

*MESABA AVIATION, INC.*



*ANNUAL REPORT • 1985*

## Corporate Profile

**Mesaba is the dominant regional carrier serving the hub airport of Minneapolis/St. Paul.**

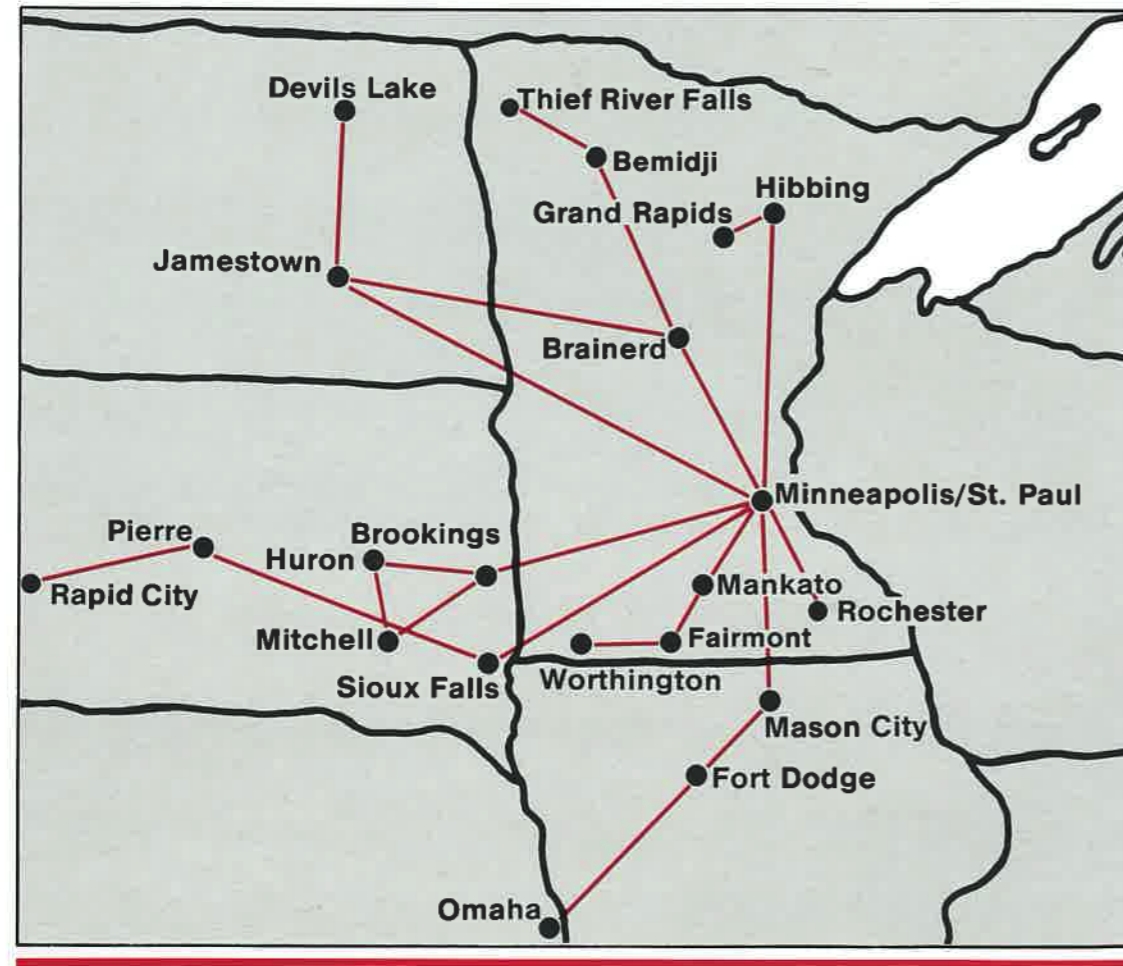
A U.S. Domestic Air Carrier, Mesaba Aviation, Inc. is an expanding regional airline, providing regularly-scheduled passenger and freight service to more than 20 small and medium-sized cities in Minnesota, Iowa, Nebraska, North Dakota and South Dakota. Mesaba is the dominant regional carrier serving the hub airport of Minneapolis/St. Paul, where the majority of its passengers interline with other carriers. Mesaba also carries U.S. air mail on a systemwide basis.

Since December 1, 1984, Mesaba has operated as Mesaba/Northwest Orient AirlinK, under a major marketing agreement with Northwest Orient Airlines. Through this relationship, Mesaba is able to provide improved connecting service between its regional cities and Northwest's

worldwide route system as a fully independent corporate entity.

Mesaba was one of the fastest expanding U.S. regional carriers in fiscal 1985 in terms of percentage growth in revenue passenger-miles. The Company currently operates a fleet of two, 44-passenger Fokker F27 prop jets and six, 15-passenger Beechcraft 99 prop jets. A third Fokker is scheduled to enter service mid-year in fiscal 1986.

Mesaba's common stock is traded on the NASDAQ National Market System under the symbol MESA. The majority of the Company's personnel are based at Minneapolis/St. Paul International Airport in Minneapolis, Minnesota.



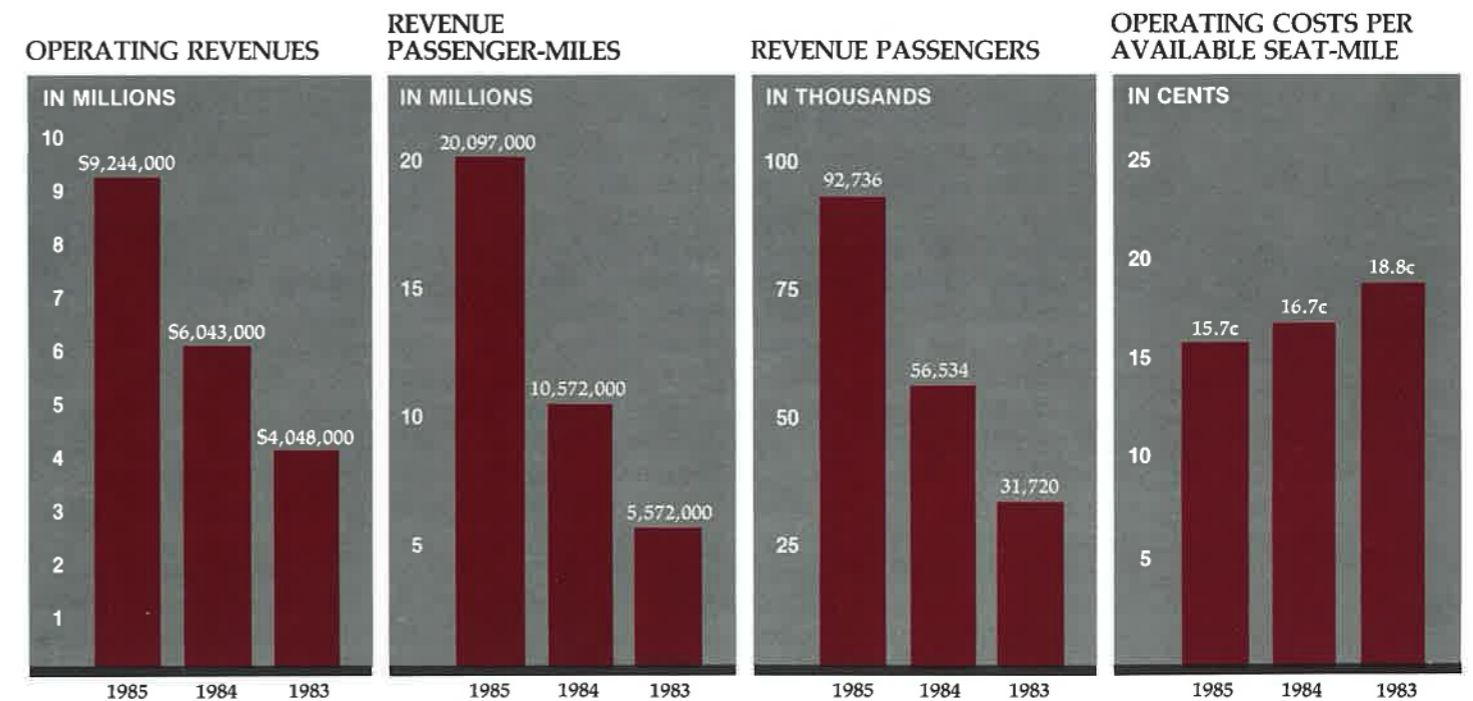
## Financial Highlights

(in thousands, except per share data)

| YEAR ENDED MARCH 31                     | 1985     | 1984     | 1983     | 1982     |
|---|----------|----------|----------|----------|
| Operating revenues                      | \$ 9,244 | \$ 6,043 | \$ 4,048 | \$ 1,587 |
| Operating expenses                      | 8,715    | 5,274    | 3,682    | 1,694    |
| Operating income (loss)                 | 529      | 769      | 366      | (107)    |
| Income (loss) before extraordinary item | 165      | 425      | 120      | (178)    |
| Extraordinary item                      | —        | —        | 68       | —        |
| Net income (loss)                       | 165      | 425      | 188      | (178)    |
| Net income (loss) per share             | .07      | .19      | .14      | (.16)    |

## Operating Statistics

| YEAR ENDED MARCH 31              | 1985   | 1984   | 1983   | 1982   |
|----------------------------------|--------|--------|--------|--------|
| Revenue passengers carried       | 92,736 | 56,534 | 31,720 | 10,527 |
| Revenue passenger-miles (000)    | 20,097 | 10,572 | 5,572  | 1,409  |
| Available seat-miles (000)       | 53,613 | 29,163 | 16,581 | 4,684  |
| Passenger load factor            | 37.5%  | 36.3%  | 33.6%  | 30.1%  |
| Yield per revenue passenger-mile | 30.4¢  | 29.7¢  | 30.6¢  | 39.4¢  |
| Aircraft miles flown (000)       | 2,907  | 1,944  | 1,084  | 311    |
| Departures                       | 24,398 | 19,506 | 12,974 | 4,136  |





## To Our Shareholders:

**Mesaba successfully demonstrated its underlying earnings power in fiscal 1985 amid a program of heavy investments in the future of this airline.**

Mesaba successfully demonstrated its underlying earnings power in fiscal 1985 amid a program of heavy investments in the future of this airline and quality air service for our region. Our ability to maintain profitability while investing in aircraft, route expansion, facilities and marketing programs makes us optimistic about Mesaba's long-term prospects. With many of our growth plans and strategies now in place, we believe that Mesaba is prepared for profitable, long-term growth as the dominant regional carrier serving the Twin Cities of Minneapolis and St. Paul.

Paced by strong traffic growth, Mesaba reported record operating revenues of \$9,244,000 for the fiscal year ended March 31, 1985, up 53 percent from \$6,043,000 in fiscal 1984. Reflecting the impact of high investments in growth programs, our operating income declined to \$529,000 in fiscal 1985 from \$769,000 in the prior year. Net income for the year amounted to \$165,000 or 7 cents per share, compared to \$425,000 or 19 cents per share in fiscal 1984.

The successful implementation of our large Fokker F27 jet prop aircraft under Federal Aviation Administration operating regulations as a "Domestic Air Carrier" was the major operational highlight in fiscal 1985. These 44-passenger aircraft have proven to be very reliable, have the amenities desired by the traveling public and provide Mesaba with considerably greater flexibility in terms of capacity and scheduling. The passenger acceptance of our F27s is demonstrated by our April 1985 average load factor of 51 percent for all F27 flights into and out of the Twin Cities. Together with our six, 15-passenger Beechcraft 99 jet props, Mesaba has the type of fleet that is enabling us to capitalize on promising new opportunities throughout our service region.

During the year, Mesaba also established a major marketing relationship with Northwest Orient Airlines. Operating as Northwest Orient Airlink since December 1, 1984, but fully maintaining our independent corporate existence, Mesaba has already realized benefits from this relationship in our most competitive markets. Since much of our future growth will be in these types of larger markets, we believe that the

positive impact of our Airlink agreement will become increasingly pronounced in coming years.

A summary of the major investments made by Mesaba during fiscal 1985 include:

- Startup and certification expenses associated with introducing our first two Fokker F27 jet prop aircraft.

- The cost of developing the new F27 routes of Minneapolis/St. Paul-Brainerd-Bemidji, Minnesota and Minneapolis/St. Paul-Sioux Falls-Pierre-Rapid City, South Dakota. We devoted significant resources to developing these promising markets and our efforts are being rewarded by steadily rising load factors.

- The expenses of relocating our major maintenance, operations and some corporate offices to a leased, 34,000-square-foot facility at Minneapolis/St. Paul International Airport. This move has enabled us to consolidate hangar, shop and office space under one roof. We are constantly evaluating the benefits and efficiencies that would result from further consolidations.

- The costs associated with implementing the Northwest Orient Airlink program. A variety of miscellaneous expenses affected Mesaba during the first few months of this relationship, but the benefits of this marketing agreement have begun to occur and will continue as we move forward.

Two other elements of our fiscal 1985 performance also merit some attention at this time. First, we became eligible to carry U.S. air mail on January 1, 1985, and this has generated additional operating revenues with little extra expense. Second, we are continuing to reduce our reliance on federally-subsidized air service revenues. Public service revenues accounted for 27 percent of our total revenues in fiscal 1985, down from 37 percent in fiscal 1984 and 39 percent in fiscal 1983. We expect this trend to continue over the next year, as evidenced by public service revenues accounting for 20 percent of total operating revenues in April 1985.

As a commuter carrier in 1978 when the Airline Deregulation Act was passed, we successfully competed for routes under the Essential Air Service program, which served as a foundation

for future operations. With the development of a growing and commercially-viable regional route system since then, we have been able to steadily lessen our reliance on public service revenues, while maintaining quality service to the cities we serve. Our success at meeting this objective has become all the more important in light of the Administration's intent to curtail all funding of the Essential Air Service program prior to its scheduled termination in 1988. We are strong advocates of this program and believe it should and will be continued. Mesaba, however, is prepared to deal with any funding cutbacks in a way that would minimize the short-term impact on our financial performance.

Finally, Mesaba qualified for inclusion in the NASDAQ National Market System starting on March 5, 1985. This means that our last sale price is available to all securities dealers within 90 seconds of a trade and that Mesaba stock is now marginable.

The months since the end of fiscal 1985 have been extremely busy and productive for us. In the first quarter of fiscal 1986, we added two new cities to our growing route system, Rochester and Thief River Falls, Minnesota. During fiscal 1986 we also plan to inaugurate additional service in competitive markets, where we expect to realize the benefits of our Mesaba/Northwest Orient Airlink relationship.

Some of this additional service will be provided by a third Fokker F27, which we plan to purchase during this summer. This purchase, including spare parts, will be financed by a convertible loan package of about \$2.5 million with Northwest Aircraft Inc., a wholly-owned subsidiary of NWA Inc. This package will facilitate our growth and should help ensure the continuing success of our marketing agreement with Northwest Orient.

It bears noting that prior to the introduction of our third F27, Mesaba has efficiently absorbed and utilized all of its existing fleet capacity. During the past year, we have added four new cities with one less aircraft, since we returned one of our two leased Beech 99s in April 1985. In anticipation of future fleet requirements



beyond the third Fokker, we are considering leasing additional aircraft, and we are evaluating the possibility of raising additional equity through a public stock offering, which would be our first since originally going public in March 1983. We have made wise use of the proceeds from our first offering and we plan to maintain adequate working capital to support our growth plans.

Looking ahead, we believe that fiscal 1986 is shaping up as a very good year for Mesaba in our plan of structured, long-term growth. We have already experienced strong traffic growth and set new passenger records in the first two months of the first quarter. This makes us optimistic about attaining solid gains in both operating revenues and net income during fiscal 1986. In addition to building total traffic, we will also be working to improve load factors and yields on our system.

A special word of thanks is due Mesaba's outstanding employees, who made fiscal 1985 the productive year that it was. We also appreciate the continuing support of our shareholders and look forward to rewarding your confidence in Mesaba with good results in fiscal 1986.

Sincerely,

Robert D. Swenson  
President and Chief Executive Officer





## Mesaba: Positioned For Long-Term Growth

Mesaba Airlines is the leading regional carrier serving the Twin Cities in terms of passengers and scheduled departures. Although Minneapolis/St. Paul is our major hub airport, our system also includes service to the smaller hubs of Omaha, Nebraska, and Sioux Falls and Rapid City, South Dakota. Altogether, Mesaba's route system as of June 3, 1985, encompassed 21 small and medium-sized cities in the five states of Minnesota, Iowa, Nebraska, North Dakota and South Dakota. By comparison, our route system consisted of only six cities in Minnesota in 1981.

Over the past five years, our central growth strategy has focused on taking maximum advantage of airline deregulation. Essentially, the Deregulation Act of 1978 enabled major carriers to withdraw from many short-haul markets and gain easier access to additional long-haul routes. For many communities in this region, the resulting need for dependable, short-haul replacement service has generated a range of growth opportunities for Mesaba. Many of the regional markets that are currently in our system were formerly served by such carriers as Republic, Western and Ozark. When they pulled out of certain cities, Mesaba was quick to step in. The result has been quality air service for many portions of our region and profitable growth for Mesaba.

### Entering Future Markets

We are currently competing with other carriers in over 50 percent of our markets. The ability to be successfully competitive is attributable to the quality of our fleet, the skill of Mesaba's personnel and our experience in serving this region.

These factors will continue serving us well, because we believe that a great deal of Mesaba's future growth will be generated in competitive markets.

Our growth in competitive markets makes Mesaba's Airlink relationship with Northwest Orient Airlines an important aspect of our future plans. Under this marketing agreement, Mesaba retains its completely independent corporate existence. With fully coordinated flight schedules between Mesaba and Northwest, the agreement provides travelers with better connecting service between our regional cities and Northwest's global route system.

### Operating as Northwest Orient Airlink

Northwest Orient Airlink offers a wide range of competitive fares for travelers, and flights are prominently displayed in the Official Airline Guide and travel agent reservation systems as Northwest Orient Airlink flights. All Mesaba flights arriving or departing the Twin Cities and Omaha appear in Northwest's timetables and all Mesaba cities are treated as Northwest Orient cities for marketing and reservations purposes. This includes full integration of Northwest's free flight plan into our system and through-baggage check-in.

Mesaba's ticket counter and baggage check-in operations in the Twin Cities, Omaha and Rochester, Minnesota, are handled by Northwest personnel under the Airlink agreement. Possibly most important of all, Mesaba flights now operate from the main terminal at Minneapolis/St. Paul International Airport. This move from the

*Mesaba's "Airlink" relationship with Northwest Orient Airlines will be an important aspect of our future plans as we continue to grow in competitive markets.*

less convenient regional commuter terminal is a major competitive advantage for Mesaba.

### Flying A Modern, Efficient Fleet

In addition to initiating Mesaba/Northwest Orient Airlink, Mesaba has sharpened its competitive edge through several other strategies. First, the quality of our large equipment gives us a competitive advantage in terms of passenger comfort and amenities, operating efficiency and scheduling flexibility in many markets. These benefits will become still more obvious in the future as we expand our fleet of Fokker F27 jet props. These 44-passenger aircraft are permitting Mesaba to enter and develop new markets relatively quickly and effectively. Passenger acceptance of our first two Fokkers over the past year has been extremely good and we intend to purchase additional F27s in response to capacity and scheduling requirements.

Our competitive capabilities received an added boost from the move to consolidate most of Mesaba's operations at our Minneapolis/St. Paul facilities. The operating efficiencies gained by consolidating most functions under a single roof should become increasingly apparent in the coming year.

### Looking To The Future

The strategies and plans implemented over the past year have positioned Mesaba for a period of profitable, managed growth. Our future controlled expansion will be guided by a number of central growth strategies, such as:

- We intend to maintain our position as the dominant regional carrier serving the Twin Cities by selectively adding new cities to our regional route system. Before adding any new cities, the market under consideration must be able to meet certain minimum profitability requirements over the long term.
- Our Fokker F27 fleet will be expanded in a timely manner in order to meet capacity and scheduling requirements.
- We will continue with our priority to improve our overall operating efficiencies. We will also take all appropriate steps designed to improve load factors on our routes and increase the yield per passenger-mile.

Mesaba was a small commuter airline only five years ago. Since that time, our revenue passenger-miles have expanded 14-fold and available seat-miles are nine times greater. Mesaba has been one of the most rapidly growing carriers in the regional airline industry with the people and programs in place that should continue facilitating our long-term growth and profitability. With our 12 years in the scheduled airline business and over forty years of aviation history, Mesaba has been able to grow in a structured manner offering quality and reliable services to our customers.

*The quality of our growing Fokker F27 fleet gives Mesaba a competitive advantage in terms of passenger comfort, operating efficiency and scheduling flexibility.*





## Financial Review

**OPERATING REVENUES.** Operating revenues totaled \$9,244,000 in fiscal 1985, up 53 percent from \$6,043,000 in fiscal 1984 and \$4,048,000 in fiscal 1983. Passenger revenues remained the largest component of total operating revenues, rising 95 percent in fiscal 1985 to \$6,103,000 from \$3,135,000 in fiscal 1984 and \$1,708,000 in fiscal 1983. Revenue passengers carried in fiscal 1985 increased to 92,736, compared to 56,534 in fiscal 1984 and 31,720 in fiscal 1983. Reflecting the Company's strategy to continue reducing its reliance on federal subsidies from essential air service, public service revenues as a percentage of total operating revenues declined to 27 percent in fiscal 1985 from 37 percent in fiscal 1984 and 39 percent in fiscal 1983. The Company expects this declining trend to continue in fiscal 1986.

The increased fiscal 1985 operating revenues reflected the positive impact of the Company's first two 44-passenger Fokker F27 jet prop aircraft, the addition of new routes, the benefits of the Northwest Orient Airlink marketing agreement in Mesaba's competitive routes, and operating certain routes for a full year which were introduced in late fiscal 1984.

Essential air service to Fort Dodge and Mason City, Iowa is now operated on an interim contract basis, and the Company has submitted a two-year bid for continuing service to these communities. Other competitors also are bidding for this route, and the federal government's decision is expected later this year.

**OPERATING EXPENSES.** Operating expenses totaled \$8,715,000 in fiscal 1985, an increase of 65 percent from \$5,274,000 in fiscal 1984 and also up from \$3,683,000 in fiscal 1983. In spite of this increase, operating expenses per available seat-mile (one passenger seat times one aircraft mile flown) declined to 15.68 cents in fiscal 1985 from 16.73 cents and 18.82 cents in fiscal years 1984 and 1983, respectively. The 1985 decline reflected the lower operating costs of the first two Fokker F27 aircraft plus the larger base of available seat-miles over which fixed costs are spread. In addition, the Company was able to

preserve its yield per revenue passenger-mile (one passenger times one aircraft mile flown), which stood at 30.36 cents in fiscal 1985, compared to 29.65 cents in fiscal 1984 and 30.64 cents in fiscal 1983.

The fiscal 1985 increase in total operating expenses reflected the effect of a series of major investments intended to facilitate the Company's future growth. These included: relocating a significant portion of Company operations to a leased 34,000-square-foot facility at Minneapolis/St. Paul International Airport; the cost of developing new Fokker F27 routes; start-up and related costs of the Company's Fokker F27 aircraft; and the expenses associated with implementing the Northwest Orient Airlink marketing agreement.

**NONOPERATING EXPENSE (INCOME).** Nonoperating expense totaled \$262,000 in fiscal 1985, compared with nonoperating income of \$14,000 in fiscal 1984 and nonoperating expense of \$178,000 in fiscal 1983. Interest expense rose \$239,000 to \$394,000 in fiscal 1985, due primarily to a term loan with the Company's major bank lender to finance the purchase of two Fokker F27 aircraft. Interest income declined by \$41,000 to \$82,000 in fiscal 1985 as short-term investments were used to support a number of major expansion programs, including Fokker start-up costs and those associated with relocating certain Company operations to Minneapolis/St. Paul.

**PROVISION FOR INCOME TAXES.** The Company's provision for Federal and State income taxes was \$102,000 in fiscal 1985, compared to \$358,000 and \$68,000 in fiscal years 1984 and 1983, respectively. The decreased provision in fiscal 1985 reflected the lower level of operating income and the effect of investment tax credits.

**NET INCOME.** Reflecting the impact of increased operating and nonoperating expenses, net income totaled \$165,000 or 7 cents per share in fiscal 1985, down from \$425,000 or 19 cents

per share in fiscal 1984 and \$188,000 or 14 cents per share in fiscal 1983. Fiscal 1983 results included an extraordinary credit of \$68,000 or 5 cents per share, due to utilization of a net operating loss carryforward from the prior year.

**LIQUIDITY AND CAPITAL RESOURCES.** The Company had a slight deficit in working capital of \$23,000 at March 31, 1985, compared to working capital of \$1,163,000 at March 31, 1984. The Company's working capital at March 31, 1984 was used in fiscal 1985 principally to finance: start-up costs for the two Fokker aircraft of \$292,000, payments of long-term debt of \$694,000, and increases in the current maturities of long-term debt by \$359,000, resulting from the term loan for financing two Fokker F27 aircraft and a Beechcraft 99 loan due a Foundation, which became current and has since been paid. The Company's cash and short-term investments at March 31, 1985 totaled \$357,000, compared to \$1,257,000 at March 31, 1984. Cash and short-term investments have begun to trend upward during the first two months of fiscal 1986.

Long-term lenders to the Company have placed certain restrictive covenants on Mesaba, and at March 31, 1985 the Company had either complied with these covenants or obtained formal waivers to place it in compliance with these loan agreements.

The Company expects to fund its working capital requirements in fiscal 1986 with internally-generated funds from operations, cash and other liquid assets on hand at March 31, 1985, and a \$1,050,000 revolving line of bank credit. The Company also is evaluating the possibility of raising additional capital to support future operations through a public stock offering.

Subsequent to March 31, 1985, the Company entered into a Debenture Purchase Agreement for \$2.5 million with Northwest Aircraft Inc., a wholly-owned subsidiary of NWA Inc. The debenture bears interest at an annual rate of 9%, has a term of 6 years and provides for retirement of 45% of the principal amount prior to matu-

ity. The principal of the debenture is convertible into the common stock of Mesaba at the rate of \$3.96 per share from time to time prior to the retirement of the debenture.

**EFFECT OF INFLATION.** The Company's results of operations for fiscal 1985 were not significantly affected by inflation.

### Common Stock Information

The common stock of Mesaba Aviation, Inc. is traded on the NASDAQ National Market System under the symbol MESA. The following table sets forth the closing bid or last sale price of the Company's common stock for the fiscal quarters of 1985 and 1984.

|                | Fiscal Years                  |                               |                               |                               |
|----------------|-------------------------------|-------------------------------|-------------------------------|-------------------------------|
|                | 1985                          |                               | 1984                          |                               |
|                | High                          | Low                           | High                          | Low                           |
| First Quarter  | 3 <sup>5</sup> / <sub>8</sub> | 2 <sup>5</sup> / <sub>8</sub> | 4 <sup>5</sup> / <sub>8</sub> | 2 <sup>1</sup> / <sub>8</sub> |
| Second Quarter | 3 <sup>5</sup> / <sub>8</sub> | 2 <sup>5</sup> / <sub>8</sub> | 4 <sup>3</sup> / <sub>4</sub> | 3 <sup>1</sup> / <sub>8</sub> |
| Third Quarter  | 3 <sup>7</sup> / <sub>8</sub> | 2 <sup>7</sup> / <sub>8</sub> | 4                             | 3 <sup>1</sup> / <sub>4</sub> |
| Fourth Quarter | 3 <sup>1</sup> / <sub>8</sub> | 2 <sup>3</sup> / <sub>4</sub> | 4                             | 3 <sup>1</sup> / <sub>8</sub> |

On June 14, 1985, the number of holders of record of common stock was 886.

No cash dividends have been paid by the Company to date.

## MESABA AVIATION, INC.

## Balance Sheets

| Assets  | March 31           |                    |
|---|--------------------|--------------------|
|   | 1985               | 1984               |
| <b>CURRENT ASSETS:</b>  |                    |                    |
| Cash  | \$ 54,339          | \$ 43,115          |
| Short-term investments  | 302,256            | 1,213,502          |
| Accounts receivable   | 881,746            | 886,137            |
| Inventories -   |                    |                    |
| Service parts   | 343,813            | 328,277            |
| Aircraft held for resale  | 62,348             | 61,911             |
| Prepaid expenses  | 54,647             | 13,268             |
| Total current assets  | <u>1,699,149</u>   | <u>2,546,210</u>   |
| <b>PROPERTY AND EQUIPMENT:</b>  |                    |                    |
| Flight equipment  | 6,751,510          | 4,384,587          |
| Buildings and improvements  | 366,769            | 187,233            |
| Furniture and equipment   | 730,841            | 394,072            |
| Accumulated depreciation and amortization   | (1,330,808)        | (753,877)          |
| Net property and equipment  | <u>6,518,312</u>   | <u>4,212,015</u>   |
| <b>OTHER ASSETS</b> , principally deferred preoperating costs,<br>net of accumulated amortization of \$139,000 and \$41,000,<br>respectively, and aircraft deposits | 457,293            | 312,936            |
|   | <u>\$8,674,754</u> | <u>\$7,071,161</u> |
| <b>Liabilities and Stockholders' Equity</b>   |                    |                    |
| <b>CURRENT LIABILITIES:</b>   |                    |                    |
| Current maturities of long-term debt  | \$ 931,607         | \$ 572,854         |
| Accounts payable  | 376,659            | 253,782            |
| Accrued liabilities -   |                    |                    |
| Public service subsidies  | —                  | 157,025            |
| Payroll and other   | 381,012            | 240,946            |
| Deferred ticket revenue   | 32,729             | 158,988            |
| Total current liabilities   | <u>1,722,007</u>   | <u>1,383,595</u>   |
| <b>LONG-TERM DEBT</b> , net of current maturities   | 3,483,108          | 2,502,815          |
| <b>DEFERRED INCOME TAXES</b>  | 454,000            | 358,000            |
| <b>COMMITMENTS AND CONTINGENCIES</b> (Note 4)   |                    |                    |
| <b>STOCKHOLDERS' EQUITY:</b>  |                    |                    |
| Common stock, \$0.01 par value; 5,000,000 shares authorized,<br>2,127,539 and 2,107,604 shares issued and outstanding   | 21,275             | 21,076             |
| Paid-in capital   | 2,393,805          | 2,370,096          |
| Retained earnings   | 600,559            | 435,579            |
| Total stockholders' equity  | <u>3,015,639</u>   | <u>2,826,751</u>   |
|   | <u>\$8,674,754</u> | <u>\$7,071,161</u> |

The accompanying notes are an integral part of these balance sheets

## MESABA AVIATION, INC.

## Statements of Operations

|   | Years Ended March 31 |                   |                   |
|---|----------------------|-------------------|-------------------|
|   | 1985                 | 1984              | 1983              |
| <b>OPERATING REVENUES:</b>  |                      |                   |                   |
| Passenger   | \$6,102,511          | \$3,134,911       | \$1,707,557       |
| Public service  | 2,514,785            | 2,231,300         | 1,576,355         |
| Aircraft sales and services   | 379,294              | 433,951           | 601,839           |
| Freight and other   | 247,218              | 242,909           | 162,395           |
| Total operating revenues  | <u>9,243,808</u>     | <u>6,043,071</u>  | <u>4,048,146</u>  |
| <b>OPERATING EXPENSES:</b>  |                      |                   |                   |
| Flying operations   | 2,870,347            | 1,751,552         | 1,129,557         |
| Maintenance   | 1,613,349            | 871,072           | 412,825           |
| Aircraft and traffic servicing  | 1,635,757            | 836,339           | 588,489           |
| Reservations, sales and advertising   | 809,999              | 528,702           | 365,732           |
| Aircraft sales and services   | 309,452              | 394,699           | 562,134           |
| General and administrative  | 723,785              | 524,226           | 314,530           |
| Depreciation and amortization   | 752,611              | 367,295           | 309,095           |
| Total operating expenses  | <u>8,715,300</u>     | <u>5,273,885</u>  | <u>3,682,362</u>  |
| Operating income  | <u>528,508</u>       | <u>769,186</u>    | <u>365,784</u>    |
| <b>NONOPERATING EXPENSE (INCOME):</b>   |                      |                   |                   |
| Interest expense  | 394,323              | 155,050           | 213,030           |
| Interest income   | (82,485)             | (123,220)         | (8,954)           |
| Other, net  | (50,310)             | (46,104)          | (26,013)          |
| Net nonoperating expense (income)   | <u>261,528</u>       | <u>(14,274)</u>   | <u>178,063</u>    |
| Income before income taxes and<br>extraordinary item  | 266,980              | 783,460           | 187,721           |
| <b>PROVISION FOR INCOME TAXES</b>   | <u>102,000</u>       | <u>358,000</u>    | <u>68,000</u>     |
| Income before extraordinary item  | 164,980              | 425,460           | 119,721           |
| <b>EXTRAORDINARY CREDIT</b> - Income tax<br>benefit from utilization of net operating loss<br>carryforwards | —                    | —                 | 68,000            |
| Net income  | <u>\$ 164,980</u>    | <u>\$ 425,460</u> | <u>\$ 187,721</u> |
| <b>INCOME PER SHARE:</b>  |                      |                   |                   |
| Before extraordinary credit   | \$ 0.07              | \$ 0.19           | \$ 0.09           |
| Extraordinary credit  | —                    | —                 | 0.05              |
| Net income per share  | <u>\$ 0.07</u>       | <u>\$ 0.19</u>    | <u>\$ 0.14</u>    |

The accompanying notes are an integral part of these statements

## Statements of Changes in Financial Position

|  | Years Ended March 31 |                     |                    |
|--|----------------------|---------------------|--------------------|
|  | 1985                 | 1984                | 1983               |
| <b>SOURCES OF WORKING CAPITAL:</b>               |                      |                     |                    |
| Net income before extraordinary credit           | \$ 164,980           | \$ 425,460          | \$ 119,721         |
| Items not affecting working capital -            |                      |                     |                    |
| Depreciation                                     | 611,272              | 312,163             | 229,817            |
| Amortization of deferred maintenance costs       | 242,194              | 224,091             | 76,469             |
| Amortization of preoperating costs               | 141,339              | 55,132              | 79,278             |
| Deferred income taxes                            | 102,000              | 358,000             | —                  |
| Total working capital provided by operations     | 1,261,785            | 1,374,846           | 505,285            |
| Extraordinary credit                             | —                    | —                   | 68,000             |
| Issuance of common stock                         | 23,908               | 5,451               | 1,525,421          |
| Additional borrowings of long-term debt          | 2,033,000            | 2,050,332           | 276,873            |
| Sale of property and equipment                   | 14,490               | 8,383               | 36,944             |
| Total sources of working capital                 | 3,333,183            | 3,439,012           | 2,412,523          |
| <b>USES OF WORKING CAPITAL:</b>                  |                      |                     |                    |
| Purchase of property and equipment               | 3,174,253            | 2,805,439           | 705,812            |
| Reduction of long-term debt                      | 1,052,707            | 616,290             | 283,024            |
| Increase in other assets                         | 291,696              | 231,292             | 82,688             |
| Total uses of working capital                    | 4,518,656            | 3,653,021           | 1,071,524          |
| Increase (decrease) in working capital           | <u>\$(1,185,473)</u> | <u>\$ (214,009)</u> | <u>\$1,340,999</u> |
| <b>CHANGES IN COMPONENTS OF WORKING CAPITAL:</b> |                      |                     |                    |
| Cash and short-term investments                  | \$ (900,022)         | \$ (93,053)         | \$1,325,499        |
| Accounts receivable                              | (4,391)              | 366,048             | 321,124            |
| Inventories                                      | 15,973               | 129,082             | (150,911)          |
| Prepaid expenses                                 | 41,379               | (19,061)            | (35,334)           |
| Notes payable                                    | —                    | —                   | 153,536            |
| Current maturities of long-term debt             | (358,753)            | (340,754)           | (57,831)           |
| Other current liabilities                        | 20,341               | (256,271)           | (215,084)          |
| Increase (decrease) in working capital           | <u>\$(1,185,473)</u> | <u>\$ (214,009)</u> | <u>\$1,340,999</u> |

The accompanying notes are an integral part of these statements

## Statements of Changes in Stockholders' Equity

for the years ended March 31, 1985, 1984 and 1983

|   | Common Stock     |                 | Paid-in Capital    | Retained Earnings (Deficit) | Total Stockholders' Equity |
|---|------------------|-----------------|--------------------|-----------------------------|----------------------------|
|   | Shares           | Amount          |                    |                             |                            |
| <b>BALANCE, MARCH 31, 1982</b>                              | 1,200,000        | \$12,000        | \$ 848,300         | \$(177,602)                 | \$ 682,698                 |
| Sale of common stock, net of offering costs and commissions | 900,000          | 9,000           | 1,516,421          | —                           | 1,525,421                  |
| Net income  | —                | —               | —                  | 187,721                     | 187,721                    |
| <b>BALANCE, MARCH 31, 1983</b>                              | 2,100,000        | 21,000          | 2,364,721          | 10,119                      | 2,395,840                  |
| Sale of common stock under stock option plan                | 7,604            | 76              | 5,375              | —                           | 5,451                      |
| Net income  | —                | —               | —                  | 425,460                     | 425,460                    |
| <b>BALANCE, MARCH 31, 1984</b>                              | 2,107,604        | 21,076          | 2,370,096          | 435,579                     | 2,826,751                  |
| Sale of common stock under stock option plan                | 15,205           | 152             | 10,749             | —                           | 10,901                     |
| Issuance of stock bonuses to employees                      | 4,730            | 47              | 12,960             | —                           | 13,007                     |
| Net income  | —                | —               | —                  | 164,980                     | 164,980                    |
| <b>BALANCE, MARCH 31, 1985</b>                              | <u>2,127,539</u> | <u>\$21,275</u> | <u>\$2,393,805</u> | <u>\$ 600,559</u>           | <u>\$3,015,639</u>         |

## Notes to Financial Statements

(1) **Summary of Significant Accounting Policies-Short-Term Investments:** Short-term investments consist of savings certificates, certificates of deposit and commercial paper, stated at cost which approximates market.

**Inventories:** Inventories consist of expendable aircraft service parts, fuel and aircraft held for resale and are stated at the lower of average cost or market. During 1985, Mesaba changed from a first-in, first-out inventory pricing method to the average cost method. This change in pricing method did not have a significant effect on total inventory valuation or net income.

**Property and Equipment:** Property and equipment are stated at cost and depreciated on a straight-line basis for financial reporting purposes over estimated useful lives of 7-10 years for aircraft engines, flight equip-

ment and rotatable parts, 5-36 years for buildings and improvements, and 3-10 years for all other equipment. Flight equipment includes \$169,000 of interest capitalized in 1985 relating to the acquisition of the Fokker aircraft. Leasehold improvements are amortized over the life of the lease or the life of the asset, whichever is shorter. Accelerated methods of depreciation are utilized for tax reporting purposes.

Maintenance and repairs are charged to expense when incurred except for major aircraft engine repairs. For purchased aircraft, the deferred method of accounting is followed whereby major overhaul costs are capitalized when the expenditure is incurred and amortized over the estimated number of hours until the next scheduled overhaul. For leased aircraft, major engine repair costs are accounted for using the accrual method to recognize the liability for engine usage.



Notes to Financial Statements, continued.

Under this method, the estimated cost of future overhauls is accrued based upon hours flown at a rate computed to provide for the overhaul cost when it occurs.

**Development and Preoperating Costs:** The costs of developing new routes and certain preoperating costs incurred to start up new routes are deferred and amortized over two years. In addition, certain preoperating costs incurred in the acquisition and related certification of two Fokker F27 aircraft are deferred and amortized over five years.

**Revenue Recognition:** Revenues are recorded as income when the respective services are rendered. Tickets which are sold but not yet used are recorded as deferred ticket revenue.

**Public Service Revenues:** Mesaba receives public service revenues for serving certain communities that do not generate sufficient traffic to fully support profitable air service. The amount of such subsidies is negotiated with the Department of Transportation (formerly the Civil Aeronautics Board) under a competitive bid process. The subsidies are projected to meet all operating expenses and to provide a return on investment with respect to eligible routes.

**Investment Tax Credits:** Investment tax credits generated through the acquisition of assets are accounted for under the deferred method for financial reporting purposes and are amortized as a reduction of income taxes over the useful lives of the related assets.

**Income Per Share:** Net income per share has been computed based upon the weighted average number of common and equivalent shares outstanding during each year. The equivalent shares include the net additional shares which would be issuable upon the exercise of stock options assuming that the Company used the proceeds received to purchase additional shares at market value (the "treasury stock" method). The weighted average common and equivalent shares outstanding were 2,266,627 in 1985, 2,268,022 in 1984 and 1,344,664 in 1983.

**(2) Long-Term Debt -**

The Company's long-term debt is summarized as follows:

|   | March 31    |             |
|---|-------------|-------------|
|   | 1985        | 1984        |
| Note payable to bank, interest rate of prime plus 1% (11.5% at March 31, 1985), due in varying quarterly principal installments through June 1989 plus monthly interest payments, collateralized by Fokker F27 aircraft, parts and equipment, and a secondary security in all other commuter aircraft owned | \$3,310,000 | \$1,700,000 |
| Note payable to bank, interest rate of prime plus 1% (11.5% at March 31, 1985), due in monthly principal installments of \$11,734 to March 1988, collateralized by aircraft   | 422,417     | 563,222     |
| 10% note payable to a foundation, due in June 1985, collateralized by aircraft  | 280,000     | 310,000     |
| Note payable to bank, interest rate of prime plus 1% (11.5% at March 31, 1985), due in monthly principal installments of \$4,500 plus interest through September 1988, collateralized by aircraft   | 189,000     | 243,000     |
| Note payable to Lowell Swenson, Chairman of the Board, interest rate of prime plus 1.5% (12% at March 31, 1985), due in monthly installments of \$4,030 through February 1988, collateralized by aircraft   | 141,045     | 189,403     |
| Other   | 72,253      | 70,044      |
|   | 4,414,715   | 3,075,669   |
| Less- Current maturities  | (931,607)   | (572,854)   |
| Total long-term debt  | \$3,483,108 | \$2,502,815 |

Operating restrictions placed on the Company by its lenders include the following covenants relating to:

- Requiring certain levels of tangible net worth, net working capital and the maintenance of certain other financial ratios.
- Restricting the amount of additional debt.
- Retaining present management and ownership control.

Mesaba has complied with, or obtained waivers to place it in compliance with these financing agreements as of March 31, 1985.

As of March 31, 1985, the portion of long-term debt due in the five subsequent years is as follows:

|      |            |
|------|------------|
| 1986 | \$ 931,607 |
| 1987 | 821,164    |
| 1988 | 857,134    |
| 1989 | 699,310    |
| 1990 | 1,105,500  |

Subsequent to March 31, 1985, the Company entered into a Debenture Purchase Agreement with Northwest Aircraft Inc., a wholly-owned subsidiary of NWA Inc., through which the Company will receive up to \$2,500,000 for the purchase of a third F27 aircraft. This six-year debenture carries a 9% interest rate and is convertible into common stock at the rate of one share for each \$3.96 of principal.

**(3) Short-Term Borrowings -**

During 1985, the Company entered into demand line of credit agreements with two banks, under which it may borrow up to \$800,000 at the banks' prime interest rate. Subsequent to March 31, 1985, the Company increased this line of credit to \$1,050,000. Borrowings are collateralized by inventory, accounts receivable and certain equipment. A summary of the Company's short-term borrowings is as follows:

|                          | 1985    | 1984 | 1983    |
|--------------------------|---------|------|---------|
| Balance at yearend       | \$ -    | \$ - | \$ -    |
| Maximum borrowings       | 175,000 | -    | 374,000 |
| Average daily borrowings | 9,300   | -    | 178,000 |
| Average interest rate    | 11.0%   | -%   | 15.7%   |

**(4) Commitments and Contingencies-**

Mesaba leases its corporate headquarters and certain terminal facilities under operating leases which provide for future minimum rental payments as follows:

|      |          |
|------|----------|
| 1986 | \$85,000 |
| 1987 | 59,000   |
| 1988 | 47,000   |
| 1989 | 47,000   |
| 1990 | 8,000    |

Mesaba also leases aircraft under operating leases that provide for future minimum rental payments of \$51,500 in 1986. Rent expense under all operating leases totaled approximately \$371,000 in 1985, \$307,000 in 1984 and \$94,000 in 1983.

Effective December 1, 1984, Mesaba began operating as Mesaba/Northwest Orient AirlinK under a marketing agreement with Northwest Airlines, Inc. (Northwest). As part of this five-year agreement, Mesaba's gate facilities at the Minneapolis/St. Paul International Airport were moved to the main terminal and certain ticketing functions, baggage handling and other ser-

vices are now handled by Northwest personnel.

In the normal course of its business, the Company is subject to claims, disputes and litigation. In the opinion of management, these matters can be successfully defended or resolved without a material adverse effect on the financial position of the Company.

**(5) Income Taxes-**

Mesaba provides deferred taxes for all timing differences between financial and income tax reporting. The provision for income taxes for the years ended March 31, 1985, 1984 and 1983 is comprised of the following elements:

|  | 1985       | 1984       | 1983      |
|--|------------|------------|-----------|
| <b>Current</b>   | \$ -       | \$ -       | \$ -      |
| <b>Deferred</b>  |            |            |           |
| Accrued expenses not deductible for tax reporting purposes                                 | (14,000)   | (50,000)   | (22,000)  |
| Accelerated depreciation   | 374,000    | 246,000    | 77,000    |
| Deferred preoperating costs  | 239,000    | 53,000     | (15,000)  |
| Deferred maintenance costs   | 48,000     | 29,000     | 3,000     |
| (Benefit) utilization of tax operating loss carryforwards for financial reporting purposes | (525,000)  | 102,000    | 27,000    |
| Amortization of investment tax credits not realized for tax reporting purposes             | (20,000)   | (22,000)   | (2,000)   |
| Total provision for income taxes   | \$ 102,000 | \$ 358,000 | \$ 68,000 |

The difference between the statutory federal income tax rate and the effective tax rate for the years ended March 31, 1985, 1984 and 1983 is as follows:

|   | 1985  | 1984  | 1983   |
|---|-------|-------|--------|
| Statutory federal tax rate                      | 46.0% | 46.0% | 46.0%  |
| State taxes, net of federal benefit             | 5.1   | 5.1   | 5.4    |
| Amortization of deferred investment tax credits | (7.6) | (2.8) | (6.0)  |
| Impact of graduated federal tax rate            | -     | (2.6) | (10.3) |
| Other   | (5.3) | -     | 1.1    |
|   | 38.2% | 45.7% | 36.2%  |

The income tax benefit resulting from utilization of operating loss carryforwards in the year ended March 31, 1983, is reflected as an extraordinary credit in the

accompanying statements of operations.

At March 31, 1985, Mesaba had net operating loss carryforwards of approximately \$1,262,000 and investment tax credit carryforwards of \$142,000 for federal tax reporting purposes. These carryforwards expire in varying amounts from 1997 through 2000 and are available to offset future taxes payable.

#### (6) Transactions with Stockholders and Affiliated Company-

In the normal course of business, Mesaba purchased aircraft and repair parts from Northern Eagle Airways, Inc. (Northern Eagle), a company owned by Lowell Swenson, Chairman of the Board and a director of Mesaba. Northern Eagle, which sold its operations in 1984, was a fixed base operation located in Thief River Falls, Minnesota. During 1985, 1984 and 1983, the Company made purchases of approximately \$28,000, \$55,000 and \$9,000, respectively, from Northern Eagle.

During 1985, the Company paid a member of the Board of Directors for consulting and other services. Total payments were \$40,000 and included salary, equipment purchases and other expenses.

#### (7) Stock Options and Employee Stock Purchase Plan-

The Company has stock option plans for key employees and directors and, as of March 31, 1985, has reserved 325,000 shares of common stock for sale to participants. Under the plans, options are granted by the Compensation Committee of the Board of Directors and are exercisable for five years commencing one year after the date of grant. The purchase price of the stock is 110% of the fair market value of the stock at the date of grant for participants owning 10% or more of outstanding common stock and 100% of fair market value for all other participants.

Stock option transactions for 1985 were as follows:

|  | Shares<br>Under<br>Option |
|--|---------------------------|
| Options outstanding, beginning of year<br>(\$0.72 to \$3.96 per share) | 241,391                   |
| Granted:   |                           |
| \$3.50 per share   | 6,000                     |
| \$3.19 per share   | 5,000                     |
| \$3.06 per share   | 1,810                     |
| \$2.75 per share   | 2,000                     |
| Exercised  |                           |
| \$0.72 per share   | (15,205)                  |
| Options outstanding, end of year<br>(\$0.72 to \$3.96 per share)       | <u>240,996</u>            |

Effective April 1, 1985, the Board of Directors has

adopted an employee stock purchase plan which allows all full-time personnel employed by Mesaba for more than six months the opportunity to purchase shares of stock in the Company through payroll deductions. All administrative costs of this plan are paid by Mesaba.

### Auditors' Report

To the Shareholders of  
Mesaba Aviation, Inc.:

We have examined the balance sheets of MESABA AVIATION, INC. (a Minnesota corporation) as of March 31, 1985 and 1984, and the related statements of operations, changes in financial position and changes in stockholders' equity for each of the three years in the period ended March 31, 1985. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the financial statements referred to above present fairly the financial position of Mesaba Aviation, Inc. as of March 31, 1985 and 1984, and the results of its operations and the changes in its financial position for each of the three years in the period ended March 31, 1985, in conformity with generally accepted accounting principles applied on a consistent basis.

ARTHUR ANDERSEN & CO.

Saint Paul, Minnesota,  
June 14, 1985.

## Mesaba Aviation, Inc.

### Board of Directors

Lowell T. Swenson\*  
Chairman of the Board  
Mesaba Aviation, Inc.

Robert D. Swenson  
President & Chief Executive Officer  
Mesaba Aviation, Inc.

Philip L. Swenson  
Secretary & Assistant to the President  
Mesaba Aviation, Inc.

Rodney G. Clark  
Medical Doctor

M.C. Lund  
Former President  
Frontier Airlines, Inc.

Rodger T. Munt\*  
Senior Vice President  
Fairchild Aircraft Corporation

William G. Ness\*  
Chief Executive Officer  
Arctco, Inc.

Mervin D. Prestebak\*  
Farmer and Contractor

Earl W. Dagg  
Medical Doctor

\*Member—compensation committee

### Corporate Officers

Robert D. Swenson  
President & Chief Executive Officer

Jeffrey A. Claypool  
Vice President-Flight Operations

Allan A. Hann  
Vice President-Marketing and Customer Services

Bernhard C. Loegering  
Vice President-Maintenance

David K. Knudson  
Vice President & Treasurer

Philip L. Swenson  
Secretary & Assistant to the President

### Corporate Information

Transfer Agent

Norwest Bank Minneapolis, N.A.  
Minneapolis, Minnesota

Corporate Counsel

Halpern & Druck  
Minneapolis, Minnesota

Auditors

Arthur Andersen & Co.  
Saint Paul, Minnesota

10-K Report

A copy of the Company's latest Form 10-K annual report will be provided free of charge to any shareholder upon written request to:

Vice President & Treasurer  
6201 34th Avenue South  
Minneapolis, Minnesota 55450

Notice of Annual Meeting

The annual meeting of Mesaba Aviation, Inc. shareholders will be held on Friday, August 9, 1985 at 3:00 p.m. at the Rodeway Inn, Bloomington, Minnesota.



Mesaba Aviation, Inc.  
6201 34th Avenue South  
Minneapolis, Minnesota 55450