

# Mesaba Aviation, Inc./1988 Annual Report



Pilots are encouraged to use the Minneapolis-St. Paul Terminal Area Congestion Program for light aircraft and below 8000 feet. For more information, contact the FAA.

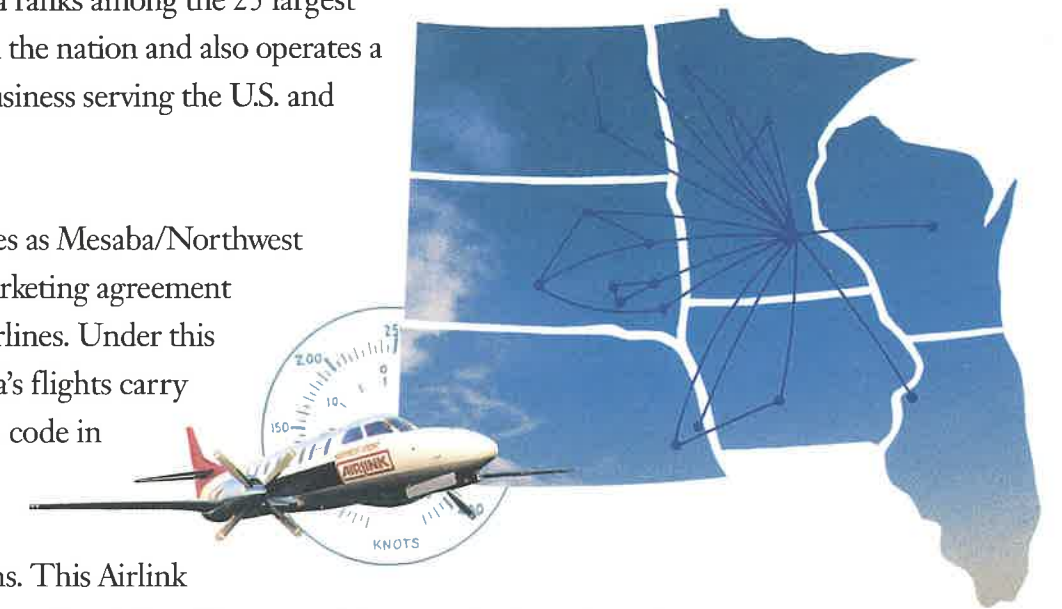
## Corporate Profile

A U.S. Domestic Air Carrier, Mesaba Aviation, Inc. is a regional airline serving the hub airport at Minneapolis/St. Paul, Minnesota. The airline provides scheduled passenger and air freight service to 21 cities in Minnesota, Illinois, Iowa, Nebraska, North Dakota, South Dakota and Wisconsin. Mesaba ranks among the 25 largest regional carriers in the nation and also operates a growing charter business serving the U.S. and Canada.

The airline operates as Mesaba/Northwest Airlink under a marketing agreement with Northwest Airlines. Under this agreement, Mesaba's flights carry Northwest's airline code in the nation's computerized reservations systems. This Airlink relationship enhances Mesaba's ability to provide convenient service and competitive fares between its regional markets and Northwest's global destinations.

Mesaba currently operates a fleet of six 48-passenger Fokker F27 jet props and seven 19-passenger Metro III jet props. A new and substantially larger main base and hangar are due to be completed at Minneapolis/St. Paul International Airport toward the end of calendar year 1988.

Mesaba's common stock is traded on the NASDAQ National Market System.



## Highlights

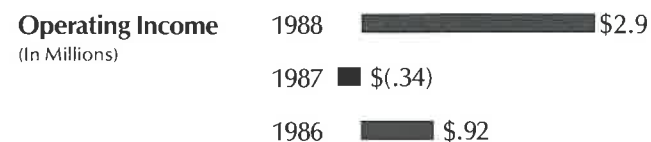
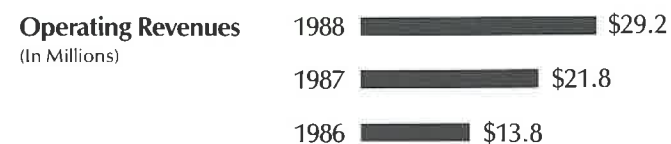
### Financial

(In thousands, except per share data)

Year Ended March 31	1988	1987	% Change
Operating Revenues	\$ 29,171	\$ 21,806	34
Operating Expenses	26,266	22,148	19
Operating Income (Loss)	2,905	(342)	
Net Income (Loss)	1,549	(213)	
Earnings (Loss) Per Share			
Primary	.51	(.07)	
Fully Diluted	.45	(.07)	

### Statistical

Year Ended March 31	1988	1987	% Change
Revenue Passengers	376,101	292,457	29
Revenue Passenger Miles (000)	82,712	61,172	35
Available Seat Miles (000)	153,685	133,414	15
Passenger Load Factor	53.8%	45.9%	17
Yield per Revenue Passenger Mile	32.3¢	32.6¢	(1)
Operating Cost per Available Seat Mile	16.8¢	16.3¢	3



## To Our Shareholders

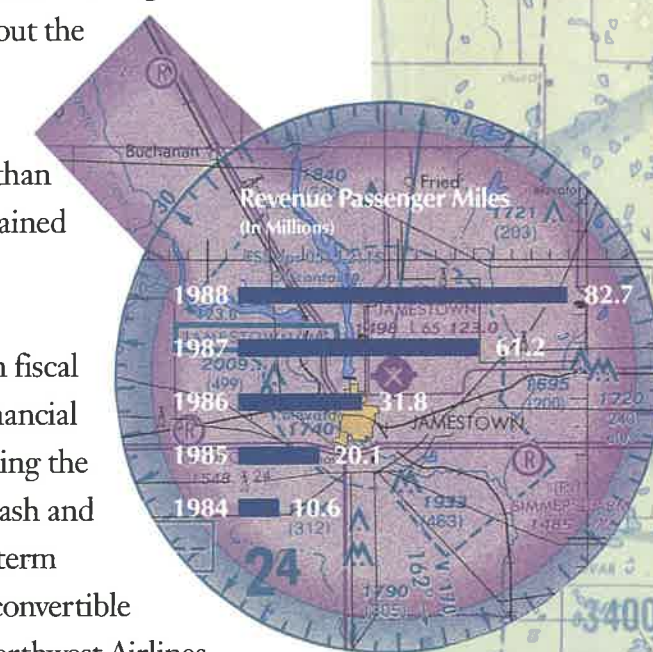
Mesaba posted record revenues and earnings in fiscal 1988, making it the most successful year in the history of your company. For the fiscal year ended March 31, 1988:

- Mesaba's operating revenues rose 34 percent to \$29,171,000.
- Operating income totaled \$2,905,000, compared to the operating loss of \$342,000 reported in fiscal 1987.
- Net income amounted to \$1,549,000 or 45 cents per share on a fully diluted basis, a substantial turnaround from the net loss of \$213,000 or 7 cents per share on a fully diluted basis a year ago.
- Reflecting its confidence in Mesaba's future, your Board of Directors declared the first cash dividends in the company's history for fiscal 1988, totaling 6 cents per share.

### Strong Traffic and Load Factors Throughout the Year

Our record fiscal 1988 results were achieved on the basis of a 35 percent increase in revenue passenger miles to 82,712,000 and a systemwide passenger load factor of 53.8 percent, up substantially from 45.9 percent a year ago. Equally important, our regional system continued to generate good traffic volumes and high load factors throughout the second half of the year, which has been a seasonally slower period for Mesaba in some prior years. These strong operating statistics more than compensated for our relatively low yield, which remained virtually unchanged from the year earlier level.

We utilized our strong cash flow from operations in fiscal 1988 to significantly strengthen Mesaba's overall financial condition. All long-term bank debt was paid off during the year, and we ended fiscal 1988 with \$3.4 million in cash and short-term investments. Our only remaining long-term obligations consist of approximately \$2,200,000 of convertible subordinated debentures held by a subsidiary of Northwest Airlines.



### Largest Regional Airline at Minneapolis/St. Paul

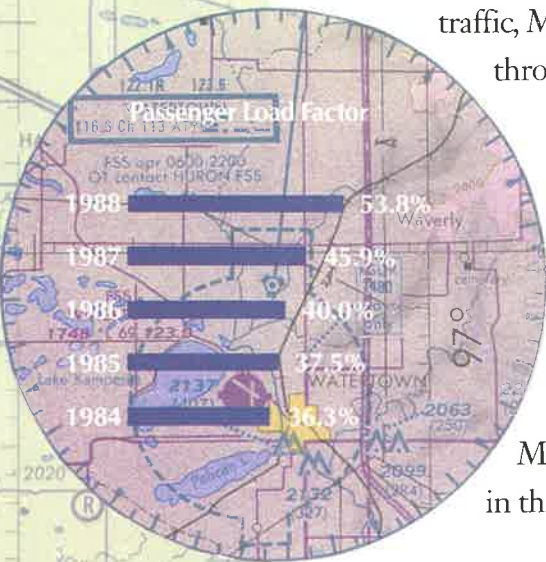
Mesaba's fiscal 1988 performance reflects the consistent, traffic-generating capacity of our regional route system, which is helping us attain improved earnings on a year-round basis. With a steadily expanding share of regional traffic, Mesaba is the leading provider of regional air service throughout our six-state market of the Upper Midwest.

We are continuing to benefit from our Airlink marketing relationship with Northwest Airlines, the dominant carrier by a wide margin at Minneapolis/St. Paul. By sharing Northwest's flight designator code in the nation's computerized reservations systems and offering a complete range of single-carrier fares to more than 190 destinations, Mesaba is a beneficiary of Northwest's strong market position in this region.

### Providing Substantial Feed Traffic to Northwest

The value of this Airlink relationship also works to the benefit of our marketing partner. Approximately 70 percent of the total passengers carried by Mesaba in fiscal 1988 made connections with Northwest flights at Minneapolis/St. Paul, accounting for approximately three percent of Northwest's total passenger boardings at this major hub. This represents a substantial amount of feed traffic, which should continue to increase in the years ahead.

Over the past few years, Mesaba has been one of the nation's fastest growing regional airlines and today ranks among the 25 largest in the industry. We fully intend to remain a strongly growing enterprise, and for this reason, Mesaba must now establish an enhanced and strengthened operational foundation capable of supporting our next stage of growth and corporate development. Toward this end, we have started taking important steps in a number of key areas.



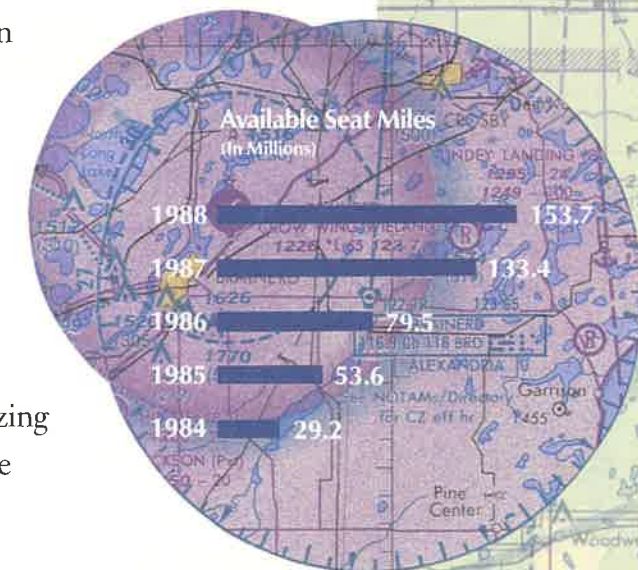
### New 80,000 Square Foot Main Base and Hangar

First, construction was started earlier this spring on a 80,000 square foot main base and headquarters facility at Minneapolis/St. Paul International Airport. Scheduled for completion later this calendar year, the hangar and maintenance portion of this project will be large enough to simultaneously service up to three Fokker F27s and three Metro III jet props. This greatly expanded maintenance capability will be able to meet our growing fleet and projected maintenance requirements for many years to come. At a total cost of approximately \$4,500,000, our new main base will be lease financed from the Metropolitan Airports Commission for a period of 20 years at favorable terms.

### Need for Additional Fleet Capacity

Once we occupy this new hangar facility, we will then be in a better position to acquire and maintain additional fleet capacity. Based on our conservative management policies, we have attempted to add aircraft over the years only when the need has been clearly demonstrated. Since Mesaba's fleet is nearing full utilization, additional equipment is required for handling increased traffic volumes, building service frequencies in key markets, capitalizing on attractive growth opportunities, and spurring the development of our promising charter business.

A step in this managed capacity expansion program was taken in January when we entered an operating lease for one Fokker F27 jet prop. This was the first addition to our fleet since June of 1986 when we took delivery of the last seven new Metro IIIs. As a result, we are now operating a highly efficient and reliable fleet of 13 aircraft: six 48-passenger Fokker F27 jet props and seven 19-passenger Fairchild Metro III jet props.



### Strong Demand for Mesaba's Charter Operations

In addition to handling scheduled passenger service, our newest F27 is also being partially utilized for Mesaba's charter business. Since starting this operation last year, we have experienced a strong and continuing demand for charter service using aircraft of our size.

The potential of this business causes us to believe that Mesaba could profitably deploy more than one aircraft for full-time charter flights. We plan to realize this objective within the next 12 months.

As a new and still relatively limited operation, our charter business made only a modest

contribution to Mesaba's revenue stream in fiscal 1988. However, we believe charter operations can develop into a growing business of steadily increasing importance over the next few years.

### Proposed Formation of New Holding Company

To promote our long-term growth and development, we strongly recommend that our shareholders approve the formation of a holding company organization at this year's annual meeting. As discussed in your proxy statement, Mesaba would become a wholly-owned subsidiary of AirTran Corporation, a Minnesota corporation that we recently formed.

Upon the effective date of the proposed reorganization, each share of Mesaba common stock would be automatically converted on a share-for-share basis into shares of AirTran Corporation. Your ownership interest in AirTran would then be exactly the same as it is now. You would, however, benefit from the significantly greater degree of flexibility that we would gain by operating as a holding company. This form of organization would provide us with additional options for raising capital for business expansion as well as facilitate the process of acquiring, establishing and managing new business opportunities as they arise in the future.

### Fiscal 1989: Another Profitable Year

Looking ahead, fiscal 1989 is shaping up as another year of solid profitability due to the basic underlying strength of our regional operations. To meet or exceed our fiscal 1988 earnings, Mesaba must continue growing to absorb the added expense associated with our new main base facility. Having attained maximum facility utilization, we will be in a strong position to support significant additional growth once we occupy our larger, more efficient hangar in the second half of fiscal 1989.

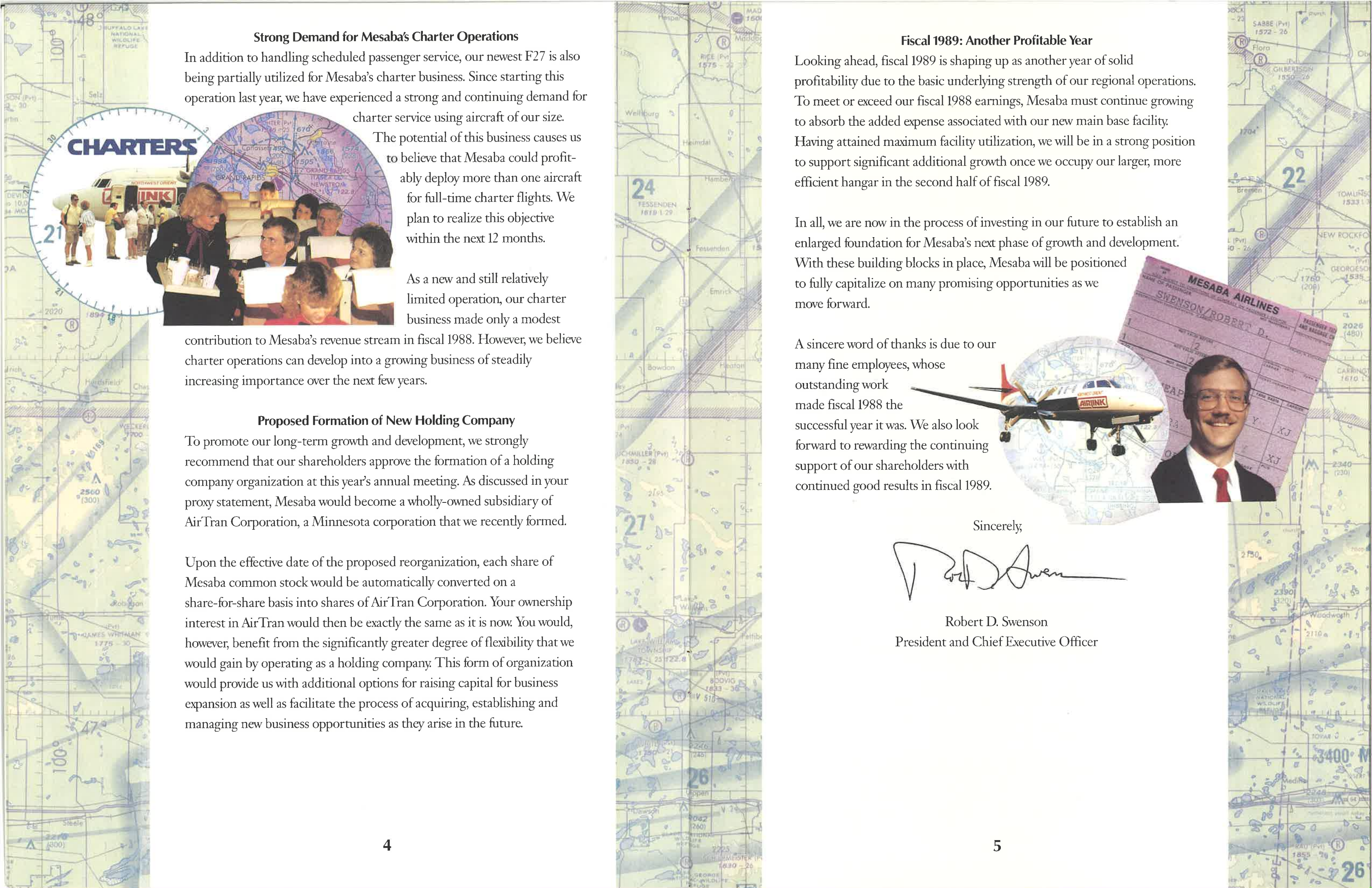
In all, we are now in the process of investing in our future to establish an enlarged foundation for Mesaba's next phase of growth and development. With these building blocks in place, Mesaba will be positioned to fully capitalize on many promising opportunities as we move forward.

A sincere word of thanks is due to our many fine employees, whose outstanding work made fiscal 1988 the successful year it was. We also look forward to rewarding the continuing support of our shareholders with continued good results in fiscal 1989.

Sincerely,



Robert D. Swenson  
President and Chief Executive Officer



## Management's Discussion and Analysis of Financial Condition and Results of Operations

### Earnings Summary

The Company reported net income of \$1,549,000 for the fiscal year ended March 31, 1988, compared to the net loss of \$213,000 in fiscal 1987 and the net income of \$201,000 in fiscal 1986. On a fully diluted per share basis, net income amounted to 45 cents in fiscal 1988 versus a net loss of 7 cents in 1987 and net income of 8 cents in 1986. The significant improvement in fiscal 1988 earnings was attributable primarily to the strong traffic and passenger load factors generated by the Company's route system, which is aligned with the operations of Northwest Airlines under an Airlink marketing agreement.

### Results of Operations

**Operating Revenues.** Operating revenues totaled \$29,171,000 in fiscal 1988, an increase of 34 percent from \$21,806,000 in 1987 and also up from \$13,763,000 in 1986. The fiscal 1988 increase resulted from continued growth of passenger revenues, reflecting the strength of the Company's six-state regional route system focused on its Minneapolis/Saint Paul hub. Revenue passenger miles rose 35 percent to 82,712,000 in fiscal 1988 from 61,172,000 in 1987 and 31,815,000 in 1986. Available seat miles for fiscal 1988 rose 15 percent to 153,685,000 from 133,414,000 in 1987 and 79,462,000 in 1986. As a result, the passenger load factor increased to 53.8 percent in 1988 from 45.9 percent in 1987 and 40.0 percent in 1986. Yield per revenue passenger mile was 32.3 cents in fiscal 1988, virtually unchanged from 32.6 cents in 1987 and down from 34.8 cents in 1986.

General aviation, freight and charter revenues rose to \$1,542,000 in fiscal 1988, up significantly from \$699,000 in 1987 and \$621,000 in 1986. The Company's expanding charter operations accounted for most of the 1988 increase.

**Operating Expenses.** Total operating expenses rose to \$26,266,000 in fiscal 1988, an increase of 19 percent from \$22,148,000 in 1987 and \$12,845,000 in 1986. The 1988 increase reflects the higher level of miles flown in comparison to prior years. Operating costs per available seat mile rose to 16.8 cents in fiscal 1988 from 16.3 cents in 1987 and 15.7 cents in 1986.

Flight operations expenses increased 21 percent in 1988. Fiscal 1988 was the first complete year in which operating leases were in effect for the seven Metro III aircraft introduced during the first half of fiscal 1987. The Company's sixth Fokker F27 jet prop entered service during the fourth quarter, which also contributed to the increase in operating lease expense. The average cost of fuel rose to 77 cents per gallon in fiscal 1988 from 70 cents in 1987 and at the same time aircraft fuel consumption increased in response to an 18 percent increase in the number of hours flown during the year.

Maintenance costs increased 40 percent in fiscal 1988. The 1988 increase in maintenance costs is largely the result of a higher level of aircraft repairs due to: the greater number of flight operations during the year; the impact of severe winter weather; and the increased number of aircraft in service for the full year. The warranty period on the Metro III aircraft expired in fiscal 1988, resulting in the Company absorbing additional Metro repair costs. In accordance with the maintenance schedule of its lease agreements, the Company accrued \$1,363,000 in fiscal 1988 for future aircraft overhauls on an hours-flown basis, compared to \$1,295,000 in fiscal 1987.

Aircraft and traffic servicing expenses rose 19 percent in fiscal 1988. The 1988 increase reflected the expansion of flight operations, attributable to increased passenger traffic. Ground and in-flight personnel were added to support the higher traffic volumes, and other significant expenses, including landing fees and terminal charges, also rose in line with the increase in flight operations.

Reservations, sales and advertising expenses declined substantially in fiscal 1988 from prior years due to the impact of the Company's Airlink marketing agreement with Northwest Airlines. Under this agreement, Northwest provides substantially all reservations and advertising functions for the Company.

General and administrative expense increased 18 percent in fiscal 1988. This increase was due principally to the addition of personnel required to support the Company's higher volume of business.

Depreciation and amortization expenses increased modestly over the level of prior years, reflecting the Company's strategy of meeting equipment needs through operating leases, which have permitted a reduced investment in fixed assets.

Operating Income (Loss). Operating income totaled \$2,905,000 representing a 10 percent operating margin in fiscal 1988.

Nonoperating Expense (Income). The Company incurred net nonoperating expense of \$209,000 in fiscal 1988, compared to \$133,000 in 1987 and \$478,000 in 1986. During 1987 the Company realized a gain of \$287,000 on the sale of five Beech 99 aircraft. The Company made no significant equipment sales in fiscal 1988.

#### Financial Condition

Net cash flow provided from operations totaled \$5,537,000 in fiscal 1988, up from \$1,773,000 in fiscal 1987. Cash and short-term investments, provided primarily from operations, rose to \$3,402,000 at March 31, 1988 from \$2,080,000 at the end of fiscal 1987. During fiscal 1988, funds used for purchases of property and equipment declined, reflecting the Company's decision to meet its equipment needs primarily through operating leases. Working capital increased to \$2,564,000 at March 31, 1988 from \$1,207,000 at the end of fiscal 1987. As a result, the Company's current ratio improved to 1.58 at March 31, 1988 from 1.28 at March 31, 1987.

At March 31, 1988, the Company had a bank line of credit in the amount of \$1,000,000, with interest payable at the prime rate plus one percentage point. The Company did not utilize the line of credit during fiscal 1988. Any borrowings under the line are secured by certain inventories and accounts receivable.

The Company made total debt repayments of \$2,967,000 in fiscal 1988, which eliminated all long-term bank debt. At March 31, 1988, remaining long-term debt, exclusive of current maturities, totaled \$1,981,000, down from \$3,727,000 at the end of fiscal 1987. Long-term debt at March 31, 1988 consisted principally of convertible debentures held by Northwest Aircraft, Inc., a wholly-owned subsidiary of NWA Inc. The Company issued these Debentures in June 1985 and used the proceeds to purchase a Fokker F27 aircraft and related spare parts. The debentures, which are due in semi-annual installments through November 1991, are convertible into the Company's common stock at the rate of \$3.96 per share.

Stockholders' equity rose to \$6,670,000 at March 31, 1988 from \$5,197,000 at March 31, 1987. This increase, coupled with the reduction in long-term debt, caused the ratio of long-term debt to stockholders' equity to improve to .30 from .72 a year ago.

In April 1988, the Company entered into a lease and operating agreement with the Metropolitan Airports Commission for the construction of a new hangar, maintenance and headquarters facility at Minneapolis/Saint Paul International Airport. The project is currently under construction and is expected to be completed in the fall of 1988 at an estimated cost of \$4,500,000 of which the Company has advanced \$700,000. The agreement calls for facility lease payments over a 20-year term, sufficient to reimburse the Commission for the balance of funds advanced toward the project, at an interest rate of 8.51 percent. The agreement also requires the Company to pay annual ground rent of \$144,000 over the same 20-year term with the Commission reserving the right to revise the rent every fifth year.

Historically, the Company has relied largely upon borrowings, internally-generated funds and the sale of common stock to fund its capital requirements. Management believes that funds from operations, borrowings and lease financing will provide adequate resources for meeting the Company's anticipated capital requirements in fiscal 1989.

#### Effect of Inflation

The Company's operating costs are subject to general economic and inflationary pressures. While operating costs have increased during each of the past three years, the Company does not believe that its results have been significantly affected by inflation.

#### Effect of Change in Accounting Principle

In December 1987, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 96 (FASB 96), "Accounting for Income Taxes," which changes the method used in accounting for income taxes. This new standard, which must be adopted for fiscal years beginning after December 15, 1988, requires companies to take into account changes in income tax rates in determining the deferred tax amounts recorded on the balance sheet. The Company has elected not to adopt FASB 96 for the fiscal year ended March 31, 1988 and believes that its adoption will not have an adverse impact on the Company's results of operations and financial position.

## Balance Sheets

Mesaba Aviation, Inc.

As of March 31	1988	1987
<b>Assets</b>		
<b>Current Assets:</b>		
Cash and short-term investments	\$ 3,401,552	\$ 2,080,089
Accounts receivable, net	2,613,825	2,479,615
Inventories	724,139	731,079
Prepaid expenses and deposits	225,331	273,504
<b>Total current assets</b>	<b>6,964,847</b>	<b>5,564,287</b>
<b>Property and Equipment (Note 2):</b>		
Flight equipment	10,419,135	9,529,062
Other property and equipment	2,309,901	2,065,185
Accumulated depreciation and amortization	(4,211,183)	(2,550,263)
<b>Net property and equipment</b>	<b>8,517,853</b>	<b>9,043,984</b>
Other Assets, principally deferred preoperating costs, net of accumulated amortization of \$526,000 and \$373,000, respectively	149,016	302,387
	<b>\$15,631,716</b>	<b>\$14,910,658</b>

As of March 31	1988	1987
<b>Liabilities and Stockholders' Equity</b>		
<b>Current Liabilities:</b>		
Current maturities of long-term debt (Note 4)	\$ 491,332	\$ 1,711,556
Accounts payable	1,349,510	1,489,860
Accrued liabilities—		
Payroll	617,506	331,150
Maintenance (Note 2)	969,823	236,763
Property taxes	174,403	239,882
Other	462,686	347,731
Income taxes payable	336,000	—
<b>Total current liabilities</b>	<b>4,401,260</b>	<b>4,356,942</b>
Long-Term Debt, net of current maturities (Note 4)	1,980,692	3,727,465
Other Noncurrent Liabilities, principally accrued maintenance (Note 2)	1,334,436	1,195,630
Deferred Income Taxes (Note 5)	1,245,000	434,000
<b>Commitments (Note 6)</b>		
<b>Stockholders' Equity:</b>		
Common stock, \$0.01 par value; 7,000,000 shares authorized, 2,992,905 and 2,941,827 shares issued and outstanding, respectively	29,929	29,418
Paid-in capital	4,456,081	4,352,109
Warrants issued for 234,539 common shares (Note 8)	225,789	225,789
Retained earnings	1,958,529	589,305
<b>Total stockholders' equity</b>	<b>6,670,328</b>	<b>5,196,621</b>
	<b>\$15,631,716</b>	<b>\$14,910,658</b>

The accompanying notes to financial statements are an integral part of these balance sheets



## Statements of Operations

Mesaba Aviation, Inc.

For the Years Ended March 31	1988	1987	1986
<b>Operating Revenues:</b>			
Passenger	\$26,719,358	\$19,914,990	\$11,071,566
Public service	909,498	1,192,443	2,070,179
General aviation, freight and charter	1,541,802	698,988	621,482
Total operating revenues	<u>29,170,658</u>	<u>21,806,421</u>	<u>13,763,227</u>
<b>Operating Expenses:</b>			
Flight operations	10,648,670	8,767,275	4,503,087
Maintenance	6,523,824	4,666,615	2,138,657
Aircraft and traffic servicing	5,076,284	4,265,761	2,475,496
Depreciation and amortization	1,835,827	1,630,379	1,525,107
Reservations, sales and advertising (Note 1)	217,752	1,157,919	1,112,582
General and administrative	1,963,278	1,660,149	1,089,629
Total operating expenses	<u>26,265,635</u>	<u>22,148,098</u>	<u>12,844,558</u>
Operating income (loss)	<u>2,905,023</u>	<u>(341,677)</u>	<u>918,669</u>
<b>Nonoperating Expense (Income):</b>			
Interest expense	366,221	477,500	466,566
Other, net (Note 2)	(157,001)	(344,606)	11,786
Net nonoperating expense	<u>209,220</u>	<u>132,894</u>	<u>478,352</u>
Income (loss) before income taxes	<u>2,695,803</u>	<u>(474,571)</u>	<u>440,317</u>
(Provision) Benefit For Income Taxes	(1,147,000)	262,000	(239,000)
Net income (loss)	<u>\$ 1,548,803</u>	<u>\$ (212,571)</u>	<u>\$ 201,317</u>
<b>Net Income (Loss) Per Share:</b>			
Primary	\$ 0.51	\$ (0.07)	\$ 0.08
Fully diluted	<u>0.45</u>	<u>(0.07)</u>	<u>0.08</u>
<b>Weighted Average Shares Outstanding:</b>			
Primary	3,054,687	2,880,210	2,537,971
Fully diluted	<u>3,646,996</u>	<u>2,919,238</u>	<u>2,565,198</u>

The accompanying notes to financial statements are an integral part of these statements

## Statements of Changes in Stockholders' Equity

Mesaba Aviation, Inc.

For the Years Ended March 31	Common Stock		Paid-In Capital	Warrants		Retained Earnings	Total Stockholders' Equity
	Shares	Amount		Shares	Amount		
Balance, March 31, 1985	2,127,539	\$ 21,275	\$ 2,393,805	—	\$ —	\$ 600,559	\$ 3,015,639
Sale of common stock, net of offering costs and commissions	700,000	7,000	1,850,347	35,000	26,250	—	1,883,597
Exercise of stock options	20,406	204	14,425	—	—	—	14,629
Issuance of stock bonuses	3,166	32	12,238	—	—	—	12,270
Issuance of warrants	—	—	—	85,495	85,495	—	85,495
Net income	—	—	—	—	—	201,317	201,317
Balance, March 31, 1986	2,851,111	28,511	4,270,815	120,495	111,745	801,876	5,212,947
Exercise of stock options	87,366	874	69,168	—	—	—	70,042
Issuance of stock bonuses	3,350	33	12,126	—	—	—	12,159
Issuance of warrants	—	—	—	114,044	114,044	—	114,044
Net loss	—	—	—	—	—	(212,571)	(212,571)
Balance, March 31, 1987	2,941,827	29,418	4,352,109	234,539	225,789	589,305	5,196,621
Exercise of stock options	34,980	350	40,385	—	—	—	40,735
Conversion of NWA debentures	16,098	161	63,587	—	—	—	63,748
Dividend paid on common stock	—	—	—	—	—	(179,579)	(179,579)
Net income	—	—	—	—	—	1,548,803	1,548,803
Balance, March 31, 1988	<u>2,992,905</u>	<u>\$ 29,929</u>	<u>\$ 4,456,081</u>	<u>234,539</u>	<u>\$ 225,789</u>	<u>\$ 1,958,529</u>	<u>\$ 6,670,328</u>

The accompanying notes to financial statements are an integral part of these statements

## Statements of Cash Flows

Mesaba Aviation, Inc.

For the Years Ended March 31	1988	1987	1986
<b>Cash Flows from Operating Activities:</b>			
Operations—			
Net income (loss)	\$ 1,548,803	\$ (212,571)	\$ 201,317
Adjustments to reconcile net income (loss) to net cash provided by operating activities:			
Depreciation and amortization	1,835,827	1,630,379	1,525,107
Accrued maintenance, long-term	156,102	1,004,929	—
Deferred income taxes	811,000	(262,000)	239,000
Gain on sale of commuter aircraft (Note 2)	—	(287,418)	—
Cash flows from operations before changes in current operating items	4,351,732	1,873,319	1,965,424
Increase in accounts receivable, net	(134,210)	(720,040)	(877,829)
Decrease (increase) in inventories	6,940	(143,630)	(181,288)
Decrease (increase) in prepaid expenses and deposits	48,173	141,492	(360,349)
Increase in accounts payable and accrued liabilities	928,542	622,131	1,232,855
Increase in income taxes payable	336,000	—	—
Net cash flows provided by operating activities	5,537,177	1,773,272	1,778,813
<b>Cash Flows from Investing Activities:</b>			
Purchases of property and equipment, net	(1,156,325)	(1,754,992)	(4,888,342)
Proceeds from commuter aircraft sold (Note 2)	—	1,678,500	—
(Decrease) increase in other liabilities	(17,296)	(65,346)	231,422
Increase in other assets	—	(63,283)	(183,086)
Net cash flows used for investing activities	(1,173,621)	(205,121)	(4,840,006)
<b>Cash Flows from Financing Activities:</b>			
Proceeds from issuance of common stock and warrants	104,483	196,245	1,995,991
Dividends paid	(179,579)	—	—
Proceeds from issuance of debt	—	1,007,383	2,692,927
Repayment of debt	(2,966,997)	(1,242,418)	(1,433,592)
Net cash flows (used for) provided by financing activities	(3,042,093)	(38,790)	3,255,326
Net increase in Cash and Short-Term Investments	1,321,463	1,529,361	194,133
Cash and Short-Term Investments:			
Beginning of year	2,080,089	550,728	356,595
End of year	\$ 3,401,552	\$ 2,080,089	\$ 550,728

The accompanying notes to financial statements are an integral part of these statements

## Notes to Financial Statements

Mesaba Aviation, Inc.

### Note 1—Business

Mesaba Aviation, Inc. (Mesaba) is a regional air carrier providing scheduled passenger and air freight service to 21 cities in the Upper Midwest. Effective December 1, 1984, Mesaba began operating as Mesaba/Northwest Airlink under a five-year marketing agreement with Northwest Airlines, Inc. (Northwest). As part of this agreement, as amended, all flights are designated as Northwest flights, all flights appear in Northwest's timetables and Mesaba receives ticketing and certain check-in, baggage and freight handling services from Northwest at certain airports. Mesaba also benefits from its relationship with Northwest through prorated fare arrangements and advertising and marketing programs. The amended agreement also states that, beginning in fiscal 1987, Northwest is to assume substantially all reservation and advertising functions. A portion of these expenses were previously borne by Mesaba. In addition, Northwest has provided certain aircraft financing for Mesaba (see Notes 4 and 8). Approximately 70%, 65% and 51% of Mesaba's passengers connected with Northwest in fiscal 1988, 1987 and 1986, respectively.

### Note 2—Flight Equipment

Mesaba's fleet consisted of the following aircraft as of March 31, 1988:

Number of Aircraft	Type of Aircraft	Seating Capacity
7	Fairchild Metro III (Metro)	19
6	Fokker F-27 (F-27)	42-48

Mesaba owns three of the F-27 aircraft; the remaining aircraft are leased under operating leases.

During 1986, Mesaba converted its fleet of six Beech aircraft to new Metros, with three Metros leased under operating leases prior to March 31, 1986 and four additional Metros leased and placed in service in May 1986.

Under an agreement with Fairchild Aircraft Corporation (Fairchild), Fairchild agreed to make payments to Mesaba of \$1,050,000 to offset the cost of integrating the new aircraft into service. The excess of funds received over costs incurred in integrating such aircraft has been recorded as deferred revenue and will be amortized over the terms of the operating leases (12 years).

In addition, Fairchild purchased Mesaba's five Beech aircraft in early 1987, which resulted in a net gain of approximately \$287,000. The remaining Beech aircraft, which was leased under an operating lease, was returned to the lessor during the first quarter of fiscal 1987.

Aircraft maintenance and repairs are charged to expense when incurred, except for major airframe and engine overhauls. For purchased aircraft, major overhaul costs are capitalized when the expenditure is incurred and amortized over the minimum available operating hours until the next scheduled overhaul. For leased aircraft, the estimated cost of future overhauls is accrued based upon hours flown, thus providing for the overhaul cost when it occurs.

**Note 3 – Summary of Significant Accounting Policies**

**Short-Term Investments:**

Short-term investments, which consist primarily of commercial paper, are stated at cost, which approximates market.

**Inventories:**

Inventories consist of expendable aircraft service parts and fuel and are stated at the lower of average cost or market. Expendable parts are charged to maintenance as consumed.

**Property and Equipment:**

Property and equipment is 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 equipment and rotatable parts; 3-10 years for all other equipment; and 5-36 years for buildings and improvements. Leasehold improvements are amortized over the shorter of the life of the lease or the life of the asset. Accelerated cost recovery methods of depreciation are applied for tax reporting purposes.

**Other Assets:**

Certain preoperating costs incurred in the acquisition and certification of the F-27 aircraft were deferred in fiscal 1985 and are being amortized over five years. Comparable preoperating costs associated with the conversion to the new Metro aircraft have been fully recovered from integration funds received from Fairchild, as described further in Note 2.

**Revenue Recognition:**

Passenger revenues are recorded as income when services are rendered. Mesaba also receives public service subsidy revenues for service to certain communities that do not generate sufficient traffic to fully support profitable air service.

**Income Per Share:**

Primary net income per share has been computed based upon the weighted average number of common and common equivalent shares outstanding during each year. The equivalent shares include the net additional shares which would be issuable upon the exercise of stock options and warrants, assuming repurchase of common shares with the related proceeds. Fully diluted net income per share was determined on the assumption that all convertible debentures were converted. Net income was adjusted for the interest, net of tax, paid on the debentures.

**Note 4—Debt**

Mesaba has a demand line-of-credit agreement with a bank under which it may borrow up to \$1,000,000 at the prime interest rate plus 1%. Borrowings are collateralized by inventory and accounts receivable. There were no borrowings under the line of credit during fiscal 1988. The maximum and average daily borrowings outstanding were \$925,000 and \$244,000 in 1987, respectively, and \$807,000 and \$172,000 in 1986, respectively. The weighted average annual interest rate during the period borrowings were outstanding was 8.2% in 1987 and 9.5% in 1986.

Long-term debt as of March 31 is summarized as follows:

	1988	1987
Convertible debentures issued to Northwest Aircraft Inc. (NWA), an affiliate of Northwest; interest rate of 9%; due in semiannual installments through November 1991; convertible into common stock at the rate of one share for each \$3.96 of principal; collateralized by aircraft and parts	\$ 2,229,912	\$ 2,451,475
Note payable to Fairchild; interest rate of 7.5%; due in equal monthly installments of \$21,875, including interest, through February 1989; collateralized by parts and equipment	231,841	467,279
Notes payable; paid in full during 1988	—	2,414,914
Other	10,271	105,353
	<u>2,472,024</u>	<u>5,439,021</u>
Less—Current maturities	(491,332)	(1,711,556)
Total long-term debt	<u>\$ 1,980,692</u>	<u>\$ 3,727,465</u>

The debenture financing agreement requires Mesaba to maintain minimum levels of tangible net worth, cash flow and certain other financial ratios. Mesaba was in compliance with these requirements as of March 31, 1988.

As of March 31, 1988, the portion of long-term debt due in the four subsequent fiscal years is as follows:

1989	\$ 491,332
1990	250,780
1991	250,000
1992	1,479,912
	<u>\$ 2,472,024</u>

**Note 5—Income Taxes**

Mesaba provides deferred taxes for all timing differences between financial and income tax reporting. The provision (benefit) for income taxes for the three years ended March 31, 1988 is comprised of the following elements:

	1988	1987	1986
Current	\$ 336,000	\$ —	\$ —
Deferred:			
Accelerated depreciation	366,000	489,000	518,000
Deferred preoperating costs	(57,000)	(96,000)	73,000
Deferred maintenance costs	(435,000)	(551,000)	419,000
Tax over book gain on sale of fixed assets	—	(550,000)	—
Accrued expenses not deductible for tax reporting purposes	18,000	215,000	(63,000)
Deferred tax effects of tax operating loss carryforwards	805,000	257,000	(671,000)
Difference between investment tax credits realized for tax reporting purposes and investment tax credits recognized for book purposes	114,000	(26,000)	(37,000)
Total provision (benefit) for income taxes	<u>\$1,147,000</u>	<u>\$(262,000)</u>	<u>\$ 239,000</u>

The difference between the statutory federal income tax rate and the effective tax rate for the three years ended March 31, 1988 is as follows:

	1988	1987	1986
Statutory federal tax rate	37.0%	(46.0)%	46.0%
State taxes, net of federal effect	5.3	(5.3)	5.2
Amortization of deferred investment tax credits	(1.0)	(5.5)	(8.4)
Additional federal provision required and other	1.2	1.6	11.5
Effective tax rate	<u>42.5%</u>	<u>(55.2)%</u>	<u>54.3%</u>

In December 1987, the Financial Accounting Standards Board issued Standard No. 96 (FASB 96), "Accounting for Income Taxes," which particularly affects the treatment of deferred taxes. The new accounting rules and disclosure must be adopted by fiscal 1990, with earlier adoption permitted. The Company has elected not to adopt FASB 96 for the fiscal year ended March 31, 1988 and believes that its adoption will not have a material adverse effect on Mesaba's financial position or results of future operations.

**Note 6—Commitments**

Mesaba leases aircraft, its current corporate headquarters and certain terminal facilities under operating leases which provide for future minimum rental payments approximately as follows at March 31, 1988:

1989	\$ 4,251,053
1990	4,168,408
1991	4,168,408
1992	3,930,908
1993	3,045,408
Thereafter	<u>14,956,888</u>

Rent expense under all operating leases totaled approximately \$4,094,000 in 1988, \$3,614,000 in 1987 and \$567,000 in 1986.

On April 18, 1988, Mesaba entered into a lease and operating agreement with the Metropolitan Airports Commission (Commission) for the construction of a new hangar, maintenance and headquarters facility at the Minneapolis/Saint Paul International Airport. The project is currently under construction and is expected to be completed in the fall of 1988 at an estimated cost of \$4,500,000 of which the Company has advanced \$700,000. The agreement calls for facility lease payments over a 20-year term sufficient to reimburse the Commission for the balance of funds advanced toward the project, at an interest rate of 8.51%. The agreement also requires Mesaba to pay annual ground rent of \$144,000 over its term.

**Note 7—Transactions With Related Parties**

During 1986, Mesaba entered into an agreement with Fairchild to purchase the Metro aircraft (which purchase agreement was subsequently assigned to third-party lessors) and Fairchild agreed to purchase Mesaba's fleet of Beech aircraft at fair market value. One of Mesaba's directors was an officer of Fairchild and was involved in the aircraft negotiations but abstained from voting on the ratification by the board of directors of these agreements.

**Note 8—Capital Stock**

Mesaba has stock option plans for key employees and directors which authorize the issuance of up to 525,000 shares of common stock for such options. 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 the outstanding common stock and 100% of the fair market value for all other participants.

Stock option transactions for the two years ended March 31, 1988 were as follows:

	Shares Under Option
Options outstanding, March 31, 1986 (\$0.72 to \$4.25 per share)	314,590
Granted (\$2.88 to \$5.00 per share)	63,000
Exercised (\$0.72 to \$2.00 per share)	(87,366)
Options canceled	(17,000)
Options outstanding, March 31, 1987 (\$0.72 to \$5.00 per share)	273,224
Granted (\$3.88 to \$5.00 per share)	34,630
Exercised (\$0.72 to \$3.63 per share)	(34,980)
Options canceled	(2,000)
Options outstanding, March 31, 1988 (\$0.72 to \$5.00 per share)	<u>270,874</u>

Mesaba has 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 Mesaba at the market price through payroll deductions. All administrative costs of this plan are paid by Mesaba.

Mesaba issued warrants to the underwriter involved with its 1986 stock offering. These warrants allow for the purchase of 35,000 shares of Mesaba's common stock at \$3.90 per share and are exercisable any time through November 1990.

Also during 1986, Mesaba issued warrants to NWA in consideration of a guarantee by NWA of its lease agreements for the Metro aircraft. These warrants allow for the purchase of shares of Mesaba's common stock at \$5.15 per share through July 1, 1991. As of March 31, 1986, warrants for the purchase of 85,495 shares had been issued to NWA and warrants for an additional 114,044 shares were issued during 1987.

During fiscal 1988, a portion of the NWA debentures (Note 4) was converted into 16,098 shares of common stock at a rate of \$3.96 per share.

## 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, 1988 and 1987 and the related statements of operations, changes in stockholders' equity and cash flows for each of the three years in the period ended March 31, 1988. 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, 1988 and 1987 and the results of its operations and its cash flows for each of the three years in the period ended March 31, 1988, in conformity with generally accepted accounting principles applied on a consistent basis.

Arthur Andersen & Co.

Minneapolis, Minnesota,  
May 13, 1988

## Five-Year Selected Financial and Statistical Data

Mesaba Aviation, Inc.

	Year ended March 31,				
	1988	1987	1986	1985	1984
(dollar amounts in thousands, except per share data)					
<b>Statement of Operations Data:</b>					
Operating revenues	\$ 29,171	\$ 21,806	\$ 13,763	\$ 9,244	\$ 6,043
Operating expenses	26,266	22,148	12,844	8,715	5,274
Operating income (loss)	\$ 2,905	\$ (342)	\$ 919	\$ 529	\$ 769
Net income (loss)	\$ 1,549	\$ (213)	\$ 201	\$ 165	\$ 425
Net income (loss) per share					
Primary	\$ 0.51	\$ (0.07)	\$ 0.08	\$ 0.07	\$ 0.19
Fully Diluted	0.45	(0.07)	0.08	0.07	0.19
Weighted average number of shares outstanding (000's)					
Primary	3,055	2,880	2,538	2,267	2,268
Fully Diluted	3,647	2,919	2,538	2,267	2,268
March 31,					
	1988	1987	1986	1985	1984
<b>Balance Sheet Data:</b>					
Current assets	\$ 6,965	\$ 5,564	\$ 4,661	\$ 1,699	\$ 2,546
Net property and equipment	8,518	9,044	8,707	6,519	4,212
Other assets, net	149	303	495	457	313
Total assets	\$ 15,632	\$ 14,911	\$ 13,863	\$ 8,675	\$ 7,071
Current liabilities	\$ 4,401	\$ 4,357	\$ 3,349	\$ 1,722	\$ 1,383
Long-term liabilities	4,561	5,357	5,301	3,937	2,861
Stockholders' equity	6,670	5,197	5,213	3,016	2,827
Total liabilities and stockholders' equity	\$ 15,632	\$ 14,911	\$ 13,863	\$ 8,675	\$ 7,071
Year ended March 31,					
	1988	1987	1986	1985	1984
<b>Selected Operating Data:</b>					
Revenue passengers carried	376,101	292,457	152,087	92,736	56,534
Revenue passenger miles (000)	82,712	61,172	31,815	20,097	10,572
Available seat miles (000)	153,685	133,414	79,462	53,613	29,163
Cost per available seat mile	\$ .168	\$ .163	\$ .157	\$ .157	\$ .167
Passenger load factor	53.8%	45.9%	40.0%	37.5%	36.3%
Breakeven load factor	49.1%	47.6%	38.7%	36.9%	31.8%
Yield per revenue					
passenger mile	\$ .323	\$ .326	\$ .348	\$ .304	\$ .297
Number of departures	30,314	30,194	26,851	24,398	19,506

## Officers/Directors

Mesaba Aviation, Inc.

### Board of Directors

Earl W. Dagg 2  
Medical Doctor

M.C. Lund 1, 3  
Former President  
Frontier Airlines, Inc.

Rodger T. Munt 1, 3  
Aviation Consultant

William G. Ness 2, 3  
Chief Executive Officer  
Artco, Inc.

John S. Olbrych  
Vice President  
State Street Bank & Trust Co.

Mervin D. Presebak  
Private Investor

Alan R. Stephen  
President  
Scenic Airlines, Inc.

Lowell T. Swenson 1  
Former Chairman of the Board  
Mesaba Aviation, Inc.

Philip L. Swenson  
Vice President,  
Planning and Marketing, and Secretary  
Mesaba Aviation, Inc.

Robert D. Swenson 1  
Chairman of the Board, President  
and Chief Executive Officer  
Mesaba Aviation, Inc.

- 1 Executive Committee
- 2 Audit Committee
- 3 Compensation Committee

### Corporate Officers

Robert D. Swenson  
Chairman of the Board, President  
and Chief Executive Officer

Patrick J. Thompson  
Senior Vice President,  
Operations

Kenneth P. Bronson  
Vice President,  
Finance and Treasurer

J.L. Haarbauer  
Vice President,  
Maintenance and Engineering

Richard A. Lawrence  
Vice President,  
Flight Operations

Lawrence E. McCabe  
Vice President,  
Corporate and Government Affairs

Philip L. Swenson  
Vice President,  
Planning and Marketing, and Secretary

Michael R. Wind  
Vice President,  
Ground and In-Flight Services

## Stock Price and Dividend Information

The common stock of Mesaba Aviation, Inc. is traded on the NASDAQ National Market under the symbol MESA. The following table sets forth the high and low last sale prices of the Company's common stock for the fiscal quarters of 1988 and 1987.

		Bid Price of Common Shares		Dividends Per Share	
		1988	1987	1988	1987
First Quarter	High	5 $\frac{3}{8}$	5 $\frac{3}{4}$	—	—
	Low	4 $\frac{3}{8}$	3 $\frac{7}{8}$	—	—
Second Quarter	High	5 $\frac{5}{8}$	4 $\frac{3}{8}$	—	—
	Low	4 $\frac{1}{4}$	2 $\frac{3}{4}$	—	—
Third Quarter	High	4 $\frac{1}{2}$	3 $\frac{7}{8}$	\$ .03	—
	Low	2 $\frac{7}{8}$	2 $\frac{5}{8}$	—	—
Fourth Quarter	High	4 $\frac{1}{2}$	4 $\frac{7}{8}$	\$ .03	—
	Low	3 $\frac{1}{2}$	2 $\frac{7}{8}$	—	—

On June 5, 1988, the number of recordholders of the Company's common stock was 1,157.

### Shareholder Information

*Transfer Agent*  
Norwest Bank Minneapolis, N.A.

*Corporate Counsel*  
Briggs and Morgan  
Minneapolis, Minnesota

*Auditors*  
Arthur Andersen & Co.  
Minneapolis, Minnesota

*Form 10-K*  
A copy of the Company's Form 10-K annual report will be provided free of charge to any shareholder upon written request to:  
Vice President, Finance and Treasurer  
Mesaba Aviation, Inc.  
6201 34th Avenue South  
Minneapolis, Minnesota 55450

# MESABA

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

