If a significant portion of the collateral base goes off-lease for an extended period of time (see "Ownership

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Risks" below), this could trigger a covenant default and an obligation to repay a portion of the outstanding indebtedness under the credit facility. While the Company currently does not anticipate that it will be required to make any repayments in the near term, this belief is based on certain assumptions regarding renewal of existing leases, a lack of extraordinary interest rate increases, no lessee defaults or bankruptcies, and certain other matters that the Company deems reasonable in light of its experience in the industry. There can be no assurance that these assumptions will turn out to be correct. If the assumptions do not prove to be true, and the Company has not obtained an applicable waiver or amendment of applicable covenants from its lenders to deal with the situation, the Company may have to sell a significant portion of its portfolio in order to maintain compliance with the covenants, or, if that is not possible, default on its credit facility.

**Repossession of Haitian Lessee Aircraft.** As discussed in Note 2 to the Company's June 30, 2003 Consolidated Financial Statements, above, the Company has declared a default under the lease for two DHC-7 aircraft leased to a Haitian carrier. The Company is currently in the process of exercising its legal remedies to repossess the aircraft from the lessee. Because the lessee and the aircraft are located in a foreign country, there is risk that the repossession procedure will not be as promptly or as easily accomplished as would be the case if this were a U.S. lessee (See, "International Risks" and "Risks Related to Regional Carriers" below). Any delay in regaining possession of the aircraft will necessarily delay the Company's ability to prepare the aircraft for remarketing and will prevent the Company from earning any revenue with respect to these aircraft. Further, the repossession procedure may require substantial legal, logistical and other related costs to the Company, which at this time cannot be calculated.

The two aircraft being repossessed are special purpose aircraft, with short take-off and landing abilities, which make them attractive to specific niche operators. Because they have four engines, however, they are relatively more expensive to operate than other two-engine 50-passenger turboprop aircraft and, therefore, unattractive to operators not requiring the aircraft's special characteristics. Thus, it has been the Company's experience that the remarketing period for DHC-7 aircraft may be significantly longer than for other similar turboprop aircraft. Consequently, a significant amount of time may pass before the DHC-7 aircraft begin to generate cash flow for the Company.

**General Economic Conditions.** The Company's business is dependent upon general economic conditions and the strength of the travel and transportation industry. The industry is experiencing a cyclical downturn which began in mid-2001. This downturn was exacerbated by the terrorist attacks of September 11, 2001. More recently, fears surrounding Severe Acute Respiratory Syndrome ("SARS") caused a reduction in airline passenger loads, particularly in markets where the outbreak is concentrated, from which the affected carriers have not yet fully recovered. As a result, there continues to be a severe reduction in air travel and less demand for aircraft capacity by the major air carriers. The duration of the downturn is uncertain.

The Company's lessees and targeted potential lessees have been primarily outside the U.S. If those lessees experience financial difficulties, this could, in turn, affect the Company's financial performance. It appears that the downturn has had an impact on some non-U.S. regional carriers, but it remains to be seen how widespread the impact will be and how severely such carriers will be affected. It is possible that in certain instances, current economic circumstances may favor the Company, in that planned aircraft replacements for the Company's leased aircraft by its lessees may be cancelled or postponed, resulting in greater likelihood of renewals by existing lessees. Further, demand for more economically operated turboprop aircraft, which make up the Company's portfolio, relative to the more expensive new regional jets, may increase (see

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"Leasing Risks" below). However, there can be no assurance that the Company will realize any increase in renewals of existing leases or experience an increase in demand for turboprop aircraft.

Since regional carriers are generally not as well-capitalized as major air carriers, the downturn may result in the increased possibility of an economic failure of one or more of the Company's lessees. The combined effect of decreased air travel, further weakening of the industry as a result of subsequent threats of attacks similar to the September 11 events, an increase in the price of jet fuel due to fears of hostilities, and increased costs and reduced operations by air carriers due to new security directives, depending on their scope and duration, could have a material adverse impact on the Company's lessees and thus the Company's results.

At this time, in response to lower passenger loads, many carriers have reduced capacity, and as a result there has been a reduced demand for aircraft. As a result, market lease rental rates have decreased. This reduced market value for aircraft could affect the Company's results if the market value of an asset or assets in the Company's aircraft portfolio falls below book value, and the Company determines that a write-down of the value on the Company's book is appropriate. Furthermore, as older leases expire and are replaced by lease renewals or re-leases at current depressed rates, the lease revenue of the Company on its existing portfolio is likely to decline, with the magnitude of the decline dependent on the length of the downturn and the depth of the decline in market rents.

Special Purpose Financing; Lessee Renewal. The Company has one aircraft financed under special purpose financing, separate from the credit facility. The financed aircraft is the sole recourse collateral for the loan. Under the loan agreement, the maturity date of the loan is March 19, 2006. Currently, the lease for the aircraft expires on November 30, 2003. If the lessee does not renew the lease, the Company will have a six-month remarketing period, beginning at the expiration of the lease. If the Company is unable to re-lease the aircraft within the six-month remarketing period, the Company would have to re-negotiate the financing. If the Company is unable to obtain such financing, it likely would have to sell the aircraft in order to repay the special purpose financing by the maturity date. There is no assurance that a sale under those terms would yield a purchase price sufficient to repay the special purpose loan from the sales proceeds.

Risks of Debt Financing. The Company's use of acquisition financing under its credit facility and its special purpose financings subjects the Company to increased risks of leveraging. If, due to a lessee default, the Company is unable to repay the debt secured by the aircraft acquired, then the Company could lose title to the acquired aircraft in a foreclosure proceeding. With respect to the credit facility, the loans are secured by the Company's existing assets as well as the assets acquired with each financing. Any default under the credit facility could result in foreclosure upon not only the asset acquired using such financing, but also the existing assets of the Company securing the loan.

All of the Company's current credit facility indebtedness carries a floating interest rate based upon either the lender's prime rate or a floating LIBOR rate. Interest rates are currently at historically low levels and this has partially offset the effect of falling market lease rates. If interest rates rise, and lease rates do not increase at the same time, the Company would experience lower net revenues and, if the interest rate increase were great enough, may not be able to cover its interest expense with lease revenue.

Leasing Risks. The Company's successful negotiation of lease extensions,

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re-releases and sales may be critical to its ability to achieve its financial objectives, and involves a number of risks. Demand for lease or purchase of the assets depends on the economic condition of the airline industry which is, in turn, sensitive to general economic conditions. The ability to remarket equipment at acceptable rates may depend on the demand and market values at the time of remarketing. The Company anticipates that the bulk of the equipment it acquires will be used aircraft equipment. The market for used aircraft is cyclical, and generally reflects economic conditions and the strength of the travel and transportation industry. The demand for and value of many types of used aircraft in the recent past has been depressed by such factors as airline financial difficulties, increased fuel costs, the number of new aircraft on order and the number of aircraft coming off-lease. The Company's expected concentration in a limited number of airframe and aircraft engine types (generally, turboprop equipment) subjects the Company to economic risks if those airframe or engine types should decline in value. If "regional jets" were to be used on short routes previously served by turboprops, even though regional jets are more expensive to operate than turboprops, the demand for turboprops could lessen. This could result in lower lease rates and values for the Company's existing turboprop aircraft.

**Lessee Credit Risk.** If a customer defaults upon its lease obligations, the Company may be limited in its ability to enforce remedies. Most of the Company's lessees are small regional passenger airlines, which may be even more sensitive to airline industry market conditions than the major airlines. As a result, the Company's inability to collect rent under a lease or to repossess equipment in the event of a default by a lessee could have a material adverse effect on the Company's revenue. If a lessee that is a certified U.S. airline is in default under the lease and seeks protection under Chapter 11 of the United States Bankruptcy Code under Section 1110 of the Bankruptcy Code, the Company would be automatically prevented from exercising any remedies for a period of 60 days. By the end of the 60-day period, the lessee must agree to perform the obligations and cure any defaults, or the Company would have the right to repossess the equipment. This procedure under the Bankruptcy Code has been subject to significant recent litigation, however, and it is possible that the Company's enforcement rights may be further adversely affected by a declaration of bankruptcy by a defaulting lessee.

**Risks Related to Regional Air Carriers.** Because the Company has concentrated its existing leases and intends to concentrate on leases to regional air carriers, it is subject to certain risks. First, some of the lessees in the regional air carrier market are companies that are start-up, low capital, low margin operations. Often, the success of such carriers is dependent upon arrangements with major trunk carriers, which may be subject to termination or cancellation by such major carrier. These types of lessees result in a generally higher lease rate on aircraft, but may entail higher risk of default or lessee bankruptcy. The Company evaluates the credit risk of each lessee carefully, and attempts to obtain a third party guaranty, letters of credit or other credit enhancements, if it deems them necessary. There is no assurance, however, that such enhancements will be available or that even if obtained will fully protect the Company from losses resulting from a lessee default or bankruptcy. Second, a significant area of growth of this market is in areas outside of the United States, where collection and enforcement are often more difficult and complicated than in the United States.

**Reliance on JMC.** All management of the Company is performed by JMC under a management agreement which is in its seventh year of a 20-year term and provides for an asset-based management fee. JMC is not a fiduciary to the Company or its stockholders. The Company's Board of Directors, however, has ultimate control and supervisory responsibility over all aspects of the Company and owes fiduciary duties to the Company and its stockholders. In addition, while JMC may not owe any fiduciary duties to the Company by virtue of the management agreement, the officers of JMC are also officers of the Company, and in that



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capacity owe fiduciary duties to the Company and the stockholders by virtue of holding such offices with the Company. In addition, certain officers of the Company hold significant ownership positions in JHC and the Company. JMC is also the management company for two other aircraft portfolio owners, JetFleet III, which raised approximately \$13,000,000 from investors, and AeroCentury IV, Inc. ("AeroCentury IV"), which raised approximately \$5,000,000 from investors. JetFleet III and AeroCentury IV are in the liquidation or wrap-up phase. In the first quarter of 2002, AeroCentury IV defaulted on certain obligations to noteholders. The indenture trustee for AeroCentury IV's noteholders has foreclosed and has taken over management of the remaining two assets. JetFleet III is in compliance with the terms of its trust indenture.

The management agreement may be terminated upon a default in the obligations of JMC to the Company, and provides for liquidated damages in the event of a wrongful termination of the agreement by the Company. All of the officers of JMC are also officers of the Company, and certain directors of the Company are also directors of JMC. Consequently, the directors and officers of JMC may have a conflict of interest in the event of a dispute over obligations between the Company and JMC. Although the Company has taken steps to prevent conflicts of interest arising from such dual roles, such conflicts may still occur.

**Ownership Risks.** Most of the Company's portfolio is leased under operating leases, where the terms of the leases are less than the entire anticipated useful life of an asset. The Company's ability to recover its purchase investment in an asset subject to an operating lease is dependent upon the Company's ability to profitably re-lease or sell the asset after the expiration of the initial lease term. Some of the factors that have an impact on the Company's ability to re-lease or sell include worldwide economic conditions, general aircraft market conditions, regulatory changes that may make an asset's use more expensive or preclude use unless the asset is modified, changes in the supply or cost of aircraft equipment and technological developments which cause the asset to become obsolete. In addition, a successful investment in an asset subject to an operating lease depends in part upon having the asset returned by the lessee in serviceable condition as required under the lease. If the Company is unable to remarket its aircraft equipment on favorable terms when the operating lease for such equipment expires, the Company's business, financial condition, cash flow, ability to service debt and results of operation could be adversely affected.

**International Risks.** The Company has focused on leases in overseas markets, which the Company believes present opportunities. Leases with foreign lessees, however, may present somewhat different credit risks than those with domestic lessees.

Foreign laws, regulations and judicial procedures may be more or less protective of lessor rights than those which apply in the United States. The Company could experience collection problems related to the enforcement of its lease agreements under foreign local laws and the remedies in foreign jurisdictions. The protections potentially offered by Section 1110 of the Bankruptcy Code would not apply to non-U.S. carriers, and applicable local law may not offer similar protections. Certain countries do not have a central registration or recording system with which to locally establish the Company's interest in equipment and related leases. This could add difficulty in recovering an aircraft in the event that a foreign lessee defaults.

A lease with a foreign lessee is subject to risks related to the economy of the country or region in which such lessee is located, which may be weaker than the U.S. economy. On the other hand, a foreign economy may remain strong even though the U.S. economy does not. A foreign economic downturn may impact a foreign lessee's ability to make lease payments, even though the U.S. and other

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economies remain stable. Furthermore, foreign lessees are subject to risks related to currency conversion fluctuations. Although the Company's current leases are all payable in U.S. dollars, the Company may agree in the future to leases that permit payment in foreign currency, which would subject such lease revenue to monetary risk due to currency fluctuations. Even with U.S. dollar-denominated lease payment provisions, the Company could still be affected by a devaluation of the lessee's local currency that would make it more difficult for a lessee to meet its U.S. dollar-denominated lease payments, increasing the risk of default of that lessee, particularly if its revenue is primarily derived in the local currency.

Government Regulation. There are a number of areas in which government regulation may result in costs to the Company. These include aircraft registration, safety requirements, required equipment modifications, and aircraft noise requirements. Although it is contemplated that the burden and cost of complying with such requirements will fall primarily upon lessees of equipment, there can be no assurance that the cost will not fall on the Company. Furthermore, future government regulations could cause the value of any non-complying equipment owned by the Company to decline substantially.

Competition. The aircraft leasing industry is highly competitive. The Company competes with aircraft manufacturers, distributors, airlines and other operators, equipment managers, leasing companies, equipment leasing programs, financial institutions and other parties engaged in leasing, managing or remarketing aircraft, many of which have significantly greater financial resources and more experience than the Company. The Company, however, believes that it is competitive because of JMC's experience and operational efficiency in identifying and obtaining financing for the transaction types desired by regional air carriers. This market segment, which is characterized by transaction sizes of less than \$10 million and lessee credits that may be strong, but are generally unrated, is not well served by the Company's larger competitors in the aircraft industry. JMC has developed a reputation as a global participant in this segment of the market, and the Company believes this will benefit the Company. There is, however, no assurance that the lack of significant competition from the larger aircraft leasing companies will continue or that the reputation of JMC will continue to be strong in this market segment and benefit the Company.

Casualties, Insurance Coverage. The Company, as owner of transportation equipment, may be named in a suit claiming damages for injuries or damage to property caused by its assets. As a triple net lessor, the Company is generally protected against such claims, since the lessee would be responsible for, insure against and indemnify the Company for, such claims. Further, some protection may be provided by the United States Aviation Act with respect to its aircraft assets. It is, however, not clear to what extent such statutory protection would be available to the Company and such act may not apply to aircraft operated in foreign countries. Also, although the Company's leases generally require a lessee to insure against likely risks, there may be certain cases where the loss is not entirely covered by the lessee or its insurance. Though this is a remote possibility, an uninsured loss with respect to the equipment, or an insured loss for which insurance proceeds are inadequate, would result in a possible loss of invested capital in and any profits anticipated from, such equipment, as well as a potential claim directly against the Company.

Possible Volatility of Stock Price. The market price of the Company's common stock could be subject to fluctuations in response to operating results of the Company, changes in general conditions in the economy, the financial markets, the airline industry, changes in accounting principles or tax laws applicable to the Company or its lessees, or other developments affecting the Company, its customers or its competitors, some of which may be unrelated to the Company's

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performance. Also, because the Company has a relatively small capitalization of approximately 1.5 million shares, there is a correspondingly limited amount of trading of the shares. Consequently, a single or small number of trades could result in a market fluctuation not related to any business or financial development relating to the Company.

### Item 3. Controls and Procedures

Quarterly evaluation of the Company's Disclosure Controls and Internal Controls. As of the end of the period covered by this report, the Company evaluated the effectiveness of the design and operation of its "disclosure controls and procedures" ("Disclosure Controls"), and its "internal control over financial reporting" ("Internal Controls"). This evaluation (the "Controls Evaluation") was done under the supervision and with the participation of management, including the Company's Chief Executive Officer ("CEO") and Chief Financial Officer ("CFO"). Rules adopted by the SEC require that in this section of the Report the Company present the conclusions of the CEO and the CFO about the effectiveness of our Disclosure Controls and Internal Controls based on and as of the date of the Controls Evaluation.

CEO and CFO Certifications. Attached as exhibits to this report are two separate forms of "Certifications" of the CEO and the CFO. The first form of Certification is required in accordance with Section 302 of the Sarbanes-Oxley Act of 2002 (the "Section 302 Certification"). This section of the report which you are currently reading is the information concerning the Controls Evaluation referred to in the Section 302 Certifications and this information should be read in conjunction with the Section 302 Certifications for a more complete understanding of the topics presented.

Disclosure Controls and Internal Controls. Disclosure Controls are procedures that are designed with the objective of ensuring that information required to be disclosed in the Company's reports filed under the Securities Exchange Act of 1934 (the "Exchange Act"), such as this report, is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's ("SEC") rules and forms. Disclosure Controls are also designed with the objective of ensuring that such information is accumulated and communicated to the Company's management, including the CEO and CFO, as appropriate to allow timely decisions regarding required disclosure. Internal Controls are procedures which are designed with the objective of providing reasonable assurance that (1) the Company's transactions are properly authorized; (2) the Company's assets are safeguarded against unauthorized or improper use; and (3) the Company's transactions are properly recorded and reported, all to permit the preparation of the Company's financial statements in conformity with generally accepted accounting principles.

Limitations on the Effectiveness of Controls. The Company's management, including the CEO and CFO, does not expect that its Disclosure Controls or its Internal Controls will prevent all error and all fraud. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the Company have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the control. The design of any system of controls also is based in part upon certain

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assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions; over time, control may become inadequate because of changes in conditions, or the degree of compliance with the policies or procedures may deteriorate. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected.

Scope of the Controls Evaluation. The CEO/CFO evaluation of the Company's Disclosure Controls and the Company's Internal Controls included a review of the controls objectives and design, the controls implementation by the company and the effect of the controls on the information generated for use in this report. In the course of the Controls Evaluation, we sought to identify data errors, controls problems or acts of fraud and to confirm that appropriate corrective action, including process improvements, were being undertaken. This type of evaluation will be done on a quarterly basis so that the conclusions concerning controls effectiveness can be reported in the Company's quarterly reports on Form 10-QSB and annual report on Form 10-KSB. The Company's Internal Controls are also evaluated on an ongoing basis by other personnel in the Company's finance organization and by the Company's independent auditors in connection with their audit and review activities. The overall goals of these various evaluation activities are to monitor the Company's Disclosure Controls and the Company's Internal Controls and to make modifications as necessary; the Company's intent in this regard is that the Disclosure Controls and the Internal Controls will be maintained as dynamic systems that change (including with improvements and corrections) as conditions warrant.

Among other matters, the Company sought in its evaluation to determine whether there were any "significant deficiencies" or "material weaknesses" in the Company's Internal Controls, or whether the Company had identified any acts of fraud involving personnel who have a significant role in the Company's Internal Controls. This information was important both for the Controls Evaluation generally and because item 5 in the Section 302 Certifications of the CEO and CFO require that the CEO and CFO disclose that information to the Audit Committee of the Company's Board and to the Company's independent auditors and to report on related matters in this section of the Report. In the professional auditing literature, "significant deficiencies" are referred to as "reportable conditions"; these are control issues that could have a significant adverse effect on the ability to record, process, summarize and report financial data in the financial statements. A "material weakness" is defined in the auditing literature as a particularly serious reportable condition where the internal control does not reduce to a relatively low level the risk that misstatements caused by error or fraud may occur in amounts that would be material in relation to the financial statements and not be detected within a timely period by employees in the normal course of performing their assigned functions. The Company also sought to deal with other controls matters in the Controls Evaluation, and in each case if a problem was identified, the Company considered what revision, improvement and/or correction to make in accordance with our on-going procedures.

In accordance with SEC requirements, the CEO and CFO note that, there has been no significant change in Internal Controls that occurred during our most recent fiscal quarter that has materially affected or is reasonably likely to materially affect our Internal Controls.

Conclusions. Based upon the Controls Evaluation, the Company's CEO and CFO have concluded that, subject to the limitations noted above, the Company's Disclosure Controls are effective to ensure that material information relating to the Company and its consolidated subsidiaries is made known to management, including the CEO and CFO, particularly during the period when periodic reports are being prepared, and that the Company's Internal Controls are effective to provide

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reasonable assurance that the Company's financial statements are fairly presented in conformity with generally accepted accounting principles.

### Item 4. Submission of Matters to a Vote of Security Holders

On April 24, 2003, the Company held its annual stockholder's meeting in San Carlos, California. At that meeting, Marc J. Anderson and Thomas W. Orr were re-elected to the Board of Directors.

The vote tally was as follows:

	FOR ELECTION	WITHHELD
Mr. Orr	1,128,322	5,662
Mr. Anderson	1,128,058	5,926

The stockholders also confirmed the appointment of PricewaterhouseCoopers LLP as auditors of the Company.

The vote was as follows:

In Favor	1,123,919
Against	1,483
Abstaining	8,852

### Item 6. Exhibits and Reports on Form 8-K.

#### (a) Exhibits

##### Exhibit

##### Number

##### Description

- 31.1 Certification of Neal D. Crispin, Chief Executive Officer, pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification of Toni M. Perazzo, Chief Financial Officer, pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1\* Certification of Neal D. Crispin, Chief Executive Officer, pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 32.2\* Certification of Toni M. Perazzo, Chief Financial Officer, pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

\* These certificates are furnished to, but shall not be deemed to be filed with, the Securities and Exchange Commission ("SEC").

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#### (b) Reports on Form 8-K.

Report on Form 8-K disclosing First Quarter 2003 Results, filed with the SEC on April 22, 2003.

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### SIGNATURES

In accordance with the requirements of the Exchange Act, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

AEROCENTURY CORP.

Date: August 13, 2003

By: /s/ Toni M. Perazzo

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Toni M. Perazzo

Title: Senior Vice President-Finance and  
Chief Financial Officer