

 CROATIA AIRLINES

A REGIONAL STAR ALLIANCE MEMBER 

# The Management's Business Report for 2009



April 2010



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## Typical indicators

### Fleet – March 2010

type of aircraft	number	seats	ownership	lease	Ø age (years)	the end at 2009	ownership	lease
Airbus A320	3	486	2	1	12,39	4	2	2
Airbus A319	4	528	4	-	11,13	4	4	-
Q-400	4	152	-	4	1,42	4	-	4
<b>TOTAL</b>	<b>11</b>	<b>1166</b>	<b>6</b>	<b>5</b>	<b>7,81</b>	<b>12</b>	<b>6</b>	<b>6</b>

### Traffic indicators

description		2009	2008	2007
flights (km)	DIST 000	15771	16466	15722
growth rate	%	-4	5	
departure	FLTS	25383	26013	24349
growth rate	%	-2	7	
block hours	BH	33515	35790	33759
growth rate	%	-6	6	
passengers carried	RPAX 000	1751	1869	1715
growth rate	%	-6	9	
freight&mail carried	CGO T	3672	4393	4608
growth rate	%	-16	-5	
passenger km flown	RPKM mln	1245	1372	1303
growth rate	%	-9	5	
available seat -km	ASKM mln	2027	2103	2009
growth rate	%	-4	5	
<b>passenger load factor</b>	<b>PLF %</b>	<b>61,4</b>	<b>65,2</b>	<b>64,9</b>
tonne km flown	TKM mln	115	126	120
available tonne - km	ATKM mln	224	231	220
<b>weight load factor</b>	<b>WLF %</b>	<b>51,1</b>	<b>54,7</b>	<b>54,6</b>

## Financial indicators

Indicators	unit	2009	2008	2007	2006
Operating revenues	mln kn	1,347	1,631	1,464	1,345
Annual change rate	%	-17	11	9	
Total revenues	mln kn	1,439	1,729	1,537	1,510
Annual change rate	%	-17	12	2	
Operating expenses	mln kn	1,512	1,662	1,416	1,361
Annual change rate	%	-9	17	4	
Total expenses	mln kn	1,638	1,818	1,536	1,479
Annual change rate	%	-10	18	4	
Total operating expenses without fuel	mln kn	1,310	1,304	1,169	1,113
Annual change rate	%	0	12	5	
Total expenses without fuel	mln kn	1,436	1,460	1,289	1,231
Annual change rate	%	-2	13	5	
Operating profit/loss	mln kn	-165	-31	48	-16
Operating profit/loss (%of operating rev.)	%	-	-	3.3	-
Operating profit/loss(% of total revenue)	%	-	-	3.1	-
Net profit/loss	mln kn	-199	-89	1	32
Net profit/loss (% of operating revenue)	%	-	-	0.1	2.3
Net profit/loss (% of total revenue)	%	-	-	0.1	2.1
EBIT	mln kn	-	-	57	103
EBITDA	mln kn	-	139	237	268
EBIT margin	%	-	-	3.9	7.7
EBITDA margin	%	-	8.5	16.2	19.9
Unit operating cost	kn/ASKM	0.75	0.79	0.70	0.69
Unit operating cost without fuel	kn/ASKM	0.65	0.62	0.58	0.57
Unit operating revenue	kn/RPKM	1.08	1.19	1.12	1.10
Passenger yield (total pass.rev.in EUR/RPKM)	€cent/RPKM	11.84	13.65	12.66	12.19
Avarage number of employees		1,171	1,122	1,062	1,049
Annual change rate	%	4	6	1	
Net operating profit rate	%	-	-	2.9	4.8
ROE (return on equity)	%	-	-	0.2	4.4
ROCE (return on capital employed)	%	-	-	3.5	5.6
Total asset turnover		0.84	0.94	0.77	0.71
Total asset operating turnover		0.79	0.89	0.73	0.63
Current asset turnover		5.64	5.52	6.53	9.03
Cash ratio		0.10	0.14	0.22	0.25
Quick ratio		0.30	0.50	0.57	0.50
Current ratio		0.40	0.62	0.67	0.62
Financial stability		1.36	1.14	1.06	1.07
Solvency ratio		0.19	0.29	0.34	0.33
Financing ratio (total liabilities/equity)		4.38	2.47	1.92	2.00
Interest cover operating profit		-	-	0.85	-
Cover ratio I (equity/non-current assets)		0.22	0.36	0.40	0.37
Cover ratio II		0.73	0.88	0.94	0.94
Investment ratio		0.09	0.10	0.11	0.06

## Croatia Airlines in 2009 – Introduction

Croatia Airlines is a national air carrier and the Company mission is to connect the Republic of Croatia with the world and to contribute to the development of tourism in the Republic of Croatia. Over the twenty years of its operations, Croatia Airlines has connected Croatian cities with all the major European capital cities and, via these hubs, with the whole world.

Croatia Airlines entered the new millennium with a fleet of new medium-haul aircraft, which has enabled the Company to be positioned today as a medium-size air carrier with one of the most modern aircraft fleets in Europe. In 2009, Croatia Airlines continued the investment cycle in order to further develop its fleet. Two more Q400 aircraft were delivered to the Company, with another two aircraft of the same type to be delivered in 2010.

### Ownership Structure

Croatia Airlines (the Company) is a joint-stock company, with equity capital of 989,975,500 kn, divided into 4,975,476 shares. Of the total number of shares issued, 51,197 are preference shares (CRAL-P-A, CRAL-P-A1, CRAL-P-A2, CRAL-P-A3, CRAL-P-A4) with face value of 100 kn per share and 4,924,279 are ordinary shares (CRAL-R-A) with face value of 200 kn per share.

Review of shareholders and their share capital	Capital (kn)	%
REPUBLIC OF CROATIA	938.175.000	94,77
CROATIAN PRIVATISATION FUND (0/1) FOR DAB	21.315.200	2,15
CROATIAN PRIVATISATION FUND (1/1)	14.413.600	1,46
JANAF DD	2.200.000	0,22
AIRPORT ZAGREB	1.302.500	0,13
CROATIA LLOYD	1.027.000	0,10
ENIKON D.D.	735.600	0,08
RATKO ŽURIĆ	676.200	0,07
CONING ENGINEERING	521.400	0,05
CROATIAN LOTTERY	400.000	0,04
OTHERS	9.209.000	0,93
<b>total</b>	<b>989.975.500</b>	<b>100,00</b>

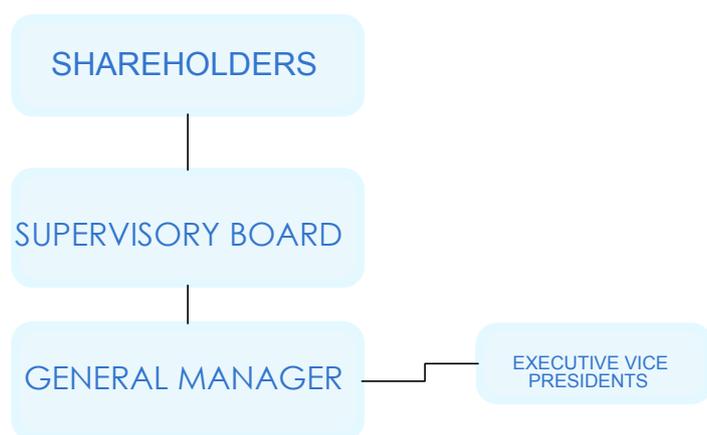
Croatia Airlines d.d. has ownership stakes in the following companies: Amadeus d.d., Pleso prijevoz d.o.o. and Obzor putovanja d.o.o.

Pleso prijevoz d.o.o. is 50% owned by Croatia Airlines, while the other 50% is owned by the Zagreb Airport. Pleso prijevoz is a company that organizes transport of employees of the Zagreb and Split airports, passenger transport between airports and their respective cities and transport of lost luggage.

Amadeus Croatia d.d. was established by Croatia Airlines (95% ownership) and Amadeus GDS, a global distribution system headquartered in Madrid. It enables travel agents on the territory of the Republic of Croatia to access the Amadeus database located in Erding near Munich for the purpose of booking and issuing passenger tickets for transport by aircraft, ship and rail, as well as booking hotel accommodation and rent-a-car vehicles.

Obzor putovanja d.o.o. is 100% owned by Croatia Airlines, and the company organizes business and tourist trips, conferences, congresses and makes incentive travel arrangements.

## The Company's management and organization



The Company organization has its business functions grouped in six Business areas headed by Executive officers and corporate functions organized within the Managing director's office, Corporate affairs office and Operations quality and safety office.

The business area of traffic comprises flight, cabin and land operations and the traffic training centre. The business area of technical operations comprises aircraft maintenance, engineering operations, technical support and technical training. The business area of finance comprises finance, accounting, controlling and revenue accounting. Management of human resources, legal affairs, information technologies, assets and infrastructure are covered by yet another business area. The last two business areas cover network and revenue management and sales and procurement and marketing.

**Human Resources**

At the end of 2009, the Company employed 1,131 persons, including 55 employees in representative offices located abroad.

There was a 4 pp increase in the number of operating employees in the course of 2009 due to the increase in the fleet of aircraft by two units. The number of non-operating employees went down by 2 pp, primarily due to employee retirement with no replacement employment.

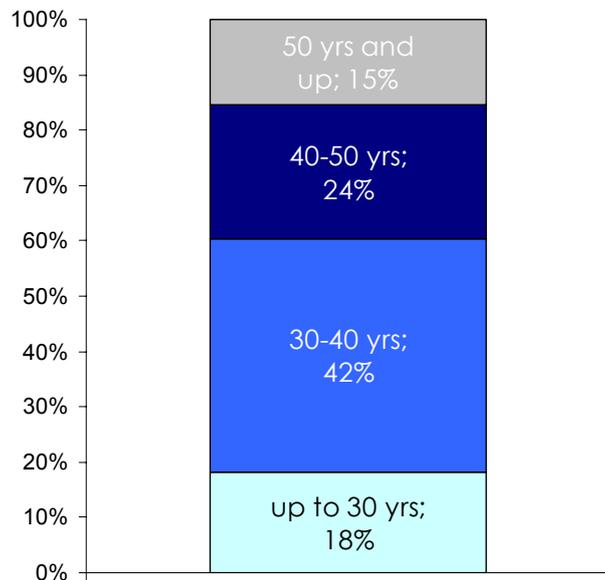
The addition of two new Q400 aircraft to the fleet required employment of an additional number of pilots. The Company employed 61 seasonal cabin staff to meet the requirements of the flight schedule in the summer season. A number of employees, who worked as volunteers in technical sectors in 2008, were given work contracts in March 2009. At the start of the year, Internet and telephone sales services took over not only bookings but also sales of tickets, and the new working-hours organization required employment of 7 additional employees.

The share of Company operating staff<sup>1</sup> is 59pp (672), and non-operative staff represents 41pp (459).

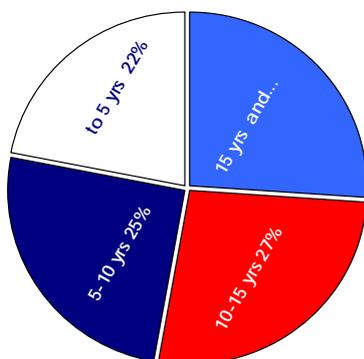
Regarding qualifications, 50pp of employees have university and college degrees, with the average age of employees being equally favourable (38 years), while regarding gender structure, there are more men employed (53pp).

Of the total number of employees, 104 (9pp) have employment contracts for a limited period of time.

Structure by age 2009



Structure by employment record



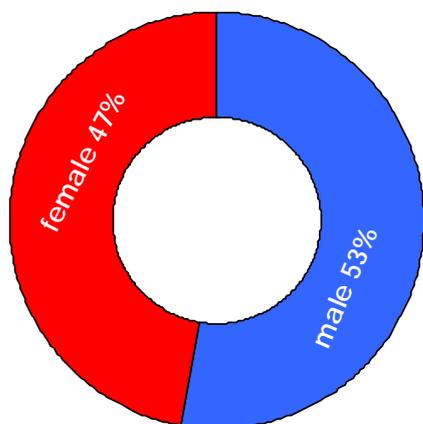
Average years of service of operating staff were 9 years, of non-operating staff 11 years, while the average years of service at the Company level were 10 years.

The above indicators show that staff turnover is low in the Company, given the fact that it was established 20 years ago and that it employed about 200 persons in the first years of its operations. Subsequent development of the Company required higher employment rates up to the year 1998.

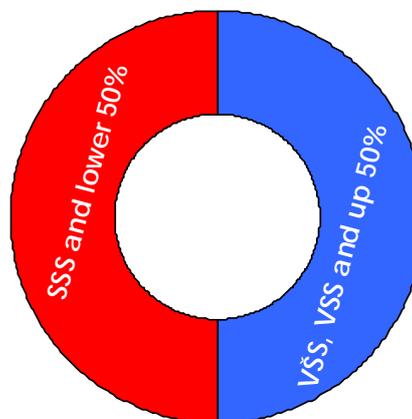
<sup>1</sup> Includes pilots, cabin staff, technical staff, traffic and ground operative staff, and excludes catering staff

There were 22 pp women employed in top and middle management, and in the overall management, there were 45 pp of women employees in 2009.

Structure by gender



Structure by qualifications



Based on the findings of a survey on organizational climate and job satisfaction conducted in 2008, a system of monitoring and developing management competencies in the Company was set up and implemented in 2009 in cooperation with the AT Adria consultancy company, with the goal to improve human resources management in the Company.

Due to the fact that the year 2009 saw a considerable fall in passenger, cargo and mail transport volumes as a consequence of the global crisis and the difficulties experienced by air transport industry, labour productivity measured by air transport industry indicators recorded a fall.

### Labour Productivity

DESCRIPTION		2009.	2008.	2007.
tonne km by employee	000	101,3	113,5	114,3
annual change rate	%	-11	-1	0
passengers carried by employee		1548	1679	1630
annual change rate	%	-8	3	0

#### Training investments and programmes

By continuous investment in employee training, Croatia Airlines continued to develop and strengthen its human resources, because the Company has always considered the industry it operates in as both labour and capital intensive.

Considerable funds are invested every year in employee training, with the focus on specialist training and maintaining the readiness of the Company pilots and cabin staff.

Investment in education (kn)	2009	2008	2007
Operative staff	9.038.224	12.741.691	11.037.487
annual change rate	-29%	15%	51%
Non-operative staff	1.121.429	1.328.785	974.064
annual change rate	-16%	36%	-14%
<b>Total</b>	<b>10.159.653</b>	<b>14.070.477</b>	<b>12.011.551</b>
annual change rate	-28%	17%	-1%

There are years when it is necessary to prepare staff for new aircraft delivery or when a capacity increase is planned, which then requires considerable investments to be made in operational training and education.

Croatia Airlines provides training to its employees simultaneously at three different levels: to operating sector employees, technical sector employees and non-operating sector employees.

The year 2009 was marked in the Technical training centre by active cooperation with the CCAA, aimed at bridging the problems present in the area of aviation industry regulations and implementing corrective measures recommended by the audits carried out. Changes in regulations created the need to train all air mechanics and a number of engineers in Fuel Tank Safety level 2, and 95 % of the needs for this type of training were met in the second half of 2009. Also in 2009, and in agreement with Shannon Aerospace, the programme of basic training for mechanics was continued in order to enable them to obtain the "A" licence in line with the PART 66 regulations. The Technical training centre organized training provided by instructors of Ultra Electronics Controls and Heatcon for the ANVS system on DHC-8 Q400, that is, Hot bonding – composite repairs.

Training of aircraft captains and co-pilots as well as training on a simulator for a new type of aircraft in the Croatia Airlines fleet, the Q400, was carried out in 2009 by the company "Flight Safety International", while practical training took place in a number of European companies. The Croatia Airlines instructors who are certified trainers for the new aircraft type were providing training to our flight staff throughout the year in order to ensure that commercial flight processes are carried out without difficulties.

Our cabin crew was given all the required training in the Croatia Airlines training centre in Zagreb.

When providing training to its employees, Croatia Airlines relies primarily on its internal resources, that is, use of own certified team of instructors. This does not only result in savings of funds, but it also enables the Company to develop its own know-how and be less dependent on external resources while at the same time promoting the Company culture and business strategy.

The E-learning project team, consisting of representatives from all the training organizational units, prepared a project analysing all the prerequisites, necessary investments and possible benefits of introducing E-learning into the existing training system. The project has shown that, provided necessary investments are made, there is potential for more efficient and less costly training to be provided in the future with parallel reduction in the number of actual working hours lost.

Training programmes that cannot be carried out in the Croatia Airlines training centre due

to lack of internal resources, are carried out at the IATA (International Air Transport Association) centre, and external experts are engaged to carry out in-house programmes attended by a number of targeted employee groups.

Croatia Airlines, as the national flag carrier of the Republic of Croatia, uses its training centre to provide various training programmes needed by passenger and cargo transport agencies to obtain the IATA licence, as well as training programmes for airports, forwarding companies and other air carriers. Training provided by Croatia Airlines to a large number of employees of IATA accredited agencies in 2009 covered tariffs, ticket issuance and ticket replacement, training for a couple of hundred employees of the Zagreb, Pula and Rijeka airports on issues of safety and security, and training provided to the Skopje airport and other air carrier employees on transport of hazardous goods.

#### **Responsibility to employees**

As a rule, the Company offers its employees work contracts for an indefinite period of time, while a certain number of cabin crew is employed for a definite period of time in the summer season.

Employment for a definite time period is used only in case of temporary staff replacements or replenishments during peak load periods when there is increased need for human resources in certain business areas and processes.

#### **Benefits and supports**

In addition to regular wages, the Company provides various benefits to its employees. These range from accident-at-work insurance, luncheon vouchers, loyalty awards for years of service, holiday-bonus payments, coverage of cost of travel to and from work, severance pay when employees retire, an allowance in case of a deceased close family member and an allowance in case of continuous sick leave exceeding 90 days.

In case of extended sick leave, serious illness or a dire financial situation, the Company tries to help its employees and their families by contributing to the cost of medication and medical treatment. Regular support is also provided to children of our deceased employees with monthly allowances during their schooling.

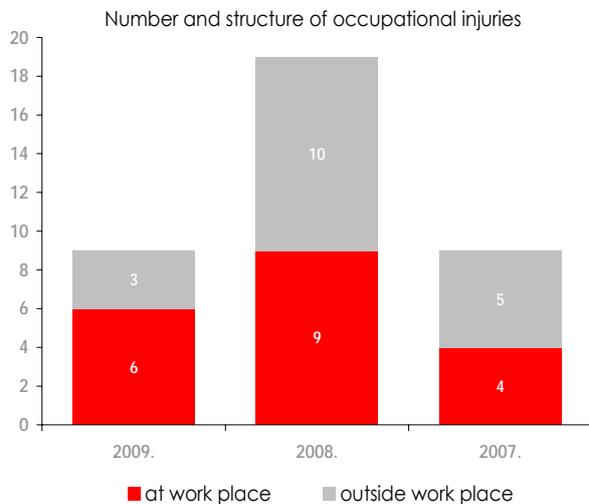
#### **Occupational safety**

Organizations of safety at work as well as fire fighting measures are regulated by internal acts of the Company. Risk assessment is used to define measures of occupational safety to be additionally implemented by employees performing work under special working conditions, who also have to follow a special system and criteria related to their regular medical check-ups.

Regular training is provided to employees to enable them to work in a safe manner and basic training in fire fighting measures is given to all new employees. Training was provided for the first time to employees authorized for safety at work by employers as well as employees directly authorized by employers related to safety at work.

Regular checks and tests are organized on all machinery, devices, equipment and installations used to signal and extinguish a fire. All hazardous waste from work operations is regularly managed and required records, reports and statistics are compiled and maintained. All planned internal supervision exercises in organizational units were carried out as well as supervisions following an injury at work.

A regular inspection was carried out by fire fighting inspectors of the city of Zagreb, as well as supervision by inspectors of safety at work. No objections were made by either of the inspections.



There were a total of 9 injuries at work (5 women and 4 men) in 2009. Of the total number, 6 employees were injured at their place of work, and 3 were injured on their way from or to their place of work. According to the classification of injuries following the AUYA method, there was in 2009 one severe injury, two moderate injuries and six minor injuries, and there were no lethal outcomes related to injuries at work and occupational diseases.

#### Protection of employees' dignity

In order to provide mechanisms for protection of employee dignity, the Company acted in line with the newly defined legal framework and appointed a person who would be authorized, in addition to the Management Board, to deal with employee complaints related to employee dignity protection. It is the Company ambition to create a work environment free of any kind of behaviour that may threaten the dignity of its employees and that is why rules of procedure in case of any kind of harassment or inappropriate behaviour have been established. The procedures and data related to them are inviolable and confidential, and starting the procedure is easily and quickly accessible to all employees via the Company Intranet pages.

#### Employees and Management relations

Five trade unions are active in the Company: Croatian Union of Air Traffic Pilots, Union of Engineers and Technicians in Aviation, Independent Professional Union of Croatian Aeromechanics, Air Cabin Staff Union. Collective agreements were entered with them in 2009.

A collective agreement was signed in 2009 with the Independent Professional Union of Croatian Aeromechanics. Towards the end of the year, negotiations were started with a single negotiating team representing all five unions, as existing collective agreements were valid until the end of the year.

The Company has had an active Workers' Council with 9 members since 2006. Pursuant to the Labour Act, the Workers' Council makes it possible for workers to participate, in the way and manner stipulated by law, in decision-making related to the economic and social rights and interests that are of special importance to them.

## Social responsibility

### Transport and Tourism

Croatia Airlines is a national flag carrier and as such, the Company social responsibility is to connect the country by domestic and international air traffic with the world, as well as to contribute to the development of Croatian tourism. The Company has been adapting to the needs of tourism industry and its development by setting up a network of direct flights to Zagreb as the capital city and a number of destinations on the Adriatic, in cooperation with its air-carrier partners and by aligning its operations with those of other modes of transport, whenever possible.

The important role played by the Company in connecting domestic air traffic destinations and maintaining air traffic inside Croatia was recognized by the Government of the Republic of Croatia, when, at the end of 2006, it passed the decision specifying the obligation of the Company to maintain scheduled airline traffic in the country until the year 2011.

The decision also specifies that the difference between the Company's unrealized revenues and costs of maintaining scheduled domestic air traffic is covered from the government budget as a yearly subsidy to maintain all regions connected by scheduled domestic airline flights. Such support to maintaining regional traffic is in line with the stipulations and regulations in force in the European Union.

### Croatian Brand

The mission of Croatia Airlines is also to contribute to the development of Croatian tourism industry and the economy in general. The Company understands that its strong national identity is recognized by its passengers and it serves and promotes food and beverages of Croatian origin on its flights, while the country's natural beauties, historic monuments and cultural events are presented via the Company Inflight magazine and video-system.

Films presenting Croatian ecologically-preserved islands, underwater world, the coast, national parks and other Croatian regions are shown daily on the Company network of flights served by Airbus aircraft. Films aimed at raising awareness of the need to preserve endangered species are also shown, for example by promoting the project aimed at protecting dolphins around the islands of Cres and Lošinj as well as by telling the story of the pure-bred white Lipizzaner horses from the Đakovo horse-breeding centre.

The Company regularly promotes and sponsors cultural events contributing to the advancement of tourism in Croatia, among them the Festival by Julian Rachlin and friends, The Dubrovnik Summer Festival, The Omiš festival of Dalmatian klapa singing, association Friends of the chanson, and prominent cultural and scientific institutions. In 2009, Croatia Airlines sponsored the Croatian Paralympic Committee, Youth Sports Games as well as numerous smaller sports events, while its successful cooperation with the Croatian Olympic Committee goes back a number of years.

### Support to community

Croatia Airlines has been providing support, whenever possible, to institutions in need of humanitarian aid or organizing humanitarian projects. The Company has also been providing direct humanitarian aid by free-of-charge transport of patients in serious condition, children or persons in distress, and has participated in humanitarian activities by providing free transport and use of its video-system and Inflight magazine.

Donations made in 2009 went, among other recipients, to the Mediterranean Institute for

Life Sciences, the Katarina Zrinski Women's Association, the Maslina Children's Home, as well as to many other sports events and cultural projects and to help provide medical assistance to severely ill children and persons with disabilities.

**Business ethics**

The Committee for monitoring the implementation the Code of Ethics has been active in the Company since 2002. Its tasks are to monitor the implementation of the Code of Ethics in the Company operations, and to propose ways of solving problems in each case when a report is made on the violation of or disrespect for the accepted ethical principles. The Committee is also responsible for improving ethical behaviour and promoting ethical values in the Company operations, everyday activities and employee relations. Members of the Committee are elected among the Company employees.

**Internal Company activities**

A number of sports associations are active in the Company, covering sports such as football, skiing, mountain climbing, sailing, basketball and tennis. Some of them have been successful in international competitions organized by air travel industry while also contributing to the quality of the employee leisure time.

## Development position

With 1.75 million passengers at the end of 2009, Croatia Airlines reached the total of 20.4 million passengers in the period since its operations started in 1993. Based on these figures, the average yearly growth rate of the Company in the same period has been about 8.5 pp.

The existing **destination network**, developed and maintained over a number of years and including domestic, European and Euro-Mediterranean traffic, was expanded again in 2009 to include new destinations, Barcelona and Gothenburg, with Athens as a new destination planned for 2010, as well as a direct scheduled flight Zagreb-Rome. The Company intends to continue expanding the network over the next few years, both in the region and in Europe, thus creating a wider market and offering new services while simultaneously restructuring its fleet capacity.

The Company network development does not stop in Europe, as talks are going on with many partners in order to improve connections between our market and interesting destinations in the USA and Canada. Talks were started in 2007 with our American partner United Airlines on ways to improve the quality of transfer options available between Croatia and North America. Based on the cooperation agreed upon, it is expected that airports in Zagreb, Split and Dubrovnik will be connected with Washington, Chicago, San Francisco and Los Angeles via seven European cities in the foreseeable future. This will enable the Company to offer its passengers direct flights from Croatia to the USA with only one stop-over on joint flights under the codes of both partners. Code-share agreement has not yet been implemented due to legal and regulatory obstacles at the central government level, but it is a major step in the future development strategy of Croatia Airlines. A newly established Civil Aviation Agency started operations in 2009, with responsibility to control certificates, operating licences and implementation of international aviation standards, and it is expected that cooperation agreed upon will become operational.

Croatia Airlines has become a leading regional air carrier by volume of operations, and it is the Company **strategic objective** to be a regional leader with plans to expand in the south-east of Europe over middle and long-term, while remaining focused on the Zagreb Airport as its hub airport. By adopting the strategy of expansion in south-eastern Europe, Croatia Airlines has aligned its development goals with those of the Republic of Croatia. In spite of the competitive potential of other countries of the region, Croatia Airlines has an opportunity to become a regional leader. In order to achieve this position, it is necessary to ensure an adequate level of synergy on the market with the Zagreb Airport as the future regional air traffic hub. The Company considers its membership in the global association of air carriers, Star Alliance, to be a huge comparative advantage, as the association transports a quarter of all air passengers globally. The membership should bring long-term synergy effects, to be evidenced by operating and financial indicators.

The Croatia Airlines **business model** envisages a strong network-based, scheduled-flights operator, based in the well-connected hub, the Zagreb Airport. By gradually reducing the volume and relevance of chartered flights in its overall operations, the Company will bridge the issues related to the economic policy and the development of the national tourism industry, as its volume of operations does not yet support all-year-round tourism, in line with the national air carrier development plans. By defining its operations in this way, the Company will be protected from seasonal fluctuations that can reach high levels in chartered-flight operations and its focus will shift to more stable yearly operations, without pronounced seasonal fluctuations.

The strategy of network-based operations is aimed at clear distinction between primary, secondary and tertiary routes, and between domestic and regional routes while simultaneously defining their relevance and optimizing flight frequencies.

The strategy of market segmentation defines domestic scheduled air traffic as of special interest for the Republic of Croatia, and as a separate market where Croatia Airlines is under obligation to provide services until the year 2011. **Croatia Airlines has taken over the obligation to provide services of domestic traffic with Government compensation of losses incurred in accordance with the PSO<sup>2</sup> approach of the European Union.** It is expected that after 2011 the process of tendering will be organized (for a period of three to five years), and Croatia Airlines will do what is necessary to win the concession again. The strategy of market segmentation and the separation of the loss-making domestic traffic operations to be covered by the system of government subsidies will make international scheduled air traffic the core of the profitable growth strategy of the Company.

In 2008, the Company started **replacing the short-haul fleet** by using 10-year operating leases by adding to the fleet the first two Dash 8 - Q400 aircraft, produced by Bombardier, and by releasing three ATR aircraft from the fleet. **Renewal and development of the fleet** was continued by taking delivery of two more Dash 8 - Q400 aircraft in June 2009, with two more Dash 8 - Q400 aircraft to join the fleet in spring 2010. **By improving the fleet structure,** Croatia Airlines is putting in place the prerequisites for the optimization of its revenues, "pricing" and booking management models, while gradually moving closer to meeting the European standards of aircraft and fuel productivity, and transport quality and timeliness.

The targeted fleet structure to be achieved by 2014 is related to the expected developments, among them accession of the Republic of Croatia to the European Union in 2012, with the expected positive effect on the volume of air traffic, as recorded by all the new EU member states upon their accession to the EU.

The fleet structure is envisaged to consist of 8 Airbus A319 aircraft, 2 Airbus A320 aircraft and 6 Q400 aircraft, so that the total increase would be from 12 aircraft in 2009 to 16 in 2014. The planned fleet growth will result in seating capacity increase from 1,480 seats in 2009 to 1,836 seats in 2014, thus a capacity increase of 24pp. The new fleet structure will ensure flexible and dynamic network planning and capacity utilization in an optimum mix of various aircraft sizes, in accordance with the number of seats sold on scheduled flights and the network peak load times. Flexibility of planning and utilization will result in better-quality network and traffic optimization, which will have an impact on the expenses incurred in the system.

Of strategic importance are also the guidelines defined for a number of areas of fleet capacity structure optimization, among them defining the ratio of owned to leased aircraft, reducing the number of Airbus 320 aircraft in the fleet, realizing better operational and commercial efficiency on primary Star Alliance routes by replacing ATR42 aircraft with Q400 (MUC, VIE, ZRH) ones, and optimizing the fleet in the growing market of south-eastern Europe. The policy of „Right sizing“<sup>3</sup> is an important prerequisite of the profitable

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2 Public Service Obligation

3 Policy of reducing the unfavourable "gap" in the fleet capacity (42-132-162) based on short-haul ATR aircraft

growth strategy implementation.

Each of the above factors related to fleet capacity management channels the future fleet development and cost structure towards unavoidable optimization with growth based on the most economical approach.

Quality of Dash 8-Q400 aircraft has been confirmed by the number of turboprop aircraft of the type produced up to now, as there are more than 650 such aircraft in use and more than 13 million hours of flying on the same type of aircraft recorded globally. The number 400 marks the largest aircraft in the family (there are also Q300 and Q200), with capacity of more than 70 seats, and the letter Q marks the most up-to-date series developed to produce the lowest possible level of noise. The Q400 interior design represents advancement towards higher level of convenience in the business and economy class, with simultaneous improvement in the passenger cabin design and decoration. New Croatia Airlines aircraft are used to present the new Company interior design. Dash 8-Q400 is among the most advanced passenger aircraft from the point of view of ecology, and its fuel consumption efficiency is 30pp above the same indicator in *jet* aircraft, so that its emissions of harmful gases into the atmosphere are considerably lower.

**Advancement  
and expansion  
of operations**

Another important step in one of the most relevant non-core activities of the Company was the opening **of a new hangar capacity in 2008** at the Zagreb Airport, located opposite the existing Croatia Airlines hangar. Over the 16 years of maintenance of short and medium-haul aircraft, Croatia Airlines has gained a huge amount of experience. Since 2001, when it obtained the JAR-145 authorization to provide base and line maintenance of foreign aircraft, Croatia Airlines has been providing aircraft maintenance services to foreign companies. In 2004, the JAR-145 certificate was replaced by the EASA Part 145 certificate from the Aviation Safety Agency, which is the basic criterion for maintenance service provision to foreign companies. Until the end of 2009, the Technical centre of Croatia Airlines performed 100 C-checks on aircraft of a number of European air carriers, of which 35 were completed in 2009. Technical expertise has made it possible for Croatia Airlines to be recognized as a safe company. The most important user of the technical support services, i.e. of aircraft maintenance, is Lufthansa Technik, which has been contracting every year an increase in the number of C-checks performed on its Airbus A319/320 aircraft in Zagreb.

In the middle of 2008, Croatia Airlines started the **implementation of the SAP IT system**. The project consists of the implementation of the SAP ERP business system and the SAP SEM and the BI/DWH planning and reporting system. Implementation of the transactional segment of the system was completed at the end of 2009, and the implementation of the BI/DWH segment of the project is expected in the course of 2010. The implementing contractor is S&T consultancy, licensed by SAP.

The selected SAP ERP solution has replaced the domestic transactional system Laus to cover the field of finance, accounting, procurement and sales. Planning and controlling will be improved once the overall IT solution is implemented, as its functionalities are to replace existing systems developed using the Microsoft Office tools with limitations that are seen as bottlenecks hindering the future development of the Company. That is why the introduction of a new IT system has been a primary goal of the Company in the medium-term period. The new system is expected to enable Croatia Airlines to improve productivity, gain better insight into its operations and speed up the process of business strategy implementation, while enabling better operating control of all activities and planning and adapting to the changes in the market and in technology. The new system

will require changes in work processes, as well as in work organization, and will in its final phase also require changes in organization and job description. A more up-to-date and detailed information will, on the other hand, enable the management to set up a monitoring system, speed up decision-making and increase flexibility in making decisions and implementing changes as these capabilities are going to be needed by all the air carriers exposed to negative industry development trends.

Although it is at this stage difficult to assess the effects of the new system implementation, there is no doubt that they will not be reflected in direct cost reductions, but rather in **better process management due to their standardization and increased transparency because of the SAP recording systems**. In addition to that, positive effects can be expected only upon completion of all the stages of the project, scheduled for 2011.

In January 2009, Croatia Airlines made a successful transition to the Amadeus Altea module, which is a part of the **Star Alliance Common IT Platform (CITP)**. Croatia Airlines started migration from its old system to the Star Alliance one with the booking and distribution system and storage, sharing and managing data in April 2007. CITP is a strategic programme aimed at providing customers with a better service, lower distribution costs and faster new product market launch. The new system was developed by Amadeus, provider of one of the largest booking systems in air transport.

Traditional booking and distribution support systems result in considerable cost multiplication as a result of a large number of participants in the booking process who manage its various segments, market divisions (code share contracts), Frequent Flyer programmes and the process of getting passengers ready for boarding (checking in, boarding, luggage handling, managing aircraft loading). Multiplication of costs in traditional cost management systems is due to multiple single interconnections that need to be established between the carriers involved. Migration to a new inventory platform enables Croatia Airlines, as well as other air carriers involved in the project, to improve their yield potential, while for the Star Alliance it is yet another step towards the establishment of a common platform. Integration via the common IT platform enables all those involved to cut costs, align services and maximize joint potential of all the carriers in the association.

The project is currently at the closing of stage 1, with migration and implementation of the new system of transport documents issuance scheduled for 2010. Savings that Croatia Airlines is expected to make once the CITP project is implemented will be the result of lower booking fees in certain distribution channels (primarily own sales using the Amadeus booking system).

In 2008, Croatia Airlines started the **“Revenue Integrity” project** in order to eliminate or reduce revenues lost in the booking process. The most frequent causes of revenue loss related to the booking process involve booking with no ticket issued, wrong booking classes, prohibited class combinations, abuse of tariff rules, blocking of seats (by entering false names), booking duplication, change of names, unnecessary segments (segments with inactive status, double segments) and many others. As a result there are a high number of no-show passengers in the booking system and late cancellations of bookings, unnecessary catering costs for no-show passengers, related GDS costs and blocking of seats for passengers who actually want to travel. Improvements are expected to be achieved by automated booking controls, more efficient use of GDS in the process of booking regular passenger capacity, reduction of distribution costs, increased capacity utilization and revenue on flights with the possibility to plan them in a more precise manner. In order to integrate revenue management, the Calidris tool has been selected, as it was considered to offer better control of the capacity to be marketed, with more options of

repeat bookings over a longer period of time. The tool has been implemented and is fully operational.

Croatia Airlines **Call centre started operations on 1 March 2009**, providing support to the passengers from the moment they think of buying a ticket to the start of their trip, including ticket sales, bookings, providing information on flight schedule and changes to it, on irregularities in traffic, ticket prices, products and services, providing information on internet booking, sale of special services such as travel insurance, acquisition of co-branding cards and additional services and products offered by Croatia Airlines. The Call centre will also take calls placed to our office outside working hours, and provide after-sales service, resolve customer receivables, provide information to users (general travel terms, EU regulations, Montreal convention) and other information related to the Company.

First mService services provided by Croatia Airlines within the **e-commerce project** were offered at the end of March 2009, among them free SMS text service, enabling users to send SMS messages free of charge via the Croatia Airlines Internet pages. After they have purchased their ticket online, users get access to the application enabling them to send SMS texts to anybody anywhere in the world. If they decide to use the service, they can send 5 text messages free of charge. Another mService option is the SMS PNR info, aimed at users booking tickets via the Croatia Airlines Call centre, enabling them to receive information on the booking made in the form of a SMS text. The message will contain information such as the booking code, the PBZ ATM code, ticket price, deadline for ticket collection etc. The aim of the service is to reduce the number of repeat calls to the Call centre providing the same information.

A part of the e-commerce project is the introduction of **Web Check-in at** domestic and foreign airports. Web Check-in has been available since 2008 in Amsterdam, Bruxelles, Paris, Frankfurt, Düsseldorf, Munich, London, Vienna and Zagreb and since 2009 at the airports in Zurich, Sarajevo, Skopje, Podgorica, Rome, Barcelona and Dubrovnik.

Service improvements within the e-commerce project have continued with the automated information sent to passengers about changes in their flight schedule. Passengers who have bought tickets on Croatia Airlines web pages are thus informed about changes in their flight schedule via email and SMS messages. Another novelty is the option to buy tickets on the Internet 10 months before the flight, and flights by partner companies are also on offer.

October 2009 saw the beginning of pilot training for **Electronic Flight Bag (EFB)** project with supervision of the Civil Aviation Agency. This is an information system that helps pilots carry out all the activities during the flight management process, helping them perform all the required activities faster, safer, more efficiently and with less paperwork. EFB has been developed in cooperation with Lufthansa Systems and it should have a direct effect on operating cost reduction and improvement of operating processes while at the same time increasing safety of flying. The system makes flight preparation and documents management easier, it ensures a more precise and faster calculation of aircraft pre-flight performance and exchange and integration of all the necessary operating data in a single location – flight plans, weather forecasts, information on the situation in the air, navigation means, company information and the like. The project is a continuation of other activities undertaken by Croatia Airlines aimed at preserving the environment by reducing fuel consumption, harmful gases emissions, and cutting the amount of paper used. Croatia Airlines is the first company to integrate the EFB platform with all the other external information systems in order to enable a complete flight crew preparation. The project

singles out Croatia Airlines as a leading regional air carrier in terms of technology. The project is expected to be fully implemented in the course of 2010.

#### **Anniversaries and Awards**

Croatia Airlines marked the 20<sup>th</sup> anniversary of its foundation on 7 August 2009, with numerous employees and passengers receiving prizes and rewards on the occasion.

FlyOnLine Club, a special reward programme for users of Internet services of Croatia Airlines, marked three years of operations in March 2009.

Ten years of commercial cooperation between Croatia Airlines and Lufthansa in passenger transport were marked on 28 April 2009.

The year 2009 was also the fifth year of Croatia Airlines membership in the Star Alliance association as a regional member, and in June 2009, Star Alliance accepted the Croatia Airlines application for full membership in the association<sup>4</sup>. Star Alliance has been changing its business structure in accordance with its expansion plans and the development needs of its members. Regional concept is no longer applicable and Croatia Airlines is a full member of the alliance as of 1 January 2010 without any additional costs or conditions.

#### **Environmental Protection**

On 16 October 2009, Dubrovnik hosted a meeting of presidents of the European air carriers' association (AEA) who had gathered to discuss the current situation in aviation industry and to find solutions to the crisis that brought about a fall in traffic volumes and in revenues and destroyed the industry profitability. The meeting was hosted by Ivan Mišetić, managing director of Croatia Airlines, who took over the duty of the AEA chair for 2009 on 1 January 2009.

Air transport is an important factor in the development of global economy, but is also contributes to global climate change due to emissions of greenhouse gases and it impacts the environment by generating noise, using non-renewable energy resources and generating waste.

As it is expected that air traffic will continue to grow and CO<sub>2</sub> emissions with it, it was already specified in the Kyoto Protocol that air carriers should participate in emissions reduction programmes. That process was completed in 2008, when the final regulations were passed on the participation of all the carriers flying in the territory of the EU and to and from airports in the EU in the EU emissions trading scheme (EU ETS)

Although air carriers are expected to start paying for emissions into EU ETS in 2012, complex preparations for participation should have been done already in 2009, while fuel consumption monitoring, CO<sub>2</sub> emissions and tonne kms as the market benchmarks should be put in place in 2010. Aviation is a global industry and it advocates the establishment of a global ETS as the only way in which global goals of aviation emissions reduction can be reached and unfair market competition can be eliminated, and European air companies will be affected if a global agreement is not reached.

As this is an important factor in their operations and a considerable financial burden on their finances, air carriers have started participating actively in the creation of regulations via

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<sup>4</sup> The Star Alliance was established in 1997 as the first truly global air carrier association, enabling passengers to have access to destinations all over the world. It has 26 members, and the following companies are expected to join in the next two years: Aegean Airlines, Air India and TAM Airlines. Air carriers –members of Star Alliance fly with a total of 3,740 aircraft and they provide flight services to around 586 million passengers a year. The network of destinations counts 1,077 airports in 175 countries, and passengers have the choice of 19,700 flights a day.

ICAO, the UN organization for civil aviation, IATA, global association of air carriers and AEA, the European association.

AEA, the European association of air carriers, has passed a programme of recommended measures to reduce emissions of harmful gases in aviation<sup>5</sup>, based on the following four pillars: further technological advancement through science and research, infrastructure upgrading, operating measures (better regulation of air traffic, optimized route selection, reduced flying in circles above airports, a single European sky, aimed at reducing CO2 emissions by 12pp) and ETS economy-based instruments (supply and demand will be used to purchase deficits or sell surpluses of emission rights defined in relation to the needs and specified rights of a company).

Croatia Airlines has participated, as a member of expert bodies within AEA, in the process of designing the ETS elements related to air carriers and the Company completed the required preparatory measures for participation in EU ETS in 2009.

As the Republic of Croatia is not yet a full member of the EU and, based on the rules established by EU ETS, the European Commission has decided that for administrative purposes, Croatia Airlines will have the German Emissions Trading Authorities (DEHST), part of the German Federal Environment Agency, as its competent authority for the purpose of administration of its participation in EU ETS.

In accordance with the EU ETS regulations and the requirements made by competent authorities, Croatia Airlines designed the Company ETS system to monitor and measure CO2 emissions and tonne kms in the periods defined. The Company submitted monitoring plans to competent authorities before 31 August 2009 and was given the necessary approval.

The Company EU ETS was consequently implemented before the end of 2009 and 1 January 2010 marked the start of the official continuous monitoring of CO2 emissions and tonne kms for the purpose of reporting in accordance with EU ETS rules and as a basis for the Company measures to reduce emissions.

Croatia Airlines has been participating in activities related to aligning and implementing European regulations related to global climate change and the Kyoto Agreement on Air Traffic in the Republic of Croatia. The Company has also participated in the implementation of the environment and sustainable development related regulations in the country and their alignment with the corresponding European regulations concerning air transport and the Company, as well as technology development and procedures and processes to reduce negative impact on the environment.

Most environmental activities focus on the reduction of fuel consumption, greenhouse gas emissions, particularly carbon dioxide (CO2), and noise level at taking off and landing. Taking off at reduced engine power is also implemented, which extends engine durability, but also achieves fuel saving and CO2 emission reduction at that flight stage. Flight planning programme and Fuel Cost Index help determine the most favourable flight plan in terms of fuel consumption. Flight Data Monitoring System enables noise intensity monitoring at every flight, which is indispensable due to ever more demanding regulations, the crowded European sky.

In addition to the operational and broader corporate sense, the company participation in EU ETS will reflect financially in terms of continuously increasing new expenses.

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5 Emissions Containment Policy of the European Aviation Industry

## Business environment and operational Risks

### Environment in Croatia

In 2009, the Croatian economy was marked by a decline in gross domestic product, to some estimates lower by 5.8 percent in real terms compared to 2008. Industrial production volume was lower by a relatively high rate of 9.2 per cent. Average annual inflation amounted to 2.4 per cent. Throughout the year, a high deficit in the balance of payments and high foreign debt were continuously present.

In 2009, tourism was marked by a drop in the total number of visitors of 2.9 per cent compared to the previous year. During the high season, 10.9 million visitors stayed in the country, with 56.3 million overnights, i.e. 1.4 per cent less than 2008. The most important foreign tourists in terms of overnight stay were visitors from Germany, Slovenia, Italy, Austria and the Czech Republic.

Air traffic at Croatian airports in 2009 fell by 3.6 per cent and passenger traffic by 5.81 per cent. Out of registered 4.9 million passengers at Croatian airports, Croatia Airlines transferred 1.75 million, amounting to 36 per cent of the total number of passengers at Croatian airports.

Thirty foreign airlines participated in scheduled air traffic (16 from the network operating system and 14 low-cost airlines), which was 17 per cent less than in 2008, from 58 destinations (+21 per cent), with 399 flights in the weeks of traffic peak. Sixteen foreign carriers (-57 per cent) participated in charter traffic, from 34 European destinations (-5 per cent), with 45 flights in the weeks of traffic peak. In terms of the ratio of passengers flying low-budget airlines, Zagreb Airport recorded 10 per cent, Pula 19 per cent, Dubrovnik 22 per cent, Split 33 per cent and Zadar 69 per cent.

As a Croatian company with significant export potential, in the very focus of entire economy's strategic definition, the Company presented itself on the international market under the impact of severely unfavourable domestic market factors and the impact of domestic monopoly built into the system inputs and prices. These factors greatly complicate the company's position in relation to large competitive systems, which are either unburdened by the same factors or are significantly more flexible in sustaining them due to their size and financial strength. The process of joining the EU and levelling out national and international initial operating conditions is estimated as extremely important for the company and its further growth.

In September 2009, the European Aviation Safety Agency (EASA) performed a monitoring of the Croatian Civil Aviation Agency. The preliminary monitoring report demonstrates significant advances and improvements of Croatian aviation authorities in eliminating drawbacks, which is particularly important in the light of Croatia's accession negotiations with the European Union. As a newly established regulatory body on the Croatian aviation market, in its full legislative capacity, the Agency will be in charge of solving numerous issues and deregulated economic conditions between the involved parties. It is expected to greatly contribute to transparency of operation of the entire industry, as well as individual market players.

A drop in the demand as a consequence of the global crisis and difficult situation in the

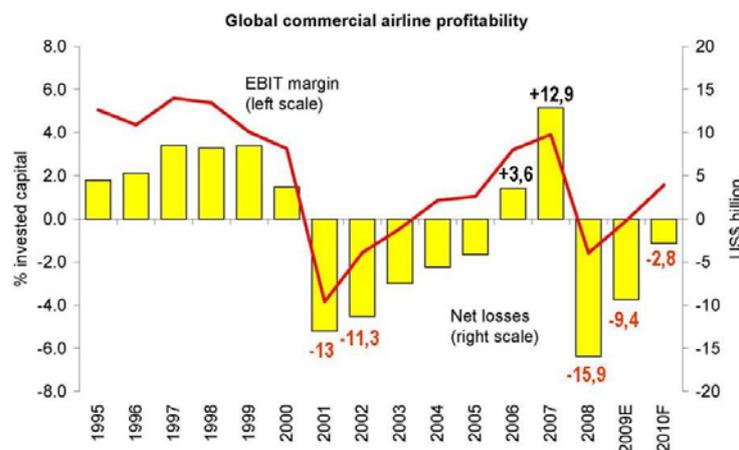
aviation industry marked Croatia Airlines' operations. The company's business results were additionally burdened by its limited capacity for further debt increases, continuous decrease in financial subsidies for sustaining unprofitable domestic traffic and the impact of shorter tourist season and uncertainty related to the beginning of market recovery.

### International environment

Aviation industry has been through one of the hardest years in the history of international air transportation. According to the International Air Transport Association (IATA), the 2009 decline in international passenger air traffic was the most dramatic since World

War II. In terms of demand, the industry will remember 2009 as the worst year in history. Passenger air traffic demand fell by 3.5 per cent, with an average flight occupancy rate of 75.6 per cent. Cargo air traffic dropped by 10.1 per cent in comparison with 2008, with a 49.1 per cent capacity utilization rate.

### Global Aviation Industry Profitability



AEA published alarming data on the crisis consequences in Europe, according to which in 2009 European airlines flew 20 million fewer passengers, i.e. recorded a decline in passenger mileage of 4.5 per cent. Thirty-five thousand jobs were lost and another 60,000 people are expected to be laid off. Another problem is that not all stakeholders in the aviation supply chain have acknowledged the severe consequences, not even all legislators. Airports and air traffic controls have raised prices of their services, which would be difficult to take even in the best of times. For the first time in history, all European airlines registered a loss, while at the same time airports continued to make record-breaking profit. Aviation authorities were asked to speed up the implementation of the existing legislation, which would enable more moderate prices of air traffic control, airport taxes and insurance fees. AEA especially advocates freezing airport taxes and air traffic control prices during crisis.

In order to alleviate difficult conditions that have befallen air traffic and airlines, at European airlines' request, the European Commission temporarily suspended the regulation on obligatory timeframe for particular company's takeoff and landing and airport infrastructure utilisation in certain times of the day. This measure prevented airlines from having to take off or land simply in order to maintain their historical airport capacity. However, this measure was only temporary and referred to the 2009 summer season, but it enabled companies to reduce capacity without the risk of losing their airport rights. In

such operational conditions, airlines across Europe tried to reduce the number of routes and service frequency due to reduced demand, with the aim of reducing overall losses. The problem is that the dire crisis consequences were not recognised by all the stakeholders in the aviation supply chain and not even by all legislators.

Global aviation industry will take at least three years to recover from the passenger traffic decline caused by the worst recession of the sector in the last six decades. The consequences will be felt in the years to come, while the burden of the crisis is best illustrated by the fact that in the last decade global aviation industry recorded a loss of \$49 billion, while in the three previous decades (1970-1999) it amounted to \$42 billion.

### Operational risks

Croatia Airlines and its operations are exposed to volatile impacts from the domestic and foreign market and the global recession. The highest risk factors include expected developments on the sales market in recession, fuel and interest rate market developments.

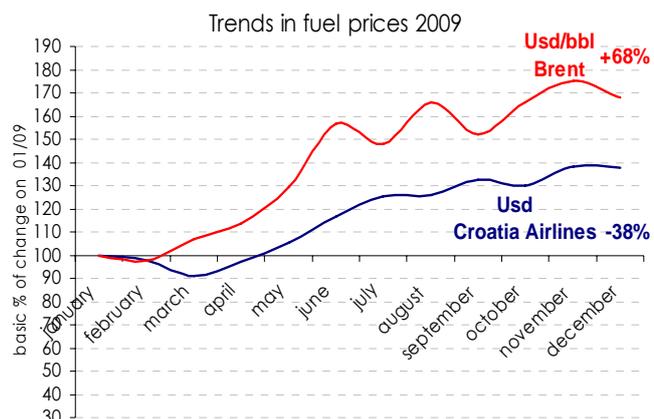
### Economic Downturn and the Global Economic Crisis

The end of 2008 was marked by retardation in the world economic growth, while the condition of the major world economies worsened much faster than leading economists had predicted. A large number of bankruptcies and job losses, as well as growing debt ensued in 2009. The Croatian economy continued facing the economic crisis and recession. The GDP drop in 2009 was estimated at 5.8 per cent. Aviation industry took a severe blow. According to IATA estimates, global aviation industry finished 2009 with a loss of \$9.4 billion. In comparison with 2008, when the losses resulted from a major growth in fuel price, the loss in 2009 was the consequence of the global crisis and losses inherited from the previous year.

Croatia Airlines has not been immune to market movements, sharing the aviation industry's destiny. The spill over of the negative global effects especially emerged in the form of reduced demand and drop in passenger and cargo traffic. In 2009, the Company invested a lot of effort in reorganising all its areas of business in order to minimise negative effects. Throughout the year, Croatia Airlines twice revised its business plan so as to mitigate negative crisis consequences. Business rationalisation in 2009 was based on postponing investments not directly related to the core business and flying, aircraft maintenance and operation and guaranteed safety level. In addition to investment savings, a cost savings measure programme harmonised with the implemented government cost savings programme included planned and achieved cost saving on management salaries and flying cost rationalisation, while maintaining high operational safety.

### Fuel

The market price of jet fuel was extremely volatile in the past years. Whereas in 2008 it reached its record-breaking values, early in 2009, given the global economic situation and recession gripping more and more countries, it was followed by a decline in oil demand. In the first quarter of 2009 oil prices reached its five-year minimum, and in the second and third quarter of 2009 the prices

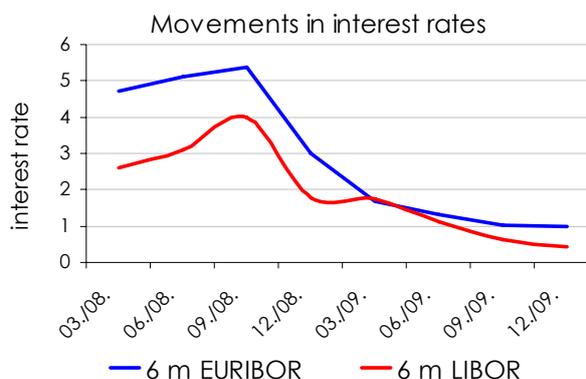


again began to grow, reaching \$70 per barrel. In September, the average price was \$67 per barrel only to increase to \$74 per barrel by the end of the year.

The average price at which Croatia Airlines purchased its fuel in 2009 amounted to \$606/t, by \$99/t lower than the planned price for 2009, which included a higher risk of fuel price change than the actual one. Fuel expenses in 2009 amounted to HRK202 million, which was 24 per cent below plan and 43 per cent lower than in 2008.

### Interest risk

Taking most of its long-term loans with variable interest rates exposed the company to interest rate risk. The previous year (2009) was characterised by a continuous interest rate decline on the financial markets, resulting in Croatia Airlines' interest expenses lower than planned and lower than in 2008.



### Cash flow risk

The company manages the risk through regular monitoring of the payments due and maintaining adequate and sufficient cash and deposits to cover accrued financial expenditures. A negative impact on the cash flow was exerted by a reduced capital inflow from the core business, while the investment standstill, while not affecting operational safety, had a positive impact on the cash flow. Given that the scope of the recession caused a decline in operating income by HRK284 million and had a direct impact on the expected cash inflow, minor solvency issues occurred early in the summer of 2009. They were bypassed with a short-term loan of €4 million, paid off on 2 November 2009.

In the last quarter of 2009 the short-term PBZ loans amounting to a total of €8.6 million were replaced by a long-term loan from the same bank, while the remaining part of the long-term loan was used to cover short-term current liabilities.

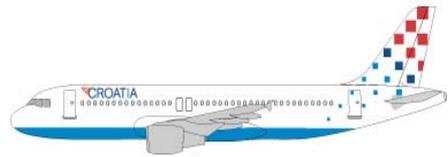
### Currency risk

The company is most susceptible to the risk of a negative impact of Kuna currency exchange rate when taking long-term loans and financing aircraft leases, mostly in Euros. The company covers this susceptibility with international ticket sales, generating sufficient foreign currency inflow to cover debt liabilities. In June 2009, the company signed 23 forward contracts with PBZ, amounting to a total of \$9.5 million, due twice a month, and closing in June 2010.

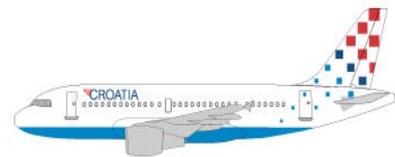
## Fleet and capacities

Since 2010, Croatia Airlines has been operating a fleet of 10 aircraft: eight Airbuses, two of which leased, and two Q-400 on operational leases. In June the fleet was joined by the third and fourth Q-400, completing Croatia Airlines fleet at a total of 1,480 seats. By including the last two Q-400 aircraft, Croatia Airlines continued the short-haul fleet reconstruction process, which will be completed next year with another two turboprop airplanes of the same type.

A 320 – four aircraft  
162 seats per aircraft – 648 seats total



A 319 – four aircraft  
132 seats per aircraft – 528 seats total



Q-400 – four aircraft  
76 seats per aircraft – 304 seats total



Croatia Airlines fleet made a total of 25,383 flights and an **aircraft total time of 33,515 block hours in 2009**, which constituted a two per cent decline over 2008.

Dash 8-Q400 joined the Croatia Airlines fleet in May 2008 when the first aircraft arrived from the Canadian manufacturer Bombardier Aerospace. The second one followed in July 2008, while the third and fourth was delivered in June 2009.

During the monitored period, Croatia Airlines effected “ad hoc” aircraft lease, which operated on 34 flights covering flight schedule in emergency situations, such as air traffic disturbances, aircraft repair etc.

From 22 May to 30 June 2009, Croatia Airlines “wet-leased” (including both aircraft and crew lease) a CRJ 200 aircraft from the Slovenian Adria Airways with 48 seats, in order to cover the period until the arrival of the two new Q-400.

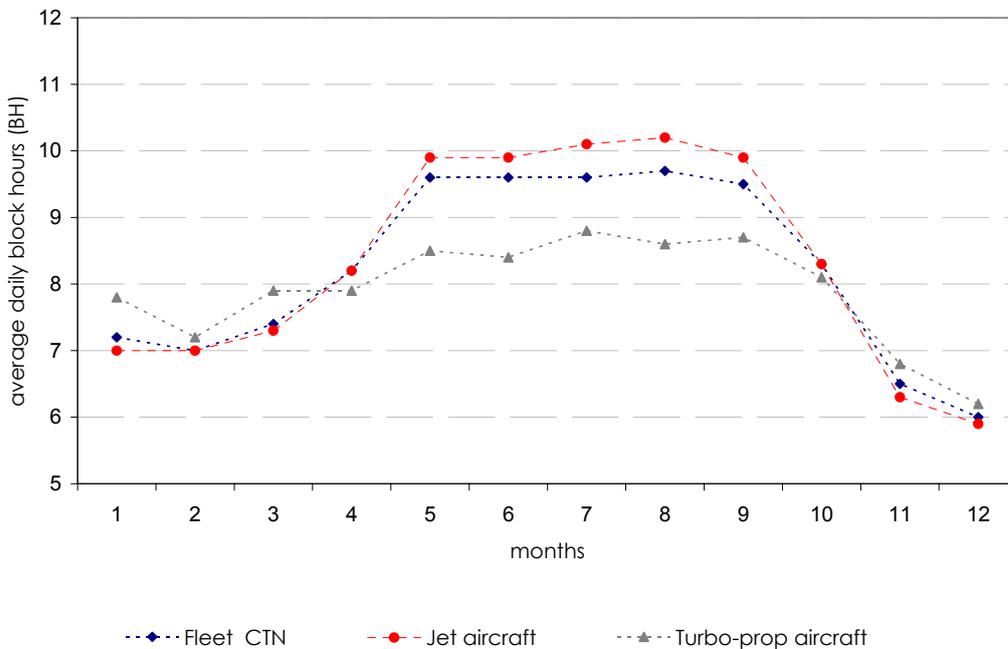
Fleet utilization

Aircraft type	Ø number of aircraft	Ø daily block hours (BH)	growth of utilisation 09/08
Airbus A320	4	8,2	-8%
Airbus A319	4	8,6	-7%
Q-400	3,05	7,9	-5%
<b>TOTAL</b>	<b>11,05</b>	<b>8,2</b>	<b>-8%</b>

In 2009, the Croatia Airlines fleet flew 3,021 block hours per aircraft, presenting **an eight per cent utilization decline** in comparison with the previous year. Utilisation drop is a result both of implemented reductions in flight schedule and fleet size growth.

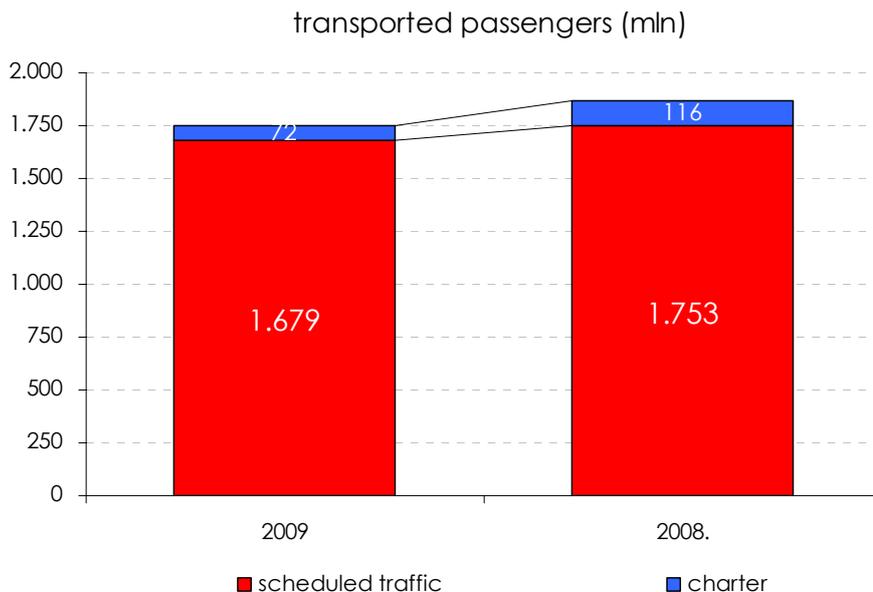
The average annual number of aircraft, amounting to 11.05 airplanes, was by four per cent higher than the previous year's average. The average grew due to fleet reconstruction, the arrival of two Dash 8-Q400 aircraft in June 2009 and the permanent grounding of two remaining ATR aircraft late in October last year. The available ASKM in 2009 dropped by four per cent, and passenger mileage also fell by nine per cent.

Fleet utilization by months



## Market

As a consequence of the recession in the entire aviation industry, Croatia Airlines business 2009 was marked by a decline in both passenger and revenue figures. Financial sales results for 2009 speak of a drop in regular traffic domestic sales within Croatia of nine per cent and a drop in regular traffic international sales of seven per cent in comparison with the previous year. Recession developments on the market causing this decline were also reflected on a drop in the number of passengers, as well as in a decrease in realised average fees.



The overall number of passengers in 2009 dropped by six per cent compared to 2008

Regular domestic passenger numbers dropped by nine per cent, and international ones by two per cent.

The number of charter passengers amounted to approximately 71.6

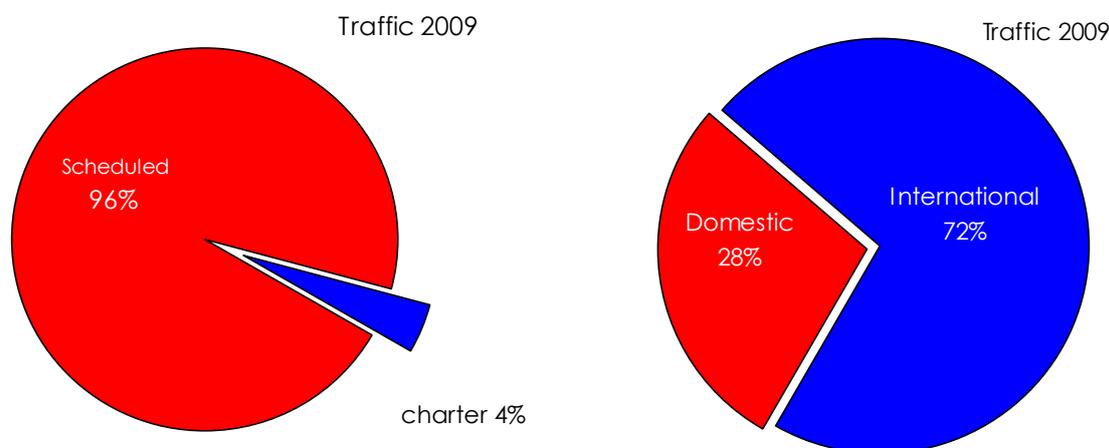
thousand, which is 38 per cent below the figure for the same period previous year. In accordance with strong company focus on regular scheduled traffic, in the monitored period charter comprised only four per cent of the total traffic volume.

Passenger mileage of AEA (Association of European Airlines) members, including Croatia Airlines, whose overall results serve as good international comparison and measuring factor for regular traffic, dropped by an average 4.3 per cent in 2009. Croatia Airlines experienced a decline in regular traffic passenger mileage of five per cent, while the seat-mileage capacity remained on the 2008 level. In the same period, the AEA experienced a four per cent drop. Given the overall traffic volume decline, keeping capacity on the previous year level resulted in a 3.7 per cent lower passenger load factor (PLF), while AEA's PLF drop in the context of reduced capacity was less drastic, amounting to 0.3 per cent on average.

The market recession was also reflected on cargo traffic volumes. In this period, cargo traffic dropped in tons by 16.4 per cent compared to the same period previous year. Regarding cargo, Croatia Airlines has a contract with the international agent Cargo Counts, in charge of distribution, sales management and foreign sales network maintenance. In 2009, the said contract was taken over by Lufthansa Cargo, the owner of Cargo Counts, terminated early in 2009 by Lufthansa due to changes in organisational structure. In mid-September, a new contract was signed directly with the Lufthansa Cargo sales agent.

The overall passenger **PLF<sup>6</sup>** amounting to **61.4 per cent** dropped by 3.8 per cent, while **WLF<sup>7</sup>** amounting to **51.1 per cent** fell by 3.6 per cent compared to the previous year. **The transported 1,750,874 passengers or six per cent less** were namely 491,519 regular domestic passengers, 1,187,748 regular international passengers and 71,607 charter passengers.

In 2009, Croatia Airlines flew directly to eight regular domestic destinations and 18 international Euro-Mediterranean destinations. Croatia Airlines has developed its destination network through the existing commercial association with Star Alliance members – Lufthansa, Austrian Airlines, TAP Portugal, SAS, Swiss and Turkish Airlines. All comparative advantages of alliance membership have been utilised to strengthen the Company position. In 2009, Croatia Airlines helped connect a total of approximately 40 destinations through regular scheduled and charter traffic.



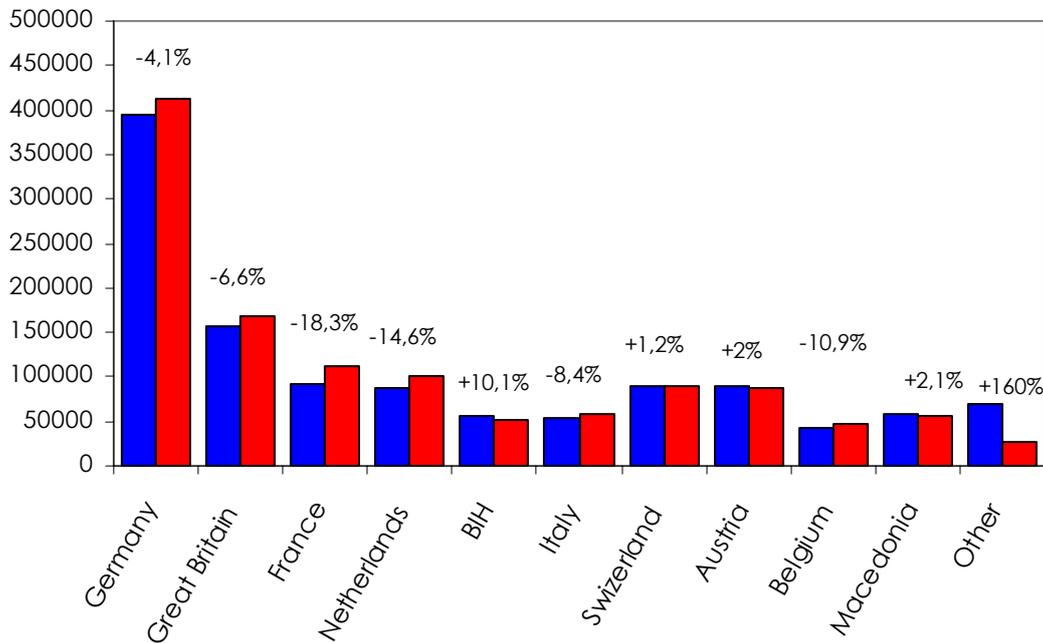
The millionth passenger in 2009 flew on 3 August on the route Dubrovnik-Zagreb. On 24 July 2009, Croatia Airlines flew the twenty-millionth passenger in its history, which was incidentally the year celebrating its 20<sup>th</sup> birthday and five years of its membership in Star Alliance, the largest global aviation association.

Regarding regular scheduled international traffic, there were 21,031 fewer passengers transported than in the same period previous year, whereas PLF dropped on all markets except Macedonian, as a result of the independence of Kosovo and increased passenger traffic to Kosovo via Skopje in the first three months. The most dramatic decline was marked on the French, Benelux and Italian market, as a result of a drop in the number of visitors from these markets, while the markets of Bosnia and Herzegovina, Austria, Switzerland and Macedonia registered a capacity growth which had an impact on the growth in demand and number of transported passengers.

<sup>6</sup> PLF – Passenger load factor – labour productivity measured by the utilization of passenger capacities

<sup>7</sup> WLF – Weight load factor – labour productivity measured by the load utilization

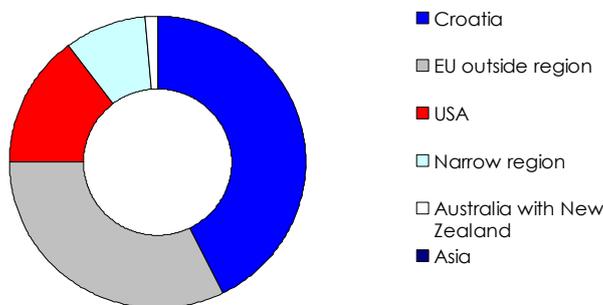
International scheduled passengers by flights market  
 2009 2008



Amsterdam and London routes achieved the highest load level (PLF).

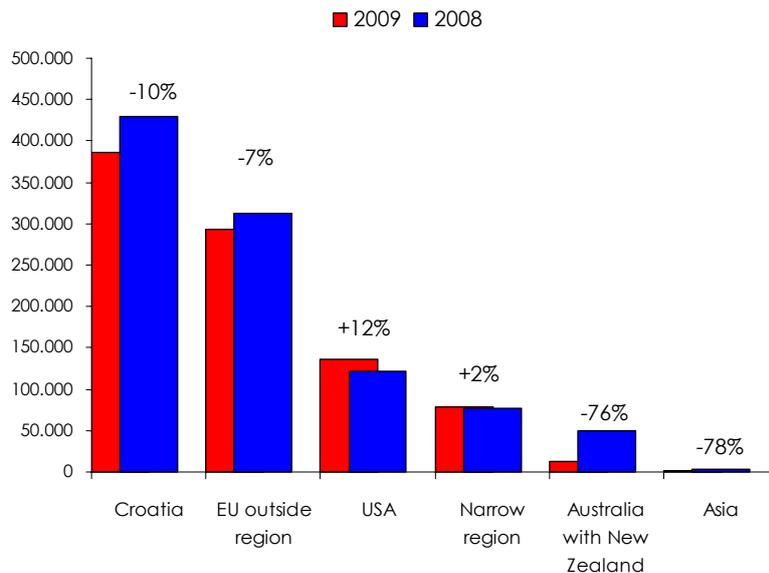
In 2009, Croatia Airlines introduced two new destinations – Barcelona and Gothenburg. From 29 March to 24 October, Croatia Airlines aircraft flew according to the summer timetable, on customised flights adapted to passenger needs and new fleet structure. The introduction of two new Q400 aircraft in June 2009 enabled Croatia Airlines international destination network expansion. The novelty consisted of direct flights from Croatian destinations to Barcelona (three times a week) and Gothenburg (twice a week) until June. Additional flights on specific routes (Zagreb – Copenhagen) were flown, and the weekly frequency of flights from Zagreb to Priština was enhanced. Direct flights from Pula to Paris (twice a week) were another novelty.

Distribution of sales market in scheduled traffic 2009



Sales data in distributor sales markets from 2009 indicate that, in addition to the domestic market, the greatest significance for the Company operations lies in European countries and the US market, with a historical demand for Croatia.

Changes in sales market (000 kn)



**A sales decline was registered in all sales channels.** Sales through in-house sales agents (branch offices) dropped by 13 per cent, BSP agent sales by four per cent, while non-BSP agent sales fell by 39 per cent.

**The domestic market** registered a sales decline of **nine per cent**, and the **foreign market sales fell** by seven per cent compared to the previous year. **The European Union market experienced a five per cent drop**, while the most dramatic decline was registered on the British and French markets. The markets in Spain, Sweden and Italy experienced a sales rise. Outside the EU, significant growth occurred on the new Kosovo market. Outside Europe, serious growth was registered on the American market, marking 2009 as the year of recovery from the recession. A dramatic decline on the Australian market was a result of the Australian strategic partner raising the price of their service up to the point of non-competitiveness.

Croatia Airlines participated at several European fairs presenting Croatian tourism: Ferienmesse (Vienna), Boot (Düsseldorf), Ferie (Copenhagen), Fitur (Madrid), Fespo (Zurich), TUR (Gothenburg), SITC (Barcelona), IMEX (Frankfurt), World Travel Market (London) and Croatian Days, organised by Leipzig airport.

Throughout the year, marketing actions “Europe starting from 164 Euros,” “An ideal amusement... or a gift?” from €119 return international flights and a domestic action “It’s nicer in two” were implemented. On the occasion of Croatia Airlines’ 20<sup>th</sup> birthday, the company organised a campaign “10,000 seats for 99 Euros”. Another prize-draw was organised; and if passengers registered at the Croatia Airlines website and sent interesting answers on Croatia Airlines services, they could win twenty free tickets.

In April intense promotional activities for the new destinations (Barcelona and Gothenburg) and routes (Pula – Paris) took place. In July flight advertisements Paris – Pula, Vienna – Dubrovnik, Vienna – Split, Zurich – Split and Zurich – Dubrovnik were published in Google search engines for the French, Austrian and Swiss markets. Aiming to promote international flights on the national market, strengthen the brand name and attract a larger

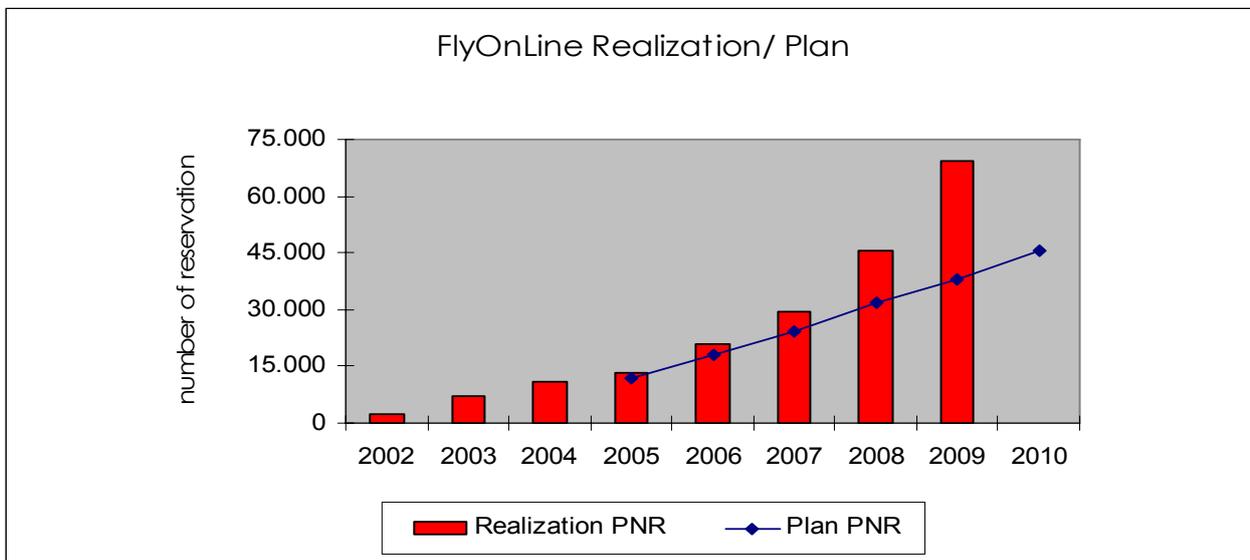
number of passengers to Croatia in the high season, the Google online campaign was intensified in Croatia, Bosnia and Herzegovina, the United Kingdom, Germany, the Netherlands and France. In September the online activities were continued, advertising promotional prices on four large markets: the United Kingdom, Germany, the Netherlands and France.

In March a new direct marketing, i.e. user communication channel was introduced – text messages.

In September and October members of the Miles&More programme were offered additional flight benefits – they could offer double status miles on Croatia Airlines, Lufthansa, SWISS, Austrian Airlines, LOT Polish Airlines, Adria Airways and Air Dolomite European flights.

In October, a promotional campaign advertising co-branding with Erste Card Club (Diners and VISA credit cards) took place, aiming to increase the number of customers and expenditure on co-branded cards.

Croatia Airlines helped its FlyOnLine users achieve cost savings on European flights. The passengers who booked and paid an international flight via the company website were charged a lower ticket issue fee. The objective was to raise Internet sales. **FlyOnLine booking grew by 52 per cent and online sales financially increased by 42 per cent compared to the previous year. Telephone sales grew as well, doubling the previous year's results**, while July was also the best month in history in terms of credit card phone payment.



PNR – Passenger Name Record – passenger booking identification

## Financial operations

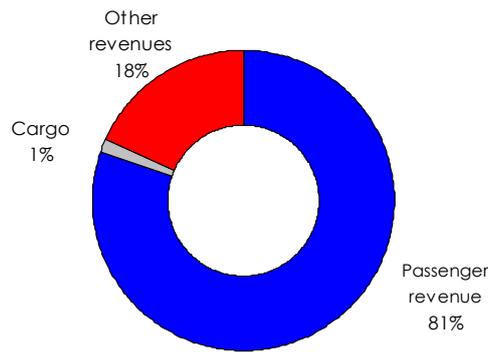
### Profit and loss account<sup>8</sup>

(000 kn)	2009	2008	Index 09/08	2007
Passenger traffic	1.081.830	1.352.819	80	1.210.527
Cargo traffic	18.323	26.348	70	22.534
Other revenues	247.102	252.138	98	230.873
<b>OPERATING REVENUES</b>	<b>1.347.256</b>	<b>1.631.305</b>	<b>83</b>	<b>1.463.935</b>
Flight operations	415.646	533.596	78	374.563
Maintenance	153.312	155.010	99	143.209
Passenger services	98.861	101.259	98	93.825
Aircraft and traffic services	355.873	338.589	105	317.350
Promotion and sales	222.298	225.753	98	214.424
General and administ. expenses	95.669	98.372	97	87.436
Amortization	147.889	172.440	86	179.346
Other expenses	22.948	36.832	62	5.790
<b>OPERATING EXPENSES</b>	<b>1.512.495</b>	<b>1.661.850</b>	<b>91</b>	<b>1.415.944</b>
<b>PROFIT/LOSS FROM OPERATIONS</b>	<b>-165.239</b>	<b>-30.546</b>	<b>-</b>	<b>47.991</b>
Interest expense	-35.944	-56.206	64	-56.140
Interest revenue	1.638	2.995	55	8.433
Foreign exchange differences, net	3.238	-6.542	-	3.092
Other financial expenses	-8.098	-4.970	163	-2.338
Other financial revenues	5.627	6.095	-	0
<b>NET FINANCIAL EXPENSES</b>	<b>-33.539</b>	<b>-58.628</b>	<b>57</b>	<b>-46.953</b>
<b>NET PROFIT</b>	<b>-198.778</b>	<b>-89.174</b>	<b>-</b>	<b>1.039</b>

Passenger traffic dropped by 20 per cent, operating income by 17 per cent, and operating costs by nine per cent. **Operating loss** amounting to HRK165 million, merged with fleet financing expense resulted in the **total net operating loss amounting to HRK199 million in 2009**.

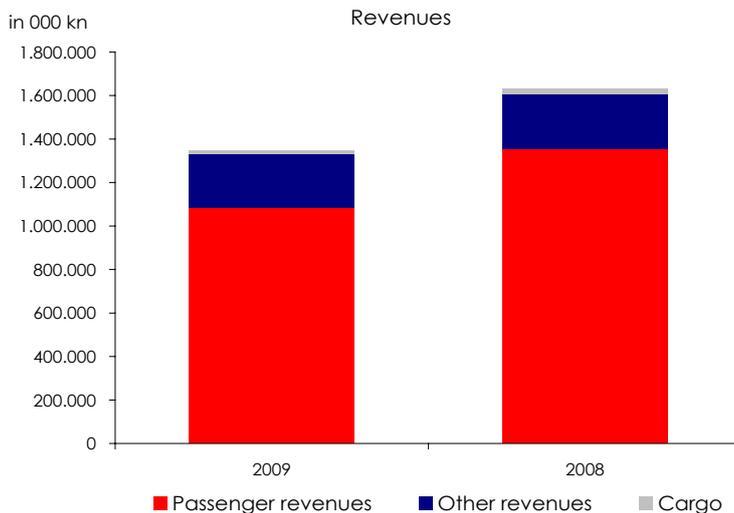
<sup>8</sup> In the audit report of profit and loss accounts, booking system revenues and expenses are displayed as promotion and sales net result, whereas in this report, as well as in all other internal reports, the said revenues and expenses are expressed by gross principle (booking system revenue as part of other revenues, and expenses as part of promotion and sales expenses).

Structure of operating revenues 2009



The passenger income share in operating income fell by three per cent compared to the previous year, now amounting to 81 per cent.

The decline in passenger income in relation to 2008 is a result of both the six per cent drop in the number of passengers and in average passenger fee accompanying industrial trends of a decline in yield and fee pressure.



Cargo income dropped by 30 per cent, in the wake of natural indicators.

In 2009, the contract on cargo transportation with Cargo Counts agent was taken over by Lufthansa Cargo, the owner of the mentioned agent, liquidated early in 2009 due to a change in the organisational structure.

Other operating income dropped by two per cent primarily due to reduced

government grants for domestic traffic and lower commissions from foreign carriers due to reduced traffic volume.

At the same time, **operating expenses dropped as well, namely by nine per cent. The most significant decline was registered in flying expenses due to reduced fuel price. The ratio of fuel expense** in total operating expenses fell by nine per cent compared to the previous year and **amounted to 13 per cent of the total operating expenses.** Regarding flying costs, aircraft lease expenses increased due to the arrival of two new Q400s and lease costs for A320 TCF, sold late in 2008 and taken as return lease. At the same time, fleet amortisation costs lower than the previous year was achieved.

Throughout the year, air traffic service cost grew due to a growth in aircraft total time, resulting from operating the more expensive Q400 instead of the permanently grounded ATR aircraft and growing air traffic control cost as a consequence of the Croatian Air Traffic Control decision to raise the terminal fee.

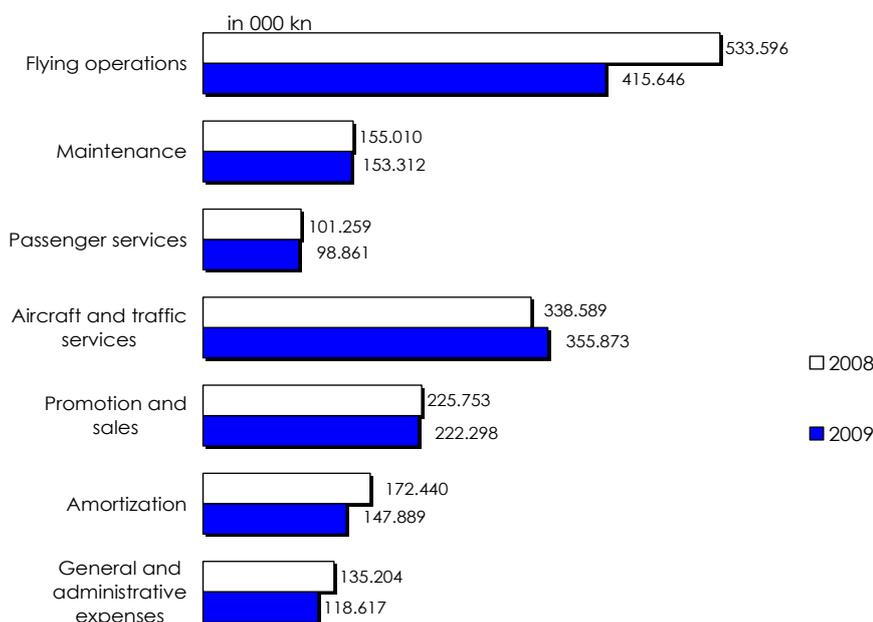
The decline in the number of passengers reduced the cost of passenger service, mainly attendance costs and air traffic disruptions.

Maintenance cost is also lower than the previous year, when it was burdened by skyrocketing expenses of ATR aircraft sale and fleet release preparations.

Traffic decline had an impact on the sales and promotion cost as well, primarily in terms of commission costs.

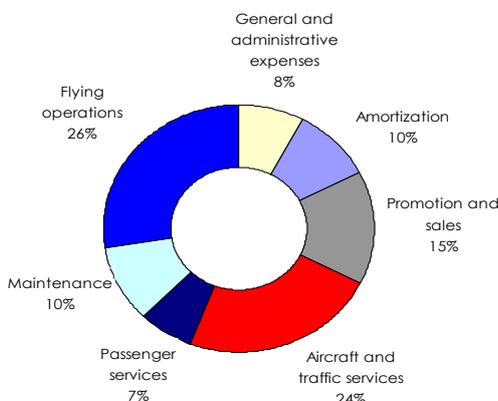
General and administrative expenses also tended to decrease in different expense categories which were continuously in the focus of business rationalisation (personnel hiring and training, current maintenance, intellectual services, vehicle expenses, various fees etc).

Other expenses also fell in 2009 compared to 2008, which was burdened by expensing current aircraft value, resulting from the sale of three ATR and one Airbus aircraft.



The largest share refers to flying and air traffic services cost. Flying cost share in total 2009 expenses dropped by five per cent due to reduced fuel cost in relation to the previous year, while the service cost rose by four per cent.

Structure of operating expenses 2009



## Assets, financing and investments

### Balance Sheet

(000 kn)	end 2009	end 2008	Index	end 2007	Index
<b>ASSETS</b>					
Non-current assets	1.414.148	1.476.098	96	1.707.793	86
Current assets	290.287	353.559	82	290.118	122
<b>TOTAL ASSETS</b>	<b>1.704.434</b>	<b>1.829.658</b>	<b>93</b>	<b>1.997.911</b>	<b>92</b>
<b>LIABILITIES</b>					
Capital and reserves	316.607	527.133	60	685.227	77
Non-current liabilities	828.120	794.436	104	931.493	85
Current liabilities	559.708	508.089	110	381.190	133
<b>TOTAL LIABILITIES</b>	<b>1.704.434</b>	<b>1.829.658</b>	<b>93</b>	<b>1.997.911</b>	<b>92</b>

*Note: Assets and liabilities level change in 2007 compared to the already published report for that period resulted from the need to restructure certain audit report categories for 2008 in accordance with the International Accounting Standards.*

At the end of the year, the asset value (liabilities and capital) decreased by seven per cent due to tangible asset decline caused by selling the ATR and A320CTF aircraft in 2008 and existing fleet amortisation.

Liabilities and capital were reduced as a result of 2009 losses and reduced loan-related liabilities and leasing (instalment payment).

At the end of 2009, long-term loan liabilities in domestic banks amounted to a total of HRK113.7 million, while the rest of the long-term loan principal in foreign syndicates amounted to HRK758.7 million.

## Investment in 2009

Investments	2009	2008	2007
Investments in aircraft	57.731.593	43.661.671	97.135.032
Investments in spare parts, tools and equip.	19.034.634	33.574.859	6.925.484
Construction investments	2.850.623	13.150.273	11.710.758
Intangible assets	6.312.363	6.861.115	1.172.153
Other equipment	5.199.195	2.922.564	1.439.159
Maintenance Reserve	18.571.237	39.254.966	36.704.562
<b>Total</b>	<b>109.699.646</b>	<b>139.425.448</b>	<b>155.087.148</b>
<b>Financial investments in aircraft (predelivery financing)</b>	<b>15.028.271</b>	<b>29.602.418</b>	
<b>Other financial investments</b>	<b>853.081</b>	<b>1.414.976</b>	<b>2.796.209</b>

**Aircraft investments** included planned twelve-year Airbus (CTG and CTH) testing worth of HRK17.4 million and Airbus (CTK and CTL) undercarriage replacement amounting to HRK6.8 million, as well as minor aircraft modifications worth of HRK3 million. Three Airbus aircraft engines were inspected and the regular engine blade replacement worth of HRK30.5 million took place. Aircraft investment grew due to the increased amount of works, inspections and engine works, pursuant to the fleet maintenance plan.

In addition to the listed investments, C-type inspections were internally performed on four Airbus aircraft (CTL, CTK, CTM and CTF) and two Q400 (CQA and CQB).

**Spare parts, tools and equipment investments** amounted to HRK19 million.

**Construction investments** amounted to HRK2.8 million, of which HRK1.8 million referred to the investment in the technical base project and HRK0.9 million to the investment in the varnish room pertaining to the project of hangar and technical maintenance equipment. Other expenses refer to minor infrastructural investments. The major part of the planned building investment was postponed for the upcoming period.

**Intangible asset investments** amounted to HRK6.3 million, largely representing integrated IT system investment, implemented with the assistance of S&T Croatia experts, **based on SAP ERP solutions** with some elements of the SAP BI system for planning and decision-making support, integrating the SAP system with the existing specialised industrial Croatia Airlines IT systems through SAP NetWeaver infrastructure. As planned, the SAP system was put in operation on 1 July 2009, the implementation of all interfaces was completed by the end of 2009, while the project will continue by introducing the SAP BI system and implementing the SAP SEM IT planning system.

**Other equipment** investment amounting to HRK5.2 million mainly referred to IT equipment investment worth of HRK4.3 million.

**Maintenance reserves** (investment in future aircraft and engine maintenance) amounted to HRK18.6 million.

In 2009, **aircraft financial investments** amounting to HRK15 million was realised, of which HRK11.1 million referred to Airbus aircraft pre-delivery financing, used to expand the mid-haul fleet in the upcoming mid-term period. The amount of HRK3.9 million pertains to the deposit for the third and fourth Q400 aircraft.

**Other financial investments** amounted to HRK0.85 million, referring to employee home loans guarantees.

## Cash flow movements

cash flow (000 kn)	2009	2008	Index	
<b>Balance of funds, beginning of period</b>	<b>69.918</b>	<b>77.841</b>	<b>90</b>	As a result of the recession and reduced traffic volume, the cash flow level (inflow and outflow) in 2009 dropped by 12 per cent compared to the previous year.
Inflow from activities	1.399.861	1.632.192	86	
Inflow from Government	130.286	99.922	130	
Sales of assets	604	124.728	0	
Loans	138.061	32.891	420	
Financial inflow	31.642	43.673	72	
<b>Total inflow</b>	<b>1.700.453</b>	<b>1.933.406</b>	<b>88</b>	Operating inflow decline resulting from reduced traffic and revenues was accompanied by a reduced capability of covering liabilities in due date.
Obligations	1.425.442	1.675.692	85	
Investments	46.014	57.965	79	
Loans	198.854	163.715	121	
Financial outflow	32.922	43.956	75	Throughout the year, loan debt amounting to HRK138 million was accrued, while HRK199 million worth of loan
<b>Total outflow</b>	<b>1.703.232</b>	<b>1.941.329</b>	<b>88</b>	
<b>Net change during the period</b>	<b>-2.779</b>	<b>-7.923</b>	<b>35</b>	
<b>Balance of funds, end of period</b>	<b>67.139</b>	<b>69.918</b>	<b>96</b>	

liabilities were closed.

In the last quarter of 2009 the short-term PBZ loans were closed amounting to a total of €8.6 million by a long-term loan from the same bank, while the remaining part of the long-term loan was used to cover short-term current expenditures. Additionally, a short-term solvency loan (taken out in May) was used and completely covered by the end of the year. In late 2009, based on realised guarantees, the Croatian Government financed the payment of six monthly instalments of the BLB loan for fleet refinancing.

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President & C.E.O.