

remaining intangible value would be dependent upon the other major network carriers' desire to add another hub to their network systems at Detroit, Memphis or Minneapolis. Currently, there are limited options for Pinnacle Airlines as all of the major networks have very strong ties with other regional operators.

Eclat Report Financial Review of Pinnacle Airlines and Stability of Northwest—According to the report, Pinnacle Airlines is currently in sound financial shape with a current operating margin of 13.2 percent (13.2%), a profit margin of 8.9 percent (8.9%) and a return on equity (ROE) of 29.1 percent (29.1%). The revenue growth for Pinnacle Airlines has been strong over the period of 1998–2001 at a compound average annual rate of 28.0 percent (28.0%). In the first 9 months of 2002, this growth actually accelerated to 61.4 percent (61.4%) in a year-over-year comparison.

The Eclat Report concludes that through 2005 (the amendable date for the contract with Northwest), there is no reason to suspect that the company will not continue such strong revenue growth. "Salaries, wages, and benefits" only accounted for 21.5 percent (21.5%) of costs (the average is mid-thirties). As the company currently is constructed (prior to the expected IPO), their long-term debt load is virtually non-existent and their liquidity is superb. Current financial conditions clearly indicate an ability to cover any short-term obligations. However, if the company were to go public, the balance sheet will be fundamentally altered by the assumption of a \$200 million note payable to Northwest. Such a note would raise the debt/equity ratio to 277 percent (277%) and would significantly limit Pinnacle Airlines' ability to borrow in the future and radically raise the cost of capital. Due to the guaranteed operating margin, however, even a note of this magnitude would not be difficult for the company to cover.

In order to estimate the value of a Pinnacle Airlines IPO, Eclat created a model based on the Three-Stage Free Cash Flow to Equity (FCFE) valuation technique.⁴ The result of the FCFE model is that the estimated value of a Pinnacle Airlines IPO is approximately \$221.6 million if Eclat assumes that the growth in the first phase is

approximately 14 percent (14%) and lasts for five years (Eclat Appendix 9–1).⁵ Eclat believes this growth assumption is conservative when compared to Pinnacle Airlines' recent growth, but is based on only the "guaranteed" portion (95 total RJ's) of their agreement with Northwest. The five-year term assumption was a result of the fact that Northwest is able to renegotiate in 2008. This Eclat model was adjusted by Eclat based on differing high growth revenue assumptions and the impact of such adjustments dramatically lowered the value of the IPO. The value of equity for Pinnacle Airlines, assuming a high growth period revenue growth rate of 11 percent (11%), would be \$147.7 million (Eclat Appendix 9–2). Assuming a high growth period revenue growth rate of 8 percent (8%), the value of equity for Pinnacle drops to \$81 million (Eclat Appendix 9–3).

According to Eclat, Northwest has emerged as, perhaps, the most stable airline in the industry with minimal low fare carrier exposure and with the smallest losses of any carrier. Northwest reported a net loss of \$46 million, with operating income of \$8 million in the third quarter of 2002. Northwest ended the quarter with over \$2.5 billion in cash and short-term receivables. Northwest is a global carrier with an alliance with KLM and its Amsterdam hub and a Northwest Tokyo Hub. The labor situation is stable with all of its unions currently under contract.

8. Reasons for Entering into the Exemption Transactions. The Applicant represents that, for several years leading

⁵ During the second stage, the growth assumption is 10 percent (10%) and a term of three years. The 10 percent (10%) is consistent with the industry's long-term revenue average, and the three-year term is based on the belief that such strong growth will last for a total of 8 years from 2003. In the third and final stage, the model assumes that growth will continue to commence at a constant rate of 5 percent (5%). This assumption brings the growth rate back in line with Pinnacle Airlines' growth in the years prior to their arrangement with Northwest. Other assumptions made in the model include Beta and Net Capital Expenditure growth. Pinnacle Airlines' Beta was based on a calculation off of industry average and is assumed to be .66 in the high growth period. According to Eclat, while this appears at first glance to be a very low figure, it is very much related to the terms of the fixed fee relationship with Northwest. According to the terms of the agreement, growth is virtually assured and therefore the company's stock is unlikely to fluctuate as wildly as the market in general. In the other two phases, the firm Beta is linked to the current industry average. The assumptions about net capital expenditure growth in all three phases are standard figures based on historical norms. When estimating the cost of equity for Pinnacle Airlines, a market risk premium of 5.3 percent (5.3%) was assumed. This number is based on the historical risk premium found between stocks and treasury bonds published by the Federal Reserve Bank (in the United States from 1962–2000).

up to 2001, Northwest had been among the most profitable of the nation's major airlines. The Applicant notes Northwest's financial performance in 1998 and 1999 was adversely affected by labor disruptions; however, Northwest's performance quickly recovered in 2000. However, the airline industry began to suffer a significant financial downturn in early 2001 that was substantially worsened by the events of September 11, 2001, which in combination, have disproportionately affected the airline industry. Northwest states that industry losses in 2001 totaled \$10 billion, of which Northwest's share was \$700 million.⁶ Northwest asserts that, because of the potential of a war with Iraq, which has dramatically increased fuel prices, as well as ongoing terrorism threats, the timing of an economic recovery for the airline industry is uncertain. Northwest concludes that to weather the current economic uncertainty, Northwest and other major airlines must maintain a high level of liquidity. The Applicant notes that Northwest is, by many measures, the best prepared among the industry to withstand this difficult period and expects to return to

⁶ These numbers are exclusive of federal funds received by the airlines as a result of the Air Transportation Safety and System Stabilization Act, Pub. L. No. 107–42 (September 21, 2001) (Airline Stabilization Act). In 2001, Northwest recognized \$461 million of grant income from the United States Government that was recorded as non-operating income. The events of September 11, 2001 had an immediate and severe impact on the U.S. airline industry's passenger traffic and yields. Immediately following these events, the Federal Aviation Administration (FAA) ordered all aircraft operating in the U.S. to be grounded, an order that remained in place for over 48 hours. Northwest Airlines was only able to operate a limited portion of its scheduled flights for several days after the grounding order was lifted as it repositioned displaced aircraft and crews. Passenger traffic and yields on both domestic and international flights declined significantly when flights were permitted to resume, and the number of tickets refunded was substantially above normal. Northwest has continued to experience significantly lower revenue and has incurred additional costs (e.g., higher security costs and insurance premiums) as compared to periods prior to September 11, 2001. In addition to increased rates, aviation insurers have also significantly reduced the maximum amount of insurance coverage available to commercial air carriers for liability to persons other than employees or passengers for claims resulting from acts of terrorism, war or similar events.

Under the Airline Stabilization Act, each air carrier is entitled to receive a maximum amount of compensation payments equal to the lesser of (i) its direct and incremental pretax losses attributed to the terrorist attacks for the period of September 11, 2001, to December 31, 2001, or (ii) its available seat mile and/or revenue ton mile allocation of the \$5 billion compensation available under the Airline Stabilization Act. Northwest Airlines received a total of \$410 million as of December 31, 2001, and was expected to receive a final \$51 million of additional funds under the Airline Stabilization Act in early 2002.

⁴ This model is designed to value firms, like Pinnacle Airlines, that are expected to go through three phases of growth—an initial phase of high growth, a transitional period where the growth rate declines, and a steady-state period where growth is stable. Once these growth assumptions are made, the present value of expected free cash flow is calculated.